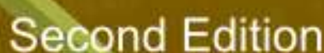

The Financial Evolution of the Caribbean Community (1996-2008)

Edited by
Ramesh Ramsaran

The Financial Evolution in the Caribbean (1996-2008)

This publication is an updated edition of The Financial Evolution of the Caribbean Community (1970-1996) edited by Laurence Clarke and Donna Danns. The book charts developments in Caribbean financial systems from the mid-1990s to around 2008 and identifies the main policies and structural factors influencing their reconfiguration. The Caribbean experience has to be seen against the backdrop of factors affecting the real sectors of the economy, the quality of financial polices, the occurrence of debt, currency and banking crises in various parts of the world and the emergence and persistence of a severe recession in the developed countries towards the end of the first decade of the 21st century. In various degrees, the contributions not only seek to capture changes in the financial infrastructure but also point to challenges facing financial institutions stemming from domestic factors and external influences. While financial innovations driven by technology and market realities are welcome, and indeed necessary to meet consumer expectations and finance growth, imaginative company structures, unscrupulous managers, new financial products and a liberalized policy environment have severely tested government regulations in recent years, raising issues of confidence and creating a certain amount of instability in some cases. The ineffectiveness of traditional tools of monetary control has also forced central banks to experiment with new instruments to manage liquidity, contain inflation and defend the exchange rate.

About the Editor

Ramesh Ramsaran is Professor Emeritus at the Institute of International Relations, The University of the West Indies, St Augustine. He is a former Professor of International Money and Finance, and at one time served as Coordinator of the then Regional Programme of Monetary Studies (RPMS) and later as Executive Director of the Caribbean Centre for Money and Finance (CCMF), the successor organization. Professor Ramsaran's main research interests have focused on money and finance in the Caribbean, and he has written extensively on these subjects. Among his many written and edited books are: The Monetary and Financial System of the Bahamas (1984), Money and Finance in Trinidad & Tobago (co-author, 1988), The Challenge of Structural Adjustment in the Commonwealth Caribbean (1992), An introduction to International Money and Finance (1988), Caribbean Survival and the Global Challenge (2002), The Fiscal Experience in the Caribbean (2004) and Size, Power and Development in the emerging World Order (2006). Professor Ramsaran has also served as a consultant to the World Bank, the UNDP, the UNECLAC and the African, Caribbean and Pacific (ACP) Secretariat.

Caribbean Centre for Money and Finance
The University of the West Indies
St Augustine, Trinidad and Tobago

The Financial Evolution of the Caribbean Community (1996-2008)

Second Edition

Edited by
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The University of the West Indies
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Note: Except where otherwise stated, the currency notation used in the various chapters refers to the national currency of the various countries.

Preface and Acknowledgements

There is a vast theoretical and empirical literature on the relationship between finance and development. Despite many controversies, the empirical evidence indicates that money, financial policies and financial institutions can influence the pace and quality of transformation in the real sectors of the economy. Caribbean scholars from both academic and other institutional bases have contributed significantly to this literature. In the post-war period important lessons have emerged from the use of fiscal deficits, monetary expansion and inflation, exchange rate and interest rate policies, debt accumulation, credit rationing and controls, central bank operations, the behaviour of financial markets, the competition between banks and non-bank financial institutions, development finance and liberalised versus controlled financial systems. Central banks in the region have become more experienced and are now more aware of their role and the critical areas for intervention. The question of relevance which surfaced when they first came into being is now a moot point. They are still evolving with an increased range of functions.

In the Caribbean, the population is making increased use of financial services in response to the innovations taking place in the financial sector. The infusion of technology and the introduction of new institutions and instruments have helped to modernize the financial structure. With respect to development, however, questions remain over the extent of the financial sector's contribution to the growth process. There is a view that rather than drive development the sector lives off the economic accomplishments of other more dynamic factors. In some areas, e.g. stock market development, nationally and regionally, relevant policy actions have been lacking. National and regional regulatory systems also need more frequent up-dating. Several aspects of public policy in relation to financial development need to be exposed to more critical public scrutiny.

The present volume focuses on the evolution of monetary and financial systems in CARICOM countries since the mid-1990s. It builds on an earlier publication which covered a previous period. The inspiration for this effort came from the need for a text that would provide comparative insights into financial developments taking place in regional economies against the backdrop of changes in the development paradigm and a number of regional and global crises. This project started while I was the acting Executive Director for the Caribbean Centre for Money and Finance and I agreed to continue with the exercise after I demitted office. I am extremely grateful to the individuals and teams from the various central banks who contributed to the book. These include: Sharon Branch, La Toya Johnson, Shaniska Adderley, Sherry Sands, Andrea Adderley and Latera Carey-Mc Phee from the Central Bank of The Bahamas; Stacia Howard from the Central Bank of Barbados; Gloria Garcia, Azucena Quan-Novelo and Christine Vellos from the Central Bank of Belize; Dr Gobind Ganga from the Bank of Guyana; Gail Lue Lim from the Bank of Jamaica; Saira Jahangir-Abdoelrahman from the Central Bank of Suriname; Dr

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I am also extremely grateful to the staff of the Caribbean Centre for Money and Finance, who always felt that this project was necessary, not only to help us understand the financial evolution taking place in the region, but also to gauge the kind of financial challenges that lie ahead. Persistence has its rewards. I am indebted to Ms Pamela Joseph for her role as "coordinator" and providing invaluable secretarial assistance. Ms Julia Jhinkoo was helpful in filling some of the data gaps. Simeon Wu-Kwai assisted with the presentation of data and graphs in the introductory chapters, as well as with the preparation of the manuscript for the printer. Ms Tessa Ottley shouldered the responsibility for editing the text.

Ramesh Ramsaran

1

Introduction

Ramesh Ramsaran

The monograph, *The Financial Evolution of the Caribbean Community (1970-1996),* edited by Laurence Clark and Donna Danns, was published by the Caribbean Centre for Money and Finance (then the Caribbean Centre for Monetary Studies) in 1997. That work captured the essential monetary and financial developments in CARICOM countries from the 1970s to the mid-1990s, and has been an invaluable reference work for students, researchers and policy-makers interested in the working and development of financial systems. When the decision to update this volume was taken, the aim was to cover developments in the period between 1996 and 2008, with a tentative publication date set for early 2010. The initial publication schedule was revised as a result of the late submission by some contributors.

Much has happened since the mid-1990s, both in the region and internationally, that impacts on the well-being of Caribbean peoples. Following textbook models of efficient resource allocation, global markets have become more competitive and dynamic. The establishment of the World Trade Organization in 1995 not only signalled a renewed commitment to a rules-based system of international commerce but a clear intent to encourage the growth of international trade by removing the remaining barriers to the free movement of goods and services. Through trade, services and capital liberalization, the process of global integration has intensified. The removal of exchange and capital controls has spawned new forms of financial intermediation and increased the room for speculation and risk-taking in financial markets which now appear to have

more opportunities for making profits than markets for goods and services. National financial and real sector markets are also being forced to comply with the competitive model as economies become more open and interdependent. Information and communication technologies continue to affect the speed and efficiency with which things are done in every sphere of life. In stock-market trading, for example, where speed is important, trading floors have now given way to matching engines and execution algorithms. Electronics are also fast transforming the traditional operations of commercial banks. With the distribution of global resources highly skewed, using resources more efficiently has become a major goal of social and economic policy with increasing emphasis on productivity. An increasingly open world economy, with countries of different sizes and resource endowment and at different stages of development, presents serious challenges for many countries. Openness, however, also brings opportunities which call for new modes of engagement if increasing inequality at the international level is to be prevented.

Even in the face of globalization, regional trade agreements (RTAs) continue to be attractive, with some 293 in force at the end of 2010, out of the 480 notified to the World Trade Organization (WTO). While some have been stagnant, in others there has been a deepening and widening process taking place at the same time. On January 1st, 1999 the European Union adopted the Euro as its single currency which replaced most of the national currencies and is now shared by 17 of its Member States who make up the Euro area. A few countries (including Britain) have opted to stay out. The Euro was not only intended to advance the European integration project, but there was hope that it would eventually challenge the US dollar as a reserve and international currency. With many of the European countries now facing serious debt and financial problems, the Euro area is currently in turmoil, and there are questions about whether it can survive in its present form. The constraints placed on national governments to deal with adjustment issues are being seen as a major disadvantage of a common currency arrangement. Further questions have also arisen that have relevance for other integration groupings. For example, to what extent can integration of the real sectors proceed without strong collaboration in the fiscal, monetary and financial sectors? Also, what are the most critical fundamentals that must be adhered to if shared development and stability are to proceed hand in hand.

The structure of global economic power has been changing as developed countries loose their technological hegemony. Emerging new dynamic economies are out-performing the traditional pace-setters. BRICs (i.e. Brazil, Russia, India, China) have brought a new dynamic to the global economy. At the same time many countries are falling behind. The thinking on development has also been changing as the worth and the relevance of new and traditional strategies come under critical scrutiny. The focus has shifted from emphasis on growth to more broad-based and human development, poverty eradication, environmental sustainability, equity, gender issues, vulnerability, governance and political empowerment. The top-down and trickle-down approaches to development have now largely fallen into disrepute in favour of more comprehensive social and economic policies addressing a wider range of issues. Experience has shown that there is no magic or unique formula for progress given the differences in country experiences and economic structures. Some countries have done well with a combination of import substitution and an active role for government in developing a diversified production base and significant export capacity. Others have relied more on market forces and private sector initiatives. In some countries, including those in the Caribbean which tried to use an inward or semi-closed model of development to reinforce political independence or achieve greater self reliance, the nationalistic postures of an earlier era are giving way to more embracing policies drawing on external resources, know-how and experience. The policy changes are to be seen both in the real and financial sectors.

Too often policy prescriptions seek validation not on the basis of the strength of diagnoses, but on who makes them. Many of the policies conceptualized to deal with debt-ridden countries in the 1980s were predicated on the assumption that one set of solutions could be applied to all countries, and this explains the same mix of neo-liberal dogmas found in reform packages and structural adjustment programmes. Basic to the agenda which was captured in the so-called "Washington Consensus' was a set of market-based solutions including privatization of state enterprises, fiscal discipline, competitive exchange rates, liberalization of inward foreign direct investment, de-regulation, trade liberalization and market-determined and real interest rates. Embraced by the International Financial Institutions (IFIs), implicitly or explicitly, these prescriptions had a profound effect on economic policies in the 1990s. With the drive for 'macro-economic stability' and the search for solutions to the debt

problems which had rocked the international financial system, there was less concern with the impact on the poor in this period.

With the emergence of a series of crises in the late 1990s and the possibilities of contagion, the market-based model of development came under closer scrutiny. The collapse of the stellar performers, in Asia in particular, restarted a new discussion on an effective role for the state, stronger institutions, the need for some types of controls, the sequencing of reforms, greater surveillance, closer monitoring of capital movements, more appropriate exchange rate and interest rate policies and vulnerability in a globalising system. Increasing poverty in many countries implementing structural adjustment programmes shattered the view that unfettered markets provide the best solutions in situations where institutions hardly work, and where there is increasing inequality of incomes and strong concentrations of wealth, ownership and influence. The absence of competition in a real sense, corrupted and incompetent bureaucracies, archaic fiscal systems, weak governance and highly outdated laws and regulations could not be addressed in short time frames. International trade policies in favour of the rich countries were not an irrelevant issue in a situation where poor countries were being asked to liberalise their trading regimes. While macro-economic stability improved in many cases and the balances were righted to some extent, the poor became poorer or increased in number. In response, poverty alleviation and debt reduction programmes and write-offs began to feature more prominently in the development conversation. Interestingly, the fiscal situation in many countries has weakened, while the level of public debt has increased. In a number of countries vulnerability has also worsened.

As indicated earlier, the increasing liberalization of trade and finance, and the abandonment of the fixed exchange rate system, have created a more competitive national and international environment encouraging more open markets and greater movement of capital. While there are benefits to liberalization, there are also risks. Exchange rates, inflation and interest rates can be swayed by the transnational movement of large amounts of money in search of profit. Controlling liquidity can be a major challenge for a central bank in this setting. Multi-currency lending and borrowing not only carry their own risks in a flexible exchange rate environment, but create a situation where private debts can amount to a major claim on the country's foreign reserves. Governments have had to devise new forms of surveillance and controls to counter external shocks and manage national

monetary and financial systems. Some are more prepared to experiment with exchange rate innovations while others stick with what they know. For the Caribbean, the loss of preferential markets in a liberalizing world means that they not only have to compete in those markets but they will also have to open their own economies to an unprecedented extent. The European Partnership Agreement (EPA) signed between the European Union and CARIFORUM countries on October 15th, 2008, is a reciprocal agreement that would influence the Caribbean's trade relations with other countries. In the past, for various reasons, the Caribbean did not take advantage of all the market opportunities available to it. The extent to which it can do so now would depend on the extent to which it can design a policy framework to optimize internal and external real and financial resources to create an efficient and diversified production base with strong competitive ability.

Post-independence development strategies have been moderately successful in improving living standards in the region, but vulnerability has increased on many fronts. Agriculture has declined with a concomitant increased dependence on imported food. With generally low public and private sector savings, and with the private sector unable to fully exploit the opportunities in the local or foreign markets, the region has become increasingly dependent on foreign capital. Some of the old concepts of sovereignty and self reliance extolled in the early post-independence years are less in vogue today. Small countries not only have their own peculiar challenges to face, but they also have to conform to emerging global norms which are often fashioned by the self-interest of the rich nations. In this respect, offshore banking, which some countries in the region have been trying to promote, holds limited potential as an economic activity, given the increasingly hostile position taken by the United States and other European countries who believe that the main purpose of such banks is for illegal operations including the laundering of money. The registration of offshore companies in tax havens by companies based in the industrialized countries is also seen as a device to reduce their tax liability in their home countries. Host countries are being asked to meet extremely high regulatory standards. Costs would have to be weighed against potential benefits.

The role of finance and financial institutions occupies a large place in the development literature. Controls on the lending policies of commercial banks have been removed in many countries, though banks continue to be

under stricter supervision than non-banks. This, however, has been changing, particularly in light of the creative alliances between financial institutions aimed at gaining greater economic power or escaping the scrutiny of regulators. Based on experience, central banks in various jurisdictions are also developing their own forms of liquidity and monetary control. Many countries have set up specialized financial institutions to accelerate the development process. In the absence of a coherent set of policies these have met with various degrees of success. There is an old debate in the literature over whether financial development precedes real development or follows it. Whatever the position taken there is obviously a close relationship between finance, growth and development as the current global financial crisis cum economic meltdown shows.

The relevant questions for developing countries, including those in the Caribbean, are firstly, can the savings effort be lifted, and secondly, are savings being channelled in the most critical areas, or in activities which can have the greatest development impact. The first revolves not only around the growth of income, but also around the efficiency of mobilization and the macro-economic environment. Interest rates, inflation, the availability of a spectrum of saving instruments and confidence in the financial system all influence saving behaviour. High inflation rates in some Caribbean countries have led to increased dollarization of the economy. Even where the inflation rate is low and local currency interest rates are higher, residents have been switching to foreign currency accounts. In today's world, access to foreign currency accounts and facilities to transfer funds abroad can encourage leakage from the domestic system. Savers are more likely to be concerned with self interest than patriotism.

Because people save for reasons other than that of return, it makes it easy for the authorities to ignore concerns over the real rate of return (defined by the difference between the inflation rate and nominal interest rate). Policymakers are often silent in the situation where spending (particularly for consumption or imports) is being subsidized by savers receiving very low or no interest on their savings. Lack of government intervention is often explained by the need for financial markets to operate freely, but these are often highly contrived markets weighted heavily in favour of the intermediaries. It is difficult to compare the power of a few large highly organized banks with the powerlessness of a large number of small disorganized savers. A zero or near zero interest rate policy on deposits is equivalent to a tax on savings. Without financial returns savers,

particularly retirees, would eat their capital. There also appears to be another misconception. In countries in the region where there is a minimum or floor interest rate, the argument for removal in the current circumstances is that it would lower lending rates and stimulate the economy. In a free market lending institutions tend to use such opportunities to maintain high interest rate margins. Also, the evidence to support the view that reducing loan rates below a certain point would have a growth effect is often quite weak, as there may be other factors far more significant than the cost of funds militating against higher levels of borrowing and investment. The absence of well-thought-out empirical investment functions based on local experience has not helped policy-makers. There is also need for a savings policy that would address the factors affecting the flight of savings, particularly from the domestic savings stream.

Another concern relates to the use of national savings and the need to channel funds to activities which often find it difficult to attract investment on the desired scale. In some cases specialized lending institutions have been set up to deal with the peculiar problems of those sectors, but there are indications that in the absence of supporting policies the challenges persist, and new approaches are required to deal with financing in such areas as housing, agricultural development and small and medium sized businesses. Underdeveloped capital markets in the region without a range of saving instruments have put savers, investors and borrowers at a disadvantage, thus depressing saving and investment levels. There is the need not only for more innovative financial policies at the national level but also for a more secure regional framework which would allow funds to move more easily from surplus countries to deficit countries. A wider space would provide the potential for a better use of resources and higher levels of investment. The framework governing financial operations and capital movements in the region needs urgent rethinking. A regional stock market has been too long in the making.

Confidence in the financial sector has become crucial in the context of the global financial crisis, the implosion of large financial organizations in the developed countries and the collapse of a number of bank and non-bank institutions in the region. The failure of CL Financial, the Trinidad and Tobago based conglomerate in 2009, was a shock of major proportion not only to the stability of the Trinidad and Tobago economy and financial system, but to other regional economies where the company was a major

player in the insurance industry. In 2008 CLICO and British American (BA) accounted for about half of the total assets of the insurance sector in Trinidad and Tobago. The quick intervention of the Trinidad and Tobago government, and the subsequent injection of several billion dollars into the company, mitigated a more catastrophic impact on the local economy. CL Financial is not only one of the largest companies in Trinidad and Tobago, straddling both the real and financial sectors, and a major share-holder in one of the country's largest banks, but also owns and operates a large number of insurance and other companies both within and outside the Caribbean. In the Caribbean, significant government intervention was required in the various countries to avert a major financial meltdown. Trinidad and Tobago and other Caribbean countries are still dealing with the fallout effects of CL Financial's failure, including the impact on savers and policyholders. The Central Bank of Trinidad and Tobago has sued the former chairman and owner of the company for, among other things, "mismanagement of CLICO" and "misapplication and misappropriation of its income and assets to the detriment of its policyholders and mutual fund investors". (Excerpts from the statement by the Attorney General of Trinidad and Tobago made on 8th June, 2011). He also described CLICO as operating "an elaborate Ponzi scheme".

There has been widespread discussion on the causes of the company's collapse and the apportionment of blame. The Central Bank of Trinidad and Tobago points to "inadequacies in the legislative framework" which limited its intervention. At the time of their collapse both CLICO and BA had "significant statutory fund deficits" (Financial Stability Report, 2008, p.27). The public takes its cue and forms its perception not only on how well a company says it is doing, but on how the supervisory authorities are dealing with it. The regulators therefore shoulder a heavy responsibility as they are expected to have information which is generally not in the public domain. The daily speculation on the full extent of CL Financial's assets and liabilities is a reflection of the lack of transparency which has informed the management and operation of this company.

The collapse of CLICO, the major insurance arm of CL Financial, has been particularly disturbing, and questions have been raised not only about the adequacy of the legislation to deal with ambitious conglomerates with an unlimited appetite for funds, but also with the influence of politics, the competence of the regulators, the enforcement of regulations, the role of auditors and the responsibility of management in a fiduciary role.

Apparently little was learnt from the Jamaican experience of the mid-1990s where the regulatory framework also failed and which involved a major collapse of the financial sector. According to the Central Bank of Trinidad and Tobago (Financial Stability Report 2008 pp. 25-27), CL Financial, CLICO Investment Bank (CIB) and CLICO Insurance violated all the prudential guidelines of financial management over a prolonged period of time. CL Financial seemed to have got caught not by the regulators but by unforeseen events, including the collapse of the real estate market in the United States and the fall of methanol and ammonia prices. The continued absence of a proper regional regulatory framework for transnational financial companies is puzzling. Other Caribbean states were apparently of the view that CLICO was being properly monitored in its home state and paid little attention to the disparity between local assets and liabilities. The collapse of CLICO was a regional failure and the experience should provide major guidelines for the reform of the regulatory framework in the Caribbean.

The fast-growing economies of the world are associated with a high level of saving and investment. There are a number of factors which drive growth, and investment is a major one. The investment ratio (gross capital formation as a proportion of GDP) varies from one Caribbean country to another. So does the share of investment financed by domestic savings. In the ECCU region, gross investment has averaged around 40 per cent of GDP in recent years. Foreign savings have financed about two thirds of this on average. In Barbados the investment rate has averaged around 18 per cent since 2005, while the national saving has been in the region of 11 per cent. The high level of government indebtedness and low saving and investment rates in the region are not unrelated to current financial and development policies. In Trinidad and Tobago, for instance, where the economy is at a virtual standstill, loanable funds of the largely private financial institutions sector are being held in statutory and interest bearing deposits at the Central Bank, while the government is being urged to borrow money to fund projects with the aim of stimulating the economy. If the private sector is not playing a larger and more active role, it certainly does not seem to be because of lack of financial savings. Perhaps the explanation may lie in other factors including the overly conservative lending policies of the banks stemming from the global crisis, the non-existence of bankable projects, the absence of credit-worthy borrowers or simply a lack of confidence in the economy. Increasing the national saving rate and creating a policy framework for the more productive use of domestic

savings may not only accelerate the development process rate, but also reduce vulnerability through less reliance on foreign resources. Another related issue is the efficiency of government spending. Too often, budgets pander to populist objectives without giving enough attention to measures aimed at increasing efficiency and productivity. Already the public debt in several Caribbean countries is unsustainable. The experience of Greece and some other European countries at the end of the first decade of the 21st Century should provide useful lessons not only to the governments of the region but to other stakeholders. The stability of the financial sector cannot be separated from fiscal and debt management.

In recent years managing national monetary and financial systems has become more challenging. Large and rapid capital movements across national borders can destabilize the financial environment. The evolution of diversified financial systems in the post-war period, the emergence of a range of sophisticated financial instruments and the growth of powerful finance and investment houses in response to financing needs associated with economic growth and booms, have posed a major challenge to regulatory and oversight authorities. The quality of regulation has not kept pace with financial innovations and developments in most countries, thus providing some explanations for the collapse of financial institutions in both developed and developing countries.

Another challenge facing central banks in the pursuit of price and exchange rate stability is control of liquidity or the money supply. Very often fiscal policy does not support monetary policy objectives. That is one point. With financial institutions becoming less dependent on the central bank for assistance in times of difficulty, certain traditional instruments of control have become less relevant. In today's environment financial institutions not only have ready access to head office but to the inter-bank market, the local foreign currency market and even to the global financial markets. Dollarization has also opened a new window for mobilizing savings. In some countries there are no reserve requirements relating to foreign currency deposits. Underdeveloped money and capital markets with their small volume and range of securities have hampered the use of open market operations. Statutory reserves, which are still widely used, discriminate against banks and are regarded as a tax by bankers. They are often blamed for high lending rates. Inflation is affected by a wide range of factors, and monetary policy, it should be recognized, represents only one avenue for dealing with it.

Supervisory authorities would find it difficult if not impossible to micro manage or scrutinize every aspect of the operations of a financial institution. Capital adequacy, however, is one area where some international guidelines have been laid down, at least with respect to banks. In 1988 the Basel Committee on Banking Supervision, acting under the auspices of the Bank for International Settlements, categorized assets of banks in terms of credit risks and worked out minimal capital requirements based on the structure of risk-weighted assets. A large number of countries bought into the Basel Accord. Basel II, adopted in 2004, subsequently extended the scope of risks and laid down some new standards for greater transparency. Before Basel II could be fully discussed and implemented, the outbreak of the financial crisis in the United States and its spread to other parts of the world raised a whole new set of issues, particularly following the collapse of some of the largest financial institutions in the world. A third accord, Basel III, which is still in the discussion stage, draws heavily on recent financial experience and calls for higher regulatory standards to deal with issues of stress and shocks.

The capitalization of most Caribbean banking systems is regarded as sound, though there are questions about the increasing proportion of nonperforming loans (NPL) in some countries and the adequacy of loan loss provisioning. The increasing presence of the international banks has removed some of the earlier concerns. Non banks play an important role in the economy and there is need for more pervasive supervision and critical review of their present capitalization. Given the experience with CL Financial, supervision and oversight of the entire financial sector in the region needs to move closer to international standards. The suggestion by some to increase and widen the scope of deposit insurance does not recognize the nature of the problem. Deposit insurance does not prevent bank failure or other institutional collapse when innovations get ahead of regulations or fiduciary responsibility is abandoned in the interest of greed or ambition. The following section summarizes economic and financial trends in CARICOM countries.

The Bahamas has acquired a reputation as one of the world's leading tourist resort cum tax haven and offshore financial centres. In 2009 the per capita income (GDP at current market prices) was estimated to be around US$24,000, the highest among CARICOM countries. In its 2010 Human Development Report, the United Nations ranked The Bahamas at 43 (out of 169), second only to Barbados in the region. Since 1995 the economy has

grown at an average annual rate of about 2.2 per cent, declining for the first time in 2008 and again in 2009. The unemployment rate increased from 7.6 per cent in 2006 to over 14 per cent in 2009. Despite a persistent deficit in the fiscal accounts and the current external balance, gross official foreign reserves increased from US$342.6 million in 2000 to US$ 815.9 million in 2009. At the same time the public debt as a proportion of GDP increased from 40 per cent in 2006 to 54 per cent in 2009.

At the end of September 1995, 415 banks and trust companies were registered in The Bahamas. Following the "blacklisting" of the country by the Financial Action Task Force (FATF) and the Organisation for Economic Cooperation and Development (OECD) in 2000 the new regulations put in place (including Minimum Physical Presence Requirements) led to the departure or closure of a number of registered entities. At the end of June 2010 the total had fallen to 280. Of this number, 122 held a licence to deal with the public, while 158 held licences described as restricted, non-active or nominees. Most of these institutions have an external clientele. A limited number deal with the Bahamian public. There are only seven authorized dealers, of which six are clearing banks. The domestic assets of the commercial banks increased from BH $2,421.3 million (79 % of GDP) in 1995 to BH $8,970.8 million (125 % of GDP) in 2009. Commercial banks remain the most important depository institutions in the domestic financial system. With the increase in the spread of bank branches the number of inhabitants per branch has been falling. In light of recent developments the Central Bank has been paying careful attention to the soundness of the commercial banks, and in November 2009 set higher minimum risk-weighted target and trigger ratios, of 17% and 14% respectively for all commercial banks, resulting in average risk weighted capital adequacy ratios of about 24 per cent, well above the international capital standards of eight per cent.

Despite a narrow resource base and a modest economic growth rate, Barbados has achieved a level of social and economic development which has consistently placed it as the top performer among CARICOM countries in the United Nations Human Development reports. Current per capita GDP is around US $15,000 (per capita GNI in 2008 was estimated as US $21,673 PPP) with life expectancy at 77.7 years. However, Barbados is an open economy heavily dependent on the international economy and has been severely affected by the global economic crisis. After growing by four per cent on average between 2004 and 2007, the economy declined in

2008 and 2009 and faced a similar prospect in 2010. The unemployment rate which had dropped from 24 per cent in 1993 to 7.4 per cent (on average) in 2007, increased to eight per cent in 2008 and ten per cent in 2009. The fiscal situation has also weakened with the public debt increasing from 77 per cent of GDP in 2005 to over 100 per cent in 2009. Stock-market trading has also dropped since 2007, reflecting the decline in economic activity.

With the growth of per capita income the financial sector has also been growing. Financial assets increased from BB $6.9 billion (172% of GDP) in 1996 to BB $17.5 billion (237.7% of GDP) in 2008. Commercial banks are the largest subsector accounting on average for 50 per cent of financial assets. All six banks are now foreign owned with the Canadian banks accounting for more than 70 per cent of bank assets. The banks are reportedly well capitalized and face no immediate threat from the increasing proportion of non-performing loans. The structure of the banks' loan portfolio has shifted increasingly towards personal loans as Barbadians seem to be making greater use of their lending facilities. With respect to the insurance sector, the Barbados' subsidiaries of CL Financial faced a major crisis in 2009, when the parent company in Trinidad and Tobago collapsed. Government intervention was required in both countries to reduce the impact on other companies and on the respective economies.

Over the last two decades the Barbadian financial sector has been increasingly liberalized allowing the traditional monetary tools to be rationalized. The country, however, has opted to operate with a fixed exchange rate system which requires careful monitoring of imports and movements in foreign exchange reserves. The present rate, which has been fixed at BB $2 to US $1 since 1975, is a subject of frequent discussion in terms of its appropriateness. There are indications of some appreciation in the real effective exchange rate in recent years, raising questions of the impact on the competitiveness of the economy.

In current terms, the per capita GDP of Belize is around US $4,500. Since 2005, the economy has grown at a moderate rate of 2.6 per cent a year, with the annual inflation rate averaging below five per cent. About 40 per cent of the population is described as poor. The unemployment rate is estimated to be between 12 and 15 per cent.

There seems to be a big gap between the investment and savings rate. Since 2005 the gross investment rate has averaged around 21 per cent as compared to 15 per cent for the gross national savings rate. The weak fiscal situation over the years has resulted in a rapid growth of the public debt amounting to over 100 per cent in 2005. This fell to 80 per cent in 2009. In line with this trend debt service as a per cent of exports of goods and services declined from 36.6 per cent in 2005 to 12 per cent in 2009. The share of government revenue required to service debt also declined from 90.7 per cent to 25.5 per cent over the period.

The environment for private investment and saving continues to suffer from institutional and policy deficiencies. There seems to be the need for a properly functioning stock market and a more active policy to encourage private investment and saving. "Notwithstanding the growth in the number of financial intermediaries there was no substantial change in the borrowing and saving instruments available to the general public." (Belize paper). There are questions about the soundness of the banking system in the context of international standards. Non-performing loans as a per cent of total loans increased from seven per cent in 2007 to 20 per cent in 2010. The paper also notes that the "lending requirements of the commercial banks, the main source of credit continued to favour large borrowers… Small borrowers and entrepreneurs seeking to engage in non-traditional development projects faced more obstacles." (Belize paper).

The Eastern Caribbean Currency Union (ECCU) is comprised of six independent states and two British overseas territories. The independent countries are Antigua and Barbuda, Dominica, Grenada, St Kitts and Nevis, Saint Lucia and St Vincent and the Grenadines. The British overseas territories are Montserrat and Anguilla. Though the group shares a common central bank and currency it is not fully integrated, financially or economically. In 2007 The Organisation of Eastern Caribbean States (OECS) initialled an OECS Economic Union Treaty to further advance the economic process and create a single financial space, but this has been slow in implementation. The total population of the group in mid-2009 was 617,418 with an average per capita GDP (at current market prices) of US $7,250. In the 1980s real GDP grew by over seven per cent a year. In the first half of the 1990s this dropped to 2.4 per cent a year, and averaged 3.6 per cent between 1996 and 2008. In 2009 and 2010 the economy declined. Since 1995 the inflation rate has been averaged around three per cent

annually, slightly higher than that of Belize and The Bahamas, but lower than that of Barbados.

The share of banks and insurance in total real GDP has been increasing over the last three decades. It increased from 6.6 per cent in 1983 to 9.5 per cent in 1995 and to 14.6 per cent in 2009. In this latter year it was second only to government services. There are 40 commercial banks operating in ECCU member states, of which 26 are foreign branch banks and 14 are indigenous. The assets of commercial banks increased from EC $6,232.0 million (106 % of GDP) in 1995 to EC $24,740 million (205 % of GDP) in 2009. The foreign banks account for 55 per cent of total assets, while the indigenous banks hold the other 45 per cent. There are 41 offshore banks with 25 registered in Antigua and Montserrat. The insurance companies are largely agencies of companies registered in Trinidad and Tobago, Barbados and the Bahamas. "There is no single regulatory framework or supervisory structure for the non-bank financial institutions across the ECCU; regulation/supervision is driven by domestic institutions such as ministries of finance and departments of cooperatives." (ECCB paper).

The chapter on Guyana's financial system highlights the transition from a state-controlled and highly repressed financial sector to one driven by market forces and private initiatives. The implementation of the Economic Recovery Programme (ERP) in 1989 was instrumental in transforming a dysfunctional system and stimulating the Guyanese economy in the 1990s. The modernization of the regulatory framework did much to improve the strength and stability of financial institutions.

The banking system, which is now completely privatized, accounted for 46 per cent of financial assets at the end of 2008. Of the six banks, three are foreign-owned and account for about two thirds of the total commercial banks' assets. Foreign-owned insurance companies hold about 60 per cent of the sector's assets.

In the area of monetary control and exchange rate policy, Guyana's experience is somewhat different from that of the rest of the region. In pursuing the objective of price stability, the Bank of Guyana has been using a number of policy tools, but indirect instruments of monetary control through the auction of treasury bills in the primary market have been the predominant tool. "Reserve requirements, re-discount rate and moral suasion have been used rarely over the review period (i.e. 1996-2008). The

monetary policy strategy has been to target monetary aggregates within the framework of monetary programming." (Guyana paper).

With the emergence of a vibrant parallel foreign exchange market in the 1980s the authorities attempted to unify the official and unofficial exchange rates through a series of measures including devaluations and the adoption of the cambio system in 1990. A great measure of stability has returned to the economy. The exchange rate has depreciated rapidly moving from GY $140.5 to US $1 in 1995 to GY $194.75 in 2000 and to GY $203.5 in 2010. The economy, however, has grown at an average rate of over 2.5 per cent a year since 1995. Between 1989 and 1991, the annual inflation rate averaged 53 per cent. Since 1995 it has averaged around six per cent a year.

The paper on the Jamaican financial sector not only tracks the development of financial institutions since the 1960s, but also identifies the main factors influencing financial and exchange rate policies. Following the attainment of independence in 1962 the economy grew by an average rate of over five per cent a year in the following decade. Concomitant with this was a fairly rapid growth of financial institutions and assets. This process continued into the 1970s and 1980s despite severe economic difficulties which occasioned the first Stand-by Agreement with the IMF in 1973, accompanied by wide ranging financial and economic reforms. A three-year Extended Fund Agreement with the IMF followed in 1978 which required the implementation of a number of demand management measures. Further agreements with the Fund followed in 1981, 1984 and 1988 accelerating the removal of a range of financial and monetary controls. The nominal exchange rate which stood at JA $0.90 to US $1 at the end of 1977 fell to JA $1.78 at the end of 1979, to JA $3.28 at the end of 1983 and has been sliding steadily downwards since. At the end of 1995 the rate was JA $39.62 and in 2009 it reached JA $89.33.

By the early 1990s, the liberalization and de-regulation programmes had not only changed the financial landscape but had also ushered in a more risky environment. By this time, the paper argues "the so-called 'pure' financial institution had all but disappeared as institutions sought to diversify their operations in order to remain competitive, viable and relevant. In fact, with the expansion in credit card facilities to other financial institutions, there was little difference between these and commercial banks." (Jamaica paper).

In the absence of adequate regulation, "many insurance companies created subsidiaries in the form of trust companies, finance houses and merchant banks, and affiliated themselves with commercial banks through which they were able to complement short-term lending and long-term leased and mortgage financing." (Jamaica paper). Insurance companies were also raising cash by selling bank products disguised as insurance policies and investing in real estate and other long-term assets.

Through the formation of complex organizational structures, the banks were able to hide certain transactions from the Central Bank which itself was operating within a very weak legislative framework. The inflation rate which had climbed from 8.4 per cent in 1987 to 80.2 per cent in 1991 dropped to 25.5 per cent in 1995, occasioning significant changes in the book value of assets.

The crash of the stock and real estate markets in the mid-1990s led to a run on both banks and insurance companies, causing the take-over of a number of institutions by the government. In the period following, a number of laws were revised while some new ones were introduced to strengthen the regulatory framework. Through a process of mergers, closures and acquisitions, the financial sector was transformed in a way which allowed institutions to return to their core business. Deposits in the commercial banks increased from JA $89.1 billion at the end of 1995 to JA $357.1 billion at the end of 2009.

In recent years, the Jamaican economy has been hit hard by the global economic crisis which has affected not only its growth prospects but also its fiscal, foreign exchange and debt servicing positions. Net official reserves fell from US$2.3 billion in May 2008 to US$1.7 billion at the end of 2009. Since 1995 the exchange rate has depreciated by more than 100 per cent, moving from JA $35.35 in 1995 to JA $88.49 to US $1 in 2009.

In the 1990s and early part of this decade, the Surinamese economy was in serious difficulty. Fiscal deficits, government borrowing from the Central Bank beyond statutory limits, bouts of hyper-inflation, the suspension of Dutch development aid and changes in the exchange rate all created a very unstable economic environment. The replacement of the Surinamese guilder (Sf) at a rate of Sf 1,000 per Surinamese dollar (SRD) on 1st January, 2004 followed the adoption of a series of stabilization measures including reduced lending by the Central Bank to the government and increased use

of treasury bills as a source of financing. Suriname now operates a *de jure* managed exchange rate regime.

Since 2005, with the rationalization of government borrowing, improved commodity prices and the adoption of more responsible fiscal and monetary policies, the economy has settled into a more stable growth rate which averaged 1.8 per cent a year between 1996 and 2000 and increased to 5 per cent between 2001 and 2008.

With liberalization and de-regulation the financial sector has grown. Financial assets as a per cent of GDP grew from 49 per cent in 1996 to 72 per cent in 2008. The money supply as a per cent of GDP increased from 37 per cent to 46 per cent over the period. A salient feature of the Surinamese economy is the increased dollarization of the economy which had its beginning in the hyper inflation experience of the 1990s. Suriname is one of the most dollarized economies in the region. Since 1992 residents have been allowed to open foreign currency accounts in commercial banks. Foreign currency deposits as a per cent of total deposits increased from about 20 per cent in 1996 to 57 per cent in 2005. Foreign currency loans have followed a similar path.

Since the mid-1990s the Trinidad and Tobago economy has grown faster than any other CARICOM economy. Between 1995 and 2009 the real GDP growth rate has averaged 5.7 per cent a year. Since 1995 the economy declined for the first time in 2009 and continued this trend into 2010. The unemployment rate fell from 17.2 per cent in 1995 to less than five per cent in 2008, but increased to 6.7 per cent in 2010. Since 1995 the inflation rate has averaged around 5.5 per cent a year. Since 2001 the headline inflation rate has fluctuated between 1.3 per cent (2009) and 14.5 per cent (2008). Between 2002 and 2008 the economy benefitted significantly from increased prices for its main commodity exports, viz., petroleum, natural gas and methanol. The fiscal balance as a per cent of GDP which was negative in 2002 (fiscal year) was positive in the following six years, averaging 4.2 per cent. The current external account surplus as a per cent of GDP averaged 17 per cent between 2001 and 2010. The net official reserves increased from US$ 1.7 billion in 2001 to US$9.0 billion in 2010.

Between 1995 and 2000 real value-added in the ‘Finance, Insurance and Real Estate’ sector increased by 11 per cent as compared to a 64 per cent increase between 2001 and 2008. As a proportion of total GDP the sector’s

share increased from 10 per cent in 1995 to 13 per cent in 2008 and 2009. In terms of assets and the range of services offered, the financial sector has grown significantly since the mid-1990s. Technology is an increasing feature of the services offered by the commercial banks. Commercial bank's assets increased from TT $20,053 million (63% of GDP) at the end of 1995 to TT $103,983 million (84% of GDP) at the end of 2009. The ownership pattern of the banking sector has also changed since the mid-1990s, with the foreign-owned entities now more dominant. Some types of non-bank institutions have also been growing both in terms of numbers and assets. The number of finance houses and merchant banks, for example, increased from 13 in 1996 to 20 in 2007. The number of registered life insurance companies and the number of companies writing new business have been stable over the past 10 years. The life insurance business is highly concentrated, with four of the largest companies accounting for over 75 per cent of the industry's total assets.

As indicated earlier, in January, 2009 Trinidad and Tobago's financial sector received a major shock with the collapse of CL Financial, a locally based conglomerate involved not only in financial services, but in a host of other unrelated activities including real estate, energy, manufacturing and distribution. CL Financial reportedly operated through some 40 companies in 28 countries. CLICO and British American Insurance Company were its major insurance subsidiaries which had a strong presence in the insurance business throughout the Caribbean. In January 2009 the Trinidad and Tobago Central Bank intervened not only in CLICO and BA, but also in the CLICO Investment Bank (CIB), another subsidiary of CL Financial. CIB was registered as a non-bank financial institution and accounted for 11.4 per cent of the total assets of the banking system. At the end of 2008 it was estimated that about 40 per cent of the bank's loan portfolio was to affiliated companies. CIB has been closed with some matters still to be resolved in the courts.

Caribbean financial systems have been evolving against the background of a complex set of factors including an inadequate regulatory framework that has failed to sufficiently address allocative and prudential objectives. The influence of structural features in the respective economies is also discernible in policy and operations. Because of their extreme openness Caribbean economies are easily affected by developments in the global economy. Problems in the financial sector normally have their origins in shocks to the real sector of the economy, which affect income and

employment. Falling commodity prices, reduced tourism activity, declining remittance flows, drastic falls in foreign investment and adverse movements in the terms of trade could cause severe social and economic disruptions, particularly in small undiversified economies. In such a situation even banks that are well regulated may come under stress. Capital that may seem adequate in one period may not be in another. Regulations not only have to address conditions caused by external developments but consequences emanating from poor management and betrayal of fiduciary responsibility. Imaginative prudential regulations often help in protecting financial institutions from themselves. A framework for confidence is important because it is a factor that features in both financial and real growth, and helps to mitigate the effects of contagion. A growing economy is better able to deal with financial crises than a stagnant or declining one.

2

An Overview of Global and Regional Economic and Financial Developments

Ramesh Ramsaran

In the post-war period world output grew at a steady rate until 2009. The global economy, however, has evolved in an uncertain environment, with this growth taking place against the background of occasional booms and busts, profound problems in the international monetary system, a series of debt, currency and banking crises, regional conflicts and a global ideological divide that for many years influenced both political and economic organization and management in many countries. Real GDP growth has been associated with an even faster growth in international trade, major changes in global trading patterns and a restructuring of global economic power carrying with it a skewed distribution of the benefits of global expansion. At the same time, significant developments in information and communication technology and the liberalization of capital markets have encouraged greater transnational movements of capital and radical innovations in capital markets, responding to the changing needs of a growing pool of savers and investors. The emergence of flexible exchange rate systems in the 1970s, followed by the debt crisis in the 1980s, spurred the development of a new range of financial instruments to deal with exchange rate and interest rate volatility. Domestic deregulation and the removal of barriers to capital flows and the rights of establishment led to greater competition and increased the reach of financial institutions. The new emerging environment, which allowed investors to hedge risks and to react to new information with greater speed, accelerated the financial globalization process. In an increasingly open world economy, budgetary deficits

became easier to finance with the greater use of innovative risk management techniques. Investment levels became less constrained by the volume of domestic savings. Financial institutions also became bolder in their lending activities with their ability to securitize and distribute risks.

A salient feature of post-war economic management is the greater dependence on market signals for policy making. The main argument for the liberalization of goods and financial markets is that it would lead to a more efficient allocation of real and financial resources. In the process, economies have become more interlocked making it easier for shocks in one country to affect others. Contagion is a structural feature of the modern world economy. In this situation both booms and busts have spillover effects, the extent of which may be difficult to predict. Globalization brings both opportunities and risks, but recent crises in the 1990s and the current global recession have raised a number of issues relating to the quality of supervision and regulation, the capitalization of banks, accounting and valuation methods relating to assets, the role of credit rating agencies, capital controls, deposit insurance, government intervention, the functioning of capital markets and moral hazards arising from bailouts and other forms of assistance. In short, the internationalization of banking activities and financial markets has taken place without a proper regulatory framework and oversight authority. This is significant given the innovative capacity of financial institutions and their disposition to get around regulations. Regulators have been more reactive than proactive.

Capital movements have fueled growth in many countries, but have also played a major part in recent financial crises. The groundwork for this, of course, was laid with the emergence of the Euro-currency markets and the collapse of the crisis-prone fixed exchange rate system, which facilitated the growth of the international bond and equity markets. A regime of flexible exchange rates is more compatible with free capital movements, but many countries still choose to operate a fixed or pegged system, depending on monetary and fiscal policy to deal with the external balance.

The rest of this chapter is organized as follows. The first section attempts to capture global financial highlights in the 1980s and 1990s. The second presents a brief review of major economic trends since 2000. The third section outlines economic and financial developments in CARICOM states in recent years. Some concluding remarks appear in the final section.

2.1 Two Decades of Crises, Growth and Innovations – The 1980s and the 1990s

In the 1980s, the growth of world output slowed considerably, particularly towards the end of the decade and early 1990s. World trade growth declined reflecting the fall in production in both developed and developing countries. In many emerging market economies (in Europe, Middle East, Africa and Latin America) the drop in output was significant and was associated with increasing unemployment. The servicing of existing debt was made more difficult by depressed prices for exports, declining investment, stagnating aid flows, high borrowing rates and difficulties in accessing foreign markets. The intervention of the IMF in many countries not only failed to reverse the economic slide, but worsened social conditions raising questions about the efficacy and relevance of the IMF's austerity programmes.

The 1980s, however, was not all about recession, balance of payments problems, debt, inflation and issues of structural adjustment. The economic challenges of the period gave rise to a whole new range of sophisticated financial instruments (e.g. futures, options, swaps, etc.). Government borrowing created a larger pool of short- and long-term marketable securities. Exchanges emerged for the trading of the new securities. Institutional investors became a major force in financial markets which became progressively integrated with each other. The increasing liberalization of trade and capital movement was critical to the growth of financial markets.

The 1990s decade was one of both growth and crises. The emerging and developing (E and D) countries as a group grew faster than the advanced economies both in the 1990s and the subsequent decade, averaging close to five per cent compared to just over two per cent for the advanced economies. While per capita income growth was almost the same for both groups in the 1990s, the (E and D) group outperformed the advanced economies in the following decade. It is interesting to note that this stellar performance took place against the backdrop of a series of financial crises in various parts of the world.

The countries affected by financial crises in the 1990s and the early 2000s differed in terms of size, location and levels of development. While some causes were common, each crisis had its own peculiarities. In the 1980s foreign exchange shortages and debt servicing problems created difficulties not only for the debtor countries but also for the financial institutions to

whom money was owed. Isolated bank failures and problems facing the savings and loan industry in the United States were contained. The 1990s posed a greater challenge. The decade started off with the Western European Exchange Rate Mechanism (ERM) crises of 1992-1993. This was followed by the Mexican (or Tequila) crisis of 1993-1994 when political instability and an overvalued currency led to a massive loss of international reserves in 1994. The East Asian crisis of 1997-1998 began in Thailand following the collapse of the Thai government, and spread to other countries in Southeast Asia where in some cases weak financial systems and currency pegs failed to withstand the panic runs of speculators and investors.

Table 2.1: World GDP Growth and Consumer Prices (%)

	Growth of Real GDP (%)					Consumer Prices (%)	
	World	Advanced Economies	Africa	Developing Asia	Developing Western Hemisphere	Advanced Economies	Emerging and Developing Economies
A.V.1991-2000	3.1	2.8	2.4	7.4	3.3	2.7	44.5
2001	2.2	1.2	4.9	5.8	0.7	2.2	7.7
2002	2.8	1.6	6.5	6.9	0.6	1.5	6.8
2003	3.6	1.9	5.5	8.2	2.2	1.8	6.7
2004	4.9	3.1	6.7	8.6	6.0	2.0	5.9
2005	4.6	2.7	5.8	9.5	4.7	2.3	5.7
2006	5.2	3.0	6.0	10.3	5.6	2.4	5.5
2007	5.4	2.7	5.5	11.0	5.7	2.2	6.4
2008	2.9	0.2	4.8	7.7	4.3	3.4	9.7
2009	-0.8	-3.4	0.8	7.0	-1.8	-0.1	5.5
2010	5.0	3.0	3.8	9.3	5.9	1.6	6.2

A.V. Average
Source: IMF, World Economic Outlook, Various Issues.

In Indonesia, inflation and deregulation eventually led to rioting and the resignation of the President. Up to this time the fast-growing Asian economies were lauded for their economic policies and strong export growth. The Russian crisis of 1998 may have been triggered by the Asian crisis, but a number of other factors were behind its deepening. The fall in major export prices and the expensive Chechnya war contributed to the fiscal deficits (which were greatly mismanaged), increasing internal debt and the failure of the government to meet many commitments. The

attempts to prop up an unrealistic exchange rate between the ruble and the dollar through high interest rates failed as investors lost confidence in the policies of the government. In August 1998 the stock market and currency market collapsed, the country defaulted on its sovereign debt and the ruble was devalued. The IMF and the World Bank intervened with a bailout package of US $22.6 billion.

The Brazilian currency crisis of 1998-99 came after almost two decades of struggle with debt and inflation. Brazil's external debt increased from less than US $100 billion in 1980 to US $120 billion in 1990. By the year 2000 it had reached US $244 billion. Between 1982 and 1994 the annual inflation rate fluctuated between 100 per cent and 3000 per cent. By adopting a crawling peg system of exchange rate, inflation was brought under control. High interest rates not only discouraged currency hoarding but attracted foreign capital. A series of budgetary and current account deficits, however, soon depleted the country's foreign exchange reserves and investors lost confidence in the government's ability to maintain the peg. Developments in Russia where the government could not service its debt may have precipitated events in Brazil. After experiencing significant depreciation and capital outflows, Brazil's new currency (the Real), which was pegged to the US dollar between 1994 and 1999, was allowed to float. Fearing the wider implications of a Brazilian economic collapse, particularly for other Latin American economies and American banks, an assistance package amounting to some US $42 billion was put together by the IMF, the World Bank, the Inter-American Development Bank and other industrial countries.

Within six years Turkey experienced two crises. In the mid 1990s budgetary deficits and the financing of this deficit by printing money led to a significant rise in inflation. In 1994 the currency was devalued and this country lost a large part of its foreign reserves. The economic crisis of 2001 followed a 3-year IMF stabilization programme which failed to attract popular support or halt the slide in the Turkish economy saddled with a foreign debt of over US $100 billion. The currency was allowed to float and within a few months lost almost half its value, and with it, popular confidence.

In Argentina, the economic and financial crisis of 1999-2001 came on the heels of a long period of hyper-inflation, rising external debt and an experimentation with currency and exchange rate regimes. In the 1970s the annual inflation rate averaged over 120 per cent, but this rose in the

1980s to 500 per cent, with annual figures ranging between 100 and 3000 per cent in the decade. In the 1970s and 1980s Argentina experienced a number of currency crises stemming from hyper inflation that was fueled by the monetization of fiscal deficits. Following the introduction of a Currency Board system in 1991, which fixed the exchange rate between the peso and the US dollar, the inflation rate subsided, private investment flowed and for a few years the economy experienced positive growth. The devaluation of currencies in Argentina's major trading partners in the latter half of the 1990s made imports cheaper, but negatively affected Argentina's exports. In the meantime the public external debt had continued to grow, moving from US $62 billion in 1990 to over US $150 billion in 2001. The debt service ratio exceeded 40 per cent in 2001. In this same year there was a massive flight of capital. At the same time the government indicated it could not service its debt and cut expenditure in a number of areas including wages. A run on the banks followed leading the Government to freeze bank accounts. Rising unemployment and the ensuing social instability resulted in the changes of four presidents in two weeks.

2.2 Developments in the First Decade of the 21st Century

At the turn of the 21st century, the world economy continued to enjoy buoyant growth and generally low inflation, with emerging markets and developing countries as a group outperforming the advanced economies. In the Asian countries which had developed dynamic trading sectors, output growth was averaging over seven per cent per year compared to under three per cent for the advanced countries. World merchandise exports expanded at a rate of 5.5 per cent per year in the period 2000-2007 as compared to three per cent for world GDP. The strong economic performance in many parts of the world was accompanied by the continued rise in Foreign Direct Investment (FDI). FDI inflows reached US $1,833 billion in 2007. Net FDI inflows to developing countries averaged US $211 billion per year between 2000 and 2006. The strengthening of a more accommodating capital movement framework was assisted by the signing of a number of international investment agreements which numbered 5600 at the end of 2007. These included bilateral investment treaties (2608), double taxation treaties (2,730) and free trade agreements (254).

In 2009 world output declined by 0.8 per cent, after growing at an average annual rate of 3.8 per cent between 1960 and 1990, 3.1 per cent between 1991 and 2000, and 3.9 per cent between 2001 and 2008. In 2009

production plummeted in both the advanced countries and the emerging and developing economies, and has remained depressed in most economies of the world. Foreign Direct Investment (FDI) inflows declined by some 16 per cent in 2008, and fell by a further 37 per cent to US $1,114 billion in 2009. This contraction affected developed, developing and transition economies. Table 2.2, which presents figures in net terms, shows that almost all categories of financial flows to developing countries declined in 2008 and 2009.

At the end of the first decade of the 21st century the world economy is still recovering from the financial crisis and recession that emerged following the outbreak of the Sub-Prime Mortgage crisis in the United States in the early part of 2007. High liquidity and low interest rates fueled the growth of the sub-prime market to the extent that by 2006 non-prime loans amounted to almost 50 per cent of total mortgage originations. Securitization, which allowed primary or original lenders to package and transfer risks through less than transparent instruments, and the willingness of investors to hold such securities, contributed to the booming credit market and the spreading of risks. These securities took a variety of sophisticated forms, some of which were not understood by investors or regulators or even by the credit rating agencies themselves which gave their endorsement to transactions reflecting poor underwriting standards.

The credit and housing boom attracted the participation of financial institutions not only in the United States, but from other countries as well, through the acquisition of new complex financial products and other risk management techniques. From mid-2006, rising interest rates and falling house sales prices resulted in rising mortgage delinquencies and falling values of sub-prime backed securities. Faced with losses and asset write-downs, many banks in the United States and Europe severely restricted their lending activities and tried to strengthen their asset base. Non-bank financial institutions, including insurance companies and pension funds, also faced declines in asset prices and losses in equity.

Developments over the years have shown that it is difficult to isolate the problems in the real sector from difficulties in the financial sector and vice versa. It is now also increasingly difficult to shield one economy from crisis in another, not only because of trading and investment links but also because of the way financial institutions spread their risks. The fall in asset values had systemic repercussions which existing regulations and tools

Table 2.2: Net Capital Inflows to Developing Countries (US $ Billions)

Inflows	2001	2002	2003	2004	2005	2006	2007	2008	2009
Net private and official inflows	212.6	154.4	262.4	342.2	464.8	610.2	1110.5	743.9	597.8
Percentage of GNI	3.7	2.7	3.9	4.3	4.9	5.5	8.0	4.5	3.7
Net equity inflows	165.5	162.5	178.8	243.6	341.1	451.0	643.2	533.9	462.2
Net FDI inflows	158.8	154.3	152.5	206.7	273.6	343.3	508.1	587.1	354.1
Net portfolio equity inflows	6.7	8.3	26.3	36.9	67.5	107.7	135.1	-53.2	108.2
Net debt flows	47.2	-8.1	83.6	98.6	123.7	159.2	467.3	209.9	135.5
Official creditors	31.0	6.7	-11.9	-24.1	-64.0	-96.6	0.0	27.8	76.4
World Bank	7.4	-0.5	-2.5	2.4	2.7	-0.2	5.2	7.3	17.7
IMF	19.5	14.2	2.4	-14.7	-40.2	-26.7	-5.1	10.0	26.5
Other official creditors	4.1	-7.0	-11.8	-11.8	-26.6	-42.6	0.0	10.6	32.2
Private creditors	16.2	-14.8	95.5	122.7	187.7	228.8	467.3	182.1	59.1
Net medium-and long-term debt flows	-3.2	-1.7	38.3	69.8	113.2	144.9	283.1	196.1	52.7
Bonds	15.5	11.1	23.1	34.3	48.2	31.7	88.2	24.1	51.1
Bank and other private creditors	-18.7	-12.8	15.2	35.5	65.0	113.2	194.9	172.0	1.6
Net short-term debt flows	19.4	-13.1	57.2	52.9	74.5	83.9	184.2	-14.0	6.4
Worker remittances	93.8	109.9	136.8	158.6	190.6	225.3	277.2	323.5	305.2

Source: World Bank, Global Development Finance: External Debt of Developing Countries, Washington, D.C., 2011.

could not contain. Several large institutions failed or came near to failing. Lehman Bros, one of the largest investment companies in the United States, filed for Chapter 11 bankruptcy protection on September 15th, 2008 following loss of clients' stocks, other losses and devaluation of assets by credit rating agencies. Other major financial institutions (such as Bear Stearns, Goldman Sachs, Merrill Lynch, and Morgan Stanley) were also under threat. Morgan Stanley applied to convert from an investment bank to a financial and holding company. Merrill Lynch, one of the world's largest brokerage firms, merged with the Bank of America. Many of these changes were driven by loss of business and the need for government assistance.

Faced with a major collapse of the financial system, the US government was forced to intervene with a number of conventional and unconventional measures including lending directly to securities dealers and offering controversial bailout and rescue packages. The Emergency Economic and Stabilization Act of 2008 provided the US Treasury with US $700 billion to buy risky and non performing debt from lending institutions and to make cash injections into the banking system. Fearing the consequences for the economy if Bear Stearns, one of the world's largest investment companies, was allowed to go bankrupt, the US government loaned JP Morgan Chase US $29 billion to purchase the company. In return for a two-year interest bearing loan, the government also acquired a 79.9 per cent equity position in American International Group (AIG), one of the world's largest insurance companies. It also acquired Fannie Mae and Freddie Mac, two large mortgage lending companies. In return for financial assistance the government found itself owning stock in car manufacturing companies (e.g. General Motors, Chrysler), insurance companies and a large number of banks including Citigroup Inc and Bank of America Corp. Besides the US $700 billion bailout plan the government provided a number of support programmes to restore confidence in the financial sector.

With an increasing interdependence among nations, driven by trade and capital liberalization, crises tend to spread more easily across national frontiers, particularly in the absence of correct diagnosis and relevant policy responses. The Sub-Prime Crisis in the US not only spread to other markets burgeoning into a major recession, but also quickly engulfed other countries where output and employment also declined. Not all countries were affected to the same extent. The key factor was the degree of economic linkage. Many European banks had acquired high yielding sub-

prime assets and were thus directly and immediately affected. Asset losses and credit write-downs were experienced by major banks. As the liquidity crisis spread, several European countries decided, in late 2008, to strengthen the banks by injecting capital into them or by setting up inter-bank loan guarantees for up to five years or by buying stakes in banks. An early casualty was Northern Rock which sought assistance from the UK government in the face of a liquidity crisis and a run in 2007. A few months later, in February 2008, the bank was nationalized by the UK government.

By the third quarter of 2008 ripple effects were being felt in emerging economies as foreign exchange, stock and sovereign debt markets came under major stress. "Exchange rates came under pressure in all regions, leading to a combination of depreciation and depletion of foreign reserves. Concerns about dwindling capital flows and external sustainability drove up sovereign spreads, particularly in emerging Europe and Latin America. Moreover the deteriorating economic outlook hit stock markets hard."[1]

The Iceland crisis of 2008-2009 raised further questions about unregulated financial expansion, global integration and the need for greater collaboration among supervisory authorities. Iceland is a small country of about 320,000 people and traditionally depended on the export of marine resources. Based on its plentiful thermal energy resources, an aluminium smelter was established and became operational by the mid-1990s. The driving force behind the boom of the 1990s and the first seven years of the 21st century, however, was the unprecedented growth of the financial services sector following the liberalization programme of the 1980s and 1990s. This, combined with the privatization of the major banks in 1998-2003, provided the platform for expansion into other countries, particularly in Europe. Besides the increased exposure in the form of foreign deposits, including Icesave accounts arising from internet banking, the Icelandic banks borrowed heavily in short term markets to finance the expansion of Icelandic investment companies. Bank assets grew at a rate several times that of GDP and the changing institutional structure made it very difficult for the Central Bank to supervise. The challenge to the bubble was to come, not so much from exposure to the sub-prime market in the United States, as from the liquidity squeeze in money and capital markets as the banks found it increasingly difficult to refinance existing loans.

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1 IMF, World Economic Outlook, April 2009, p. 133.

Real per capita income increased at an average annual rate of almost two per cent per year in the 1990s. This trend continued for several years after. Based on 2005 data, the United Nations in it's 2007/2008 Human Development Report ranked Iceland as the number one country in the world. A construction boom, fueled by very accommodating lending by the banks doing both retail and investment banking, contributed to the bubble. Real estate prices skyrocketed. Inflation and a rising level of imports were soon reflected in the external account. The Central Bank raised interest rates to offset the effect of rising inflation and to protect the currency. Interest rates of the order of 15 per cent in the first half of 2008 attracted foreign money. Towards the latter part of 2008 the real value of the Krona fell significantly. The banking sector, which was also a big lender to the government, collapsed in October 2008, and the government took control of the three largest banks. Soon thereafter a stabilization programme with financial support was signed with the IMF. That was not the end of the matter. The then government, which received heavy criticism for its handling of the crisis, collapsed a few months later in January 2009. The government also got into a major political row with the governments of Britain and the Netherlands over compensation for the assistance given to their citizens who held accounts with the Icelandic banks.

The decline in growth in the industrial countries led to reduced demand for exports from developing countries, including the oil exporting nations. In the Western Hemisphere developing countries, for example, output growth fell from four per cent in 2008 to minus 2.3 per cent in 2009, while in Africa it fell from 5.2 per cent to 1.9 per cent over the same period. Lower import capacity both in the developed and developing countries resulted in a decline in the volume of international trade. Reduced FDI flows associated with the global credit squeeze and capital flight contributed to the declining economic activity. The flow of remittances to developing countries also felt the impact of the recession in the advanced nations. Remittance flows to developing countries fell from US $325 billion in 2008 to US $307 billion in 2009.

In 2010, amidst signs of an economic recovery from the global recession, several simmering problems in European countries reared their heads at the same time, putting the Eurozone under severe strain and even raising questions about the future of the Euro itself. Lack of growth, debt problems, large fiscal deficits, fragile banking systems and declining productivity reflected structural problems in a number of countries.

Greece was among the early casualties seeking external assistance. Burdened with a large stock of debt and with the government finances in shambles, Greece requested a bailout package of EUR €110 billion (US $150 billion) from the IMF and the EU in May 2010. A few months later Ireland also sought external help, following the bust in the property boom and the threat faced by the banking system. In both countries, austerity measures triggered social unrest leading to industrial action in Greece and a change of government in Ireland. Around the same time other European countries (Italy, Belgium, Spain and Portugal) faced similar challenges arising from budgetary and debt servicing problems which contributed to a very unstable economic environment. In mid-2011 Italy was also forced to introduce a package of austerity measures to address a huge fiscal deficit and a public debt amounting to over 120 per cent of GDP. Italy is the third largest economy in Europe, and has a sovereign debt in the region of 1.9 trillion Euros—almost five times the size of Greece's.

In France and Britain severe expenditure cuts were undertaken in 2010 to shore up the public finances. In the UK, faced with a public debt close to 60 per cent of GDP and a budget deficit amounting to 12 per cent, the newly elected government plans to reduce public expenditure by USD $128 billion over a four-year period. Included in the package were cuts in welfare benefits, reduction of the armed forces, a tax on banks and increased university fees. In France the retirement age was raised to 62 and in Britain to 66. Unable to meet its target commitments under the initial bailout package, Greece's debt was further downgraded in 2011 leading the country to seek additional assistance. In July, 2011 the leaders of the Eurozone countries approved a further package amounting to USD $155 million (109 billion Euros) with contributions coming from the IMF, banks and other private lenders. This assistance was provided on condition of further austerity measures being undertaken. Protests and riots in Greece, however, accompanied by political instability, have made it difficult to implement these measures. Greece's debt is edging towards USD $500 billion which is estimated to amount to almost 200 percent of GDP in 2012. Greece which has experienced five years of economic contraction is now feeling the effects of years of reckless spending and poor economic management. There are not many options open to it. Among these are a pull-out from the Euro and restoration of a national currency. In the absence of bail-out assistance, however, the economy is almost certain to collapse.

The combined public debt of Greece and Italy is around USD $3.5 trillion – which is about twice the economy of France. The possibility of default has created a frightening scenario for governments and the financial sector in Europe and the rest of the world. New financing for creditor banks in Europe is already under consideration. A global recession is again on the cards, particularly following a forecast of only a 0.5 per cent growth for Europe in 2012 by the European Commission. In 2010 and continuing into 2011 signs of a shaky recovery were overshadowed by a still depressed US economy faced with high unemployment, persistent fiscal deficits, a burgeoning national debt and a weak currency. To be sure, the United States remains the world's largest economy with a GDP (in PPP terms) of some USD $14 trillion, followed by China and Japan. The national debt has reached the current credit limit (USD $14.3 trillion) which is close to 100 per cent of GDP. In August of 2011 a crisis with global repercussions was triggered when haggling in the US Congress over raising the debt ceiling (which was seen as necessary for the government to meet its financial obligations) led Standard and Poor's, one of the world's leading rating agency, to lower the United States' credit rating one notch from triple-A to AA plus, leading to uncertainty over a range of financial assets and havoc in global stock markets. This was the first such decision since 1917.

Table 2.3: Selected International Nominal Exchange Rates

End of Period	US $ Per Euro[1]	US $ Per Pound	Yen Per US $	Yuan Per US $	Can $ Per US $	US $ Per SDR
1995	1.31	1.55	102.83	8.32	1.36	1.48
1996	1.25	1.70	116.00	8.30	1.37	1.44
1997	1.10	1.65	129.95	8.28	1.43	1.35
1998	1.17	1.66	115.60	8.28	1.53	1.41
1999	1.00	1.62	102.20	8.28	1.44	1.37
2000	0.93	1.49	114.90	8.28	1.50	1.30
2001	0.88	1.45	131.80	8.28	1.59	1.26
2002	1.05	1.61	119.90	8.28	1.58	1.36
2003	1.26	1.78	107.10	8.28	1.29	1.49
2004	1.36	1.93	104.12	8.28	1.20	1.55
2005	1.18	1.72	117.97	8.07	1.16	1.43
2006	1.32	1.96	118.95	7.77	1.16	1.50
2007	1.47	2.00	117.35	7.80	1.07	1.58
2008	1.39	1.46	103.34	7.79	1.06	1.54
2009	1.44	1.62	93.57	7.75	1.14	1.57
2010	1.34	1.56	87.78	7.77	1.03	1.54

1 Dollars per ECU through 1998; Dollars per Euro beginning 1999
Source: IMF, International Financial Statistics, Various Issues.

While printing money has helped to finance the deficits, a large part of the national debt is owed to foreign governments and central banks, including China, Japan, the United Kingdom and oil exporting countries. Though paying very little, US treasuries rank among the world's safest investments. Essentially, the money that the strong exporters make is invested back in the US which, for a number of reasons, is still regarded as the world's banker. The problems being faced by the Euro and the challenges facing European governments in dealing with sovereign debt have mitigated the fallout from the US downgrade. The continuing loss of real value by the US dollar, however, has rekindled the debate for an alternative reserve asset and international currency. Interestingly, the threat of currency wars occurs with great frequency between the United States and Japan, and China, the latter two often being accused of deliberately undervaluing their respective currencies to boost their exports. Table 2.3 shows recent trends in exchange rates between the US dollar and major currencies.

The link between gold and the US dollar was cut in 1971 following huge losses in gold reserves. Despite this, the US dollar has remained the most widely used currency in international trade. Over 60 per cent of official reserves are held in US dollars and the prices of most commodities are quoted in US dollars. Foreign currencies pegged to the US dollar will float with it, and to the extent that the dollar weakens this would negatively affect the buying power of international reserves. In this situation reserves management is a critical issue. The asset options are not many. In mid-2011 concern over the sovereign debt in Europe and the United States has put both the Euro and the US dollar under enormous pressure. The price of gold which was US$ 271.04 per ounce in 2001 has increased steadily to over US$1,600.00 in July, 2011, reflecting the lack of confidence in two major reserve currencies.

2.3 Economic and Financial Developments in CARICOM Countries

While there have been improvements on some fronts over the last four or five decades, many of the fundamental development objectives of governments in CARICOM states have proved elusive. These include diversifying production and exports, increasing domestic agricultural production and reducing dependence on imported food, establishing a larger manufacturing base, expanding the scope of domestic input-output linkages, creating a larger pool of permanent jobs, increasing productivity, orienting education towards the skills requirements of the economy,

expanding the technological capacity of the economy, significant improvement in social infrastructure and services and generally putting the economy on a more solid basis. Generally, policy stances have reinforced the natural vulnerability of these countries, most of which are small island states. Poverty levels in some states have also been increasing. Income and the unemployment rate still fluctuate greatly in response to changes in market conditions of major exports, including services. It is easy to interpret the conditions created by temporary booms as development achievements. At the regional level, some of the most fundamental initiatives required to advance the integration movement remain in abeyance.

Amidst the rapid changes taking place in the global economy, it is difficult to discern a coherent development strategy with clear objectives and supporting policies as a relevant response in any CARICOM state. Remnants of the colonial economy and a substantial legacy of the failed import substitution strategy are still in place as individual countries slowly adapt to the policies driving the modern world economy. Economic survival now depends heavily on efficiency and competitiveness. Mechanisms for accessing technology, training, education, finance, infrastructure and inflation help define the environment which allows entrepreneurs to compete on a world scale. In rethinking its role in governance, the government has a critical part to play in formulating and implementing policies in a number of these areas. In some CARICOM countries, however, welfare considerations responding to populist sentiments have tended to overwhelm the developmental role of the state leading to persistent fiscal and debt problems.

Since 1980 most CARICOM countries have experienced a steady increase in both total and per capita income, notwithstanding booms and busts in commodity prices, periodic recessions in the industrial countries and the seasonal damage inflicted by floods and hurricanes. In the 1980s average output growth in the economies of Guyana, Suriname and Trinidad and Tobago was negative. This was a difficult decade for a large number of developing countries in the hemisphere which were faced with debt problems and the challenges arising from the implementation of structural adjustment problems. Despite this, The Bahamas, Belize and the ECCU (Eastern Caribbean Currency Union) countries grew by over four per cent annually in the period. In the 1990s real GDP growth rates dropped significantly in The Bahamas and ECCU member states, but improved in

most of the others. Guyana, Trinidad and Tobago and Suriname returned to a positive growth path following the declining output trends in the 1980s. In the first eight years of the 21st century total income increased in all the countries with Belize, Suriname and Trinidad and Tobago outperforming the others. In this period, the Trinidad and Tobago economy grew by an annual average rate exceeding seven per cent. The region benefitted from buoyant commodities markets and economic growth in major trading partners. The exceptional growth performance in Trinidad and Tobago resulted from the increased prices for oil and gas. In Suriname real GDP has been growing at almost five per cent per year in recent years. In 2009 output fell in almost all CARICOM countries, reflecting the global recession.

Table 2.4: Average Growth of Real GDP (%)

	1981-1990	1991-2000	2001-2008	2009[e]
Bahamas	5.0	3.3	1.0	-4.5
Barbados	1.0	1.4	1.0	-5.5
Belize	4.5	5.3	4.5	0.0
EC Currency Union	6.2	3.0	3.2	-7.3
Guyana	-3.5	5.1	1.9	2.3
Jamaica	2.4	0.9	1.5	-3.0
Suriname	-0.4	0.9	4.9	2.0
Trinidad & Tobago	-3.2	3.5	7.1	-3.5

e estimate

Source: Calculated from official publications.

Table 2.5: Average Annual Growth of Real Per Capita GDP[1]

	1994-2000	2001-2009
Barbados	2.8	0.7
Belize	2.7	1.5
Guyana	3.2	1.5
Jamaica	-1.2	0.9
Trinidad & Tobago	5.0	6.0
EC Currency Union	2.4	2.2
Antigua and Barbuda	1.4	2.0
Dominica	2.4	2.5
Grenada	5.1	0.4
Montserrat	3.3	0.8
St. Kitts-Nevis	4.5	0.8
St. Lucia	0.3	1.5
St. Vincent & the Grenadines	3.8	4.9

1 At market prices

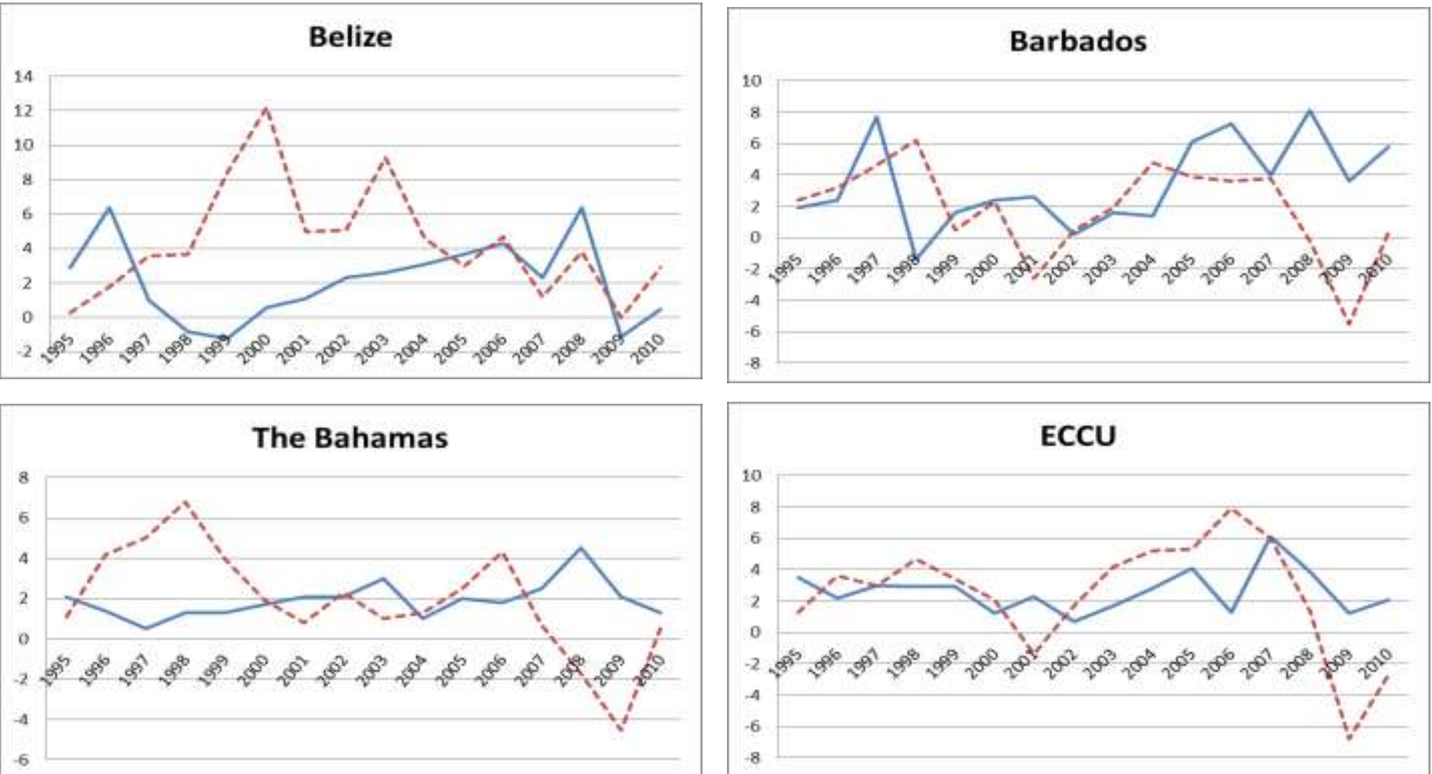
Sources: Computed from official data.

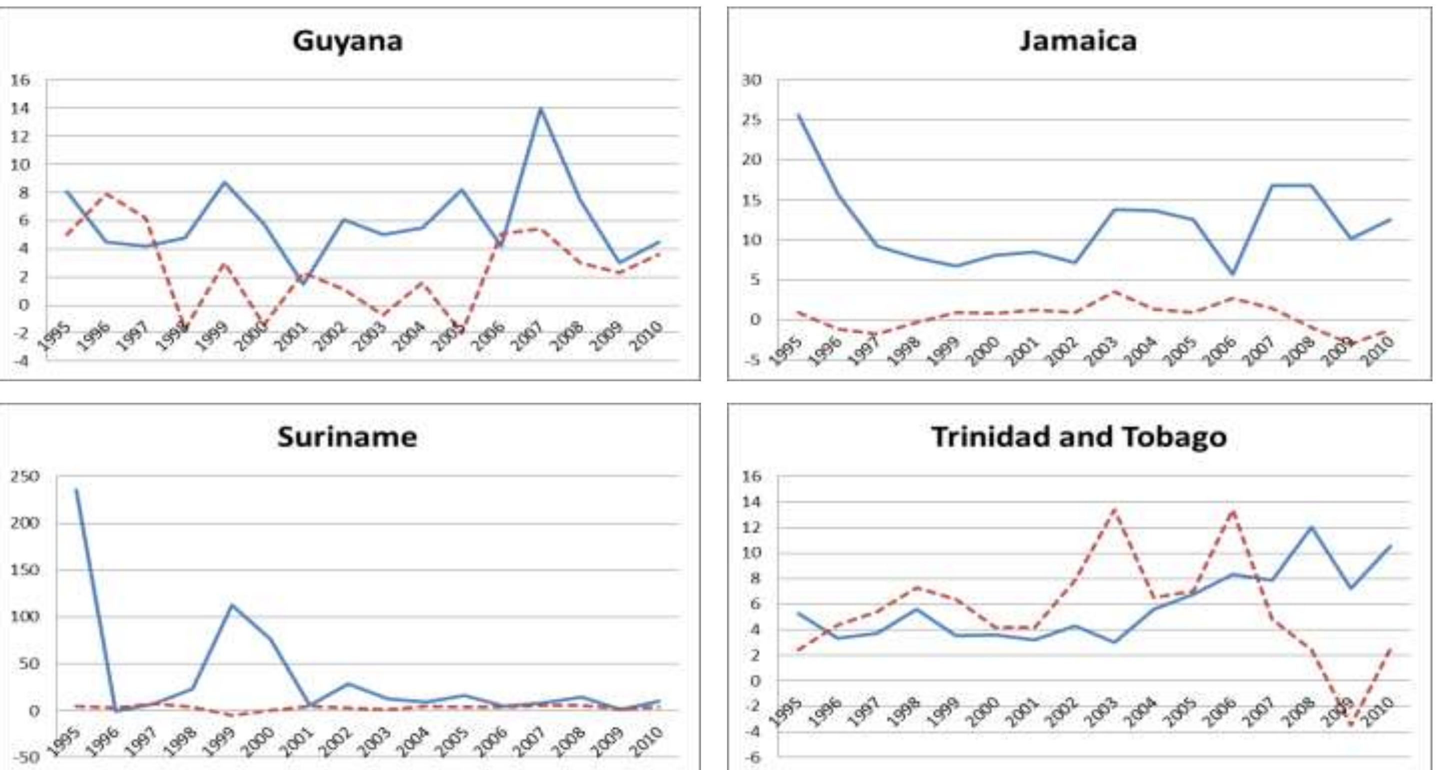
Since the early 1990s the growth of real per capita income in all English-speaking CARICOM countries has been positive, except for Jamaica in the 1990s where per capita income fell by 6.7 per cent between 1992 and 2000. For several countries per capita income growth rate has slowed since the turn of the century compared to the 1990s. Among them are Belize, Guyana, Barbados and St. Kitts-Nevis. With a real per capita income growth rate of six per cent since 2001, Trinidad and Tobago exceeded its performance of five per cent in the 1990s.

As indicated earlier, in 2009 output declined in most countries, reflecting the recession and financial crisis affecting the advanced economies. The Caribbean economies depend heavily on commodity exports, tourism, remittances and foreign investment. In Trinidad and Tobago the energy sector contributes around 40 per cent to GDP and accounts for more than half of current revenue and over 80 per cent of export earnings respectively. The prices of oil and gas-based products increased steadily between 2002 and 2008 when the effects of the global recession began to put downward pressure on energy prices. The price of a barrel of oil (West Texas Intermediate) increased from US $26.03 in 2002 to US $99.63 in 2008, but fell to US $61.69 in 2009. The price of natural gas increased from US $3.37 mmbtu in 2002 to US $8.86 mmbtu in 2008, but fell to US $3.95 mmbtu in 2009. After growing by an average rate of almost eight per cent between 2001 and 2006, growth in the Trinidad and Tobago economy declined to 2.3 per cent in 2008 and became negative in 2009.

The loss of preferential export markets and development policies have impacted negatively on the export-oriented agricultural sector developed in the colonial period. Tourism has grown to become a major industry in the Caribbean, replacing some of the traditional activities which once dominated the landscape. Its contribution in terms of income generation, foreign exchange earnings and employment creation varies from economy to economy. In a few countries (e.g. Anguilla, Aruba, Antigua) the travel industry contributes over 70 per cent to GDP. In most of the others it is between 30 and 50 per cent. In The Bahamas the number of visitors now exceeds 1.5 million a year with tourist expenditure amounting to over US $2,000 million as compared to less than US $1000 million in the early 1980s. In Barbados the travel industry accounts for almost half of foreign exchange earnings, while in the ECCU member states the contribution is even more significant. Because of the heavy dependence on tourism, the economic downturn in the major markets has had an immediate negative

Chart 2.1: Inflation % and Real GDP Growth Rate %




Guyana
Jamaica
Suriname
Trinidad and Tobago
Inflation rate
Real GDP Growth Rate

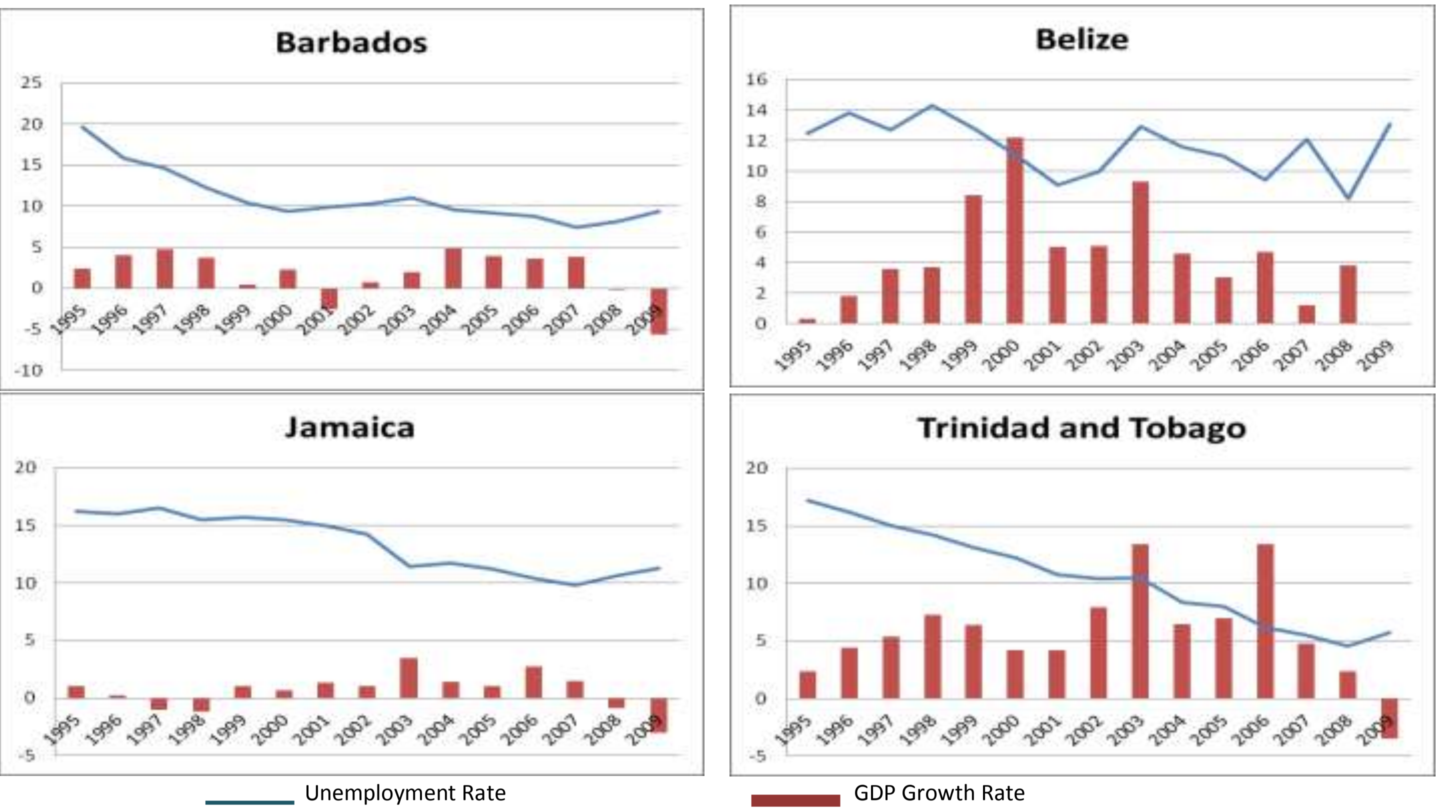
impact on regional economies. In Barbados and Jamaica, for example, the number of visitors fell by about nine per cent in 2009.

Tourism has grown to become a major global industry contributing to the economies of both developed and developing countries. In 2010 international tourism is estimated to have generated US $910 billion in export earnings. The industry is not only highly competitive, but very sensitive to a wide range of factors, many outside the control of individual governments. Tourism carries with it a high element of vulnerability, but also has good potential for growth and development in a well-thought-out policy framework encompassing other economic activities. The high import content of the industry in the Caribbean, and the decline of agriculture and manufacturing, point to serious flaws in planning and development policy.

With a declining agricultural sector and the failure to develop a vibrant manufacturing sector, Caribbean economies have become increasingly service-oriented. In the ECCU countries, for instance, agriculture now accounts for only about five per cent of GDP as compared to over 20 per cent in the 1970s. The services sector now contributes over 80 per cent to total value-added and manufacturing for around five (5) per cent. In The Bahamas and Barbados, the services sector is similarly dominant. In Guyana, agriculture still plays a significant role in the economy, contributing over 20 per cent to GDP compared to around 16 per cent for mining and manufacturing. Trinidad and Tobago is less dependent on services which contribute a little over 50 per cent to GDP. The petroleum industry contributes 35 to 40 per cent to total output, while the share of manufacturing is in the region of eight per cent. Agriculture's contribution has fallen to less than one per cent. In Jamaica, agriculture, mining and manufacturing now contribute less than 20 per cent to GDP. The share of manufacturing has been declining, reaching 8.5 per cent in 2008, compared to 10.7 per cent in 1999.

Experience has shown that economic growth in itself may not lead to an increased standard of living or greater self-reliance. Growth and development are not necessarily the same thing, though there is a broad consensus that the expansion of income is needed for the reduction of poverty. Growth can also take place without generating employment opportunities or reducing vulnerability. Inflation can worsen poverty by wiping out real income gains. The distribution of income, job creation and the rate of inflation help to define the quality of growth. In most countries

Chart 2.2: Unemployment Rate % and Real GDP Growth Rate %



of the CARICOM region the unemployment rate has fallen from the early 1990s. In The Bahamas for instance, the rate declined from an average of 12.6 per cent between 1991 and 1996 to an average of 8.7 per cent between 1997 and 2008. With the decline of the economy in 2009, the rate increased sharply to over 14 per cent. In Barbados the rate fell from a high of 24.3 per cent in 1993 to an average of 9.3 per cent since 2000. In Jamaica the rate has averaged around 11 per cent since 2003, compared to an average of 15 per cent in the period 1991-2002. In Trinidad and Tobago the rate declined steadily from 20 per cent in 1990 to single digit (8.4 per cent) in 2004 and continued downwards to 4.6 per cent in 2008. In 2009, the rate increased slightly to 5.3 per cent, corresponding to a small decline in the economy.

Notwithstanding a weak economic base and periodic fluctuations in the level of economic activity, not only has per capita income increased over recent decades, but the general level of well-being has also been enhanced, as reflected in an increasing UN Human Development Index for most countries of the region. The Index mirrors movements in other critical indices such as health, education and income. Life expectancy at birth is now generally over 70 years. In most countries, literacy and school enrolment rates are close to 100 per cent. Having said this, however, a not insignificant proportion of the population in the region continues to live in poverty. Poverty affects over 30 per cent of the population in several countries and there are indications that it is increasing in some (e.g. Belize and Grenada). The increasing level of crime throughout the region may be explained by several factors, but poverty and unemployment are certain to be among them. While there has been progress on several fronts, as indicated earlier, the quality of social and economic policies and the pace of development have not had the desired transformational impact on Caribbean economies and societies. In the UN 2010 Human Development Index only two Caribbean countries (Barbados 42nd and The Bahamas 43rd) were ranked in the top 50 out of 169 countries examined. Trinidad and Tobago was ranked 59th, Belize 78th, Jamaica 80th, Suriname 94th, Guyana 104th and Haiti 145th. With respect to competitiveness, the Global Economic Forum in its 2010-2011 Report ranked Barbados 43rd in the top 50 out of 137 countries. Trinidad and Tobago was ranked 84th, Jamaica 95th and Guyana 110th respectively. Some of the criteria used included infrastructure, goods market efficiency, technological readiness, institutions, labour market efficiency, financial market development, market size, health, education and the macro-economic environment.

Table 2.6: Average Annual Inflation Rates

	1991-2000	2001-2008	2009	2010 [c]
Bahamas	2.5	2.4	1.9	1.3
Barbados	2.9	3.9	3.6	5.8
Belize	2.0	3.2	-1.1	0.5
EC Currency Union	2.7	2.9	1.2	2.1
Guyana	8.3 [a]	6.6	2.9	4.5
Jamaica	24.9 [b]	11.9	9.6	12.6
Suriname	101.9	16.2	1.3	10.3
Trinidad & Tobago	5.5	6.5	7.2	10.5

a 1992-2000
b The average for the period 1997-2000 was 7.5% compared to 36.4% for the period 1991-1996
c estimate
Source: CCMF and official publications.

In certain circumstances policy makers may risk a certain amount of inflation if this can lead to a higher level of output and employment. Out of control, however, inflation can have consequences which can nullify a wide range of social and economic policies. Inflation reduces the value of the money which may lead to demand for higher wages and higher costs of local production, which in turn may impact on the balance of payments. To the extent that residents switch to foreign goods (imports increase), and the foreign demand for local goods falls (exports decrease) there will be increased pressure on the exchange rate, other things remaining equal. A redistribution of income will also take place with persons with fixed incomes being at a disadvantage. Of course, even without inflation, insufficient local production to meet domestic or foreign demand can also exert pressure on the exchange rate. To the extent that this latter situation is structurally related, monetary and fiscal measures would tend to be less relevant. Not surprisingly, food inflation is a major factor in Caribbean inflation. For example, in Trinidad and Tobago headline inflation increased by an average rate of 6.2 per cent per year between 2001 and 2009, while food inflation increased by 16 per cent annually over the same period. In Barbados, the all items index increased by 28 per cent between 2000 and 2009 as compared to 38 per cent for the food and beverage index.

The relationship between inflation and growth is not easy to decipher and lends itself to a great deal of speculation. Cross country experiences indicate that countries with moderate (below 35 per cent) and low (below five per cent) inflation rates are associated with higher growth rates than countries experiencing hyper-inflation, which tends to have a negative

impact on the efficiency of the country.[2] Low inflation rates, however, do not guarantee high economic growth rates. The Bahamas, Barbados, Belize and the ECCU states are associated with low rates of inflation, generally under five per cent. Since the early 1990s, Guyana's rate has stabilized but still exceeds five per cent on average. On the other hand, Jamaica's and Suriname's rates have also declined but are less predictable as reflected in the fluctuations from year to year. Table 2.6 shows that, except for Jamaica and Suriname in the 1990s, the inflation experience in the Caribbean has generally been at a moderate level. On the other hand the respective growth rates shown in Table 2.4 also project a moderate performance, even if, in certain cases and at certain times, the growth rate tends to exceed the inflation rate.

2.4 Balance of Payments

A heavy dependence on foreign trade continues to be one of the salient features of Caribbean economies. On average exports of goods and non-factor services amount to over 40 per cent of GDP, while the proportion for imports of goods and non-factor services tend to exceed 60 per cent. Reliance on a narrow range of activities for export earnings and dependence on external sources for critical imports underline the vulnerability of these countries to external developments. In Trinidad and Tobago, export of petroleum and energy-based products accounts for over 80 per cent of foreign exchange earnings. In The Bahamas tourism-related activities dominate the export sector contributing close to 75 per cent of foreign exchange earnings. In most of the ECCU member states tourism is also the dominant activity. In Barbados tourism related services account for more than half of foreign exchange earnings. In Guyana gold exports, which started in 1984, amounted to 37 per cent of domestic exports in 2009 as compared to 20 per cent in 1995. Bauxite, sugar and rice contributed another 41 per cent. Agricultural and marine products feature high in Belize's domestic exports. Sugar, molasses, bananas, citrus juices, papayas and marine products accounted for close to 90 per cent of exports (excluding petroleum products) in 2009. In this same year tourism earnings exceeded the value of domestic exports, giving some indication of the growth of this activity.

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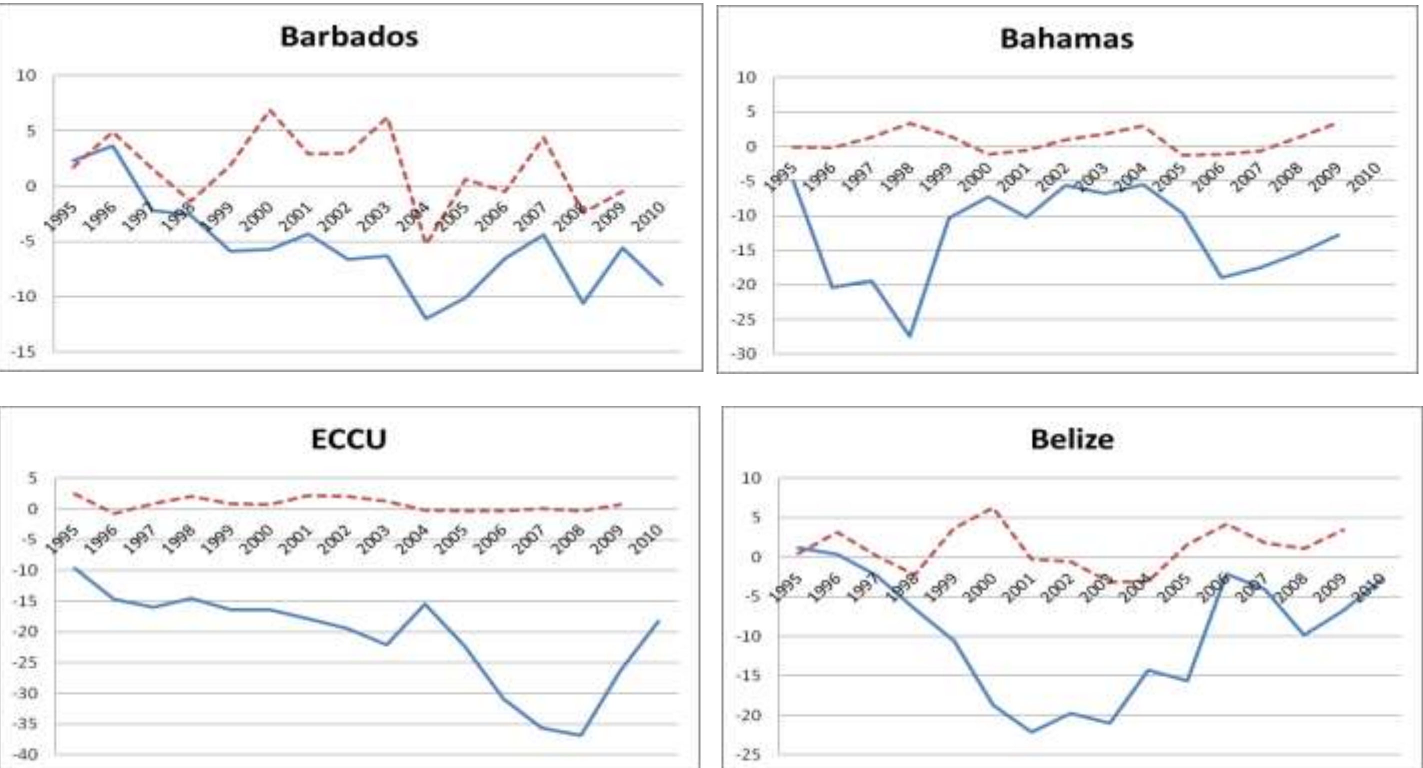
[2] M. Bruno and W. Easterly, "Inflation Crises and Long-run Growth," in Journal of Monetary Economics Vol. 41, no. 1, Feb., 1998. See also Spiegel, "Macroeconomic and Growth Policies," in United Nations National Development Strategies: Policy Notes, New York: U.N., 2008.

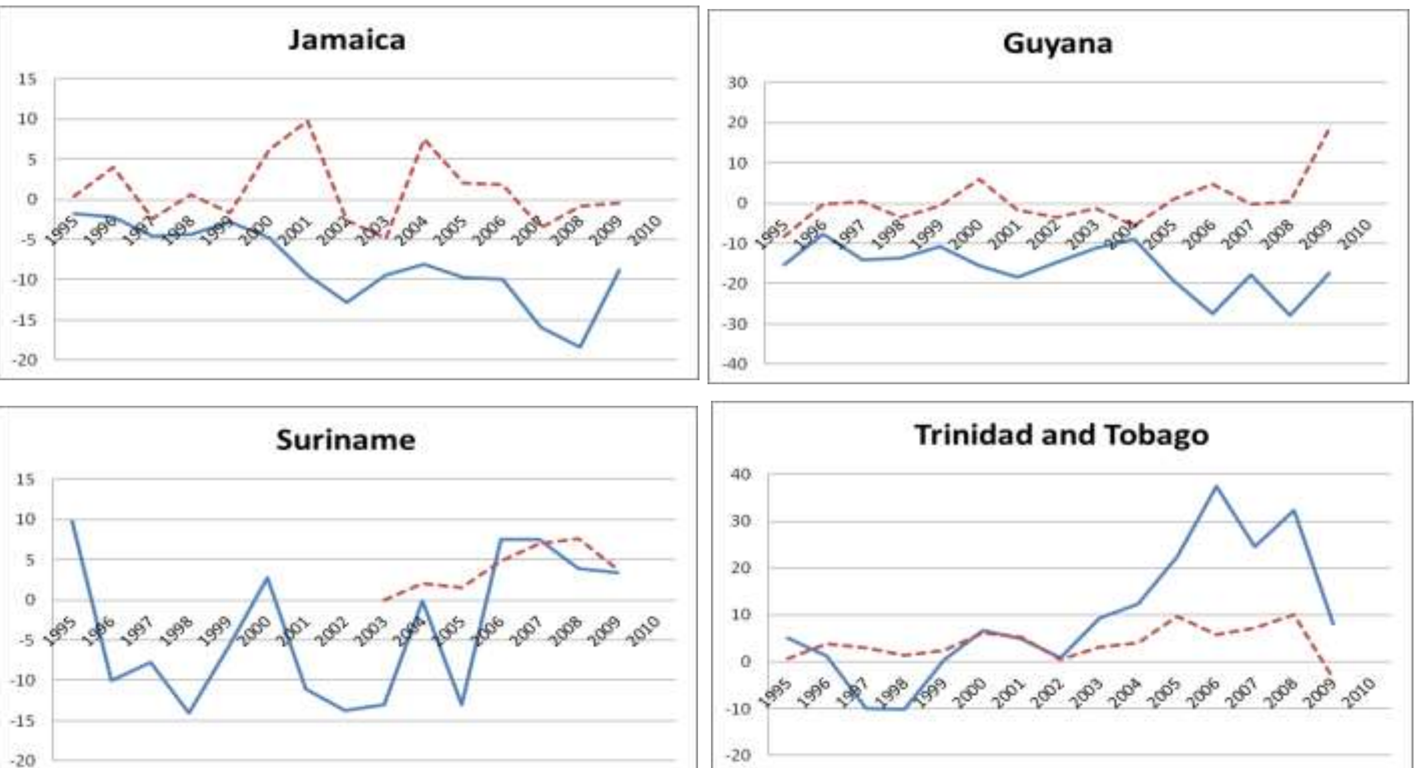
One consequence of a small economy is the need to import a wide range of consumer and capital requirements. Global trade policies have made it difficult to sustain high cost production and have had a profound effect on Caribbean economic structure. Economic policies in the post-independence period have not changed the orientation or functioning of CARICOM economies. Given the high import content of consumption, foreign exchange availability defines the standard of living in these countries. Throughout the region (with the exception of Trinidad and Tobago) imports have tended to grow at a faster rate than exports leading to persistent deficits in the current account of the balance of payments. In most CARICOM countries these deficits have averaged over 10 per cent of GDP since 1995. In a few states (e.g. Grenada, St. Kitts-Nevis) the ratio has been over 20 per cent in recent years. Trinidad and Tobago has been in a more favourable position enjoying a current account surplus of over five per cent of GDP since the mid-1990s.

Because many products used for consumption or as intermediate or capital goods are not produced locally, it is often difficult to reduce certain types of imports without creating social hardship or affecting production. In Jamaica, for instance, food accounted for 10 per cent of total imports and mineral fuels for 40 per cent in 2008. Machinery and transport made up another 15 per cent. In Trinidad and Tobago, raw materials, construction materials, transport and machinery equipment accounted for 36 per cent of total imports in 2008. In this country food imports increased from US $269 million in 1998 to US $613 million in 2008 (or by 128 per cent). In Barbados, food and fuels account for about 36 per cent of total imports. The significance of the growing dependence on imported food has to be seen against the global rise in food prices and the reluctance of some countries to export food. In a number of states, resources traditionally used to produce food have been diverted to the production of cheap energy.

The current account balance has been helped by the increasing inflows of remittances from nationals living abroad. The significance of these flows varies from country to country. In Belize, for example, inflows increased from US $24.3 million in 2002 to US $76.4 million in 2009. This latter figure was the equivalent of 31 per cent of domestic exports. In Jamaica remittance inflows increased from US $683 million (9.2% of GDP) in 1988 to US $2,021 million (16.5% of GDP) in 2008. The global recession has had a negative impact on these flows to the region since 2009. In ECCU countries

Chart 2.3: The Balance of Payments as a % of GDP (Current and Overall)




Jamaica
Guyana
Suriname
Trinidad and Tobago
Current External Balance % of GDP
Overall Balance of Payments % of GDP

remittance inflows have averaged between one per cent and nine per cent of GDP in recent years.

Table 2.7: Overall Balance of Payments (% of GDP)

	Bahamas	Belize	Barbados	ECCU	Guyana	Jamaica	Suriname[1]	Trinidad & Tobago
1990	0.4	3.1	(2.7)	1.0	110.6	2.1		(3.7)
1991	0.4	(4.6)	(2.7)	0.7	12.8	(5.5)		(4.4)
1992	(1.0)	(0.3)	1.0	3.1	(10.6)	8.8		(2.1)
1993	0.6	3.4	1.2	(0.1)	(11.0)	2.7		3.6
1994	0.3	(0.8)	4.3	(0.4)	(12.1)	7.1		3.7
1995	(0.1)	0.5	1.7	2.4	(8.3)	0.4		0.6
1996	(0.2)	3.2	4.9	(0.8)	(0.2)	4.0		3.8
1997	1.3	0.2	1.6	0.9	0.5	(2.4)		3.0
1998	3.3	(2.2)	(1.4)	2.1	(3.4)	0.6		1.3
1999	1.6	3.7	1.9	0.9	(0.6)	(1.6)		2.4
2000	(1.1)	6.2	6.9	0.7	6.0	6.2		6.1
2001	(0.5)	(0.3)	2.9	2.2	(1.7)	9.8		5.3
2002	1.0	(0.6)	3.0	2.0	(3.5)	(2.6)		0.5
2003	1.8	(3.1)	6.2	1.3	(1.2)	(4.8)	0.0	3.1
2004	3.0	(3.0)	(5.3)	(0.2)	(5.5)	7.5	2.1	4.0
2005	(1.3)	1.6	0.6	(0.4)	1.0	2.1	1.6	9.7
2006	(1.1)	4.2	(0.5)	(0.3)	4.7	1.9	4.9	5.8
2007	(0.6)	1.8	4.4	0.0	(0.1)	(3.5)	7.0	7.3
2008	1.4	1.1	(2.4)	(0.4)	0.5	(0.8)	7.6	10.0
2009	3.5	3.5	(0.5)	0.7	18.6	(0.4)	3.8	-3.6

1..Estimated from change in reserves; blank boxes indicate the unavailability of data
Source: CCMF and official publications.

Capital inflows associated with private investment or government borrowing are not always able to offset deficits in the current account. Capital inflows are a function of a wide range of internal and external factors, and therefore tend to fluctuate from year to year. With respect to Foreign Direct Investment (FDI) the stock in ECCU member states increased from an estimated one billion US dollars in 1990 to ten billion in 2009.[3] Most of this was tourism-related. Among CARICOM countries, Trinidad and Tobago, Jamaica and The Bahamas have been the most attractive for FDI. In Trinidad and Tobago the stock increased from an estimated US $2.4 billion in 1990 to US $17 billion in 2009. In Jamaica the stock increased

[3] See UNCTAD, Global Investment Report, 2010.

from less than one billion to over eleven billion US dollars over the same period.[4] Foreign investment, of course, also generates income outflows, so the net effect in any one year would depend on the size of the various flows including capital flight and capital repatriation.

Table 2.8: Net Official International Reserves (US $Millions)

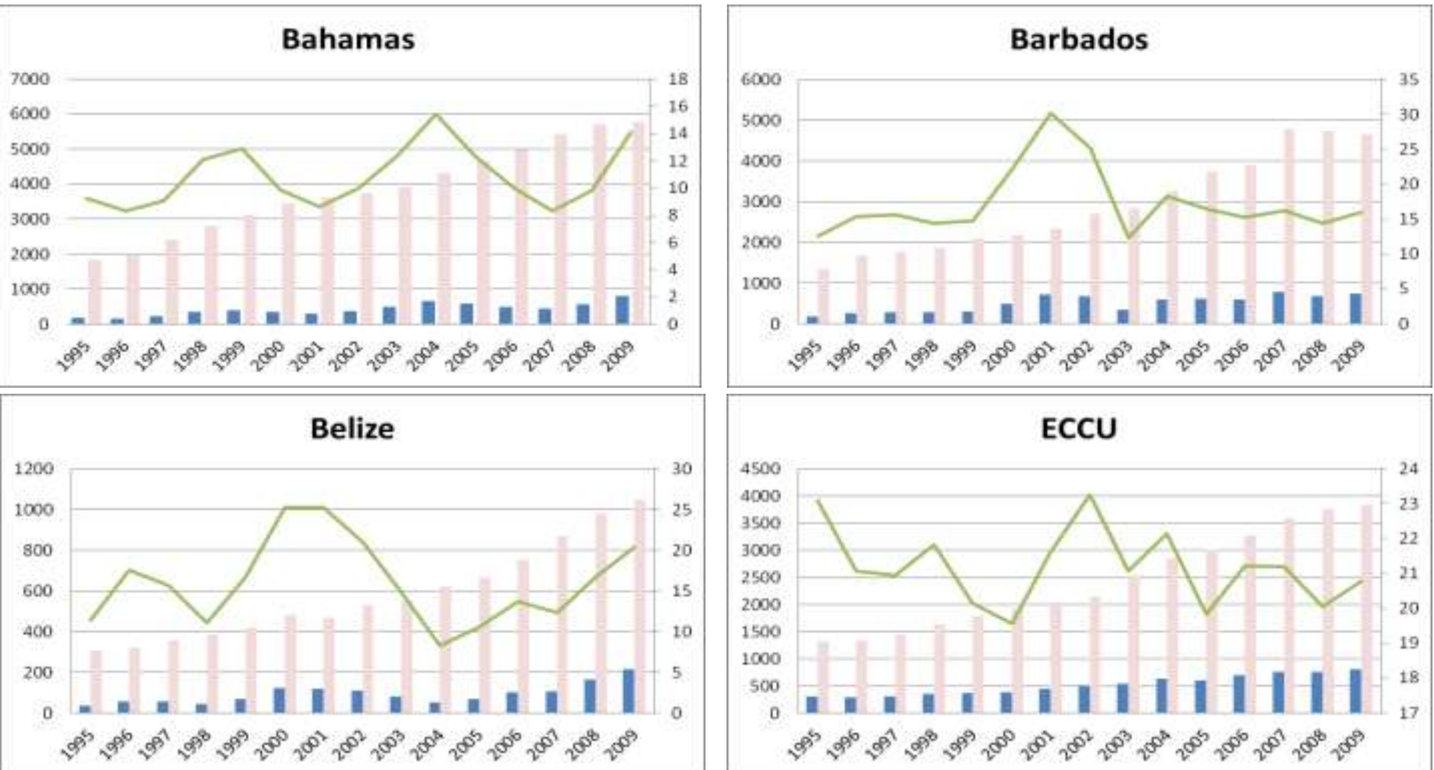
End of Year	Bahamas[1]	Barbados	Belize	ECCU	Guyana	Jamaica	Trinidad & Tobago[2]	Suriname[3]
1995	170.6	170.3	34.9	303.2	86.4	418.6	293.5	157.6
1996	163.0	256.8	56.5	281.0	153.9	694.9	506.8	180.4
1997	219.5	274.9	55.8	302.1	149.9	540.0	684.0	164.5
1998	338.8	269.3	42.4	356.0	122.2	579.4	765.5	90.0
1999	404.0	306.4	70.1	361.4	126.8	446.3	949.8	34.9
2000	342.6	484.4	122.0	377.0	178.4	974.0	1,388.0	14.4
2001	312.4	706.8	118.6	441.7	187.4	1,839.4	1,858.5	113.8
2002	373.2	683.2	111.7	501.0	183.4	1,600.7	1,907.4	98.2
2003	484.3	351.6	81.7	535.8	176.1	1,168.1	2,241.9	104.2
2004	667.8	595.2	52.0	630.0	136.6	1,864.3	2,524.2	142.2
2005	578.8	617.8	70.3	597.0	160.5	2,095.2	3,998.8	162.1
2006	499.0	597.0	103.2	693.3	222.3	2,325.1	5,117.9	261.2
2007	454.2	775.0	107.3	761.7	254.0	1,886.0	6,658.8	435.9
2008	562.9	679.6	164.5	755.5	298.8	1,380.3	9,364.1	495.9
2009	815.9	743.9	213.1	799.0	569.4	1,754.0	8,655.1	778.0

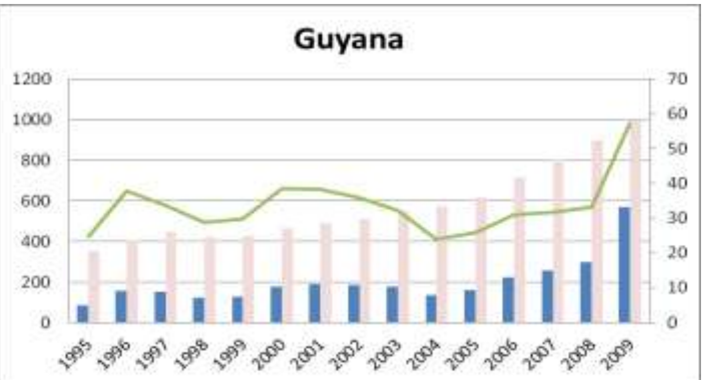
1 Gross external reserves of the Central Bank
2 Excludes Heritage and Stabilization Fund
3 Net international reserves, except for 2009 which is an estimated gross figure.
Source: Official Publications and IMF, International Financial Statistics, Various Issues.

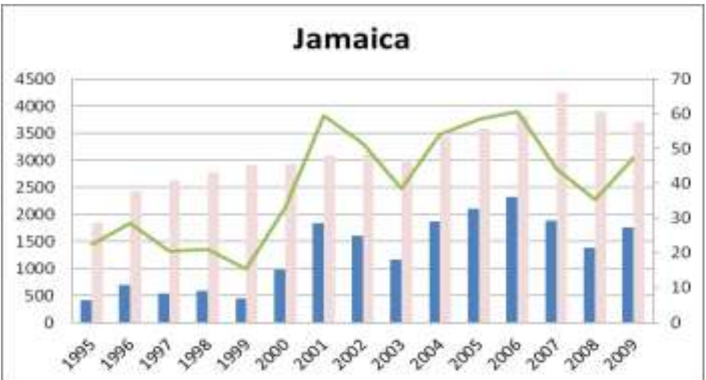
Given the persistent current account deficits in almost all Caribbean countries the overall balance of payments figures in Table 2.7 give a good indication of performance in the capital account. Incidentally, capital inflows often hide serious problems in the sectors reflected in the current account of the balance of payments. The figures in Table 2.7 reflect the unpredictability of capital flows to the region, and explain the fluctuation in the level of foreign exchange reserves, the adequacy of which is often measured in terms of the number of months import cover. The healthy overall position for Trinidad and Tobago in recent years reflects the surplus in the current account resulting from buoyant prices for energy exports. The import cover for this country increased from an average of less than

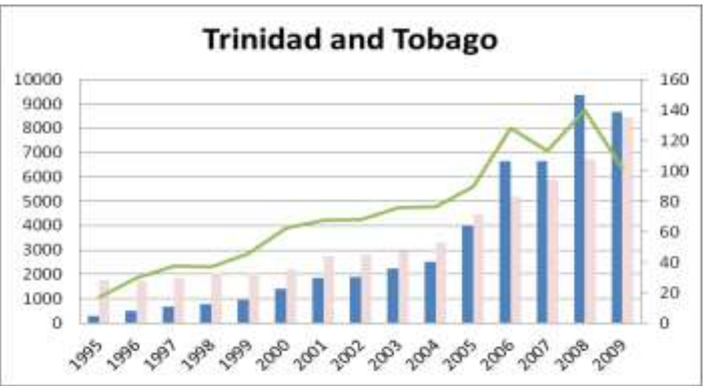
[4] Ibid.

Chart 2.4: Official Foreign Reserves as a % of Broad Money (M2)




Guyana


Jamaica


Trinidad and Tobago

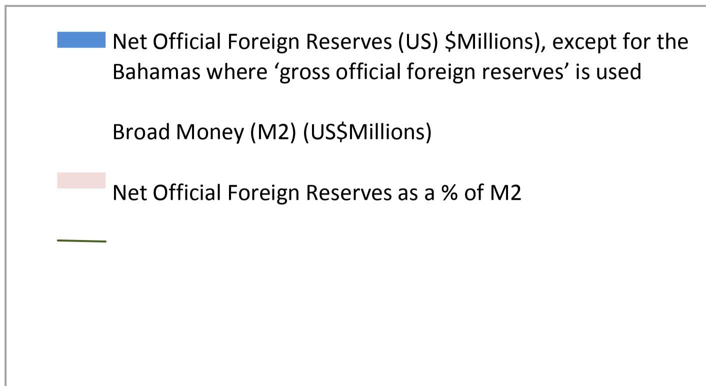
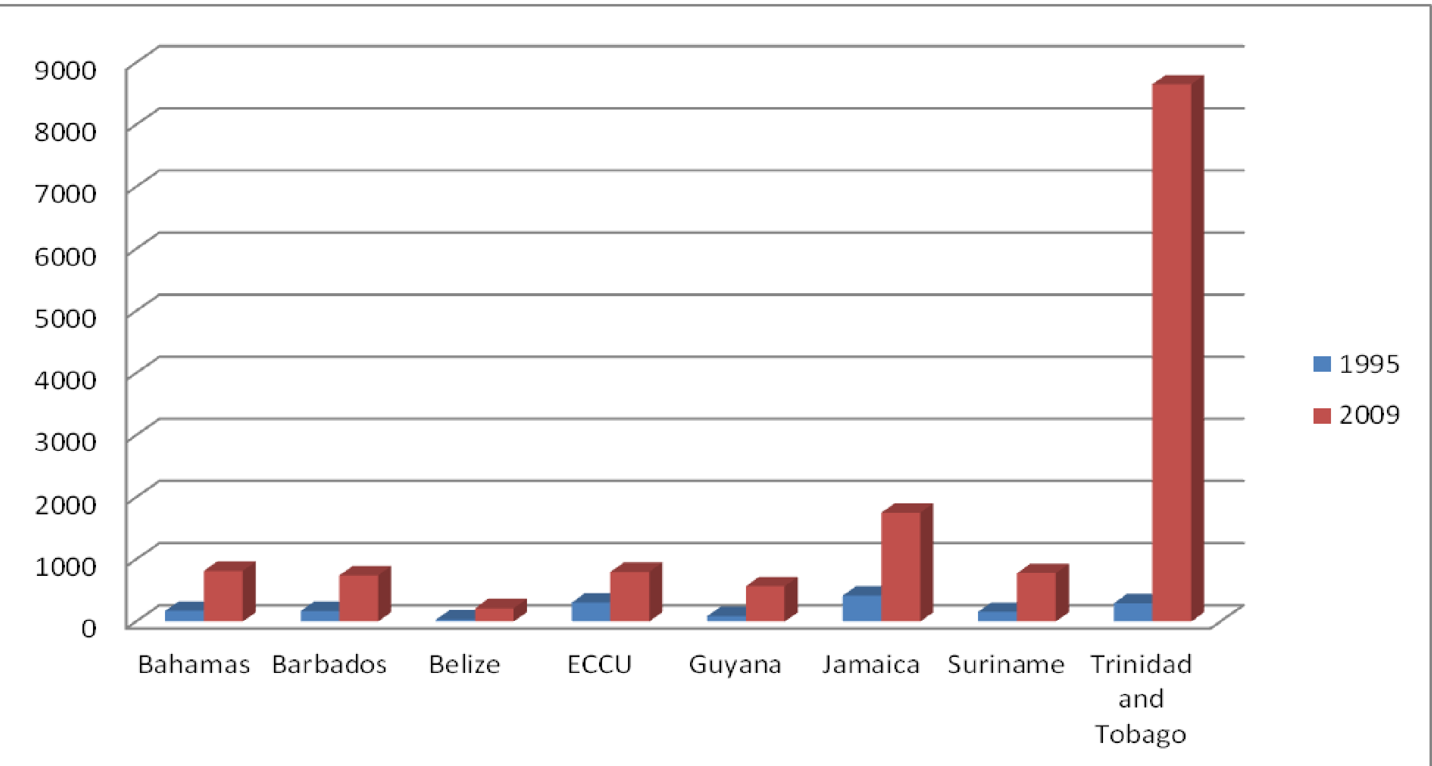

Net Official Foreign Reserves (US) $Millions), except for the Bahamas where 'gross official foreign reserves' is used
Broad Money (M2) (US$Millions)
Net Official Foreign Reserves as a % of M2

Chart 2.5: Net Official Foreign Reserves (US $Millions)



three months between 1991 and 2000 to an average of over six months since. Net official reserves increased from US $1,695 million (5.6 months import cover) in 2001 to US $8,652 million (12.4 months import cover) in 2009. In the case of Barbados, the cover increased from an average of less than three months in the 1990s to over four on average since 2000. The other countries have contended with a cover of three to five months in recent years. In the case of the Eastern Caribbean Central Bank, the establishment Act of 1983 requires it to "maintain a reserve of external assets not less than 60% of its notes and coins in circulation, and other demand liabilities". The actual percentage at the end of March 2009 was 96.79% (102.05% in 2008).

Foreign reserves can also be analysed in relation to the narrow money supply (M1), or more commonly, the broad money supply (M2). The ratio of foreign reserves to broad money fluctuates from period to period and varies widely across the region. The ratio has averaged around 11 per cent for The Bahamas to 72 per cent for Trinidad and Tobago since 1995. The comparative figures for the other countries were Belize 16 per cent, Barbados 17 per cent, the ECCU 21 per cent, Guyana 33 per cent and Jamaica 39 per cent.

2.5 The Public Debt

Since the turn of this century the debt situation has worsened in most counties in the region. In Barbados for example, the total public debt increased from US $2.2 billion in 2000 to US $4.6 billion in 2009, or by over 100 per cent. In Belize the disbursed outstanding external debt increased from US $423 million to over US $1 billion over the same period. In Jamaica the total external debt moved from US $3.3 billion in 2000 to US $6.6 billion in 2009. With one or two exceptions, the outstanding public debt in Caribbean countries has increased at a faster rate than total production (GDP), putting increasing pressure on public revenue and foreign exchange earnings. In 2009, only two countries (Suriname and Trinidad and Tobago) among those under discussion had a debt/GDP ratio under 50 per cent. In a number of cases, the ratio had exceeded 100 per cent by 2009. These included Barbados, Guyana and Jamaica and some members of the EC Currency Union. Among the countries in the latter group, the debt/GDP ratio in St. Kitts and Nevis was the highest at almost 200 per cent. Antigua and Grenada are associated with ratios of over 100 per cent. With the assistance of some debt write-off, the debt/GDP ratio for St. Vincent has fallen below 70 per cent in recent years. In Dominica

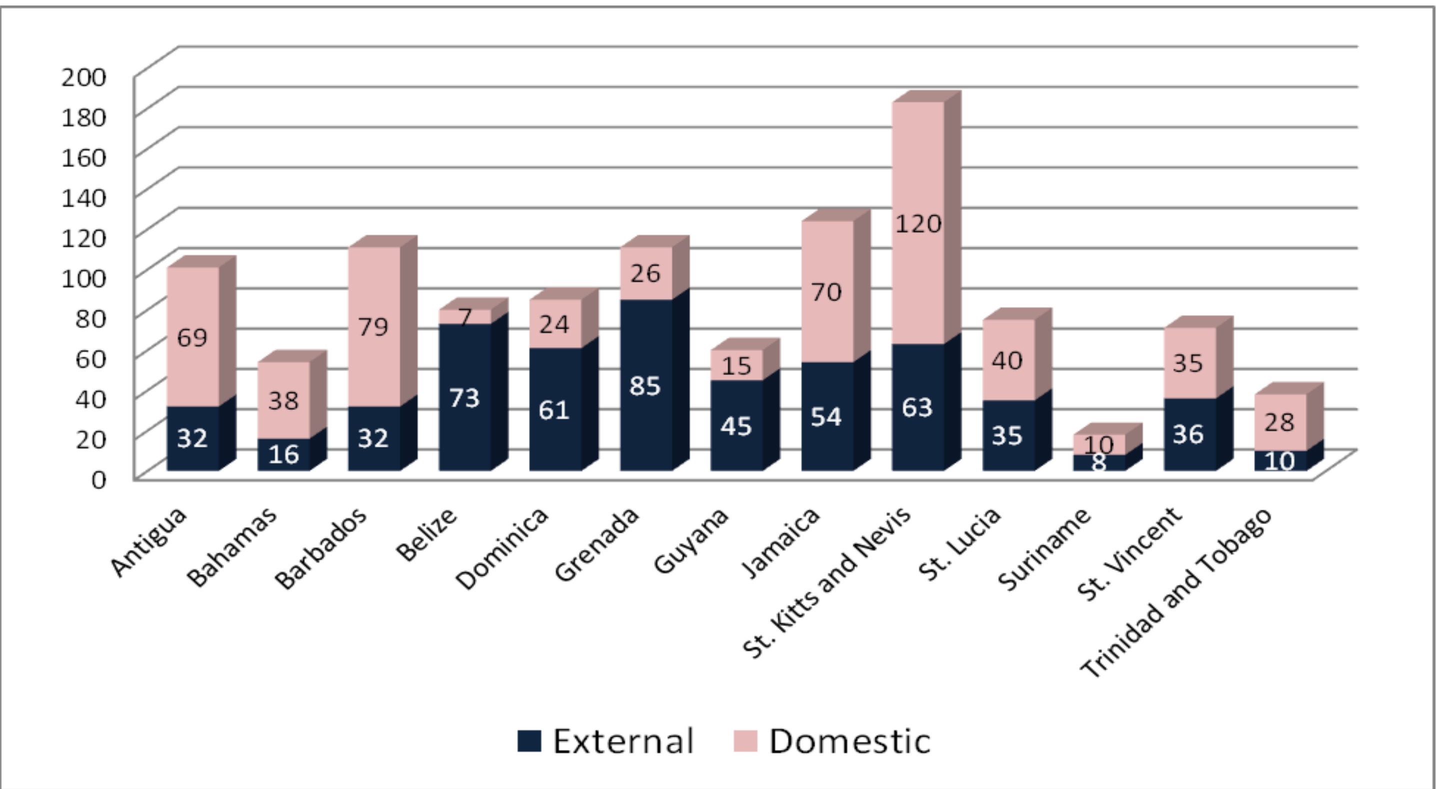
the debt ratio declined from over 100 per cent in 2003 to 84 per cent in 2009. In St. Lucia, however, the ratio has been increasing and was estimated to be over 70 per cent in 2009. The debt/GDP ratio has been increasing in all the ECCU member states. In response to the worsening debt and fiscal situation, ECCU member states agreed to an Eight-Point Stabilization and Growth Programme in June 2009. Stemming out of this, in October, 2010, country-specific fiscal targets were established which included debt service ratios no greater than 15 per cent of current revenue, a primary surplus of at least three per cent of GDP and the previously agreed objective of reducing the debt to GDP ratio to 60 percent by 2020. Members of the Monetary Council, at its 69th meeting on 11 February 2011, presented their respective government's annual fiscal targets for the Debt to GDP and the Primary Balance to GDP ratios. These targets are shown in Table 2.9.

Table 2.9: ECCU Public Sector Debt[1] as a % of GDP and 2011 Debt and Fiscal Targets

	DOD[2] EC$ Millions	DOD[2] as a % of GDP[3]	2011 Fiscal Targets for ECCU Member Countries	
			Debt/GDP	Primary Balance/GDP
Anguilla	191.6	32.8	27.6	-1.5
Antigua and Barbuda	3,085.3	101.0	84.0	1.4
Dominica	862.8	84.6	66.2	2.4
Grenada	1,883.8	111.4	94.1	-1.9
Montserrat	9.3	6.5	6.2	-2.0
St Kitts and Nevis	2,686.9	182.6	147.8	5.0
Saint Lucia	1,911.6	74.9	67.0	-2.9
St Vincent and the Grenadines	1,118.4	71.1	61.8	-0.1
TOTAL ECCU	11,749.6	97.2		

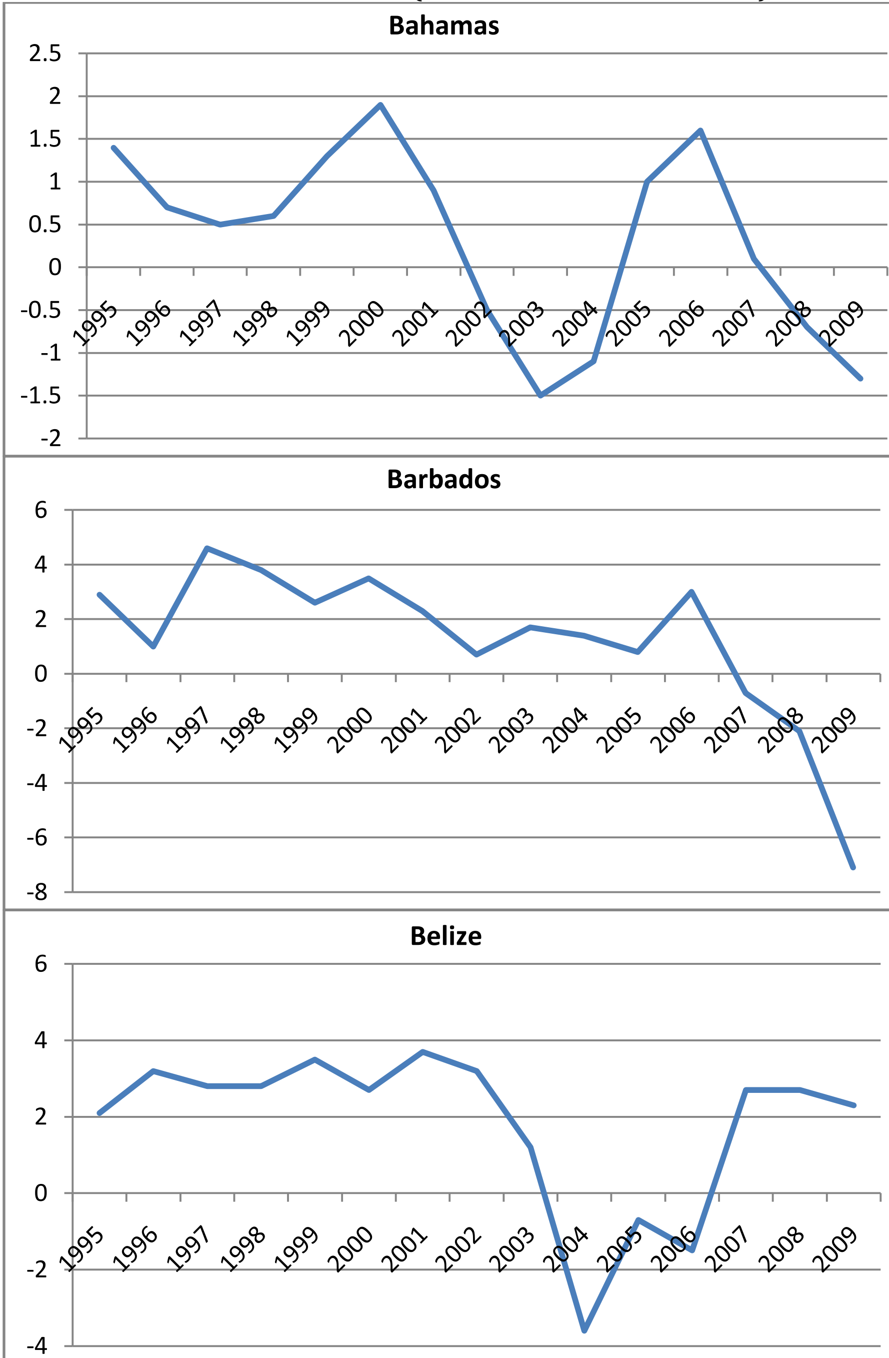
1..At end of 2009
2 Disbursed Outstanding Debt (DOD)
3 At current market prices
Source: ECCB

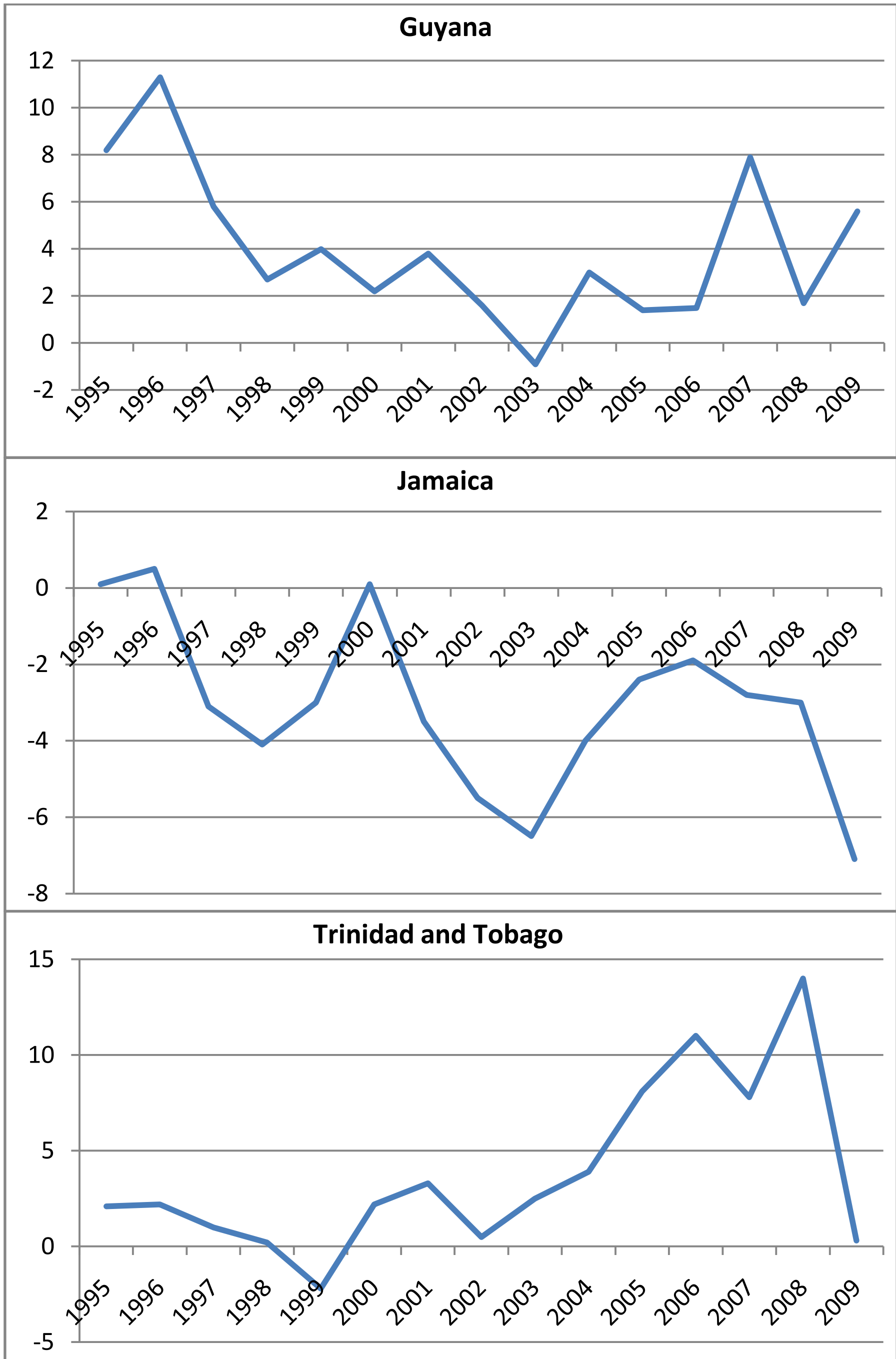
Chart 2.6: Public Debt 2009 (% of GDP)



2.6 The Fiscal Situation

Chart 2.7: Fiscal Balance (Current Account as a % of GDP)




Guyana
12
10
8
6
4
2
0
-2
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
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Jamaica
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-2
-4
-6
-8
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Trinidad and Tobago
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10
5
0
-5
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009

In most countries of the region the growth of total expenditure has tended to outpace the growth of revenue, leading to persistent fiscal deficits which are financed largely from borrowing both from internal and external sources (See Table 2.10). Generally, revenue growth has been negatively affected by the slow growth of the economies. Fiscal deficits (as a percentage of GDP) have generally increased since the turn of the century as a result of inadequate savings efforts, dwindling grants and the need to fund ambitious development programmes. Since 2001 the average overall deficit/GDP ratio for Belize, Guyana, Jamaica and the EC Currency Union has exceeded four per cent. The current fiscal balance also generally worsened in the 2000s period. Trinidad and Tobago has fared better than the other states as a result of the buoyant energy prices in the period 2001 to 2008. Between 2000 and 2008 the current fiscal surplus averaged 4.7 per cent of GDP, while the overall ratio was in the region of 1.6 per cent. In fiscal 2009, however, with anticipated recurrent revenue declining by 32 per cent, the government approved a deficit budget, as was the case in other CARICOM countries. The economic downturn in Caribbean economies since 2009 reflects the region's dependence on the global economy which has been in the grips of a severe recession and financial crisis.

Table 2.10: Fiscal Operations and Growth of the Public External Debt

	Average Overall Fiscal Balances as a % of GDP			Outstanding External Debt as a % of GDP				Outstanding Total Debt as a % of GDP			
	1991-2000	2001-2008	2009p	1991	2000	2008	2009	1991	2000	2008	2009p
Bahamas	-2.4	-2.6	-2.4	14.0	6.9	11.4	15.5	31.0	33.3	42.5	53.6
Barbados	-1.8	-3.8	-5.8	24.6	20.3	28.1	32.0	58.0	64.0	94.5	108.5
Belize	-4.6	-4.2	-2.8	32.0	54.8	70.4	75.0	n.a.	65.0	84.8	89.0
ECCU	-2.7	-4.4	-3.5	32.1	44.1	46.0	60.5	n.a.	81.6	95.0	108.0
Guyana	-6.5	-7.3	-6.0	603.4	169.5	72.5	74.1	634.0	206.5	104.3	108.1
Jamaica	-1.0	-5.8	13.6	180.0	40.0	50.1	54.2	200.0	88.7	109.9	n.a.
Suriname	-7.4	0.5	-1.8	n.a.	n.a.	10.3	9.0	n.a.	n.a.	17.9	20.0
Trinidad & Tobago	-0.6	1.6	-5.4	25.0	35.0	5.5	10.0	53.0	54.4	24.0	37.5

p provisional
n.a. not available
Source: CCMF and official publications.

To finance the deficits, governments have borrowed from both internal and external sources. Some have relied more heavily on the internal market than others. For example, at the end of 2009, domestic debt as a

proportion of the total outstanding public debt for The Bahamas was 78 per cent; for Jamaica 61 per cent; for Barbados 71 per cent; for Trinidad and Tobago 60 per cent; and for Antigua 62 per cent. In the case of Guyana, Belize and Grenada, the foreign debt component was 72 per cent, 85 per cent and 72 per cent respectively of the total.

The growth of the public debt has coincided with sluggish economic growth rates, thus putting increased pressure on the public finances and foreign exchange earnings. In Jamaica, for example, interest payments in fiscal 2008/09 amounted to 47 per cent of recurrent revenue and were higher than wages and salaries payments. Since 2000 the external debt service ratio (accrued) has averaged 13.3 per cent. In Barbados debt service payments have been averaging nine per cent of public revenues in recent years. In St. Kitts and Nevis interest payments now take over 20 per cent of recurrent revenue. In St. Lucia and Antigua total debt service payments now amount to about 30 per cent of public revenues and are equivalent to about 10 per cent of GDP respectively. In Trinidad and Tobago the debt service ratio has fluctuated between one per cent and six per cent in recent years. As a general observation, it should be noted that the debt service ratio often serves as a poor guide to foreign borrowing, given the way it is defined.

2.7 The Financial Sector

There are several indicators which point to the increasing importance of the financial sector in Caribbean countries alongside increasing monetization of the various economies. One is the growth of bank assets which will be discussed later. Another is the ratio of broad money to GDP. Despite occasional crises, banking habits have spread and Caribbean peoples have maintained a high level of confidence in the banking system while at the same time complaining about the quality of service and high bank charges. Technological innovations and an increasing range of services and instruments have no doubt contributed to the popularity of the banks. The recent global financial upheaval and the contagion effect stemming from the high level of interdependence in the world economy have put an intense focus on a range of issues associated with the financial sector. Most of these relate to regulation and the emergence of complex financial structures and instruments, while others stem from the movement of capital, the increase in public debt to unsustainable levels, the relationship between finance and growth, the role of interest rates and control of liquidity or the money supply.

Even before the recent global economic downturn and financial crisis, many developing countries were reviewing the performance and operations of their respective financial sectors in the context of the need for greater public confidence and an effective role in national development. Countries with high saving rates generally had less need for foreign capital. As intermediaries, financial institutions are expected to play a critical role in the saving/investment process. In many cases the regulatory framework had become outdated and could not deal with a range of new issues emerging from a rapidly changing environment. The venture of banks into non-bank business and vice-versa, excessively risky lending and investment, large interest rate spreads and capital adequacy had already raised concerns for regulators. The impact of statutory requirements on the operations of commercial banks in a competitive setting involving banks and non-bank financial institutions remains an ongoing concern. The control of financial institutions by commercial and industrial companies and linkages between various types of financial institutions are yet to be adequately addressed.

With institutions expanding across national borders, effective regulatory and supervisory arrangements have been slow to take shape, thus increasing the risk to savers and investors. The role and adequacy of deposit insurance has always been a contentious issue as has been a minimum or real interest rate policy. The arguments relating to the pros and cons of greater competition, the pace of liberalization and the speed and sequence of reforms were driven by concerns for greater efficiency and more effective contribution to economic development. The recent bailouts by governments and the IMF have added fuel to the recurring moral hazard argument. Situations involving inflation with no or little growth have prompted questions about the extent to which inflation can be controlled, or about the extent to which it can be traded for growth.

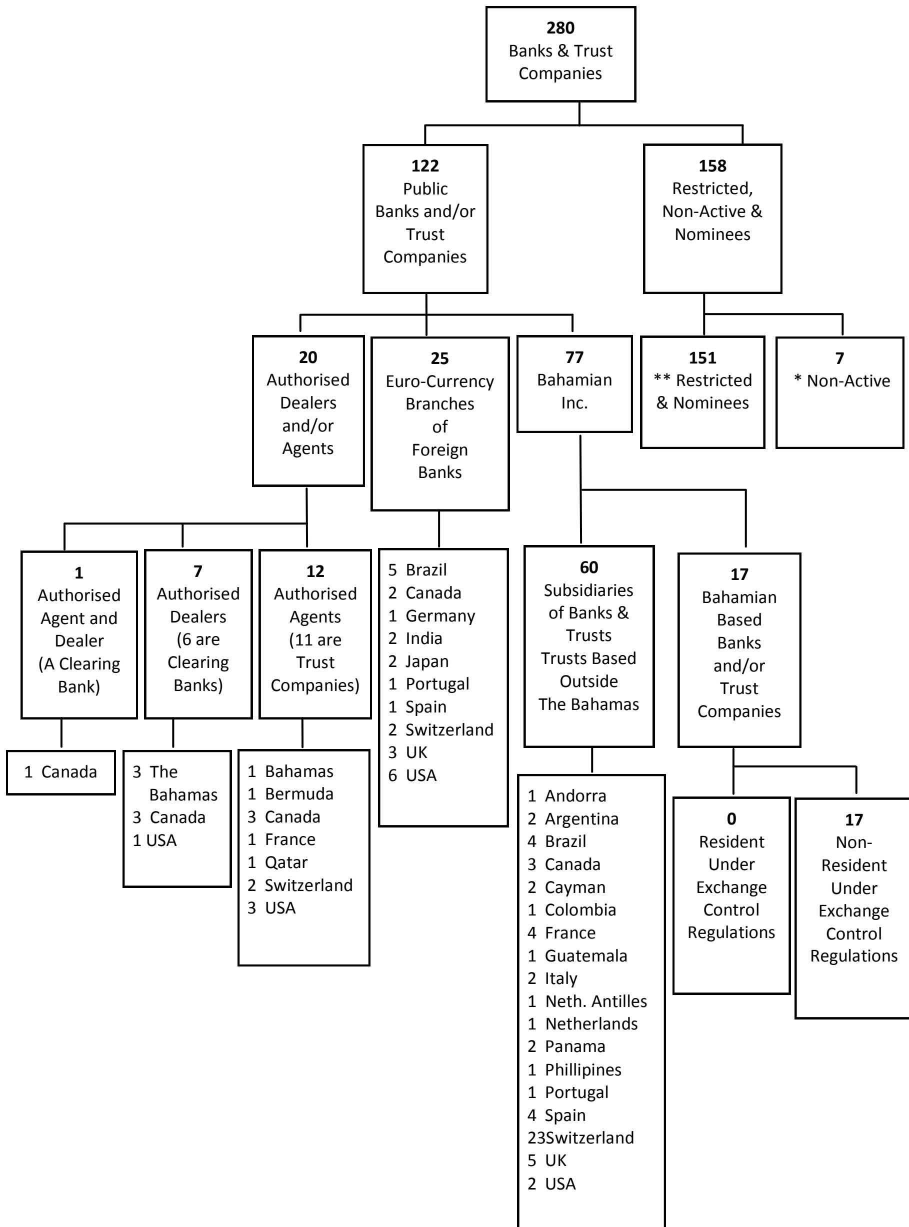
Inflation affects real saving when it grows faster than interest rates. Savers usually do not fare well in an inflationary or high risk environment. The view that repressing interest rates or making marginal reductions in lending rates will encourage borrowing is based on a particular set of conditions, and assumes that there will be no negative effect on savings. A high savings rate makes possible a high level of investment. In a market setting, however, savings are not automatically transformed into producing assets. In this respect public policy is too often ambivalent. What financial institutions do with the resources they mobilize often decide the quality

and pace of development. One of the dilemmas of development is that while risky areas with high transformational and growth possibilities may find it difficult to attract funds, safe or high return activities are favoured by lending institutions concerned with enhancing their own profit positions. Not surprisingly, one can have a situation with high liquidity subsisting side by side with low investment, zero or negative growth rates, increasing public debt and high levels of unemployment.

The financial sector contributes between five and 15 per cent of GDP in CARICOM economies. The sector is comprised of a range of bank and non-bank institutions providing services critical to social and economic development (See Table 2.11). These include commercial banks, life and non-life insurance companies, finance companies, trust companies, mortgage finance companies, building societies, merchant banks, credit unions, mutual funds, development banks, pension funds, stock exchanges, national insurance schemes, deposit insurance and central banks. There are others. Though small in number the commercial banks sub-sector accounts for the largest share of assets. In Trinidad and Tobago, for example, this is about 40 per cent if the assets of the Central Bank are excluded. In recent years some countries in the region have been trying to promote themselves as centres for offshore or international banks which are permitted to do business largely with non-residents. Barbados, Belize and some ECCU member states have attracted a number of such institutions. According to the most recent data (2008) the offshore financial sector in Barbados contributed BB $60 million (2%) to government revenue and employed 1216 persons (less than 1%) of the labour force. In Belize the nine international banks registered there had assets totaling BZ $358 million in 2007. The Bahamas, of course, has an international reputation as a tax haven and offshore financial centre. As of end of June 2010, 280 banks and trusts were registered in the Bahamas, but only a small number of these were licensed to do business with local residents (See Chart 2.8). In the ECCU the offshore or international sector currently has 41 banks, over 54,000 IBCs (International Business Companies), 1,187 trust companies and 119 insurance companies.

Stock markets are relatively new in the Caribbean (CARICOM countries). Their introduction coincides with a perceived need to increase investment and to spread ownership of domestic companies. The first (the Jamaican stock exchange) was established in 1969. This was followed by one in Trinidad and Tobago in 1970, and another in Barbados in 2001. In the

Chart 2.8: Banks and Trust Companies Licensed in The Bahamas as at 30th June, 2010



** 1 Authorised Agent is counted here, as it holds a Non-active licence.*
** 1 Authorised Agent is counted here, as it holds a Restricted licence.*
Source: The Central Bank of the Bahamas

Table 2.11: Number of Financial Institutions 2008

Financial Institutions	Barbados	Belize	ECCU[1]	Guyana	Jamaica	Suriname	Trinidad & Tobago
Commercial Banks	7	5	40	6	7	8	8
Finance Companies and Merchant Banks	13[a]		16[b]	4	3[a]		10
Trust and Mortgage Finance Companies				3			7
Development Banks		1	6		1		1
Credit Unions	35	13	61	45	48	28	130
Insurance Companies	30	13	161	11	18	13	51
Thrift Institutions							3
Home Mortgage Bank							1
Private Registered Pension Funds				28		32	256[c]
Licensed Foreign Exchange Dealers				21			
Micro Finance Companies				3			
Building Societies			4	1	4		
National Export-Import Banks					1		
International or Offshore Banks	50	9	37				
Mutual Funds	17	1					
Government Savings Bank		1					
National Development Foundations			6				
Stock Market or Exchange	1		1	1	1		1
Central Bank	1	1	1	1	1	1	1
National Insurance Scheme or Social Security Board	1	1	8	1	1		1
Other			26[d]		1[f]	6[e]	

Note: Blank boxes indicate unavailability of information.

a Includes trust companies.

b Include trust and mortgage finance companies.

c Refers to self-administered pension plans which are supervised by the Central Bank. The figure excludes insured pension plans, pension plans to be wound-up and those under judicial management.

d Money transfer services.

e Provident funds and savings funds.

f The National People's Cooperative Bank of Jamaica.

1 Figures represent the total number of institutions operating in all member states of the ECCU. The same institution operating in more than one member state would be counted more than once. The number of commercial banks range from two in Montserrat to eight in Antigua. The number of insurance companies range from seven in Montserrat to twenty seven in St. Lucia.

latter country the stock exchange succeeded the Securities Exchange which was set up in 1987. Since then stock exchanges have been set up in The Bahamas, the Eastern Caribbean and Guyana, as well as in some Caribbean countries outside of CARICOM. As a mechanism for raising capital or investment, stock markets have not lived up to the initial expectations.

Some of the reasons normally advanced for this include the continued preference for bank credit, the family ownership of businesses and unfamiliarity with the working of a stock exchange by the general population.

Financial innovation has been a slow process in the financial sectors of various countries over many decades. In more recent years however, the rapid advances in technology have had a major impact on financial institutions and markets. Efficiency has increased and competition has become more intense. New instruments and techniques have emerged as a result of advances in mobile communication, the spread of the internet and the development of satellite technology. At the same time techniques such as securitization have made finance more complex and difficult to regulate.

In the early post-independence years, increasing local ownership and taking control of key sectors of the economy was a major plank of development policy. Many foreign institutions reduced their role in the economy or pulled out completely. With the adoption of more open and less nationalistic policies in recent years, some have returned. In Guyana the major banks were nationalized in the 1980s, but, starting in 1994, the banks gradually returned to private ownership in the following eight years as part of the de-nationalisation process. Three of the six commercial banks are foreign-owned and account for about two thirds of commercial banks assets. Bank assets amount to about 46 per cent of total financial sector assets. In Trinidad and Tobago five of the six commercial banks were either fully or majority owned by nationals or domestically owned corporations in 1996. Through mergers, acquisitions and rebranding the situation has changed dramatically since then. Today, six of the eight banks are either majority or fully owned by foreign entities. The number of branches increased from 117 in 1995 to 134 in 2009. The sector is highly concentrated. Four of the largest institutions account for about 90 per cent of bank assets. In Suriname the government holds an interest in five of the eight commercial banks. Three are wholly-owned and one majority (51%) owned. The three largest banks account for about 80 per cent of total assets and deposits. In Barbados all six banks (one branch and five subsidiaries) are foreign owned. Four have their headquarters in Canada, one in Trinidad and Tobago and one in Bermuda. The three largest banks hold 70 per cent of total bank assets. In Belize where the banking sector is also foreign dominated, two banks account for some 66 per cent of the

banking sector's assets. In the ECCU states there are 40 banks ranging from eight in Antigua to two in Montserrat. A particular bank operating in more than one member state is counted more than once. Of the 40 banks there, 26 are branch banks and 14 indigenous banks. The foreign branch banks account for 55 per cent of total bank assets, while the indigenous banks hold 45 per cent. In Antigua, the Bank of Antigua, which was owned by the Stanford Financial Group, was taken over by the Eastern Caribbean Central Bank in 2009 following a run on that bank, and later transformed into another entity (Eastern Caribbean Amalgamated Bank) with the government and other local institutions owning 40 percent.

In the non-bank financial sector there has also been significant growth and restructuring since the mid-1990s. Closures, mergers, acquisitions and rebranding have changed the configuration of the sector which is dominated by insurance companies. In Guyana, for example, where the assets of Non Bank Financial Institutions (NBFIs) increased almost fivefold between 1996 and 2007, insurance companies accounted for almost 30 per cent of the sector's assets. In Belize, gross premium income increased by close to 300 per cent between the mid-1990s and 2007. In Trinidad and Tobago, gross premium income of the life insurance sector increased by an average of 11.3 per cent (12.9 per cent for the non–life sector) a year between 2003 and 2008. In 2009, however, gross premium income for the life insurance industry fell by over 50 per cent as a result of the collapse of CLICO and British American Insurance which accounted for over 50 per cent of gross premium income of the sector. In Barbados, while the number of credit unions has declined since 1996 membership increased from 54,505 in 1996 to 148,604 (53 % of the population) in 2008. Credit unions are an important part of the culture and financial landscape of all Caribbean countries. There are over 350 in the CARICOM region. In Trinidad and Tobago, while the number of finance companies and merchant banks changed only marginally (from 10 to 11) between 1995 and 2009, the number of branches increased from 12 to 30 over the period. At the same time the number of loan accounts increased from 8,425 to over 40,000. In Suriname, banks account for over 70 per cent of financial assets as compared to about 20 per cent for pension funds, eight per cent for insurance companies and two per cent for credit unions and cooperatives.
Though the growth of some categories of financial assets has lagged behind that of GDP, generally financial assets have been growing at a faster rate than GDP. This applies particularly to commercial banks. The ratio of bank assets to GDP has been increasing at a faster rate in Barbados and ECCU

Table 2.12: Financial Assets as a % of GDP

Jamaica			
Institutions	**1990**	**2000**	**2009**
Commercial Banks	56.5	57.7	52.9
Finance Houses	0.9	0.3	0.2
Merchant Banks	14.8	2.0	3.0
Building Societies	9.7	11.6	14.8
Credit Unions	2.7	3.9	5.3
Trinidad & Tobago			
Institutions	**1990**	**2000**	**2009**
Commercial Banks	54.4	64.1	83.7
Finance Companies and Merchant Banks	5.4	9.3	10.8[a]
Trusts and Mortgage Finance Companies	na	17.5	6.9
Thrift Institutions	na	0.2	0.1
Trustee Funds Under Administration	na	27.1	44.0
Development Banks	na	2.6	3.0
Barbados			
Institutions	**1990**	**2000**	**2009**
Commercial Banks	56.5	84.4	143.4
Trusts & Mortgage Finance Companies	10.0	8.8	9.6
Finance Companies and Merchant Banks	1.5	3.7	8.7
National Insurance Fund	8.1	16.1	31.6
Credit Unions	3.9	7.4	16.9
Insurance Companies	14.6	10.3	na
Guyana			
Institutions	**1990**	**2000**	**2009**
Commercial Banks	91.3	90.6	99.2
New Building Society	10.6	11.2	14.9
Trust Companies	3.2	4.6	2.9
Finance Companies	na	3.8	13.9
Insurance Companies	18.6[b]	9.8	10.1
Pension Schemes	2.2	7.9	8.1

a 2008
b Life
na not available
Source: Computed from official publications.

than in the other countries. In Barbados the ratio increased from 70 per cent in 1995 to over 140 per cent in recent years. In the ECCU it almost doubled in the period reaching over 200 per cent in 2009. In The Bahamas, Belize and Guyana the ratio has also increased steadily since the mid 1990's. In The Bahamas it has crossed 100 per cent. In Jamaica bank assets as a proportion of GDP has remained fairly steady at around 56 per cent on average. In Trinidad and Tobago the ratio tended to decline in the late

1990s, averaging 64 per cent between 1995 and 2008. The figure increased to 84 per cent in 2009 partly as a result of the fall in GDP.

Table 2.12 shows that different types of financial institutions have grown at different rates. For example, in Trinidad and Tobago trustee funds under administration increased from TT $13,937 million (27% of GDP) in 2000 to TT $54,608 million (44% of GDP) at the end of 2009. In Jamaica the assets of building societies and merchant banks increased 3.6 times and 4.1 times respectively between 2000 and 2009 compared to a threefold increase in GDP. With respect to commercial banks assets, however, these have grown at an average annual rate of 11.9 per cent compared to 10.2 per cent for GDP since 1995.

Table 2.13: Bank Assets as a Percentage of GDP

	Bahamas	Barbados	Belize	ECCU	Guyana	Jamaica	Trinidad and Tobago
1995	78.9	70.5	54.0	106.3	65.2	60.7	63.3
1996	82.1	81.2	54.8	109.2	78.5	57.3	66.4
1997	74.8	83.3	60.2	114.9	83.7	57.5	74.2
1998	103.8	79.0	62.7	121.0	93.0	63.5	69.5
1999	107.5	83.0	63.2	128.4	84.2	55.9	67.5
2000	83.3	84.3	65.3	136.1	90.6	57.6	64.1
2001	88.2	92.7	67.9	143.4	93.2	57.1	69.3
2002	92.1	106.0	66.8	152.5	97.5	56.0	72.4
2003	95.3	111.7	70.6	156.5	93.7	57.8	65.3
2004	101.6	114.0	74.0	166.2	93.9	55.5	60.7
2005	101.8	112.6	76.4	174.2	98.7	52.8	58.4
2006	106.6	116.7	78.1	177.6	98.4	54.7	58.6
2007	112.7	140.6	83.7	191.3	93.8	55.0	57.3
2008	120.9	148.0	89.6	187.5	98.5	53.9	51.5
2009	124.6	143.3	93.4	204.6	99.2	52.8	83.8

Source: Computed from Official Publications

Deposits provide the bulk of the funds used by commercial banks for lending or investment. At the end of 2009 they accounted for 78 per cent of total assets in Barbados, 62 per cent in Jamaica, 66 per cent in the ECCU, 84 per cent in Guyana, 66 per cent in The Bahamas, 77 per cent in Belize and 68 per cent in Trinidad and Tobago. In the latter country saving deposits tend to account for the largest share of bank deposits, on average about 35 per cent. Demand and time deposits on average contribute about 32 per cent each to the total. In Barbados, saving deposits also dominate, accounting for 46 per cent of total bank deposits at the end of 2009,

compared to 36 per cent for demand and 18 per cent for time respectively. In the same period, savings deposit accounted for more than half of total deposits in Jamaica, 61 per cent in Guyana and 18 per cent in Belize where time deposits tend to dominate, accounting for 61 per cent of the total. The deposits to loans ratio varies widely across the region. At the end of 2009, Trinidad and Tobago was at the high end with 160 per cent (when foreign currency deposits are included), while The Bahamas was at the lower end with less than 100 per cent.

Table 2.14: Foreign Currency Deposits (US $Millions)

End of Period	2001	2005	2006	2007	2008	2009	2009 % of Total Deposits
Bahamas	91.8	144.2	159.1	200.1	201.3	231.9	4.9
Barbados	242.1	583.4	520.2	856.0	663.9	598.5	13.6
Belize	61.3	85.6	37.6	41.7	31.9	33.1	3.3
Guyana	315.7	558.0	682.7	767.6	708.8	714.8	31.7
ECCU	500.9	745.7	932.0	1,011.7	990.2	1,088.5	17.9
Jamaica	946.2	1,572.4	1,598.0	1,741.3	1,602.8	1,665.3	29.4
Suriname	170.6	384.3	475.9	614.3	596.0	839.7	54.0
Trinidad & Tobago	854.7	1,296.8	1,798.5	2,025.9	2,678.3	3,735.8	32.0

Source: CCMF and Official Publications

A noticeable feature in regional financial systems is the growing volume of foreign currency deposits which account for varying proportions of total bank deposits in the various countries. In Barbados, for example, foreign currency deposits increased from US $47 million (5.1% of total deposits) in 1990 to US $598 million (13.6% of total deposits) in 2009. In Trinidad and Tobago, the figure increased from US $366 million (18.5% of total deposits) in 1995 to US $3,640 million (32% of total deposits) at the end of 2009. In this country foreign currency loans has averaged around 22-23 per cent of total loans in recent years. With over a 50 per cent foreign currency deposit ratio, Suriname would be the most dollarized country in the CARICOM region. Besides a reserve requirement of 25 per cent on local bank deposits, Suriname has also instituted a reserve requirement of 33.3 per cent on foreign currency deposits. This growth in foreign currency deposits in recent years has taken place in a situation where the local currency deposit rates have been higher than those of foreign currency deposit rates which in the case of Trinidad and Tobago have averaged around 2-2.5 per cent. In Jamaica the weighted average interest rate on foreign currency deposits has been around four to five per cent in recent

years compared to six to seven per cent for local currency deposits. This would suggest that foreign currency is being held for reasons other than that of return.

A bank's balance sheet in many ways reflects the environment in which it operates. One critical parameter which influences bank behaviour is the prevailing statutory requirement which itself is related to monetary policy objectives and conditions in the economy. The demand for loans and a bank's concept of prudence will also determine how much of its resources take the form of loans to the public and private sectors. Available investment opportunities (e.g. government securities, bonds) and interest returns also play a part in the allocation of investment resources. Having met statutory requirements, a bank then looks for the best mix of assets consistent with its liabilities structure that can meet its liquidity requirements and enhance its profit position.

Table 2.15: Composition of Commercial Banks' Assets (End of 2009, %)

	Balance with Central Bank	Loans and Advances	Investments	Foreign Assets	Other	Total
Bahamas	3.9	72.0	10.9	7.0	6.2	100.0
Barbados	4.3	52.4	14.2	16.5	12.6	100.0
Belize	9.4	71.4	4.3	8.1	6.8	100.0
ECCU	5.2	60.2	4.6	1.4	28.6	100.0
Guyana	14.1	27.0	23.3	10.7	20.9	100.0
Jamaica	14.8	44.8	11.1	20.0	9.3	100.0
Trinidad & Tobago	14.7	43.6	18.2	10.0	13.5	100.0

Source: Official Publications

The data in Table 2.15 show that the structure of bank assets varies from country to country in the region, but generally loans and advances take a much higher share of resources than investments. The amount of resources held at the Central Bank (for statutory or other reasons) is not insignificant in Guyana, Jamaica and Trinidad and Tobago. Part of this reflects statutory requirements, but there may also be interest -bearing deposits related to attempts to deal with excess liquidity.

In the context of the global financial crisis and the failure of a number of financial institutions in the region, certain issues have arisen with respect to the operation of various categories of financial institutions and the out-

Chart 2.9: Bank Asset as a Percentage of GDP

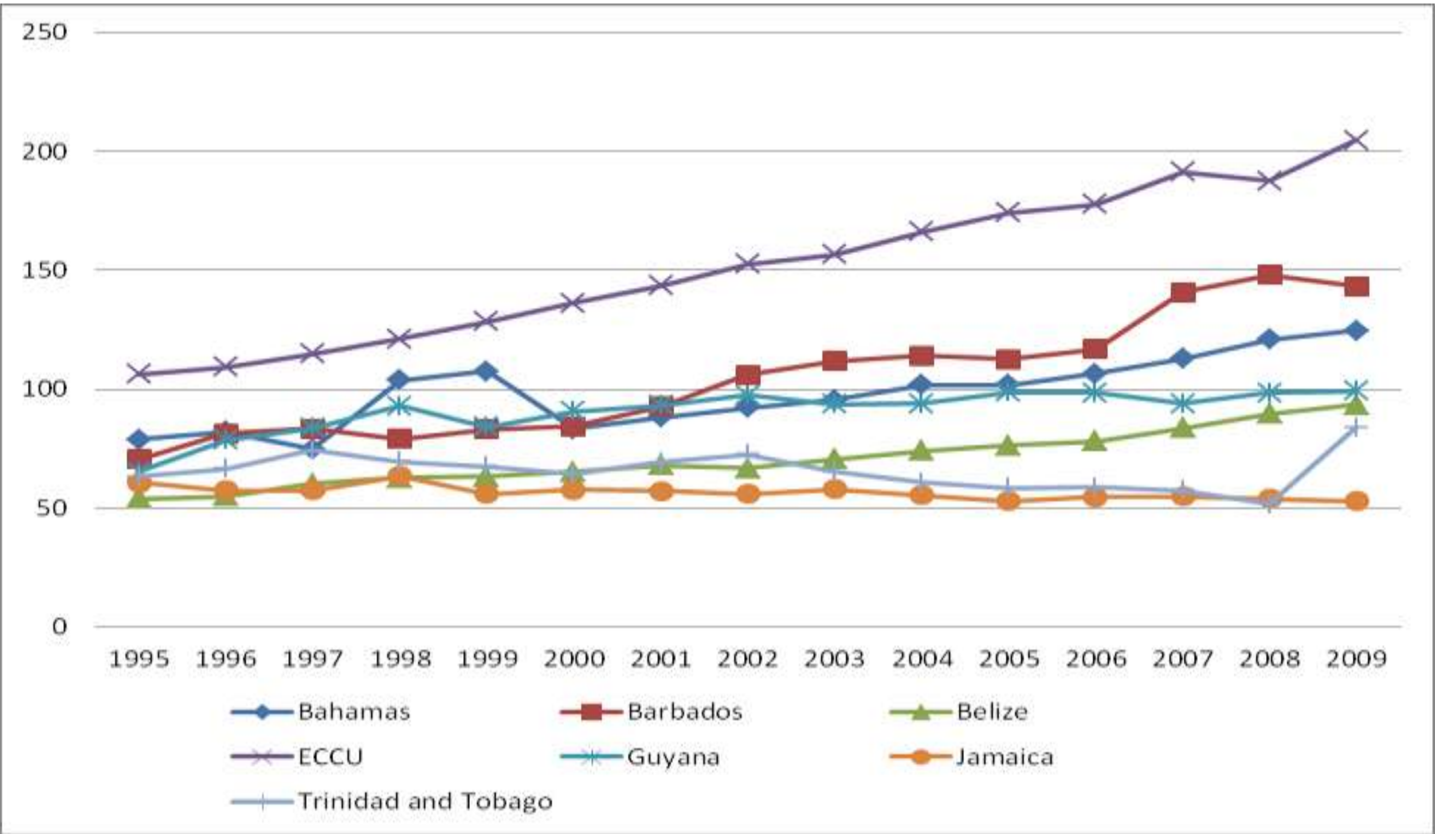
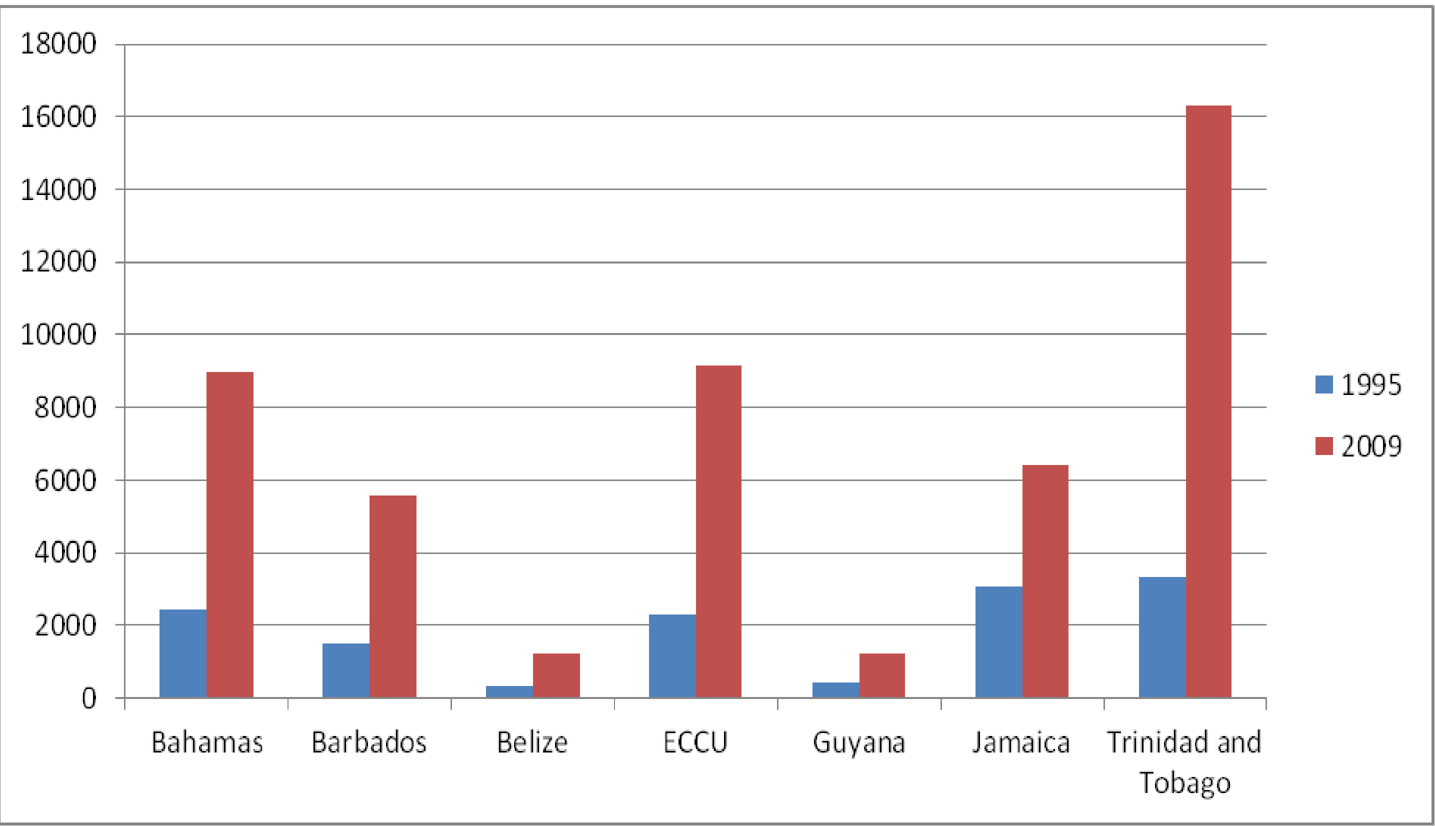


Chart 2.10: Bank Assets 1995 and 2009 (US $Millions)

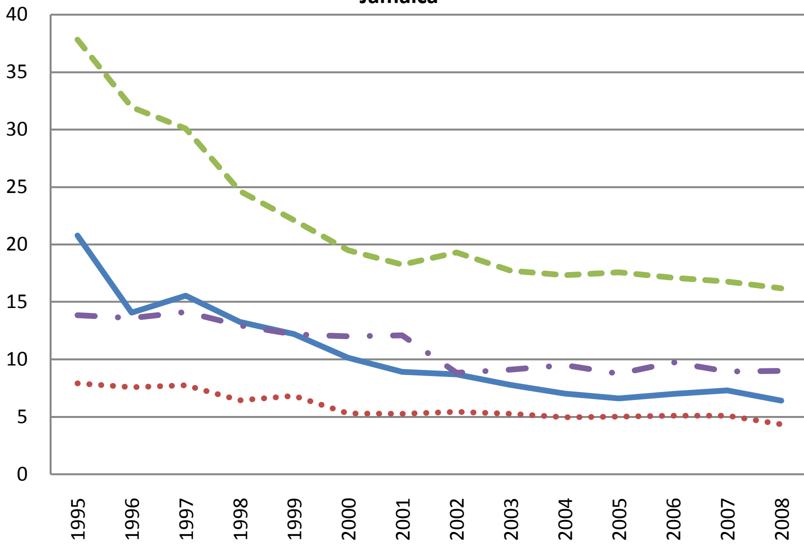


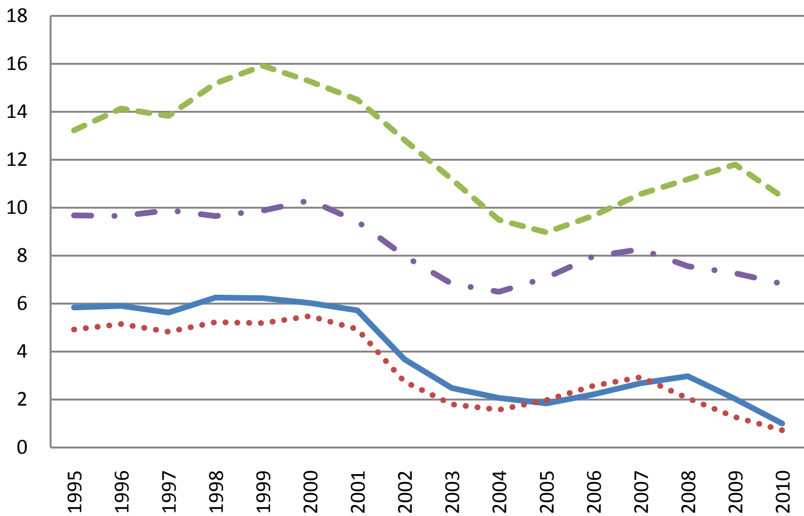
datedness or adequacy of the relevant regulatory framework. One is the blurring of the lines between banks and non-bank financial institutions in terms of the products they offer, and what this means for not only the fairness of the 'playing field' and competition, but for effective regulation. Another is the adequacy of the capital base of various types of financial institutions. In many cases there is no legal stipulation for capital requirements. With respect to commercial banks, these institutions have not been too adversely affected by the international financial crisis. Commenting on the Trinidad and Tobago situation a recent Central Bank report had this to say: "The banking system has remained well-capitalized throughout the decade. While there has been a modest decline since the early 2000s, the average level of regulatory capital to risk-weighted assets over the last three years to 2008 has been in excess of 18 per cent. The level compares with a minimum regulatory requirement of eight per cent. The significant capital buffer is an excellent indicator of the banking system's ability to cope with internal challenges (such as an increase in non-performing loans) as well as exogenous shocks"[5] The report further argued "that a strong capital base, conservative operating policies and robust overall health" (p 30) have helped the banking system to cope with challenging situations.

Non-bank institutions, particularly where they are part of a conglomerate involved in financial and non-financial business, are more difficult to regulate. In the late 1980s and 1990s the emergence of groups of different types of financial institutions in Jamaica "to take advantage of opportunities for minimizing the impact of regulations, supervision and taxation upon the group" [6] played a major part in the failure of the financial sector. The collapse of CL Financial in 2009 owed much to the complex structure of the group which was comprised of both financial and non-financial companies. In such situations it is difficult to tell what is a liquidity problem and what is a solvency problem. In both the Jamaican and Trinidad and Tobago crises, insurance companies were used to raise funds through the offer of deposit-like high interest rate products.

[5] Central Bank of Trinidad and Tobago, Financial Stability Report, 2008, p. 16.
[6] G. Bonnick, Storm in a Teacup or Crisis in Jamaica's Financial Sector, St. Augustine, CCMS, 1988

Chart 2.11: Commercial Banks: Local and Foreign Currency Weighted Loans and Deposit Rates





Weighted Deposits Rates Local Currency
Weighted Deposits Rates Foreign Currency
Weighted Loan Rates Local Currency
Weighted Loan Rates Foreign Currency

A review of the operations of CLICO, CLICO Investment Bank (CIB) and British American Insurance Company (BA) by the Central Bank of Trinidad and Tobago reveals financial adventurism and a degree of managerial incompetence bordering on recklessness, as well as a serious lapse in supervision.[7] Among other things CIB is 'charged' with:

- a loan portfolio which was risky in nature and of relatively poor quality.
- in order to mobilize funds, CIB paid interest rates which were significantly higher than the average for similar institutions. About 70 per cent of total deposits were related party deposits.
- funds were also mobilized through the issue of investment certificates which were not always covered by liquid investments held in trust.
- CIB's operations were affected by poor financial record keeping and weak corporate governance.

On the other hand CLICO's vulnerabilities included, *inter alia,* the following:

- a shift away from traditional insurance to a focus on the mobilization of short term deposit-like instruments paying guaranteed above-market interest rates.
- an asset liability mismatch deriving from a concentration of long-term assets (real estate and non-traded equities) whose rates of return depended heavily on capital appreciation.
- poor corporate governance practices.

The official explanation for this situation puts heavy emphasis on deficiencies in the regulatory legislation and the exploitation of these by CL Financial. Why these deficiencies persisted for so long has not been properly answered. There is speculation, however, that the close association between senior officials of the company and the major political parties in Trinidad and Tobago was used to shield the company from close scrutiny. Apparently nothing was learned from the Jamaican debacle in the 1990s. In a 1998 lecture one commentator made the following recommendations, *inter alia*, after reviewing the Jamaican experience.[8]

- Financial regulations should pay greater attention to the investment portfolio of institutions, and specifically ensure greater

[7] Central Bank of Trinidad and Tobago, Financial Stability Report, 2008, pp.25-26.
[8] G. Bonnick, op. cit., pp. 32-33.

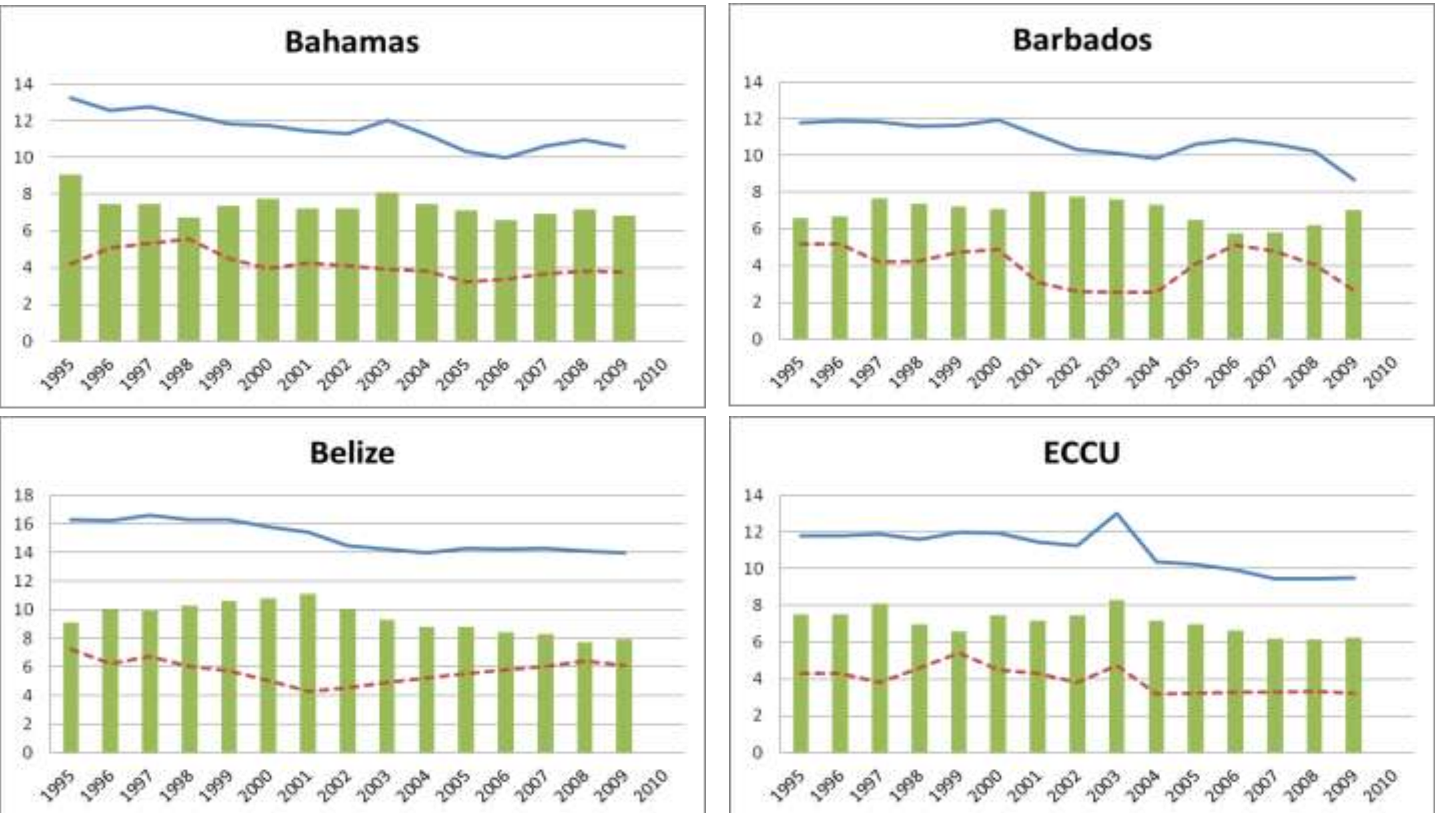
transparency of the risks being taken by the investment managers. Institutions often gambled with savers' funds.

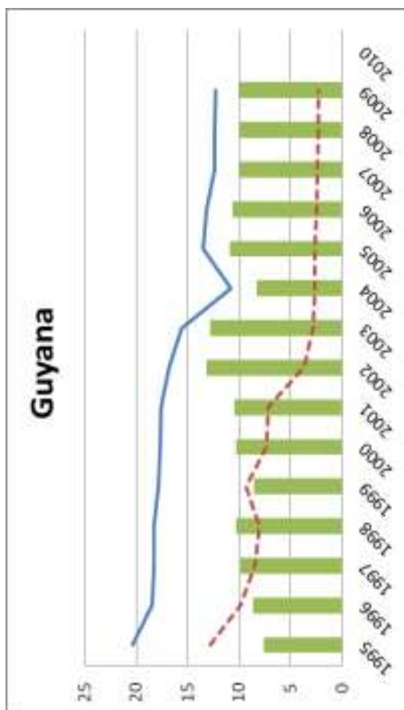
- Regulators should pay attention to whether leverage is excessive.
- Particular attention should be paid to transactions off the balance sheet.

In Antigua the run on the Bank of Antigua owned by the Stanford Financial Group followed international issues arising from a sister organization, the Stanford International Bank, an offshore bank registered in Antigua. In early 2009, Sir Allen Stanford, who was knighted by the Antiguan government in 2006 (knighthood revoked in April, 2010), and who was one of the biggest private investors in Antigua, was accused by the United States Securities and Exchange Commission of being involved in a US$ 8 billion fraud including running a Ponzi scheme and violating US securities laws. The Bank of Antigua was a domestic registered bank under the regulation of the Eastern Caribbean Central Bank (ECCB), and despite assurances by the Central Bank that the bank was not in trouble, the revelations about the group and the reported use of the Stanford International Bank in illegal operations instigated an intense run on the bank, which, as indicated earlier, was eventually taken over by the ECCB and transformed into a new organization. This experience has underlined concerns about the regulation of offshore banks.

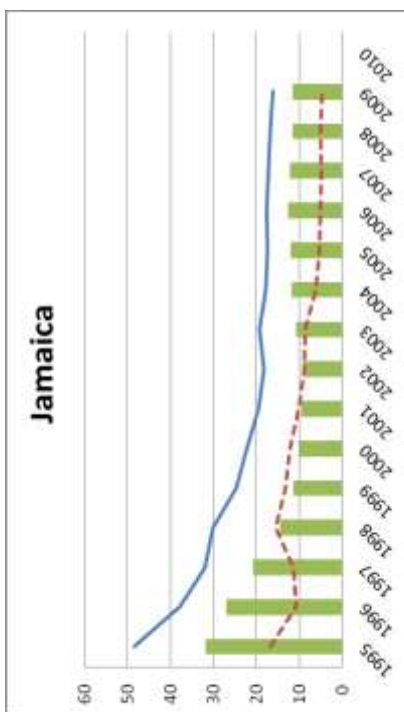
Another contentious issue relates to interest rate policy. One aspect of this issue comes from the often expressed concern over the margin between loan rates and deposit rates – i.e. the interest rate spread. The extent of the spread would depend on which rates are used. As can be seen in Table 2.16, the margin varies from country to country. In Trinidad and Tobago the spread for commercial banks has averaged around eight per cent in recent years based on the difference between the weighted average loan rate and the 3-month deposit rate. For non-bank institutions the spread tends to be lower. Foreign currency transactions are associated with a spread of just over five per cent. In The Bahamas, the ECCU and Barbados the local currency spread is on average slightly lower (7 to 7.5%) than Trinidad and Tobago's. In Belize, it has averaged around nine per cent in recent years, while in Guyana and Jamaica the spread averages over 10 per cent. Commenting on the Trinidad and Tobago situation in the late 1990s, an IMF report made the following observations. "The banking industry in Trinidad and Tobago presents a mixed picture with regard to competitiveness. None of the six banks is large enough to exercise

Chart 2.12: Commercial banks: Deposit Rates, Loan Rates and Interest Rates Spread





Commercial Banks Interest Rate Spread %
Average Weighted Loan Rate %
Deposit Rate %



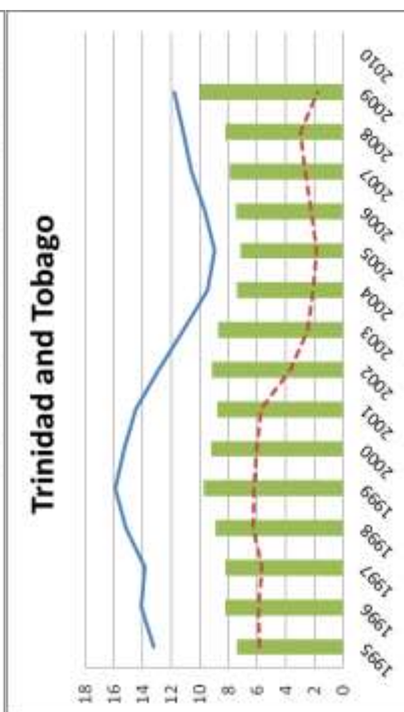


Table 2.16: Commercial Banks Loans and Deposit Rates

	Weighted Average Loan Rates (%)			Average 3-month Deposit Rates (%)			Savings Deposits %	Average Inflation Rate		Prime Lending Rate[1]	
	1991-1996	1997-2007	2008-2009	1991-1996	1997-2007	2008-2009	2008-2009	1991-2000	2001-2009	2000	2009
Bahamas	14.2	11.4	10.8	5.4	4.0	3.6	2.2	2.5	2.3	6.00	5.50
Barbados	12.4	11.0	10.0	5.0	4.0	3.5	3.7	2.9	3.9	9.50	8.20
Belize	15.1	15.0	14.2	6.3	5.4	6.3	5.2	2.0	2.7	na	14.08
ECCU	11.7	11.2	9.5	4.3	3.9	3.5	4.5	2.7	2.7	9.50	8.50
Guyana	23.4	15.6	12.3	15.7	5.2	2.3	3.0	8.3[a]	6.1	17.25	14.54
Jamaica	43.6	21.4	16.6	29.3	11.1	10.0	4.4	26.4	11.4	na	17.20
Suriname	22.4	21.9	na	10.7	11.5	na	na	101.9	14.3	na	
Trinidad & Tobago	13.2	12.3	12.6	6.9	4.4	3.0	1.5	5.5	6.5	16.50	13.00

na not available
a 1992-2000
1 End of year
Source: CCMF and official publications

monopoly power. However, their relatively small number, absence of new entry over many years, the large interest rate spreads, and record profits suggest a degree of monopolistic market power. This situation makes the banking system appear financially sound but it carries a hidden cost for the rest of the economy by keeping the costs of capital high and the incentive for financial savings low."[9]

The advocates of a low interest rate policy argue that such a policy is necessary to stimulate investment and growth and to increase the competitiveness of the economy. However convincing this argument, the monetary authorities (with one or two exceptions) in the region have largely refrained from fixing deposit or lending rates, leaving the market to determine their levels. Banks operate in different regulatory and macro-economic environments and incur a variety of costs that tend to influence the spread. Greater competition or lower reserve requirement can exert a downward pressure on the spread. More efficient operations can also lower cost and impact positively on profits. On the other hand the ability to operate with large spreads can discourage efforts to increase efficiency.

The payment of interest is an incentive for savers to save more. Even with a nominal zero or negative interest rate, saving will still take place, since people save for a variety of reasons. The question of a real return (nominal interest rate minus the inflation rate) to encourage financial savings and maintain real income has generated a fair amount of discussion in the literature. In Trinidad and Tobago, Suriname, Jamaica and Guyana the rate on short-term fixed and savings deposit tend to be negative. In The Bahamas, Belize and the ECCU where the inflation rate is lower, the rates tend to be positive.

2.8 Monetary and Exchange Rate Policies

Many of the early central banks set up in developing countries saw their main function as promoting growth and development. Undeveloped money and capital markets and the domination of the banking sector by transnational banks made it very difficult to control liquidity with traditional instruments of monetary control. In any event monetary policy was believed to be less effective than fiscal policy. Over time, central banks have increased the scope of their functions, in some cases expanding their

[9] IMF, Trinidad and Tobago – Selected Issues (IMF Staff Country Report No. 97/41, May 1997), p. 52

regulatory role to cover non–bank institutions. Today's central banks see the maintenance of financial stability as an important part of their evolving functions. Legislation, however, are not often specific on how to do this. About three decades ago targeting the money supply at some constant growth rate was widely accepted as the anchor of monetary policy. Implicit in this policy was that money supply growth causes inflation and the velocity of circulation was stable, or at least predictable. Unstable money demand functions, however, soon made nonsense of this approach. In the 1990s inflation targeting, with or without a medium term numerical target, gained popularity in several countries. A major advantage of this approach, which requires a well-functioning money and capital market, is that it can help build policy credibility by putting low inflation as the primary goal of monetary policy. Implementation, however, requires some stringent conditions including putting fiscal policy in a subsidiary role to monetary policy and allowing wages, interest and exchange rates to be freely determined.[10] Not many developing countries, however, are able to operate a freely floating exchange rate system. Some countries now believe the exchange rate is the most critical instrument in maintaining a stable environment in an open economy, and tend to either peg their rate to a low inflation country, or operate a highly managed system. Whatever the approach taken, price stability ranks high on the agenda of modern central banks.

With the exception of Jamaica, the money supply (both in its narrow and broad versions) has grown at a faster rate than nominal GDP since the mid-1990s. In effect this means that the money supply (one form of wealth) as a proportion of GDP has been increasing. As indicated earlier, this is often viewed as one indicator of the increasing monetization of the economy. With the exception of Jamaica, M1 and M2 have also grown at a faster rate than the average inflation rate (See Table 2.18).

Some degree of inflation is difficult to avoid in practice. Many countries are prepared to accept some inflation if it leads to higher levels of growth and employment. High inflation rates, however, are strongly disliked by policy-makers if only because they influence behaviour in a way that impacts negatively on key variables in the economy. It is an intermediate target used to achieve other objectives. Inflation rates are fueled by a variety of factors, including monetary and fiscal policies, import costs,

[10] See A.A. Hossain, Central Banking and Monetary Policy, 2009, pp.208-209

disequilibrium in goods and services market, wage settlements in excess of productivity increases and exchange rate movements. Some of the same instruments through which inflation is generated can also be used to reduce it. The policy trajectory is important, given the possibilities for trade-off between price stability and other objectives, such as growth and employment.

Table 2.17: Money Supply as a % of GDP

	M1		M2	
	1995-1997[a]	2007-2009[a]	1995-1997[a]	2007-2009[a]
Bahamas	13	17	64	76
Barbados	19	47	58	118
Belize	13	26	50	72
ECCU	14	19	59	81
Guyana	15	25	58	76
Jamaica	11	9	24	20
Trinidad and Tobago	10	11	31	32

Note: Figures rounded
a Average for period
Source: Calculated from official publications

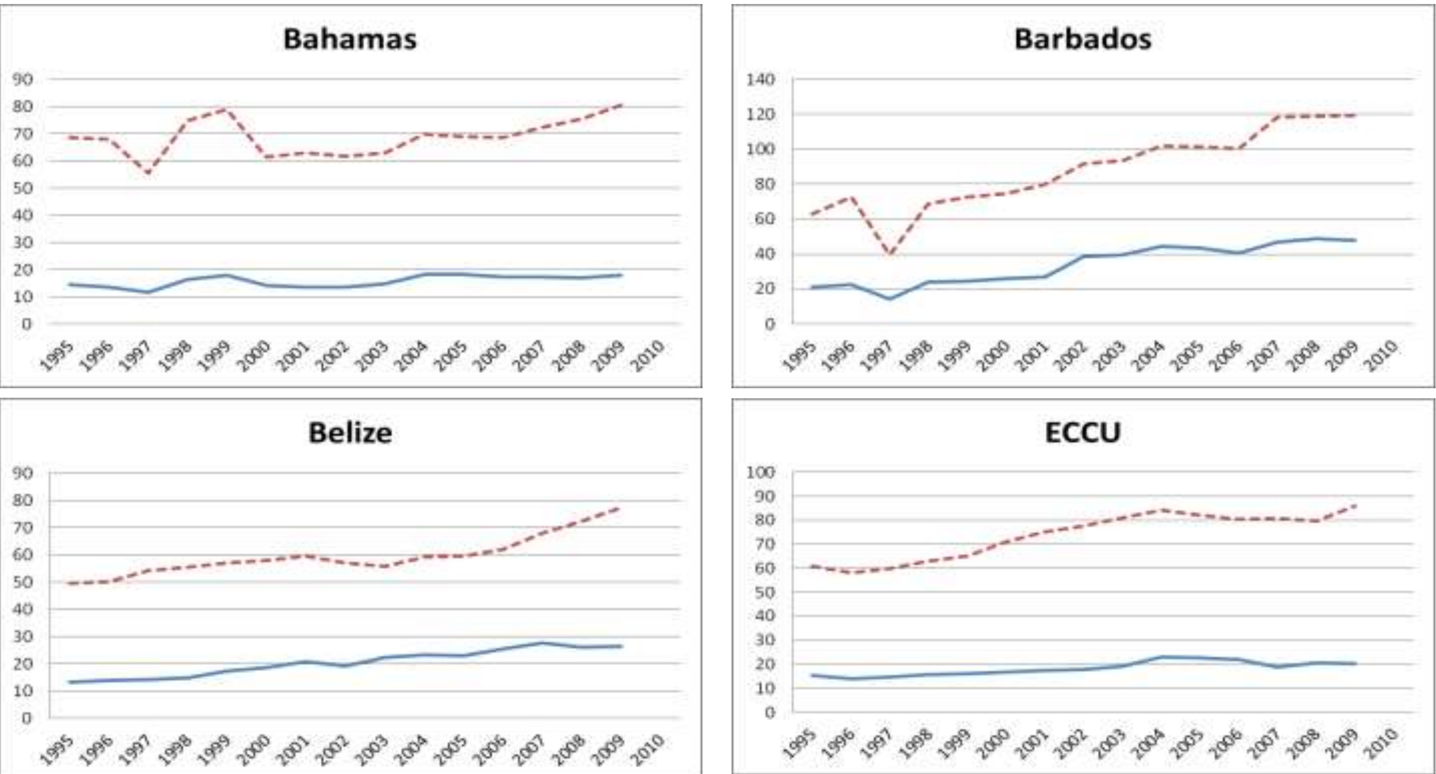
Table 2.18: Average Annual Inflation Rate and Average Growth of Nominal GDP and the Money Supply[1] (%) (1995-2009)

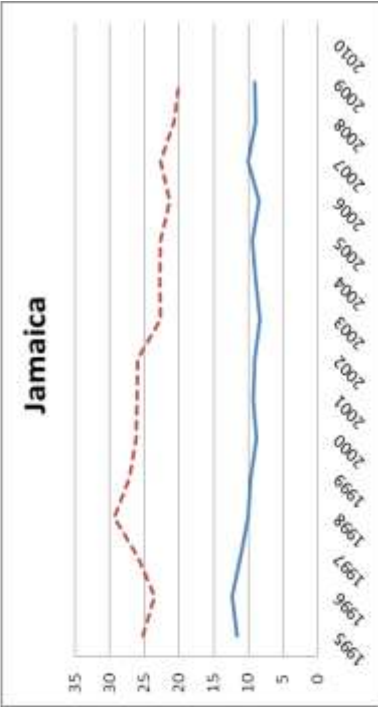
	Average Inflation Rate %	Nominal GDP Growth Rate %	M1 (%)	M2 (%)
Bahamas	1.9	4.3	7.2	7.5
Barbados	3.6	4.4	10.7	9.2
Belize	2.2	5.7	11.0	9.1
ECCU	2.9	5.3	6.3	7.5
Guyana	6.0	7.8	11.7	10.6
Jamaica	12.0	12.6	11.6	11.3
Trinidad & Tobago	5.5	10.2	13.5	11.4

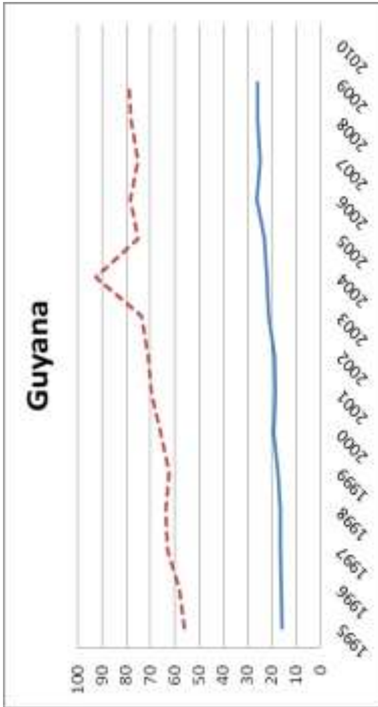
1 Excluding foreign currency deposits
MI Narrow Money: Currency in circulation plus bank demand deposits
M2 Broad Money: MI plus bank savings and time deposits
Source: Calculated from official publications

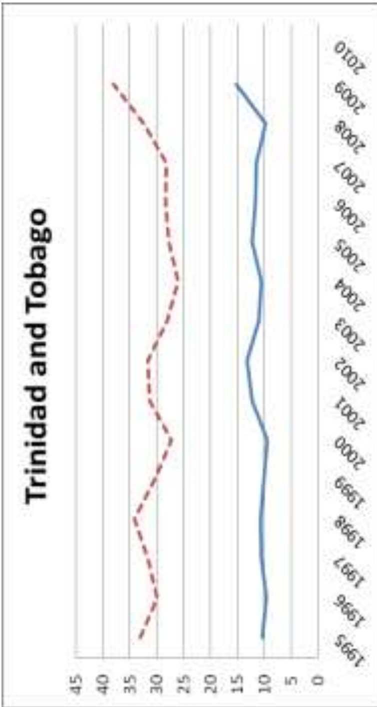
The expansion of the money supply through the monetisation of fiscal deficits has been a major cause of inflation in many countries. When the supply response cannot meet additional demand the effect is quickly felt on prices, the exchange rate and the foreign reserves. If the exchange rate is fixed, the impact will be on the foreign reserves. A commitment to a fixed exchange rate is therefore inconsistent with expansionary monetary and fiscal policy. Financing deficits by borrowing from sources other than the central bank poses less of a risk to financial stability but may carry a

Chart 2.13: Narrow Money (M1) and Broad Money (M2) as a % of GDP









M1 = Currency in Circulation plus Demand Deposits

M2 = M1 + Bank Savings and Time Deposits

heavy servicing cost in terms of revenue and foreign exchange in the absence of economic expansion.

Income (or GDP) divided by the money supply provides a measure of the money or income velocity of circulation which reflects the speed with which money moves or changes hands in the economy in a particular period. The velocity of money, which has a long and controversial history in the economics literature, is not independently measured. Depending on the kind of assumptions one makes about velocity in the equation of exchange, the money supply can be linked directly to prices or national income. Some, inclined towards the quantity theory of money, assume that velocity tends to remain constant or fairly stable, at least in the short run. Others take a different view, arguing that it is affected by a range of factors which make it very unstable. How the money supply is defined would, of course, influence the value of velocity.

In most cases, the velocity of money has been falling as a result of the trends in the two variables that define it (see Tables 2.19 and 2.20). In Jamaica, however, the velocity of both M1 and M2, has tended to increase. In Trinidad and Tobago the M1 figure has shown a slight decline since 2000 while the M2 figure has shown a slight increase. With respect to both M1 and M2, Jamaica and Trinidad and Tobago have the highest velocities. Interestingly, Jamaica, Guyana and Trinidad and Tobago are associated with the highest inflation rates in the region. The moderate inflation rate in most CARICOM countries may explain the falling income velocity of money. In inflationary situations, there is a tendency for the velocity of circulation to increase since people are less inclined to hold money. The incentive to hold money is affected more by expected rate of inflation than by actual rate. Attractive interest rates, particularly on short term securities, may have the same effect. Based on the standard deviation the velocity of M2 is far more stable than the velocity of M1 in all the countries.

In the period since 1990, the inflation rate in Belize, The Bahamas and ECCU member states has averaged less than three per cent per year. The Barbados rate has been slightly higher, around 3.3 per cent, while the rate for Trinidad and Tobago has been close to six per cent per year. In Guyana where the nominal exchange rate has been depreciating since the early 1980s, the inflation rate averaged 88 per cent per year in the 1989-91 period, but has since fluctuated between 16.8 per cent (1994) and 1.5 per cent (2001), averaging close to seven per cent between 1992-2009. In

Jamaica, where the nominal exchange rate has also been depreciating, the inflation rate has been relatively high averaging some 12 per cent in the period 1995-2009. With a stable currency in the 1980s, Suriname experienced an inflation rate of less than 15 per cent per year in that decade. With the emergence of significant fiscal deficits in the early 1990s financed largely by the Central Bank and the adoption of a multiple exchange rate system between 1992 and 1994, there was a sharp spike in prices averaging almost 400 per cent per year, between 1992-1995. In the later part of the 1990s decade there was again a sharp increase in prices (averaging 71 per cent per year in the period 1998-2000), associated with the deterioration in the overall fiscal balances. Since 2002 the rate has trended downwards, averaging 9.1 per cent between 2003 and 2009.

Table 2.19: Income Velocity of Circulation[1]

	Narrow Money		Broad Money	
	1995-1997[a]	2007-2009[a]	1995-1997[a]	2007-2009[a]
Bahamas	7.7	5.6	1.6	1.2
Barbados	3.8	2.0	1.3	0.8
Belize	7.2	3.7	1.9	1.4
ECCU	5.8	4.7	1.3	1.2
Guyana	6.1	3.8	1.7	1.3
Jamaica	8.7	10.0	2.1	3.6
Trinidad & Tobago	10.0	8.6	3.3	3.4

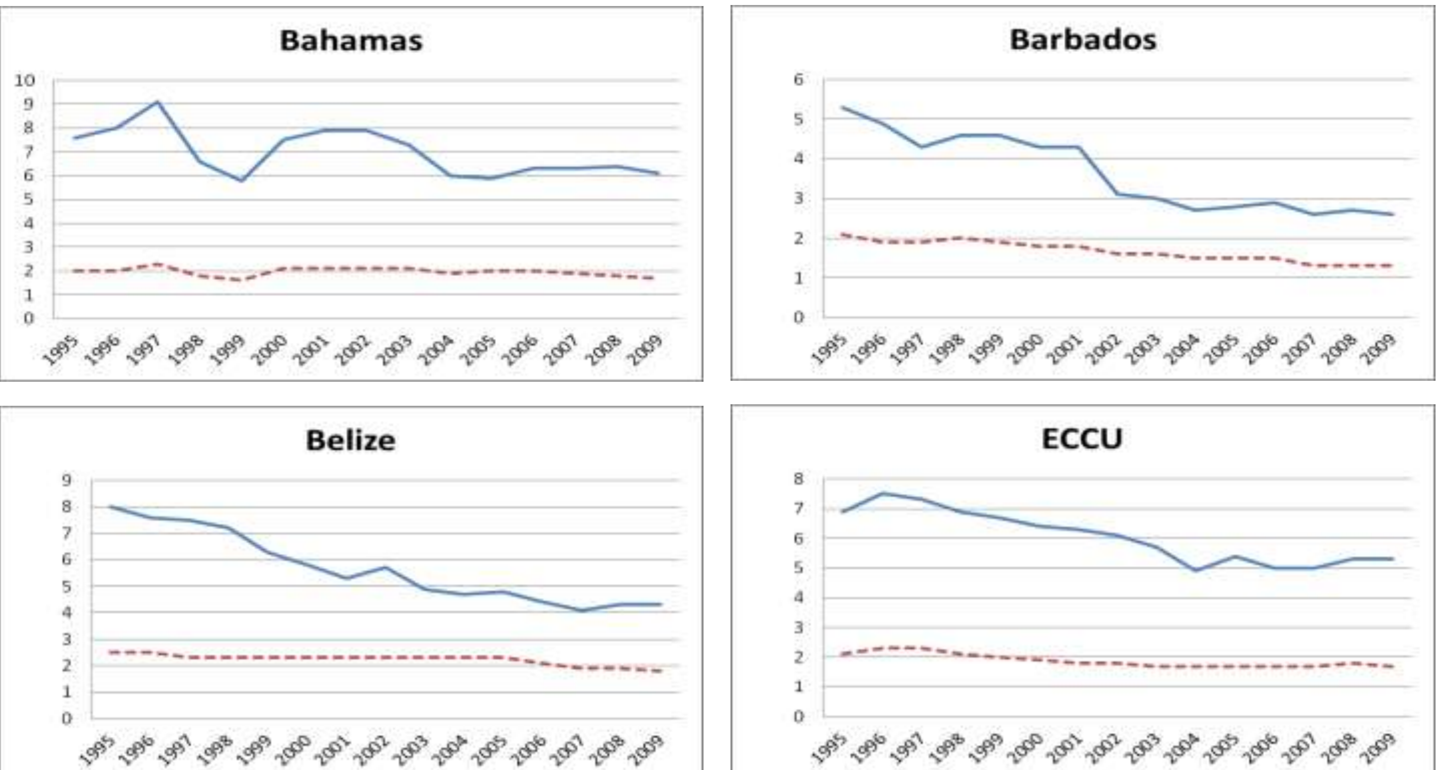
1 GDP at market prices divided by the money supply
a Average for the period
Source: Calculated from official publications

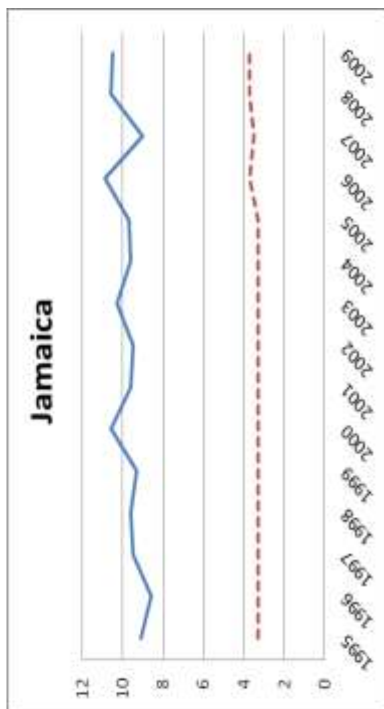
Table 2.20: Income Velocity of Money: Average Values (AV) with Standard Deviation (SD) (1995-2009)

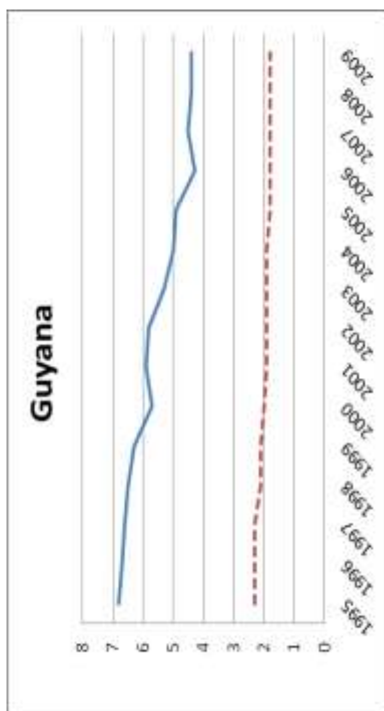
	M1		M2	
	AV	SD	AV	SD
Bahamas	6.98	0.99	1.96	0.18
Barbados	3.65	0.98	1.67	0.27
Belize	5.66	1.35	2.23	0.21
ECCU	6.05	0.88	1.89	0.22
Guyana	5.54	0.92	1.98	0.19
Jamaica	9.76	0.67	3.39	0.17
Trinidad and Tobago	9.35	1.15	3.84	0.46

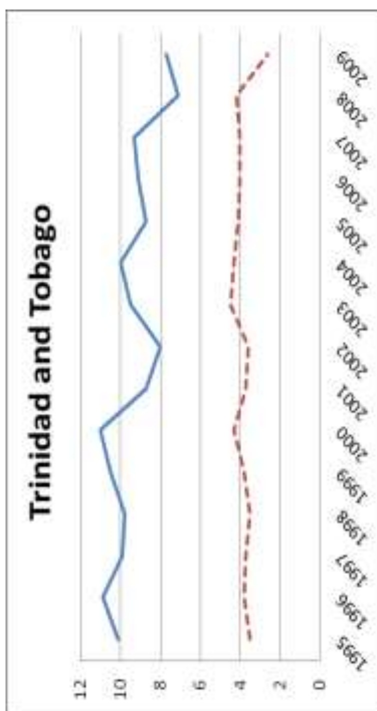
M1 Narrow Money: Currency in circulation plus bank demand deposits
M2 Broad Money: MI plus bank savings and time deposits
Source: Calculated from official publications

Chart 2.14: Income Velocity of Money









M1 = Currency in Circulation plus Demand Deposits

M2 = M1 + Bank Savings and Time Deposits

Central banks in the region use a number of different instruments to influence liquidity in the economy, some proving to be more effective than others. The traditional instruments include the cash or statutory reserve ratio, the liquid assets ratio, open market operations, and the bank or re-discount rate, and moral suasion. In more recent years these tools have been complemented in certain cases by the repo (or reverse repo) rate, special interest paying deposits in the central bank, the issuing of long term bonds, the selling of foreign currency to the banks and the extension of liquid assets requirements to non-bank licensed depository financial institutions.

The cash or statutory reserve requirement generally applies to banks, but can be extended to non-banks and are used by monetary authorities in response to developments in liquidity conditions in the economy. It is defined in terms of deposits and may also be part of the liquid assets ratio instrument. There is no universal figure for the reserve ratio which varies from country to country and from period to period. The cash reserve requirement has recently been reduced in Belize from 10 per cent to 8.5 per cent and is part of the liquid assets requirement. Basic statutory reserves are generally un-remunerated. The Eastern Caribbean Central Bank currently uses six per cent and this is applicable to all deposits. In Trinidad and Tobago when increasing un-remunerated reserves from 11 per cent of deposits in 2007 to 17 per cent in 2008 could not deal with an unusual liquid situation, the Bank offered an interest paying facility. Commercial banks do not like the traditional reserve instrument since they feel it gives an unfair advantage to institutions not subject to it. They also see un-remunerated reserves as a tax since they can generate income by lending or investing resources sterilized by the central bank. Lower or no reserve requirements, the commercial banks argue, would lead to lower lending rates, though this may not happen if the banks can maintain the spread between lending and deposit rates. The reserve requirement tool is, in effect, a direct and blunt instrument and monetary authorities are developing new methods of control. Some central banks have recognized that there is a case for moving away from heavy reliance on reserve requirements, one arguing that "the effect of central bank alterations on reserve requirements has been found to be short term and to have an uneven impact due to variations in institutional sizes and liquidity positions."[11] In Trinidad and Tobago, where fiscal policy has been at odds

[11] Central Bank of Belize, Annual Report 2009, p. 15.

with monetary policy in recent years, the Central Bank has come to rely less on reserve requirements and open market operations and more on the repo rate as a tool of monetary policy.[12]

With respect to open market operations, the securities market has suffered from volume and an active secondary market, legislative ceilings on the issuance of government securities and the tendency of financial institutions to hold securities to maturity in the absence of limited investment opportunities.[13] Excess cash reserves of commercial banks increased from TT $303 million at the end of 2007 to TT $1,936 million at the end of 2008. This took place against a background where the reserves requirement was changed from 15 to 17 per cent of deposit liabilities in November, 2008. Excess reserves averaged TT $2,257 million over the period October 2009 to mid-June 2010, compared with TT $1,629.6 million in the corresponding period of the previous year. The liquidity situation was largely driven by net fiscal injections which amounted to TT $11,913 million between October 2009 and June 2010 and TT $12,321 million in the corresponding period in the previous year.[14]

To deal with the abnormal liquidity situation, commercial banks have been requested to place interest bearing deposits with the Central Bank. At the end of June 2009 such deposits amounted to TT $2.3 billion (or 5.6 per cent of total deposits). The sale of foreign exchange to authorized dealers has also been used to absorb liquidity from the financial system.[15] The repo rate which was introduced in 2002 has become the principal monetary policy instrument to influence market interest rates. It is the rate applied to overnight financing by the Central Bank to commercial banks temporarily unable to meet their liquidity requirements. The repo rate increased from 5.25 per cent in 2002 to 8.75 per cent in 2008 and decreased to 5.00 per cent in March 2010, the lowest level since 2002. Between February 2009 and March 2010, the rate was adjusted downward on nine occasions to encourage expansion of credit to the private sector.

And while the declining repo rate had a downward effect on the prime rate, actual lending rates did not fall to the same extent, allowing banks to

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[12] Central Bank of Trinidad and Tobago, Monetary Policy Report, April 2010, p. 14.
[13] Central Bank of Trinidad and Tobago, Monetary Policy Report, Various Issues.
[14] Trinidad and Tobago Government, Ministry of Finance, Review of the Economy, 2010, p. 45.
[15] Central Bank of Trinidad and Tobago, Monetary Policy Report, April 2010, p. 16.

increase their interest spread in order to preserve their profit margins.[16] In a situation of excess reserves even the repo rate seems to lack effectiveness. The Bank of Jamaica also relies on the reverse repurchase rate on 30-day instruments as its signal rate.

Table 2.21: Movements in Bank Rate (End of Period)

	Bahamas	Belize	Barbados	Guyana	Jamaica[1]	Trinidad & Tobago		
						Bank Rate	Repo Rate[2]	Reverse Repo Rate [3]
1990	9.00	12.0	13.50	30.00	28.65	13.00		
1991	9.00	12.0	18.00	32.50	35.06	13.00		
1992	7.50	12.0	12.00	24.25	23.22	13.00		
1993	7.00	12.0	8.00	17.00	39.36	13.00		
1994	6.50	12.0	9.50	20.25	26.95	13.00		
1995	6.50	12.0	9.50	17.25	34.97	13.00		
1996	6.50	12.0	12.50	12.00	27.00	13.00		
1997	6.50	12.0	9.00	11.00	29.00	13.00		
1998	6.50	12.0	9.00	11.25	22.00	13.00		
1999	5.75	12.0	10.00	13.25	18.35	13.00		
2000	5.75	12.0	10.00	11.75	16.45	13.00		
2001	5.75	12.0	7.50	8.75	12.95	13.00		
2002	5.75	12.0	7.50	6.25	12.95	7.25	5.25	4.75
2003	5.75	12.0	7.50	5.50	15.00	7.00	5.00	4.50
2004	5.75	12.0	7.50	6.00	13.80	7.00	5.00	4.50
2005	5.75	12.0	10.00	6.00	12.60	8.00	5.00	4.50
2006	5.25	12.0	12.00	6.75	11.95	10.00	8.00	7.50
2007	5.25	12.0	12.00	6.50	11.65	10.00	8.00	7.50
2008	5.25	12.0	10.00	6.75	14.65	10.75	8.75	8.25
2009	5.25	12.0	7.00	6.75	10.50	8.25	6.25	5.35

1 The period 1990-1995 relates to Treasury Bill Rates; 1996-2009 – reverse repurchases rate (30-day maturity) rate
2 In May 2002, the Central Bank introduced a system of announced overnight or 'repo' rates for short term government paper
3 Includes Finance Houses and Trust Mortgage Finance Companies and represents rates for licensed institutions only
Source: Official Publications

The changes in the bank or discount rate as an instrument of monetary control in the region has become increasingly infrequent, and tends to be used sparingly as a signal rate. For example, the Bahamas rate has not changed since 1999 while the Belize rate has been stuck at 12.0 per cent since 1990.

[16] Central Bank of Trinidad and Tobago, Monetary Policy Report, April 2010, p. 14.

2.9 Exchange Rates

The Bahamas, Barbados, Belize and the ECCU member states have pegged their respective currencies to the US dollar and have operated with the same exchange rate for decades. Despite fiscal deficits and a growing public debt, single digit inflation rates have prevailed in these countries, reflecting the role of stable exchange rates as an anchor for prices. Interestingly, in classifying member countries in terms of *de facto* (rather than *de jure*) exchange rate arrangements, the IMF puts a currency board label on the ECCU, and describes the Guyana, Suriname and Trinidad and Tobago currency position as a stabilized arrangement with a US dollar anchor. Jamaica is placed in the stabilized arrangement category with a monetary aggregate target. The Bahamas, Belize and Barbados are described as having a conventional peg.[17]

Between December 1971 and October 1992 the Surinamese Guilder was fixed to the US dollar at the rate of 1.7850 Guilders to the dollar. Declining foreign exchange and government revenues, increasing fiscal deficits, and high inflation rates brought the exchange rate into question. In response to the increasing divergence between the official rate and the black-market rate, a multiple exchange rate system was introduced in October 1992, but was difficult to administer. The inflation rate jumped from 26 per cent in 1991 to 44 per cent in 1992 and averaged 366 per cent per year between 1993 and 1995. An official fixed exchange rate system was adopted in July 1994, but the authorities had difficulty defending it, and a multiple system emerged again. The economy declined in 1993 and 1994, and by July 1995, the country had returned to a unified system. With people becoming increasingly unwilling to hold the Surinamese Guilder, it was replaced by the Surinamese dollar (SRD) on 1st January 2004 at a rate of one dollar equal to 1000 Guilders. Since 2006 a *de facto* dual exchange rate system has prevailed in which the official market rate is set at SRD 2.745 per US $1 while the commercial market rate is held within a range of SRD 2.75 – 2.80 per US $1. The former is used for government external financing and debt service operations while the latter is applied to all other current transactions.

In April 1993, Trinidad and Tobago ceased pegging its currency to the US dollar at a fixed rate and adopted a floating exchange rate regime. In

[17] IMF, Annual Report on Exchange Arrangements and Exchange Restrictions, 2010, Washington, DC, 2010, pp.13-15.

practice it has operated a highly managed system with the rate moving within a very narrow band. With the foreign exchange earnings from the energy sector, the Central Bank has been able to intervene in the market when supply/demand conditions in the foreign exchange market put pressure on the exchange rate. The rate has remained fairly stable (some would argue almost fixed) since the early 1990s. The nominal TT dollars per US dollar rate moved from TT $5.81 at the end of 1993 to TT $6.29 at the end of 1998 and remained around that rate until 2008. It declined to TT $6.37 at the end of 2009 and to TT$6.40 at the end of 2010.

Table 2.22: Caribbean Countries Nominal Exchange Rate Movements (National Currencies Per US dollar)

End of Period	1980	1990	1995	2000	2005	2008	2009
Bahamas ($)	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Barbados ($)	2.01	2.00	2.00	2.00	2.00	2.00	2.00
Belize ($)	2.00	2.00	2.00	2.00	2.00	2.00	2.00
ECCU (EC$)	2.70	2.70	2.70	2.70	2.70	2.70	2.70
Guyana ($)	2.60	45.00	145.50	184.75	200.25	205.25	203.52
Haiti (Gourdes) ($)	5.00	5.00	16.16	22.52	43.00	39.82	42.02
Jamaica ($)	1.78	8.04	39.62	45.41	64.38	80.21	89.32
Suriname ($)	1.78	1.78	0.41	2.18	2.74	2.74	2.74
Trinidad & Tobago ($)	2.40	4.25	5.99	6.30	6.31	6.30	6.37

Source: IMF, International Financial Statistics, Various Issues.

Following the onset of a severe economic crisis in Guyana in the 1980s, a number of reforms under the rubric of the Economic Recovery Program (ERP) was initiated in 1988 with a view to deregulating the economy which had become highly centralised. A significant parallel foreign exchange market had emerged in Guyana creating dual rates which not even the devaluation of the Guyana dollar in 1987-89 could bridge. The exchange rate was devalued from GY$4.4 per US dollar in 1986 to GY$33 per US dollar at the end of 1989. A first step towards unification of the exchange rate saw the cambio or free markets among banks and registered dealers established in March 1990, creating two markets, the official and the cambio market. In an attempt to correct the growing disparity between the parallel rate and the official rate, the Guyana dollar in the official market was again devalued from GY $33 per US dollar in 1989 to GY $45 in 1990, and to GY $101.75 in February, 1991. The latter rate equalled the parallel rate at that date. By 2010 there were 21 foreign exchange traders in the market, six commercial banks and 15 non-banks. There are differences in the buying and selling rates of the bank and non-bank

cambios. The Central Bank rate is determined by the simple average of the buying and selling rate at the three larger bank cambios.

Guyana's exchange rate depreciated from GY $126 per US dollar at the end of 1992 to GY $184.8 at the end of 2000 (or by 47 per cent). Since then the rate has fallen by about 10 per cent reaching GY $203.25 at the end of 2009. With the stabilization of the exchange rate the inflation rate has fallen significantly from the 1980s and early 1990s. After declining at an average rate of over three per cent per year in the 1980s, the economy has been growing at an average rate of 3.5 per cent per year since 1990. The net international reserves which were negative in the early 1990s increased to US $178.4 million at the end of 2000 and to US $569.4 million at the end of 2009.

Jamaica currently operates a managed floating exchange rate regime under which the Central Bank sells foreign currency to dealers for resale under specified terms. In late 1983, the Government of Jamaica abandoned the fixed exchange rate and introduced an auction system (March 1984) to discourage the growth of the black market and ensure a greater availability of foreign exchange to the formal sector. The exchange rate depreciated from JA $1.781 per US dollar at the end of 1982 to JA $5.480 at the end of 1988. With a persistent build-up in the demand for foreign exchange and a depreciating Jamaican dollar, the auction system was suspended in November of 1989. The inflation rate increased sharply in the late 1980s/early 1990s and economic growth also declined.

In a continuing effort to liberalise the system, a cambio system was established in early 1994 to encourage greater competition and efficiency in the foreign exchange market. By this time the exchange rate had depreciated to JA $33.20 per US dollar at the end of 1994, and continued to JA $45.51 at the end of 2000. At the end of 2009, it was JA $89.33. The inflation rate, however, has fallen since the mid-1990s, averaging about 11 per cent per year since 1996. Between 1990 and 2008 the economy grew by only 1.5 per cent per year.

2.10 Conclusion

If nothing else, the recent global financial crisis has revealed the potentially devastating risks of unregulated and pseudo-regulated financial markets and institutions. Besides the economic costs of failure to the economy, failed institutions also have a traumatic effect on a wide range of savers,

pensioners, holders of insurance policies and other investors. These include not only individuals, but government agencies (e.g. national insurance boards), social organizations (e.g. credit unions and pension funds) and major corporate entities. Regulatory bodies must be properly staffed. Traditionally, central banks have concentrated their attention on commercial banks, and generally they have performed this function well. In the region, the extensive Jamaican banking collapse in the 1990s was exceptional. Non-bank institutions (including insurance companies) were left to ministries of finance, and other government departments which were generally not well equipped to carry out proper supervision, leading to a number of failures which have tarnished the entire financial sector in some cases. Where non-banks are linked to commercial banks, this tends to complicate supervision by creating networks and opportunities for by-passing prudential regulations and misleading regulators. Recent failures have shown an astonishing lack of scruples and responsibility on the part of owners, managers and senior officials. Given the implications of failed or delinquent financial institutions for the community, warning signals must be picked up early and to this end a wide range of forensic skills is required in regulatory bodies, complemented by judicial changes which can deal with financial crimes swiftly and fairly.

In recent years, many pieces of legislation have been revised or updated to plug loopholes and widen the scope of central bank supervision. In some cases, however, money-laundering legislation is still not up to international standards. Stress tests have become more frequent and more regular reporting has replaced the annual checks. The collapse of CL Financial not only revealed serious flaws in supervisory practice and the national and regional regulatory framework, but offers critical insights for reforms which can protect depositors and policy holders in the future.

In developing countries, the development and growth of the financial sector is generally not seen as an end in itself. A crucial function of the sector is to mobilise savings for investment. Pooling of domestic savings can reduce dependence on foreign resources. Mobilisation is linked to a range of factors including the number and location of offices, the range of financial instruments, the level of interest rates, the inflation rate and, critical in today's environment, confidence in the financial system. Financial instruments need to be diverse and transparent with clearly defined risks and subject to official approval. In various aspects of their operations institutions must be made to conform to international best

practice. Given the opportunities for contagion, all financial intuitions should be regulated, including stipulations for minimum capital requirements. With respect to commercial banks, this group of institutions, largely branches of foreign banks, is reportedly well-capitalized, though there are some concerns with respect to the increasing proportion of non-performing loans in certain states. The present regulatory framework for non-banks is far from satisfactory.

Stock markets in the region have not done particularly well as a mechanism for raising capital and providing opportunities for the public to invest in equity. In Guyana, for example, 11 companies are trading, but two account for 52 per cent of the trading periods and 70 per cent of the volume. National insurance schemes, too, have not invested their funds in ways which could bring enhanced benefits to their membership. There is clearly much scope for improving the saving/investment environment, of which regulation is only one aspect.

In light of the global liberalization of capital markets, national financial policies need to recognize and reflect new financial developments. With the growth of money transfer services and the ability of residents to hold foreign currency accounts, for example, local savings have more opportunities for exiting the local savings stream in the absence of adequate incentives and assurance. In recent years monetary, exchange rate and, to a lesser extent, fiscal policies have done well in curbing inflation in an unstable environment, and the authorities need to remain sensitive to factors, particularly of a populist nature, which could have a destabilizing effect. There are limits on the extent to which borrowing can be used to prop up a welfare state. In some Caribbean countries the public debt is already approaching dangerous levels.

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3

The Evolution of the Financial Sector in The Bahamas (1996-2007)

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The financial sector in The Bahamas is one of the essential pillars of the economy. It is characterized by its dualistic nature – a thriving offshore sector alongside a vibrant domestic sector, regulated by exchange controls. The majority of banks are subsidiaries of larger foreign banks and, in the case of the local system, they control most of the asset base. Over the years, developments in the financial sector have focused on strengthening the architecture of the financial system in The Bahamas via adherence to international standards governing the monitoring and supervision of domestic banks and other deposit-taking financial institutions.

The financial sector in The Bahamas remains dynamic and has been evolving over the years as a leading financial centre in the region. In addition to the Central Bank of The Bahamas, the sector is comprised of commercial banks, trust companies, offshore banks, insurance companies, investment fund companies, private trust companies, a deposit insurance corporation, a development bank, a mortgage corporation, private pension funds, co-operative societies, credit unions and money transmission businesses. All of these institutions have advanced in importance over the

years and play a vital role in the mobilization and intermediation of funds in The Bahamas.

Further, The Bahamas' sole stock exchange, the Bahamas International Securities Exchange Limited (BISX), was incorporated in September 1999 and successfully launched its domestic market for the listing and trading of local public companies in May 2000. BISX commenced with a listing of 17 domestic public companies, which at end-2007 had grown to 19. In addition, in April 2001, BISX initiated a Mutual Fund listing facility, to meet the needs of international investors, who may require the extra visibility afforded by a listing on an established securities exchange as a basis for their choice of an investment vehicle. Meanwhile, over-the-counter trading, which is captured in the broader Fidelity Capital Market Limited's Index (Findex), continues to expand.

In addition, given the expanding needs of domestic capital market development and ongoing regional integration initiatives, in 2006 there was additional gradual liberalization of the Exchange Control regime. These measures focused on adjustments to capital account transactions, aimed at enhancing opportunities for investments abroad by Bahamians and at facilitating meaningful development of the domestic capital market.

Moreover, during the period 1996 to 2007, the financial sector underwent numerous legislative updates, with the implementation of tighter legal and regulatory measures. These initiatives partly stemmed from the 'blacklisting' of the country in 2000 by the Financial Action Task Force (FATF) and the Organization for Economic Cooperation and Development (OECD), with the FATF identifying The Bahamas as one of the jurisdictions that was the least cooperative in the fight against money laundering and the OECD labeling the country as a tax haven. Thus, commencing in 2001 and continuing into 2007, a number of new laws were enacted and amendments made to existing ones, in an effort to ensure that the country's financial sector was in compliance with international standards.

Another notable development within the financial sector was the introduction of on-site inspection of banks and trust companies. These examinations initially focused on the implementation of the statutory and regulatory requirements regarding Know-Your-Customer (KYC) and anti-money laundering policies and procedures. However, the scope of on-site inspections has broadened over the years to encompass investigation of

the financial condition and internal control systems of banking and trust entities.

Overall, the financial sector in The Bahamas has undergone a number of structural changes in order to maintain the safety, soundness and integrity of the Bahamian banking and financial system. Further, since the financial sector in The Bahamas is sensitive to macroeconomic developments, including the fiscal situation and external shocks, policies affecting this sector have always been geared towards ensuring that economic and financial stability prevails.

3.1 The Economic & Policy Setting of The Bahamas

The Bahamian economy is primarily service-based, with tourism the principal industry, contributing approximately 40% of Gross Domestic Product (GDP), followed by financial services, which adds some 10% - 15% to GDP. The remaining approximately 45% of total GDP is linked to Government, construction, agriculture, manufacturing and other "miscellaneous" sectors. The Bahamas is an open economy with the import of goods and services representing, on average, approximately 45% of GDP from 1996-2007. Further, over 90% of all imports over the review period originated from the United States, which also supplies in excess of 80% of all stopover visitors. Moreover, the economic climate within which The Bahamas operates is one that embraces a fixed exchange rate regime, which is on par with the United States dollar (US$1 = B$1). Therefore, within this context, economic developments in the United States have had a direct impact on the Bahamian economy. Downturns in the United States generally translate into a lagged slowdown in the domestic economy, while recoveries result in upbeat economic activity for The Bahamas.

Given the exchange rate system adopted, the country employs the use of direct monetary policy instruments in order to maintain stability of the currency. The direct monetary policy tools used by the Central Bank of The Bahamas include reserve requirements, administratively-set interest rate ceilings, individual bank credit ceilings and moral suasion. According to the Central Bank of The Bahamas Act 2000, banks are required to maintain a reserve called a "Statutory Reserve" against their Bahamian dollar deposit liabilities. Since its inception in June, 1974, the ratio has been unchanged at 5%, although the Central Bank has the power to raise the ratio up to 20% to influence monetary conditions.

For the review period, 1996-2007, the most recent utilization of the credit ceiling instrument was in 2001. As a consequence of the September 11, 2001 terrorist attack on the United States and a downturn in tourism activity during this period, the Central Bank on September 20, 2001 imposed a freeze on outstanding bank credit to the private sector. Under this policy "Banks were instructed to provide new credit only to the extent of resources provided for ongoing repayments but were at liberty to determine how such reserves would be allocated within their portfolio." However, the restriction on credit was subsequently removed in August 2004.
Overall, as a result of the policies pursued and the relative openness of The Bahamas, the economy maintained economic stability and experienced growth, despite being exposed to some global adverse economic conditions during the review period. In discussing the economic and policy setting of The Bahamas during 1996-2007, the period of economic performance will be divided into two phases, the credit accommodation period, 1996-2001 and the more credit restrictive period, 2002-2007. Each period is characterized by world economic developments and varying rates of output growth, monetary and fiscal performance and balance of payments outturn.

During the credit accommodation period, 1996 through to 2001, real GDP growth advanced at an estimated average annual rate of 4.3%, reaching its highest level of 7.7% in 1998. The growth in real GDP was aided by a low inflation environment, with the inflation rate at an annual average of 1.4% over the five-year period, and gains in the tourism sector, which had a per annum average rate of increase of 5.2%, peaking in 2000 at 15.2%. In addition, tourist expenditure, which represented on average 31.6% of GDP from 1996 to 2001, grew on average by 3.7% per annum, with its highest rate of growth in 1999 of 17.0%.

Meanwhile, a review of economic performance during the credit restrictive period (2002-2007) revealed that real GDP slowed to an annual average of 1.7%. This downturn was occasioned by a slowdown in the global economy in 2002, following the September 11, 2001 terrorist attack in the United States and the negative effects of two hurricanes in 2004—Jeanne and Frances – that impacted the Bahamian economy. Moreover, the inflation rate firmed to 2.1% on average each year, reflective of the upward spiral in crude oil prices to record levels on the world markets during the review period. Tourism grew by a modest 1.7% per annum, with the highest rate

of growth being 8.9% in 2004. Nevertheless, tourist expenditure improved by an average 4.9% per annum over 2002-2007. Further, stopover visitors continued to provide the majority of tourism earnings accounting on average for 91.3% of the total. Average expenditure per stopover visitor ($1,107.59) was approximately 10 times that for cruise passengers.

Construction activity, which is pivotal to economic expansion in The Bahamas, was subdued during the period 1996-2001, reflecting declining commercial activities. The estimated value of construction starts during 1996-2001 decreased by an annual average of 0.3%, with the falloff in commercial property starts averaging 16.4%. However, residential activities remained buoyant, rising by 5.3% on average each year. For the period 2002-2006, despite the sustained high levels of residential starts, which rose by a per annum average of 6.6%, total construction starts contracted by 3.3% on average each year, explained by an average 26.9% downturn in commercial starts.

On the monetary front, policies are geared towards maintaining the fixed exchange rate regime. Consequently, maintaining an adequate level of external reserves is essential, hence the necessity of the adoption of policies to influence domestic credit and money supply. Monetary and credit aggregates over the 11-year review period indicated that there was a gap between domestic credit growth and money supply expansion (Table 3.1). During 1996-2001, the average growth in domestic credit of 10.5% exceeded money supply advances of 9.7%. However, with the Central Bank adopting a restrictive policy stance during the latter five years of the review period, there was a narrowing in the rate of growth for both domestic credit and money supply, with the respective rates estimated at 8.2% and 7.2%. As a result of the more restrictive credit posture in 2002-2007, there was a significant build up in bank liquidity. Nevertheless, liquidity pressures eased when the credit restriction was lifted in August 2004.

Notwithstanding, there was a fair degree of stability with interest rates. The Central Bank's Discount Rate[18] narrowed to 5.75% in 1999 from 6.50% in 1996, and remained unchanged at that level until February 2005 when there was a further downward adjustment in the rate to 5.25%, which

[18] The Discount Rate is the benchmark rate used by the commercial banks to effect changes to their Prime Lending Rate.

Table 3.1: The Bahamas: Financial Survey (1996 - 2007) (B$M)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
A. Net Foreign Assets	(108.6)	(113.4)	(24.0)	(50.5)	(83.7)	(234.5)	(357.3)	(143.8)	104.3	(32.3)	(254.5)	(213.8)
B. Total Domestic Credit	2,776.7	3,059.3	3,425.7	3,823.5	4,270.4	4,676.9	4,940.4	4,974.0	5,227.2	5,899.5	6,742.9	7,434.3
Government (Net)	422.1	419.8	452.6	495.5	508.5	626.0	651.4	506.5	547.1	642.5	677.0	866.8
Private Sector	2,263.9	2,551.0	2,836.7	3,155.1	3,618.6	3,902.1	4,069.6	4,094.6	4,339.4	4,953.7	5,668.7	6,218.4
Public Corporations	90.7	88.5	136.4	172.9	143.3	148.8	219.4	372.9	340.7	303.3	397.2	349.1
C. Money Supply												
Currency in Circulation	96.1	109.7	125.6	148.4	151.4	153.5	154.8	160.1	176.6	195.3	202.1	223.7
Demand Deposits	349.7	409.1	470.8	609.8	652.3	623.2	662.9	747.3	957.8	1,052.3	1,049.0	1,076.5
M1	445.8	518.8	596.4	758.2	803.7	776.7	817.7	907.4	1,134.4	1,247.6	1,251.1	1,300.2
Savings Deposits	355.1	392.9	437.9	548.0	596.1	604.6	630.7	678.8	779.9	881.8	953.3	992.1
Fixed Deposits	1,427.1	1,554.4	1,809.1	1,888.4	2,063.7	2,244.0	2,296.2	2,315.9	2,410.3	2,556.6	2,781.5	3,144.8
M2	2,228.0	2,466.1	2,843.4	3,194.6	3,463.5	3,625.3	3,744.6	3,902.1	4,324.6	4,686.0	4,985.9	5,437.1
Residents F/C Deposits	28.8	41.5	60.7	53.0	86.3	91.8	91.6	101.2	96.9	144.2	159.1	200.1
M3	2,256.8	2,507.6	2,904.1	3,247.6	3,549.8	3,717.1	3,836.2	4,003.3	4,421.5	4,830.2	5,145.0	5,637.2

Source: Central Bank of Bahamas

remained in effect until end-2007. Similarly, commercial banks' prime lending rate softened to 6.00% in 1999 from 6.75% in 1996 and was stable at that level until February 2005, when there was a further reduction to 5.50%, which remained unchanged at end-2007.

The Government's fiscal performance for the overall review period (1996-2007) signaled that there was an inequality between revenue and expenditure growth. Aggregate revenue grew at an average annual rate of 6.2%, while expenditure advanced by an average 7.2% per annum, resulting in the fiscal deficit approximating on average 2.4% of GDP (Table 3.2). During the period 1996-2001, which coincided with the period of a boom in the domestic sector, aided by expansionary economic activities in the global economy, the fiscal deficit to GDP ratio averaged 0.8%, as revenue rose on average by 5.9% and expenditure by 6.9%. However, during 2002-2007, despite Government's stance of fiscal prudence and the introduction of revenue enhancement measures, the deficit to GDP ratio elevated on average to 1.9%, reflective of the slowdown in economic growth in the domestic economy, as the major world economies experienced a downturn resulting from a combination of factors. These factors included spillover effects from the September 11, 2001 terrorist attack on the United States, geopolitical unrest in the Middle East, rising world oil prices, the United States housing crisis and weaknesses in the financial sector.

Corresponding to sluggish economic activity over the latter sub-period, the average national debt to GDP ratio increased from 37.5% between 1996 and 2001 to 40.8% during 2002-2007. As a result, fiscal policy over the latter sub-period was geared towards reducing the debt to GDP ratio and keeping the deficit to GDP ratio within the 2.0% range.

An examination of the balance of payments suggested that there has been a continuous rise in the trade balance, resulting in a deterioration in the current account deficit. The current account deficit averaged $656.1 million in the eleven years through 2007, increasing from an average $504.6 million per annum in the sub-period 1996-2001 to $807.5 million in the later sub-period, 2002-2007 (Table 3.3). Consequently, the average current account deficit to GDP ratio has been increasing during the review period. During 1996-2001 the current account deficit to GDP averaged 9.3%, but rose to 12.1% over the last sub-period, 2002-2007. On the capital and financial account side, The Bahamas maintained robust growth in net inflows, increasing from a yearly average of $499.6 million during the

Table 3.2: The Bahamas: Government Financing (1996 - 2007) (B$M)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
A. REVENUE & GRANTS (i + ii + iii)	686.4	737.1	761.3	869.1	950.7	920.3	888.9	900.9	960.2	1,119.5	1,302.3	1,322.1
i) Tax Revenue	615.3	665.8	681.4	793.3	871.8	820.1	799.2	823.0	853.8	983.8	1,156.4	1,198.5
ii) Non-Tax Revenue	70.6	69.9	79.5	75.5	78.8	100.1	89.7	77.9	91.2	122.5	148.0	123.5
iii) Capital Revenue & Grants	0.5	1.3	0.5	0.3	0.0	0.1	0.0	0.0	15.2	13.2	(2.1)	0.0
B. EXPENDITURE (i + ii + iii)	750.3	875.6	841.8	920.5	958.6	1015.5	1023.2	1109.5	1157.2	1,282.0	1,387.6	1,553.9
i) Current Expenditure	650.6	707.7	724.4	788.4	819.2	863.1	918.7	994.8	1016.7	1,114.9	1,185.5	1,325.3
ii) Capital Expenditure	69.6	132.3	82.0	96.8	105.6	92.9	99.5	72.7	83.6	113.6	139.0	164.8
iii) Net Lending [() = repayment]	30.1	35.5	35.4	35.3	33.8	59.5	5.0	42.0	57.0	53.6	63.1	63.8
C. OVERALL BALANCE (A - B)	(63.9)	(138.5)	(80.5)	(51.4)	(7.9)	(95.3)	(134.3)	(208.6)	(197.1)	(162.5)	(85.3)	(231.8)
Financing (Net)												
Borrowing less Repayments												
Other Financing	16.9	7.2	11.5	(27.1)	14.2	(16.0)	(57.6)	(93.3)	45.1	40.8	(62.2)	(12.2)
Memo: Total Direct Charge												
i) B$ Internal	45.0	56.1	39.1	45.0	51.0	58.9	66.4	103.0	57.6	65.0	97.7	62.0
ii) Foreign Currency	8.4	9.0	7.3	14.6	8.6	9.4	31.4	130.0	0.0	0.0	1.8	1.8

P Provisional

Source: Public Treasury Accounts and Monthly Statistical Printouts

Table 3.3: The Bahamas: Selected Economic Indicators (1996-2007) (B$ millions)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Population ('000)	285.0	288.9	293.7	298.4	303.6	308.9	311.9	316.3	320.7	325.2	330.0	334.0
Exchange Rate (B$/US$)	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Retail Price Index (Oct/Nov.)	101.2	102.0	103.9	105.4	106.0	108.2	110.5	113.8	115.1	117.4	119.5	122.5
Tourism Expenditure	1,397.5	1,416.1	1,354.0	1,582.9	1,734.4	1,647.7	1,759.8	1,757.3	1,884.5	2,068.9	2,057.3	2,187.2
Construction Starts	180.2	458.6	163.5	162.4	193.4	177.9	275.8	256.5	174.6	208.9	249.2	223.4
Balance of Payments												
Current Account (Net)	(236.0)	(608.4)	(948.8)	(198.1)	(442.0)	(593.9)	(423.0)	(430.8)	(257.9)	(746.9)	(1,556.8)	(1,429.8)
Capital & Financial Account (Net)	156.8	405.4	860.0	585.2	420.5	569.7	436.3	554.5	499.3	890.1	1,216.0	929.5
Overall Balance	(7.5)	56.6	119.3	65.4	(61.4)	(30.2)	60.7	111.1	183.7	(88.9)	(79.1)	(46.0)
National Debt	1,547.3	1,712.7	1,802.1	1,905.9	1,898.2	1,980.1	2,224.3	2,403.7	2,540.2	2,736.9	2,884.6	3,064.1
Public Foreign Currency Debt	359.7	419.7	430.7	480.3	437.1	412.2	565.5	617.0	581.7	553.4	633.2	640.6
Money Supply (M3)	2,256.8	2,507.6	2,904.2	3,247.6	3,549.9	3,717.1	3,836.2	4,003.3	4,421.5	4,830.2	5,145.1	5,637.3
Domestic Credit	2,776.7	3,059.3	3,425.7	3,823.5	4,270.4	4,676.9	4,940.4	4,974.0	5,227.2	5,899.5	6,742.9	7,434.3

Source: The Central Bank of The Bahamas

period 1996-2001 to an average of $754.3 million per annum over 2002-2007. The capital and financial account as a proportion of GDP averaged 10.8% over the 11-year period, with the highest rates of 18.2% and 17.7% recorded in 1998 and 2006, respectively. However, the capital and financial account to GDP waned to 12.8% at end-2007. The buoyancy in capital inflows was directly related to robust foreign direct investment proceeds associated with tourism projects. Increased net capital inflows resulted in the overall external payments balance registering a yearly average surplus of $23.6 million during 1996-2007.

The overall consumption pattern in the domestic economy was mixed over the 1996-2007 period, featuring expansions in both private sector credit and the national debt. During the credit expansion phase, 1996-2001, the rate of increase in private sector credit exceeded that of government consumption. Banks' private sector credit grew by an annual average of 11.3%, on par with public sector credit growth, but significantly higher than a per annum average rise in the national debt of 4.8%. However, during the credit restrictive period, 2002-2007, the estimated average rate of increase in private sector consumption fell to 8.2%, which was below the 13.8% recorded for the public sector, and slightly above the 7.6% average growth in the national debt. The significant expansion in public sector consumption was reflective of ongoing capital works and infrastructural developments in the country.

3.2 The Evolution of the Financial Sector

3.2.1 The Central Bank of The Bahamas

The Central Bank of The Bahamas has the responsibility of fostering an environment of monetary stability conducive to economic development, and ensuring a stable and sound financial system. The Central Bank evolved from the Currency Board/Commissioners of Currency and the Monetary Authority. The Currency Board was established in 1919 in the aftermath of the changes which took place following Britain's decision to decentralize the colonial monetary arrangements. The Currency Board's sole responsibility was restricted to the issuance and redemption of the currency.

The Bahamas Monetary Authority (BMA) was instituted in 1968, in direct response to the changing financial environment of the 1960s and the devaluation of the Pound Sterling in 1967. This brought into focus the need

for strong and sound monetary accords, especially in regards to exchange control management in the country. In 1966, the Bahamian dollar was pegged to the US dollar, replacing the Bahamian pound, which had a fixed parity to the pound sterling and was governed under the 1965 Currency Act. During this process of converting, banks suffered large exchange rate losses because the majority of their assets were denominated in pound sterling and it proved to be difficult to find domestic investment opportunities. Hence, this was one of the major reasons why the BMA was established. Other reasons included a need for an institution that would relieve banks of exchange rate risks arising from capital flows and provide for closer supervision and monitoring of the banking system which was expanding and becoming more complex to manage.
The BMA was able to enforce tighter controls on banks in The Bahamas that were under its supervision, and this helped to forge a stronger link between the public and private sectors through its advisory role to Government and its relationship with commercial banks. A major hindrance to the BMA was its limited authority, which prevented development of effective monetary policies in respect of reserve requirements for commercial banks and credit controls. The events of the late 1960's emphasized the shortcomings of this arrangement. As banks converted sterling assets to Bahamian dollar assets by extending loans and advances to the private sector, the BMA was essentially incapable of dealing with the external imbalances, created by the sharp expansion in the domestic money supply. The global recession of the early 1970s, brought on by the OPEC oil crisis, also heightened the need for sound balance of payments management.

During the period there were several exchange rate changes. In February 1970, the gold parity of The Bahamian dollar was changed from 0.870898 to 0.888671, the Bahamian dollar was set at a one-to-one parity with the United States (US) dollar and the sterling at B$2.40 = £1.00. Further, in August 1971 the Government allowed the trading of the Bahamian dollar at par with the US dollar, while the pound sterling rate was free floating. However, upon changing the gold parity to 0.843828 grams, the Bahamian dollar was devalued and adjusted to B$0.97 = US$1.00 in December 1971 and in June 1972, the exchange rate between the two currencies was fixed at this rate. Eight months later in February 1973, the Bahamian dollar was devalued by 12.7%, against a 10% devaluation of the US dollar in the open market. In light of this situation where the Bahamian dollar and US dollar were both devalued against gold, it was decided that both currencies

would trade at parity in the Bahamian market, and to date this arrangement remains in place.

In addition the BMA was responsible for the redemption and issuance of banknotes. The BMA was allowed by law to charge a commission of 1% to facilitate these transactions because of cost outlays directly associated with the purchase/sale of the pound sterling. Whether or not a charge was levied or passed onto customers was left up to the discretion of the banks. Throughout the 1970's, vis-à-vis the Central Bank, the rate was reduced and maintained below 1%, but declined to 0.15% in September 1982. From December 1971 to February 1973 the net spread in sterling balances rate was maintained below 1% and later re-established at 1%.

Presently, US dollar balances from banks are bought at B$1.0000 by the Central Bank and sold to banks at a rate of B$1.0025. To maintain a harmonized system of lending with the general public, banks can purchase balances (cheques, travelers' cheques, and wire transfers) from the public at a rate B$0.9950 and sell at B$1.0125. Meanwhile, cash balances are purchased and sold at B$1.0000 and B$1.0050, respectively.

Following the abolition of the Bahamas Monetary Authority, The Central Bank was established on June 1, 1974 under The Central Bank of The Bahamas Act of the same year. The role was solidified under the 1974 Act and the Central Bank was mandated to ensure monetary and financial stability. This was broadened by the passage of The Central Bank of The Bahamas Act, 2000. The new Act allowed the Central Bank to share supervisory information with overseas regulatory authorities. The sharing of information enhanced these authorities' ability to exercise regulatory functions, and permitted the Bank to follow the most stringent controls and conditions in fulfilling its mandate. Under the new Act, the Central Bank consolidated the supervision of the banking sector.

Moreover, the Central Bank's role included being the issuer of legal tender, maintaining the parity of the B$ to US$ (1:1 ratio), under the fixed exchange rate regime and maintaining external reserves to safeguard the value of the Bahamian dollar. The role also encompassed the promotion of monetary and financial stability, through the proper administration of policy controls and to act as banker and advisor to the Government, as well as to hold the position of banker of last resort to domestic banks. Overall,

the Central Bank functions as the regulator and supervisor of the domestic banking sector.

In The Bahamas, the fundamentals of monetary policy are to maintain stable credit and other conditions to support the fixed parity between the Bahamian dollar and the US dollar. The instruments of monetary policy are inclusive of the statutory reserve requirement, which is a percentage of banks' Bahamian dollar deposit liabilities and this rate can range between a low of 5% and a high of 20%. However, the rate was set at 5% in 1974 and remains unchanged to date. Selective credit controls is another monetary policy tool employed by the Bank and it involves the setting of quantitative limits by the Central Bank to curtail consumer lending, via the restriction of the level of new credit and the aggregate level of credit granted.

Further, the instrument of open market operation that facilitates the purchase and sale of Treasury bills and Government bonds is utilized by the Central Bank. In addition, the Discount Rate is used when there is a liquidity shortfall and to meet statutory requirements. Another tool that is used is moral suasion and this takes the form of a once a month meeting with the Governor and top officials of the eight clearing banks to advise them of the Central Bank's monetary policy objective and the credit and/or interest rate policy that it would like the banks to pursue in order to fulfill these objectives.

The Central Bank was established with a startup capital grant of $3.0 million in 1974 and at that time total external reserves amounted to B$42.0 million. Over the ensuing years, there has been robust growth in external reserves, averaging $403.2 million per annum over the 1996-2007 period (Table 3.4). Moreover, total domestic assets more than doubled during the 1996-2007 period, advancing to $219.2 million in 2007 from $64.2 million in 1996. At the end of 2007, total assets had more than doubled in value to reach $838.9 million vis-à-vis total assets of $335.1 million in 1996, with foreign currency as a portion accounting for 54.1% of total assets. Meanwhile, claims on the public sector, which averaged 46.7% in 1996, accounted for 42.5% of the total claims at end-2007. On the liability side there was an acceleration, with currency averaging an annual growth rate of 9.0% over 1997-2006 and holding 40.0% of the total in 2007, while bank deposits represented 40.4% and public sector deposits held 3.2% of total liabilities.

Table 3.4: The Bahamas: The Central Bank – Net Domestic Assets (1996-2007) (B$M)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
External Reserves	163.0	219.5	338.8	404.0	342.6	312.4	373.2	484.3	667.8	578.8	499.8	453.9
Monetary Base	227.2	257.2	310.2	373.5	360.8	407.3	451.5	484.4	639.0	587.4	569.5	673.0
Currency in Circulation	143.5	157.3	173.3	223.2	216.0	218.6	221.3	239.9	255.3	301.2	318.4	333.9
Bank Balances	83.7	99.9	136.9	150.3	144.8	188.7	230.2	244.5	383.7	286.2	251.1	339.1
Net Domestic Assets (Liabilities)	64.2	37.7	(28.6)	(30.5)	18.3	94.9	78.3	0.1	(28.9)	8.6	69.8	219.2
Net Credit to Government	146.3	126.0	59.3	69.8	120.8	187.5	173.0	108.5	141.9	122.0	184.9	332.3
Advances	52.0	50.0	53.5	53.5	53.5	56.9	71.8	71.0	71.0	77.0	63.0	72.0
Registered Stocks	20.9	10.8	8.4	5.6	8.9	34.0	38.6	43.8	78.5	72.7	77.6	132.4
T-Bills	80.3	80.4	-	14.0	66.3	98.8	72.0	-	-	-	52.4	143.5
Less: Deposits	6.9	15.3	2.6	3.2	7.8	2.2	9.4	6.3	7.6	27.7	8.1	15.6
Net Credit to Public Corporations	(0.3)	(3.1)	(1.3)	(9.5)	(6.5)	(2.3)	(2.4)	(14.4)	(79.1)	(17.8)	(10.3)	(2.9)
Claims on Banks	-	0.3	0.3	0.2	-	-	-	-	-	-	-	-
Other Items (Net)	(81.8)	(85.4)	(86.9)	(91.0)	(96.1)	(90.3)	(92.3)	(94.0)	(91.7)	(95.6)	(104.9)	(110.2)

Source: The Central Bank of The Bahamas

Monetary Policy

In The Bahamas, the essential objective of monetary policy is to ensure the maintenance of stable credit and other conditions to aid the fixed parity between the Bahamian and United States dollars, which has been in place since 1973. Hence, the Central Bank's primary mandate has been to ensure that this goal is achieved. In particular, from the inception, the Central Bank was given the mandate to make certain that external reserves remained at least 50% of the aggregate value of notes and coins in circulation, and demand liabilities of the Bank.

The Bank's monetary objectives are primarily pursued via the use of direct policy instruments, namely reserve requirements, moral suasion, selective credit controls and the Bank's discount rate. There is also the limited use of the indirect monetary policy instruments such as open market operations. With the use of these measures, the Bank manages liquidity and ensures there is an adequate level of international reserves. According to Section 19 of the Central Bank of the Bahamas Act, commercial banks are required to maintain a Statutory Reserve of 5% against their Bahamian dollar deposits. Although the Act states that the Bank has the liberty to increase the ratio to a maximum of 20%, it has remained unchanged at the 5% level since its inception in June 1974.

Over the past ten years, the Bank has had to use these direct tools on a number of occasions. For instance, in May 1998, against a backdrop of accelerated consumer credit growth, the Bank requested that financial institutions impose either a 25% down payment or an equity requirement on new consumer loans. However, in January 1999, when liquidity positions had improved, the Bank had institutions remove this requirement. In another act of moral suasion, the Central Bank in July 2001 requested that commercial banks be stricter in imposing collateral requirements, and in their determination of credit worthiness.

Further, in September 2001, in light of the terrorist attacks on the United States and the consequent reduction in tourism activities that ensued, the Central Bank instituted a freeze on credit to the private sector. As such, banks were only permitted to offer new credit which could be financed by the banks' current repayment resources. As a result, in the years following the credit restriction policy, private sector credit grew at a reduced rate. In August 2004, amidst an improved economic outlook, these restrictions were abolished (Table 3.1).

During the course of the review period, the bank also imposed a number of regulations in an effort to ensure that the banking sector was stable and performed in the best interest of the economy. As such, a number of guidelines were imposed in August 2004. The first was a limit on debt, such that borrowers' total debt service ratio was within the range of 40%-45% of normal monthly income. Further, for all personal loans that were not insured by mortgage indemnity insurance, a minimum equity contribution of 15% was enforced. However, in September 2004, due to the extensive damages suffered as a result of hurricane Frances, these regulations were relaxed. Accordingly, to give relief to households and businesses which experienced damage due to the hurricane, the 15% requirement was not imposed. Moreover, the maximum debt service ratio was raised to 55% to accommodate such borrowers.

In addition to imposing various credit restrictions and acts of moral suasion, the Bank also made changes to its discount rate in an effort to influence interest rates, and bring about the desired changes in liquidity and, by extension, the economy. Within the 1996 - 2007 period, the Central Bank altered its Discount Rate on two occasions. The first occurred in June 1999, when, in an environment of strong economic conditions and a very liquid market, the Central Bank lowered its discount rate by 75 basis points to 5.75%, allowing the banking system to make use of the surplus in excess reserves. Commercial banks' Prime Rate, which moves in tandem with the Central Bank Discount Rate, was also lowered by 75 basis points to 6.00%. In February of 2005 amidst similar conditions, the Central Bank reduced the Discount Rate by 50 basis points to 5.25% and accordingly, the Prime Rate was adjusted by the same amount to 5.5%.

While the use of Open Market Operations to conduct monetary policy in The Bahamas is limited, the Central Bank does act as an official registrar and transfer agent for the Government in the purchase and sale of short-term Treasury bills and longer dated Bahamas Government Registered Stock (BGRS). As such, the Bank governs both the primary and secondary markets for Government securities. With the purpose of offering short-term financing to the Government, Treasury bills are sold by tender, with maturities of 91 or 182 days; and in denominations of B$100. BGRS on the other hand, are longer term securities which are issued under The Bahamas Registered Stock Act, 1973 and feature maturities of up to 25 years. These securities are issued at par, require a minimum investment of B$100, and

carry interest rates that vary with the Bahamian Prime Lending rate and length of maturity of each tranche.

The amount of securities issued in a given fiscal year is determined according to the budgeted financing provision permitted by the House of Assembly. In accordance with the Public Treasury Bills Act, amended December 1990, the amount of Treasury Bills outstanding is limited to 20%-25% of the Government's average ordinary revenue in the previous three years. As of June 2008, the total value of Treasury Bills outstanding was B$230.5 million.

Although the Central Bank has been communicating with the Bahamas International Securities Exchange (BISX) about the implications of transferring the secondary market for Government Registered Stock, the Central Bank still assumes the role of facilitating the secondary market in Treasury bills. Because the secondary market in Treasury bills has limited activity, the Central Bank provides liquidity to the market by discounting these securities in the event that they must be sold before maturity. These short-term securities are rediscounted at 0.5% above the average discount rate and sold after tender at a rate of 0.1% below the average discount rate. In addition, the Bank is also permitted to offer loans with Government paper as collateral; the interest rate of these loans rises in tandem with the length of the loan.

Another important aspect of the monetary sector and monetary policy are foreign exchange controls. In an effort to sustain external reserves following the September 11 attack, the Bank increased the Bahamian Dollar Open Position limit of the commercial banks to $5.5 million in November 2001 from $0.5 million in prior years. This policy initiative limited net foreign currency outflows and consequently restricted any reductions in external reserves. Nevertheless, in March 2002 the rise in commercial banks' net exposure limit was repealed and the original $0.5 million limit was reinstated.

Approximately three years after the limit was rescinded, there was a change in the way in which the Bahamian Dollar (B$) Open position was determined. With the view of allowing for improved flexibility in the foreign currency operations of commercial banks, the Central Bank established a fixed formula to determine banks' external exposure limit.

The new limit was the value of 5% of each bank's Bahamian Dollar Tier 1 capital up to $5.0 million.

Further, in an attempt to encourage inter-bank market activity, the Central Bank increased the respective buying and selling rates for US dollar balances from US$1.0000 / B$1.0025 and US$1.0000 / B$1.0040 to US$1.0000 / B$1.0000 and US$1.0000/B$1.0025.

With the aim of relaxing controls on foreign exchange transactions and liberalising the capital account, in January 2006 a number of changes were made to the Exchange Control Regime governing capital account transactions. In particular, changes were made to the investment currency market rate structure such that bid/offer rates were lowered to 12.5%/10% from 25%/20%. With regard to overseas portfolio investments by domestic residents, employees of foreign companies with local offices were permitted to invest up to US$25,000 per year in company shares (up from US$10,000 per annum in prior years). Further, the National Insurance Board was granted approval to invest up to a maximum of $25 million annually at the official exchange rate, and licensed broker dealers were permitted to invest in overseas markets up to a maximum of 5% of the previous period external reserves or $25 million, whichever is larger.

An allowance for timeshare investment was also made, giving individuals over the age of 18 years the permission to invest up to $25,000 once every ten years at the official rate. Additionally, the amount of emigration-related transfers for Bahamians relocating abroad was raised to $250,000 from $125,000 per family annually. Meanwhile, the controls on the capital transactions of temporary and permanent residents with a restricted right to work were relaxed, with the amount temporary residents could now borrow increased to B$50,000 from $6,000 for consumer related purposes, and their investment opportunities in the local stock exchange expanded. In addition, temporary residents that have been working in The Bahamas for at least three years were given the autonomy to borrow up to B$200,000 for housing. As it relates to securities exchange transactions, Bahamian companies are now allowed limited listing of their securities on CARICOM member countries' stock exchanges.

In addition to conducting monetary policy, the Bank has also undertaken a number of other projects to modernise the financial sector in order to make it more efficient. In May 2004, the Bank implemented the Real Time

Gross Settlement System (RTGS), which facilitates the settlement of Bahamian dollar payments electronically and in real time. Specifically, the arrangement allows for the processing of high-value payments between financial organizations and their customers, between financial institutions and the Central Bank, or inter-bank transfers.

More recently, the Central Bank in conjunction with the Clearing Banks Association undertook a venture to establish an Automated Clearing House (ACH) facility, which would enhance the local banking system's efficiency via a cost effective and timely settlement arrangement. The facility would achieve this goal by electronically and automatically clearing low-value payments such as cheques and direct debits, a role currently filled by the real time clearing system. The initiative began in 2005 and is scheduled to be implemented in October 2008.

3.2.2 The Banking Sector

The financial services industry comprises The Bahamas' second major industry, contributing an estimated 15%-20% of Gross Domestic Product (GDP). Therefore, the growth and sustainability of this industry is pivotal to the economic development of the country. The country's competitiveness in financial services has been driven by its sovereignty, political stability, tax neutrality, proximity to the United States and technological and physical infrastructure. The Bahamas' reputation for providing quality financial services and innovative product packages to meet investors' demands has been attributed to a trained workforce, sound policies and progressive legislation and regulations.

The banking sector has been the cornerstone of the financial services industry. The domestic banking sector, offering primarily retail banking services, grew from B$2.4 billion in total assets in 1996 to B$7.1 billion in 2007. There was a four-fold increase in capital resources from B$292.6 million to B$1.7 billion. In addition, employment in the domestic banking sector expanded by 26.4% to 3,766 persons in 2007. Aggregate operational expenditures increased by 64.1% from B$169.3 million over the period, indicating expansions in salaries and physical facilities in The Bahamas. Similarly, the offshore banking sector experienced significant growth, with employment advancing by 43.3% to 1,155 persons by end-2007 and operational costs, inclusive of salaries and government fees, increasing from B$80.7 million in 1996 to B$172.9 million in 2007. Assets of

international banks and trust companies stood at approximately US$186 billion in mid-1996 compared to about US$351.2 billion in mid-2007.

Over the period, The Central Bank and the Government of The Bahamas have increasingly focused on the quality, not the quantity, of banking institutions operating in the jurisdiction. As a result, total banking sector growth measured in terms of total assets, capital and total employment did not materialize as a result of an increased number of banks operating in and from within The Bahamas, but was primarily caused by an expansion in licensees that continued operations.

At the end of 1996, 425 licensed bank and trust entities were providing services, with some 299 being public institutions and 126 being restricted, non-active, or nominee companies. However, with the enforcement of the Minimum Physical Presence Requirements for Banks and Trust Companies Licensed in The Bahamas, the number of banks and trust companies was reduced by more than half to 245 at end-2007, of which 138 were public entities and 107 were restricted, non-active or nominee companies. Public institutions comprised three categories of entities: 21 were listed as authorized dealers and agents, 30 as Eurocurrency branches of foreign banks and 87 as Bahamian incorporated companies. Of the authorized dealers and agents and Bahamian incorporated companies, there were eight commercial banks and 12 Other Local Financial Institutions (OLFIs). Of the eight commercial banks, seven were authorized dealers that could conduct business in all foreign currencies and gold, and one held authorized dealer and agent status which permitted it to deal in Bahamian and foreign currencies and securities as well as in gold. Two of the commercial banks are fully Bahamian-owned and the other six are branches and subsidiaries of international banking groups. OLFIs are either Bahamian incorporated companies or subsidiaries of foreign banks.

Developments within the banking sector were generally positive from 1996- 2007. Nevertheless, in 2000 the sector came under intense scrutiny by the Financial Stability Forum (FSF), The Organization for Economic Cooperation and Development (OECD) and the Financial Action Task Force (FATF). These international agencies identified deficiencies in The Bahamas' financial services regulatory and supervisory environment, resulting in the blacklisting of the country. Within the same year, the United States Internal Revenue Service (IRS) indicated that it would implement new procedures governing withholding taxes on US securities

held by Americans at financial institutions in offshore financial centres and this had implications for The Bahamas.

The FSF, OECD and FATF identified offshore financial centres (OFCs) that were seen as un-cooperative in cross-border exchanges of information and international regulatory cooperation, and were considered to be tax havens impeding onshore tax compliance and global tax cooperation. Also, the FATF named The Bahamas, along with 14 other countries, as non-cooperative in the fight against money laundering.

More specifically, the FATF stated that the listed countries had not implemented their 40 recommendations to prevent money laundering and did not have adequate “Know Your Customer” (KYC) regimes. Systemic problems in preventing the flow of questionable cash through their jurisdictions typically arose from deficiencies in financial regulations, such as inadequate regulations and supervision of financial institutions, inadequate rules for the licensing and creation of financial institutions, inadequate customer identification and excessive secrecy provisions. In the case of The Bahamas, the FATF observed that a comprehensive anti-money laundering legislation was in place, but there was a lack of information about beneficial ownership of trusts and international business companies (IBCs), as well as professional codes which allowed for the concealment of the identity of clients. According to FATF, even if anti-money laundering efforts were strengthened worldwide, weaknesses in these jurisdictions provided an avenue for money launderers to integrate proceeds of crime into the legitimate economy, thereby sustaining the vulnerability of the international financial system to money laundering.

The “blacklisting” by the OECD, FATF, and the FSF along with the IRS’ initiative, highlighted at a global level The Bahamas’ deficiencies in the regulation, legislation and supervision of its financial system. These organisations called upon the Government of The Bahamas to take actions which they recommended or face some form of sanction restricting access to onshore banking and securities markets. The Government of The Bahamas responded by rectifying identified deficiencies, bringing the banking infrastructure in line with international standards.

Changes in the Legislative Framework Governing Bank Operations

Commencing in April, 2001, The Bahamas’ financial services sector came under significant scrutiny by a number of multilateral agencies (FSF, OECD,

IRS) which individually identified various aspects of the offshore financial services in The Bahamas that posed a significant threat to financial stability. In the wake of these supra-national initiatives and the impending US Treasury led Qualified Jurisdictions (QJ) initiative, the Government embarked on an ambitious overhaul of financial sector legislation—enacting on the 29th December, 2000, the following new laws: The Banks and Trust Companies Regulation Act, 2000, The Central Bank of the Bahamas Act, 2000, The Financial Intelligence Unit Act, 2000, The Proceeds of Crime Act, 2000, The Financial and Corporate Service Providers Act, 2000, The Financial Transactions Reporting Act, 2000, The International Business Companies Act, 2000, The Evidence (Proceedings in other Jurisdictions) Act, 2000 and Criminal Justice (International Cooperation) Act, 2000.

The Central Bank of the Bahamas Act, 2000 replaced the Central Bank Act of 1974. The Bank and Trust Companies Regulation Act, 2000 (BTCRA) repealed the previous version, which was in place since 1965. These new laws increased the powers and autonomy of the Central Bank and established new provisions to regulate banks and trust companies within The Bahamas, respectively. Overall, these laws worked to strengthen the existing financial supervisory framework of The Bahamas and ensure that the country's financial sector adheres to internationally accepted standards and procedures.

Further, of the laws passed, specific legislation established a framework for Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) from within The Bahamas. The Financial Transactions Reporting Act, 2000 and the Financial Transactions Reporting Regulations, 2000 detailed the minimum "KYC" and anti-money laundering requirements, including documents needed to verify customer identity, length of record keeping and obligation of reporting suspicious transactions by financial institutions. The Proceeds of Crime Act, 2000 criminalized money laundering related to drug trafficking and other serious offences. The Financial Intelligence Unit Act, 2000 established the financial sector watchdog, the Financial Intelligence Unit (FIU), to investigate suspicious financial activity, and The Financial and Corporate Service Providers Act, 2000 provided for the licensing and regulation of financial and corporate service providers.

Moreover, in 2001 the Central Bank's Supervision Department technical resources were expanded to establish a group of specialists to conduct on-site examinations under the coordination of a Senior Bank Supervision Consultant. Two senior on-site supervision experts were recruited to supervise the commencement of this work and to assist with the development of an expanded supervisory team.

In addition, in order to improve the supervision of licensees locally, the BTCRA legally permitted the Inspector of Banks and Trust Companies to share information with other local regulators. As such, the Group of Financial Service Regulators (GFSR) was formed in the year 2002. The mandate of the GFSR, who signed a Memorandum of Understanding (MOU) in October 2002, was to ensure that regulatory bodies within The Bahamas were more harmonized and coordinated when supervising financial conglomerates under the purview of two or more regulatory agencies and to facilitate the sharing of information amongst domestic regulators. The GFSR consisted of representatives from the Central Bank of The Bahamas, as well as The Securities Commission of The Bahamas, the Office of the Registrar of Insurance Companies, The Inspector of Financial and Corporate Services and the Compliance Commission. However, in 2004 the Department of Cooperative Development was invited to join the GFSR, thereby formally extending this cooperation network to the credit union sector.

At the end of June 2005, the GFSR published an information-sharing handbook that established the code of conduct for the interaction of local members of the GFSR and shared information cross-border with overseas regulators. Moreover, to enhance the supervision of financial conglomerates, the Government, under the chairmanship of the Minister of State for Finance, appointed a Financial Services Regulatory Reform Commission to consider options for consolidating the regulatory agencies within the financial services industry into a single local regulator.

Furthermore, the Central Bank concluded Memoranda of Understanding (MOUs) covering regulatory cooperation with foreign regulatory authorities where significant ongoing cross-border interaction was anticipated. As of December, 2007, The Central Bank had entered into MOUs with six foreign regulators and signed a multilateral MOU with CARICOM member central banks. Also to facilitate regional cooperation, the Central Bank maintained open lines of communication and membership with bodies such as the

Association of Banks of the Americas (ASBA), Offshore Group of Banking Supervisors (OGBS), Caribbean Group of Banking Supervisors (CGBS) and the Caribbean Financial Action Task Force (CFATF).

These measures taken by the government and the Central Bank, combined with the efforts of other local regulatory agencies, were instrumental in The Bahamas' removal from the FATF's list of Non-Cooperative Countries and Territories (NCCT) on June 22, 2001. The OECD also cleared the name of The Bahamas in March, 2002, after the signing of a letter of commitment with the OECD agreeing to exchange information with overseas authorities on tax matters. The Bahamas achieved Qualified Jurisdiction (QJ) Status from the United States Internal Revenue Service (IRS) on January 9, 2001, due to its enhanced "KYC" regime and because the Bahamas Government had indicated an interest in pursuing a Tax Information Exchange Agreement (TIEA) with the United States. The Bahamas' removal from the "blacklists" and its achievement of QJ status were significant positive developments and signaled the restoration of the jurisdiction's reputation as an international financial centre.

The legislative framework was further strengthened in the years that followed, with amendments made in 2003 to specific Acts. Amendments were enacted to the Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) laws that were passed in year 2000; the Financial Transactions Reporting Act (FTRA), 2000; and the Financial Transactions Reporting Regulations (FTRR), 2000. Amendments were made to align The Bahamas' anti-money laundering regime and KYC standards with the new risk-based approach of the FATF's revised 40 recommendations on money laundering.

The Government also enacted the Anti-Terrorism Act in 2004, which addressed the eight special recommendations of the FATF. The Terrorism Act defined the offence of terrorism and criminalised the financing of terrorism. The laws also provided for the seizure and confiscation of terrorist assets; reporting of suspicious transactions related to terrorist financing; and strengthening of existing mechanisms for cooperation in this regard between The Bahamas and other countries.

The Enhanced Role of Supervision

The Bank Supervision Department is charged with promoting and maintaining the safety, soundness and integrity of the Bahamian banking

and financial system. Traditionally, this objective was achieved through the responsible licensing, exiting and ongoing supervision of banks and trust companies. Ongoing supervision of banks was conducted by assessing the fitness of proposed directors and senior management, approving significant changes to ownership structure, monitoring the financial soundness of banks and their compliance with prudential requirements through analysis of audited and unaudited financial statements.

The Bahamas implemented the Basel Capital Accord (Basel I) in 1992, which heightened the monitoring and enforcement of capital adequacy standards. As a result, in accordance with Basel requirements, all banks and trust companies are required to maintain a capital adequacy ratio of at least 8% at all times.

In January 2001 the Bank Supervision Department had commenced on-site inspections of the records of banking and trust entities licensed to operate in The Bahamas. Within the first year, some 116 on-site inspections were conducted, representing more than 30% of total licensees for that year. These inspections focused on determining the sufficiency with which licensees had implemented the statutory and regulatory requirements for know-your-customer/anti-money laundering policies and procedures.

Starting in August 2001, the scope of on-site examinations was expanded to focus on safety and soundness issues of licensees, inclusive of risk management processes, internal control systems and the effectiveness of the corporate governance structures. By 2002, the examination methodology reflected a risk-focused approach, which resulted in those licensees deemed to be of potentially higher risk being examined on a more frequent basis. In addition to expanding their scope of operations, onsite examiners conducted joint inspections of bank operations with other local and foreign supervisors.

With the establishment of the examination unit, which worked closely with the offsite unit, the effectiveness of the supervisory function was substantially augmented as examiners uncovered deficiencies in banks' operations that were not evident from the analysis of financial statements alone. Over the years, on-site examinations have become an integral component of the bank supervisory oversight function, providing valuable insights into trends and activities of the industry and the operating techniques and practices applied by individual licensees.

Moreover, the Central Bank established a Policy Unit within the Bank Supervision Department in 2002. The mandate of the Unit was to ensure that policies and guidelines issued by the Policy Unit were consistent with international best practices and addressed concerns within The Bahamas. The research and development of supervisory policies and prudential guidelines by the Unit has been shaped by international supervisory development and has been guided by the Central Bank's Basel Core Principles Self-Assessment, the 2002 IMF's Module II Assessment of The Bahamas and the regulatory reform agenda established by the Policy Advisory Committee.

Since the establishment of the Unit, The Central Bank has been committed to a transparent and consultative approach to policy development, making industry participation a valuable and necessary component in the development of supervisory policies. Therefore, the Policy Unit, in consultation with the Legal Unit of the Central Bank, drafted guidelines and invited comments from licensees and other industry stakeholders to assist in fine-tuning these documents to make them more applicable in the Bahamian context.

The Policy Unit, since its inception, has issued guidelines covering a broad array of prudential issues, ranging from implementing proper corporate governance structures, maintaining capital adequacy, managing liquidity risks, controlling impaired assets, establishing minimum standards for outsourcing functions and employing procedures to prevent money laundering and the financing of terrorism. All applicable licensees are expected to adhere to these policies and guidelines.

Ownership Structure and Product Evolution

Prior to 1996, there were five domestic banks with Bahamian ownership, namely Bank of The Bahamas, British American Bank (1993) Limited, Finance Corporation of The Bahamas, Commonwealth Bank Ltd. and Workers Bank Ltd. However, over the years 1996-2007 there were mergers, acquisitions and share offerings via BISX. The percentage shareholding in three domestic banks did not change dramatically over the 1996-2007 period. For the Finance Corporation of The Bahamas (FINCO), 25% was owned by the Bahamian public and 75% by a subsidiary of Royal Bank of Canada. With respect to British American Bank (1993) Limited, 32% was owned by Bahamians and 68% by Fidelity Bank & Trust International Limited. In June 2005, British American Bank (1993) Limited

name was changed to Fidelity Bank (Bahamas) Limited because the British American group was no longer the anchor shareholder of the Fidelity group. The shareholding structure of the renamed entity remained unchanged. Commonwealth Bank maintained its 100% Bahamian ownership, in excess of 900 shareholders. However, ownership of the bank was concentrated in the hands of five shareholders, who collectively owned 50% of the entity. As a result, in November 1999, the bank purchased three million common shares from its three major shareholders and subsequently reissued these shares in April, 2000 to the general public, a move that served to increase the shareholder base by the largest number of new shareholders.

In October 1997, Canadian Imperial Bank of Commerce (Bahamas) Limited (CIBC), a wholly owned subsidiary of CIBC West Indies Holdings Limited, Barbados, offered some $30 million or 9% in common shares to the public. The purpose of the share issue was to begin the process of enabling Bahamians to participate in the ownership of CIBC (Bahamas) Limited, as it was intended that 49% of its equity would be sold to the Bahamian public in stages over time. To ensure that the share issue did not result in a concentration of ownership, a single party was limited to acquiring 0.25% of the existing issued share capital. Amounts exceeding this limit were only permitted with the prior approval of the Minister of Finance. The share issue was fully subscribed and members of the public held a 9% shareholding in CIBC (Bah) Limited after the issue.

In October 2001, the Caribbean banking operations of CIBC West Indies Holdings Limited, Barbados, and its subsidiaries merged with the Caribbean banking operations of Barclays, which is now referred to as the FirstCaribbean Group. The group moved its headquarters to Barbados, with the holding company being FirstCaribbean International Bank Limited. Barclays Bank PLC, a company incorporated in England, owned 45% of the holding company; CIBC, a company incorporated in Canada 45%; and 10% by public shareholders of the countries in the Caribbean region. The group had a presence in at least 15 countries throughout the Caribbean and had the outreach to meet the needs of its Caribbean clientele. A year later within The Bahamas, CIBC (Bah) Limited acquired Barclays Bank PLC's Bahamas banking operations and the name was changed to FirstCaribbean International Bank (Bahamas) Limited (FCIBB), to reflect the local operation and developments within the group. However, in 2007 the ultimate ownership changed, whereby CIBC Canada acquired the shareholding of

Barclays Bank PLC, London, to possess 87.4% of the holding company FirstCaribbean International Bank Limited, Barbados, while for FCIBB, the Bahamian public acquired 4.8% and the holding company the remaining 95.2%.

Another Bahamian owned bank was Workers Bank Limited, with the Bahamas Hotel Catering & Allied Workers' Union being the majority shareholder. Workers Bank Limited commenced operations in 1990, but poor lending practices were implemented, resulting in high levels of non-performing loans and corresponding high levels of provisions. The bank's poor performance resulted in a deficient capital position in comparison to the risks associated with its asset portfolio, necessitating continued equity investments from its major shareholder. Consequently, in October 2001, the Bank of The Bahamas Limited acquired the operations of Workers Bank Limited.

With the acquisition of Workers Bank Limited performing assets and deposit liabilities, the Bank of The Bahamas began to expand its product line and market share. In October 2002, The Bank of The Bahamas was renamed Bank of The Bahamas International (BOBI) and provides services, such as trade financing and the issuance of debit cards which can be used outside the country. In November 2005, the BOBI made a rights offering of 3.6 million common shares to the general public in order to strengthen its capital position, to facilitate growth in its operations and expand its shareholder base. Thus, by end-2007, the BOBI was owned by a combined 51% by the Government of the Bahamas and the National Insurance Board, while some 4,000 Bahamian shareholders possessed 49%.

In The Bahamas, banks servicing the resident population have generally provided a means by which borrowers can access the funds of savers. Banks offer chequing, savings and time deposits, hybrids between chequing and interest bearing savings accounts, as well as various types of loans. Deposits could be held in local and foreign currency, with special features to assist their clients in achieving specific savings objectives. Loans were extended over varied maturities and for varying purposes, such as mortgages, consumer purchases and business ventures. Credit card financing was provided via Visa, pre-paid Visa, Visa debit card, Discover, MasterCard, Suncard, RBC Esso Card, RBC Doctors Hospital Visa Card, the latter two being specialized credit cards offered by the Royal Bank of Canada. Over the years, the number of cards issued has increased from

53,000 in 1996 to 135,953 by end-2007, with the corresponding level of debt outstanding rising by almost $200 million to $257 million.

To make it more convenient to conduct banking business, banks offered extended hours of operation on peak days of the week and commenced "Drive-Thru" teller services. Banks, such as Scotiabank and Royal Bank of Canada, signed onto the Cirrus and Maestro worldwide interbank network to provide their clients access to their accounts at overseas locations. Further, Bank of The Bahamas offers money transfer services via its MoneyGram operation and Fidelity Bank through Western Union. Given the advancement in banking technology worldwide, along with increased demands of the local clientele to conduct business without physically visiting a bank, the range of self-service banking options was expanded to include online banking, telephone banking and increased accessibility to ATMs. However, Citibank discontinued its retail and consumer banking operations in December, 2001, deciding to concentrate instead on its corporate and wholesale business. Meanwhile, Scotiabank (Bahamas) Limited established a small business loan programme utilizing a loan underwriting centre located in Jamaica.

As banks continued to expand into new products and services, in June 1999, Finance Corporation of Bahamas Limited was granted approval to incorporate a wholly owned subsidiary to assume FINCO's insurance agency license and to conduct insurance business in relation to FINCO's portfolio of real estate mortgages. Scotiabank (Bahamas) Limited offered credit insurance products to ensure that outstanding loan balances were settled in the event of death and Bank of The Bahamas International offered trust services to Bahamians.

The process of liberalizing exchange controls in The Bahamas, particularly on capital account transactions, has also aided in the expansion of the products that domestic institutions can offer clients. Commencing January 2006, up to 5% of the country's previous year's external reserves, or a maximum of $25 million, has been allocated on an annual basis for funding the Bahamian Depository Receipt (BDR) programme. In the final quarter of 2007, one institution launched BDRs, enabling Bahamians to diversify their investment portfolios into publicly traded foreign securities.

3.2.3 Domestic Banking Sector

The domestic banking sector consists of commercial banks and other local financial institutions (OLFIs). Commercial banks are defined as deposit money banks operating demand, savings and fixed deposits, and issuing loans through a number of branches. Other Local Financial Institutions are primarily banks and trusts which opt to deal mainly with non-residents and only in Bahamian dollars.

In The Bahamas, commercial banks have historically been the most important depository institutions within the domestic banking sector, being responsible for bank intermediation for private entities and a source of funding for public sector activities. At end-1996 there were nine commercial banks, which operated 83 branches and sub-branches across the country. Over 1996-2007 the number declined by one and at end-2007 eight banks were operating 94 branches countrywide. The number of inhabitants per commercial branch decreased from 4,000 to 3,300 over the 12-year period. Arguably, the efficiency with which banking services were rendered also increased, along with the spread of services nationwide, as the number of employees in commercial banks increased from some 2,266 in 1996 to 3,146 staff in 2007, with average staff count per institution increasing from 252 to 394.

Of the eight commercial banks operating at end-2007, two were wholly Bahamian owned, three were partially owned by Bahamians and the remainder were branches of large international banks from Canada (2) and the United States (1). From 1996 to 2007, the market concentration intensified, as in 2007 the four largest commercial banks held more than 75% of private sector deposits and credit, compared to approximately 50% in 1996. Although all commercial banks have increased their advertising over the years in an effort to differentiate their bank from the others and to increase market share, the landscape of the commercial banking sector is still best categorized as oligopolistic.

There were twelve OLFIs at the close of 2007, all of which predominantly catered to the offshore market. The group of OLFIs no longer consisted of savings and loans institutions operating in the domestic market. These OLFIs have all been subsumed into the commercial banking operations. Savings and loans institutions had typically been subsidiaries of major commercial banks which specialized in offering mortgages to Bahamian residents. However, over time, as commercial banks focused on marketing

themselves as full-service entities inclusive of mortgages, a segregated/specialized mortgage component was no longer necessary. Commercial banks strategically adopted a "one stop shop marketing concept", focused on meeting all of their clients' needs. Although some of these OLFIs remain in name, the product lines traditionally provided by savings and loans were repackaged and aligned with that of a full commercial bank.

For the entire domestic banking system, credit extended to institutions, including the Government, comprised the largest asset category over the period from 1996-2007 (Table 3.5). Total credit outstanding expanded from $2.6 billion in 1996 to $7.1 billion in 2007. Credit to the Government grew by 94% to stand at $534.5 million in 2007, up from $276.0 million in 1996. Domestic banks, however, extended less credit to the Government as a percentage of total outstanding credit, declining to 7.6% of total credit in 2007 from 10.5% in 1996. Conversely, domestic banks provided a three-fold increase in credit to public corporations from $87.3 million in 1996 to $341.6 million in 2007. As a result, over the review period, the Government's funding needs were being increasingly met by institutional investors, including the National Insurance Board and the Deposit Insurance Corporation. Nevertheless, the banking sector remained an important source of the Government's internal borrowing, with the banking system's gross claims on the Government declining only marginally to 33% of the direct charge in 2007, down from 34.2% in 1996.

With regards to the private sector, domestic banks provided credit in the amount of $6.2 billion in 2007, significantly higher than the $2.2 billion granted in 1996. The proportion of loans extended to the private sector correspondingly increased to 87.7% of total outstanding credit in 2007 from 86.1% in 1996. Loans to private individuals contributed to increased profitability of banks and the build-up of capital resources in the domestic banking system to $1.7 billion at end-2007 from $292.6 million at end-1996. However, credit to the private sector was typically granted for personal loans, accounting for a yearly average of 68.2% or $2.7 billion of private sector loans over 1996-2007. Of personal loans, some 51% were related to residential mortgages and 46% comprised consumer loans.

Private sector loans to productive sectors were modest, with credit to the tourism sector at an annual average of 5.5% of total loans, construction at 7.1%, manufacturing at 1.7% and fisheries at 0.3% over the period under

Table 3.5: The Bahamas: Balance Sheet of Domestic Banks (1996-2007) (B$M)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Assets												
Net Foreign Assets	(271.5)	(334.7)	(354.7)	(456.1)	(429.2)	(546.9)	(730.6)	(628.1)	(563.5)	(611.0)	(754.1)	(667.6)
Net Claims on Central Bank	131.5	137.7	162.7	229.5	202.3	252.7	295.8	322.4	461.3	389.7	366.5	450.5
Domestic Assets												
Domestic Credit												
Credit to Government (Net)	276.0	294.3	393.3	425.7	387.8	438.6	478.5	398.0	405.2	528.9	494.5	534.5
Credit to Public Corporation	87.3	84.3	131.3	166.1	132.9	141.2	211.8	365.6	332.1	286.4	389.2	341.6
Credit to Private Sector	2,263.8	2,551.0	2,836.7	3,155.2	3,628.8	3,902.1	4,069.6	4,094.6	4,339.4	4,953.7	5,668.7	6,206.2
Credit to Other Financial Institutions	0.7	(1.0)	(1.0)	(1.9)	2.4	0.9	3.4	(1.9)	(14.1)	(5.8)	(17.8)	(6.9)
Total Domestic Credit	2,627.8	2,928.5	3,360.3	3,745.0	4,151.9	4,482.8	4,763.3	4,856.4	5,062.6	5,763.3	6,534.5	7,075.4
Other Assets (Net)	(38.0)	(2.7)	0.7	34.8	44.5	25.8	65.7	303.3	318.1	264.3	255.3	198.9
Total Assets	2,449.8	2,728.8	3,169.1	3,553.3	3,969.6	4,214.4	4,394.3	4,854.1	5,278.6	5,806.3	6,402.2	7,057.3
Liabilities												
Bahamian Dollar Deposits												
Demand	346.0	401.7	472.5	592.4	641.6	612.9	652.8	725.6	870.1	1,026.3	1,030.7	1,066.1
Savings	355.1	392.9	437.9	548.0	596.1	604.6	630.7	678.8	779.9	881.8	953.3	992.1
Fixed	1,427.3	1,554.4	1,809.2	1,888.5	2,068.8	2,244.0	2,296.2	2,315.9	2,410.3	2,556.6	2,781.5	3,144.8
Foreign Currency Deposits	28.8	41.5	60.7	53.0	86.3	91.8	91.6	101.3	96.9	144.1	159.1	200.1
Total Deposits	2,157.2	2,390.5	2,780.2	3,081.8	3,392.8	3,553.3	3,671.3	3,821.5	4,157.2	4,608.8	4,924.7	5,403.2
Capital and Surplus	292.6	338.3	388.9	471.4	576.8	661.1	723.0	1,032.5	1,121.4	1,197.5	1,477.5	1,654.1
Total Liabilities	2,449.8	2,728.8	3,169.1	3,553.3	3,969.6	4,214.4	4,394.3	4,854.1	5,278.6	5,806.3	6,402.2	7,057.3

Source: The Central Bank of Bahamas

review. In an attempt to stimulate lending to these sectors, the Government offered guaranteed schemes for tourism projects and small business operations. Nevertheless, such incentives did not significantly alter the percentage of private loans granted to these sectors.

Funding for the growth of domestic banks' asset portfolios was derived from increased deposit placements at these institutions (Table 3.5). Bahamian dollar fixed deposit and savings deposits comprised on average 51% and 15% of total funding resources, respectively. For the review period, fixed deposits grew by $1.7 billion to $3.1 billion and savings deposits rose by $637 million to $992.1 million by end-2007. It should be noted that this source of funding has been considered sustainable as the average growth rate of total Bahamian dollar deposits, which is a proxy for the national savings rate, was 8.4%, exceeding the average growth in nominal GDP of 5.8% over the period.

Another source of funding for domestic banks was resource inflows from overseas. This source of funding has advanced over time as represented by the expansion in net foreign assets from $271.5 million in 1996 to $667.6 million in 2007. Net foreign assets grew as the US dollar assets of domestic banks became more substantial and as the head offices of domestic banks provided foreign currency funding. Although resource inflows from the head offices were effectively less than 15% of total bank funding, it was a reflection of the ongoing support for Bahamian licensees within international banking groups.

Bank Failure and the Establishment of Deposit Insurance

From a historical perspective, bank failure and its resultant consequences have been limited in the domestic banking sector. By the end of 1997, however, the failure of Gulf Union Bank (Bahamas) Limited (Gulf Union Bank) proved to be the impetus for the development of a deposit insurance system in The Bahamas. The Gulf Union Bank was granted a bank license in November 1985, but after years of improper lending practices and the build-up of delinquent loans, the bank experienced serious liquidity problems that threatened its safety and soundness. Gulf Union Bank's capital was also inadequate relative to its risk structure and ongoing obligations. Consequently, the Central Bank intervened and required that the principals of Gulf Union Bank take corrective action to solve its liquidity problems and restore its capital reserves to prudentially prescribed limits. Thus, Gulf Union Bank's license was suspended in October 1997 to allow

the bank time to strengthen its capital position. Unfortunately, by the end of that year, it was evident that attempts to recapitalize the bank were unsuccessful and that the bank had effectively failed. Hence, the Central Bank revoked its license and an application was filed with the Supreme Court for the liquidation of the institution.

When placed in liquidation in December, 1997, Gulf Union Bank had total deposits of $33.3 million, with $16.8 million in Bahamian dollars and $16.5 million in United States dollars. Although Bahamian dollar deposits of Gulf Union Bank only represented 0.7% of the total, it affected 2,525 Bahamian depositors. As a consequence, the Government announced its intention to establish a deposit insurance fund to provide partial reimbursement to depositors of the failed Gulf Union Bank and to address future bank failures were they to occur. Therefore, in September 1999, The Protection of Depositors Act, 1999 was passed and came into effect in November of that same year.

The Act established the Deposit Insurance Corporation (DIC) which provides a safety net for depositors in the domestic banking sector in the event that a banking institution failed. The Corporation provides coverage to depositors of its fourteen member institutions, by insuring Bahamian dollar deposits up to a maximum of $50,000 per single depositor per member institution.

The DIC was initially funded by a Government-guaranteed bond issue of $6.75 million, a $0.5 million injection from the Central Bank and a $0.5 million collective contribution from domestic banks, based on their pro rata percentage share of all deposits insured by the DIC as at November 30, 1999. These proceeds established the Deposit Insurance Fund (the Fund) and were used to make payouts to depositors of Gulf Union Bank. By year-end 1999, approximately 86.1% of the qualified depositors of Gulf union Bank had received payment, with some B$3.9 million being paid out of the Fund.

To ensure the ongoing sufficiency of the Deposit Insurance Fund, the DIC was given the power to levy contributions and premiums on member institutions. Membership in the DIC is mandatory by law for all institutions licensed under the Banks and Trust Companies Regulation Act and that are conducting banking business wholly or partly in Bahamian dollars. A member institution is required to pay annual premiums equal to 0.005% of

the average of that institution's resident Bahamian dollar deposits as at March 31 and September 30, of the previous year.

From the inception, premiums were based on the size of a bank's deposit liability structure. However, indications are that in the future, there will be a movement towards levying premiums on the risk asset framework of banks. Consideration will also be given to extending deposit protection to those entities whose business has become increasingly indistinguishable from that of banks.

The establishment of the DIC reinforced the confidence of Bahamian depositors and represented a renewed commitment on the part of the Government and The Central Bank to ensure the stability, safety and soundness in the domestic financial system. Showcasing its resolve in maintaining a deposit insurance system consistent with international best practice standards, The Bahamas became one of the 25 founding members of the International Association of Deposit Insurers (IADI) which was formed in 2002.

3.2.4 Offshore Banks and Trust Companies

The offshore banking and trust sector offers a full range of services, including private banking, private wealth management, estate planning, asset management, fund administration and corporate services. The quality of services offered by reputable offshore entities has contributed to the sustainability of the sector over the period.
In December, 1996, there were 405 offshore banks and trust companies operating in and from within the Bahamas. By end-2007, the number of banks and trust companies in the offshore sector had fallen significantly to 224, comprising 30 Eurocurrency branches of foreign banks, 68 subsidiaries of banks and trusts based outside The Bahamas, 19 Bahamian-based banks and/or trust companies and 107 restricted, non-active and nominee licensees. Offshore banks and trusts originated from over 20 countries, representing branches and subsidiaries of the largest and most prestigious financial groups in the world. Of the 98 offshore branches and subsidiaries, Switzerland had the largest representation in the market with 30 institutions, followed by the United Kingdom (11), United States (9) and Brazil (9).

The 45% decline in the number of offshore banks and trusts from 1996 to 2007 was primarily a consequence of the enhanced legislative, regulatory

and supervisory framework implemented in 2000. The Central Bank, in keeping with its commitment to facilitate consolidated supervision, began to formulate a policy whereby offshore banks and trusts would no longer be permitted to structure their operations in such a way as to avoid supervision in both The Bahamas and their home jurisdiction. Offshore licensees targeted by the Central Bank were "managed institutions", "shell banks" and "stand-alones". These institutions were typically not affiliated with any financial services group subject to effective consolidated supervision and/or had no physical presence with management personnel located in The Bahamas.
Under this new Central Bank policy, no licensee would be permitted to operate in or from within The Bahamas without a physical presence appropriate to the business of that institution. To formalize this policy, in May 2001 the Central Bank issued general guidelines for the transition of managed banks to full physical presence. Subsequently, specific guidelines for branches of foreign banks, unrestricted banks and trust companies and restricted banks and trusts were issued. These guidelines specified how each category of licensee was to establish a full physical presence with adequate corporate governance arrangements, records management, physical facilities and operating procedures in The Bahamas by June 30, 2004.

It should be noted that branches and restricted licensees were permitted to continue operations without maintaining a full physical presence provided they were managed under agreements with other licensees which met certain strict criteria. The Central Bank also did not license a foreign bank to operate a managed branch from The Bahamas unless its parent organization already maintained or established a subsidiary or branch with a full physical presence in the jurisdiction and satisfied the criteria and operating requirements.

In 2001, 356 bank and trust licensees operated. Some 221 of these licensees operated through physical presence. Therefore, 135 existing licensees were strictly managed and were affected by this physical presence policy. They were required to review their operating conditions and make the necessary changes as specified in the applicable guidelines. In the ensuing years, the number of banks and trust companies in The Bahamas began to shrink, as some banks underwent mergers or opted to leave, as opposed to meeting the physical presence requirements. By end-2004, the number of banks and trusts decreased to 266, with 213

maintaining a physical presence. In 2005, after licensees were to have completed their transition to physical presence, on-site examinations were conducted, with the special mandate of ensuring that respective banks and trusts had switched from being managed by other licensees and had established a physical presence in The Bahamas.

The reduction in the number of banks and trusts without physical presence had a negative impact on employment in the banking and trust sector. More specifically, total employment in the sector decreased from 4,586 persons in 2001 to 4,343 persons in 2004, in line with the overall reduction in the total number of licensees over that period. Nevertheless, the Government benefitted from entities pursuing an enhanced physical presence, as fees collected expanded by 14.5% to $18.9 million, while other administrative costs for these entities rose by 16.3% to $194.8 million in 2004.

The physical presence initiative modified and improved the quality and structure of institutions operating in the offshore sector. Most offshore bank and trust entities maintained records in The Bahamas, which could be verified through on-site inspections by the Central Bank. Where “managed entities” still existed, physically present reputable banking groups maintained management agreements with these entities. For the most part, “stand-alones” and “shell banks” which did not facilitate effective supervision within The Bahamas or on a consolidated basis internationally, have been eliminated from the sector.

3.2.5 Non-Bank Financial Institutions

The major non-bank financial institutions include private insurance companies, private and public pension funds, and credit unions and cooperatives. Credit unions and cooperatives, which have in times past played a less significant role than the other entities, have garnered significant importance over the past decade and are becoming a key source of financing for consumers. Additionally, other public financial entities include The Bahamas Development Bank, The Bahamas Mortgage Corporation and the Post Office Savings Bank.

Private Insurance Companies

Insurance companies continue to be one of the principal managers of private pension funds thereby stimulating savings in support of the local mortgage and Government bond markets. This is evidenced by the fact

that at the end of 2006, insurance companies controlled $144.0 million in mortgages, accounting for approximately 7.3% of the market and held Government bonds valued at $47.0 million.
The current legislative regime governing the insurance sector includes the Insurance Act, 1969, as amended; the Insurance (Registration) Regulations 1970, as amended; the Non-Resident Insurer (Exemption) Regulations 1978; the External Insurance Act, 1983 and the External Insurance Regulation 1984. The Office of the Registrar of Insurance Companies, created under the 1969 legislation and passed in 1983, is responsible for regulating the industry and enforcing both the 1969 and 1983 legislations.

At the time of the 1969 enactment, there were more than 300 insurance companies, operating mainly in the offshore sector. Following the requirement that companies publish financial statements, many firms emigrated to Bermuda and the Cayman Islands. Compounding the exodus of many insurance companies was the 1% tax levied on gross insurance premiums under the Insurance (Amendment) Act, 1975. The enactment of the External Insurance Act in 1983 was the turnaround point for the insurance industry, which began to experience some advancement in numbers. At present, there are approximately 205 insurance companies registered to do business in The Bahamas, including 169 companies operating locally.

There are three types of insurance companies presently operating in The Bahamas; these are life and health, property and liability, and captive companies. The life and health insurance sector continues to be dominated by subsidiaries of Canadian and US life insurance companies. Bahamian-owned companies account for less than 30% of the market at end-2006, unchanged from 1996. Of the 169 local companies registered in 2006, 11 are life and health companies (five Bahamian-owned and six foreign companies), 19 are property and casualty companies (seven Bahamian-owned and 12 foreign-owned entities) and 33 are captive insurance companies. In addition, there are 45 insurance brokers and four underwriting managers registered to operate in The Bahamas as at end-June 2007.

At year-end 2006, insurance companies possessed $620 million in annual gross premiums, with $129 million in annual gross premiums for non-resident insurance companies. Annual gross premium income of domestic life and health insurance entities stood at about $333.4 million, while total

assets reached $814.9 million. Non-resident life and health insurance companies held gross premiums of approximately $6.5 million and total assets of about $30.0 million. For resident general insurance companies, yearly gross premiums stood at $281.0 million and total assets at $285.5 million. Meanwhile, non-resident general insurance companies recorded around $39.4 million in premiums and total assets amounted to just about $9.6 million in 2006. Approximately 1,391 persons were employed in the insurance industry in 2006. The industry also administers 27.5% of domestic private pension funds and holds $688 million (11.5% of GDP) in pension savings at the end of 2006.

The Office of the Registrar of Insurance Companies is presently undergoing an institutional organization structure change, to become the insurance supervisory entity (Commission) for oversight of all insurance companies in The Bahamas. It has taken measures to shift from a prescriptive, one-size-fits-all rules-based inspection approach, to a risk-based supervisory approach that places a higher level of management accountability on the industry. It is also looking to enact a new Domestic Insurance Act to replace the 1969 Insurance Act, a new External Insurance Act to replace the 1983 External Insurance Act and ratify a new Pensions Act.

The Domestic Insurance Act was passed in 2005, but it has not yet been enacted because the supporting regulations have not been completed. This Bill will make new provisions for regulating insurance business, reinforcing the regulatory framework for the domestic insurance industry to meet acceptable international standards and offer better protection to policyholders and provide for the creation of an independent supervisory authority. The revised External Insurance Act and new regulations should provide the legislative framework to allow The Bahamas to become competitive in the insurance industry, as it is anticipated that it will help re-establish The Bahamas as a niche market for captive insurance.

3.2.6 Cooperatives

Cooperatives have been in existence in The Bahamas for more than three decades. All Bahamian cooperatives are governed by the Cooperative Societies Act, 1974 and the Department of Co-operatives, which was established to enforce the Act. In conjunction with the Bahamas Co-operative League and Insurance Brokerage Limited—which was created in 1994—the Department of Co-operatives is better able to meet its mandate

of law enforcement, inspection and supervision, education and training, and resource and development, among others.

There are two forms of cooperatives, non-financial cooperative societies and credit unions. Total cooperative membership at the end of 2007 stood at 31,253 individuals with total assets of $238.2 million.

3.2.7 Non-Financial Cooperative Societies

Growth in non-financial co-operative societies has declined over the years, as the number of Producer Service Co-operatives stands at six from 13 at end-1995. These six non-financial co-operative societies[19] have been in existence from as early as 1980. Moreover, membership has fallen to 286 in 2007 from the 1,639 members recorded in 1996, while total assets have declined by 9.5% to $1.9 million. The majority of these co-operative societies are to be found in the Family Islands. Two-thirds of these societies are agricultural in nature, while one is multi-purpose and another relates to the fisheries sector.

3.2.8 Credit Unions

Credit unions have played a pivotal role in the lives of Bahamian consumers since 1996. Members are offered not only consumer loans at below market interest rates, but enjoy other services, such as savings accounts, mortgages, retirement accounts, credit cards and financial counselling. The services they provide reinforce the diversity of the financial services sector.

Since the first credit union was established in 1975, the total number registered at the Department of Cooperative Development increased to 16 at the end of 2007. In addition, since 1995, membership has grown by 46% to 30,967; this membership represents about 18.0% of the total employed labour force and almost all of the membership in the co-operative movement. Cumulative loans of credit unions have grown more than three-fold since 1995 to stand at $155.2 million, while aggregate share capital has fallen to $11.5 million (Table 3.6). Additionally, overall assets amounted to approximately $236.3 million; among all credit unions, four account for about 80.0% of total assets and 84.0% of total loans. These

[19] Bahamas Agribusiness Cooperative Society Limited, North Cat Island Cooperative Society Limited, Abaco Agricultural Cooperative Society Limited, North Abaco Fishing Cooperative Society Limited, Eleuthera Agricultural Cooperative Society Limited and the Grand Bahama Farmers Cooperative Society Limited

Table 3.6: The Bahamas: Balance Sheets of Credit Unions (1996-2007) (B$M)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Assets												
Cash and BCLL Deposits	9.6	12.5	11.5	10.0	9.2	5.1	7.7	9.2	10.0	11.5	12.5	9.6
Loans	108.6	131.5	113.1	110.4	95.5	75.2	83.5	95.5	110.4	113.1	131.5	108.6
Investments/ Securities	30.7	33.2	33.6	23.4	18.3	15.4	16.9	18.3	23.4	33.6	33.2	30.7
Accounts Receivable	0.006	0.004	0.0003	0.002	0.002	0.969	0.013	0.002	0.002	0.0003	0.004	0.006
Fixed Assets	7.6	9.4	8.8	9.4	9.4	9.7	10.5	9.4	9.4	8.8	9.4	7.6
Other Assets	6.0	6.3	6.2	5.0	5.8	4.2	5.4	5.8	5.0	6.2	6.3	6.0
Total Assets	162.5	192.9	173.3	158.3	138.2	110.5	124.1	138.2	158.3	173.3	192.9	162.5
Liabilities												
Members Deposits	76.5	107.6	97.8	95.3	90.4	69.3	81.0	90.4	95.3	97.8	107.6	76.5
Other Deposits	61.3	53.3	48.0	37.0	28.6	23.9	24.2	28.6	37.0	48.0	53.3	61.3
Due to Banks	0.5	0.7	0.6	1.2	1.1	0.1	0.6	1.1	1.2	0.6	0.7	0.5
Loans	0.3	5.3	5.3	6.0	1.7	1.3	1.8	1.7	6.0	5.3	5.3	0.3
Dividends Payable	0.02	0.02	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.02	0.02
Other Payable	3.9	3.1	3.1	2.6	2.0	1.5	2.2	2.0	2.6	3.1	3.1	3.9
Other Liabilities	3.7	3.4	1.8	1.7	1.6	2.2	1.2	1.6	1.7	1.8	3.4	3.7
Total Liabilities	146.0	173.4	156.6	143.8	125.4	98.4	111.0	125.4	143.8	156.6	173.4	146.0
Members Equity	16.5	19.5	16.7	14.4	12.9	12.1	13.1	12.9	14.4	16.7	19.5	16.5
Total Liabilities & Equity	162.5	192.9	173.3	158.3	138.2	110.5	124.1	138.2	158.3	173.3	192.9	162.5

Source: The Central Bank of The Bahamas

four entities are the Teachers and Salaried Workers Cooperative Credit Union Limited, which holds 46% of overall union assets; the National Workers Cooperative Credit Union Limited (14%); the Bahamas Law Enforcement Cooperative Credit Union (10%) and the Bahama Islands Resorts & Casino Cooperative Credit Union (9.0%).

An issue of major concern for the credit union movement as it develops is the increasing efforts to provide prudential supervision and guidelines that are parallel to the regulatory environment presiding over the wider banking industry. In an effort to remedy this matter, a new Co-operative Act was ratified on October 4, 2005. The Co-operative Societies Act, 2005 along with the Regulations and Model Bye-Laws, establish a progressive legislative platform for Bahamian Credit Unions and Producer-Supplier Co-operatives. The Act was derived from a Model Co-operative Act, developed by the Caribbean Confederation of Credit Unions in 1990, with the support from the Faculty of Law at The University of the West Indies. The Bill harmonizes with corresponding legislation in Barbados, Belize and OECS member states.

The 2005 enactment seeks to ensure the safety and soundness of credit unions by compelling all credit unions to maintain Liquidity, Stabilization, Development and Statutory Reserve Funds. Further, it is proposed to establish equity shares as a means of building member capital in credit unions and identify an Apex Body for all co-operatives in The Bahamas. In addition, the regulation seeks to confer responsibility for the administration and management of the Liquidity, Reserve, Stabilization and Development Funds to the Apex Body; require that all co-operative societies comply with the co-operative principles and introduce accountability for directors of societies and allow for penalties for improper decisions; establish a Registered Societies Appeal Tribunal to hear appeals from a decision of the Director of Societies; provide for the establishment of Consumer, Housing, Industrial and Producer-Supplier Co-operatives and exempt these institutions from stamp duties and other fees.

3.2.9 Pension Funds: Private

Private pension schemes in The Bahamas date back to 1862, when there was restricted use by the Government. From a legislative perspective, pension arrangements were initially administered according to the precepts outlined in the Trustee Act (1893). These procedures addressed issues related to trust administration, mainly in respect of capital values

and investment, solvency and soundness, in addition to viable investment options, which was chiefly in the form of Government bonds and securities. This coincides with the nature of private pension arrangements which are created as trusts, thereby ensuring the independence of these assets, as well as the administration of the same, which are distinct from other company assets.

The use of formal and more diverse private pension arrangements in The Bahamas commenced in the early 1960's. These arrangements were primarily motivated by the lack of a national pension scheme in the country. In principle, private pension plans are generally meant to supplement retirement benefits under the National Insurance Board (NIB) Act. The main rationale for this is due to the fact that NIB contributions are capped at a ceiling whereas earnings from private pension schemes have greater growth potential, given the possibility of higher earnings associated with increasing income. As a result, employees view the availability of pension benefits as a key factor influencing their employment choice.

Within the last decade, private pension schemes have become an increasingly important domestic savings vehicle behind the accumulated assets held in bank deposits, as well as the holdings of the National Insurance Board. Buoyed up by periods of vibrant economic activity that supported accretions in the total labour force, the pool of active employees participating in such arrangements has increased to an estimated one fourth of the Bahamian work force. According to the most recent 2005 pension fund survey, with a database spanning more than a decade, private pension funds have grown at an average five-year rate of 6.3%. Moreover, a buildup in contributions stemming from a steady labour force supplement, as well as higher returns on investments, have placed private pension fund assets at just under $1 billion (15.9% of GDP) at the close of 2005. This was below the approximately $1.3 billion in NIB assets (21.6% of GDP), but higher than the share of other financial institutions, including life and health insurance companies and credit unions at $687.9 million (11.5% of GDP) and $190.4 million (3.2% of GDP) respectively. Nonetheless, private individual's savings in the form of bank deposits accounted for the majority share of domestic assets at $2.6 billion (43.6% of GDP).

As was the case in earlier periods, the pension schemes of communications and utility companies comprised the bulk of pension fund assets (30.9%), followed by the financial sector (25.9%) and the tourism industry (24.0%).

(Tables 3.7 and 3.8) Defined contribution plans, inclusive of provident funds, were the most popular pension scheme utilized, representing more than 75% of the entire pension fund pool, 14.7% of pension participants and 21.6% of total pension assets. Such schemes have often been associated with smaller firms due to the cost of savings when compared to defined benefit schemes that require higher funding costs. Conversely, the more traditional defined benefit plan is the premier choice for medium to large sized firms and such plans are held by 85.3% of the participants and occupy approximately 80% of total plan assets.

On the basis of employee participation, the survey disclosed that there was an almost even split between mandatory and voluntary plan participation. By category, more than half of the defined benefit plans required mandatory participation while defined contribution schemes were less stringent, with fewer than 50% of these arrangements requiring mandatory participation. Following growth of 4.6%, there were 41,568 private pension fund participants, which represented approximately 25.9% of the labour force. The majority of these participants (70%) are employed in the tourism sector, namely hotels and restaurants, followed by financial services (11.7%), communications and utilities (6.8%), while the other sectors combined accounted for the remainder (11.5%).

Given the fact that the management of pension fund assets is of a fiduciary nature, such assets have long been primarily invested in secure low-risk products such as Government bonds and securities. Consequently, the survey revealed that 36.0% of pension fund assets were in the form of public debt, while 17.6% of the assets were allocated to bank deposits (Tables 3.9 and 3.10). Indeed, capital market investments have captured growing appeal as evident by steady increases in its proportion of pension fund assets. In particular, a record 30.5% of assets holdings were in the form of equities and mutual funds, a more than doubled allocation, compared to the pre-2000 period. It was also observed that the pension fund assets of the larger financial and tourism sectors were predominately invested in these higher earning capital market instruments. However, apart from the communications and utilities sector, which maintained a large percentage of investments in public sector debt instruments (46.8%), the pension fund asset allocation of the remaining sectors also reflected a shift towards greater capital market vehicles. In regard to pension fund administration, 31.4% of pension funds, mainly those within the financial sector, are administered in-house, while 27.5% are managed by insurance

Table 3.7: The Bahamas: Private Pension Investments by Industry (B$M)

	1995R	1997R	1998R	2000R	2001R	2002R	2003R	2004R	2005P
INDUSTRY									
Construction	0	0	1	1	1	1	1	1	2
Communications & Utilities	191	223	242	240	251	257	271	274	295
Education	5	6	8	9	10	11	12	13	14
Financial Sector	109	134	147	180	188	183	190	218	248
Health	1	1	1	1	1	1	1	1	2
Hotel & Restaurants	86	86	130	154	165	171	185	197	229
Manufacturing	14	16	21	41	8	7	8	8	8
Non - Profit Organizations	0	0	0	1	1	1	1	2	2
Oil Companies	14	15	15	15	15	16	17	18	22
Other Services	10	16	18	26	28	31	36	40	45
Private Distribution	11	12	14	17	19	24	27	30	32
Professional Services	4	5	6	9	9	11	12	13	14
Real Estate	3	4	5	7	6	5	5	6	6
Transportation	12	16	17	24	27	31	31	31	37
TOTAL	461	533	623	724	728	749	796	853	954

Source: The Central Bank of Bahamas Survey on Pension Funds and Central Bank Estimates

Table 3.8: The Bahamas: Private Pension Investments by Industry (% Distribution)

	1995R	1997R	1998R	2000R	2001R	2002R	2003R	2004R	2005P
INDUSTRY									
Construction	0.10	0.08	0.08	0.10	0.13	0.12	0.14	0.13	0.24
Communications & Utilities	41.43	41.78	38.78	33.13	34.44	34.29	34.06	32.10	30.91
Education	1.19	1.13	1.22	1.25	1.36	1.42	1.47	1.50	1.42
Financial Sector	23.69	25.09	23.56	24.80	25.87	24.44	23.89	25.57	25.94
Health	0.11	0.11	0.11	0.16	0.17	0.15	0.13	0.15	0.19
Hotel & Restaurants	18.70	16.15	20.79	21.32	22.61	22.84	23.27	23.12	23.95
Manufacturing	2.98	2.98	3.30	5.64	1.08	0.92	0.95	0.95	0.85
Non - Profit Organizations	0.07	0.06	0.05	0.11	0.11	0.11	0.13	0.27	0.17
Oil Companies	2.97	2.72	2.41	2.11	2.09	2.11	2.10	2.13	2.27
Other Services	2.13	3.04	2.97	3.59	3.83	4.16	4.48	4.70	4.74
Private Distributions	2.46	2.29	2.32	2.35	2.55	3.19	3.36	3.50	3.34
Professional Services	0.91	0.99	0.92	1.23	1.25	1.46	1.47	1.51	1.50
Real Estate	0.56	0.67	0.74	0.91	0.80	0.65	0.65	0.67	0.58
Transportation	2.71	2.92	2.76	3.29	3.71	4.13	3.90	3.68	3.89
TOTAL	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Source: The Central Bank of Bahamas Survey on Pension Funds and Central Bank Estimates

Table 3.9: The Bahamas: Private Pension Investments (B$M)

	1995	1997	1998	2000	2001R	2002R	2003R	2004R	2005P
	(B$'000)								
Government Bonds	137	162	183	232	237	266	289	344	343
Bank Deposits	124	148	198	201	210	194	196	170	168
Real Estate	3	4	5	7	7	13	13	8	7
Employer's Business	3	3	4	7	7	7	7	5	8
Mortgages	91	79	77	44	38	35	32	30	26
Private Sector Bonds	4	16	2	1	1	3	3	21	2
Equities	37	53	75	119	114	120	128	138	202
Mutual Funds	10	13	18	48	43	35	38	59	89
Loans	8	10	10	9	9	10	12	18	18
Contributor Arrears	2	6	9	3	5	5	10	5	5
Dividends	5	6	8	9	10	11	10	6	4
Other Investment	37	34	36	42	46	49	58	48	81
Total	461	534	623	724	728	749	796	853	954

Source: The Central Bank of The Bahamas Survey on Pension Funds & Central Bank Estimates

Table 3.10: The Bahamas: Private Pension Investments (B$M) (% Distribution)

	1995	1997	1998	2000	2001R	2002R	2003R	2004P	2005P
Government Bonds	29.82	30.32	29.35	32.09	32.50	35.57	36.36	40.33	35.95
Bank Deposits	26.85	27.71	31.77	27.83	28.90	25.96	24.60	19.96	17.64
Real Estate	0.71	0.70	0.76	1.01	0.97	1.69	1.61	0.94	0.74
Employer's Business	0.70	0.65	0.59	1.00	0.98	0.89	0.89	0.58	0.88
Mortgages	19.66	14.73	12.42	6.05	5.25	4.72	4.02	3.54	2.68
Private Sector Bonds	0.78	3.04	0.28	0.09	0.09	0.43	0.39	2.52	0.24
Equities	7.96	9.93	12.06	16.46	15.66	15.97	16.08	16.21	21.15
Mutual Funds	2.07	2.50	2.82	6.65	5.97	4.74	4.79	6.95	9.32
Loans	1.79	1.83	1.53	1.29	1.27	1.35	1.45	2.10	1.93
Contributor Arrears	0.48	1.05	1.45	0.48	0.70	0.71	1.30	0.59	0.56
Dividends	1.04	1.15	1.24	1.29	1.39	1.41	1.26	0.68	0.42
Other Investment	8.13	6.39	5.72	5.76	6.33	6.56	7.24	5.61	8.49
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Source: The Central Bank of The Bahamas Survey on Pension Funds & Central Bank Estimates

companies, 24.2% by other professional administrators and 17.0% by banks and trust companies.

3.2.10 The National Insurance Board

The National Insurance Act (1972) came into effect in October 1974, establishing a national insurance scheme for all employed, self-employed and voluntarily-insured persons. The National Insurance Board (NIB) (a quasi-government agency) has been mandated to administer the scheme and provide social security benefit payments to the insured and non-insured. By law all employers and employees (permanent and temporary), regardless of nationality or immigration status, and all self-employed persons should participate in this plan. The plan was implemented through a three-phase process, with employers and employees brought into the programme on October 7th 1974 ("First Appointed Day"), followed by self-employed persons who were included on April 5th 1976 ("Second Appointed Day"), and the final inclusion was the addition of industrial benefits in 1980 ("Declared Day"), this provided the basis for repealing the Workmen's Compensation Act. The scheme operates on a Pay-As-You-Go (PAYG) system and covers sickness, funeral, invalidity, maternity, retirement, survivorship (given on the death of the bread-winner), industrial injury (which includes disablement), death and medical care. The plan also offers old age non-contributory pensions (OANCP) and other non-contributory social assistance.

The headquarters of the National Insurance Board (NIB) is located on the Island of New Providence, but the (NIB) conducts business from 25 local offices and several sub-offices, which have been set up in New Providence, Grand Bahama and most of the Family Islands. Contributions are made based on a "contribution week", Monday–Sunday, and are calculated on wages/salary earned during that week. The contribution amount was capped at the 1984 figure of $250 and later amended on January 1st 1999 to $400. Contributions for employees range from 1.7% to 3.4% and 5.4% to 7.1% for employers. Self-employed persons are classified into group "A", who contribute 6.8% and group "B", who pay 8.8% of average income capped at $400.

The NIB has made tremendous strides in its development and has continued to record surpluses on its account, with accumulated reserves up by 73.6% to $1,351.1 million in 2005, compared to $778.4 million in 1996. The current surpluses of NIB represent an important source of savings,

especially in comparison to the other savings plans that exist in the economy. This is the second largest pool of savings after private individuals' bank deposits and as such can impact greatly on the successful execution of monetary policy and the balance of payments. The investment of these surpluses has had macroeconomic implications, as it relates to the level of credit advanced and what is available. These savings are a large source of credit funding for the Government and the public corporations, growing at a four-year average of 5.0% during 2002 to 2005. Investment practices are governed by the National Insurance Act (1972), and the Board is mandated to invest in assets which carry minimal risk, high yields and optimum liquidity. To this end, the objective is to encourage socio-economic development in The Bahamas. Table 3.11 provides a breakdown of the assets and liabilities of NIB over the period 1996 – 2005. Under the new relaxation of Exchange Control Restrictions on Capital Account (2006), a maximum of $25 million per annum at the official exchange rate has been made available for NIB to invest in foreign investment instruments. Thus NIB now has the option of diversifying its investment portfolio outside of The Bahamas.

Annual reports from NIB for 1996-2005 showed that total assets over the 10-year span increased from $792.4 million to $1,386.8 million, with the investment portion up to $1,267.0 million in 2005 from $742.1 million in 1996 (Table 3.11). The value of assets as at the end of 2005 outstripped M1 and was below M2 at a rate of 4.2%. The investment portfolio remained largely concentrated in short, medium and long-term domestic instruments, consisting primarily of Government debt and certificates of deposits. The 2005 report revealed that $590.6 million, or 42.6% of total assets, were invested in Government bonds; $126.3 million (9.1%) in Treasury bills; $170.3 million (12.3%) in bank deposits; $143.4 million (10.3%) in other investments; $131.6 million (9.5%) in the Bahamas Mortgage Corporation debt; $19.2 million (1.4%) in loans to Government Corporations and $40.8 million (3.0%) in equities. Over the years, the Board has also invested in direct financing leases.

The NIB's accomplishments have been quite significant in its 33 years of existence and the Board has been progressive and innovative. The Board continues to invest by building clinics in the Family Islands, and purchasing several real estate complexes that were formally leased to the Government. Further, the Board signed a major contract with the Government to build an office complex for the Police Department in

Table 3.11: The Bahamas: The National Insurance Board (B$M)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Assets										
Cash and Demand Deposits	6.6	4.6	4.5	13.7	6.3	12.3	8.2	25.2	87.2	27.5
Investments										
Short-Term Fixed Deposits	76.9	80.8	106.5	168.5	234.0	309.5	295.2	224.3	151.7	170.3
Long-Term Fixed Deposits	5.5	5.1	3.0	-	-	-	-	-	-	-
Loans to Public Corporations	29.4	25.8	25.0	28.0	23.0	12.7	11.9	31.1	33.5	19.2
Bahamas Mortgage Corp. Bonds	107.2	107.2	107.2	103.4	101.1	93.7	92.7	114.4	109.8	131.6
Treasury Bills	25.2	24.6	36.2	24.9	15.9	5.0	67.7	131.4	152.6	126.3
Government Registered Stocks	471.2	525.6	541.4	537.5	530.2	514.7	506.2	494.4	519.5	590.6
Other Investments	26.7	30.2	33.4	39.4	55.3	56.0	95.7	157.3	175.6	229.0
Total Investments	742.1	799.3	852.7	901.6	959.4	991.5	1,069.3	1,152.8	1,142.7	1,267.0
Fixed Assets	21.2	21.7	24.6	31.0	47.2	38.7	38.1	36.9	37.3	36.3
Other Assets	22.5	20.7	25.8	26.1	29.5	79.7	71.7	39.4	55.6	56.0
Total Assets	792.4	846.3	907.6	972.4	1,042.5	1,122.1	1,187.3	1,254.3	1,322.9	1,386.8
Liabilities										
Reserves										
Short-Term Benefits	10.4	10.6	11.2	11.0	9.9	8.4	7.9	6.3	2.4	10.9
Pension	609.1	653.9	703.7	755.2	814.1	882.0	937.5	995.1	1,054.7	1,118.9
Other	158.9	167.1	176.0	185.7	195.7	208.1	217.1	225.1	228.5	221.4
Total Reserves	778.4	831.6	890.9	951.9	1,019.6	1,098.5	1,162.5	1,226.5	1,285.7	1,351.1
Other Liabilities	14.0	14.7	16.7	20.4	22.9	23.6	24.8	27.8	37.2	35.6
Total Liabilities	792.4	846.3	907.6	972.4	1,042.5	1,122.1	1,187.3	1,254.3	1,322.9	1,386.8

Source: The National Insurance Board

Freeport, Grand Bahama Island. Nevertheless, in the interest of prudent exchange rate and balance of payments management, NIB and the Central Bank have ongoing consultations with respect to the Board's investment portfolio.

3.2.11 *Bahamas Mortgage Corporation*

In October 1983, the Bahamas Mortgage Corporation (BMC) was created by an Act of Parliament dated the same year[20]. In its role as a public sector financial intermediary, the BMC distributes Government-guaranteed loans as set forth in the Housing Act. However, the corporation is also authorized to issue private mortgage loans and assist the Department of Housing with construction and infrastructure funding.

Over the years, thousands of Bahamians have received funding for the construction of new homes, the purchase of new or existing homes, as well as housing renovations and extensions. On average 272 loans are approved annually, with Government housing initiatives comprising the bulk of its loan portfolio. As a matter of policy, BMC allocates 5% of its funding towards non-guarantee or uninsured loans, the result being that borrowers can access greater financing. During the past two decades, BMC has issued total financing of nearly $350 million.

From a financial standpoint, BMC's mortgage portfolio firmed to $212.5 million as at year-end 2005 compared to $152.8 million in 1996 (Table 3.12). The corporation has the right to issue up to $120 million in Government bonds to facilitate its financing requirements. Further, its total Government-guaranteed mortgage bonds outstanding stood at $123.2 million in 2005, which was $7.3 million above the 1996 level. Such bonds are issued in $100,000 allotments, with returns normally pegged to the Prime Rate. The National Insurance Board remains the largest holder of these bonds, accounting for 86%, followed by commercial banks (13%) and insurance companies (1%).

[20] The Bahamas Mortgage Corporation's mission is to "stimulate, encourage, and promote home ownership for Bahamians with low to moderate income, by providing superior mortgage finance services.

Table 3.12: The Bahamas: Balance Sheets of Mortgage Corporations (1996-2005) (B$M)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Assets										
Cash	11.3	11.2	11.8	14.7	16.3	12.0	6.7	13.5	4.0	-
Sinking Fund Investments										
Government Registered Stock	22.0	30.4	33.0	36.7	38.5	36.3	35.8	37.9	36.4	36.8
Bank Deposits & Other Sinking Fund	10.4	6.0	9.3	11.7	10.8	10.5	12.9	17.4	23.1	25.1
Total	32.4	36.4	42.3	48.4	49.2	46.8	48.7	55.3	59.5	62.0
Construction in Progress	5.9	7.5	8.3	9.3	13.4	18.9	26.1	30.0	48.9	32.5
Mortgages	101.1	100.6	100.0	96.1	89.7	87.2	77.8	76.0	72.9	100.3
Other Assets	2.1	0.7	0.7	0.5	0.9	1.3	9.4	13.6	16.5	17.7
Total Assets	152.8	156.5	163.1	169.0	169.5	166.1	168.7	188.4	201.9	212.5
Liabilities										
Current Liabilities	3.2	2.5	3.3	2.9	3.4	2.8	3.0	4.0	7.3	7.1
Bonds Payable	115.9	114.9	114.9	114.9	109.7	101.6	98.2	111.3	117.0	123.2
Capital	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Accumulated Surplus (Deficit)	32.7	38.1	43.9	50.1	55.4	60.7	66.5	72.1	76.5	81.2
Total Liabilities	152.8	156.5	163.1	169.0	169.5	166.1	168.7	188.4	201.9	212.5

Source: The Bahamas Mortgage Corporation

3.2.12 *The Bahamas Development Bank (BDB)*

The Bahamas Development Bank (BDB) has been in operation for 30 years, having been established to assist in the economic development of The Bahamas by financing the development of industry, tourism and agricultural diversification, either through the financing or investing in approved enterprises. It has been providing the necessary financing of projects which commercial banks would not ordinarily finance because of the length to maturity and perceived riskiness of these loans. When the BDB commenced operations in 1978, it was given $5.0 million in authorized capital; however, eleven years later (1989), that amount was increased to $50.0 million to furnish the institution with more funding from the Government. The figure has remained unchanged as at end-2007. The importance of the BDB in providing needed financing is highlighted by the rise in credit given to the public. At the end of 1996, credit outstanding totalled $28.5 million, but it almost doubled to $56.4 million in 2007.

Funding for the BDB is primarily obtained from loans acquired from international lending institutions and capital funding from the Government. The share of resources obtained through capital funding has been declining over the years, going from 54% of all resources in 1996 to 45% in 2000 and finally to 39% at end-2007. However, resources obtained through borrowings increased from 51% of total resources in 1996 to 72% in 2000 and then to 90% of all resources in 2007. Resources obtained from the Caribbean Development Bank (CDB) and the National Insurance Board (NIB) continue to be vital to the Bahamas Development Bank in meeting its mandate, as contributions from NIB ($38 million) accounted for 76% of resources, while contributions from the CDB ($7.9 million) for 16% of resources at the end of 2007.

The substantial increase in loans highlights the institution's ongoing issue with profitability. The number of non-performing loans has grown noticeably, with 51.0% of loans falling into this category. Accumulated operational losses for 2007 were 63.0% of total assets, this compares to approximately 5.9% of total assets in 1996. After suggestions were made for the Bank to play a more significant role in the development of small enterprises, a major initiative was undertaken in 2007 to go beyond just funding, and to contribute toward business success by helping business persons during the development, implementation and growth stages of

Table 3.13: The Bahamas: Bahamas Development Bank Sectoral Credit (B$'000s)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Agriculture	1,914	1,784	2,012	1,655	2,007	1,898	1,942	1,548	1,581	1,761	1,869	1,960
Fisheries	6,592	6,329	7,188	7,998	7,919	7,225	7,631	7,699	8,226	8,156	7,104	7,207
Manufacturing	2,932	2,897	2,873	2,768	2,308	1,949	1,936	1,832	2,163	2,521	2,896	3,117
Transportation	3,899	3,887	3,935	3,456	3,358	3,181	5,162	5,997	8,061	8,608	9,339	9,002
Other Industries	9,783	9,596	11,127	14,193	15,435	18,154	19,147	19,411	21,012	22,576	23,910	24,945
Tourism	3,384	3,193	3,648	5,234	8,771	9,253	9,839	10,411	10,294	9,719	9,728	10,172
Hotels	1,244	1,212	1,619	1,671	2,392	2,249	2,586	2,544	2,487	2,483	2,394	2,309
Hotel Apartments	335	486	487	1,059	3,752	4,358	4,525	5,513	5,476	5,408	5,240	5,322
Other	1,805	1,495	1,542	2,504	2,627	2,646	2,728	2,354	2,331	1,828	2,094	2,541

Source: The Bahamas Development Bank

their investment projects. Therefore, the goal of the Business Advisory Services Unit is to develop early warning systems for potential problem areas for new businesses, provide supporting documents for the expansion of any future plans and afford businesses options for achieving their objectives. For those businesses that are already established and are facing financial problems, the Unit will perform a systematic review and will attempt to resolve these delinquent loans. According to statistics for 2007, the tourism sector is the largest single beneficiary of the BDB's lending (18.0%), followed by transportation (16.0%) and fisheries (12.8%). The remainder of loans are dispersed among agriculture, manufacturing and other sectors (Table 3.13).

Most recently, the BDB has commenced exercises to reduce the number of non-performing and delinquent loans on its books. In addition, the Bank has devised a new strategy for reversing the trend of delinquency by introducing more stringent requirements for obtaining a loan.

3.2.13 The Stock Exchange

In September of 1999, The Bahamas' sole stock exchange, Bahamas Securities Exchange Limited (BISX), was inaugurated and was incorporated as a private company, owned by 45 dedicated shareholders. In May 2000, it commenced listing and trading of securities of local public companies. BISX is registered with the Securities Commission of the Bahamas as a Securities Exchange under the Securities Industry Act 1999. As such, it has the mandate of regulating its members and listed companies.

Over the seven-year period in which it has been operational, the number of companies listed on BISX has grown from 15 in 2000 to 19 in 2007, with the highest number of companies listed at 20 in 2006. As it stands, there are four broker-dealer members which have the authority to trade listed securities on BISX. In April of 2001, BISX introduced the mutual fund listing facility, which provided for primary and secondary listings for the Bahamian and international mutual funds that are registered.

During the review period (2000-2007), the performance of the Bahamian stock exchange has been for the most part upbeat. Although the annual value of stock traded has oscillated between a low of $7.4 million (registered in 2003) and a high of $36.3 million (registered in 2005), the value over the seven-year period averaged $23.4 million. The movement in value over the years is reflective of the mix of companies listed, changes in

their performance and the consequent fluctuations in the stock prices. The volume of shares traded on the exchange peaked at 8.0 million shares in 2004, while the lowest level of trading was registered in 2002 at 3.0 million (Table 3.14). The average annual trading volume on BISX over 2000-2007 was 4.9 million each year.

With the goal of improving the infrastructure of the capital market and enhancing the capacity and efficiency of the Exchange, in 2002 the BISX Joint Capital Market Development Working Group was established. The working group consisted of representatives from both the private and public sectors and had a mandate to develop a long-term financing proposal for BISX. Upon conducting a study funded by the Central Bank of The Bahamas, a strategic plan featuring recommendations was compiled and provided to the Government. One of the initiatives that stemmed from this exercise was the development of a framework for the listing of Bahamas Government Registered Stock (BGRS) on BISX, along with transferring the secondary market transactions of the registered stock to the Exchange.

In 2006, the Central Bank, along with the BISX and the Bahamas Government, worked together to assess the feasibility of the transfer, considering its cost and benefits. However, as of end-2007, a conclusion had not been drawn, as an appraisal of the transfer's process and merit continued.

Table 3.14: Bahamas International Stock Exchange (BISX) Trading Volume & Value 2000-2007

Year	Value(B$M)	Volume
2000	23.6	3,719,730
2001	23.2	4,017,533
2002	15.1	3,030,485
2003	7.4	3,568,971
2004	24.3	7,996,294
2005	36.3	6,723,973
2006	28.7	5,251,167
2007	28.3	4,770,278

Source: BISX Year End Statistical Reports 2000-2007

3.3 Conclusion

The financial sector of The Bahamas continues to play a pivotal role in the economic development of the country and has maintained its dynamism over the years. During the review period, 1996-2007, considerable

resources were devoted to implementing the revamped financial legislation and regulations, in order to ensure that the developments within the financial system are in keeping with international standards.

Further, the evolution of the financial system over the period 1996-2007 has been vibrant with the introduction of a variety of banking products. More sophisticated banking services, such as credit cards, debit cards, money-backed mortgages, telephone and online banking, are now being offered. Developments also feature the establishment of the Bahamas' sole stock exchange, BISX, which is a vital part of the financial sector. In addition, Bahamians now have access to a wider range of investment products such as mutual funds.

Moreover, capital account liberalization measures introduced in 2006 provided a boost to the modernization of the financial sector. More specifically, the local stock exchange is now allowed to engage in cross-border listings on principal CARICOM exchanges, while the National Insurance Board has been granted permission to invest an approved annual amount overseas.

Overall, developments in the Bahamian financial system over the past 11 years have increased the scope of financial services afforded and financial institutions are taking advantage of international technological advancements. The financial sector has undergone momentous changes, resulting in widespread accessibility to better-quality financial products.

4

The Evolution of the Barbadian Financial Sector (1996-2008)

Stacia Howard

Since the mid-1990s when the last edition of this volume was published, the Barbadian financial sector has undergone a number of changes, and in 2007 it is noticeably larger, broader and deeper than in 1996 when our review begins. In the earlier years of post-independence Barbados, the financial system was almost constantly in a state of flux: the Central Bank was learning to cope with its various monetary and exchange rate stability mandates; the commercial banks were adjusting their internal systems to address the development needs of the fledgling economy; non-bank financial institutions were trying to cement their place in their respective niche markets; the stock market was having a hard time convincing companies to list on the exchange; and government was learning the hard way how to manage a small island developing state.

During the first three decades following independence in 1966, policymakers struggled with three sharp recessions (1974-75, 1981-82 and 1991). The first two recessions were the direct result of oil shocks in 1973 and 1979, and highlighted with great clarity the vulnerability of the Barbados economy to international developments. While policymakers were able to weather the first recession on their own, the second, in the 1980s, prompted a request for assistance from the International Monetary Fund (IMF). The worst recession during the period 1970-1996 however, was the last, in 1991, which was so severe that the economy reeled from widespread job losses and a sharp contraction in output in addition to destabilised fiscal and external sectors. Once again, emergency assistance

was required from the International Monetary Fund to assist government with restoring stability; however, the effects of that recession continued to be felt for a number of years.

These events interrupted the otherwise steady advancement of the financial system and economy as a whole. In recognition of its limited natural resources, policymakers worked at positioning the Barbadian economy as a service-oriented one and thus put measures in place to encourage the expansion of the already vibrant tourism market as well as to develop an international financial sector. This thrust towards services came at a time when the limitations of the manufacturing and agricultural sectors were becoming abundantly clear. Therefore, as tourism and other service sectors grew, the contribution of agriculture and manufacturing started to slip.

One key sector that benefited during this time was financial services. Firstly, confidence in the sector had grown significantly, and a greater proportion of savings was entrusted to the commercial banks and other deposit-taking financial institutions, as reflected by higher ratios of bank deposits to GDP. Secondly, the Central Bank was working towards less reliance on direct tools of monetary policy and as a result financial markets blossomed. Thirdly, government actively encouraged the emergence of what at that time were non-traditional financial instruments such as mutual funds. Finally, increased demand for financing was being spurred by the rapid development of the services industries.
While there are numerous factors behind these changes, such as macroeconomic factors and monetary policy changes, perhaps the most significant is the ongoing gradual liberalisation of the financial system, as this has directly or indirectly impacted all aspects of the system. Financial liberalisation became a specific goal of policy makers following the 1991 recession and as such, many of the measures undertaken from the mid-1990s to 2007 are in line with this aim and will surface in greater detail throughout this review. Nonetheless, it is worth noting that despite the great strides towards a more market-oriented sector with fewer controls, there is quite a bit of work still ahead before Barbados can boast a fully liberalised financial system.

4.1 Economic Developments

The Barbadian economy has been on a steady upward path from 1996 to 2008, with the exception of a decline in output in 2001 in the wake of

September 11th. Real GDP growth has averaged 2.4%, almost doubling the 1.3% averaged between 1970 and 1995, and reached as high as 4.8% in 2004 at the onset of a three-year credit boom. Nominal GDP during this period also more than doubled, leading to a GDP per capita of $12,687.3 US[21], one of the highest in the region. The 1996-2008 period also saw the consolidation of the transition to a service-based economy, as the share of tourism value-added to total real GDP increased from 13.5% to 15.3%, coincident with the decline in the shares of agriculture and manufacturing from 8.1% and 10.4% to 5.5% and 6.9%, respectively.

The economic gains made in this 13-year period were translated into social gains, as evidenced by a reduction in the average unemployment rate to singles digits for the first time in the post-independence period, falling to a low of 7.4% in 2007. Additionally, according to the Human Development Index of the United Nations Development Programme (UNDP), Barbados has a high level of human development and ranks first amongst 108 developing countries in terms of the Human Poverty Index of the UNDP.

As a fixed exchange rate regime, the level of net international reserves has been paramount as it permits the successful defence of the exchange rate peg. Although the country has been able to maintain the 2:1 parity with the US dollar since the introduction of the Barbados dollar, there are clearly identifiable periods of 'strain' as well as periods of buoyant growth in the level of reserves. In 1996, the level of net international reserves of the monetary authorities stood around $513.8 million and maintained a generally upward path until 2003, when it was roughly triple that, at $1,503.3 million. Between 2004 and 2006, however, the net international reserves declined by around $309.4 million as a result of a credit boom during that three-year period. Despite a resurgence in 2007, the reserves once again started to fall as the country grappled with the negative fallout from the global financial crisis that took hold in 2007 and into 2008. While the level of reserves is still sufficient to cover nearly four months of imports of goods and services, it is below the high of just over six months reached in 2001.

The pressure on the net international reserves reflects to a large degree the weaknesses in Barbados' external current account. Prior to the transition to a service-based economy, the external current account was

[21] Source: United Nations Statistics Division

largely in surplus. From 1997, however, Barbados has not been able to yield a surplus and, in fact, the deficit has steadily deteriorated. The capital and financial account has therefore been the major contributor to the sustainability of the net international reserves.

Government operations during the 1996-2008 period has largely been aimed towards supporting overall economic activity and the broader social goals, as well as the introduction of the CARICOM Single Market and Economy. This latter goal was spearheaded by the Arthur administration, which was in power in Barbados from 1994-2008. Although a new government took the reins in early 2008, the longevity of the Arthur administration translated into political stability throughout the review period. The fiscal balance during the period improved somewhat (moving from an average of 3.6% between 1980 and 1995 to 2.9% between 1996 and 2008), though substantial variation still prevailed from one year to the next. One of the most notable developments in the public sector during this time was the increased use of public-private sector partnerships, usually in the form of build-operate-lease-transfer operations (BOLTs), which allowed the government to pursue a number of expensive capital projects such as the construction of a new prison and the expansion of the ABC highway.

4.2 The Barbadian Financial System

The Barbadian financial system consists of the central bank, commercial banks, merchant banks, finance companies, trust companies, credit unions, insurance companies and pension funds, financial asset management firms, financial brokerage firms and a stock exchange. These institutions operate primarily in money, credit, equity, bond and foreign exchange markets and are of both domestic and international ownership. Between 1996 and 2007, the financial system developed substantially and this section will focus on overall transformation of the sector before delving into the specific institutions and markets (in the remaining sections of the chapter). There are a number of ways to assess the development of financial sectors. This study will broadly follow the suggestions made by the World Bank and the IMF (2005) (in their Financial Sector Assessment Handbook). As such, Table 4.1 summarises the key indicators of financial sector development: size, breadth and competition, concentration and efficiency.

The size of the financial system, as measured by the value and percentage of total assets of financial intermediaries to GDP, has grown substantially

since 1996 from roughly $7.0 billion to $17.5 billion and from 172.0% of GDP to 237.7% of GDP in 1996 and 2008, respectively. This represents a more than doubling of the assets of the sector. The significantly increased use of the financial sector is evidenced by greater ratios to GDP of both credit and bank deposits. This suggests that the use of the financial sector has risen substantially over the last 12 years and this has led to rapid growth in the size of the sector.

Table 4.1: Descriptive Statistics of the Barbadian Financial System

	1996	1999	2002	2005	2008
Total Financial Assets [1]	6,869.2	8,175.1	11,165.5	15,444.9	17,497.0
Total Financial Assets [2]	172.0	165.0	225.5	258.7	237.7
Money Supply to GDP (%)	26.0	28.2	46.2	53.4	49.9
Private Sector Credit [2]	39.5	51.2	55.6	63.5	70.7
Bank Deposits [2]	78.9	78.9	103.8	117.3	121.4

1 In absolute terms ($Bds millions)
2 As a percentage of GDP (%)
Source: Central Bank of Barbados

When considering the penetration of the financial sector, the development is just as impressive. The ratio of gross insurance premiums to GDP, especially non-life insurance premiums, has risen markedly while the growth of mutual funds' assets has been remarkable. The Barbadian population, therefore, has been making greater use of the financial services available by not just the banks but also the non-bank financial intermediaries. This indicates that the system has grown much broader since the 1990s. This development is further evidenced by the new kinds of institutions present in the market in 2007 that were non-existent in 1996, such as dedicated asset management firms, brokerage companies and merchant banks. However, it must be noted that a number of institutions also exited the market. For example, Barbados no longer has a development bank and there are no government-owned commercial banks or mortgage finance institutions (although the government still owns shares in some of these entities). In fact, government now focuses on providing financial services for niche segments of the market through: the Barbados Youth Business Trust, which finances youth-owned small businesses; the Enterprise Growth Fund, which provides venture capital to eligible companies; and the Barbados Agency for Micro Enterprise Development Ltd. (commonly referred to as Fund Access), which lends to small and medium-sized enterprises.

Table 4.2: Share of Financial System Assets (%) [1]

	1996	1999	2002	2005	2008
Central Bank of Barbados	11.0	9.0	10.6	7.5	7.3
Commercial Banks	54.2	58.0	56.1	53.7	57.7
Credit Unions	3.4	4.1	5.1	5.7	5.9
Insurance Companies[2]	12.2	7.2	6.8	11.3	8.5
Trust and Mortgage Finance Companies	6.9	5.2	4.8	4.9	3.8
Finance Companies and Merchant Banks	1.0	2.0	2.7	3.3	3.0
National Insurance Fund	11.1	14.5	13.9	13.6	13.9
Total	100	100	100	100	100

1 The assets in mutual funds are not available
2 2008 information not available for insurance companies, so last available period used
Source: Central Bank of Barbados

According to the FSA (World Bank, IMF 2005) Handbook, the gradual withdrawal from the financial sector by government could be viewed positively since it is noticed that financial sectors tend to become more efficient the more governments limit their involvement. This also seems to hold true for the Barbados case, as evidenced by lower interest rate spreads, lower intermediation costs and higher levels of competition (as measured by the Herfindahl Index). Table 4.2 also clearly suggests that while commercial banks continue to dominate the system, credit unions and finance companies and merchant banks have been slowly increasing their market share of total financial system assets. Indeed, when assessing the share of private sector financing of the various financial intermediaries, the market shares of credit unions and finance companies and merchant banks have risen from 1.2% and 1.5% to 3.7% and 4.3%, respectively.

Despite this improvement, the financial sector is still very much bank-based, with non-bank financial institutions not yet providing meaningful competition to the commercial banks. A study conducted by Belgrave, Craigwell and Moore (2006) assessed the competition posed by credit unions and found that, despite their growing market share and popularity within the Barbadian public, they have yet to provide serious competition to the banks. Furthermore, commercial banks still account for the majority (83.9%) of total domestic deposits and individuals still entrust most of their savings (almost 75%) to commercial banks. Credit is also still mainly provided by commercial banks, which accounted for roughly 65% of total credit extended to the non-financial private sector in 2007.

4.3 Financial Institutions

4.3.1 Central Bank of Barbados

The Central Bank of Barbados is the lead financial institution in Barbados as well as the monetary authority. In addition to its role in executing monetary policy, it also has responsibility for regulating commercial banks, merchant banks, finance companies, trust companies, mortgage finance companies, offshore banks and international trusts, maintaining financial stability and the general promotion of macroeconomic stability and development. Incorporated in 1972, the Central Bank has evolved in line with the development of Barbados and the course of its development has been summarised under the following sections: liberalisation, monetary and exchange rate policy, bank supervision and other.

Liberalisation

The concept of financial liberalisation is best understood by investigating its opposite: financial repression. Financial repression refers to the set of government legal restrictions imposed on the activities of financial intermediaries, preventing them from functioning at their full capacity. Financial liberalisation, therefore, involves the removal of these restrictions and focuses on eliminating credit controls, deregulating interest rates, increasing the autonomy of banks, privatising banks, allowing free entry into the financial sector and liberalising international capital flows.

Barbados has been gradually liberalising its financial sector since 1991 and most of the effort was concentrated between 1991 and 1993. During this period, the Rate of Interest Order 1973 was revoked and all ceilings on credit and the system of credit controls was discontinued. In 2001, the government securities requirement was simplified to a single security ratio that would be applicable to all stipulated government securities and in 2003 the indicative weighted average lending rates for commercial banks were discontinued. By the end of 2003, therefore, the only interest rate still controlled by the Central Bank was the minimum deposit rate, which the Bank still uses as its main monetary policy tool to this day.

With respect to exchange controls, these too have been gradually liberalised. In the early years (1980-1995), the central bank slowly delegated increasing authority to authorised dealers. For example, in 1994, on the advice of the Central Bank, commercial banks were permitted to open foreign currency accounts in the names of companies operating in

Barbados for the first time, provided they fell within prescribed limits. By the mid-2000s, this process had accelerated in order to fulfil Barbados' commitments for free movement of capital under the CARICOM Single Market and Economy.

Monetary and Exchange Rate Policy

The primary goal of the Central Bank since its establishment in 1972 has been exchange rate stability. The Barbados dollar is pegged 2:1 to the US dollar and the country, through the Central Bank, has maintained this exchange rate since the birth of the Barbados dollar. The monetary and exchange rate policy of the Central Bank of Barbados from 1996-2008 evolved in line with the gradual liberalisation of the financial system, but kept as its main focus the maintenance of the 2:1 peg. Hence, although the number of direct monetary policy tools, such as credit ceilings and fixing interest rates, declined significantly as the system became less restricted, some restrictions were kept in place to allow the Central Bank to continue to successfully defend the peg.

Whether Barbados should float its exchange rate similar to its regional counterparts, such as Jamaica, Trinidad and Tobago and Guyana, is a question that has occupied the minds of policymakers, particularly following the increased easing of exchange controls in the 2000s. Due to its fixed exchange rate, the country needs to exercise care when opening up its financial system to the rest of the world, even though it is committed to allowing the free movement of capital between Barbados and CARICOM. In fact, there is a general consensus that by opening up to CARICOM, Barbados is de facto open to the rest of the world by virtue of the fact that many CARICOM countries have no restrictions on international capital movements. Capital can therefore use another CARICOM country as a conduit to the remainder of the world. For this reason, the Central Bank has been cautious about which controls are lifted and when in order to minimise the disruption to the financial system. As such, some limited controls still remain on transactions between Barbados and the rest of CARICOM. Apart from exchange controls, the Bank also intervenes in the foreign exchange market by setting the rates at which foreign currency can be bought and sold by authorised dealers. These rates are based on prevailing international exchange rates and are sent to the commercial banks on a daily basis.

As said earlier, the main monetary policy objective is the maintenance of the fixed exchange rate at its current 2:1 peg by ensuring an adequate level of net international reserves. The Central Bank also adjusts its monetary policy when necessary to support general macroeconomic development and financial stability. With respect to the operational aspects of monetary policy, liberalisation has essentially cut the monetary policy tools down to three main instruments: the minimum deposit rate, the discount window and reserve requirements. The minimum deposit rate is the primary tool and is adjusted the most frequently, followed by the discount rate and then reserve requirements. In fact, reserve requirements are adjusted so infrequently that the requirement on local cash reserves has only been changed four times in the entire history of the Central Bank. In 2006, the Central Bank introduced a foreign currency reserve requirement for all financial institutions offering foreign currency accounts at an initial requirement of 6% of foreign currency deposits. This new requirement was introduced in acknowledgement of the role that foreign currency deposits would increasingly play in a liberalised environment.

Bank Supervision and Regulation

The Central Bank of Barbados is one of four regulators of financial institutions operating within the Barbadian financial system. The remaining three are: the Supervisor of Insurance, which regulates the operations of insurance companies; the Department of Cooperatives, which is responsible for credit unions; and the Barbados Securities Commission, which oversees the Barbados Stock Exchange and its listed companies/instruments and licensed broker/dealers. The Central Bank of Barbados monitors the operations of commercial banks and those institutions licensed under Part III of the Financial Institutions Act, 1997, which include finance companies, trust companies, merchant banks and mortgage finance companies. In addition, it also has responsibility for the supervision of offshore banks, as licensed under the International Financial Services Act, 2002.

The Bank Supervision Department of the Central Bank is charged with the task of ensuring that institutions licensed under the Financial Institutions Act, 1997, and the International Financial Services Act, 2002, adhere to the stipulations of the relevant Act, and in this way are responsible for the day-to-day monitoring of the stability and viability of all licensed entities. However, there are other departments that also play key supportive roles. The Research Department monitors the impact of macroeconomic

developments on the financial system and vice versa and currently plays a lead role in stress testing the system. The Banking, Currency and Investments Department monitors interbank activity and performs the lender of last resort function of the Central Bank. Finally, the Foreign Exchange and Exchange Control Department monitors all external capital flows and in this way is constantly aware of the external transactions of financial institutions. This coordinated approach ensures that the Barbadian financial system, particularly those entities licensed by the Central Bank of Barbados, functions efficiently and effectively and offers a stable financial environment.

The Central Bank of Barbados intends to implement the Basel II Accord as issued by the Basel Committee on Banking Supervision of the Bank for International Settlements. As such the Bank is taking athree-pronged approach in preparation for the implementation of Basel II and has been concurrently preparing various guidelines and procedures to support all three pillars of the Accord. As at the end of 2008: Areas of National Discretion have been issued to support the standardised approach to credit risk; measurement guidance and reporting forms have been drafted to support Pillar I; a number of guidelines have been issued to the industry to improve risk management as recommended under Pillar II; and the Bank has moved to risk-based approach supervision and continues to strengthen its internal procedures. In coming years, additional requirements will continue to be introduced to the market and the relevant legislation will be amended. This move will allow Barbados to sustain its reputation as a stable financial jurisdiction, which adheres to all relevant international norms.

Financial Development

One of the key roles of the Central Bank of Barbados is fostering the development of the financial sector. This role is not just limited to the entities regulated by the Central Bank, but also the wider financial services industry. As such, the Central Bank has played a key role in the development of the Barbados Stock Exchange, has a memorandum of understanding with the other regulators of financial institutions and sits on the boards of key institutions within the industry. In this way, it is able to effectively influence the direction of financial development within the country.

One of the most important ways that the Central Bank fosters financial development is by playing a key role in the drafting of the legislation and/or guidelines that would govern the provision of a new financial service in Barbados. For example, the Central Bank has provided guidelines relating to anti-money laundering and Internet and telephone banking and was critical of the introduction of deposit insurance.

4.3.2 Commercial Banks

The Barbadian banking sector experienced a number of changes since 1996. These changes have affected the ownership and structure of the sector, the balance sheet, the services offered by the sector as well as the soundness of the sector.

Ownership and Structure

In 1996, there were seven commercial banks operating in Barbados. Of these institutions, there was one British bank (Barclays Bank PLC), three Canadian banks (Royal Bank of Canada (RBC), Bank of Nova Scotia and Canadian International Banking Corporation (CIBC)), two Barbadian banks (Barbados National Bank (BNB) and The Mutual Bank of the Caribbean Inc.) and one bank owned by a financial institution from Trinidad and Tobago (The Caribbean Commercial Bank (CCB)). These banks operated 42 branches and this situation continued up until the beginning of the 2000s.

Since 2002, there has been one new entrant (Bank of Butterfield), which acquired The Mutual Bank of the Caribbean Inc. (2004); the domestic operations of Barclays Bank PLC and CIBC were merged to form FirstCaribbean International Bank, which is now majority owned by CIBC; the government sold BNB to Republic Bank of Trinidad and Tobago; and RBTT Bank of Trinidad and Tobago bought CCB. This resulted in a banking sector that has no domestically owned commercial banks, a drastically different situation from that which prevailed in the middle of the 1990s when a third of the banks were domestically owned and the remainder where branches of extra-regional banks. Moreover, Citicorp entered the market and is the sole merchant bank operating in Barbados.

This change in ownership had an important effect on the competitive dynamics of the industry. Craigwell et al (2007) found that from 1991 to 2002, competition within the sector had generally been increasing. In 2003, there was a sharp decrease in competition, which the authors hypothesised could be the result of the reduction in the number of banks

due to merger and acquisition activity. From 2004, however, the situation returned to one of increasing competition. One of the factors that could explain this trend towards rising competition is perhaps the difference with respect to the importance of the Barbados operations of regional banks versus that of extra-regional banks. While not downplaying the significance that extra-regional banks place on operations in countries such as Barbados, in terms of the share of the total operations of these various institutions, the Barbados operations of regional banks have a greater weight than those of extra-regional banks, and this could have played a role in determining the competitive elements of the sector. For example, there was no major change in the modus operandi of the sector when FirstCaribbean International Bank – now the largest bank in the industry in terms of asset base – came into existence; however, when Bank of Butterfield, a relatively small Bermudan-owned bank, entered the market, there was a noticeable change in the dynamics of the mortgage market, in particular.

The spate of mergers and acquisitions may have been in response to more than just increasing their competitive edge. However, Birchwood (2000), in a study on the impact of these types of strategies on bank performance for CARICOM banks, found that there was no clear indication that size was a critical factor in determining the profitability of CARICOM banks, though some evidence suggested that asset growth may play a role in increasing profits.

The Evolution of the Balance Sheet

The composition of the balance sheet of commercial banks is perhaps the most illustrative of the evolution of the banking sector between 1996 and 2007 (see Table 4.3). In earlier years, the asset base of the balance sheet was heavily skewed towards loans. For example, in 1973, loans and advances represented 74.1% of total assets, while total investments accounted for a mere 0.8%. Over time, this distribution started to shift, with the share of loans and advances falling to 61.8% in 1980, 56.7% in 1990 and as low as 42.1% in 2003. At the same time, commercial banks were increasing their investment portfolio. Initially, they expanded into government securities (as a result of the introduction of the government securities reserve requirement) and then into private investments, especially in the latter six years of our review period. This diversification of the balance sheet away from pure loans and advances is one strong sign

that the financial system is becoming deeper and the banks are increasingly able to find attractive non-traditional investments.

Table 4.3: Commercial Banks' Balance Sheet: Assets (BDS $ millions)

	1996	1999	2002	2005	2008
Cash	62.7	88.8	103.9	126.8	141.4
Balances due from					
Central Bank of Barbados	181.1	107	429.5	177.1	422
Other Banks in Barbados	70.2	95.6	68.9	17.1	35.8
Investments					
Government					
Treasury Bills	467.5	354.8	491.7	450.5	462.3
Other	406	426.2	667	719.1	625.4
Private	11.3	35.6	34.8	559.5	457.4
Loans & Advances	1,614.60	2,612.10	2,910.30	4,081.80	5,703.00
Foreign Assets	675.4	668.9	1,060.50	1,467.40	2721.6
Other Assets	234.3	349.2	500.5	698.1	1,232.50
Total Assets	3,723.00	4,739.20	6,267.10	8,297.30	11,801.40

Source: Central Bank of Barbados

Table 4.4: Commercial Banks' Loan Portfolio: Shares of Total Loans (%)

	1996	1999	2002	2005	2008
Corporate	56.5	50.6	48.1	46.4	42.8
Agriculture	2.6	1.8	1.6	1.0	0.8
Fisheries	0.1	0.1	0.1	0.1	0.0
Mining & Quarrying	0.1	0.1	0.1	0.1	0.1
Manufacturing	8.1	3.7	3.0	2.7	2.3
Distribution	15.7	12.3	9.9	9.0	7.3
Tourism	10.4	11.6	11.5	12.7	8.8
Entertainment & Catering	1.9	0.8	1.0	1.0	1.1
Transport	1.2	1.4	1.2	0.6	0.8
Construction	5.0	7.0	7.8	7.7	7.5
Professional and Other Services	8.2	7.7	6.0	7.6	8.4
Utilities	1.2	0.9	0.4	0.2	0.6
Financial Institutions	2.1	3.2	5.4	3.7	5.2
Government	2.3	2.8	5.4	7.1	8.8
Central Government	0.0	0.0	0.0	0.5	0.6
Statutory Bodies	2.3	2.8	5.4	6.6	8.2
Personal	32.6	41.5	40.7	44.3	46.2
Miscellaneous	8.6	5.1	5.8	2.3	2.2
TOTAL	100.0	100.0	100.0	100.0	100.0

Source: Central Bank of Barbados

In addition to its lessening importance, the composition of the loan portfolio has also been evolving (See Table 4.4). For most of the history of the Barbadian banking sector, the majority of loans were granted to

businesses, followed by personal lending and then government. Originally, more than 75% of all credit extended went to corporations, with less than 20% being extended to individuals. From the 1990s, that trend started to show strong signs of changing with the share of personal loans starting to advance (32.6%), edging out to some extent the dominance of corporate loans. By the end of 2008, corporate loans and personal loans accounted for roughly the same share of total credit extended.

This turn away from heavy dependence on corporate loans reflects a number of changing dynamics within the financial system (see Table 4.5). Firstly, individuals were becoming increasingly financially savvy and were using the services of banks in a more active way. History suggests that the average Barbadian initially used commercial banks as a depository and was reluctant to partake in any other services. At the same time, the commercial banks themselves had not yet started to aggressively tap the household market and were focusing more on the corporate sector. The two to three decades following independence (which took place in 1966) were decades of fairly rapid economic development, as the country turned away from agriculture and focused heavily on developing the manufacturing and tourism sectors. This effort would obviously necessitate funding and so the focus of commercial banks leaned in that direction. Thirdly, before the elimination of credit controls, the Central Bank would have also played a role in directing credit towards business. With the removal of these barriers, banks became freer in their lending and thus the loan portfolio would have been adjusted.

Table 4.5: Commercial Banks' Balance Sheet: Liabilities (BDS $ millions)

	Deposits		Balances Due To		Foreign Liabilities	Other Liabilities	Total Liabilities
	Barbados Dollar	Foreign Currency	Central Bank of Barbados	Other Banks in Barbados			
1996	2,624.1	529.3	28.7	10.5	140.8	390.0	3,723.0
1999	3,362.7	549.5	38.5	24.6	228.6	535.2	4,739.2
2002	4,327.3	814.8	26.4	2.4	370.2	983.0	6,812.6
2005	5,838.9	1,167.0	26.2	39.2	506.0	720.0	8,297.3
2008	7,607.1	1,327.9	37.3	22.9	1,738.2	1,067.9	11,801.4

Source: Central Bank of Barbados

The changes on the liability side of the balance sheet have not been as drastic. Deposit liabilities still account for roughly 80% of total liabilities and thus provide the main source of funding for commercial bank operations. The composition of deposit liabilities, however, has undergone

substantial changes. As recently as 1980, Barbados dollar deposits accounted for nearly all of total deposits. In 1995, the Central Bank permitted the establishment of foreign currency accounts for non-resident individuals and Barbadians living abroad where foreign exchange emanates from abroad, as well as resident individuals earning a minimum of BDS$50,000 and companies operating in Barbados earning a minimum of BDS$100,000 a year in foreign exchange and have regular payments the to service. Hence, from mid-1990s, the share of foreign currency deposits has been on the rise and by 2008, foreign currency deposits represented nearly 15% of total deposits and were mainly owned by non-residents.

Range of Services

The range of services offered by commercial banks has developed in line with the development of the Barbadian economy as a whole. Furthermore, some services have been introduced in response to legislative changes within the financial sector. For example, the introduction of the mutual funds industry, and the consolidation of the industry with the enactment of specific legislation to govern the industry, spurred the introduction of this product within commercial banks. Similarly, the Guidelines for Electronic Banking governed the introduction of telephone and internet banking within the industry. Even some traditional products have been enhanced; for example, many savings accounts now come with debit cards and so function more and more like demand accounts. Many commercial banks have also developed more and more specialist units within their operations, such as small business units to service the needs of smaller enterprises, and wealth management services to better attend to their more discriminating clients and merchant banking arms to perform investment banking activities.

Soundness of the Banking Sector

The Barbadian financial system has a long-standing history of stability and the last decade or so has been no different. When the financial soundness indicators of the International Monetary Fund are considered (see Table 4.6) – which can be summarised under the headings capital adequacy, asset quality, earnings and profitability, liquidity and exposure to FX risk – the resilience of the sector is certain. The capital adequacy ratios show that from 1996 to 2008, the commercial banks have been well above the stipulated minimum capital adequacy ratio of 8%. At the same time, the asset quality has been improving, as indicated by declining ratios of nonperforming loans to total loans; however, the sectoral distribution of

loans indicates that banks may be considered somewhat over-exposed to a small number of sectors. The banking sector has managed to maintain profitability throughout our review period, even during the recession of 2001, and this is a testament to the sector's ability to find investments that would yield adequate returns even in the worst of times. The liquidity profile is one of excess liquidity and this has been the case throughout the history of the banking sector. In recent years, however, liquidity conditions have been tightening. There is a theory that developing countries often experience higher levels of liquidity in the financial system in response to the perceived higher risk. As countries develop, liquidity levels should fall given that the perceived risk should be decreasing. Therefore, declining liquidity may be a sign of increased confidence in the financial system and the macro-economy as a whole.

Table 4.6: Financial Soundness Indicators (%)

	1996	1999	2002	2005	2008
Regulatory Capital to Risk-Weighted Assets[1]	n.a.	n.a.	18.8	12.7	13.9
Regulatory Tier 1 Capital to Risk-Weighted Assets[1]	n.a.	n.a.	n.a.	11.5	13.9
Nonperforming loans to total gross loans	n.a.	n.a.	9.3	5.5	3.4
Sectoral distribution of loans to total loans[2]	66.5	76.1	75.6	82.7	79.0
Return on assets	1.5	2.4	1.9	1.9	1.4
Noninterest expenses to gross income	46.4	45.3	51.1	47.7	40.7
Liquid assets to total assets	21.0	13.7	10.9	9.0	12.2

1 Excludes branches of foreign banks
2 Share of top 5 sectors as at December 2008
Source: Central Bank of Barbados and International Monetary Fund

With respect to efficiency, which can be considered as the use of resources in such a way as to maximise the production of goods and services, as the sector has evolved, the level of efficiency has been high. The study by Moore, Craigwell and Coppin (2005) suggests that "Barbadian banks have relatively low levels of inefficiencies, 'wasting' only 4.8% of inputs, when compared to international counterparts" and that bank size, loan-to-asset ratio, national income growth and financial innovation are the most significant determinants of bank efficiency. With respect to financial innovation, for example, as technological advances became more widespread, information technology increasingly played a greater role in the banking industry. As an illustration, for the period of 1979-2001, Craigwell, Moore and Coppin (2003) found that the introduction of automatic teller machines (ATMs) in the 1990s increased the productivity – i.e. the output generated per unit of input – of banks by between 3% and 17%.

4.3.3 Non-Bank Financial Institutions

Credit Unions

The credit union movement in Barbados has a long, vibrant history and continues to be an important part of the financial system. While since 1996 the number of credit unions has declined from 50 societies to 37 at the end of 2008, the membership has more than doubled to roughly half the population of Barbados (from 54,505 to 148,604, with the total Barbadian population in 2007 estimated at 269,000 persons[22]) and the combined assets of credit unions has grown by more than five times (from $230.5 million to $1,202.4 million). The growth of the sector has in part been the result of policy interventions by the government; For example, in 1996 the government introduced tax incentives aimed at encouraging Barbadians to direct more of their savings to the credit unions and mutual funds. This extraordinary expansion has led to a situation where a few credit unions are roughly the size of the smaller commercial banks and offer similar services to those offered by the banking sector. For example, many credit unions now offer debit card facilities and are hooked up to the same automated banking machine network as the commercial banks. For the most part, however, the vast majority of credit unions are small and offer traditional credit union services.

Finance Companies, Mortgage Finance Companies and Trust Companies

Finance companies, mortgage finance companies, merchant banks and trust companies are licensed under Part III of the Financial Institutions Act, 1997, and regulated by the Central Bank of Barbados. These institutions, commonly called Part IIIs, provide support services to the commercial banks, as a large proportion of them are affiliated with commercial banks. Many developed in response to various policies of the monetary authorities. For example, when restrictions on credit strained the operations of commercial banks, the banks moved a proportion of their consumer loan portfolio to their affiliated Part III company, which was not affected by these restrictions. With the removal of credit controls, many of these activities returned to the commercial banks and these Part IIIs began to operate more independently.

The bulk of the Part III affiliates of commercial banks are trust and/or mortgage finance companies. Both specialise in offering credit to the

[22] Source: United Nations Statistics Division

general public and, as such, the loan portfolio of these institutions represents the largest share of total assets. During the period 1996 to 2008, the total combined assets of trust and mortgage finance companies expanded by 61.1%, underpinned by the accumulation of local securities as well as placements at other financial institutions in Barbados. The loan portfolio, on the other hand, grew by a much smaller margin of 25.2%, unlike the period of very rapid expansion in the 1980s when the Central Bank of Barbados still imposed credit controls. This expansion has been funded mainly by time deposit liabilities, which have expanded by 15.6%, as well as a doubling in the capital paid up during the period.

Currently, there are three finance companies, which provide mainly consumer loans for automobiles and home improvement and real estate, and one merchant bank, which currently attends to the financing needs of the corporate sector. Their combined loan portfolio has grown substantially between 1996 and 2008, expanding by more than five-fold. This advancement has been broad-based across all asset categories, with foreign assets, local securities, other assets and liquid assets – cash and balances with banks and other financial institutions in Barbados – all growing by even greater margins. This rapid accumulation in assets has been underpinned by equally impressive growth in deposit liabilities, which have grown more than seven-fold during the same period. Merchant banks offer a range of deposit accounts and finance companies are allowed to offer time deposit facilities to the public.

Insurance Companies and Pension Funds

Insurance companies in Barbados have enjoyed a very successful history. Following rapid expansion in the 1970s and 1980s – total local assets expanded by an annual average of 16.8% between 1973 and 1990 – the growth in the industry, as measured by the accumulation of local assets, appears to have slowed. In the 1990s, the industry faced some challenges, with the insurance industry averaging an increase in assets of just 1.8%. The following decade showed signs of recovery and insurance companies currently represent 11.3% of total financial system assets compared to a low of roughly 7% in the late 1990s. The suite of financial services offered by the insurance sector has also expanded significantly. In addition to the traditional insurance services and mortgage solutions offered in the 1990s, the sector also offers mutual funds, retirement savings plans and other long-term savings plans.

Of particular note in the history of the insurance sector has been the demutualization of the 162-year old Barbados Mutual Life Assurance Society in 2000 to become Sagicor Life Inc, a shareholder-owned company with share capital. Since this transition, the company has emerged as a leader in financial services in the region, operating in Panama, the United States of America and the United Kingdom, in addition to CARICOM, the Cayman Islands and the Netherland Antilles. Furthermore, the Sagicor Financial Group is listed on the Barbados Stock Exchange, Trinidad and Tobago Stock Exchange, Jamaica Stock Exchange and the London Stock Exchange. In addition, the Insurance Corporation of Barbados Limited, one of the largest domestic insurance companies and historically a government-owned entity, was privatised in 2006.

Mutual Funds

Mutual funds have been a useful addition to the suite of financial products in Barbados for some time, but it is only with the income tax amendment in 1996 that the total assets under management rose significantly. In ten years, the total mutual fund assets grew by more than 100%: in 1998 they were approximately $44 million and by 2008 this figure had expanded to more than $500 million. The phenomenal growth in the last decade has added much needed liquidity to the Barbados Stock Exchange, in particular, as it added institutional investors to the stock market.

Alleyne and Moore (2006) found that, given that the principal determinant of investments into mutual funds are national income and previous levels of mutual fund investments, it is likely that the tax benefits of holding mutual fund accounts may encourage some individuals to shift into these assets. The Income Tax Amendment No. 2, 1996-30 allowed persons to deduct up to $10,000 of investments in mutual funds from the calculation of taxable income. These amounts had to be held for at least five years, with sums withdrawn within five years being subject to personal income taxes during the year in which the withdrawal is made. In 2007, further amendments were made to the tax benefits structure that effectively reduced the attractiveness of these assets from an income tax standpoint and this may have a decelerating effect on the growth in mutual fund assets.

Up until 1998, the mutual fund industry in Barbados was not formally regulated. In 1998, the Mutual Funds Act, 1998 was passed, outlining the regulations concerned with the authorisation and control of funds and their

administration when carrying out business in or from Barbados as well as issues relating to licensing and registration, supervision and enforcement of the powers of the Barbados Securities Exchange. In 2002, the legislation was replaced by the Mutual Funds Act, 2002, which basically changed the regulator from the Barbados Securities Exchange to the Barbados Securities Commission and granted it greater regulatory powers as well as some improvement to the corporate governance structure of the industry.

Nonetheless, despite its success in attracting investors, a few obstacles to the growth of the industry still remain. First of all, the regulation of the industry still lags behind that of other financial institutions in Barbados. For the most part, these entities submit only audited financial statements, which can take sometimes more than six months following the end of the review period before they are available. The Barbados Securities Commission, with the help of the Central Bank of Barbados, has started to investigate the possibility of requesting un-audited statements from the industry on a quarterly basis to improve transparency and standardise reporting. This would be useful for both the investors as well as the regulators because it would facilitate the comparison of like institutions and is likely to result in more detailed reporting than is currently the norm. The second hurdle to the industry's development was discovered by Alleyne and Moore (2006) when their study showed that the rate of return on the fund between 1987 and 2004 was not statistically different from zero, and thus investors are not placing money with these entities in a search for return. This finding highlighted a couple of challenges: firstly, the limits on the investments of mutual funds has possibly curtailed their returns to some extent; and secondly, the investing public is perhaps not as financially savvy with respect to choosing investment vehicles as they could be.

Stock Exchange and Securities Commission

The Barbados Stock Exchange (BSE) came into being in 2001 with the enactment of the Securities Act 2001 – 13, which repealed and replaced the original Securities Exchange Act, Cap 318A, 1982. It is privately owned by its members and is administered by a board of directors. This non-profit organisation has played an integral role in capital market development in Barbados and continues to be the main means of exchange of shares in companies; shares in unlisted companies are usually traded over the counter. Though still considered underdeveloped by international standards, there have been efforts to modernise the exchange. For

example, the BSE introduced electronic trading in 2001 and moved from a three-day to a five-day trading week in 2007.

It is regulated by the Barbados Securities Commission (BSC), a statutory body that was established in 2001 with the enactment of the Securities Act. At this time, the BSC took over the responsibility of regulating the securities market from the then Securities Exchange of Barbados, which prior to this change was a self-regulating entity. Between the enactment and when the BSC became fully operational on January 2nd 2003, the regulatory functions were delegated back to the BSE as well as the Barbados Central Securities Depository Inc.

The BSC is the regulator of both the securities and mutual fund industries. Specifically, it is responsible for: ensuring the fair, orderly and equitable dealing in securities; registering, authorising or regulating self-regulatory organisations, securities companies, brokers, dealers, traders, underwriters, issuers and investment advisers; controlling and supervising the activities of these participants in order to maintain proper standards of conduct and professionalism in the securities business; overseeing the administration of any contingency fund; protecting the securities market against improper practices; creating and promoting the orderly growth and development of the capital market; and protecting investors from insider trading, market manipulation and the dissemination of false or misleading information (adapted from the website of the BSC).

This change in regulatory supervision came at a time when both international and local capital markets were in a state of flux. First of all, the market reactions to 9/11 had to be monitored closely, as care had to be taken that the market response did not pose additional threats to the system. At the same time, there were a number of mergers and acquisitions taking place that affected some listed companies. For example, during 2001, Barclays Bank PLC and CIBC (now FirstCaribbean International Bank) were working towards merging their operations and there was a take-over in effect for Life of Barbados Limited (acquired by Sagicor Life Inc.). These transactions would have had implications for shareholders and since these entities were all publicly listed companies, the BSC began operations at a very hectic time. These mergers and acquisitions also highlighted a number of concerns about the “take-over code” and effectively set the agenda for the BSC for the next few months.

In 2004, work began on strengthening the regulatory framework, focusing on reviewing the legislation and regulations surrounding the industry and so far there is completed draft legislation on Unclaimed Intangible Property as well as Take Over Bids. In addition, investigations have started to evaluate the possibility of adopting disclosure systems that would address cross-border regulatory issues. The strengthening of cross-border securities regulation is an important step towards the creation of the Caribbean Stock Exchange, a process that has been in train for more than a decade. In 1991, the BSE, Trinidad and Tobago Stock Exchange and the Jamaica Stock Exchange made the first tangible step towards this goal when they began cross-border trading of listed securities. Since then, there has been a greater effort towards harmonisation of the three stock exchanges.

Barbados Deposit Insurance Corporation

The Barbados Deposit Insurance Corporation (BDIC) was established by The Central Bank of Barbados under the Deposit Insurance Act-29 of 2006 and started operations June 8th 2007. The BDIC manages the Deposit Insurance Fund, which is financed by the initial contributions as well as annual premiums from its member institutions and a matching contribution by the Central Bank of Barbados. At the end of 2008, there were 14 members, including six commercial banks and eight deposit-taking non-bank financial institutions and the BDIC guarantees up to $25,000 of the deposits of their customers. The BDIC is an independent entity, however, the Central Bank of Barbados is represented on its Board by the Governor and the Director of Bank Supervision.

4.4 Markets

Capital market development in Barbados has lagged behind the development seen in the rest of the financial system. Despite great strides made with respect to equity markets – market capitalisation has grown more than eightfold between 1996 and 2008 – accessing capital from both equity and bond markets remains underdeveloped. To date, as far as this author is aware, no publicly listed company has sought to raise funds on the BSE once they have had their Initial Public Offering (IPO). Furthermore, bond issuance by private companies, whether publicly traded or over-the-counter, is sporadic at best. In fact, government bonds and those issued by statutory bodies account for almost all bonds in Barbados and trading of these instruments on the secondary market (provided by the BSE) is virtually non-existent. There is a theory that Barbadian investors prefer to

hold securities until maturity and that this practice has hindered the development of active secondary markets. This situation is likely to have been compounded by a reluctance of companies to cede control or risk aggressive takeover through the acquisition of shares. With such inactive markets, the emergence of a derivatives market has been significantly hindered, as simple pre-requisites, such as the determination of useful yield curves, have not developed.

4.5 Conclusion

In conclusion, the Barbados financial system has a reputation for being one of the most stable financial systems in the Caribbean. Partially through the efforts of the government and the Central Bank, the financial services industry has expanded at an extraordinary rate. Furthermore, non-traditional services and institutions have emerged and this has boded well for the economy as a whole. Nonetheless, market development continues to lag behind that of institutional development and this concern has persisted despite the efforts of policymakers. As such, while boasting a varied and stable financial system, Barbados still has a way to go in terms of ensuring that financial markets are as deep and as liquid as they need to be in order to adequately foster and support economic growth.

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5

The Evolution of the Financial Sector in Belize (1996-2007)

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As Belize, a former British colony, approaches 27 years of independence, its economy remains small, open and import-dependent, highly vulnerable to exogenous and weather-related shocks. While traditional industries such as sugarcane, citrus and banana remain dominant on the productive landscape, marine products, papaya, and petroleum have emerged as important export commodities. Corn, rice, beans, cattle, pig and poultry are also key areas of production, allowing Belize virtual self-sufficiency in basic grains and fresh meat. Some diversification in the economic base of the country has occurred with the fostering of information technology-based companies under export processing zone status, development of an international banking sector, commencement of duty-free retailing activities aimed at Mexicans at the Belize-Mexico border, and development of cruise ship tourism. In the late 1990s, tourism became the top foreign exchange earner, bolstered by a short-lived exponential growth in the cruise-tourism sector, while the discovery of oil in commercial quantities in 2006 provided a timely boost to exports and economic growth. Notwithstanding these developments, the country continues to be highly import-dependent with foreign currency earnings remaining vital to economic activity and social well-being.

Since independence, successive governments have stated their commitment to the principle of private sector led growth, with government providing the facilitating business environment of basic infrastructure and non-commercial public services. However, the relatively large size of the public sector means that government activities materially impact the country's economic performance with expansionary fiscal policies and pre-election spending splurges boosting GDP growth at the expense of burgeoning external imbalances that must eventually be corrected to protect the fixed exchange rate, while tightened fiscal stances tend to contribute to a deceleration in economic growth.

Illustrating this, the years 1996-1998 were the continuation of a period of fiscal tightening as the United Democratic Party (UDP) government that had assumed power in the latter part of 1993 sought to reduce pressures on the balance of payments and the fixed exchange rate by lowering domestic consumption and bringing the fiscal accounts onto a more sustainable footing. In December 1995, the government instituted a temporary wage freeze and cut its workforce by almost 9% in order to reduce the public sector wage bill. Revenue measures included the implementation of a 15% value added tax (VAT) in 1996. These adjustments initially resulted in a sharp improvement in the fiscal balance which swung from -3.8% of GDP in 1995 to 0.4% in 1996. In the subsequent two years, expenditures outpaced revenues so the fiscal deficit rose to around 2.0% of GDP. Concurrent with its efforts at fiscal discipline, the government facilitated the expansion of commercial free zone merchandising, the creation of an international banking sector, development of information technology based companies under export processing zone status and the initial foray into cruise ship tourism. Concerted efforts in investment promotion and export development were the mandate of BELTRAIDE, a statutory agency that was set up to be a one-stop focal point for investors and companies with export potential.

Since the impact of developmental efforts are generally long-term in nature, while fiscal adjustments are immediate, GDP growth slowed to an average of 2.9% with the lowest growth of 1.4% occurring in 1996, a year in which the fiscal measures contributed to a 1.3 percentage point rise in the unemployment rate to 13.8%, a one-off spike in the rate of inflation to 6.4% and (aided by Taiwanese grant funds) a doubling in the official reserves coverage to 2.7 months of imports. In the real sector, activities contracted in construction, financial intermediation, manufacturing and

'real estate, renting and business services'. Hotel and restaurant activity also contracted for the second consecutive year. The main growth driver was export agriculture, which pushed up the contribution of the primary sector by 6.9%.

In the subsequent two years, GDP grew by 3.5% and 3.7%, respectively, driven by a surge in farmed shrimp production, continuing growth in distribution, telecommunication services and a strong rebound in tourism. Unemployment remained high and a widening external current account deficit was partially financed by the drawdown of reserves, which fell to 1.6 months of imports. The somewhat heavy-handed approach of the government in correcting the fiscal excesses of its predecessor generated a rising tide of public disapprobation, particularly when the decision was taken to retrench staff at the midpoint of its term in office. Discontent with the Government's conservative fiscal strategy ultimately led to a landslide victory for the opposition People's United Party (PUP) in the 1998 general elections.

The new administration had made several promises as part of its electoral campaign, prominent among which was the goal of building 10,000 houses and the creation of 15,000 jobs. It aimed to deliver on these through expansionary fiscal and monetary policies and proceeded on an aggressive reversal of the previous administration's economic strategy. Having campaigned against the 15% VAT, this was immediately repealed and a sales tax of 8% was substituted. Spending was ratcheted upward significantly as a housing construction boom was launched together with various other infrastructural projects. Capital was raised to finance these initiatives through the sale of public assets such as the telephone, electricity, water and sewerage companies, as well as substantial short term external borrowing on commercial terms. On the monetary policy side, commercial bank reserve requirements were lowered and, among other things, the banks were allowed to include lending for new housing mortgages as part of their approved liquid asset portfolio. After initially financing its expanding budget deficits externally, the government resorted to increased usage of domestic credit via the central bank's overdraft facility with inevitable negative consequences for the balance of payments and official foreign reserves.

Fuelled in part by the surge in domestic consumption and investment, GDP growth averaged 8.2% over 1999-2003 even with some slowdown in

growth during 2001 and 2002 because of hurricane and storm damage. Growth was buoyed up as well by a rapid growth in commercial free zone trade, expansion in farmed shrimp production and steady increase in stay-over tourist arrivals that was accompanied by exponential growth in cruise ship arrivals during 2002-2004. This period also saw the development of a small international banking sector, while telecommunications expanded strongly due to investments in preparation for year 2000 readiness and the prospective opening of the local market to competition, since it was expected that the exclusive license enjoyed by the telecommunications company would shortly be ended. The fiscal deficit rose to an average of 7.7% of GDP, while the public sector's external and domestic debt to GDP ratio (excluding contingent liabilities that it was eventually obliged to take on) almost doubled to 94.1%. The upward movement of the debt stock was exacerbated in 2002 and 2003 as the government had to borrow to refinance costly, external short-term debt and set up a sinking fund which was only a portion of what was needed to meet a sizeable Salomon Smith Barney bond repayment that was due in 2005. Pressure on the fixed exchange peg mounted as the external current account deficit soared.

Faced by the persistence of sizeable macro-economic imbalances after four years of fiscal expansion, the Central Bank obtained the green light in the latter part of 2002 to impose a 2.0% increase in commercial bank reserve requirements. No further action was countenanced in 2003, a year in which the sitting government was returned to office for a second consecutive term after successfully contesting the general elections. This turned out to be a brief hiatus since there was an urgent need to bring the country onto a more sustainable footing to avoid a sovereign default on the external debt. The period 2004-2007 was therefore one of fiscal and monetary tightening combined with sustained efforts to obtain new funds from abroad that would enable the government to meet its external obligations. In addition to tightened controls on recurrent expenditures and reduced capital spending, tax rates were increased. The latter included the replacement of the sales tax with a broader based 10% value added tax. Since the government had campaigned against VAT when it was in opposition, the new tax was accorded the name of GST (General Sales Tax). A decision was made to freeze salaries for civil servants but this was rescinded after the National Trade Union Congress of Belize (NTUCB), which includes the powerful teachers union, went on a national strike. The business sector had also been exerting pressure for an investigation into the affairs of the Belize Social Security Board (BSSB), citing issues of

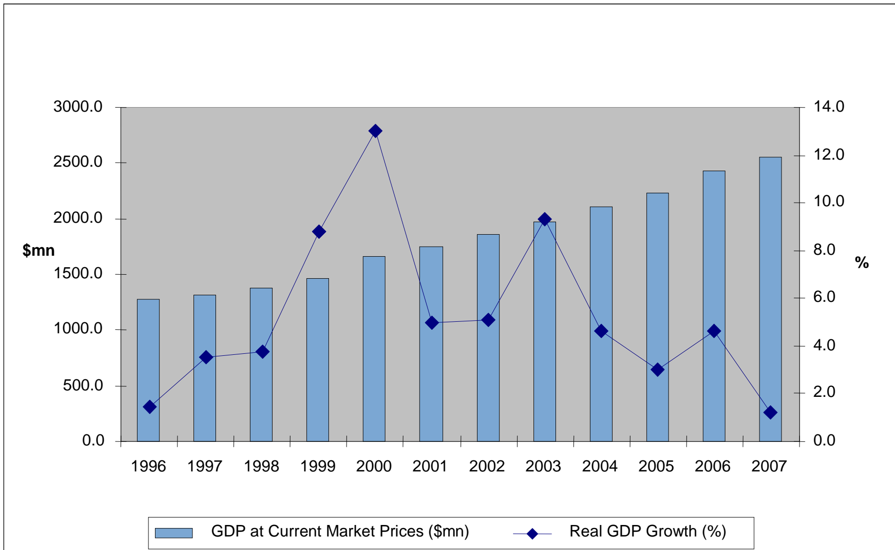
governance and lack of transparency where its investments were concerned. The resulting Senate Select Committee investigation revealed substantial irregularities with damaging implications for the long-term viability of the social security scheme. These revelations helped to spark a nationwide protest headed by the NTUCB and other civil societies such as the Association of Concerned Belizeans (ACB) who charged the government with mismanagement and corruption and also demanded an investigation into the affairs of the Development Finance Corporation (DFC). Meanwhile, with the foreign reserves under unrelenting pressure, the Central Bank progressively raised commercial bank reserve requirements in 2004, 2005 and 2006 in an effort to reduce growth in credit and foreign exchange demand.

At the end of 2005, the external debt to GDP ratio stood at 87.0%. In addition to refinancing existing debt obligations, funds had to be borrowed to enable the government to undertake the forced buyback of the water utility when its refusal to approve an increase in rates that would enable the foreign purchaser (CASCAL) to achieved the originally agreed returns on its investment caused the latter to invoke the buyback clause contained in the sale/purchase agreement. The bunching up of debt maturities and put options on various international bonds had been making the debt servicing problem an increasingly difficult one to solve, especially as international rating agencies were lowering Belize's credit scores and causing a steady deterioration in the terms being offered by lenders. With its borrowing options vanishing, the government's only recourse appeared to be to approach its creditors and seek a restructuring of its external commercial debt. Arrangements for this were finalized in February, 2007 when some US$0.5bn in commercial debt was exchanged for a 22-year bond with step-up coupon rates. While this provided some short-term relief by smoothing out debt service payments, the government remained under tremendous pressure to improve its fiscal management and long-term debt servicing capacity. Adding further to the government's debt problems was its assumption of debt servicing responsibilities for private sector loans that had been given a government guarantee earlier without adequate public disclosure or consensus.

In the more austere conditions, GDP growth decelerated to an average of 3.4% even though boosted by the start of commercial petroleum production in 2006. The government reduced its fiscal deficit from 6.3% of GDP in 2004 to 1.1% in 2007 and its primary balance reverted from a deficit

to a surplus position by 2006. After averaging nearly 20% of GDP in 2000-2003, the external current account deficit/GDP ratio progressively fell to an average of 14% in 2004-2005 before shrinking to around 2% in 2006-2007. The improvement enabled the gross international reserves to climb back up to 2.3 months of imports. The drying up of commercial sources of credit ensured a slowing down in international borrowing as this became confined to bilateral and multilateral sources that offered more favourable payment terms though with certain conditions being attached. Subsequently, as a result of pressure from the IDB which had agreed to provide a policy-based loan to support the balance of payments, the Government dealt with DFC's insolvency by putting a halt to its lending and refocusing its activities on loan collections.

Chart 5.1: GDP Growth (1996-2007)



Public confidence in the government continued to plunge as a series of new disclosures were made of contracts and agreements that appeared to benefit a minority of private investors perceived as closely connected to the ruling administration at the expense of the public purse. The saga of the privatized telephone company, in which it was repurchased, resold, repurchased and resold with substantial losses being generated on each transaction leg, was difficult (to say the least) for the government to explain or defend, especially since it was simultaneously seeking to raise revenues by imposing higher taxes on the public. The unpopularity of its

revenue raising measures was hence further accentuated by concerns about the lack of transparency in the handling of public finances. One such issue that became a flashpoint for public uprising was a hitherto secret loan guarantee given to a privately owned hospital. The tipping point came when there was a steadfast refusal to reveal the details of the hospital's ownership structure at the same time that the public was being called upon to pick up the tab for its sizeable loan payments.

In the broader economy, the strongest growth push came from the advent of a petroleum industry in 2006. Other primary sector activities decelerated and then contracted due to a combination of storm damage, froghopper infestation in sugarcane, banana market uncertainty due to changes in the EU import regime, price cuts in sugar due to EU reform measures, shrimp disease and heightened competition in the international shrimp market. In the secondary sector, Williamson, a major garment factory, began cutting back on production as contracts were shifted to lower cost producers in Central America and Asia. The services sector kept a positive momentum mostly due to continued expansions in telecommunications, a pick-up in financial intermediation and continued investment and expansion in the tourism sector.

In the general elections of February 2008, the electorate registered their dissatisfaction with the state of the country's affairs by replacing the incumbent PUP administration with the opposition UDP, which achieved a sizeable parliamentary majority of 25 seats in the 31 member House of Representatives. The challenges faced by the new government included a heavy public sector debt burden, the task of raising living standards in the context of soaring food and oil prices, deteriorating economic conditions worldwide, and escalating crime.

5.1 Financial Sector Developments

The number of institutions operating in the financial system increased during the twelve-year review period with the entrance of one new domestic commercial bank bringing the number in operation to five, the establishment of ten international banks offering mostly offshore services to non-residents, and a mutual fund. There was also further financial deepening as the ratio of domestic bank deposit liabilities to GDP rose from 44.1% to 62.7%. The opening of the fifth commercial bank was notable in sparking competition among the banks and leading to a lowering in the

weighted average interest rate spread of commercial banks after 16 years of mostly uninterrupted increases.

Table 5.1: Financial Institutions Operating in Belize and Total Assets at December 31st

	1996		2007	
	No. of Institutions	Total Assets BZ$mn	No. of Institutions	Total Assets BZ$mn
Commercial Banks	4	706.5	5	2,120.5
Credit Unions	11	105.8	13	414.7
International Banks	0	-	9	357.9
Development Bank (DFC)[1]	1	62.5	1	217.2
Insurance Companies	15	52.6	13	148.4
Mutual Funds	0	-	1	31.3
Government Savings Bank	1	1	1	14.5

1 As of December 31, 2006

Sources: Central Bank of Belize, Development Finance Corporation, Ministry of Finance (Treasury), Supervisor of Insurance

The commercial banks maintained their dominance of the financial landscape with total assets of $2.1bn (84.0% of GDP) at the end of December 2007. While these banks held foreign currency deposits for resident foreign exchange earners, the degree of financial dollarization was low in that there was very limited lending in US dollars (which is subject to Central Bank approval) and the percentage of foreign currency deposits in the domestic banking system was small, declining from 9% of total deposits in 1996 to 3.5% at the end of 2007, the higher ratio at the start of the period being due to one bank's holdings of deposits from non-resident international business companies (IBC). An amendment to the International Banking Act that came into effect in January 2007 caused the transfer of these IBC deposits from the domestic system into international banks and accounted for the downward shift in the ratio of foreign currency deposits in the domestic banking system.

Notwithstanding the growth in the number of financial intermediaries, there was no substantial change in the borrowing and saving instruments available to the general public. Although the need for development of a capital market continued to be a topic of discussion, no concrete steps were taken in that direction. Public trading of shares in the privatized companies (Belize Telemedia Limited (BTL), Belize Electricity Limited (BEL)

and Belize Water Services Limited (BWSL)) occurred over the counter with interested buyers and sellers seeking each other out through newspaper advertisements. The Government continued to be the chief issuer of securities for budgetary finance. The privately owned electricity company and the DFC also launched public debenture offerings during the review period. While the former was fully subscribed, the DFC's fell far short of its goal because of well-grounded concerns about its viability and financial soundness. The lending requirements of the commercial banks, the main source of credit, continued to favour large borrowers, many of whom were also able to access financing at internationally competitive interest rates from offshore lenders. Small borrowers and entrepreneurs seeking to engage in non-traditional developmental projects faced more obstacles and the situation was not helped by the demise of the poorly managed National Development Foundation of Belize (NDFB) and the severe restrictions placed on the DFC. Credit unions played an important role in filling some of the gaps, but small size and lapses in regulatory oversight posed challenges to the continued growth of some of these institutions.

The task of managing the country's fixed exchange rate regime was made more complex and challenging by amendments to the Central Bank Act in 2001 that made it lawful for foreign exchange earners to carry out domestic transactions in US dollars and opened the door for the Central Bank to engage in international derivative transactions, in addition to the government's decision to authorize the establishment of cambios (foreign exchange bureaux) that operated between 2002 and 2005. The stated intention of the latter was to bring the foreign exchange being traded in the parallel market into the official system, and thereby reduce the intense pressures being placed on the fixed exchange rate. Since the problem emanated from large fiscal imbalances that the government did not then wish to address in a constructive way, and the country has a fixed exchange rate system, the cambio experiment was doomed to failure. Not only did legitimizing cambios fail to reduce parallel market activity, anecdotal evidence pointed to an expansion in parallel trading that was partly fuelled by the licensed cambios. Indications were that the volume of the licensed cambios' parallel trading far surpassed their 'formal' trade. To halt the legitimization of practices that were attracting foreign exchange away from the official system and undermining the fixed exchange rate, the government repealed the cambio regulation in 2005. The return to an orthodox approach to economic adjustments in the ensuing period, together with the coming on stream of petroleum exports, successfully

addressed the foreign exchange imbalance with the result that activity in the parallel market subsided significantly. By 2007, Belize's official exchange rate was held to be largely in line with its equilibrium level.

With their focus on non-resident clientele, the domestically licensed international/offshore banks were originally expected to have little impact on the domestic financial system. However, an amendment to the International Banking Act in 2002 that allowed resident commercial and export processing zone companies to conduct full banking business with international banks operating in Belize, enabled the latter to cut into a portion of the foreign exchange earnings that the domestic banks traditionally received as EPZ companies shifted some deposits and borrowing activities from the commercial banks to the international banks. There was a significant reduction in domestic bank liquidity in the aftermath of this piece of legislation.

5.2 Central Bank of Belize

Since its establishment in 1982 with the assets and liabilities of its precursor, the Belize Monetary Authority being simultaneously conferred upon it, the legal mandate of the Central Bank of Belize (CBB) has been to foster monetary stability, especially with regards to the stability of the fixed exchange rate, and promote credit conditions conducive to economic growth within the context of the Government's economic policy.

In the years up to 1995, the CBB's regulatory and supervisory oversight was limited to the domestic commercial banks. The passage of the Offshore Banking Act in 1996 expanded its purview to include oversight of offshore banks, the first of which was established in 1998. In a subsequent amendment in 2002, the title of the Act was changed, replacing the term offshore with "international". This amendment also strengthened the CBB's supervisory and regulatory powers. An amendment to the Credit Union Act in December 2005 further expanded the CBB regulatory oversight by bringing credit unions under its mantle.

As banker and fiscal agent to the government, Section 34 of the CBB Act allows the CBB to make short-term direct advances to the government up to a maximum of 20% of the current revenues collected during the preceding fiscal year, or fifty million dollars, whichever is greater. Section 35 (2) of the Act had permitted the CBB to hold government securities up to a maximum of five times the aggregate amount of its paid up capital and

General Reserve Fund. In April 2006, this was increased to seven times the aggregate amount of the paid up capital and General Reserve Fund.

The CBB's fiduciary role also includes participating in the primary and secondary market for government securities. In 1996, 1997 and part of 1998, Treasury bill rates were market determined. With the coming to power of the new regime in 1998 a government decision was made to fix the yield at 6.0% in the hope that this would cause the banks to reduce their lending rates, and this lasted until November 2001 when market forces were once again allowed to operate. After an eleven month period of steady declines, partly due to the entry of the fifth bank which needed a share of this paper to fulfill its statutory reserve requirements, the government determined that the yield should be fixed at 3.25% and it remained at this level over the rest of the period under review.

In 1995, the Central Bank had introduced an interbank facility under which banks with excess funds could lend to those with a temporary shortfall in their cash reserve requirements. The offers and uncollateralized take-ups were to be done through the Central Bank with the names of participants being concealed and with the Central Bank's implicit guarantee of credit risk. At the time the facility was launched, the interest rate was set at 10% (one per cent less than the CBB's discount rate). The facility was mostly dormant partly because the use of facsimiles to transmit information made the process cumbersome and partly because of the slowness of the banks to change their mode of operations. In particular, there appeared to be a significant reluctance on their part to reveal operational information to their competitors. Since it had been originally decided that the interest rate should be 1% below the Central Bank's discount rate, the Bank's decision to raise its discount rate to 18% in March 2004 made the cost of borrowing from the interbank facility prohibitive. With practically non-existent demand for interbank loans, the commercial banks did not query the interest rate that had been imposed. However, this situation eventually changed as progressive Central Bank increases in reserve requirements and the commencement of fiscal restraint reduced the growth of bank liquidity and caused them to begin advocating for a reduction in the interbank rate. In July 2006 the link between the discount rate and interbank rate was severed and the interbank facility rate was fixed at 11.0% by the CBB. The use of e-mails for conveying and responding to commercial bank loan requests also made the process more user-friendly and activity in the interbank facility began to accelerate. The

Central Bank continued to bear the credit risk of interbank loans and while no immediate change is on the horizon, it is expected that incremental changes will be made to improve the mechanism for conveying information on offers and bids, and also to require commercial bank loans to be collateralized, which would make the facility less reliant on Central Bank intervention.

In addition to managing the country's international reserves and administering the Exchange Control Regulations with the aim of maintaining the value and convertibility of the Belize dollar, the CBB has also been equipped with the power to set interest rates on commercial bank loans and deposits, mandate credit volumes and set the terms and conditions on loans. However, since its inception, the Bank has generally avoided exercising its latter prerogatives and, apart from setting a minimum interest rate on saving deposits, has restricted its monetary policy initiatives to alteration of the commercial banks two-tier statutory reserve requirements (cash and liquid assets), which were considered to be less disruptive to the credit market.

Although monetary and exchange rate stability are the main goals of the Bank, there are substantial obstacles in the way of its success, principal among which is the subservience of monetary policy to the fiscal stance. In 1998-2003, fiscal dominance and lack of Central Bank autonomy paved the way for the implementation of policies that contributed to large balance of payments deficits, the intensification of pressures on the fixed exchange rate, a burgeoning external debt and economic instability. With the economy having been brought to the brink of a very disorderly adjustment, the need for greater Central Bank autonomy in the implementation of monetary policy was clearly underscored. The CBB therefore began to explore its options for achieving a decoupling from its role as automatic financier of fiscal deficits as well as a more market oriented approach to dealing with liquidity build-up in the banking system.

5.3 Monetary Policy

Monetary policy underwent two swings in the period reviewed. Initially, the stance was restrictive under the UDP government with the aim of moderating credit growth and reducing pressures on international reserves. Next came a period of loosening at the behest of the incoming PUP government to free up monies to help fund a fast paced economic growth programme. A gradual process of tightening then had to be

undertaken to stem the haemorrhaging of foreign reserves and protect the fixed exchange rate.

For the most part, adjustments were effected through alterations in commercial bank reserve requirements. Given low international reserves (1.3 months of merchandise import coverage), the cash and secondary reserve requirements had been increased in December 1995 from 5% to 7% and from 24% to 26%, respectively, of average deposit liabilities and were maintained at this level up to October 1998. These measures were considered prudent in light of the need to shore up the international reserves. However, their effectiveness was limited in restricting credit expansion since private sector loans continued to grow strongly (averaging over 11% per annum) with a bias toward consumerism rather than productive activities. The fiscal deficit was also creeping back up, though the situation remained manageable.

The August 1998 change in government brought an administration whose agenda included jumpstarting the economy through increased public and private sector investments as well as a housing construction boom. In support of the government's expansionary agenda, the Central Bank was called upon to take several measures in November 1998. In addition to lowering the cash and secondary reserve requirements from 7% to 5% and from 26% to 24%, respectively, banks were also allowed to classify new loans for housing construction (up to 5% of deposit liabilities) as approved liquid assets. The Treasury bill yield was fixed at 6.0% (as per government instruction) on the premise that the improvement in return on the securities would be an incentive for commercial banks to lower their lending rates. To partially counter the negative impact on international reserves from the expected credit expansion, government one-year Treasury notes were issued and banks which purchased these with US dollars were also allowed to include these as approved liquid assets.

Fifteen months later, a further loosening occurred following a public announcement by the Minister responsible for Banks and Banking that the Central Bank would be asked to abolish the cash reserve requirement and reduce the overall reserve requirement from 24% to 19% with the intention of further reducing commercial banks' costs and with the hope that this would reduce loan rates and increase the supply of funds being supplied to the productive sector. The Minister had also indicated that the Central Bank would be establishing credit facilities at the commercial banks

with a view to providing lower cost financing for non-traditional export oriented enterprises. The Central Bank responded by reducing the cash reserve requirement for time and savings deposits to 3%, the lowest level permitted by law, and by including in commercial banks approved liquid assets any loans (using the newly available funds) for non-traditional export production. The 5% cash reserve requirement on demand deposits was kept in place since this was enshrined in the legislation.

The policy changes were eventually shown to be of limited effectiveness. While loans for housing construction ratcheted upward, commercial bank lending to the productive sector did not increase significantly. This came as no surprise to the Central Bank since the commercial banks had historically shown themselves to be risk averse, with a tendency to restrict their activity to the already established producers and traditional merchandising sector that thrives in this type of import dependent economy. The banks' weighted average lending and deposit rates declined by 90 and 170 basis points respectively, resulting in a further increase in their interest rate spread. The fall in lending rates appeared to be more influenced by competition from the DFC, BSSB and a building society, which significantly increased loans for housing construction and other projects in this period. Over a two-year span, the heightened activities of these other financial institutions factored into a temporary deceleration in commercial bank lending to the private sector.

With so much funds being pumped into the system, commercial bank excess liquidity increased more than nine-fold between 1998 and 2001. Treasury notes and new mortgages made up a significant portion of their increased holdings. Adding to the system's flushness was government's deficit spending that averaged 7.2% of GDP with financing provided through a spurt of external borrowing mostly by way of high cost, short-term commercial debt (such as bonds and mortgage securitizations), privatization proceeds and the Central Bank overdraft facility. Further monetization occurred as the Central Bank provided $84mn to the DFC representing the Belize dollar equivalent of funds borrowed from a foreign bank on terms that required the same funds to be held in the lending bank as loan collateral. The acceleration in GDP growth to an average of 8.9% in the three years up to 2001 was therefore accompanied by a 50.0% surge in the external public sector debt to 57% of GDP as well as an intensification of foreign exchange pressures with the current account deficit of the balance of payments peaking in 2001 at 21.0% of GDP.

After slowing in 2000-2001, commercial bank credit to the private sector accelerated in 2002 with a 15% expansion, while DFC lending also continued to grow robustly. Since the lending focus was on the highly import-intensive construction sector, the foreign reserves plunged to precarious levels, and the government was forced to undertake a partial refinancing of its external debt to head off a sovereign debt default. The decision was also taken at this time to legitimize cambio activities in an experimental attempt to bring the informal foreign exchange flows into the formal system. By September 2002, the situation was such that the political directorate agreed with the Central Bank's proposal to raise the cash reserve requirements on savings and time deposits from 3% to 5% and from 5% to 7% on demand deposit liabilities, with all rates being subsequently harmonized at 6% in November. The impact of these measures was reinforced by a shift of export processing zone (EPZ) deposits from the domestic system to the international banks subsequent to a legislative amendment that allowed export and commercial free zone companies to do full banking business with international banks in Belize. With these companies moving a portion of their foreign asset holdings to the offshore banks, excess statutory liquidity of domestic commercial banks was halved by the end of the year. While declining slightly, the external current account deficit was still a hefty 18% of GDP.

Over the next two years, growth in private sector credit remained robust and the government was also relying on Central Bank financing for fiscal deficits averaging 7.6% of GDP. The gross official foreign reserve position therefore remained precarious with substantial declines in 2003 and 2004 due to the pressures of servicing the public sector external debt. Since most of the debt contracted by the government was short term, Central Bank reserves were significantly below what was required and this led to another round of foreign borrowing to refinance the external debt in 2003. The refinancing bought some time for the government which chose to delay much needed fiscal adjustments. Meanwhile, with excess liquidity rebounding after two consecutive years of decline and with the need to obtain a clearer way of measuring the true position of the banks, the Central Bank made a decision in April 2004 that residential construction loans would no longer be included as part of the commercial banks' approved liquid assets. The secondary reserve requirement was simultaneously reduced from 24% to 19% of deposit liabilities in order to smooth the transition. Loans to the government continued to be included in the list of approved liquid assets however. In November, the Central

Bank also decided to restrict the borrowing of commercial banks from affiliates to a maximum of 10% of domestic deposit liabilities in order to prevent their level of foreign indebtedness from rising to unsustainable levels whilst expanding domestic credit for non-export oriented activity. One month later, the cash and liquid asset requirements were also raised by one percentage point to 7.0% and 20.0%, respectively, though the impact of these adjustments was neutralized by further monetization of the fiscal deficit and the Social Security Board's injection of proceeds into the banking system following the enforced sale of its shares in the telecommunication and electricity utilities. Excess liquidity consequently continued its upward trend, ending the year with an overall year-on-year increase of 69%.

Under the unrelenting pressure of servicing the external debt, the Central Bank ended 2004 with reduced reserves and an external asset ratio of 32%, which was below the legal threshold of 40%. This led to the third major debt refinancing episode in the first quarter of 2005. The funds were provided from external lenders at very onerous terms and with the public sector/publicly guaranteed debt now above 100% of GDP, the government finally acknowledged the need for fiscal adjustments. The year therefore began with a raft of new tax increases to beef up revenues. On the monetary policy front, the Central Bank followed its December adjustment with a further 1% increase in the primary and secondary reserve requirements (to 8% and 21%) in May and simultaneously disallowed the inclusion of long-term loans to Central Government as approved liquid assets. The Social Security Board was also convinced that they should sterilize a portion of its monthly cash inflows with the Central Bank to support these measures. Fiscal consolidation efforts yielded a small primary surplus by the third quarter of the year and these gains were maintained through the end of the year. Generally tighter conditions contributed to a deceleration in the growth of private sector credit and growth in the broad money supply decelerated from 14% to 7% in 2005. This was however still insufficient to fully cool the overheated economy and the year ended with a heavy external debt overhang, a lower but still inflated external current account deficit (13.6% of GDP) and reserves shrunken to a mere 0.8 month of import coverage.

The need for the continuation of a tight fiscal and monetary framework was obvious and the Central Bank moved to raise the reserve requirements by another percentage point on January 1, 2006. Also, after an extended

delay, the Minister of Finance finally signed a statutory instrument that brought a 2004 amendment to the International Banking Act aimed at eliminating the co-mingling of resident and non-resident deposits in domestic banks into immediate effect. Removing these large and potentially unstable flows from the domestic system caused a temporary reduction in the deposit base of the largest and most aggressive commercial bank that was offset by term loans from its foreign affiliates. After contracting in January, commercial bank excess liquidity began to expand rather rapidly, fed by robust inflows from citrus exports which were enjoying high prices, and petroleum sales, which began in that year. Net domestic credit to the government and the private sector accelerated and the Central Bank therefore intervened once more in September 2006, raising the cash and liquid asset requirements to 10% and 23%, respectively.

Significant improvements in the trade and external current account position underpinned an upsurge in the international reserves, which more than doubled in coverage to 1.8 months of imports. However, this could not dispel the looming threat of a sovereign default given the volume of expensive short-term debt that had been contracted by the public sector. In the latter months of 2006, the government therefore began to explore the possibility of restructuring its commercial debt with external creditors. The restructuring process was completed in February 2007 with a successful debt exchange that provided considerable budgetary relief by lowering interest payments and deferring amortization to 2019. Since then, improvements in the fiscal position have been fostered by petroleum taxes and royalties and bilateral grants, while elevated inflows from tourism, remittances, and foreign direct investment have boosted the banking system's net foreign assets. While growth in private sector credit was strong and bank liquidity was boosted by BSSB deposits subsequent to its unilateral decision to cease the sterilization of its monthly surpluses, the Central Bank maintained an unchanged policy stance in order to provide room for the recovery of the productive sector after the country was hit by a hurricane in August of that year. There was some concern about the effect of fiscal loosening prior to the upcoming elections, with the Central Bank suggesting the need to offset this by further tightening of reserve requirements before the end of the year. No action was taken however as these concerns were allayed by government assurances that bilateral grants from abroad would boost the official reserves and make the adjustment unnecessary. The imminence of the national elections was also

an important factor contributing to the government's reluctance to agree to further monetary tightening at that time.

5.4 Supervision of the Financial System

Between 1983 and 1995, the Central Bank exercised supervisory oversight of commercial banks under the aegis of the Banking Ordinance (Chapter 215 of the Laws of Belize). In 1996, this was replaced by the Banks and Financial Institutions Act (BFIA), which strengthened the regulatory authority and scope of the Central Bank. However, while a 2003 IMF assessment of financial sector regulation and supervision in Belize found the Central Bank's licensing procedure to be "sound", it also found it less than optimal that final authority to issue and revoke licenses to financial institutions in Belize rested with the Minister of Finance. Notably, the Offshore Banking Amendment Act of October 2002, by which the Offshore Banking Act was amended and renamed as the International Banking Act, had legally shifted the power to issue and revoke licenses from the Minister of Finance to the Central Bank. That legislative amendment strengthened the supervisory and regulatory powers of the Central Bank over the offshore banks in several ways and specified the sector's compliance with Basel Core Principles. Start-up capital requirements for A and B class licenses were increased to US$3.0mn and US$1.0mn, respectively. The Central Bank was also empowered to perform full scope examinations and undertake consolidated supervision that would include holding companies, subsidiaries and other affiliate companies. In November 2002, the Banks and Financial Institutions Act (Unit Trust) Regulations came into effect to provide for Central Bank governance of the activities of unit trust companies/mutual funds licensed under the BFIA.

The Central Bank's regulatory and supervisory framework generally satisfied the international standards set out in the Basel Core Principles for Effective Banking Supervision. A traditional CAMELS (capital, asset quality, management, earnings, liquidity and sensitivity to risk) approach was followed in assessing commercial bank performance with particular attention paid to credit quality. Efforts were also made to ensure that these institutions were in compliance with the Money Laundering (Prevention) Act and Combating the Financing of Terrorism (AML/CFT) regulations. With a view to achieving greater transparency in the system, the Central Bank began publishing quarterly balance sheets, income statements and certain financial ratios for each commercial bank in February 2003.

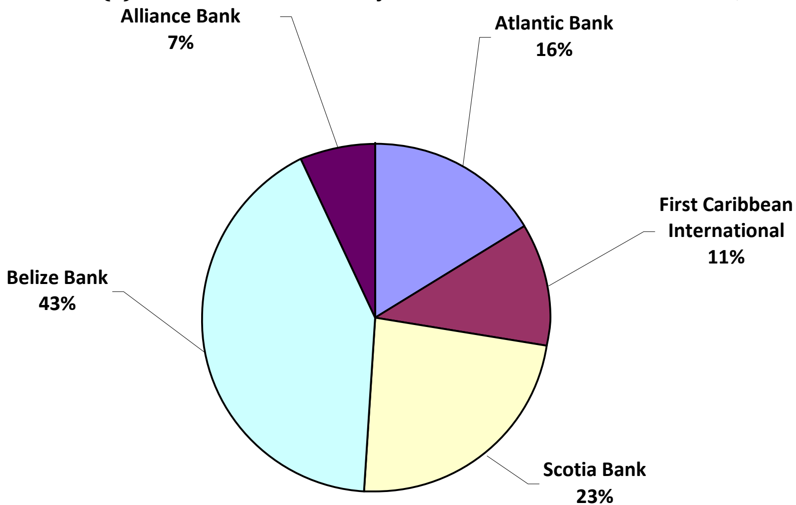
In 2005, subsequent to a CARTAC feasibility study on the Coordination/Integration of Financial Supervisory Authorities, an amendment to the Credit Unions Act was passed to bring credit unions under the Central Bank umbrella by designating the Central Bank's Governor as Registrar of Credit Unions. Oversight of the financial system nevertheless remained diffused across various agencies with the International Financial Services Commission (IFSC) that was established in 1999 being responsible for registering and regulating all offshore activities apart from international banking, while domestic insurance continued to fall under the purview of the Supervisor of Insurance who was based in the Ministry of Finance. Following the 2001 terrorist attacks on the United States and the heightening of international concerns about financial flows to terrorist agents, the government passed the Financial Intelligence Unit Act under the aegis of which the Financial Intelligence Unit (FIU) was established in June 2002. Apart from the power to investigate and prosecute financial crimes, the FIU replaced the Central Bank as the flagship institution in charge of implementing the (AML/CFT) laws and regulations. Belize subsequently signed the UN International Convention for the Suppression of the Financing of Terrorism, which permits the FIU to summarily freeze funds or financial assets related to terrorism and money laundering when urgent action is required. On March 8, 2002, Belize also signed a letter of commitment with the OECD stating that it would abide by the principles of transparency and effective exchange of information in respect of civil and criminal matters.

In the review period, modernization and globalization of the financial system continued to pose challenges to the implementation of a risk-based approach to supervision as the corporate structures of banks became more complex, requiring greater attention to cross border and consolidated supervision issues. Furthermore, since final authority to approve significant enforcement actions rested with the Minister of Finance, the Central Bank occasionally found itself to be out-manoeuvred by banks who were able to exert greater influence in that quarter. The Bank therefore initiated a revision of the BFIA to bring it into greater conformity with international best practices and to increase its regulatory authority to apply administrative penalties for infractions of the law and its regulations. Up to the end of the period reviewed, the legislative amendments had not been submitted to the House of Representatives for enactment.

5.5 Commercial Banking Activities

With assets of less than US$2.0bn, Belize's financial sector remains relatively small by international standards. Five domestically licensed commercial banks (Atlantic Bank, Alliance Bank of Belize Ltd, Belize Bank Ltd, First Caribbean International Bank Ltd, and Scotia Bank (Belize) Ltd) account for approximately two-thirds of this amount. All the banks were locally incorporated except for First Caribbean, and the banking sector was entirely private with foreign ownership being dominant.

Chart 5.2 (a): Commercial Banks by Market Share at December 31st, 2007



Source: Central Bank of Belize

The history of Belize's banking system can be traced back to 1904 when local investors established The Bank of British Honduras. This institution was acquired by the Royal Bank of Canada in 1912, which monopolized Belize's banking system until 1949. The latter was obtained by a private investor in 1987 and renamed the Belize Bank Ltd., the country's largest commercial bank, accounting for a little less than half of the banking sector. The second largest is Scotia Bank (Belize) Ltd. which opened in 1968 as a branch of Bank of Nova Scotia. In 2003, the branch was converted into a wholly owned local subsidiary of the Bank of Nova Scotia International (Bahamas) Ltd. Atlantic Bank Ltd., the third largest commercial bank, opened in 1971 and its majority shares are owned by Sociedad Nacional de Inversiones, S.A., a Honduran company. Next in size is First Caribbean International Bank (Barbados), formed in 2003 by the merger of the Caribbean operations of Barclays and Canadian Imperial Bank of

Commerce; its predecessor, Barclays Bank, had operated in Belize since 1949. The newest entrant to the banking system is Belize's smallest bank, Alliance Bank of Belize Ltd., which commenced operations in 2001.

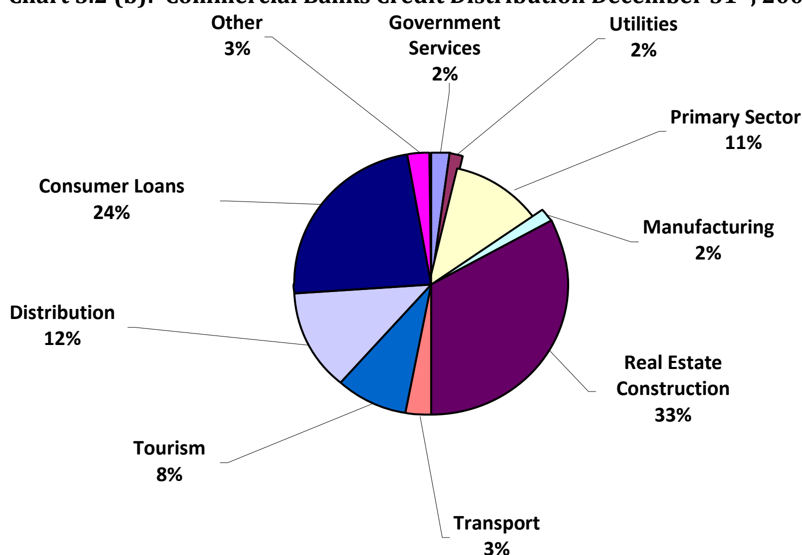
While financial intermediation has made forward strides, Belize's banking infrastructure could benefit from further development. In addition to administering the still fledgling interbank facility, the Central Bank offers a discount facility through which banks may satisfy unforeseen liquidity problems. The records show that use of the latter has been rare most likely due to the punitive interest rate that the Central Bank has instituted over the years. A deposit insurance system has not yet been established for commercial banks, and the statutory reserve requirements consequently function dually as a monetary policy tool that also provides a measure of prudential reassurance to depositors. The cheque-clearing process has remained largely underdeveloped since the time of the Monetary Authority. Three decades later this system is still labour intensive with representatives of the commercial banks assembling at the Central Bank premises daily to swap cheques.

Over the period of this review the number of bank branches more than doubled from 21 to 45, and ATM services that were first launched domestically in 1993 have gradually spread throughout the country. However, since agreement has not been reached on the establishment of a local network switch that would enable interconnectivity, the full efficiencies to be gained from the ATM system are yet to be realized. In the interim, there have been other forms of banking innovation with the start of online banking in 2003 by one bank being a key development. The other commercial banks eventually followed suit and all are currently accessible via the internet, enabling customers to view account details, transfer funds (typically between accounts in the same bank), and pay a limited number of bills online. Three banks recently launched debit card services, exclusively for Belize dollar transactions in the domestic system.

Minimal financial deepening has occurred. On the other hand, there has been a significant increase in monetization as indicated by a 14 percentage point increase (to 68.5%) in the ratio of broad money to GDP over the revision period. The commercial banks continue to limit their portfolio to traditional financial services (demand, savings and time deposits, and demand and term loans). Their loan portfolios are heavily concentrated in the construction/real estate and consumer areas, with much smaller

allocations to the sectors engaged in export production. Lending for primary production, tourism, and manufacturing activities accounts for less than a quarter of the consolidated loan portfolio, while consumer, construction/real estate and distribution loans exceed two-thirds of total lending. In the last twelve years, average annual growth in commercial bank loans was approximately 11.6%, relative to average annual growth in real GDP of 5.1%.

Chart 5.2 (b): Commercial Banks Credit Distribution December 31st, 2007



Source: Central Bank of Belize

Public concerns about the high cost of commercial bank loans cite the fact that the weighted average lending rate has never broken the 14% barrier with the banks invariably laying the blame for this on the implicit taxation of reserve requirements imposed by the Central Bank. In this regard it is noted that during the 1996-2008 period, the interest rate spread narrowed from 10% to 7.75% but appeared to be rather more responsive to the increased competition engendered by the addition of a new bank and the liquidity impact of public sector transactions than to changes in reserve requirements. As an example, when cash and secondary reserve requirements were lowered in 1998 and 2000, with banks also being allowed to classify new mortgages as approved liquid assets, the spread increased as an 80 basis points decline in the weighted average lending rate was outweighed by the 170 basis points fall in the weighted average deposit rate. Conversely, from 2002 to 2006, the reserve requirements

were periodically increased. This was also a period in which the new bank was expanding by cutting into the customer base of the other banks, the interest rate spread narrowed significantly.

Dollarization in Belize remains low as virtually all domestic activity is denominated and transacted in the local currency. To avoid balance of payments vulnerability due to the disruptions that can be caused by speculative portfolio investment flows, domestic commercial banks may not accept foreign currency deposits from non-residents. The banks may also not lend in foreign currency without the Central Bank's approval and they therefore confine their lending in US dollars to exporting firms or those in the tourism industry. An amendment to the International Banking Act in October 2002 allowing international banks licensed in Belize to accept foreign currency deposits from, and lend to, firms operating in Export Processing Zones, Commercial Free Zones (mostly exporters), and government agencies have somewhat reduced the volume of foreign currency transactions between domestic banks and exporters. Meanwhile, it is understood that because of the economy's structural trade deficit, commercial banks must occasionally rely on funds from head offices and affiliates to support their domestic lending. Bearing in mind the large external imbalances already created by public sector expansion, there was a concern in 2004 that commercial banks could be exacerbating the situation by borrowing exorbitantly from abroad to fund loans for non-tradables. In November of that year the Central Bank therefore decreed that their loans from foreign affiliates should not exceed 10% of domestic deposit liabilities.

5.6 Development Finance Corporation

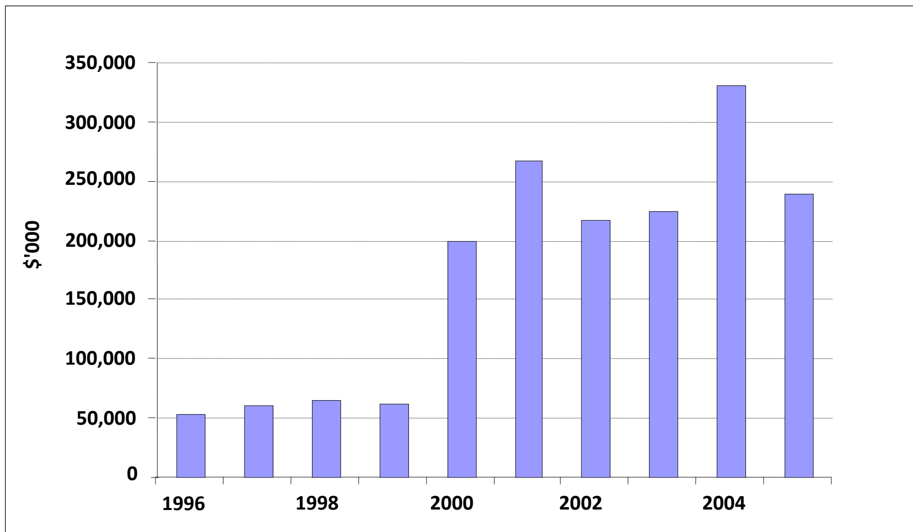
The Development Finance Corporation (DFC) was established in 1961 as a development bank with a mandate to strengthen and expand the Belizean economy through the provision of financing to all economic sectors, with an emphasis on agriculture, fishing, education, tourism and housing. In the early 1970's the Government of Belize acquired majority control of the institution, and the statutory obligations of the DFC were enshrined in the Development Finance Act of 1973. Its Board of Directors comprised four representatives from the private sector and three from the public sector, all of whom were appointed by the Minister of Finance.

After it became a statutory body, the DFC generally relied on funding from the government and from long-term concessional loans from the Caribbean

Development Bank (CDB) and other bilateral and multilateral agencies such as USAID, the World Bank, CDC, IFAD, and EIB to finance its lending activities.

This conservative approach was dispensed with shortly after the PUP took up office in 1998 when the DFC became one of its principal instruments to achieve the government's social and political objectives. With a considerable expansion in lending activity in order to support the government's aggressive housing construction programmes, DFC's loan portfolio grew by 435% over the 1999-2004 period. The corporation also began to rely on commercial sources of credit with the Central Bank transferring to it the Belize dollar equivalent of US$42mn borrowed from the International Bank of Miami, Citicorp Merchant Bank and Citibank Trinidad and Tobago. In 1999 and 2000, funds were received from the Royal Bank of Trinidad and Tobago (RBTT) as a result of several mortgage securitization transactions wherein the DFC and the BSSB pledged the income stream from a specific domestic portfolio of mortgages and other loans for repayment. The securitization carried a government subsidiary guarantee, and the Central Bank guaranteed the convertibility of repayments to US dollars. After contributions to sinking funds, annual net inflows from the securitization operations stood at about US$30mn in 1999 and 2000.

Chart 5.3: DFC Loans



Source: DFC

In 2001, the DFC's fundraising included the sale of real estate valued at US$40mn to RBTT, subject to a three-year buy-back arrangement. In 2002, additional financing was secured via the Corporation's then newly established special purpose entity (SPE), the Belize Mortgage Company 2002-1, which issued US$40mn 8.5% Class A Bonds due 2012, and US$4.5mn 12% Class B Bonds due 2012, guaranteed by the Government of Belize that became known as the 'North American Securitization Transaction'. By 2002, the DFC and Belize Social Security Board had raised approximately US$150mn in five securitization operations beginning in 1999.

Issues with non-performing loans began to emerge almost simultaneously with the rapid increase in lending as the institution was directed to drastically lower its lending guidelines. The situation was exacerbated by the government, which, in order to reduce its own fiscal deficit and debt service ratio, transferred the assets and liabilities of large projects that it had already implemented (Los Lagos, Mahogany Heights, soybean) to the DFC. These contributed to the escalation in DFC's loan portfolio of 222% in 2000 and 34% in the following year. Cash flow problems led to an almost 19% decline in lending in 2002 before it began to accelerate once more with a 3.7% increase in 2003 and a 48% expansion in 2004. The sizeable fluctuations in the non-performing loan ratio (30.3% in 2000, 19.3% in 2001, 42.5% in 2002, 26.3% in 2003, 36.4% in 2004) therefore reflected the lowering of the corporation's lending criteria as well as the massive increase in its portfolio. In 2005 and 2006 the non-performing loan portfolio stood at 48.1% and 32.2% respectively.

In describing the corporation's liquidity problems, an Inter-American Development Bank (IDB) diagnostic assessment in October 2004 highlighted its large non-performing loan portfolio, which was exacerbated by high maintenance costs associated with financing the substantial inventory of houses that it had acquired and was holding for resale. The IDB Report also cited weaknesses in DFC's corporate governance and management. One controversial example of this involved the contravention of the Corporation's lending policies in rapidly disbursing the bulk of the proceeds of a US$45mn bond issue to two local companies that were allegedly linked to the ruling administration. Both companies eventually defaulted on their loan obligations and these revelations spawned two high-profile investigations in 2005: an investigation by a Senate Commission on the BSSB, and a Commission of Inquiry into the

affairs of the DFC over the period January 1999 through December 2004, with particular reference to its loan and securitization portfolios.

The DFC's illiquidity and substantial external debt obligations inevitably led to the need for government intervention to save the institution from outright collapse. The situation was complicated by the fact that the government was going through its own severe cash flow difficulties and was vulnerable to pressure from the IDB which was providing it with financing via a policy-based loan. As a consequence of the latter, the Government announced in November 2004 that the DFC would be liquidated notwithstanding evidence presented to the Cabinet Finance Committee by the corporation's management and staff demonstrating that liquidation was not the most financially viable alternative.

In the years 2004 and 2005, the Development Finance Corporation underwent a restructuring in which its staff was reduced by 110 (from 182 to 72 persons), district branches were transformed to customer service outlets (one district office was closed completely), and all key functions were centralized at headquarters. A new Board of Directors was appointed in June 2005 headed by an experienced chartered accountant who assumed the added responsibility of chief executive officer. With the drying up of funding sources, new lending was restricted to financing of the sale of land and housing inventory, and the institution's main focus was placed on loan collection, improvement of loan quality, and reduction of operational costs. Throughout 2006, various loan discount programmes that summed to $23.0mn were implemented in accordance with government directives. These included the granting of housing loan discounts to 2,692 homeowners aimed at reducing foreclosures and discounts or complete debt forgiveness to some 1,804 student loan holders. Accounts that met specific eligibility criteria were fully liquidated, with the costs of such programmes being met by an offset against amounts owed to GOB by the DFC.

Despite these programmes, over 532 loans remained non-performing at the end of March 2007. The corporation also increased its efforts to recover outstanding sums from chronically delinquent clients by placing assets securing these loans up for auction. In 2006 some 137 properties were foreclosed with a gross recovery value of $16.9mn. Guidelines for loan write-offs were revised by the new Board of Directors and a significant portion of severely impaired loans was written off the active loan portfolio.

Such loans were not forgiven but were administered separately with collections being pursued through the courts or established collection agencies. The corporation's housing inventories were also revalued in line with the cost-approach, making their selling price more attractive to prospective home owners.

In August 2006, the institution's financial problems became the centre of national attention amidst charges of mismanagement when the DFC Commission of Inquiry commenced public hearings with coverage of the proceedings being aired by all local media houses. While this was ongoing, an amendment to the DFC Act was passed in November 2006, formalizing the liquidation process by placing a temporary moratorium on the issuance of new loans and limiting the DFC's activities to loan collections and servicing of domestic and external obligations. GOB would eventually assume external liabilities of about US$65mn associated with the DFC and BSSB securitizations, in addition to significant contingent liabilities from the North American Securitization.

The work of the Commission of Enquiry was sharply interrupted by the untimely death of the Commission's chairman in December of the same year, and since the government did not appoint a replacement, only two Commissioners were left to determine if there was any wrongdoing in the operations of the DFC, and, if so, identify those responsible. After a hiatus of several weeks, the Commission recommenced its hearings but with difficulties arising when the two Commissioners differed on major procedural issues. Almost inexplicably, one commissioner decided to preemptively submit a report of his findings to the Prime Minister and this forced the new chairman into the position of eventually having to submit a report that was also of single authorship. From the public's perspective, this represented a sabotage of the Commission of Enquiry's objectives since there could be no conclusive report. Both reports were subsequently kept from publication following court injunctions obtained by the former Chairman of the DFC board, on the basis that each had been written by one Commissioner only.

Since the commercial banks have up to now shown neither the desire nor the capacity to fulfill the DFC's role in project/development financing, it was fortuitous that the corporation's death throes were interrupted by the February 2008 change in government. The new administration expressed a desire to resurrect the institution but with more legislative safeguards to

prevent a repetition of its recent history. The old DFC Act (Chapter 279 of the Laws of Belize) was therefore repealed by passage of the DFC Act No. 1 of 2009. This legislation gives the institution far greater autonomy by increasing the number of board directors to nine, a majority of whom are nominated by the private sector. A decision-making quorum now entails no fewer than three private sector directors, the chairman of the board and one public sector ex-officio director. The Corporation has become subject to the supervisory oversight of the Central Bank and cannot borrow in excess of $5.0mn without the approval of the House of Representatives. Also in the interest of transparency, the specifics of related party transactions and loans in excess of $1.5mn must be included in its annual reports. Its present scope of operations remains limited due to the paucity of its financial resources, but efforts to identify other funding pipelines in addition to the Caribbean Development Bank are continuing.

5.7 Credit Unions

As of December 31, 2007, there were 13 registered credit unions as compared to 21 in 1995. Total assets were estimated at approximately $410mn (16.1% of GDP) as compared to $106.0mn (8.3% of GDP) in 1996, indicating that the sector had grown by an annual average of 26.5%. Size disparity continued to be notable with the smallest accounting for assets of only $0.2mn while the largest held $279mn and was actually bigger than the country's smallest commercial bank. In addition to the 68% market share of the largest credit union, a position that it has held for a substantial period of time, the balance was almost entirely accounted for by the next seven largest institutions.

Until 2002, the credit unions operated under legislation that had last been amended in 1982. The Credit Unions Act of 2002 significantly expanded the potential scope of operations, and created greater similarities between these institutions and the commercial banks they compete with. In addition to the traditional acquisition of assets through member shares, the credit unions were allowed to commence offering a variety of other services to members among which were term deposits, checking account facilities, discounting of bills, access to automatic teller machines and other unspecified electronic services. Provision was also made for depository and related business services to be offered to the government, private sector and public organizations. The long-standing, legally instituted interest rate ceiling of 6% on dividends was increased to 8% and the 12% ceiling on their lending rate was removed to increase operational flexibility.

However the supervisory structure was kept in place with the Registrar of Cooperatives and Credit Unions, a department of Central Government, maintaining responsibility for regulatory oversight.

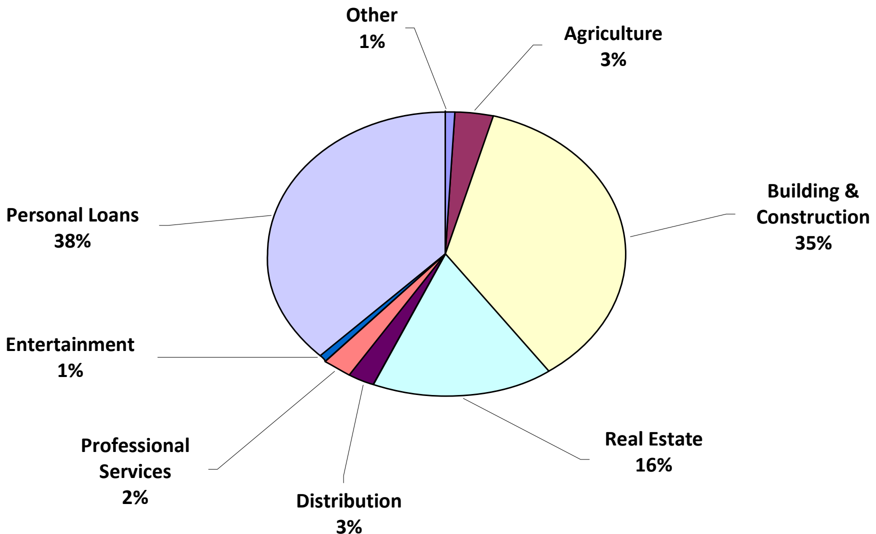
This was changed in December 2005, with the Credit Unions (Amendment) Act (Commencement) Order which designated the Governor of the Central Bank of Belize as credit unions Registrar. The 2005 amendments were aimed at bringing about integrated supervision of Belize's financial system, upgrading existing credit union supervisory standards in compliance with those set by the World Council of Credit Unions and to institute administrative penalties for non-compliance. By virtue of the legislative amendment, the advocacy role of the Belize Credit Union League was expanded to include training of credit union employees in order to facilitate continuous development of the movement.

Membership in the credit union movement has been traditionally drawn from groups that share similar characteristics such as civil servants, small communities, or church members. Since the typical member would be classified as a small saver, there are significant incentives to do business with credit unions rather than with commercial banks, which are impersonal, require that individuals have a steady source of income in order to open an account and impose more restrictive terms for loans. The commercial banks reserve their highest returns for term deposits held by larger depositors while limiting interest paid on smaller savings deposits to between 4.5% and 6%. In 2007, credit union members received average dividends of approximately 7.4%, compared to the commercial banks' weighted average interest rate on all deposits of 6.0% and their weighted average time deposit rate of 8.4%. Even though the interest rate ceiling for loans was removed in 2002, credit unions have continued to lend at 12% per annum, which, for the larger and more profitable credit unions, is further reduced by rebates that may be as high as 10% of annual interest payments. In comparison, the commercial banks weighted average lending rate exceeds 14% per annum. In addition to lower interest on loans, some credit unions have been offering other incentives such as funeral benefits of up to $4000 for the beneficiaries of members who have a minimum of $125 in savings at the time of death.

In enabling otherwise under-served groups in rural areas to gain access to financial services credit unions contribute positively to the mobilization of savings. However, although located in all six districts of Belize, they vary

greatly in terms of size and strength and so the benefits of the movement are not evenly spread across the country. The largest credit union has nearly 40,000 members, the smallest has less than 500 members. There is also a significant variability in their performance. The result of previous laxity in regulatory oversight is being shown in the need for several credit unions to significantly reduce the level of non-performing loans and improve their overall profitability. Since taking on the responsibility for regulation, the Central Bank has reviewed the performance of each credit union and efforts are underway to address the deficiencies that have come to light and to generally strengthen the credit union movement in Belize.

Chart 5.4: Credit Union Credit Distribution at December 31st, 2007



Source: Central Bank of Belize

5.8 Insurance Companies

As of December 2007, fifteen insurance companies were registered to conduct business in Belize, including five life insurers, eight general insurers and two composites. There was significant growth over the 12-year review period with gross premium income collected by the industry rising 290% (from \$28.9mn to \$112.6mn). This growth peaked in 2001 with a 32.5% expansion that was driven largely by the entrance of two new players to the industry that were able to make significant expansions in the provision of life insurance and related products such as pensions and annuities. At

the end of 2007, life insurance accounted for approximately 29.5 % of premium income with general insurance accounting for the balance.

Developments during this period included two acquisitions, one merger and the rebranding of two companies. The 1998 failure of Jamaica Mutual Insurance Company resulted in the acquisition of its domestic assets by Guardian Life Ltd and also highlighted the risk of contagion as the Supervisor of Insurance had to intervene to stop the funnelling of funds from the Belizean branch which was being used to offset losses incurred by the parent company. The Supervisor of Insurance's intervention led to the eventual sale of the company's portfolio.

The 2000 failure of BELINSCO, an insurance company that had experienced difficulties in producing accurate and timely financial statements, also highlighted the need for improved domestic supervision. BELINSCO was placed under judicial management and eventually liquidated when it was unable to meet claims brought against it. This episode highlighted several supervisory issues that were not being addressed by the Ministry of Finance and led to the reconfiguration of the post of Supervisor of Insurance. Prior to this, the supervision of the insurance sector was just one of the responsibilities assigned to the Financial Secretary.

Originally legislated in 1974, the Insurance Act underwent amendment in 2003 to increase the statutory deposit reserve from 10% to 15% of net premium income, impose stricter controls with respect to change of ownership, reporting periods, and presentation of audited annual financial reports, and grant statutory authority to the Office of the Supervisor of Insurance to conduct on-site inspections and impose sanctions for legal infractions. The amendments brought domestic insurance supervision largely in line with the International Association of Insurance Supervisors (IAIS) Core Principles, with respect to improved guidelines for corporate governance, prudential controls, and market conduct. Other efforts to promote good governance in the industry were also evidenced in the formation of voluntary self-regulatory/best practice organizations such as the Organization of Insurance Companies (ORINCO) and the Belize Association of Insurance and Financial Advisors.

The International Insurance Act became law in 1999 to govern the establishment of companies offering life insurance, general insurance, reinsurance and captive insurance business to non-resident clientele.

Regulatory purview lies with the Supervisor of International Insurance who is under the aegis of the International Financial Services Commission (IFSC). At the time of this writing, the international insurance industry remains embryonic.

5.9 International Banks

The Offshore Banking Act became law in 1996 and two years later, Belize's first international bank, Provident Bank & Trust (PBT), was licensed. Growth in the number of licensed international banks was gradual with nine more banks being eventually added to the list. Part of the reason for the slow rate of expansion was the stringent requirements imposed by the Central Bank, which sought to ensure that the jurisdiction continues to build its reputation for safety and transparency. The number of operational banks has since fallen to eight as two have since been granted permission to voluntarily wind up their operations.

Table 5.2: International Banks Operating in Belize

	No. of International Banks	Total Deposits US$mn	Total Loans US$mn	Total Assets US$mn
1998	1	-	-	-
1999	2	35.6	20.1	38.6
2000	3	55.6	37.2	59.2
2001	4	93.9	61.1	100.4
2002	7	129.1	78.3	153.2
2003	8	140.4	104.1	191
2004	8	143.2	109.6	196.7
2005	8	157.1	115.6	212.3
2006	8	254.3	144.3	309
2007	9	292.8	174	357.9

Source: Central Bank of Belize

Provident Bank & Trust dominated the sector until 2006 when an offshore branch of Belize Bank Ltd known as Belize Bank International (BBI) was established as a consequence of the fact that domestic commercial banks were no longer allowed to continue co-mingling the deposits of residents and those of non-resident international business companies (IBC's). By the end of 2007, BBI held 45% of the total assets of the sector, making it the largest international bank operating in Belize. Total credit extended by international banks has grown by an annual average of roughly 8% with BBI and PBT accounting for over 65% of total lending. In recent years, the international banks became significant contributors to increased

investment by non-residents in the territory through their financing of land purchases and construction of condominiums.

Also to be noted is that, although the international banks were initially allowed to transact business exclusively with non-residents, their operational scope was expanded in 2003 when the legal definition of "non-residents" was amended to include Belizean-based export processing zones and commercial free-zone businesses. On the regulatory front, international initiatives to combat money laundering and ensure general compliance with the Basel Core Principles led to the amendment of the Offshore Banking Act in 2002. Its successor, the International Banking Act (IBA), strengthened the regulatory powers of the Central Bank and shifted the authority to license these institutions from the Minister of Finance to the Central Bank. Start-up capital requirements for both B Class and A Class licenses were increased from US$250,000 and US$500,000 to US$1,000,000 and US$3,000,000, respectively, and in addition to gaining unlimited access to information pertaining to operations of international banks, Central Bank supervisors became empowered to perform full scope examinations of these institutions.

5.10 Conclusion

While Belize's financial system has experienced some growth and diversification, it remains comparatively underdeveloped, partly due to its small size, and, to some extent, its fixed exchange rate which limits the flow of portfolio investment capital to and from the system. Because of its important contribution to price stability and the investment climate, the country maintains full commitment to the exchange rate peg with the determination to focus only on financial innovations that are compatible with the existing framework. This of course would be subject to change if a single currency becomes the operational standard of the CARICOM Single Market and Economy (CSME).

Over the years, commercial bank expansion has enabled more residents to have their intermediation needs met by the formal financial system. However, relatively high levels of unemployment and poverty cause many to be unable to maintain formal ties to commercial banks and, in some cases, even to credit unions. This gap is being filled by the proliferation of informal and formal moneylenders. In recent years, the number of licensed moneylenders has been increasing and currently number 32, which includes nine new licensees in 2008.

Work continues in the quest to further strengthen the regulatory framework as both the Banks and Financial Institutions Act and the International Banking Act are currently being redrafted and a draft Money Transfer Services Bill has been submitted for legal vetting. With commercial bank excess liquidity continuing to expand in a context of significant variation in bank size and strength, the need for the Central Bank to transition to a more effective method of liquidity management has also led to a project to reform the arrangements for fiscal financing that will simultaneously enable the Central Bank to adopt a market approach to liquidity management in addition to its current use of reserve requirements. Other legislative amendments to the Central Bank Act, the Treasury Bill Act and the BFIA to undergird this process would consequently be necessary. The issue of private sector credit expansion via hire/purchase facilities offered by local business houses will also need to be addressed since the current laws do not provide for Central Bank regulation of the sector.

As regards the development of Belize's payments system, progress has hitherto been slow due to a lack of financing for technical assistance and infrastructure and difficulty in obtaining consensus among the commercial banks. While agreement has been reached on cheque standards, agreement on other infrastructure to allow automated cheque clearings is still lagging. A comprehensive reform resulting in establishment of a legal framework for the payment systems, Real Time Gross Settlement (RTGS) system, an automated clearing house and local network switch to allow interconnectivity to ATM's and point of sale (POS) machines to facilitate retail transactions is therefore still in the future.

6

The Financial Structure in the ECCU: Retrospect and Prospects

Eastern Caribbean Central Bank
Research Department

The financial structure of the Eastern Caribbean Currency Union (ECCU), the relative mix of financial institutions, instruments, and markets, have been influenced by both history and the small sizes of the economies. The islands of the ECCU were once organized as two administrative units – a Leeward Island Unit and a Windward Island Unit – under British colonial rule. Since political independence the countries of the ECCU, except in respect of the monetary and commercial banking systems, have become a set of disparate units. This truncation of the potential market size in the ECCU has hampered the evolution of the financial structure by limiting potential economies of scale and scope. Notwithstanding the challenges surrounding financial structure, regional output (measured in current prices) increased more than two fold between 1996 and 2008, outpacing population growth. This outturn was associated with rapid growth in the financial sector, favourable conditions for the region's exports in international markets and high and sustained public investment in education, health and other social infrastructure.

Since the mid-1990s however, the rate of growth of GDP has been trending downwards, on account of a deterioration of the terms of trade. The exports of banana and tourism services, the bases of the region's growth, have come under severe stress, made worse by declining productivity and high cost of production. Associated with the secular growth decline has

been the surge in public debt. The generalised downward trend in the ECCU's growth was interrupted briefly by a sharp growth spurt between 2005 and 2007 on account of the preparations for the Cricket World Cup 2007 (CWC 2007), but growth has since resumed its presumed long-run path. These events have served to highlight some of the structural weaknesses of the ECCU economies, notwithstanding the favourable record of achievements.

The regional policy authorities have long recognised that an imperative for the future development of the countries of the ECCU/OECS is the integration of these economies. Two important ways in which this vision has been expressed are the ECCB (1983) agreement and the OECS (1981) Treaty of Basseterre. In 2007 the OECS member states initialed an OECS Economic Union Treaty which would advance the integration of the OECS countries. The further development and transformation of the region's financial system through the creation of a single financial space is viewed as a strategy for the integration of the ECCU economies and the realisation of the OECS Economic Union. Notwithstanding the progress made thus far in the establishment of regional institutions and markets, the momentum towards a single financial space has slowed.

Financial developments over the 1996 to 2008 period were characterised by an intensification of efforts to build and consolidate money and capital markets, pursuant to the fourth purpose of the ECCB, as enshrined in Article 4 of the ECCB Agreement Act. To this end, the Eastern Caribbean Securities Exchange (ECSE) was established in 2001 and the Regional Government Securities Market (RGSM) in 2002, following the establishment of the Eastern Caribbean Home Mortgage Bank (ECHMB) in 1994. In addition, there were also efforts to expand the tools of monetary policy and also experiment with active monetary policy. Market developments saw the merger of two major players in the commercial banking sector (CIBC and Barclays) and the introduction of one new commercial banking entity (RBTT).

Going forward, two overarching factors likely to significantly influence the configuration and orientation of the ECCU's financial structure are the plan to create an OECS Economic Union by December 2009 and the unfolding global economic and financial crisis. These two forces are likely to effect major changes to the region's financial structure, with or without deliberate policy action. An appropriate policy response would likely

accelerate the achievement of the OECS Economic Union through the realization of the single economic and financial space.

The rest of this chapter is outlined as follows: first we outlined the existing financial structure and its contribution to economic growth; this is followed by a discussion on the forces which are likely to shape the future structure of the financial system. Concluding comments are provided in the final section.

6.1 Stylised Facts on the Financial System

A key characteristic of the financial system in the ECCU is the fact that the currency union is a collection of six independent countries[23] and two British overseas territories[24], with separate regulatory framework for the non-bank component of the financial system. In general the ECCU's financial system is composed of both domestic institutions and offshore financial institutions. Within the domestic category, there are approximately 166 institutions of various types. There are two basic types of financial institutions within the domestic financial system: banks and non-banks.

6.1.1 Commercial Banking Sector

In respect of the banks, there are forty (40) in total throughout the ECCU. Antigua and Barbuda has the largest number of banks (8), while Montserrat has the smallest number of banks (2). The banking sector can further be sub divided into foreign branch banks (26) and indigenous banks (14). The indigenous banks are unit banks concentrated within their country of origin. The commercial banking sector is the largest sub-component of the financial system with over EC$24.0 billion in assets at the end of 2008, up from $6.7 billion at the end of 1996. In respect of the distribution of those assets, the foreign banks held approximately EC$13.2 billion (55.0 per cent), while the indigenous commercial banks held approximately EC$10.8 billion (45 per cent). This represents a slight structural shift from the outturn at the end of 1996 when foreign branch banks controlled 64.0 per cent of commercial bank assets, and indigenous banks, 36 per cent. Moreover, the ownership structure of the indigenous commercial banks, with some minor exceptions, is largely concentrated within their country of

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[23] Antigua and Barbuda, Dominica, Grenada, St Kitts and Nevis, Saint Lucia and St Vincent and the Grenadines.

[24] Anguilla and Montserrat

origin. Commercial banks are regulated by the ECCB as prescribed by the uniform Banking Act (1983).

The commercial banking system provides the traditional financial instruments of loans and deposits and other financial payment services and instruments, such as credit cards, debit cards (domestic and international), to agents in the economy. Some commercial banks also offer broker-dealer services for economic agents to participate on the Regional Government Securities Market (RGSM) and the Eastern Caribbean Securities Exchange (ECSE).

6.1.2 The Non-Banks Financial Sector

In respect of the non-bank sector, there are approximately 127 units in total. The non-bank sector is composed of the following: finance mortgage companies; development banks; credit unions; building societies; insurance companies/agencies and money services businesses. There is no single regulatory framework or supervisory structure for the non-bank financial institutions across the ECCU; regulation/supervision is driven by domestic institutions such as ministries of finance and departments of co-operatives. Precisely because of the relatively weak regulatory framework the data on the operations of these institutions are sparse.

Finance/Mortgage Companies

There are sixteen (16) finance/mortgage companies operating within the ECCU. The largest number of these companies seven is registered in St. Lucia. These institutions essentially offer mortgages for economic agents to purchase homes. In some cases they also accept deposits, which essentially go towards the funding of mortgages.

Development Finance Institutions/Development Banks

There are six development finance institutions within the ECCU. Montserrat never had a development bank in the traditional sense. The development finance function is performed by the St Patrick's Co-Operative Credit Union. The St. Lucia Development Bank was merged with the National Commercial Bank of Saint Lucia in July of 2001 to create the Bank of St. Lucia. In 2009, the government of Saint Lucia opened a new development bank. These institutions are regulated under statutes of parliament – reports on their operations are laid annually in parliament. The financial instruments offered by these institutions are restricted to loans to individuals and institutions for investment purposes in policy-

prescribed priority sectors. These include education, agriculture and manufacturing.

Cooperatives/Credit Unions

There are approximately 72 credit unions operating in the ECCU. The majority of these credit unions are located in Dominica (16), Grenada (18) and Saint Lucia (16). These institutions are regulated at the local country level under the auspices of ministries of finance, departments of co-operatives, or, in the case of Grenada, by GARFIN. The financial instruments provided by credit unions to economic agents are deposits, loans and shares – the traditional instruments. These instruments are geared towards both consumption and investment. In recent times, some of the larger credit unions have offered their membership chequing instruments, which are cleared through the credit union account at a commercial bank.

Insurance Companies/Agencies

The insurance sector in the ECCU comprises agencies of insurance companies registered in Trinidad and Tobago, Barbados and The Bahamas. There are 133 insurance agencies operating within the ECCU jurisdiction. Except for the case of Montserrat there are over ten insurance agencies operating in each country in the ECCU. The regulatory framework is country-focused and, as a result, varies from country to country within the ECCU. Importantly also the regulatory rules in some cases are outdated as they have not kept up with developments in the insurance sector. The financial instruments offered by the insurance companies include the traditional instruments of life and general insurance policies, along with annuities. In recent times some insurance companies have offered economic agents high yielding investment financial products. Some insurance companies have also offered mortgage loans to economic agents to purchase homes.

Building Societies

There are four building societies operating within the ECCU, one each in Dominica, Grenada, Monsterrat and St Vincent and the Grenadines. These are all regulated at the local level by offices of the registrars. The building societies offer shares, deposits and loans to their membership as their key financial instruments.

Money Services

In recent times there has been an explosion of money services institutions within the ECCU. These institutions essentially facilitate the rapid transfer of financial resources from one geographical location to the next. There are, however, some institutions that provide payday advances to economic agents. In such cases the financial instrument is essentially short-term loans/credit.

6.2 Money and Capital Market Development

6.2.1 ECSE/ECSM

In recognition of the limitations of the bank-centric financial system, particularly in financing risky developmental activities and designing financial products for emerging sectors, the ECCB accelerated efforts to establish a stock exchange. These efforts came to fruition in 2001 with the establishment of the Eastern Caribbean Securities Market (ECSM). The ECSM represented a significant augmentation of market infrastructure and presented an opportunity for improving the human resource capacity of the ECCU, with the attendant emphasis on financial literacy. Further, the ECSM was a major technological advancement, being a fully electronic market with a virtual registry and depository, facilitating trading and transfers across the eight member states and beyond. In that regard, the ECSM was a critical node for the full integration of the ECCU into the global capital market.

By design, the ECSM was to be an alternative to commercial banks and other traditional suppliers of credit for businesses, existing and prospective, to raise capital within the regional financial system. It was also to deepen the regional financial system through the establishment of a secondary market on which the purchasers in the primary market could trade to fulfill their liquidity and other portfolio needs. It was envisaged that the efficiency of financial intermediation would improve as depositors would now have increased options for savings and businesses, cheaper sources of funding, thus improving economic outcomes.

At the end of 2001, there were two companies listed on the ECSE and total market capitalization was $111.4m. By the end of 2008, the number of listed companies had increased to 14 and total market capitalization to $3.9b. Companies were able to expand funding sources, reduce their weighted average cost of capital through higher equity investments and

lower debt levels, while options for the saving and investing public increased. The continued development of the stock market promises even greater economic returns in the future.

6.2.2 RGSM

The Regional Government Securities Market (RGSM), which came into existence in 2002, was designed to do for the public sector what the ECSM was to do for the private sector. Essentially, it was to diversify sources of funding (for governments) and investing (for depositors) as well as facilitate efficiency gains in both the allocation of resources and government financing activities in furtherance of developmental objectives. It was to strengthen and expand existing primary markets, increasing the domain from the domestic to the regional and international, as well as create a secondary market for liquidity and portfolio management. The ECSM and RGSM together were significant steps towards the realization of the single financial space in the ECCU.

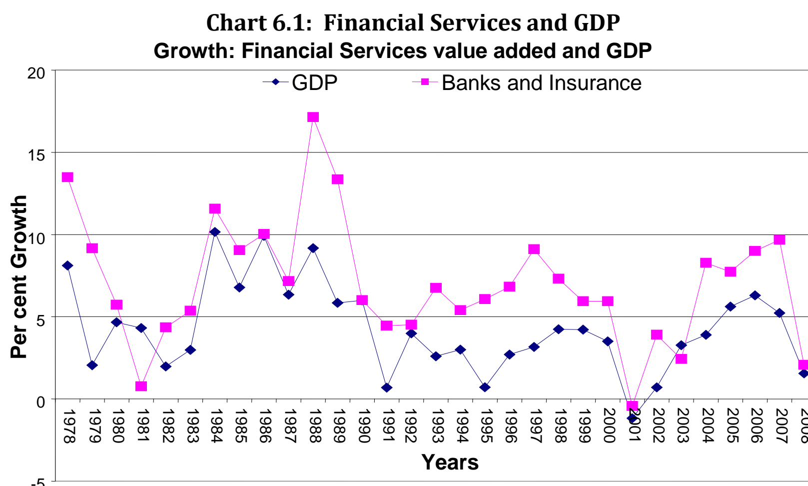
At the end of 2002, only the Government of St. Kitts and Nevis had issued securities on the RGSM, with a $75.0m, 10-year bond issued in November. Market participation increased steadily thereafter and by the end of 2008, only three members, Anguilla, Dominica and Montserrat, had not issued securities on the market. The RGSM contributed to a reduction in debt servicing costs as average interest rates were lower than the weighted average cost of capital of member governments. Additionally, cross-border participation improved dramatically, suggesting a deeper level of financial integration. The improved allocation of resources can also be discerned from the fact that there was no noticeable decline in the level of savings or the rate of accumulation in the commercial banking sector.

6.3 Relative Importance of the Financial Sector

In 1996, the financial (services) sector was the fourth largest sector in the ECCU, contributing 9.6 per cent to real GDP. Activity in the sector expanded at an average annual rate of 6.5 per cent over the period 1996 to 2008. As a result, the contribution of financial services to GDP rose by 5.4 percentage points and by the end of 2008, financial services was the second largest contributor to GDP, behind government services. Growth in the general economy is also highly positively correlated with growth in the financial sector. So for example, when there is overall expansion in financial services, GDP is normally expected to grow, and when there is a

deceleration in GDP growth, financial services is also expected to decelerate (Chart 6.1).

Chart 6.1: Financial Services and GDP



Source: ECCB

6.3.1 Monetary Policy

Within the context of the ECCU, the fixed exchange rate provides a nominal anchor for monetary policy. As a result, the primary objective of monetary policy is the maintenance of the exchange rate and the preservation of the exchange arrangement. At a minimum, this requires adherence to the 60.0 per cent statutory ratio of foreign reserves to demand liabilities of the Central Bank. The rule effectively constrains the monetary expansion, thus contributing to stability in prices and expectations, particularly in view of the fact that the parity has been maintained at EC$2.7:US$1.0 from inception. As a secondary objective, monetary policy also seeks to engender monetary and credit conditions conducive to the balanced growth and development of member states. Broadly speaking, this can be interpreted as ensuring that the financial system is adequately liquid, that financial intermediation is efficient and effective, and that the financial system is fulfilling its economic functions. Generally, the conduct of monetary policy reflects developments in these spheres of activity.

From its inception, the ECCB has primarily relied on three main tools of monetary policy: the reserve requirement, the discount rate and the minimum savings rate. The required reserve ratio, at 6.0 per cent of deposits averaged, has not been altered since its introduction in 1984.

However, administrative arrangements in respect of the reserve requirement were altered in 1994 when the reserve period was increased to four weeks as opposed to the previous one week. This regime remains in effect today. Similarly, the discount rate, which was lowered from 10.0 per cent to 9.0 per cent in 1993, was not altered during the review period.

Economic contraction in 2001, along with reduced future prospects, led to a search for policy tools to stimulate economic activity. The Monetary Council of the ECCB decided that effective 01 September 2002, the minimum savings rate which had been set at 4.0 per cent from 1985, would be lowered to 3.0 per cent. The anticipation was that the reduced cost of funding to commercial banks would have resulted in a concomitant reduction in lending rates, thus increasing the flow of credit and stimulating economic activity. However, impact was limited as only a handful of banks actually reduced their lending rates in response to the decline in the minimum savings rate.

6.4 Perspectives on the future financial structure of the ECCU

The future structure of the ECCU's financial system is likely to be influenced greatly by two developments: OECS economic union and the region's responses to the global financial crisis.

6.4.1 The OECS Economic Union

The OECS Treaty (1981) and the ECCB Agreement (1983) provide the basis for the financial and economic development of the region as an integration arrangement. An economic union comprises four components: a single currency; a single financial space, the free movement of the factors of production and a common external trade policy. In the current formulation, the gaps towards an economic union relate to the creation of a single financial space and the freedom of movement of the factors of production. The ECCB is charged with the responsibility of building a single financial space. Some progress has been made in this regard through the creation of regional institutions such as the ECHMB and the ECSE and also through market integration as delivered by the RGSM and the inter-bank money market.

The process of building a single financial space is to be accelerated to deliver the OECS economic union by December 2009. The important prospective directions would be the further development of the regional economies in ways that increases the scale and scope of institutions

through the integration of the disparate financial sectors and economies of the ECCU. This would be achieved both through the creation of regional institutions and regional regulatory frameworks for the financial institutions.

In this conceptualisation, upon completion, the single financial space would fundamentally change the operational framework of the financial sector. For example, it is envisaged that once the single financial space is created commercial banks, for example, would require only one banking license to operate throughout the ECCU and not eight as currently obtains. Therefore, once it is registered say in Antigua and Barbuda, it is registered to operate anywhere in the ECCU. It is also envisaged that the non-bank financial institutions would also have uniform regulatory frameworks coordinated from the centre.

The creation of a single financial space is also likely to result in the rationalization of many financial institutions, either through mergers or acquisitions. So for example, it is likely that the indigenous commercial banks would amalgamate into a union wide commercial bank, with headquarters and branches throughout the OECS. A similar path is expected for most of the other financial institutions.

6.4.2 The Global Financial Crisis

The global financial crisis provides the opportunity for the regional policy authorities to speedily advance the implementation of the single financial space programme and through this, the creation of the OECS economic union.

Two important and early spillovers from the global financial crisis were the collapse of the CLICO/BAICO insurance companies and the deposit run on the Bank of Antigua. These events laid bare the inadequacies of the regulatory, supervisory and coordinatory frameworks within the ECCU. Responses to these two events hold the potential to rapidly advance the creation of the OECS economic union, or to delay its achievement indefinitely.

The regional policy authorities have chosen a path that would use these two events to fast track the creation of the OECS economic union. In the first case, this would involve the creation of a public-private partnership flagship insurance company for the OECS economy. This company would

involve the regional governments along with the private sector – domestic and foreign. It is envisaged that this new entity would take over the assets and business - on a going concern basis - of the existing insurance companies which were under distress.

In respect of the indigenous banks, the focus is on their amalgamation. The Bank of Antigua was purchased by a consortium of indigenous banks and the Government of Antigua and Barbuda and renamed the Eastern Caribbean Amalgamated Bank Ltd (ECAB). This development created a vehicle through which consolidation of indigenous commercial banks within the ECCU can be achieved.

As a consequence of these two events the regional policy authorities have focused on the gaps that currently exist in the regulatory and supervisory framework and, more broadly, the institutional gaps in the ECCU. These responses build on the existing regional governance framework of the ECCB's Monetary Council and the OECS Authority. In particular much energy is now placed on the implementation of long-discussed regulations for sub-sectors of the non-banks and supervisory frameworks such as the single regulatory units within the individual countries of the ECCU.

6.5 Unresolved Issues

One of the significant unresolved issues is the insufficiency of existing regulatory resources and proposals for the management of externalities in the financial sector of the ECCU. In particular the global crisis has laid bare the previous notions of insufficient regulation and supervision. Going forward, the matter of whether the interest of the public, in the context of the single financial space/economic union, is best served by disparate regulatory units with the attendant transactions and coordination costs constraints, or by a single regulatory agency for the entire union, will have to be addressed. What type of regulatory structures would be most effective in dealing with the information asymmetries and incentives problems in the financial system?[25] Regulators must resist the temptation for forbearance and always act in the best interest of the public. Regulators must act resolutely and without delay once problems have been identified at financial institutions. This is one of the key lessons of the

[25] Both types of regulatory models now in existence – the single regulatory agency – FSA in England for example – and those which combine monetary policy and regulatory functions – the FED for example - did not fare well in the current crisis.

current global financial and economic crisis. In this sense, there is a strong case for a uniform regulatory regime for the financial sector across the ECCU.

A second unresolved issue is the optimal balance of entry and exit, in the context of a small open economy, to be permitted in the financial system. In other words, what level of competition will lead to the emergence of flagship financial institutions with the requisite governance capacity and capital to contribute to the future sustainable development of the OECS economy?

The third unresolved issue is the mechanism for the efficient resolution of financial sector instability. Financial institution failure or system instability within an economic union requires a prearranged coordinated fiscal plan. Failure to agree to such a burden-sharing mechanism before an adverse event risks major confusion and large output losses.

The fourth unresolved issue is the management of the 'too big to fail' perception that large institutions within small economies facilitate.

The fifth issue is the need for the regulators in the region to keep the financial system focused on risk management and efficient allocation of capital. To do this effectively they must prevent the same type of information and incentive problems as obtained in the US financial system from surfacing in the financial system in the region. Institutions must be discouraged from adopting financial products without fully understanding them and how they transform risk.

The final issue is the funding for the proposed restructuring of the ECCU's financial system.

6.6 Conclusion

This chapter provided several insights. First it identified the structure of the ECCU's financial structure since it was last documented in 1996. Second, it identified the relative importance of the financial sector in respect of its contribution to GDP. Third, the forces that are likely to determine the future structure of the financial system were identified. Finally, a number of unresolved issues consequent on the futuristic structure of the ECCU's financial structure were identified.

There are three direct policy implications of the research. First, the need for the regional policy authorities to re-examine the regulatory structures, incentives and effectiveness, in the context of an economic union; second, the need for the fiscal authorities to design burden-sharing arrangements to manage adverse financial shocks and improve policy responses; and third, the optimal balance between the desire to build an indigenous financial system capable of contributing to the economic transformation of the region's economy and the need to maintain financial sector stability.

The research can be extended in at least two directions:

- First to an investigation of the optimal financial structure for the economic development of the ECCU - universal banks or market-based system;
- Second, the optimal transition path to the ideal financial structure for the ECCU, and the cost thereof.

Appendix 6.1 a: Financial Institutions in the Eastern Caribbean Currency Union

INSTITUTION	REGULATOR	INSTRUMENTS	Anguilla	Antigua and Barbuda	Commonwealth of Dominica	Grenada	Montserrat	St Kitts and Nevis	Saint Lucia	St Vincent and the Grenadines	Total
Domestic											
Commercial Banks	ECCB	Deposits/Loans/Credit Cards/Debt Cards/Cheques	4	8	4	5	2	7	6	4	40
Finance/Mortgage/Leasing Companies (Licensed)	ECCB	Deposit Loans		3					1		4
Finance/Mortgage/Leasing Companies (Unlicensed)	MOF/FSU	Deposit Loans							7		
Development Finance Institutions	Unregulated	Loans	1	1	1	1		1	1	1	6
Credit Unions	Registrar of Co-ops	Deposits Loans/Share Cheques	1	5	16	15	1	3	11	7	59
Insurance Companies/ Agencies (Domestic)	MOF/FSU	Life Policies/General Annuities/Invest Products	31	25	20	23	7	12	31	31	180
Building Societies	MOF/FSU	Deposit Loans Shares			1	1	1			1	4
Money Transfer Services	Unregulated		3	5	3	2	2	4	3	4	26
ECHMB		Liquidity Bonds									
ECSE		Shares									
RGSM		T-Bills Bonds									

Appendix 6.1 b: Financial Institutions in the Eastern Caribbean Currency Union

INSTITUTION	REGULATOR	INSTRUMENTS	Anguilla	Antigua and Barbuda	Commonwealth of Dominica	Grenada	Montserrat	St Kitts and Nevis	Saint Lucia	St Vincent and the Grenadines	Total
International											
Offshore Banks	MOF/FSU		3	14	1		11	1	4	7	41
IBCs	MOF/FSU		7,078	7,500	10,000	867	14	13,334	1,279	14,000	54,072
Trust Companies	MOF/FSU		53	2				1,106		26	1,187
Insurance Companies	MOF/FSU		97	2				5		15	119

The Evolution of Guyana's Financial System (1996-2008)

Gobind Ganga

Guyana's financial system consists of a modest number of financial institutions (as shown in Table 7.1) and markets. Financial institutions comprise the banking system and the non-bank financial intermediaries. Financial markets include the money and foreign exchange markets as well as the stock market. Table 7.2 shows that during the period 1996-2008, the financial system assets doubled from G$248 billion to G$506 billion. The banking system is the largest component of the financial system, accounting for about 78 per cent of its total assets.

For over two decades prior to 1989, Guyana's financial system evolved within the framework of a "corporate state". The financial system was characterized as highly regulated and financially repressed. There were interest rate controls, allocation of financial resources to priority sectors, quantitative loan targets, intensive financing of fiscal deficits, entry regulations and strict branching licensing policies. State-owned banks were highly inefficient and unprofitable. However, the implementation of the IMF- supported Economic Recovery Programme (ERP) in 1989, which shifted public policy toward a market-oriented economy, resulted in the adoption of financial reform/liberalization measures.

The reforms were undertaken as a component of the overall scheme of macroeconomic stabilization and structural reform. The process was aimed

Table 7.1: Guyana: Number of Financial Institutions in Existence (1996-2008)

INSTITUTIONS	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Central Bank	1	1	1	1	1	1	1	1	1	1	1	1	1
Commercial Banks	7	7	7	7	7	7	7	6	6	6	6	6	6
(No. of Branches)	23	22	22	27	29	29	29	24	24	23	25	25	26
Trust Companies	3	3	3	3	3	3	3	3	3	3	3	3	3
Licensed Foreign Exchange Dealers	29	29	29	28	25	24	23	21	21	21	21	21	21
Micro Finance Companies			1	1	1	1	2	2	2	2	3	3	3
Building Society	1	1	1	1	1	1	1	1	1	1	1	1	1
Merchant Bank	1	1	1	1	1	1	1	1	1	1	1	1	1
Insurance Companies	9	9	9	9	9	9	11	11	11	11	11	11	11
Pension Schemes	22	22	22	22	22	22	26	28	28	28	28	28	28
Stock Exchange	n/a	n/a	n/a	1	1	1	1	1	1	1	1	1	1
National Insurance Scheme	1	1	1	1	1	1	1	1	1	1	1	1	1
Credit Unions	n/a	n/a	n/a	n/a	48	48	48	48	48	48	48	48	45
Finance Companies	3	3	3	3	3	3	3	3	3	3	3	3	3
Other Financial Institutions	0	0	2	2	2	2	2	2	2	2	2	2	2
TOTAL	77	77	80	80	125	124	130	129	129	129	130	130	127

n/a Not Available

Source: Bank of Guyana, Annual Reports, Ministry of Labour

Table 7.2: Guyana: Institution Composition of Financial Assets (1996-2008)

INSTITUTION	1986	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Commercial Banks	77,768.50	89,290.70	100,494.73	104,127.72	117,745.98	124,325.84	135,041.64	134,996.50	146,765.81	162,730.90	180,216.13	203,965.10	232,629.34
% of Total	*31.33*	*35.52*	*39.28*	*38.10*	*39.63*	*42.42*	*43.06*	*41.05*	*42.61*	*44.53*	*45.71*	*46.52*	*45.98*
Central Bank	146,157.7	122,797.7	*118,159.0*	126,515.8	130,940.3	113,735.4	112,695.2	115,630.9	106,935.9	114,800.0	121,408.4	130,792.1	157,013.9
% of Total	*58.9*	*48.8*	*46.2*	*46.3*	*41.1*	*38.8*	*35.9*	*35.2*	*31.0*	*31.4*	*30.8*	*29.8*	*31.0*
New Building Society	7,739.2	9,418.9	10,922.5	11,968.6	14,548.6	18,273.7	21,382.5	23,591.5	25,745.6	28,825.0	31,471.0	33,522.2	35,777.1
% of Total	*3.1*	*3.7*	*4.3*	*4.4*	*4.9*	*6.2*	*6.8*	*7.2*	*7.5*	*7.9*	*8.0*	*7.6*	*7.1*
Trust Companies	5,221.4	6,772.3	4,495.1	5,360.0	5,920.4	6,348.1	6,679.5	7,825.7	8,339.4	8,465.9	8,684.3	9,706.4	9,938.8
% of Total	*2.1*	*2.7*	*1.8*	*2.0*	*2.0*	*2.2*	*2.1*	*2.4*	*2.4*	*2.3*	*2.2*	*2.2*	*2.0*
Life Insurance Companies	5641.0	9611.2	10,685.0	11,890.1	12,762.2	13,636.3	18,210.1	25,855.4	33,949.4	28,841.0	27,922.3	34,172.7	39,254.2
% of Total	*2.3*	*3.8*	*4.2*	*4.3*	*4.3*	*4.7*	*5.8*	*7.9*	*9.9*	*7.9*	*7.1*	*7.8*	*7.8*
Pension Schemes	5,728.1	6,729.9	7,820.4	9,153.4	10,264.9	11,026.3	13,974.8	15,022.0	16,255.8	15,121.3	16,992.1	18,168.3	19,631.8
% of Total	*2.3*	*2.7*	*3.1*	*3.3*	*3.5*	*3.8*	*4.5*	*4.6*	*4.7*	*4.1*	*4.3*	*4.1*	*3.9*
Finance Companies	0.00	6,772.4	3,245.6	4,320.2	4,937.3	5,713.3	5,663.9	5,974.1	6,467.2	6,638.8	7,589.8	8,103.1	11,695.8
% of Total	*0.0*	*2.7*	*1.3*	*1.6*	*1.7*	*1.9*	*1.8*	*1.8*	*1.9*	*1.8*	*1.9*	*1.8*	*2.3*
TOTAL	248.155.9	251,393.1	255,822.3	273,335.8	297,119.7	293,058.9	313,647.7	328,896.0	344,459.1	365,423.8	394,284.1	438,439.9	505,940.0

Source: Bank of Guyana, Annual Reports

at stabilizing and enhancing the efficiency and competitiveness of the economy. The reforms were comprehensive in scope covering, in addition to the financial sector, areas including domestic investment, infrastructure development through private sector initiatives, promoting foreign competition by reducing protective barriers such as import controls and high tariffs, encouraging direct foreign investment as a source of technology upgradation, public sector reform including an aggressive privatization programme and reforming the tax system. All of these reforms are closely inter-related, and progress in one area is intended to help achieve objectives in others.

The main elements of financial reform in Guyana can be analysed under three broad categories: adjustments in the policy framework; improving the stability and soundness of the financial institutions; and strengthening the institutional capacity in the financial sector. The central features of reform with respect to adjustments in the policy framework consisted of the removal of restrictions on interest rates, credit and foreign exchange transactions, and the use of indirect instruments of monetary policy and financial control by the Bank of Guyana. The primary objective was to bring about an improvement in the system relating to allocation of funds and eliminating market fragmentation. The reforms to promote financial institution soundness included measures to strengthen the regulatory and supervisory framework such as the introduction of prudential norms. Institutional capacity strengthening was done through appropriate institution-building measures of (i) instilling a greater element of competition, (ii) improving the quality of loan assets, and (iii) strengthening the supervisory process.

The introduction of far-reaching adjustment measures and structured reforms under the ERP resulted in an improvement in the economy as shown in Table 7.3. During the period 1991-1997, growth increased at an average rate of 7.1 per cent. Inflation declined from 82 per cent in 1991 to 4.2 per cent in 1997, while public finances improved significantly with the overall fiscal deficit as a percentage of GDP declining from 33 per cent in 1991 to 1.6 per cent in 1996. However, beginning in 1998, economic activities slowed appreciably with an average growth rate of 0.3 per cent between 1998 and 2005, reflecting adverse domestic and external developments. Inflation remained at relatively low single digit levels, averaging 5.7 per cent. There was fiscal deterioration with overall fiscal deficit as a percentage of GDP averaging 8.4 per cent. Real growth

recovered during the period 2006 – 2008, averaging 4.5 percent. Inflation remained relatively low, except for 2007 when the Value Added Tax (VAT) was introduced. The fiscal position improved with the overall fiscal deficit as a percentage of GDP declining from 11.9 per cent in 2006 to 5.5 per cent in 2008.

Table 7.3: Guyana: Selected Real Sector Indicators

	Growth Rates of Real GDP (%)	Inflation Rates end of period (%)	Overall Fiscal Balances (% of GDP)	External Current Account (% of GDP)
1996	7.96	4.51	-1.6	-7.6
1997	6.18	4.16	-6.94	-14
1998	-1.67	4.73	-4.63	-13.7
1999	2.96	8.68	-2.46	-9.3
2000	-1.36	5.84	-6.5	-15.2
2001	2.28	1.5	-5.61	-18.3
2002	1.15	6.1	-3.13	-14.6
2003	-0.66	5	-7.11	-11.2
2004	1.58	5.5	-4.83	-8.9
2005	-1.95	8.2	-12.58	-19.2
2006	5.13	4.2	-11.94	-27.5
2007	5.37	14	-6.59	-21.5
2008	3.1	6.4	-5.52	-25.5

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

Against this background, an analysis of the development of the financial system for the period 1996–2008 is undertaken. Section 7.1 analyses developments in the banking system that include the major roles of the central bank and intermediation of commercial banks; Section 7.2 analyses the major non-bank financial institutions. Section 7.3 discusses the financial markets; and section 7.4 provides some concluding remarks.

7.1 The Banking System

The banking system consists of the Bank of Guyana and commercial banks. Bank of Guyana, as the central bank, is at the apex of the banking system and is responsible for the development of an efficient and stable banking system to effectively mobilize and allocate resources to promote economic growth. Six commercial banks dominate the financial system with about 45 per cent of the system's total assets at the end of 2008. Three of the banks are foreign owned and account for 60 per cent of total assets of the commercial banks.

7.1.1 Bank of Guyana

Bank of Guyana was established by virtue of the Bank of Guyana Ordinance No. 23 of 1965 and came into operation on October 16, 1965 as an autonomous institution with its headquarters in Georgetown. This Act was repealed and replaced by the Bank of Guyana Act of 1995 to enhance stability, soundness and efficiency of the banking system. This Act was then repealed and the Bank of Guyana Act of 1998 took its place. The latter provided for the compilation and monitoring of the country's balance of payments and overseeing of the country's payment system.

Bank of Guyana, being the premier monetary and financial institution, is entrusted with a number of responsibilities. In order to achieve the primary objective of price stability for sustainable growth, the Bank plays the critical role in the conduct of monetary and exchange rate policy, supervision and regulation of licensed financial institutions and developing the payment system. In addition, it undertakes a number of other inter-related and complimentary objectives. It advises the government on any issue affecting its main objective of price stability and acts as the fiscal agent, trustee and banker to government. It also advises the Minister of Finance on administering the exchange rate system. Additionally, it issues the country's notes, coins and determines the legal tender as well as managing its foreign exchange reserves. The Bank acts as the banker to commercial banks and other licensed financial institutions.

Monetary Policy

The Bank is guided in all its actions by the objective of fostering domestic price stability through the promotion of stable credit and exchange conditions, as well as sound financial intermediation conducive to the growth of the Guyanese economy. In pursuing these objectives, the Bank has been using a number of policy tools. Indirect instruments of monetary control through the auction of treasury bills in the primary market have been the predominant tool. Reserve requirement, rediscount rate and moral suasion have been used rarely over the review period[26]. The monetary policy strategy has been to target monetary aggregates within the framework of monetary programming.

[26] Reserve Requirement was changed once during the review period. Discount rate was never used because commercial banks did not borrow from the central bank.

In principle, monetary programming allowed the Bank to set a targeted path for the growth of broad money consistent with output growth and inflation. Its foundation rested on the observation that the Bank controls the supply of reserve or base money in the financial system. The 'reserve money programme' was supported by a liquidity framework which involved forecasting the changes in the main items that influenced the banking system's liquidity on a weekly basis. The underlying assumption for the effective operation of the reserve money programme was the long-run stable money multiplier defined as the relationship between reserve money and the total money supply. On the basis of the constancy of the money multiplier, the Bank determined the growth in reserve money required to attain the targeted expansion in the money stock through its open market operations.

The use of indirect instruments of monetary policy, largely through the regular auction of treasury bills, resulted in an improvement in the capabilities of the Bank of Guyana to regulate more effectively the growth in money and credit through market mechanisms. The absorption of excess liquidity through the issue of treasury bills, which has been the predominant preoccupation of the Bank in the 1990s and 2000s, has brought about better control and management of money supply and inflation during the period 1996–2008. This is evidenced by the relative stability of monetary aggregates and in particular the money multiplier which averaged 2.6 per cent and relatively low single digit rates of inflation as shown in Table 7.3. Also, the auction mechanism has helped to create competitive market conditions by compelling banks to critically examine their funds management practices and the manner of pricing their deposits and loans.

Financial Stability and Soundness

Reforms to improve the stability and soundness of financial institutions aimed at institutional strengthening and modernization of the system. This was brought about by effecting fundamental changes in the legal and regulatory framework through the enactment of the Financial Institutions Act (FIA) in May 1995. The introduction of the FIA is the most significant legislative change affecting the financial sector in recent decades. Its implementation has strengthened and modernized the regulatory and supervisory framework of the financial system, aligning it with regional and international standards. The legislation requires all institutions carrying on banking and financial business to be licensed by the Bank of Guyana

Table 7.4 a: Guyana: Selected Performance Indicators of the Commercial Banks

	1997	1998	1999	2000	2001	2002	2003[a]	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	0.81	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	9.46	9	6.1	6.3	6.23	6.68	6.90	7.03
Frequency distribution of banks capital ratios[1]	6	7	7	7	7	7	5	6	5	5	6	6
Lending to connected parties[2]												
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	61.6	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.	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 loans	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

Table 7.4 b: Guyana: Selected Performance Indicators of the Commercial Banks

	1997	1998	1999	2000	2001	2002	2003[a]	2004	2005	2006	2007	2008
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	1,185.88	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
Non performing loans (G$million)	10,946	15,636	17,635	20,612	21,504	20,058	10,561	8,135	6,907	6,779	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	6.65	5.98	1.40	1.82	1.76
Operating expense to total income	79.7	8.2	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 asset 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

a This comprises 6 commercial banks excluding GNCB which was privatized in March 2003

1 Number of commercial banks with ratios greater than the 8 percent minimum capital adequacy ratio

2 Related parties include directors, senior officers and shareholders with 20 percent or more shares

Source: Bank of Guyana

and centralizes the surveillance responsibility over all licensed financial institutions (LFIs) on the central bank.

The objectives of the FIA are: to empower the Bank of Guyana and the Minister of Finance to exercise greater supervision and regulation of banks and other financial institutions engaged in financial business; to strengthen the procedure for reviewing and evaluating applications for licenses to do financial business; to modernize capital requirements; to impose restrictions to minimize risk concentration; and to establish guidelines for acquisition of control or other changes in the ownership of financial institutions. In 2004, the FIA was amended to prohibit the granting of loans by a LFI for the purpose of purchasing shares in the said LFI or its related companies, to prevent insiders from colluding with others to obtain credit facilities by fraudulent means as well as to improve the Bank of Guyana's ability to deal speedily with problematic LFIs, particularly in relation to unsafe and unsound practices which may pose a threat of loss to depositors.

In order to implement the provisions of the FIA, the Bank issued several supervision guidelines during and after 1996. These guidelines included licensing requirements, particularly the "fit and proper" criteria; capital adequacy requirements which are aligned with recommended international best practices; loan classification and provisioning, including requirements for write-off of non-performing loans; and limits on large loans and on loans to related parties. In 2007, the Bank issued a Handbook for Directors and distributed it to all directors of LFIs as well as other stakeholders such as external auditors. Later, in January 2008, a supervision guideline on corporate governance was issued. Also in 2008, Bank of Guyana recognized that market discipline was an important form of regulation to ensure LFIs prudent behaviour. In this regard, all LFIs are required to publish data on key indicators of financial soundness.

Financial performance indicators of commercial banks show a positive picture since 1997 as illustrated in Table 7.4. During the period 1997-2008, non-performing loans to total loans and assets have declined from 24.3 per cent and 13.1 per cent respectively, to 5.3 per cent and 2 per cent, respectively. Provisions for loan loss to non-performing loans have increased from 51 per cent to 88.2 per cent. The capital adequacy ratio has been hovering at 14 per cent, well above the minimum required by law.

Profitability indicators such as the rate of return on equity and assets have been positive and relatively stable during most of the review period.

Exchange Rate Policy

Guyana continued its historical link by aligning its currency with the pound sterling at a fixed parity of GY$ 4.80 vis a vis the pound sterling after Independence in 1966. The collapse of the Bretton Woods system in 1971 led to an appreciation of the pound sterling that impacted negatively on Guyana's terms of trade. In an effort to sustain greater macro-economic stability, it was decided to change the alignment of the Guyana dollar from the pound sterling to the US dollar at GY$2.55 =US$1 effective October 1975. This parity level was maintained even though the country suffered from a serious foreign exchange crisis in the 70's.

In 1981, the rate was adjusted to GY$3.00 = US$1 after an agreement with the IMF. A new exchange rate regime was put in place with the local currency pegged to a basket of currencies comprising the pound sterling, Deutsche mark, the Dutch guilder, the French franc and the Japanese yen with the US dollar being the intervention currency. Small fluctuations in the rate were catered for as the official rate moved from GY$4.12 to GY$4.40 vis a vis the US dollar at the end of 1986.

As a consequence of a thriving parallel market for foreign currency, the exchange rate was further devalued to GY$10.00 vis a vis the US dollar in January 1987. After an IMF agreement in 1989 the rate was again adjusted to GY$33 = USD1 followed by another adjustment to GY$45 before the introduction of the cambio market in 1990. There was a dual exchange rate in this period with two transaction rates - an official and a cambio rate.

The dual exchange rate was unified in February 1991 at GY$101.75 per US dollar. The official rate was adjusted weekly by the average free market rate for the preceding week. From 1993, the exchange rate was determined daily by the average daily telegraphic transfer rates of the three largest cambio dealers. In 2007, this methodology was adjusted to the weighted average rate of the three largest cambios.

Payment System

Bank of Guyana's mission is to develop an efficient payment system. It is committed to monitor and undertake initiatives in the payment system to promote and support an efficient and stable financial system. Guyana is

essentially a cash oriented economy. Banknotes and coins are among the most widely used means of payment, predominantly for retail transactions. In recent times, there have been some notable changes to de-emphasize the use of cash while improving the efficiency of cash handling. Specifically, commercial banks have installed a number of Automated Teller Machines (ATMs) both for cash and bill payments. Tele-banking, points of sale, prepaid credit cards and on line banking have also been introduced.

Bank of Guyana has taken various measures with a view to enhance the efficiency and safety of cash payments. With effect from May 1996, the lowest denomination banknotes, namely the G$1, G$5 and G$10 were demonetized. These notes were replaced by coins of similar denominations. In addition, the 1 cent, 5 cents, 10 cents, 25 cents and 50 cents ceased to be legal tender from May 26, 1996. Prior to December 1996, the highest denomination note was the G$500. However, in December 1996 a G$1000 note was introduced. Furthermore, to deter counterfeit, Bank of Guyana over a period of time has upgraded its currency notes by incorporating enhanced security features.

In 1997, Bank of Guyana embarked on a Payment System Modernisation Programme to enhance the efficiency and effectiveness of the payment system. The programme was marked by: (a) the formal publication of the Operation Circular governing the National Clearing House; (b) establishment of Operations and Technical Committees; (c) the adoption of a cheque standardisation programme with the Magnetic Ink Character Recognition (MICR) technology platform; and (d) the rationalisation of the existing clearing house procedures and cut-off hours for same day clearing and settlement.

7.1.2 Commercial Banks

Commercial banking operations began in Guyana on February 16, 1837. By the end of 1966, there were four commercial banks, Royal Bank of Canada, Barclays Bank, Chase Manhattan Bank and Bank of Baroda. However, the system was dominated by the Royal Bank of Canada and Barclays Bank, operating more than 25 branches, sub-branches and agencies. These institutions, operating mainly in urban areas, provided short-term trade and working capital finance. It was felt that the commercial banking sector did not adequately provide the type of financing required to develop the Guyanese economy. In response to the need to improve the role of the financial sector, particularly in rural areas, the government established the

Guyana National Cooperative Bank (GNCB) in February 1970. Additionally, in 1984 the Government started a process of nationalizing foreign-owned commercial banks. Royal Bank of Canada, Chase Manhattan Bank and Barclays Bank were nationalized. By 1990, the government owned a substantial part of the commercial banking system.

The implementation of the Economic Reform Programme and the strong commitment of the government to market-oriented reform resulted in the divestment of its financial sector holdings. The re-emergence of a private banking sector began in 1994 and was completed in 2002 with the privatization of GNCB. At the end of 2008, there were six commercial banks with a network of 25 branches, accounting for 46 per cent of the financial system assets. Three of the banks are foreign owned and account for about two thirds of the total commercial banks' assets. The largest of the foreign banks is owned regionally.

Commercial Banks Assets

During the period 1996-2008, commercial banks' assets increased at an average annual rate of 9.7 per cent, or three-fold, from G$77.8 billion to G$232.6 billion as shown in Table 7.6. Assets are comprised mainly of loans to the private sector, foreign balances and public sector securities. During the review period, loans as a percentage of total assets declined from 49 per cent in 1996 to 27.6 per cent in 2008. This reflected lack of investment opportunities as evidenced by the decline in the share of loans to private businesses from 77 per cent in 1996 to 66 per cent in 2008. This decline is also attributed to prohibitive borrowing rates due to high intermediation cost that are reflected by wide spreads[27] (see Table 7.5). Holdings of public sector securities as a percentage of total assets declined from 22 per cent in 1996 to 12.8 per cent in 1999 and then increased again to 22 per cent in 2008, reflecting the decline in yields on treasury bills. Overseas holdings as a percentage of total assets, however, increased from 4 per cent in 1996 to 21.2 per cent in 2008. The shifts in portfolio reflected the diversification from loans and the quest to maximize returns on overseas investment.

[27] Since 2004, real estate loans have been growing rapidly as commercial banks offer competitive mortgage rates to consumers. Commercial banks are treated in a similar manner as the New Building Society with respect to reserve requirement and taxation in respect of low income housing loans.

Table 7.5 a: Guyana: Selected Interest Rates[1] (Percent as at Year End)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
BANK OF GUYANA													
Bank Rate	12.00	11.00	11.25	13.25	11.75	8.75	6.25	6.25	6.00	6.00	6.75	6.75	6.75
Treasury Bill Discount Rate													
91 Days	9.94	8.16	8.69	11.07	9.20	6.25	3.91	2.88	3.79	3.74	4.16	4.19	4.19
182 Days	11.00	8.98	8.69	12.66	10.66	7.31	4.12	3.70	3.96	3.84	4.18	4.48	4.48
364 Days	11.16	9.17	9.25	12.79	11.09	8.17	4.91	4.91	4.13	4.21	4.24	4.81	4.81
COMMERCIAL BANKS													
1 Small Savings Rate	7.73	7.39	7.06	7.97	7.28	6.70	4.29	4.29	3.42	3.38	3.19	3.04	3.04
2 Prime Lending Rate (weighted average[2])	17.00	17.00	17.00	17.13	17.16	17.26	17.27	17.02	15.65	15.24	14.47	13.84	13.91
3 Prime Lending Rate[3]	17.21	16.93	16.64	17.25	17.21	16.79	16.25	15.57	14.54	14.54	14.54	14.54	14.54
4 Commercial Banks' Lending Rate (weighted average)	18.46	18.32	18.29	17.87	17.68	17.60	16.83	16.79	14.31	13.50	13.12	12.29	12.35
SPREADS													
A = (2) - (1)	9.27	9.61	9.94	9.16	9.89	10.56	12.98	12.73	12.23	11.86	11.28	10.80	10.87
B = (3) - (1)	9.48	9.54	9.58	9.28	9.94	10.08	11.96	11.29	11.13	11.16	11.35	11.50	11.50
B = (4) - (1)	10.73	10.93	11.23	9.90	10.40	10.90	12.54	12.50	10.90	10.12	9.93	9.26	9.31
HAND-IN-HAND TRUST CORP. INC.[4]													
Domestic Mortgages	17.00	17.00	16.00	16.00	16.00	20.00	16.00	16.00	14.00	14.00	14.00	14.00	14.00
Commercial Mortgages	20.00	20.00	19.00	19.00	20.00	7.55	20.00	20.00	16.00	16.00	16.00	16.00	16.00
Average Deposit Rates	11.00	9.50	8.95	11.00	9.18	7.55	4.82	4.82	3.75	3.23	3.14	3.23	3.23

Table 7.5 b: Guyana: Selected Interest Rates[1] (Percent as at Year End)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
NEW BUILDING SOCIETY													
Deposits[5]	7.00	7.00	7.00	7.00	7.50	6.50	4.50	3.50	2.50	2.50	2.50	2.50	2.50
Mortgage Banks	14.00	12.00	11.00	11.00	11.00	8.00	9.95	9.95	8.95	8.95	7.50	7.50	7.50
Five dollar shares	9.00	8.00	8.00	8.50	9.00	8.00	5.75	4.75	4.00	4.00	3.80	3.80	3.80
	...	...	9.50	10.00	10.50	9.00	6.50	6.50	5.00	5.00	4.50	4.50	4.50

1 End of Period Rates
2 Special Deposit Accounts at the Bank of Guyana have been closed with effect from December 1994
3 The prime lending rate reported by the banks have been weighted by the amount of loans issued at the corresponding rate.
4 The average prime lending rate actually used by commercial banks applicable to loans and advances
5 Effective from March 2004, GNCB Trust Company has been renamed Hand-in-Hand Trust Corp. Inc.
6 Small Savings Rate
Source: Bank of Guyana, Commercial Banks and other Financial Institutions

Table 7.6: Commercial Bank Assets/Liabilities Selected (1996-2008) (G$Mn)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
No. of Banks	7	7	7	7	7	7	7	6	6	6	6	6	6
Total Assets	77,768.6	89,290.7	100,127.7	104,127.7	17,746.0	124,325.8	135,041.6	134,996.5	146,765.8	162,730.9	180,216.1	203,975.1	232,629.3
Public Sector Securities	17,221.8	18,024.9	15,850.2	13,345.5	20,264.1	20,766.1	23,958.2	32,246.9	38,166.7	40,427.2	46,020.8	43,035.6	50,909.2
% of Assets	22.1	20.2	15.8	12.8	17.2	16.7	17.7	23.9	26.0	24.8	25.5	21.1	21.9
Loans	37,161.8	44,540.1	50,048.2	53,885.0	54,660.3	52,432.9	50,473.6	41,738.4	38,136.7	40,337.1	45,968.8	52,021.3	64,117.2
% of Assets	47.8	49.9	49.8	51.7	46.4	42.2	37.4	30.9	26.0	24.8	25.5	25.5	27.6
Government %	0.1	0.0	0.0	0.1	0.1	0.0	0.0	0.2	0.1	0.2	0.2	0.2	0.1
Manufacturing %	22.4	28.4	27.5	29.5	29.5	29.1	27.4	24.2	22.5	20.2	22.1	20.4	18.1
Services %	33.6	29.9	30.3	31.7	33.0	33.3	33.0	36.1	38.0	35.6	34.7	35.6	36.7
Agriculture %	21.4	16.3	17.9	15.0	15.9	15.6	13.6	8.5	8.7	9.0	7.7	5.7	6.1
Consumers %	16.3	19.7	19.9	19.4	16.8	16.7	18.0	21.1	21.5	25.5	27.2	30.3	27.8
Mining & Quarrying %	2.7	2.1	2.1	1.9	1.5	1.4	1.4	1.7	1.1	0.9	2.1	1.6	2.6
Real Estate %	0.8	1.2	3.1	4.2	5.7	7.5	7.0	8.7	19.5	23.1	27.2	31.5	34.2
Deposits	60,077.3	69,706.7	76,554.2	79,114.0	90,965.9	95,256.5	105,347.7	112,726.4	124,095.3	140,168.6	154,632.9	175,653.2	196,010.9
% of Liabilities	77.3	78.1	76.2	76.0	77.3	76.6	78.0	83.5	84.6	86.1	85.8	86.1	84.3
Liabilities	77,768.6	89,290.7	100,494.7	104,127.7	117,746.0	124,325.8	135,041.6	134,996.5	146,765.8	162.730.9	180,216.1	203,975.1	232,629.3
Time %	32.4	33.1	33.8	32.3	36.6	34.8	32.1	29.6	24.6	24.2	21.9	21.2	21.2
Saving %	52.7	53.0	54.1	51.7	48.0	51.1	52.9	54.6	56.7	56.7	57.3	57.9	59.0
Demand %	14.8	13.8	12.2	15.9	15.4	14.2	15.1	15.8	18.7	19.2	20.8	21.0	19.8
Time	19,493.5	23,090.4	25,848.7	25,279.1	33,249.1	33,133.8	33,798.4	33,379.5	30,520.7	33,899.3	33,812.6	37,190.6	41,568.5
Saving	31,672.0	36,968.7	41,392.9	40,917.6	43,677.4	48,633.5	55,684.9	61,526.0	70,403.7	79,422.2	88,599.5	101,653.0	115,642.3
Demand	8,911.8	9,647.6	9,312.8	12,617.2	14,039.3	13,489.3	15,884.3	17,821.0	23,171.4	26,847.2	32,220.8	36,809.7	38,800.1

Source: Bank of Guyana, Annual Reports

Commercial Banks Liabilities

Deposits account for about 81 per cent of commercial banks liabilities during the period 1996-2008. Commercial banks' deposits grew at an average annual rate of 10.5 per cent or from G$60.1 billion in 1996 to G$196 billion in 2008. This growth reflected expansion of the domestic economy and the impact of financial reforms which led to improvement in banking outreach, better financial services and more diversified saving instruments. Private sector deposits, which account for 75.9 per cent of total resident deposits, grew at an average annual rate of 10.1 per cent. Individual customers' deposits, which account for 83.8 per cent of total private sector deposits, grew at an average annual rate of 9.2 per cent. Saving deposits, which account for 54 per cent of total deposits, grew at an average annual rate of 12.2 per cent, reflecting higher income and remittances. Time deposits account for 33.6 per cent of total deposits between 1996 and 2002 but declined to 23.8 per cent between 2003 and 2008, reflecting relatively lower interest rates on these deposits which resulted in a shift to saving and demand deposits. Demand deposits account for 14.4 per cent of total deposits between 1996 and 2002. However, this increased to 19.2 per cent between 2003 and 2008.

7.2 Non-Bank Financial Institutions

Non-Bank Financial Institutions (NBFIs) include depository and non-depository, licensed and unlicensed financial institutions. The group comprises the New Building Society, insurance companies, pension schemes, trust companies, credit unions and finance companies that include mainly a merchant bank and microfinance institutions[28]. During the review period, NBFIs have grown in importance with their financial resources increasing from G$24.2 billion in 1996 to G$116.3 billion at the end of 2008. Their share of the financial system resources increased from approximately 10 per cent in 1996 to 23 per cent in 2008. New Building Society and the insurance companies account for the bulk of NBFIs assets with 65 per cent of the total assets.

7.2.1 New Building Society

The New Building Society was established in Guyana under the New Building Society Act 1940, as amended. The Society is not licensed under

[28] There are also two asset management companies that are mainly responsible for debt collection.

Table 7.7: New Building Society (G$Mn)

	Claims on Local Banks	Public Sector Investments	Mortgages	**Total Assets**	Share Deposits	Other Deposits	Foreign Liabilities	Reserves & Other	**Total Liabilities**
1996	153.3	4,338.50	2,658.10	7,739.20	6,439.70	260.3	...	1,039.20	7,739.20
1997	114.7	5,054.70	3.604.3	9,418.90	7,871.20	285.5	...	1,262.30	9,418.90
1998	66.7	5,226.10	4,921..6	10,922.50	9,129.60	339.3	...	1,453.50	10,922.50
1999	123.9	4,705.20	6,090.50	11,968.60	9,918.40	317.6	...	1,732.50	11,968.60
2000	885.1	5,227.10	7,281.80	14,548.60	12,239.20	354	...	1,955.30	14,548.60
2001	1,660.70	7,019.90	8,305.70	18,273.70	15,670.80	402.9	...	2,200.10	18,273.70
2002	2,497.10	7,862.70	9,776.50	21,382.50	18,451.10	463.7	...	2,467.80	21,382.50
2003	1,686.30	9,557.90	10,868.80	23,591.50	20,257.80	521.7	...	2,812.00	23,591.50
2004	1,732.90	9,887.20	12,412.70	25,745.60	21,959.50	547.5	...	3,238.70	25,745.60
2005	1,494.10	11,436.40	13,896.60	28,825.00	23,450.20	609.5	945	3,820.00	28,825.00
2006	1,515.00	11,823.00	15,600.00	31,471.00	25,305.00	634	1,339.00	4,193.00	31,371.00
2007	2,017.00	12,008.90	16,991.50	33,522.20	26,655.20	713	1,568.20	4,383.40	33,522.20
2008	4,185.90	9,801.00	19,046.00	35,777.10	28,219.00	685.5	1,036.00	5,248.10	35,777.10

Source: Bank of Guyana, Annual Reports

the Financial Institution Act 1995 and not subject to taxation within the tax regime of Guyana. The principal activity is the provision of a range of residential mortgages and savings products. Since its establishment, the New Building Society has become increasingly important in Guyana's financial system, accounting for approximately 30 per cent of the NBFIs assets. Its assets grew from G$7.7 billion in 1996 to G$35.8 billion in 2008 as shown in Table 7.7, reflecting higher loan assets and investments.

During the period 1996-2008, mortgage loans increased seven-fold from G$2.7 billion in 1996 to G$9.8 billion in 2002 and to G$19.1 billion in 2008. This growth resulted from increased allocation of affordable house lots by the government to low and middle-income Guyanese residents as well as competitive mortgage rates offered by the Society. Investments increased two and a half fold from G$4.5 billion in 1996 to G$11.3 billion in 2008 and were largely in the form of government treasury bills.

The liabilities of the New Building Society have been essentially deposits which averaged 83 per cent of the total. During the period 1996–2008, deposits grew just over four-fold from G$6.7 billion to G$28.9 billion. This growth was due to an increase in the number of shareholders as well as to competitive interest rates offered by the Society on its savings accounts. Reserves and other liabilities, which account for 14.8 per cent of total liabilities, increased from G$1 billion in 1996 to G$5.3 billion in 2008.

7.2.2 Insurance Companies

Insurance companies were established over a century ago in Guyana. All the participants of this sector are regulated by the Insurance Act of 1998. The sector comprises the non- life and life components with shares of 22 per cent and 78 per cent, respectively. There are eleven insurance companies, six of which are non-life and five are life. These companies are both locally and foreign owned. Foreign owned companies control approximately 60 per cent of the sector assets.

The insurance sector holds the largest share of the non-bank financial institutions' total assets, averaging 33 per cent. During the period 1996–2008, total assets of the sector grew almost seven-fold, from G$5.6 billion to G$39 billion as shown in Table 7.8. The assets are held locally in the form of private sector investments and government securities, and overseas in the form of deposits and securities. During the review period, foreign assets as a percentage of total assets declined from 70 per cent to

Table 7.8: Insurance Companies (G$Mn)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Fixed Assets	3,938.1	4,714.1	4,870.1	5,183.5	5,954.6	6,605.4	7,695.4	10,405.7	16,342.6	15,273.5	12,288.8	15,744.4	16,467.4
Foreign Loans	1,075.3	1,218.8	663.1	843.9	1,274.3	1,414.0	1,245.9	1,464.3	1,564.2	1,430.4	781.2	1,525.7	1,047.6
Public Sector Investments	108.4	95.9	84.6	248.7	131.8	84.5	50.7	0.0	47.8	0.0	0.3	0.0	0.0
Private Sector Investments	113.2	1,030.3	1,609.4	1,650.0	1,908.4	2,381.9	3,793.4	7,261.1	8,498.6	4,968.5	6,960.0	5,715.2	7,154.5
Claims on Local Banks	162.5	788.1	927.0	589.0	707.2	892.8	1,695.9	1,152.6	1,568.2	2,177.4	1,716.6	2,312.5	2,616.9
Loans	95.5	284.9	807.1	869.8	698.3	687.6	1,388.6	4,760.8	5,566.0	1,253.2	3,229.5	3,880.5	3,422.7
Other Assets	148.0	1,479.1	1,723.7	2,505.2	2,087.6	1,560.1	2,340.0	810.9	362.0	3,783.4	2,945.9	4,994.4	8,545.1
Total Assets	**5,641.0**	**9,611.2**	**10,685.0**	**11,890.1**	**12,762.2**	**13,636.3**	**18,210.1**	**25,855.4**	**33,949.4**	**28,841.0**	**27,922.3**	**34,172.7**	**39,254.2**
Foreign Liabilities	2,642.1	3,379.5	3,501.3	4,146.7	4,321.7	4,991.8	4,976.9	5,855.8	5,986.0	6,638.1	6,775.4	5,231.3	5,722.4
Capital & Reserves	310	2,667.9	2,738.0	3,012.5	3,319.9	3,624.6	5,059.9	4,929.8	5,099.1	5,023.0	5,756.9	8,644.4	11,563.8
Life Insurance Fund	2,299.5	1,962	2,305.9	2,673	2,999.2	3,066.9	4,729.3	1,001.7	18,784.4	13,458.1	11,262.6	14,174.8	16,016.3
Other Liabilities	389.4	1,601.8	2,139.5	2,057.8	2,121.5	1,953.1	3,543.9	5,051.1	4,079.9	3,721.8	4,127.8	6,122.2	5,951.7
Total Liabilities	**5,641.0**	**9,611.2**	**10,685.0**	**11,890.1**	**12,762.2**	**13,636.3**	**18,210.1**	**25,855.4**	**33,949.4**	**28,841.0**	**27,922.3**	**34,172.7**	**39,254.2**

Source: Bank of Guyana, Annual Reports

42 per cent, although the amount increased from G$3.9 billion to G$16.5 billion in 2008. In contrast, investment in the private sector increased from 3.7 per cent to 40 per cent of total assets. Investment in the public sector has been phased out, beginning in 2001, because of relatively lower rates of return on treasury bills, as shown in Table 7.6.

During the period 1996-2008, the liabilities of the sector have been largely life insurance funds which grew seven-fold from G$2.3 billion to G$16 billion but as a percentage of total liabilities, they remained little changed at 41 per cent. During the review period, foreign liabilities in the form of non-resident premium increased from G$2.6 billion to G$5.7 billion, but as a share of total liabilities they declined from 47 per cent to 15 per cent. This outturn is explained by an increase in the number of resident life policies.

7.2.3 Pension Schemes

There were approximately 28 pension schemes at the end of 2008. The schemes account for about 17 per cent of total NBFIs resources. During the review period, the schemes' assets grew more than three-fold from G$5.7 billion to G$19.6 billion as shown in Table 7.9. Two of the largest pension schemes account for about 60 per cent of the schemes' total assets. The assets are distributed both locally and overseas to maximize returns. During the period 1996–2008, there was a redistribution of the schemes' assets. As a percentage of total assets, foreign assets increased from 1.6 per cent to 33 per cent while private sector investment increased from 5.4 per cent to 43 per cent. Holdings of government securities declined from 38.7 per cent to six per cent because of relatively lower yields on government treasury bills. Similarly, claims on local banks declined from 46.8 per cent to 9.8 per cent.

7.2.4 Trust Companies

There were two trust companies in Guyana at the end of 2008[29]. These companies are licensed by the Bank of Guyana and regulated under the Financial Institutions Act. They offer traditional trusteeship services, investment, brokerage, registrar and trustees of pension schemes. The

[29] In 2001, one trust company declared bankruptcy and suspended its operations. Bank of Guyana was mandated to have the company reorganized in 2002. However, there was no serious investor and therefore this did not materialize. In October 2008, Bank of Guyana was appointed liquidator of the entity.

Table 7.9: Pension Schemes (G$Mn)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Claims on Local Banks	2,681.7	4,372.6	3,995.0	3,438.4	4,253.3	3,727.0	3,757.5	4,205.6	5,834.3	3,805.8	2,928.4	2,166.3	2,034.3
Government Securities	2,218.6	985.0	680.0	1,710.9	947.5	1,500.9	1,771.6	1,617.9	930.2	1,131.3	1,124.7	1,221.8	1,173.0
Shares & Other Securities	306.5	755.9	1,065.1	1,509.1	3,173.7	3,495.3	4,720.8	5,785.7	4,945.8	5,067.2	6,583.8	4,247.0	4,549.7
Foreign Assets	91.2	80.8	139.0	157.5	666.9	1,345.9	2,017.4	2,296.8	3,199.6	3,821.5	4,895.6	5,994.3	6,479.7
Other Assets	430.1	535.5	1,941.2	2,337.3	1,223.2	956.9	1,707.5	1,116.0	1,345.9	1,295.5	1,459.6	4,538.9	5,395.2
Total Assets	5,728.1	6,729.9	7,820.4	9,153.4	10,264.9	11,026.3	13,974.8	15,022	16,992.1	15,121.3	16,992.1	18,168.3	19,631.9
Pension Funds	5,381.6	6,371.4	7,486.7	8,408.9	9,437.5	10,197.7	13,172.2	14,103.8	15,246.1	13,902.0	15,324.4	16,454.3	17,872.0
Reserves	277.5	317.1	142.0	697.8	708.4	712.9	633.1	826.5	790.0	1,038.8	1,462.0	1,570.8	1,591.1
Other Liabilities	69.0	41.4	191.7	46.8	119.1	115.6	169.9	91.7	217.8	180.4	205.7	143.1	168.6
Total Liabilities	5,728.1	6,729.9	7,820.4	9,153.4	10,264.9	11,026.3	13,974.8	15,022.0	16,255.8	15,121.3	16,992.1	18,168.3	19,631.8

Source: Bank of Guyana, Annual Reports

Table 7.10: Trust Companies (G$Mn)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Claims on Local Banks	356.6	173.4	170.4	149.7	462.6	455.7	586.0	1,457.9	1,615.4	1,938.8	1,146.7	1,113.0	1,172.0
Foreign Assets	0.0	0.0	124.8	152.1	151.6	137.4	90.8	165.6	682.8	1,018.0	3,170.7	4,363.7	5,469.0
Loans	2,558.5	3,146.4	3,630.5	4,261.9	4,563.8	4,615.3	4,484.7	4,363.3	3,562.7	2,868.7	2,445.3	2,306.5	1,548.8
Shares	2,203.9	2,723.8	164.5	366.9	273.3	690.8	1,057.8	1,306.6	199.7	222.0	970.9	778.5	755.2
Total Assets	5,221.4	6,772.3	4,495.1	5,360.0	5,920.4	6,348.1	6,679.5	7,825.7	8,339.4	8,465.9	8,684.3	9,706.4	9,938.8
Private Deposits	1,963.1	2,391.9	2,692.5	3,186.5	3,120.3	3,635.7	4,203.5	4,428.2	3,920.7	3,583.9	4,100.1	5,034.0	5,243.4
Public Deposits	0.0	0.0	0.0	0.0	200.0	0.0	0.0	805.3	1,600.0	2,372.5	2,352.1	2,465.0	2,544.6
Capital & Reserves	795.7	1,177.2	1,131.3	1,316.7	1,430.4	1,473.9	1,740.4	1,900.0	1,715.3	1,400.2	1,415.9	1,574.6	1,619.3
Total Liabilities	5,221.4	6,772.3	4,495.1	5,360.0	5,920.4	6,348.1	6,679.5	7,825.7	8,339.4	8,465.9	8,684.3	9,706.4	9,938.8

Source: Bank of Guyana, Annual Reports

trust companies' assets represent 8.5 per cent of total assets of the non-bank financial institutions.

During the period 1996-2008, assets increased 90 per cent, from G$5.2 billion to G$9.9 billion as shown in Table 7.10. Assets are comprised of foreign investments, mortgage loans and shares. During the review period, there has been a redistribution of assets, with increased overseas holdings where returns were relatively

higher than those held domestically. As a percentage of total assets, foreign assets increased from nil to 55 per cent while mortgage loans and shares declined from 33 per cent and 42 per cent to 8.9 percent and 3.7 per cent, respectively.

Deposits represent 78 per cent of the liabilities of the companies. During the review period, private deposits as a percentage of total liabilities increase from 37.6 per cent to 53 per cent while public deposits increased from nil to 26 per cent. Other liabilities, in the form of capital and reserves, increased from 15 per cent to 17 per cent.

7.2.5 Credit Unions

Credit unions are established under the Cooperatives Society Act 88:01 and regulated by the Ministry of Labour. There are 45 registered credit unions. However, only 27 are functioning. Assets of the credit unions at the end of 2004 are estimated at approximately G$735 million. Two of the credit unions account for 83 per cent of the total assets. Although the credit unions' share in the financial system is relatively small, they have been playing an important role in the system. They accept deposits and provide loans to their many members. The operations of credit unions are not adequately supervised or regulated because of lack of resources. Hence, there are many governance issues that have been plaguing the sector and these are being attended to by the Ministry of Labour.

7.2.6 Finance Companies

Finance companies consist of one merchant bank, a small number of microfinance companies, one stockbroker and one finance company. Assets of finance companies account for about eight per cent of the NBFI's total assets and are in the form of private sector loans and investments, while the sources of funds are predominately from loans and retained

earnings. The major holders of assets of the finance companies are the merchant bank and microfinance companies.

7.2.7 Merchant Bank

At the end of 2008, there was only one merchant bank, Guyana Americas Merchant Bank Inc., known as Guyana Finance Corporation until 1998. It is licensed by the Bank of Guyana to conduct non-depository financial business with the exception of trust business. In August 2005, the Bank was registered under section 47 (2) of the Securities Industry Act of 1998 to conduct business as a broker and investment advisor. The bank currently offers services such as investment management, investment advisory, investment research, corporate advisory, stock brokering and securities underwriting as well as mergers and acquisitions. Total assets remained relatively stable between 2004 and 2008, ranging between G$425 million and G$480 million. Investments in foreign securities constitute approximately 65 per cent of the bank's assets. Liabilities are mainly capital and reserves.

7.2.8 Microfinance Companies

The microfinance sector in Guyana comprises both formal and informal institutions. (Ganga and Rizavi, 2006) The formal institutions, with the exception of one (MICROFIN DFLSA), are either registered or licensed as non-profit institutions or are reliant on donor-supported programmes and projects. As a result, they are all tax exempt, with no, or minimum, supervision or regulation.

The microfinance sector is fairly small but has been playing an important role in improving the living standards of those who have access to its services. Its activities have been reasonably profitable and therefore there is scope for existing microfinance institutions to expand in the rural areas and for new ones to be established (Ganga and Rizavi, 2006).

7.3 Financial Markets

The financial markets, which comprised the money, foreign exchange and stock markets, have been relatively thin and shallow. However, with the increase in economic activities during the last few years, the money and foreign exchange markets have taken on a more significant role. Both markets have provided financial institutions with a facility for funding and

adjusting portfolio in the short term, as well as serving as a channel for the transmission of monetary policy.

7.3.1 Money Market

The money market consists of dealing in treasury bills and wholesale interbank funds. The treasury bills market is dominated by commercial banks and the terms of the bills are 91, 182 and 364 days. They are issued in the primary market weekly, if the need arises. Secondary trading is almost non-existent since bills are normally kept until maturity. However holders of bills may elect to rediscount, under penalty, with the issuer.

The interbank market provides opportunity for lending and borrowing amongst commercial banks. It is an important segment in the money market as banks are able to trade their positions to manage their liquidity imbalances. During the period 2006-2008, there were 765 transactions in the interbank market totalling G$228 billion

7.3.2 Foreign Exchange Market

The foreign exchange market comprises the Bank of Guyana as well as banks and non-bank cambios. Both banks and non-bank cambios are licensed by the Bank of Guyana to conduct transactions in foreign currencies. However, non-bank cambios can only engage in the provision of money-changing facilities. The main players in the foreign exchange market are the central bank and commercial banks. Together, they account for about 90 per cent of the transactions in the foreign exchange market. Bank of Guyana participates as the intermediary for the government, making payments for fuel and, until 2007, for wheat, and its own transactions. Commercial banks act as intermediaries for their corporate customers, exporters, importers and for themselves. Dealings in foreign exchange can be undertaken either in the spot or forward markets.

Table 7.11 shows that during the period 1996-2002, the volume of foreign exchange transactions witnessed declined from US$1445.4 million to US$1257.5 million. However, between 2003 and 2008, the volume of transactions increased sharply to US$3130.5 million, or at an average annual rate of 16.7 per cent. The increase reflected enhanced foreign trade and capital inflows in the form of remittances and disbursements from international financial institutions. The volume of interbank foreign

Table 7.11: Volume of Foreign Exchange Transactions

		Total			Commercial Banks			Non-Bank Cambios			Interbank		Exchange Rate
Year	**Total Turnover**	**Purchases**	**Sales**	**Bank of Guyana**	**Purchases**	**Sales**	**Turnover**	**Purchases**	**Sales**	**Turnover**	**Market Volume**	**Spread**	**US$/G$**
1996	1,445,552,734	483,900,206	490,492,528	471,160,000	417,091,055	423,502,651	840,593,706	66,809,151	66,989,877	133,799,028	-	3.59	141.25
1997	1,426,029,348	471,277,191	475,248,157	479,504,000	403,419,896	407,571,907	810,991,803	67,857,296	67,676,250	135,533,546	-	2.69	144.00
1998	1,197,790,173	389,070,442	388,852,731	419,867,000	332,624,413	332,068,371	664,692,784	56,446,029	56,784,360	113,230,389	-	3.86	165.25
1999	1,192,711,830	423,630,249	414,570,581	354,511,000	375,784,607	366,651,465	742,436.072	47,845,642	47,919,115	95,764,757	-	2.50	180.50
2000	1,261,926,689	403,419,709	402,766,980	455,740,000	358,505,676	357,960,754	716,466,430	44,914,033	44,941,451	89,855,484	-	3.55	184.75
2001	1,190,932,417	424,962,107	424,101,310	341,869,000	377,893,564	377,343,936	755,237,500	47,068,545	46,757,374	93,825,919	-	3.75	189.50
2002	1,257,498,810	470,733,493	470,504,317	316,261,000	420,382,188	420,195,070	840,577,258	50,351.305	50,309.246	100,600,551	-	3.86	191.75
2003	1,459,375,954	531,676,770	527,887,184	399,812,000	479,047,722	475,169,285	954,217,007	52,629,049	52,717,899	105,346,948	-	4.41	194.25
2004	1,703,876,362	603,293,065	600,085,297	500,498,000	533,967,977	530,730,305	1,064,698,282	69,325,088	69,354,992	138,680,080	-	3.80	199.74
2005	1,898,566,495	674,016,590	651,924,905	572,625,000	603,746,996	581,629,550	1,185,376,546	70,269,594	70,295,356	140,564,950	-	3.00	200.25
2006	2,093,255,085	734,962,930	720,710,155	637,582,000	671,043,338	656,622,373	1,327,665,711	63,919,592	64,087,782	128,007,374	-	2.84	201.00
2007	2,485,565,966	942,861,998	911,030,968	631,673,000	859,954,778	828,280,469	1,688,235,247	82,907,220	82,750,499	165,657,719	32,070,000	3.34	203.50
2008	3,130,512,104	1,160,015,203	1,164,692,901	805,804,000	1,052,347,680	1,056,130,691	2,108,478,371	107,667,523	108,562,210	216,229,733	32,900,000	2.95	205.25
TOTAL	21,743,593,967			6,386,906,000			13,699.666,717			1,657,156,478			
	PERCENTAGE			29			63			8			

Source: Bank of Guyana

exchange transactions was extremely small prior to 2007. However, during the last few years the volume has averaged US$32 million.

The exchange rates have been relatively volatile during the period 1996-2000, depreciating at an average annual rate of 7.1 per cent. However, during the period 2001-2008, the exchange rates have been relatively stable with annual average depreciation of 1.2 per cent. The stability reflected net purchases in the market from higher inflows. The spreads on the quoted purchasing and selling prices ranged between 1.5 per cent and three per cent.

7.3.3 Stock Exchange

The stock exchange is regulated by the Securities Council under the Securities Industries Act, No.21, of 1998. It was incorporated on June 4, 2001 and trading commenced June 2003. Essentially, it was established to allow owners to trade existing stocks and to allow companies to raise funds from the issuance of new shares. The Guyana Association of Securities Companies Intermediaries Inc. (GASCI) was formed to facilitate companies to float their shares.

There are 11 companies trading on the stock exchange. Trading on the stock exchange has been thin. During the last few years, the annual average trading periods amounted to 534 with an annual average volume of G$248 million. Two companies account for about 52 per cent of the trading periods and 70 per cent of the volume. Only existing shares were traded since there was no new listing to raise capital for companies.

7.4 Concluding Remarks

The shift in public policy in the late 1980s and the adoption of financial reform/liberalization measures have resulted in improvement in the conduct of monetary and exchange rate policy, soundness and stability of financial institutions and operation of the payment system. In addition, the financial system witnessed an increase in intermediation, particularly in the banking system. The major sources of funds mobilized have been in the form of deposits. The funds were channelled to the economy mainly in the form of loans and investment in domestic government securities, while some were invested abroad. Although, the financial markets have been shallow and thin, the money and foreign exchange markets have been playing critical roles in the financial system for efficient allocation of

portfolio and liquidity as well as channels for the transmission of monetary policy.

Notwithstanding the favourable outturns in the financial system during the review period, it is imperative that measures be implemented to further improve the system to support economic development. In this regard, several of the recommendations of the IMF's Financial Sector Assessment Programme (FSAP) in 2005 are being implemented, while others are being supported by the Inter-American Development Bank (IDB). Specifically, the IDB has provided support via three loans to the government for the implementation of a Financial Sector Reform Programme, which includes recommendations of the FSAP aimed at further strengthening the financial sector. The Financial Sector Reform Programme consists of measures to strengthen regulatory and supervisory framework for the financial sector, improve access of financial services to firms and individuals, enhance monetary policy and systems of payments, and improve the anti-money laundering framework.

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8

Jamaica's Financial System: It's Historical Development

Gail Lue Lim

The development of the financial sector in Jamaica can be divided into four distinct periods. In the beginning, the establishment of financial institutions was influenced by colonisation and the need to provide banking services for merchants who sought to repatriate funds to their homeland, primarily Britain. Because Jamaica was essentially viewed as a source of wealth, as against a haven for savings, many banks which established branches in Jamaica repatriated profits to their head offices overseas. Domestic regulation of the many financial institutions operating in Jamaica was virtually non-existent, with the Currency Board's only responsibility being the exchange of currency. There was also no participation by Jamaicans in the ownership structure of these foreign banks up to 1967. The establishment of the Bank of Jamaica (central bank) by the Bank of Jamaica Law (1960) and the enactment of the Banking Law (1960) were the first real attempts at a general regulation of banking business in Jamaica. However, in the early period, monetary policy was essentially passive as the authorities sought to ensure a smooth transition that would engender confidence and discourage capital flight.

The second phase of development, 1970s-1980, was defined by instability in the international financial system and the ultimate collapse of the Bretton Wood's system of fixed exchange rate, rapid growth in the level of financial intermediation and number of institutions and the impact of the OPEC oil crisis on the economy. With increasing inflation and a widening current account deficit, the pressure on the country's foreign exchange

reserves was extreme. Consequently Jamaica embarked on a relationship with the International Monetary Fund (IMF) with the first stand-by arrangement in 1973. Jamaica's relationship with the IMF in the ensuing years defined the central bank's monetary policy direction and its relationship with the financial sector.

Phase three, the period of the 1990s, can be defined as a period of financial liberalisation, financial sector crisis and financial consolidation. Notably, the high inflation environment which prevailed created a 'bubble' in the stock and real estate market prices, providing expansionary opportunities for financial institutions. At the same time, weak internal management coupled with poor economies of scale led many financial institutions to take unnecessary risks in order to compete. With the sudden reduction in inflation brought about by demand management policies of the central bank, many financial institutions, faced with a mismatch of assets and liabilities, were either forced to wind up or to consolidate their operations. Legislation governing the operations of financial institutions was also strengthened and banking institutions were required to take out deposit insurance in order to restore confidence in the financial sector. Concurrently, the Government created the Financial Sector Adjustment Company (FINSAC) and acquired the bad debts of financially unsound financial institutions while selling the remaining good assets to other strong financial institutions.

The commencement of the first decade of the 2000s marked a new era for the financial sector. The early years were characterized by consolidation, mergers and closures while there was also a re-emergence of foreign bank dominance. Concurrently, many institutions sought to return to their core business while making significant efforts at improving corporate governance. The assets of the financial system also experienced real growth and financial institutions were subject to greater scrutiny. In 2005, institutions involved in securities trading were placed under the supervision of the Financial Services Commission (FSC) while deposit-taking financial institutions (DTIs) remained under the supervision of the central bank. In 2008, financial institutions, particularly those operating in the securities market, were adversely affected by the spill-over effects of the global financial crisis. Whereas the impact on securities' dealers was direct as many faced calls on their liabilities (margin and repo-arrangements) based on a sharp rise in the yields on Government of Jamaica sovereign bonds, the impact on the DTIs was less direct. In the case of the DTIs, which

operated under strict prudential requirements, there was a greater impact from the deterioration in macroeconomic conditions which spurred an increase in non-performing loans. In response to the tight credit conditions and the increased demand for foreign currency, the Bank of Jamaica (BOJ) established a credit window for securities dealers unable to source funds to pay out these liabilities. The central bank also provided intermediation for foreign and local currency "repo" arrangements with financial institutions as it sought to moderate demand pressures in the foreign exchange market.

8.1 The Earlier Financial System: Banking System up to 1969

8.1.1 The Currency Board

Between 1939 and 1961, the currency authority in Jamaica was the Board of Commissioners of Currency. Established under the Currency Notes Law of 1939, the Board had statutory authority for the issue of currency notes of the Government of Jamaica.

Prior to the establishment of the Currency Board, commercial banks issued their own notes under the Bank Notes Law (1904) which gave these notes legal tender status. Under Law 9 of 1954 the commercial banks were prohibited from issuing notes in their own name. The rights of Barclays Bank DCO were however preserved. The Law 10 of 1958 demonetised all commercial bank notes circulating in Jamaica.

8.1.2 The Central Bank

Bank of Jamaica, established by the Bank of Jamaica Law (1960) commenced operations in May 1961 at a time when the country was experiencing a credit boom - hence policies were directed at limiting credit expansion and increases in imports without discouraging inflows of investment capital. Commercial banks were influenced by Bank of Jamaica through regular meetings of the Bankers' committee.

With the establishment of the central bank in 1960, legislation was also enacted for regulation of banking in Jamaica. The Banking Law (1960) represented the first real attempt at a general regulation of banking business in Jamaica. This law made it obligatory for any company wishing to carry on banking business in Jamaica to obtain a licence from the Minister of Finance, to fulfil minimum capital requirements, to make certain information available to the public and to the Inspector of Banks, to

maintain reserves at the Bank of Jamaica, and to maintain a specific minimum ratio of liquid assets to deposit liabilities.

In the management of the financial system, the Bank of Jamaica was careful to avoid any radical break with the past. Thus, in the initial period, management of the currency issue was allowed to continue with the policy of automatic exchange with sterling being maintained until August 1966, when the Bank of Jamaica Law was amended accordingly.

In the earliest years of its development (1961-63), the central bank was much concerned with maintaining the external equilibrium of the currency as a result of fluctuations in the Bank Rate in the United Kingdom. In 1963, when the Jamaican rate was on par with the U.K. there was an outflow of funds from Jamaica resulting in a fall of over $18 million in the foreign exchange reserves. This situation worsened in 1964, when the U.K. adopted a restrictive monetary policy leading to an increase in their Bank Rate. As a consequence, the Bank Rate in Jamaica was increased to discourage capital outflows.

In 1965, the Jamaican Bank Rate was not reduced in keeping with the reduction in the U.K. Rate. Thereafter, the Bank of Jamaica had to adopt measures to protect the reserves, because of the general weakness of Sterling and the prevailing high rates of interest in the U.K. In 1966, the U.K. Bank Rate was increased to seven per cent. The Jamaican Rate went from 5 per cent to 5½ per cent and the outward Commission Rate went from 3/8 per cent to 1/2 per cent.

In 1967, Sterling was devalued and this was followed by devaluation of the Jamaican currency. In order to ensure that the beneficial effects of the exercise accrued to Jamaica and were not absorbed in price increases, the Jamaican Bank Rate was increased from 5½ per cent to 6 per cent; the inward Commission Rate was reduced to 1/16 per cent and the outward Rate increased to ¾ per cent.

The situation changed somewhat in 1968, in that the commercial banks had considerable excess liquidity due to substantial inflows of foreign funds resulting from the general instability of overseas money markets. The Bank of Jamaica then established the SPECIAL DEPOSITS FUND and the Bank Rate was lowered by one percent to stimulate borrowing for productive purposes.

By 1969, the international monetary situation had become stable and funds once more began flowing from Jamaica. However, increasing interest rates overseas caused foreign firms operating here to borrow locally and because they were able to offer better securities than most Jamaican firms, they were given preference; the result was a diversion of funds from domestic to foreign owned enterprises. Because the expansion in credit grew at an enormous rate, the central bank directed the commercial banks to restrict total credit to the level existing at the end of December 1969 and also to restrict credit to non-residents and foreign controlled firms. The commercial banks had to borrow from the central bank because higher rates prevailing overseas made it less profitable for the head offices to lend in Jamaica, and in most countries there were restrictions on capital export.

8.1.3 Commercial Banks

The Bank of Jamaica (no relation to the present central bank) was the first commercial bank to operate in Jamaica. The bank was established in May 1836 by merchants in England with business connections in Jamaica. Whereas the House of Assembly granted the bank a charter of incorporation authorising a nominal capital of £300,000 and with limited liability, the United Kingdom Government subsequently disallowed the charter. Notwithstanding this, the bank continued to operate and prosper and by 1846 had six agencies in the island. The Colonial Bank, incorporated in England in 1836, commenced operations in May 1837 and at its inception introduced bank notes into the monetary system alongside the then existing island cheques issued by the Receiver General. In 1839 the Planters Bank was established primarily to cater for the needs of the sugar planters and by 1846 had eight branches operating. However, with deteriorating economic conditions and the bank itself over-extended, the institution was forced to liquidate operations in 1848. By 1864, the Bank of Jamaica, closely affiliated to the sugar industry, also succumbed to the deteriorating economic conditions and terminated its operations. With improvements in the economic conditions of the island in the late 1880's and increasing trade with Canada, many Canadian banks established branches on the island, increasing the level of financial intermediation. The influx of new banks however did not seem to result in much competition for deposits. In fact many banks did not seek to mobilise saving and idle balances as they did to finance trade and imports, and for many years approximately 50 per cent of funds raised on current and deposit accounts were by gilt-edged investments. However, the situation was undesirable as occasionally substantial amounts were applied directly from profits to

write-down the value of investments. In 1926 Sterling's Bank commenced operations, but failed by 1927. With the failure of banks on the increase, and the lack of provisions to safeguard depositors, the Bank Laws were subsequently revised.

Up until 1959 there were no American banks operating in the country. In 1960, however, First National City Bank established a branch in Kingston. Subsequently, two (2) other banks with American connections commenced operating in Jamaica. By 1961 commercial banking was well-developed in Jamaica. The banks offered current accounts; time and savings deposit facilities, made advances for a wide variety of purposes and tendered a wide range of services. They were particularly active in financing of export agriculture, imports, hotel development and the provision of working capital for industry. They offered rediscounting facilities (mainly foreign bills).

In the early days, the financial system was characterised by the ease with which Jamaican currency could be converted into sterling. Commercial banks' policies, in the absence of a central bank, were determined primarily by their head offices overseas. At the end of 1961, net foreign indebtedness to overseas head offices amounted to US$12.8 million.

The participation of Jamaicans in the ownership of these foreign banks was however non-existent prior to 1967 when a system of "pure" branch banking operated in Jamaica. In December 1966 the Bank of Nova Scotia was incorporated in Jamaica with 25 per cent of shares sold to the Jamaican public, representing the first local participation in a foreign bank.

At the end of 1969, the list of commercial banks operating in Jamaica was as follows:

- Bank of Nova Scotia
- Barclays Bank DC
- Canadian Imperial Bank of Commerce
- Bank of London & Montreal Limited
- First National City Bank of New York
- Jamaica Citizens Bank

These banks were branches of international banks and together had 106 branches across the island with main offices in Kingston.

8.1.4 Other Financial Institutions

Trust Companies

The trust companies commenced their operations in Jamaica in the early 1960s as commercial bank affiliates. At the end of 1969, only one trust institution (West Indies Trust) operated independently of commercial banks. The development of these institutions in the 1960s coincided with the start of the building boom when there was a high demand for residential mortgages. The resources of these institutions consisted mainly of local deposits, bank borrowing and share capital subscribed by the parent commercial banks. Their lending activities were concentrated in long term mortgages although the lending activities of the non-affiliated company were more varied and included some consumer credit and other short-term credit normally provided by commercial banks.

Building Societies

The building society movement also expanded significantly during the credit boom period of the early 1960s as demand for mortgage financing grew considerably. Between 1961 and 1969 the number of such institutions grew significantly notwithstanding a number of mergers of the smaller companies to facilitate expansion in their operations.

Life Insurance Companies

A rapid expansion of the life insurance companies also coincided with the boom of the building and construction sector. For example, between 1960 and 1963 total premiums paid on life insurance policies grew at a faster rate than the levels of savings in commercial banks. The insurance companies in turn invested a significant proportion of these savings in government securities and in 1963 were responsible for 18.6 per cent of Local Registered Stocks (LRS) issued that year. The support of local stock issues by life insurance companies in particular provided considerable assistance to the development of the capital market as encouraged by Bank of Jamaica.

During FY1964/65, the Government introduced a number of measures affecting the insurance industry in continuation of its policy of strengthening and improving financial institutions. Included in these efforts was the Motor Vehicle Insurance (Third Party Risk) Amendment Act of 1964 which was enforced on July 16 and which required the registration of all motor vehicle insurers in Jamaica.

Credit Unions

The first credit union in Jamaica commenced operations in 1941 with 98 members. In 1942, the Jamaica Co-operative Credit Union League was established. By the end of 1969 the number of institutions had grown to 132. The credit union movement was seen as important to the provision of cheap funds to low income earners as well as to provide a source of financial advice for small upcoming business entrepreneurs. In addition, these institutions were exempt from income tax, a factor which also propelled the growth of these institutions.

Government Savings Bank

The Government Savings Bank (GSB) was established in 1870 to control and operate a number of private banks then in existence. The bank, with a great network of branches (later through the postal services) provided a place of safe-keeping for the funds of the many peasants in the early plantocracy.

In 1932, the GSB was organised as a separate government department with its own management and staff appropriate to the needs of a savings bank. By 1957, the investment policy of the bank was altered, enabling it to invest its deposits in Local Registered Stocks issued by the Government of Jamaica instead of other Commonwealth securities.

With the expansion of commercial banking in the 1960s however, the growth of these institutions slowed significantly as the foreign owned institutions brought with them more sophisticated financial services and improved returns on savings. At March 1960, the level of deposits of the GSB was J$9.5mn while loans and withdrawals were J$10.3mn and J$9.2mn, respectively. By 1968 the level of deposits had only grown to J$11.6rnn while loans and withdrawals were $17.5mn and $11.0mn, respectively.

People's Cooperative (PC) Banks

The first People's Cooperative bank was established in Christiana, Manchester (rural Jamaica) on 19 April 1905. The initial modus operandi of the PC bank was to act as a banker, bill discounter and dealer in stocks, shares, bonds mortgages, debentures and other securities as well as to provide advances for cooperative and agricultural programmes. In the early years, membership and savings grew rapidly, coinciding with the expansion of the agriculture sector (sugar cane).

By the end of the 1960s the financial system was comprised of:

- Commercial Banks
- Trust Companies
- Building Societies
- Life Insurance Companies
- Credit Unions
- Government Savings Bank
- People's Cooperative Banks

The medium-term market was virtually non-existent with commercial banks meeting such loan demands through short-term overdrafts.

8.2 Financial System in the 1970s and 1980s

Against a background of instability in the international financial system during the early 1970s, there was rapid growth in the level of financial intermediation through establishment of new institutions in Jamaica during this period. By the end of 1979 the financial system had expanded to include:

- Merchant Banks
- Jamaica Investment Fund (Unit Trust) (1970)
- Jamaica Mortgage Bank (JMB) (1972)
- Jamaica Development Bank (JDR) (1969)
- Jamaica Export Credit Insurance Corporation Limited (JECIC) (1971)

8.2.1 The Central Bank

The decade of the 70s was very challenging for the Central bank as significant changes in the international financial system had a direct influence on monetary policy in Jamaica. In 1971, the suspension of automatic US dollar convertibility signalled the impending collapse of the Bretton Woods system of fixed exchange rate. By March 1973, the system finally collapsed with the generalised floating exchange rates. The international financial system was further shaken by the OPEC oil crisis, which placed severe pressure on Jamaica's external reserves.

In June 1973, Jamaica entered into its first Stand-by Arrangement (1 year) with the IMF for SDR 26.5mn. Despite the pressures on the country's external reserves, use was made of only 50 per cent of the resources provided by the Fund. As a consequence of these developments, the monetary authorities had a number of policy changes. These included:

a) Devaluation of the Jamaican dollar and the alignment of the

currency to the US dollar instead of Pound Sterling.

b) The Banking Law amended to expand control over the non-banks (Protection of Deposit Act (PDA) institutions).
c) Increase in liquid assets.
d) Increases in the Bank Rate and savings rate.
e) Tightening of exchange control regulations (see Appendix on policy measures).

Between 1974 and 1976, the central bank utilised additional monetary policy instruments including rediscounting facilities to regulate credit and channel funds into priority areas. With significant increase in central government credit, however, there was a substantial expansion in aggregate demand and further deterioration of the external reserves.

A dual exchange rate system was introduced to stem the deteriorating position of the external accounts in 1977. However, in the absence of special monetary measures to support the new exchange rate policy, the system was terminated in 1978 with further devaluations of the dollar. The devaluations of the currency and the set of demand management measures implemented under the three-year Extended Fund Facility with the IMF which was completed in 1978 brought about improvement in the reserves between April and December 1978. During the first year of the 1978 EFF programme, Jamaica drew the full SDR 70mn entitlement. In addition, SDR16mn was purchased under the Compensatory Financing Facility to augment foreign exchange resources.

Between 1979 and 1980, with continued deterioration of the external accounts and increasing fiscal deficit, the monetary authorities continued to use demand management measures including a voluntary liquid assets ratio (for commercial banks) and interest rate increases, to deal with the situation. The central bank also introduced a new deposit scheme for external payment arrears in February 1980. However, against the background of a large fiscal deficit, monetary policy objectives were unrealised.

With stricter control of money supply growth and a new 3-year Extended Fund Facility in 1981 which provided SDR 536.5mn, the monetary authorities continued to grapple with the economic problems of the 1970s. In addition, whereas the first year of the 1981 programme was successfully completed, the second year ended with a number of performance criteria

not met because of shortfall in programmed external flows. A waiver was, however, received in March 1983. The problem of foreign exchange reserves was exacerbated by the international recession which impacted on bauxite and alumina receipts. As a result, the central bank had to seek ways to improve reserves and protect the value of the currency. These included the implementation of an auction system through which foreign exchange could be accessed.

With the termination of the dual exchange system and establishment of the auction system in 1983 supported by a new exchange rate po1icy, the authorities were still faced with a problem of deteriorating reserves and continuing pressure on the exchange rate in early 1984. However with an aggressive interest rate policy, expansion in rediscounting facilities and the deposit scheme for payment of arrears, the reserves improved by December 1984. The measures implemented in 1984 remained in force throughout 1985 with some success.

In 1985, in order to consolidate the gains of 1984 and continue the policies initiated in the 1984/85 Stand-by programme, a 22 month Stand-by Arrangement for SDR l15.0mn was approved by the IMF. The programme involved further tightening in demand management policies and continued reliance on a flexible exchange rate system with policies designed to promote structural change and economic diversification. With improvement in the international economic situation and higher tourism and non-traditional export flows, there was significant improvement in the current account of the balance of payments and stability in the value of the Jamaica dollar.

In 1986 monetary policy was pursued within the broad framework of the Financial Sector Reform Programme. The principal objectives of this programme were the creation of an environment which would have been more conducive to more efficient intermediation and the strengthening of the central bank's ability to influence money and credit variables. In 1987 monetary policy was informed by the broader macro-economic objective of facilitating real growth within the constraints of improving the external accounts in a low inflationary environment. The bank, however, remained committed to its reform of the financial system and interfaced this with its demand management programme. Thus, in addition to the use of open market operations, (primarily issuing CD's and Treasury bills to mop up liquidity) interest rates and credit ceilings, the bank commenced the

phasing-out of the non-cash portion of the liquid assets ratio as well as reduction in overall liquid assets ratio of commercial banks and PDA institutions. In addition, rediscounting and liquidity support facilities were re-instated to improve the flexibility of the central bank in conducting monetary policy. Notably, these measures were implemented in the context of a 15-month Stand-by Agreement for SDR 85.0mn. The agreement expired in 1988 with all performance criteria met.

The central bank essentially continued its management of Financial Sector Reform Programme in 1988 - intensifying its use of open market instruments and interest rate policy in 1989. Importantly, a 20- month Stand-by Agreement for SDR 82.0mn signed in September 1988 was affected by Hurricane Gilbert and the problems of excess demand and less than programmed reinsurance flows. Consequently, many performance criteria were breached.

8.2.2 Commercial Banks

The commercial banks experienced significant growth in the 1970's notwithstanding the economic conditions that prevailed in both the domestic and international environment. With the upsurge in merchant banking, the commercial banks however, faced competition from these institutions for deposits. This was particularly significant in 1974 when the inflationary effects of the oil crisis had a contractionary impact on real incomes.

Loan Operations

Loans extended by commercial banks throughout the 1970s and 1980s continued to be restrained by credit controls of the monetary authorities (see appendix with index of policy measures). This was primarily because the period was characterised by excessive aggregate demand for imports and deteriorating external reserves. Based on high fixed deposit rates, lending rates were in the high 20s and low 30s between 1984 and 1989.

Deposits

Savings deposits continued to grow despite the high inflation rate. However, the commercial banks had to reduce the range of time deposit rates in order to attract these funds away from merchant banks, particularly in 1974. Whereas savings deposits were maintained primarily by low and middle income earners, time deposits offered attractive investment opportunities to middle income and upper income earners.

The gap between rates offered on savings (which remained fixed and determined by the monetary authorities) and fixed deposits widened significantly in the 1980s. For example, whereas at the end 1980, the savings rate was 9 per cent, time deposit rate on maturities 6 months and less than 12 months was 10¼ per cent at the top of the range. At the end of 1984, the comparable rates were 13 per cent in respect of savings and 20 per cent at the top of the range, for time deposits. Prior to the increase in savings rate in November 1989, savings at 13 per cent was 9½ per cent below the highest time deposits' rate.

8.2.3 Other Financial Institutions

Merchant Banks

In the early 1970s there was an upsurge in merchant bank activity with the first such institution established in late 1969,increasing to a total of six by 1973. These institutions grew out of the need to provide medium and long term financing for the business sector in particular. In this regard, the development of the money-market was a major part of the functions of merchant banks.

The development of merchant banks was not viewed initially as detrimental to the growth of commercial banks which operated mainly in the short-term market. However, as these institutions increased their borrowing on the short-term market in order to maintain their longer-term lending, the competition with commercial banks became a matter of concern. With a good deal of short-term money seeking the best possible return, the competition for deposits became even fiercer.

With the continued growth in merchant banking, there was growing need to regulate their activities (particularly in the area of loans) in light of the fact that their operations were not covered under the provisions of the Banking Law of 1960 although these institutions were taking deposits and lending as principals. Thus, in January 1975, all merchant banking institutions were brought under the umbrella of the Protection of Depositors Act and subjected to periodic inspection of their accounts.

The growth in merchant banking in Jamaica was quite phenomenal between 1986 and 1989 with the numbers growing from eight to 22. A major impetus behind this rapid expansion was their lease financing activities, which was fuelled by increasing costs of goods and services. Of

particular interest is the funding of motor vehicles and industrial equipment purchases.

Loan Operations

Merchant banks, as money lenders, were expected to operate primarily medium and longer-term money market, offering financing to the business sector. However, as these institutions grew, they became very involved in the short-term money market offering credit to importers at rates competitive with commercial banks. In 1974, with continuing deterioration in reserves and the breaching of IMF credit guidelines at the end of 1973, partly due to the fact that merchant banks and trust companies were not included in the original projections, the Bank of Jamaica took the decision to restrict merchant bank lending with a maturity of less than three years to amounts outstanding at 31st January 1974. As the economic conditions in the country continued to worsen, credit ceilings were also imposed on the lending of these institutions, bringing them in line with commercial banks. In the 1980s as the lending activities of merchant banks became more supportive of the import orientation of many business firms, the deposits of these institutions became more concentrated in the short-term end of the market. This further increased their competition with commercial banks and resulted in higher interest rates prevailing in the financial system.

Deposits

The deposit structure of merchant banks in the period of the 1970s was primarily skewed to the longer-term maturities. With the great demand for medium and long-term capital and the supply from domestic resources very limited, the competition for longer-term deposits was very high. In fact it was the view then, that unless more foreign capital was brought into the country, domestic interest rates would soar to uncontrollable heights. With increasing demands for these institutions to lower interest rates however, members argued that the 10 percent ceiling under the Money Lenders Law (1938) restricted their flexibility in adjusting rates and argued for greater flexibility.

With the inclusion of these institutions under the Protection of Depositors Act in 1975, the Bank of Jamaica sought to gain greater monitoring of the deposit-taking aspect of their operations. As a consequence, monthly

reports on the maturity structure of deposits were requested, the deposit structure being brought in line with that of commercial banks.

Trust Companies

The operations of trust companies which have their beginnings as off-shoots of the commercial banks were also affected by the growth of merchant banks in the 1970s. These institutions, which were subject to the Money Lenders Law, also competed with the commercial banks, notwithstanding the fact that they provided mortgage facilities to the customers of their commercial bank affiliates. In 1975, trust companies were also licensed under the Protection of Depositors Act.

Loan Operations

With increasing competition from other financial institutions (particularly merchant banks), trust companies attempted to broaden their lending activities beyond the provision of mortgages in the 1970s and 1980s. In order to access additional funding in November 1970, the trust companies argued for, and were successful in gaining, approval from Bank of Jamaica to qualify for rediscounting facilities. As a consequence of institutional limitations, however, growth of the overall group was slower than the other financial institutions.

Following a sharp deterioration in the balance of payments and accompanying economic problems, the Bank of Jamaica on 25th January 1974 also tightened credit restrictions and brought their lending activities under credit controls. Short-term (net) foreign borrowing as well as short-term lending (less than three years) was restricted. Credit ceilings were also applied to the lending activities of these institutions restricting credit for the distribution and personal lending categories, although broad restrictions were later abolished. The institutions' lending throughout the 1980s continued to be influenced by the monetary policy measures of the central bank and with continued competition from building societies and based on the limitations of their operations, their prominence as mortgage lenders began to diminish. Additionally, their other services were also being efficiently provided by other financial institutions.

Deposits

The competition for deposits with the emergence of merchant banks was a

major problem for trust companies in the early 1970's. With the relatively high rates being paid by merchant banks and limits placed on rates charged on loans under the Money Lenders Law up to the end of 1970, these institutions also lobbied to be exempted from such provisions.

Competition for deposit resources among financial institutions continued throughout the 1970's as economic conditions worsened. With credit expansion in the second half of 1973 generating serious inflation, the monetary authorities were forced to place restrictions on the operations of financial institutions. As a consequence, guidelines were issued restricting trust companies and other specified financial institutions from accepting deposits at call and up to seven days. It was noticed, however, that this measure had very little impact as many shifted to 'eight day deposits' and continued to rely on the short-term end of the market.

With improvement in economic conditions in the early 1980s, there was a noticeable shift of funds to the longer-term end of the market as foreign exchange flows and liquidity levels improved. However, by the latter part of the decade, particularly after Hurricane Gilbert in 1988, there was increased demand for imports and foreign exchange and as a consequence, competition for short-term deposits increased. The trust companies, in an effort to compete for funds were also forced to offer higher rates. Additionally, high rates prevailing on CDs and Treasury Bill short-term instruments also had the effect of pushing rates upwards.

Building Societies

The number of building societies operating in Jamaica contracted from 16 at the end of 1971 to five at the end of 1989. The reduction in the number of institutions resulted primarily from mergers of smaller institutions with larger ones in an effort to maintain economic viability and improve services to customers. Notably, the bulk of the mergers took place between 1970 and 1978. By the end of 1989, all the societies fell under the umbrella of the Building Societies Association of Jamaica (1959) which required a certain minimum ratio for liquid funds and reserves, for all members.

The pace of growth of the societies was relatively strong in the early years of the 1970s, growing at an average annual rate of 43.6 per cent by the end of 1976. The rate of savings growth in the 1980s (as was the case in late 1970s) was somewhat eroded by the high market interest rates which tended to surpass significantly the limits imposed on the societies.

In addition, the activities of these institutions were confined to investment portfolios restricted by the Building Societies Act which dates back to 1897.

Notwithstanding this, the assets of the building societies grew to J$2,268.1mn at the end of 1989 from J$57.4mn at the end of 1971.

Credit Unions

The number of institutions which constituted the credit union movement fell from 127 at the end of 1971 to 86 at the end of 1989. This reduction stemmed from a number of closures and mergers which resulted from the competitive financial environment which prevailed in this period. Simultaneously, however, total savings moved from J$9.6 million at the end of 1971 to J$582.1 million at the end of 1989 with loans moving in a similar direction from J$9.2 million to J$555.6 million at the end or 1989. At the end of 1989 the membership had grown to 342,144.

Jamaica Mortgage Bank

The Jamaica Mortgage Bank was incorporated in 1973 to finance commercial and private mortgages. However, with the establishment of a National Housing Policy for Jamaica in 1982, the institution concentrated on mobilising funds (local and overseas) to finance housing development on a wholesale basis. The Bank also provided mortgage and mortgage insurance financing in order to facilitate an adequate supply of funds to the housing construction sector.

Consequent on the financial restructuring of the institution, approved in March 1991, there was steady growth in the assets of the bank, with growth of 31.9 per cent between 1993 and 1994. The bank also supplemented its resources through investments in high yielding government securities as it too was affected by the prevailing high interest rate environment.

Development Banks

Agricultural Credit Bank / National Development Bank

Both the Agricultural Credit Bank (ACB) and the National Development Bank (NDB) were established in 1981. These institutions, born out of the Jamaica Development Bank which commenced winding-down operations soon after, were created primarily to assist small farmers and

entrepreneurs through the provision of medium to long-term financing. Funding of these institutions was provided from foreign and local sources with Jamaican Government guarantees. Funds acquired were channelled through Peoples Co-operative Banks (PC Banks), commercial banks and PDA institutions.

At their inception, it was conceived that loans secured from the resources of the ACB should be on-lent at rates well below market rate as a subsidy to small farmers and small entrepreneurs. Since 1988 these funds on-lent by commercial banks and PDA institutions were also exempted from credit controls imposed by the central bank. The growth of these institutions has been particularly noticeable since Hurricane Gilbert in 1988 which increased the need for reconstruction and development funds. In light of the high interest rates which prevailed in the system even after the hurricane, this less expensive source of funds became even more attractive.

Trafalgar Development Bank

The Trafalgar Development Bank, Jamaica's first privately owned development bank, commenced operations in May 1985. The Bank offers medium and long term loans, lease financing as well as project development and technical services in the productive sectors (mainly agriculture, manufacturing, tourism). By the end of September 1989, the assets of the company were J$146.4mn (J$42.8mn in 1986) while loans grew to J$106.0mn (from J$16.4mn in 1986). At the end of 1990 assets of the company were J$214.9mn.

People's Cooperative Banks

During the decades of the 1970s to early 1980, there was a slowing in the growth of PC banks in a context of challenging macroeconomic environment, including high inflation and high interest rates. This contributed to a fall in membership. As a consequence, the savings portfolio experienced no growth. With the establishment of the Agricultural Credit Bank by the Government, efforts were made to improve the viability and efficiency of the PC banks, as a vehicle through which loans from the ACB could be channelled to borrowers. While there was some improvement in membership, growth in the savings and loan portfolio of the PC banks was very modest.

8.3 The Financial System - 1990s

By the beginning of the 1990's the financial system in Jamaica was comprised of:

- Commercial Banks
- Merchant Banks
- Trust Companies
- Finance Houses
- Credit Unions
- Building Societies
- Development Banks
- Agricultural Credit Bank (Government)
- National Development Bank (Government)
- Trafalgar Development Bank (Private)
- People's Co-operative Banks
- Mortgage Bank (Jamaica Mortgage Bank)
- Insurance Companies
- Export Import Bank (EXIM-formerly JECIC)

Financial sector expansion in the 1990s must be viewed in the context of the prevailing macroeconomic environment which was characterised by high inflation, marginal GDP growth, high interest rates and a depreciating exchange rate. Growth in financial intermediation was also facilitated by the relaxation of controls under the financial liberalisation programmes of the 1980s and early 1990s and the exploitation of opportunities for regulatory arbitrage arising from differential reserve ratios across competing institutions.

The 'bubble' in the stock and real estate prices created by the high inflation environment provided further expansionary opportunities for commercial banks through loans and via the direct acquisition of such assets. Concurrently, with the removal of capital controls in September 1992 and the resultant increase in capital inflows, there was significant expansion in private sector credit which, in many instances, took place without the necessary risk assessment and adequate collateral. At the same time, the overabundance of small banks and insurance companies, coupled with poor economies of scale and weak internal management, made it difficult for some institutions to effectively compete. As a consequence, many institutions sought to take unnecessary risks, one of the factors contributing to the financial sector crisis in the latter half of the 1990s, as

they sought to find innovations that could enable them to capitalise on weaknesses in the regulatory environment.

Therefore, by 1994, in a context of liberalisation and deregulation, there was a noticeable reshaping of the financial system. The so-called "pure" financial institution had all but disappeared as institutions sought to diversify their operations in order to remain competitive, viable and relevant. In fact, with an expansion in credit card facilities to other financial institutions, there was little difference between these and commercial banks. This had significant implications for the conduct of monetary policy given that money supply growth and inflation are strongly influenced through the central bank's control of base money. Institutions operating under the Protection of Depositors Act did not hold current accounts with the central bank, so the ability of the BOJ to affect their credit expansion was directly through the cash reserve and indirectly through the commercial banks with which they held accounts.

Concurrently, regulation of the Jamaican financial sector, up to 1996 (in the period running up to the financial sector crisis), was largely undertaken from a purely institutional standpoint, that is, legislation was institution specific. Commercial banking institutions were governed by the Banking Act (which was subsequently amended in 1992)[30]; non-bank/licensed financial institutions - The Protection of Depositors Act (1960)[31]; building societies – the Building Societies Act; credit unions – the Co-operative Societies Act; insurance companies – the Insurance Act. Whereas the Bank of Jamaica[32] regulated commercial banks and licensed financial institutions, building societies and credit unions were monitored by the Building Societies' Association and Credit Union League, respectively, to which membership was not compulsory. Concurrently, the Superintendent of Insurance had regulatory oversight responsibility for insurance companies, a responsibility which in many instances was not effectively carried out as many companies had returns outstanding for years.

Investment firms/dealers in securities firms were largely unregulated until 1993 when attempts were made to bring them under The Securities Act

[30] The Banking Law (1960) was replaced by the Banking Act (1973) with subsequent amendments in 1984.
[31] The Financial Institution Act (1992) replaced the Protection of Depositors Act (1960).
[32] Credit Unions are in the process of being brought under the umbrella of the central bank.

(1993)[33]. The laws in place were traditionally skewed towards preserving the secrecy of customer relations with each institution, with the result that institutions did not share information. Customers were indebted to several institutions, but each institution was unaware of their customers' debt owed to the others (no credit bureaux). Inadequate information/documentation on collateral, which resulted in many customers getting more credit than they were capable of servicing, also contributed to the failure of some financial institutions in the late 1990s.

8.3.1 The Central Bank (Bank of Jamaica)

The role of the central bank in directing orderly growth of the financial system was paramount in the 1980s and early 1990s. In a context where rules for entry to operate specific financial institutions were fairly relaxed, there was not only the emergence of new financial institutions, but expansion in branch network and development of new product offerings. Many players with little or no financial market experience or qualifications saw the financial sector as an opportunity to make exorbitant profits. Further, sharp differences in the rules governing the activities of the different institutions had significant influence on the activities of many institutions and eventually impacted on the overall soundness of the financial sector.

In the 1990s, with persistent shortfalls in foreign exchange flows and the build-up of inflationary and balance of payments pressures, the Bank of Jamaica had to rely heavily on the use of corrective monetary policy instruments and effect far-reaching policy changes in order to manage financial flows. Central to the policy changes was the implementation of a 15-month Stand-by Agreement with the International Monetary Fund for SDR 82.0mn covering the period January I, 1990 to March 31, 1991. This arrangement involved the pursuance of intensified demand management policies aimed at the achievement of exchange rate stability, viability in the balance of payments, as well as rehabilitation of the social infrastructure of the economy.

Recognizing that in order to restore price and exchange rate stability it would be necessary to implement measures that encouraged the free interplay of market forces, the authorities embarked on a programme of economic reform. This involved the deregulation of the financial sector,

[33] Enacted just prior to the financial sector crisis.

including liberalisation of the foreign exchange system. Integral to the foreign exchange liberalisation was the introduction of an inter-bank foreign exchange system on September 17, 1990, aimed at reducing the build-up of arrears in the system. Under the new system, responsibility for purchase and sale of foreign exchange for trade and payments (including CARICOM) was transferred from Bank of Jamaica to “authorised dealers”. These dealers were, however, required to surrender a portion of their foreign exchange purchases to the central bank. The exchange rate of the Jamaica dollar vis-à-vis other currencies was to be determined by demand and supply forces.

Effective January 1, 1991, the Bank of Jamaica also eliminated credit ceilings on commercial bank and specified financial institutions’ loans as part of its emphasis on market forces in the allocation of financial resources and to facilitate the process of deregulation. As a supporting measure and in an effort to regulate liquidity levels in the financial system, the BOJ introduced a phased reduction in the liquid assets ratio of commercial banks in January 1991. This followed the announcement of a phased equalisation of the cash reserve and liquid assets ratio of commercial banks and institutions licensed under the Protection of Depositors Act. These measures represented furtherance of the financial sector reform and deregulation process and were in accordance with IMF targets. In addition, to facilitate its management of liquidity, the central bank on February 8 1991, introduced a Repurchase Agreement for Treasury Bills and Local Registered Stocks. Despite uncertainties in international petroleum prices, the Gulf Crisis and a slowdown in the economies of Jamaica's main trading partners, all performance criteria of the 1990/91 IMF programme were met. In April 1991, negotiations commenced for a 12-month Stand-by Arrangement amounting to SDR 43.7mn to cover the period April 1 1991 to March 31 1992.

Throughout the first six months of 1991, the central bank continued to review the operations of the inter-bank foreign exchange trading system as it sought to ensure efficiency in the foreign exchange market. It was anticipated that with the implementation of the inter-bank foreign exchange system there would have been a substantial increase in foreign exchange inflows into the banking system. This, however, did not materialise and as a consequence, there was accelerated slippage of the exchange rate and further build up in payment arrears. As foreign exchange flows into the Bank of Jamaica lessened, the Bank was forced to

adjust the terms and conditions of its foreign exchange intake from the commercial banks in order to ensure the settlement of official debt obligations and to improve flows to the market. These amendments related to:

- sale of foreign exchange to the Bank of Jamaica by authorised dealers;
- reduction in commercial banks' surrender requirements;
- removal of commissions and fees charged by commercial banks on purchases and removal of guidelines to enable a freeing up of the forward market;
- an increase in the level of foreign exchange retention by operators in the tourist industry through amendment of the Jamaica National Retained Accounts (JNRA).

Inflows were later boosted with the removal in May 1991 of the stipulation on the amount of cash that commercial banks were allowed to accept in foreign exchange accounts which presented a dilemma for the authorities as, while the banks overall had more foreign exchange, the bulk was held in "A" accounts, 50 per cent of which were unavailable to the banks themselves based on the terms and conditions that governed these accounts. As a consequence, there was an increase in foreign exchange black market activities as persons attempted to settle their overseas obligations. Hence the decision was taken to liberalise the foreign exchange regime so as to eradicate the black market and to return some stability to the exchange rate. In July 1991, in an attempt to further broaden the foreign exchange market, some building societies and PDA institutions were also granted licences as foreign exchange dealers under the Exchange Control Act. In addition, amendments to the Act were also made to encourage foreign investment inflows as well as to allow Jamaican non-resident entities to borrow overseas without Exchange Control approval. Commercial banks were also empowered to appoint foreign exchange agents to act on their behalf in the buying of foreign exchange outside their premises.

The continuous review of the foreign exchange market and the Exchange Control regime culminated on September 25, 1991 with the implementation of the Exchange Control (Removal of Restrictions Order). An important objective of this action was the elimination of the black market for foreign exchange and the encouragement of foreign exchange flows into the "formal" system. With the liberalisation of exchange

controls, the Bank of Jamaica transferred all private foreign exchange transactions (including public entities) to the banking system, retaining only foreign exchange receipts from bauxite, sugar and bananas. The Bank of Jamaica continued, however, to be responsible for the "official" transactions of Government (including government debt). The Bank also elected to supplement foreign exchange receipts from bauxite, sugar and bananas through purchases from the banking system. This was to ensure that the official obligations of the Bank of Jamaica and Government could be settled. The Exchange Control (Removal of Restrictions Order), apart from abolishing retained accounts, also allowed for CARICOM transactions to be settled by exporters or importers themselves and for exporters to hold their own foreign currency accounts locally or abroad. This was followed by the Exchange Control (Removal of Restrictions (No. 2) Order which established the system of 'Authorised Foreign Exchange Dealers' with the sole right to buy and sell foreign exchange, and setting penalties and fines for offences against the Act.

With exchange rate and price stability of prime concern, the central bank continued to place emphasis on liquidity management in 1991. Consequently, on December 1, 1991, the Bank amended requirements in respect of the foreign currency reserves of Authorised Dealers, in order to ensure the protection of depositors' funds and facilitate the achievement of monetary policy objectives. Effective December 23, 1991, amendments were made to Section 29 of the Bank of Jamaica Act to provide the Bank with greater flexibility in administering liquid assets requirements with respect to foreign currency deposits. The provision allowed for varying percentages to be fixed for different commercial banks over specific periods. This was intended to facilitate selective absorption of excess liquidity from the larger and very liquid banks and remove the disadvantage from smaller and less competitive banks.

The repeal of the Exchange Control Act was finally signed on August 17, 1992. Three features -prohibition against trading in foreign currency except by an Authorised Dealer; provisions under which the Minister of Finance can issue directions to specified classes of persons as regards to the acquisition of foreign currency; and provisions relating to offences were retained and appendaged to the BOJ Act. In an attempt to further broaden the official foreign exchange market, new guidelines were subsequently established on January 6, 1994 for licensing of new authorised foreign exchange dealers on a limited basis. In addition, on February 2, 1994, a

system of cambios was established for the buying and selling of foreign exchange in an effort to marginalise the illegal market. The Authorities also established, on April 18, 1994, a new financial market arrangement, classifying a number of financial market intermediaries as Primary Dealers. Their role was to provide continuous underwriting support for all issues of BOJ and Government securities, thereby providing secondary market liquidity for these same securities through an active two-way market. Essentially, through the trading of repurchase and reverse repurchase agreements, the central bank effected its demand management, which was integral to the control of inflation impulses and the maintenance of exchange rate stability.

With the repeal of exchange control and deregulation of the financial system, it was also quite clear that existing legislation was inadequate to ensure orderly expansion and development of the sector. Further, with the growth in terms of numbers and size of institutions the need for adequate supervision was also heightened and it was recognised that there was insufficient flexibility in the old Acts to allow the super authority to take remedial action where required. The Authorities therefore revised and implemented new financial legislation which became effective December 31, 1992. These were:

- The Bank of Jamaica Act (1960) - Amendment Act (1992).
- The Banking Act (1960) - Banking Act 1992.
- The Protection of Depositors Act (PDA) - Financial Institutions Act 1992.

Although efforts were made at enhancing regulation in 1992, these were slow in being passed through the parliamentary process and were generally not in line with the financial innovations and growth that was taking place. Further, pressures from private financial sector lobbyists ensured that the eventual legislation gave inadequate powers of intervention, sanction and enforcement to the supervisory authorities. Socio-political constraints to the timely execution of supervisory recommendations also created a moral hazard by sending accommodative signals to the market. Further, the lack of legal power to intervene prior to absolute insolvency proved a major stumbling block to timely and effective supervisory action, resulting in continuing reliance on moral suasion. Whereas deposit-taking institutions under the Bank of Jamaica's supervision became increasingly subject to prudential norms, this supervisory approach was not replicated in the rest of the financial sector. This, along with different prudential requirements,

encouraged regulatory arbitrage which was used by a certain financial industry to operate beyond the effective reach of the banking supervisors.[34]

The pursuance of an anti-inflationary policy of high interest rates and high cash reserve ratios by the monetary authorities led to a burst of the 'bubble' in the stock and real estate markets and serious difficulties in the quality of collateral. Inflation, which had increased sharply from 29.8 per cent in 1990 to 80.2 per cent in 1991, also fell sharply to 40.2 per cent in 1992 and 30.1 per cent in 1993. By 1996 inflation had fallen to 15.8 per cent and then sharply to 9.2 per cent in 1996. As a consequence, much of the real estate on the books of insurance companies, banks and non-banks was overvalued. In the case of banks, the collateral became inadequate to support the growing stock of loans when real estate prices fell as inflation was brought under control and with many borrowers unable to repay their loans or increase their collateral, the banks had less value to recoup. With increasing pressures in the insurance industry, many policy holders sought to liquidate their policies in order to reduce the loss in value. At the same time, there was a noticeable 'flight to quality' as many depositors switched their accounts to banks that were well capitalised and had strong credit portfolios. To a large extent, funds arising from liquidated insurance polices were deposited into the so-called 'safe' banks which were foreign owned. Non-performing loans (net of provisions for losses) as a per cent of total loans in commercial banks therefore grew from 7.4 per cent at the end of 1994, to 28.9 per cent at the end of 1997, at the height of the problem[35] and was evidenced primarily among the indigenous institutions. In a context where a loan was classified as non-performing if interest was not paid within 180 days, many delinquent borrowers had fallen below the 'radar', by rolling over loans in this manner and taking advantage of weaknesses in the legislative framework. Further, the large spread between deposit and lending rates in indigenous banks had made the servicing of debt unmanageable.

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[34] For example, building societies were not brought under the supervisory umbrella of the central bank until 1995. Credit unions are yet to brought under BOJ supervision.

[35] Notably, the rule of thumb is that financial distress is likely to become a systemic problem when non-performing loans (net of provisions) is approximately 15 per cent of total loans. This threshold is valid across countries even where definitions of non-performing loans vary.

The weakness in the internal control environment in which many of these institutions operated was evidenced by higher incidence of fraud and other irregularities. Concurrently, there was also evidence of problematic related party loans and although the Banking Act (1992) sought to constrain the value and growth in these loans, the data revealed an average quarterly growth rate of 18.8 per cent between 1992 and 1995. Notably, a large proportion of these loans was associated with the 'connected' relationship between insurance companies and their related commercial banks. Related party loans further increased between 1996 and 1997 in a context where encashment of insurance policies created a demand by these insurance companies, for overdraft facilities from their affiliate commercial banks.

The fact that foreign-owned and controlled institutions operating in the same environment did not experience the same problems supported the view that the poor standard of corporate governance played a major role in the poor financial performance of indigenous institutions. This is in a context where foreign-owned banks enjoyed net income and return on assets of between 1.5 per cent and 3 per cent compared to the indigenous banks which experienced negative ratios of 3.2 per cent. The major weaknesses observed in the indigenous banks were:

- Negligent boards of directors
- Dominant shareholder/manager structures
- Inappropriately excessive risk appetite coupled with a lack of effective risk mitigation
- Loophole mining
- Absence of a compliance culture even for internal policies.
- Poor credit analysis techniques
- Imprudent credit concentrations
- Poor asset-liability management and, in certain instances,
- Complex group contagion, insider dealing and material fraud.

Deficiencies in the 1992 Banking Act which contributed to the problems in the financial sector included the following:

- The Act did not provide for adequate access to commercial bank information. Whereas the central bank could inspect the books of banks, where these institutions had affiliate relationships with building societies and insurance companies, there was no authority to inspect the books of these affiliates to reconcile transactions. As a consequence, banks formed complex

organisational structures and moved their transactions upstream so that the central bank did not have access to all accounts.

- The legislation did not permit the central bank to have sanction powers or to take remedial action. Temporary management could only be installed in cases where complete insolvency had been determined by the regulator.
- Fit and proper criteria were not stringent so barriers to entry in the industry were low. In this regard, individuals could open banks as long as they had not been convicted of a criminal offence.
- The provisions for lending criteria were very broad and ambiguous and so lent themselves to various interpretations by financial institutions.
- Credit and investment limits were generous and enabled credit limit breaches and excessive connected party lending.

Therefore, in the context of the financial sector crisis and the limitations of the regulatory environment, amendments to legislation were required. The Bank of Jamaica Act (1992), the Banking Act (1992) the Financial Institutions Act (1992) and the Building Societies Act (1996) were amended in October 1997, giving the supervisory authorities more powers in respect of remedial and intervention actions. The legislation also imposed restrictions on related party lending and investment, and prohibited unsecured lending to connected parties. Greater restrictions were placed generally on secured and unsecured lending and a more precise definition of non-performing loans was instituted. There were also specific regulations in respect of shareholdings, controlling interests, unsafe practices, termination of operations, amalgamations and transfers of assets, as well as rules governing the licensing, capital and reserves and reporting requirements. The computation of capital adequacy was made more stringent as banks were required to go above the Basle risk-based standard of eight per cent to ten per cent by December 1999. Greater control was also given to the supervisory authorities over changes in ownership and stricter definitions for ‘fit and proper’ managers, directors and financial institutions. The amendments also specified the obligation and responsibility of banks’ external auditors in the presentation of findings and reporting of problems and provided greater access to information by the regulators. The central bank could direct financial institutions to reverse transactions. Legislation also enabled the supervisory authority to request special audits as deemed necessary.

The Government, in seeking to avert a complete collapse of the financial sector, established a resolution company, the Financial Sector Adjustment Corporation (FINSAC) in January 1997, which assisted in the restructuring of the sector. FINSAC purchased the non-performing loan portfolio of the failed institutions and consolidated good loans under a new commercial bank – Union Bank. In addition, a set of 'fast track' legislation to strengthen the legislative framework which governed the banking sector was introduced. The amendment to the existing legislation was in recognition of the inherent weaknesses in the legislative framework which contributed to the demise of the sector and among other things, gave the supervisory authorities more powers in respect of remedial and intervention actions to be taken in respect of ailing institutions. The macroeconomic environment improved in 1998 with inflation falling to 7.9 per cent from 9.2 per cent the previous year. In a context of the need to finance a larger fiscal deficit in the year however, domestic interest rates did not fall consistent with lower inflation. However, the financial sector contracted with FINSAC continuing to play a major role in shaping the structure and operation of the financial system.

The restructuring process was advanced through supervised mergers and closures in response to the BOJ's assessment of the need for additional restructuring and consolidation. This was also facilitated through the tightening of prudential capital requirement and the liquidity reserve equalisation programme. In 1998 the decision was taken to merge certain FINSAC controlled companies into a single commercial bank – Union Bank. As indicated earlier the merger was to involve four commercial banks, four building societies and five merchant banks, with the intention that the rehabilitated Union Bank would be divested to private interests in the near-term. The merger of two of the entities, namely Horizon Merchant Bank and Horizon Building Society into Citizens Bank (the corporate name was changed to Union Bank of Jamaica Limited with effect from 30 June 1999) was also completed during the year. At year end, the Union Bank Holding Company Limited was formed and the process of rationalising the structure of the relevant entities under Union Bank commenced.

With respect to new legislation, the Deposit Insurance Act was enacted in March 1998 to establish a scheme for the protection of depositors through the Jamaica Deposit Insurance Corporation (JDIC). The existence of deposit insurance was expected to obviate the need for a resolution company should there be financial sector difficulties in the future. The Money

Laundering Act was also enacted in 1998, making money laundering a criminal offence.

With the deterioration in international financial market conditions in 1999, the Government was unable to approach the external markets for funding of the budget and as a consequence, there was a sharp fall in the Net International Reserves (NIR) of the BOJ. This was in a context where the BOJ provided support to the foreign exchange market in order to moderate the pace of exchange rate depreciation. Additionally, the Bank opted to sell medium term government securities from its own holdings instead of reversing the downward step-adjustment in interest rates, a process which commenced in December 1998. In this regard, between December 1998 and September 1999, the benchmark rate was lowered from 22 per cent to 18.35 per cent. Against this background, inflation fell to 6.8 per cent in 1999, notwithstanding the generally unstable foreign exchange rate.

8.3.2 Commercial Banks

The deregulation of the financial sector and liberalisation of the foreign exchange market had a major impact on the operations of commercial banks. With the implementation of the inter-bank foreign exchange trading system in September 1990, commercial banks only experienced moderate improvement in foreign currency inflows in the first quarter of the year. Additionally, the removal (in May 1991) of the limit on inflows into foreign exchange accounts did not facilitate an increase in the level of foreign exchange inflows into the banking system as anticipated. Instead the illegal market continued to expand placing further pressure on the exchange rate. Pressures in the foreign exchange market following the establishment of the inter-bank system also resulted in a weakening of profit positions as a result of the faster growth in expenses attributed in the main to the higher cost of deposit and increased investment in fixed assets, particularly real estate. Whereas the removal of credit ceilings on January 1, 1991 was expected to stimulate demand for loans and advances and improve profits, given the anticipated opportunities in the foreign exchange market consequent on further liberalisation, many commercial banks concentrated their efforts in that market.

Hence, against the background of an accelerating devaluation of the Jamaica dollar, the Jamaica Bankers' Association (JBA) on June 10, 1991 initiated the implementation of standards and procedures for the conduct of the foreign exchange market. It was agreed by members that each bank

would set its exchange rate within pre-determined bands on a daily basis, as part of their effort to bring some order to the foreign exchange market. A maturity period of 'in excess of 30 days' was also established for the forward market (changed to Futures Market) with no cash transactions allowed in order to reduce speculation. With further fine-tuning of the foreign exchange market, and with improvement in expertise as well as implementation by the banks of innovative ways to inhibit the expansion of the illegal foreign exchange market, many banks returned to profit making positions by the end of 1991.

Another important aspect of deregulation of the financial sector was the deregulation of the savings rate and banking hours. Effective October 1, 1990, the floor on commercial banks savings rates was removed as the authorities sought to reduce the distortions in the interest rate structure of the banking system. However, as the environment in which the banks were operating became more competitive, these institutions began to venture into other areas in order to improve their viability. Many financial institutions competing for funds were forced to offer interest rates on deposits far in excess of rates earned on their assets, thereby placing strain on their operations. At the end of 1990 banking services were provided by 11 banks with 170 branches. Total assets of these institutions stood at J$17.088.6 million (an increase of 13 per cent over 1989). Although the operations of the commercial banks continued to be governed by the Banking Act of 1961, given the challenging and changing environment faced by these institutions, it became clear that revisions to the Act were necessary.

The liberalisation of the foreign exchange system and the establishment of authorised dealerships highlighted the need for greater monitoring of deposit taking institutions by the central bank to ensure the protection of depositors. In this regard, prudential reserve requirements were established for commercial banks which were also required to conform to acceptable standards in respect of foreign exchange exposure. Many institutions, finding it difficult to remain competitive, partly due to the nature of their operations and the limitation of their licences, had been forced to broaden their scope through the acquisition of other financial institutions (including building societies). Hence, the Banking Act was revised in September 1992 to address greater protection of depositors and provide for greater scrutiny of the activities of these institutions, in the

context of deregulation and liberalisation of the financial sector. The major amendments related to the following:

a) The licensing of banks
b) Stipulation of a capital requirement of not less than J$80mn.
c) Regarding loans and investment, the Act sought to protect shareholders and depositors while not attempting to inhibit innovation.
d) With regards to "Group Treatment" - it required that where a bank is a member of a group of companies, the bank's responsibilities are not prejudiced by its connections with other members of the group.
e) Stricter controls on insider loans.
f) Provide for institutions or persons participating in the financial industry to meet managerial and shareholders requirements.

During 1996, developments in the commercial banking sector resulted in the rationalisation of operations and branch networks. In addition, one institution, the Century National Bank, was placed under temporary management on 10 July 1996, while the Mutual Security Bank and the National Commercial Bank (NCB) were merged, effective 1 October 1996. In October 1997, A Scheme of Arrangement which involved either the transfer of all deposit liabilities to NCB or 100 per cent repayment in two tranches ((November 1997 and May 1998), was approved by depositors and creditors of Century Group. The operations of commercial banks in 1997 largely reflected effects of the programme of financial system rationalisation pursued primarily through FINSAC. In this context the asset portfolio of banks became heavily skewed towards Government debt instruments as well as in financial support for other financial institutions. This pattern was related to the sale of non-performing loans to FINSAC in return for securities, the extension of loans to related institutions that experienced liquidity problems and a general fall in the borrowing capacity of the productive sector.

Consistent with an improvement in the liquidity environment relative to 1996, interest rates declined in the first nine months of 1997 before resuming their upward trend in the latter months of the year. With continuation of the financial system restructuring process under FINSAC in April 1999, the number of commercial banks was reduced from nine to six. The reduction in numbers resulted from the merger of four commercial banks (Citizens, Island Victoria, Workers and Eagle) which had been

intervened by FINSAC. At the end of 1999, the total assets and liabilities of the commercial banks was $188 278.3 million, an increase of 15.9 per cent over 1998.

Loan Operations

With the further expansion in credit by the banking system in the 1990s, the demand for imports expanded which, in turn, increased demand for foreign exchange. With increasing balance of payments and inflationary pressures, there was a steady depreciation in the exchange rate. In order to reduce the demand for foreign exchange and improve the current accounts of balance of payments accounts, a number of monetary policy measures were applied to commercial bank and non-bank lending. These measures included:

a) Imposition of broad credit ceilings which were adjusted on a quarterly basis.
b) Phased increases in liquid assets/cash reserve ratio.
c) Increased penalties on the early encashment of Treasury bills.
d) Increased open market operations (CDs and Treasury bills).

In January 1991, however, the broad ceilings on credit were removed by the central bank under the 1991 monetary policy programme which sought to facilitate a deregulation of the financial system. Given the prevailing macroeconomic environment and the slow pace of financial legislation reform, many commercial banks tried to exploit loopholes in the banking legislation to circumvent the high reserve requirements and the tax on interest earned on deposits, which were imposed on their operations. Accordingly, many commercial banks participated in loan schemes which involved the sale of loans by one bank to another in a manner which enabled the selling bank to remove loans from its balance sheet as an asset. By merging this product with commercial paper and issuing a certificate of participation to the buyer, there was no specification of the loan being purchased or of the original borrower of the loan. Loan participation also provided a means for banks to take 'bad' loans off their books. Some commercial banks also operated managed funds on behalf of their customers. These funds were not subject to withholding tax based on the fact that they were held off-balance sheet and as a consequence were very attractive investment options.

In a context of the financial restructuring exercise in 1996, loan expansion slowed significantly to 19.3 per cent in 1996 and 8 per cent in 1997, from

40.2 per cent in 1995, reflecting a strong decline in loans to the productive sector. With a continuation of the restructuring process between 1997 and 1999, which saw the merger of four commercial banks, there was a 14.7 percent decline in the loan stock consequent on the transfer of non-performing loans from the merged institutions to the books of FINSAC, private sector loans declining by 15.1 per cent relative to 18.1 per cent in 1998.

Deposits

Between the latter part of 1989 and early 1990, short-term fixed deposits (up to six months) offered very attractive interest rates, in excess of 20 per cent per annum compared to longer-term deposits which offered rates well below 20 per cent per annum.

This pattern was influenced by a number of factors including:

1) Maturity structure and yields of Certificates of Deposit (CDs) and Treasury bills.
2) The volatility of the economy and the emphasis of borrowers on acquisition of foreign exchange for imports.
3) Competition from other financial institutions for deposits/resources.

Further, in the context of the weak financial legislation, many banks sought to garner funds that were not classified as deposits by the supervisory authorities (e.g. commercial paper and equity-linked insurance) by forging associations with building societies, insurance companies and other financial institutions and holding these in funds in many instances as of balance sheet items. In particular, because the Banking Act did not make provision for commercial paper (which were technically deposits) in the Banking Act, no reserves were held against them. Further, these funds were not subject to income tax.[36] Many banks were also innovative in the terms and conditions of many of their own instruments (term-deposits) offering competitive rates of interest for specified amounts of funds.

Based on the structure of deposit liabilities, which in some institutions was skewed to the shorter end of the market, there was an emergent picture of a mismatch of funds. This is in a context where in the process of intermediation, some banks also invested heavily in Government securities

[36] Banks however collected fees to settle these contracts.

-Treasury bills and local registered stocks, Bank of Jamaica Certificates of Deposit, as well as medium to long-term loans.

The deposit liabilities of commercial banks grew sharply between 1990 and 1992 (86.1 per cent growth in 1992), influenced by the competitive interest rate environment. Whereas in 1993 growth slowed to 37.8 per cent, there was acceleration to 49.9 per cent in 1994 coincident with a further increase in interest rates associated with a restrictive monetary programme. Notably, these flows remained a major source of funds for commercial banks, with time deposits being the major category. The introduction by the BOJ of a special deposit for commercial banks, effective 28 August 1992 and aimed at tempering inflationary pressures and import demand, affected banking system liquidity in 1995 as commercial banks were required to hold a percentage of their prescribed liabilities as a deposit with BOJ (4.4 per cent at the time). This had an impact on liquidity of the banks and engendered a fall in time deposit rates and a slowing in deposit growth to 30.1 per cent. In a context of the prevailing macroeconomic environment, deposit liabilities grew marginally by 5.6 per cent in 1996 with moderate growth experienced between 1998 and 1999 in a context of a lower interest rate environment and the continuing financial sector restructuring, which was virtually ended by 1999.

8.3.3 Other Financial Institutions

As the financial institutions responded to the competitive high interest rate environment over the years, the lines between merchant banks, trust companies and finance houses became blurred. In recognition of the similarities in their operations, the legislative framework in which these institutions operated was also changed. Accordingly, in 1993, the operations of this group of institutions (previously regulated by the PDA (1966)) fell within the legal framework of the Financial Institutions Act (FIA) enacted December 1992. Consistent with the schedule of phased reduction in the statutory cash reserve ratio which commenced in 1991, the liquid assets ratio was equated with the cash reserve at 15 per cent on 1 April and raised in stages to 17 per cent on 1 September 2003. In a context of the new requirements, the level of paid-up-capital and statutory reserves rose by 109 per cent in 1993, as institutions augmented these liabilities in an effort to meet the minimum statutory paid up capital of $20.0 million. With the cash reserve and liquid assets equated at 17 per cent, licencees used some of the margin of reserves which existed at the start of the year to expand credit.

In a context of tight demand management policies in the second half of 1993, there was a noticeable slowing in asset growth of the FIA licensees to 2.9 per cent for the year from 73.0 per cent the previous year, reflected in all aspects of their operations. This was against the background of an expansion in the foreign exchange market subsequent to liberalisation, implementation of the new FIA legislation in 1992 which required greater scrutiny of their operations and continued tight demand management policies. As a consequence, following the establishment of two new institutions in 1992, activity in the sector was flat in 1993 with the number of institutions operating under the FIA remaining unchanged. In fact, the increase in 1992 represented the transfer of activities from affiliates in anticipation of a wider definition of deposits under the new Act.

In 1994, the performance of the FIA licensees as a group was significantly influenced by the operations of those among the group with foreign exchange deposit-taking/ dealership status and in this regard, there was a significant increase in foreign liabilities, the major source of new funds. Concurrently, credit expansion was dampened by the relatively high interest rates as well as increased usage of commercial paper. In 1995, with the cash reserve remaining at 17 per cent and the Liquid Assets Requirement (LAR) raised from 17 to 25 per cent on a phased basis, the FIA licensees invested heavily in government paper in order to satisfy the non-cash component and in many instances, holding well in excess of the required level given the attractive yields on these securities.

In February 1996, the non-cash portion of the LAR was increased on a phased basis to 13.0 per cent. Whereas the cash reserve was maintained at 17.0 per cent, the non-cash portion was further increased in December bringing the total LAR to 36 per cent. Given the increase in the non-cash portion of the LAR, there was greater investment in Government instruments by the FIA licensees. Notwithstanding the BOJ's restrictive monetary policy stance in 1996, the group recorded relatively strong growth with performance influenced to a large extent by activities in the Government securities market.

With a sharp decline in inflation, a number of entities, especially those which had acquired substantial real estate holdings, found themselves with a significant mismatch of assets and liabilities. Additionally, the collateral for many loans was devalued and there was a large increase in non-performing loans. Thus at the end of 1997, the number of FIA licensees

operating in Jamaica totalled 27 relative to 28 in 1996 and 29 in 1995. Three institutions (themselves affiliates of commercial banks) accounted for approximately 40 per cent of the total assets of the sector. Between 1996 and 1997, in the context of the difficulties in the financial sector, the assets and liabilities of the FIA licensees fell by 15.5 per cent reflecting a 27.0 per cent fall in their loan portfolio relative to a 21.0 per cent decline the year before.

The year 1998 represented a period of consolidation for the FIA licensees, manifested in a reduction in the size of the sector both in terms of assets and numbers. The decline occurred in the context of the emergent stability in the foreign exchange market which implied a fall in margins on foreign exchange trades, a significant source of revenues. Against this background nine institutions surrendered their licences, either closing or merging their operations. Hence at end 1998, only 18 of the FIA licensees were in operation, reflecting a 25.4 per cent decline in assets, and a fall in their loan portfolio. The stock of government securities fell by 17.3 per cent relative to the previous year; with 54.8 per cent of holdings representing FINSAC securities compares to 8.3 per cent in 1996. Consistent with the contraction in operations was a decline in the liquidity portfolio of these near-banks. By the end of 1999, only 14 FIA licensees were in operation.

Merchant Banks

In a context of the lower LAR applied to merchant banks vis-à-vis commercial banks and the general competitive environment, merchant banking continued to expand at a relatively fast rate in the first half of the decade of the 1990s. The minimal capitalisation allowed under the Protection of Deposits Act (1960) had enabled new entrants in the financial sector to exploit the differential in the liquidity reserve requirement that existed for commercial banks and institutions operating under the PDA. In fact, the major restrictions to entry of new merchant banks stipulated a level of deposits to twenty times the capital, with capital loosely defined to include the capitalisation of non-reserve revenues. In addition, the LAR was 25 per cent in 1992 compared to 50 per cent for commercial banks.[37] Of the statutory required LAR, 17 per cent had to be held in non-interest bearing cash reserves with the central bank in the case of merchant banks as against 25 per cent for commercial banks. As a consequence, these

[37] Notably, the LAR was increased to 35 per cent in 1995 at the height of the financial sector crisis.

institutions became a channel for affiliated commercial banks to circumvent the higher capital and reserve requirements to which they were subjected, thereby accessing cheaper funds. Notably, significant portions of funds mobilised were of a short-term nature and were used by many merchant banks to invest in long-term assets such as real estate, leading to a mismatch of liabilities and assets.

Against this background, the number of institutions converting their operations to merchant banking from trust company or finance houses continued to grow throughout the 1990s. Like the commercial banks, merchant banks, consequent on the intense competition for deposits through high interest rates, also experienced reduced profit positions in the 1990s. Concurrently, there was a decline in the number of trust companies and finance houses in their purest form as their operations were steadily marginalised by the lease financing activities of the merchant banks which consequently sought to cross over before the new FIA legislation was implemented. The devaluations of the Jamaica dollar had a significant impact on the price of capital equipment and as a consequence many business firms had to seek assistance in terms of lease financing from these institutions.

The major provisions of the new Financial Institutions Act governing near-bank financial institutions (i.e. merchant bank, trust companies and finance houses) related to the following:

a) Licensing of merchant banks.
b) Minimum levels of capital (subscribed capital- J$25mn and unimpaired paid-up capital - at least J$20mn)
c) Minimum levels of deposit and provisions for possible loan losses
d) Greater scrutiny of persons acquiring control of institutions
e) Strengthening of the powers of bank supervision
f) Stricter controls on activities such as insider loans
g) Comprehensive mechanism for identifying and dealing with offences.

As the monetary authority intensified its regulatory function over merchant banks, pressure was placed on them to also adhere to credit restrictions as well as other monetary policy measures which were implemented to contain money demand. As a consequence the incidence of commercial banks limiting the effectiveness of monetary policy through merchant banks was significantly reduced in the 1990s. However, many merchant

banks, in defending their position, insisted that the flexibility of their operations was limited by their inability to create demand deposits.

By 1994 there were 26 merchant banks relative to eight at end of 1985. In 1995, the number of merchant banks operating fell to 25. On 10 July 1996, Century National Merchant Bank and Trust Company Limited was placed under temporary management of the Ministry of Finance while, on 1 October, the Mutual Security Merchant Bank & Trust Company and the NCB Trust & Merchant Bank were merged with the new entity retaining the name of the latter. With the cash reserve ratio unchanged at 17 per cent, the LAR was 35 per cent at the end of December 1996. By the end of 1997 there were 27 FIA licensees with total assets of $20.7 billion compared to $17.5 billion at end 1996.

On 2nd June 1999, the business of Citifinance Limited was transferred to Citimerchant Bank while the acquisition of Billy Craig Finance and Merchant Bank by Dehring, Bunting & Golding (DB&G) and FINSAC under a joint venture, with an accompanying name change to DB&G Merchant Bank Limited, was finalised.

Loan Operations

Loan operations of the merchant banks were influenced by monetary policy measures, in particular, credit controls which were effected by the monetary authorities up until January 1991 when these were removed. Notwithstanding this, instalment credit and lease financing arrangements continued to be a major aspect of the loan operations of the merchant banks. The major areas of loans offered by the merchant banks were:

1) Commercial/private motor vehicle purchases;
2) Real estate;
3) Industrial and agricultural equipment;
4) Local manufactured products;

However, based on the fact that these institutions were largely involved in the short-term financing, the merchant banks were seen as competing with or duplicating the services of commercial banks, particularly because many of these institutions were affiliates of the commercial banks. Hence, on the whole, merchant banks implicitly failed to fulfil their initial role as players in the medium to long-term market. In fact, from the early 1970s, with increasing credit restrictions placed on commercial banks by the central bank, many had channelled funds through their merchant banks in order to

bypass monetary policy regulations. This was based on the fact that the statutory liquid assets requirement (LAR) for merchant banks was below that required for the commercial banks (at the end of 1990 liquid assets requirement for PDA 8.0 per cent, commercial banks 33.5 per cent). Based on the inequity in the LAR, merchant banks generally had more resources available for lending.

Deposits

Merchant banks continued to be extremely aggressive in their mobilisation of deposits in the 1990s, a development observed especially since 1987. Between 1989 and 1990, the deposit structure of the merchant banks (like the commercial banks) was largely skewed in favour of short-term flows. Offering very high interest rates influenced by BOJ open market operations, these institutions continued to attract substantial funds to support their lending activities, albeit at a slower pace. Notably, the slower pace of deposit build up in the 1990s was partly influenced by the diversion of funds to less regulated financial institutions. Whereas in 1992 deposit growth was 96 per cent, by 1993 and 1994 deposit growth had fallen to about 11 per cent. By 1996, there was a 1.9 per cent decline in deposits.

Trust Companies

The number of trust companies (all affiliates of commercial banks) continued to experience a decline in the early 1990s, a development observed since 1986/87. The trust companies, in addition to their trustee services, continued to offer mortgage facilities and other limited loan services. However, their licence did not permit lease financing arrangements, a major income earner for merchant banks in particular. Accordingly, trust companies, whose services were largely duplicated by the merchant banks, declined in numbers from ten in 1981 to three in 1990 and by the end of 1993, with the revocation of West Indies Trust's licence, ceased to exist in their "purest" form. At the end of 1990 total assets and liabilities of trust companies stood at J$109.1 million, with deposits at J$86.36 million and loans outstanding at J$74.84 million. (see Appendix).

Loan Operations

Mortgage financing, the principal type of loan activity conducted by the trust companies, accounted for in excess of 80 per cent of total outstanding loans. Prior to January 1 1991 when credit ceilings were removed, loan

activities of the trust companies were also affected by broad credit controls which had an impact on the overall revenue of these financial institutions. Similar to other PDA institutions, trust companies invested significant funds in high yielding short-term securities (CDs, Treasury Bills) in order to increase their profit margins, especially in 1989 and 1990, rates offered being influenced by those offered on the Bank of Jamaica's open market operations.

Deposits

Trust companies, in order to effectively compete with other financial institutions for resources, were forced to offer relatively high interest rates on deposits. However, in view of the fact that their loan activities were primarily long-term, their deposits had to be similarly structured offering higher rates on longer-term categories. This had a negative impact on these institutions given the highly competitive financial environment which prevailed since 1986/87. Generally, customers in their effort to speculate on the value of the Jamaica dollar and with increasing expenditure on imports (primarily consumer goods) often preferred to save short-term. Notably the prevailing high rates offered on deposits also implied high mortgage rates. As a consequence many customers have either sought to divert their funds to the more flexible merchant banks, or switched to building societies which offered lower interest rates on mortgages.

Finance Houses

The growth in finance houses, similar to the trust companies, continued to decline between 1986 and 1990. At the end of 1990, six institutions were operational relative to nine in 1986, with the numbers falling to five in February 1991. These financial institutions, which were very active in the short-term market providing interim financing, offered services which were duplicated by the merchant banks. These included lease financing and instalment credit (hire purchase) arrangements. However, notwithstanding their ability under the FIA to offer lease financing, which was lucrative for the merchant banks, many finance houses also converted their operations to merchant banking which, they considered, enabled a wider scope of operations. At the end of 1990, total assets and liabilities of finance houses stood at J$265.8 million.

Loan Operations

The loan activities of the finance houses were generally directed to consumer-oriented financing. As was the case with the other PDA institutions, monetary policy requirements, including credit restrictions and adjustments in liquidity ratios, negatively affected loan expansion by finance houses particularly between 1985 and 1990. Accordingly, high interest rates featured in the system since 1985 and as conditions tightened with Bank of Jamaica's policy measures to absorb liquidity, interest rates rose even further. Notably, the interest rates on hire purchase, calculated on an add-on basis, tended to be higher than general commercial rates. In addition, because of the high rates being offered to attract deposits, lending rates were further pressured in this period.

Deposits

The deposit structure of the finance houses between 1985 and 1991 indicated a concentration of flows in the short-term categories which offered more attractive rates of interest. These rates were largely influenced by the rates offered on short-term CDs and Treasury bills. However, with strong competition from merchant banks, there was a downward trend in deposit liabilities of these institutions because of the limited scope of their operations which were out of line with the needs of many customers. In particular, the inability to offer trade credit to importers was a limitation to expanding the institutions' customer base.

Building Societies

At the end of 1990 there were six building societies operating in Jamaica with assets and liabilities totalling J$2948.8 million. In the early 1990s (prior to 1995) financial managers saw building societies[38] as avenues to attract funds and avoid the statutory cash reserve requirement for the banking system as these institutions were not required to hold statutory cash reserves. Many commercial banks saw building societies as an attractive source of cheap funds and in this regard, given the competitive financial environment, sought these institutions as an avenue to pool or expand available resources and services to meet the needs of customers. The disparity in the LAR led to alliances of building societies with other financial institutions that were facing high cost of funds. Accordingly, all

[38] The Building Societies Act was amended in 1987 and again in 1996

except one building society had some affiliation with another financial institution (i.e. commercial bank or PDA institution).

In July 1991, building societies were authorised to sell foreign exchange which enabled them to further diversify their operations. In a context where these institutions had a broad base of overseas clients comprising non-resident Jamaicans who held savings accounts in Jamaica (many to facilitate the purchase or construction of homes in the future), the building societies had a guaranteed source of foreign exchange. This guaranteed source also enhanced the attractiveness of their operations.

Although many building societies provided monthly reports on their activities to the umbrella organisation, the Building Societies Association of Jamaica (BSAJ), membership was voluntary. Further, although the central bank had access to these reports on request, when received, these were used primarily for macroeconomic analysis and as such were submitted only to the research arm of the central bank. As a consequence, the environment in which they operated was largely unregulated despite the fact that a number of institutions were also affiliated to financial institutions supervised and regulated by the central bank. In March 1994, building societies were designated "specified financial institutions". This gave the BOJ the power to supervise and examine their operations with the new amendments affecting several areas including supervision and licensing, capital adequacy and loan loss reserves.

In March 1995, the BOJ Act was amended to require the societies to hold prudential reserves. In June, a liquid assets ratio of five per cent (including a cash reserve of one per cent) was imposed. Against this background, the number of building societies grew from six in 1990 15 at the end 1994, although the expansion was not accompanied by a commensurate increase in housing stock. Instead, many of these institutions also ventured outside their core business, channelling funds to their affiliates as well as investing in high-priced real estate. The noticeable growth in the number of institutions, particularly in 1994, resulted in a major shift in market share between the traditional entities and the smaller, newer ones. Accordingly, the two major societies (Jamaica National Building Society and Victoria Mutual Building Society) accounted for 48.5 per cent of total assets of the group by the end of 1994. However, following the new designation, the growth of the building societies slowed in 1995 with the deceleration in asset growth most evident among the four oldest institutions. Although in

1995 there were 34 building societies, only 15 were members of the Building Societies Association of Jamaica (BSAJ).

In 1996, in the context of the new regulations and the restrictive monetary policy environment, the building societies were faced with many challenges with a number of institutions failing to meet the new requirements. In that year, two societies were placed under temporary management by the Ministry of Finance, while another went into voluntary liquidation. The entities placed under temporary management were First Metropolitan Building Society (FMBS) and Century National Building Society (CNBS). Notably, FMBS at the date of temporary management was acquired (November 1996) by Jamaica National Building Society (JNBS) while the Hanover Benefit Building Society was merged with the JNBS (March 1996). By the end of 1996, the number of building societies in operation had fallen to 13 from 34 the previous year, with the three largest institutions accounting for 80 per cent of total assets and liabilities.

The two large societies continued to dominate the group in 1997 increasing their market share by five per cent and performing their traditional role as mortgage lenders. With three smaller societies going into voluntary liquidation, the number of building societies fell to ten by the end of 1997. With the merger of the Horizon Building Society into Citizens Bank (renamed Union Bank) and the closure and payout to depositors of Century National Building Society, the number of societies fell further to eight by the end of 1998. The year 1999 saw further consolidation/rationalisation of the building societies. On 1 April 1999, the operations of Capital Assurance Building Society (CABS) and Citizens Building Society were merged into Eagle Permanent Building Society (EPBS). In September, the deposits of the pre-merger EPBS were transferred to Jamaica National Building Society (JNBS), along with a portion of its post-merger loan portfolio. The remaining deposits and assets of the EFBS were to be sold or transferred to UBJ and the EPBS wound up. During the year, three institutions were merged and consequently at the end of 1999, only five building societies were in operation. The year 1999 also marked the implementation of new withholding tax measures at the start of June, which had a major impact on the operations of these institutions. Hence by end 1999 the assets and liabilities of the building societies had fallen 13.9 per cent below the level at the end of 1998.

Loan Operations

The loan operations of building societies continued to be primarily in the area of mortgage financing for members and traditionally favoured the owner-occupier category. Because of the escalating cost of housing since 1983, the average loan size increased significantly in the early 1990s while the rate of growth in the number of loans slowed somewhat. Up to 1994, parliamentary approval was required for adjustment of interest rates. Thus, because these institutions were unable to adjust mortgage rates based on their own assessments of the competitiveness of the environment, loans offered through these institutions were cheaper to members than those acquired from other financial institutions. Further, whereas other financial institutions were subject to credit restrictions imposed by the central bank, this was not the case for the building societies, another factor which also favoured the establishment or acquisition of building societies by other financial institutions. Accordingly, the loan portfolio of the building societies quadrupled between 1992 and 1994, increasing by 94 per cent in 1994. However by 1995, following their designation as "specified financial institution" there was a slowing in the growth of the loan portfolio to 30 per cent and to 13.6 per cent in 1996.

Deposits

Deposit inflows into these institutions continued to be largely in the form of share-holdings which influenced the ability of members to access loans. Interest rates offered on regular share accounts were very low (given parliamentary requirement) although higher rates were payable on fixed deposit accounts. Because of the comparatively low deposit rates, the availability of funds for on-lending was lessened, many invested in high interest earning securities in order to improve income. Notwithstanding this, these institutions continued to be very successful in attracting members largely because of their mortgage facilities (which included low interest mortgage saving plans) and special concessions for members. The success in mobilising savings was also supported by the broad base of the institutions in terms of location in Jamaica and overseas as well as, their traditional record of providing funds for homes at a more affordable rate for Jamaican migrants and residents. Because of the success of building societies in mobilising savings, many financial institutions, especially after 1986/87, sought to expand their operations into conglomerates which included a building society. With a reduction in the number of building

societies in 1999, savings funds fell by 5.7 percent

Credit Unions

The credit union movement in 1990 continued to provide a source of loans for low to middle income borrowers who have shares in these institutions. These financial entities brought institutional services to rural and urban areas not generally served by major financial institutions. Given that many of their members were generally new entrants to the financial system, the growth of these savings suggested increased monetisation of the economy, rather than re-allocation of existing financial balances from one institution to another. In 1990 however, the numbers fell to 80 from 86 in 1989 (88 in 1988) as more institutions were affected by the change in the taxation regime in 1987. Prior to 1987, saving with the credit unions offered a very attractive incentive as funds accumulated in these institutions were exempt from income tax, a fact which largely explained the growth in the movement in the early years. In 1991, however, as the demand for affordable housing increased given the high interest rate environment, the credit unions were seen as a source of funding providing bridge financing and deposits for home purchases in particular. In addition, borrowing from these institutions was seen as an attractive option for hire purchase arrangements which had become very costly given the increase in interest rates. These factors encouraged the formation of four new institutions bringing the total to 84 by year end.

The group remained unchanged in 1992 but increased to 86 by 1993 with membership growing by over nine per cent, despite the increasingly competitive environment. Notably, the increase in membership was largely associated with the launch of credit card facilities (Visa and MasterCard) through the Century National Bank (CNB) in that year, a response to the competitive financial environment in which the credit unions operated. The group remained vibrant throughout 1994 as the demand for affordable loans (housing and consumer-oriented) increased and membership increased by 9.8 per cent. In that year, the Credit Union League established a Housing Development Fund which offered mortgage loans below market rates. Equity participation was invited from all credit union members. Growth continued unabated in 1995 with assets increasing by 34.2 per cent and membership growing by 7.3 per cent.

The outstanding growth rate of the Credit Union League was maintained in 1996, partly attributable to the efficient operation of its ‘central finance

facility' which provided a pool of resources to individual credit unions at concessionary rates. The pool, which was funded by deposits from credit unions and which was partly re-invested by fund managers, enabled credit unions to provide substantial mortgages (up to $600,000) to their membership. In addition, the movement continued to modernise and consolidate its operation in that year, implementing automatic banking services. Despite a fall in numbers to 73 in 1997 from 77 in 1996, consistent with developments in the macroeconomic environment, assets and liabilities grew by 30.7 per cent while membership grew by 2.4 per cent. Growth continued apace in 1998 and 1999 as credit unions remained a reliable source of loans at attractive rates of interest. In June 1999, discussions and preparations commenced for credit unions to be brought into the group of Specified Financial Institutions, to be supervised by the BOJ. However, the League was still in discussion regarding the requirements and details of supervision in 2008.

Loan Operations

The demand for loans from the credit union movement increased steadily over the years as economic conditions became tighter for the middle to low income earner. Of note, by the end of 1990, the loan portfolio had grown to J$642.6 million. This is in a context where between 1965 and 1972 loans advanced by credit unions rose from J$4.4 million to J$13.1 million and by the end of 1979 loans had moved to J$112.6 million. The interest rate on loans from credit unions were, however, fixed by government and as such, their response to changing economic conditions was also slower. In this context, their interest rates were generally lower (12.0 per cent per annum on reducing balance at end of 1990) than those which prevail in financial institutions. This was seen by the movement as a negative factor which could cripple the movement as economic conditions continued to deteriorate and market interest rates rose. With the deregulation of interest rates by 1992 and in a context of the increased demand for affordable loans, there was a notable expansion (28 per cent) in the loan portfolio of credit unions. With the launch of new financial instruments and further diversification to improve their competitiveness in a high interest rate environment, loan expansion was even more significant (38.1 per cent growth) in 1993. The loan growth remained robust in 1994 in a context where lending rates (average 24 per cent) were still well below market rates (average 60 per cent) and in 1995 loan expansion was 42.3 per cent relative to the previous year. Although there was a decline in the

rate of growth of loans to 35.7 per cent in 1996, this was largely explained by the deceleration in inflation, as well as an increase in mortgage financing by the National Housing Trust (noticeable from 1995). Following moderate loan expansion in 1997, in the context of a sharp fall in inflation, the loan portfolio grew strongly in 1998 and 1999.

Savings

Because of the low rates charged on loans, credit unions were forced to offer relatively low rates on deposits. Although credit unions found it more difficult to compete with other financial institutions for savings, the level of savings moved from J$2.3 million in 1961 to J$57.1 million in 1977 to $684.0 million in 1990. With the deregulation of the savings rate in 1992 and the more accommodating loan facilities, savings grew by 46.3 in 1993 with the average savings per member increasing by 34.1 per cent. In this regard, whereas growth in the movement up to the 1980s was partly influenced by tax incentives, the continued growth in savings in the 1990s could be explained by the growing demand for low interest loans to purchase goods in an increasingly inflationary period. As a consequence, individuals sought to buildup share accounts in order to qualify for larger loans. In 1994, total savings were 46.4 per cent higher than in 1993 and although there was slower growth to 29.4 per cent in 1995, the lending base remained strong, bolstered by the institutions' continued investment in attractive government instruments. In 1996, total savings grew by 50.7 per cent as members sought to benefit from the attractive mortgage terms. In 1997 savings grew by 31.2 per cent; however there was a deceleration to 24 per cent in 1998 and 22 per cent in 1999. Despite this, the institutions remained strong as confidence in the sector strengthened against the background of declines in other financial institutions and overall restructuring under FINSAC, as well as through initiatives to expand the range of financial services and products.

Development Banks

With plans in place for the termination of the Jamaica Development Bank by 1990, the Agricultural Credit Bank (ACB) and the National Development Bank (NDB) were considered the only remaining publicly-owned development banks.

Their expansion up to 1990 was not only facilitated by restructuring the needs of borrowers following the 1988 hurricane, but also by the

concessionary rates offered on loans as well as exemptions of their funding from banking system credit controls. By 1991, however, the lending activities of these institutions was somewhat affected by higher interest rates, given the requirements of overseas lending agencies which stipu1ated the application of market determined rates on funds on-lent to clients. The fall in interest rates in the latter half of the 1990s subsequently contributed to a decline in their balance sheets and lower profits. As a consequence the Government subsidized interest rates charged by the NDB and ACB through an injection of financial resources in order to enable these institutions to remain viable.

Trafalgar Development Bank (TDB)

The Trafalgar Development Bank continued to exhibit growth in 1989 and 1990 injecting substantial developmental financing in the manufacturing and tourism sectors in particular. Attracting significant foreign equity financing as well as other loans from overseas development financiers, this private institution experienced asset growth of J$172.2 million between 1986 and 1990. Given the rapid convergence of the cost of funds with international commercial rates by 1993, the Trafalgar Development Bank sought to improve its viability through diversification of its operations. In this regard, the TDB acquired the assets of First Jamaica National Bank Limited (FJNB), selling 49.0 per cent of its interest therein to Grace Kennedy Company Limited, while phasing out its own advisory business service operations (TABS). Consequent on the restructuring and broadening of its assets base in 1993, the TDB experienced further expansion in assets and liabilities in 1994 despite the dampening effects of prevailing high interest rates which reduced the demand for Jamaica dollar denominated loans.

The institution maintained its importance as a provider of medium to long-term financing to private sector productive enterprises up to 1996. However, its operations were somewhat constrained by the soft investment environment which prevailed in much of 1996. Loans and leases increased only marginally by 12.7 per cent in 1996 compared to growth of 82.8 per cent in 1995. As a consequence, the institution recorded asset growth of J$36.7 million or 1.6 per cent in 1996, in contrast to an expansion in assets and liabilities by J$973.2 million or 75.0 per cent in 1995. Of note, long-term foreign exchange financing for the productive sector accounted for 77.0 per cent of total new financing in 1996.

In a context where the return on investment in Government securities remained attractive despite a fall in interest rates, investments grew by 75.6 per cent in 1996. On the other hand, the lower interest rate environment had a negative impact on cash resources, particularly in the latter half of the year. Despite the continued soft investment environment in 1997, the loan portfolio of the TDB grew by 19.3 per cent in 1997, contributing to a 21.8 per cent increase in assets and liabilities. However, in 1998, the institution's operations were affected by problems in the financial sector which had a negative impact on revenue. Loan growth was a mere 1.4 per cent, partly affected by the fact that the institution was not a beneficiary of subsidized interest rates (as were the ACB and NDB). Accordingly, the bank's assets and liabilities grew by only 0.9 per cent. In 1999, the assets and liabilities recorded growth of 6.4 per cent while profits increased by 40 per cent relative to 1998. In June 1998, the bank was appointed as one of two wholesale agents under the GOJ and EU Micro and Small Enterprise Credit Scheme which became operational in 1999.

Agricultural Credit Bank (ACB)

The Agricultural Credit Bank remained financially viable in the 1990s despite the challenging macroeconomic environment and the requirement that lending should be at market rates. Accordingly, the performance of the ACB was relatively subdued in 1992 when the institution moved to a more market-oriented stance. Although this had some impact on loan demand, the institution was able to partly offset income loss by investing in Government securities. By 1993, however, with a moderate decline in interest rates and an increase in lending through other financial institutions (mainly the Peoples Cooperative Bank), the assets and liabilities of the ACB grew by 32.9 per cent.

In a context where significant funds mobilised by the ACB were from overseas lending agencies, the Bank was not adversely affected by the significant devaluations of the Jamaica dollar between 1990 and 1995. However, in 1996, a decline in domestic interest rates coupled with significant appreciation of the Jamaica dollar vis-à-vis its United States counterpart, had an overall negative effect on the operations of the Agricultural Credit Bank. Consequent on the revaluation, the bank experienced a substantial reduction in proceeds from the US$10.0 million debenture floated in the previous year, which, along with a decline in overseas loan receipts (in Jamaican Dollar terms), severely reduced

resources available to the institution. With lower rates charged on loans extended by the institution during the review year, the income earning potential of the bank was also constrained in 1996.

Based on these developments, the bank experienced a decline in profitability in 1996, as net profits fell to J$13.3 million from J$37.8 million in 1995. While the overall assets and liabilities of the ACB grew by 4.2 per cent in 1996, this was well below the 16.8 per cent increase recorded in 1995. Contributing to the growth in assets in 1996, was a J$320.1 million increase in other assets (of which unrealized losses on a Caribbean Development Bank -Government guaranteed loan accounted for J$291.0mn) and a J$184.7 million expansion in loans to financial institutions. Of overall loan expansion in 1996, J$111.1 million was channelled through Peoples Cooperative Banks, while J$52.3 million was channelled through affiliate financial institutions (including commercial banks) during the review year. Notably, increased loan disbursements through the PC banks in 1996, was consistent with the ACB's continued commitment to its Rural Financial Services Project.

The ACB remained fairly liquid throughout 1996, despite a decline in earnings on interest-bearing securities and other financial instruments in the second half of the year. However, the institution experienced a significant contraction in other receivables, largely attributable to exchange rate losses given revaluation of foreign currency loans. This contrasted with the previous year when receivables due from Government increased as a result of the impact of devaluation on foreign loans. The assets and liabilities of the bank expanded by 23.9 per cent in 1997, influenced by a 45.6 per cent growth in loans (24.5 per cent increase to PC banks), financed through loans borrowed under a domestic credit facility. However, the institution recorded a small loss relative to moderate profit recorded the year before. The loss in 1997 came against the background of reductions in the institution's lending rates in a context where the rate was de-linked from the Treasury bill rate and aligned to the savings rate. The bank continued to experience strong growth in 1998 with assets and liabilities increasing by 86.7 per cent, driven by an expansion in credit. Notably, a Government subsidy on interest rates coupled with an expansion in loans contributed to a reversal to profit from a loss position the previous year. Against the background of a sharp reduction in its loan portfolio, the assets and liabilities of the ACB remained flat in 1999 influenced by a sharp contraction in loans through affiliate financial institutions (AFIs).

Notwithstanding this, the bank recorded a moderate profit in 1999.

National Development Bank (NDB)

Consequent on the transfer of resources to the National Development Bank from the Government of Jamaica, the NBD recorded growth in assets and liabilities of 70.3 per cent in 1992. In 1993, supported by Government loans and more significantly by funding from the Caribbean Development Bank (CDB) and the European Investment Bank (EIB), the institution recorded modest growth of 5.1 per cent. Notably, the bank's balance sheet reflected activities in the money market which generated high returns in that year. Following moderate growth in 1995, NDB profits fell by 7.8 per cent, the bank experienced a turnaround in its performance in 1996, recording a 64.4 per cent growth in profits. The assets and liabilities of the institution grew by 47.9 per cent in 1996 compared to growth of 31.3 per cent in 1995. The improved performance of the National Development Bank in 1996 was achieved against a background of revaluation of the Jamaica dollar vis-à-vis its United States counterpart and lower inflation rates during the year.

The institution, which continued to offer attractive interest rates on development loans under its Interest Rebate Scheme (IRS), ensured reduction in foreign exchange risk during the review year, by maintaining its policy of requiring borrowers to repay foreign currency loans in hard currency. Lending to the productive sectors increased by 81.7 per cent relative to growth of 33.1 per cent in 1995. Although the bank continued to receive funding from overseas lending agencies such as the EIB and the CDB, domestic borrowing from the Government of Jamaica, National Investment Bank of Jamaica and the Jamaica Development Bank remained significant. With interest rates on securities and commercial bank certificates of deposits fairly competitive throughout 1996, liquidity levels in the NDB were fairly high compared to 1995. The assets and liabilities of the NDB fell by 3.3 per cent in 1997, but reflected a turnaround in 1998 when the balance sheet improved by 6.2 per cent.

In 1999, there was a major shift in the modus operandi of the institution whereby a larger portion of on-lending was directly to customers relative to previous years when funds were channelled through FIS licensees. Against this background, there was also a 2.4 per cent decline in assets and

liabilities as receivables and prepayments grew by 20.6 per cents. Loans increased by 5.9 per cent with tourism being the major beneficiary.

Peoples Cooperative (PC) Banks

Efforts at transforming PC banks into viable entities continued in the 1990s. In 1995, a major programme was launched towards transforming these banks into a viable and autonomous network of community banks in the rural areas of the country. The programme, called the Integrated People's Cooperative Bank Network (IPCBN) was launched, funded by the Government, the International Fund for Agricultural Development (IFAD) and the Canadian International Development Agency (CIDA). The Agricultural Credit Bank was charged with the task of implementation which saw the merger of the 116 PC banks in operation into 18 individual banks. The programme involved the renovation and construction of buildings, computerisation of banking operations, establishment of new accounting systems, and introduction of new services, among other improvements.

The National Export Import Bank of Jamaica (Ex-Im)

The Export Development Fund (EDF) was established in 1992, providing US dollar loans, repayable from export receipts to the non-traditional export sector. Despite the removal of exchange controls, the bank experienced a disappointing performance in both local and foreign currency loan disbursements. However, the full effect of liberalisation of the exchange control was not evident until 1993, when there was a noticeable increase in the level of utilisation of foreign currency loans. Concurrently, the demand for local currency credit facilities also increased, with the heightened demand fuelled by the relatively high interest rates charged by other financial institutions, as well as continued devaluation of the Jamaica dollar. While the bank continued to offer insurance protection to exporters' foreign currency receivables against political and commercial risk, the facility remained under-utilised as it was slow in gaining acceptance among the local financial institutions. Although the EDF became fully incorporated into the operations of the Ex-Im Bank in 1993, the resources continued to be under-utilised. The Bank also provided three types of local currency facilities, namely, the Pre-Shipment Financing Facility (PSF), the Bankers' Export Guarantee Facility (BCF) renamed the Export Credit Facility in the year and the Bankers' Export Credit Facility

(BECF) in accordance with its commitment to support and facilitate the export sector.

The demand for local and foreign currency loans further expanded in 1994, and despite an injection of additional equity by shareholders, this was still inadequate to meet the demands on the bank. The strong demand for local currency loans stemmed from the non-traditional sector which sought funding to enhance external competitiveness. Given the exceptional demand for local currency resources, the bank had to temporarily close its discount window for such loans. Local currency loans grew by 13.6 per cent in 1994. The bank recorded mixed performance in 1995 reflecting continuation of a trend observed following liberalisation. Local currency loans continued to expand (30.2 per cent) achieving their highest level in the nine-year history of the institution. On the other hand, the foreign currency loan portfolio underperformed in that year as the export sector apparently required less support from the bank. The low demand was also observed in other foreign currency-related facilities and in particular, export credit insurance which was also under-utilised. Lending to the non-traditional export sector became the major source of revenue for the institution as exporters sought to take advantage of the relatively cheap source of loans, given that lending was well below market rates. In order to meet the local loan demand, shareholders' equity was further increased by $50.0 million.

The year 1996, which marked the tenth year of operations for the entity, was mixed. The bank changed its financial year from calendar to fiscal commencing in March. Whereas local and foreign currency loan growth improved, the performance of export credit insurance was again disappointing, with declines in all major areas. Local currency disbursements grew by 11.1 per cent with manufacturing and agricultural sectors dominant in the use of short-term credit. The demand for loans by small businesses strengthened substantially, a reversal of the previous year when hurricane-related problems affected loan demand. The implementation of a graduated stratification of lending rates enabled lending to the smaller borrower at even more preferential rates. Foreign currency disbursements expanded by 15.2 per cent. The bank's operations in 1997 must be viewed in the context of the problems in the financial sector, which began in 1996. Facing a general down-turn in non-traditional exports, the bank was challenged to rethink strategies for assisting the sector. Accordingly, the bank restructured and reduced its multi-tiered

interest rates charged on loans and introduced new products and facilities to assist the export sector. The authorised share capital was also increased from J$100.0 million to J$300.0 million with share ownership of the Government increasing to 62 per cent from 50 per cent. The institution also commenced lending to overseas importers of Jamaican goods, through 'buyer credit facilities'. Local currency disbursements fell by 24.6 per cent relative to the previous year while foreign currency disbursement increased by 16.0 per cent. Continued high interest rates and production costs continued to adversely affect exports and, by extension, export credit insurance, extending the declining trend observed in 1996.

Life Insurance Companies

The life insurance industry which was governed by the Insurance Act of 1971, with supervisory oversight provided by the Superintendent of Insurance, reflected significant weaknesses in its legislative and supervisory framework in the 1980s and 1990s. As a consequence, weak management practices and risky investment behaviour went undetected as in many instances financial returns were made to that office years after the due date. Many insurance companies created subsidiaries in the form of trust companies, finance houses and merchant banks, and affiliated themselves with commercial banks through which they were able to complement short-term lending with long-term leases and mortgage financing. Consequently, institutions became more aggressive, embarking not only into more innovative financial activities but also stretching beyond the boundaries of prudent financial practices into real estate investments. Further, the tax system favoured the writing of new insurance business rather than the maintenance of business beyond two years old. This led to excessive commissions to agents which, along with their relatively small size, led to high operational costs. These developments were particularly evident in the early 1990s period of high inflation.

Insurance companies took advantage of the weakness in regulation and supervision in some instances through the sale of interest-bearing policies which involved only a small premium for insurance and a large proportion being taken as a deposit which was not subject to withholding tax. These policies enabled insurance companies to access large amounts of cash which enabled them to make investments in real estate and other long-term assets which resulted in a severe mismatch of assets and liabilities. As a consequence when the real estate market bubble burst by the mid-1990s, there was a severe liquidity crunch bringing to the fore the inadequacy of

the regulatory and supervisory environment, not only in respect of financial transactions but also in terms of tax administration.

The unprecedented cash outflows created by the encashment of short-term deposits such as insurance policies, resulted in severe liquidity problems for the life insurance industry which, through contagion, impacted affiliated commercial banks. Thus, from a marginal encashment of $148.6 million in 1991, this figure jumped to $3.3 billion in 1993, consequent on a collapse of the equity market. Faced with a large mass of assets acquired with high cost funds whose values had slumped engendering a liquidity crunch, a number of insurance companies were either taken over by government or placed on life support. Although there was a moderate improvement in 1995 in the encashment figure to $1.1 billion, this deteriorated to $3.5 billion in 1997 associated with the sharp decline in the real estate market in which many of these companies had significant investments.

8.4 The Financial System – 2000-2008

At the start of 2000, the financial system comprised:

- Commercial Banks
- FIA licensees (merchant/trust/finance companies)
- Credit Unions
- Building Societies
- Development Banks
- The Development Bank of Jamaica (merger of ACB and NDB)
- Trafalgar Development Bank (Private)
- People's Co-operative Banks
- Export Import Bank (EXIM -formerly JECIC)
- Insurance Companies

The supervisory/monitoring authorities in place were:

- The central bank (primarily through its Financial Institutions' Supervision Department, FISD)
- The Financial Securities Commission (FSC)
- The Jamaica Deposit Insurance Corporation (JDIC)

The principal legislation governing the operations of banks and other financial institutions were:

- The Banking Law
- The Financial Institutions Act, - consolidated supervision of FIA

licensees (2003) under the IAS/IFRS
- The Building Societies Act
- Bank of Jamaica (Building Societies) Regulations - amended Oct 1997 to enhance the supervisory authority of the BOJ.

These laws and regulations established stricter fit and proper controls and restrictions on lending activities in a context where controls were either limited or weak in the previous regulatory framework. External auditors of financial institutions were also obligated under law to reveal problems in a financial entity. In the case of the building societies, the Act also provided for dual cash reserves for building societies based on the size of the capital base.

Financial sector developments in the early 2000s were characterized by consolidation, mergers and closures. In addition there was an emergent dominance of foreign owned banks. In the context of financial sector problems resulting from diversification into areas which weakened the balance sheet, many institutions sought to return to core business. Significant efforts were also made at improving corporate governance. Many small institutions, in an effort to remain competitive and in business, also sought to consolidate assets or merge with other institutions in order to increase their capital base and/or meet capital requirements. In April 2000, the ACB and the NDB were merged to form the Development Bank of Jamaica, DBJ. Most financial institutions experienced slower growth in operations as a fall in interest rates (especially after 2003) impacted negatively on their balance sheets. In order to improve asset growth, many financial entities sought to increase their foreign exchange assets portfolio, making large spreads on foreign exchange transactions.

The financial sector remained stable throughout 2001 despite an increase in interest rates on open market operations instruments by the central bank in October aimed at minimizing the impact of a deceleration in foreign exchange inflows on the financial sector. In 2002, Jamaica adopted the international accounting standard (IAS) aimed at enhancing transparency in the management and valuation of financial firms and facilitating cross country comparability of the performance of the banking industry. The financial sector continued to expand, influenced by improved provision of commercial banking and related services. Legislation, which was passed in March, requiring licensees to separate deposit-taking activities from managed funds by transferring the latter to a separate legal

entity, was implemented. Accordingly, Scotia Jamaica Trust & Merchant Bank surrendered its deposit taking license in November 2002.

The year 2003 posed severe macroeconomic challenges for the country. Uncertainty in the domestic market coupled with unfavourable conditions in the international capital market contributed to very unstable foreign exchange market conditions and a sharp depreciation of the exchange rate. In this context, the announcement in December 2002 of a significant fiscal disjuncture and the downgrade of Jamaica's sovereign debt by Standard and Poor's created uncertainty in the domestic economy by January 2003. This was exacerbated by news of an impending war between the USA and Iraq and with the prospect of the Government raising funds externally to cover a maturing Eurobond in February being unfavourable, amortisation of foreign debt was financed from the NIR. The resultant sharp fall in the NIR contributed to significant speculative activity with investors switching from domestic currency assets to foreign currency investments in Jamaica and abroad.

The implementation of the International Accounting Standards/International Financial Reporting Standards (IAS/IFRS), the separation of official balance sheet 'funds management' activities and movements in exchange rates and interest rates were the predominant factors affecting the performance of licensed deposit taking financial institutions in 2003. Market conditions improved significantly in 2004, reflecting restoration of strong foreign and local investor confidence, fuelled by foreign exchange market stability, a build up in foreign reserves and an expansion in output. The trends were reinforced by Government's stated commitment to meet its fiscal targets. Early in the year, the Government and the IMF agreed to enter into a non-borrowing relationship termed 'Intensified Surveillance Programme' (ISP). Under the programme, annual and semi-annual performance targets were established, consistent with the GOJ economic objectives of a reduction in the debt burden, inflation moderation and growth. During the year however, the economy was affected by severe weather (tropical storm and hurricane) as well as increases in world oil prices. These factors had an impact on inflation which, despite moderation relative to the previous year, exceeded single digit (13.7 per cent).

The stable conditions that prevailed in 2004 were evident in the first half of 2005. However, three hurricanes coupled with a steeper rise in oil prices

had a negative impact on the economy in the second half of the year. Although headline inflation and output were less favourable than programmed as a consequence of the external shocks, these indicators reflected improvements relative to the previous year. Annual inflation moderated to 12.9 per cent from 13.7 per cent in 2004 while growth was 1.4 per cent relative to 1.0 per cent in 2004.

Macroeconomic conditions improved in 2006 in a context of heightened investor confidence and favourable international developments. The foreign exchange market was relatively stable particularly in the latter half of the year. GDP growth accelerated to 2.5 per cent driven by a rebound in agriculture and robust tourist arrivals. Inflation fell to 5.8 per cent. The financial landscape remained unchanged in 2006 with commercial banks maintaining the dominant share of the system's assets, increasing to 75.1 per cent relative to 73.7 per cent at end 2005. Building societies continued to account for the second highest share (17.9 per cent relative to 17.5 per cent in 2005). FIA licensees share declined to 7.9 per cent in 2006 from 8.8 per cent in 2005 due to a strategic restructuring of one of the licensees' balance sheet. In 2007, a sharp rise in international commodity prices, including oil and grains as well as adverse weather conditions, had a negative impact on the domestic economy. GDP growth was constrained to an estimated 1.1 per cent, while annual inflation rose sharply to 16.8 per cent. The financial sector remained stable however, notwithstanding sharp exchange rate depreciation and the world liquidity problems engendered by the sub-prime mortgage crisis. By the second half of 2008, the collapse of Bears Stearns and other major financial institutions resulted in a severe tightening of credit markets in the US and Europe. As a consequence, some financial institutions in Jamaica, in particular those with margin arrangements collateralised by GOJ global bonds, were called upon to make payments as a result of a sharp rise in the yields. Concurrently, there was a sharp increase in the demand for foreign exchange which engendered significant and sustained depreciation in the exchange rate of the US dollar vis-à-vis the Jamaica dollar, prompting a series of policy actions by the central bank including heavy sales of foreign currency into the market and direct loans to security brokerage companies. In a context where some firms were reluctant to extend foreign currency loans in the inter-bank market, the BOJ undertook to accept deposits from those institutions with excess foreign currency and on-lend (repos) to other financial institutions in need of foreign currency.

8.4.1 The Central Bank

The central bank continued to focus on monetary stability and financial system soundness in 2000. As part of its programme to strengthen coordination between the BOJ and supervisory agencies of non-banking financial institutions, an inter-agency "Financial Regulatory Council" was established during the year. The Council comprised the BOJ, the Jamaica Deposit Insurance Corporation (JDIC), the Financial Services Commission (FSC) and the Financial Secretary of the Ministry of Finance.

Although the Bank continued to pursue its demand management policies aimed at foreign exchange market stability and inflation moderation, there was some easing achieved through successive reductions in the cash reserve requirements of deposit-taking institutions as well as a reduction in the BOJ's 30-day "signal" interest rate. Open market operations however, remained the main tool to manage base money (liquidity). Notably, there were temporary increases in the 270-day and 365-day OMO rate as the central bank sought to suppress foreign exchange market pressures by absorbing Jamaica dollar liquidity in longer-term instruments. Concurrently, market-determined interest rates, although declining, remained fairly high in a context of continued (although improving) fiscal expansion. As a consequence, many financial institutions continued to invest heavily in Government instruments at attractive interest rates although total holdings by commercial banks fell by 10.9 per cent relative to the previous year. On the other hand, there was a 28.9 per cent increase in holdings of "other public sector" securities, which was largely explained by the capitalization of interest on the holdings of FINSAC notes. Notwithstanding this, given the losses incurred by fallout in the real estate sector in the latter part of the 1990s, many investors were less willing to undertake risk and as such saw Government securities as an attractive option.

Against a background of the anti-inflationary policies pursued in the latter part of the 1990s, the rate of inflation decelerated to a new low of 6.1 per cent in 2000, from 6.8 per cent in 1999. Concurrently, with inflation on the decline and growth in foreign direct investment, tourism, bauxite and mining in particular, there was significant improvement in foreign exchange inflows and the country's net international reserves (NIR). However, inflation accelerated to 8.8 per cent in 2001 influenced by non-monetary factors including an adjustment in administered prices. Following the terrorist attack on New York in September 2001, tourism and FDI flows

slowed and contributed to only marginal economic growth for the year. Monetary policy, which had eased earlier in the year, tightened significantly in October in an effort to ensure foreign exchange market stability. Concurrently, the financial sector remained stable with financial sector restructuring under FINSAC continuing and lending resumed by two restructured institutions.

During 2002, monetary policy continued to be directed at moderating inflation and maintaining a stable foreign exchange environment. With the redemption of FINSAC securities in the year, liquidity expanded, engendering an increased demand for foreign exchange. In order to stabilize the market, the BOJ increased interest rates in September and December. Notably, the foreign exchange demand pressures were exacerbated by the downgrade of Jamaica's sovereign debt by Standard and Poor's from stable to negative in December. Legislation governing the activities of deposit-taking institutions (DTIs) was also amended during the year to extend the regulatory and supervisory reach of the BOJ beyond the licensee to include the wider conglomerate, where applicable. The statute requires that the DTI as part of a group, cannot own other companies within the group unless such companies are regulated or supervised institutions.

In 2003, in a context of the challenging macro-economic environment underscored by rapid exchange rate depreciation, the BOJ operations were geared at ensuring soundness and stability of the financial sector through close monitoring of the payments system to ensure efficiency and integrity of the system. In this regard, remittance companies were added to the BOJ's oversight with the supportive and appropriate amendments to the banking legislation and regulations. In an effort to manage Jamaica dollar liquidity and temper movements in the exchange rate, the BOJ instituted a "Special Deposit" reserve requirement for deposit-taking financial institutions on 10 January 2003. In addition to broadening the menu of OMO instruments, interest rates were raised sharply on two occasions in March with the 365-day tenor peaking at 35.95 per cent. As conditions improved in the second quarter, interest rates were reduced on two occasions to 30 per cent and thereafter gradually to 23 per cent by year end. Although rising sharply in the first half of the year, underlying inflation moderated in the second half reflecting a lagged response to monetary policy tightening in the first quarter of the year.

In accordance with the generally stable macroeconomic environment in 2004, the BOJ eased its monetary policy stance during the year, through a series of reductions in interest rates. This was in a context of adequate foreign exchange supply, improved fiscal performance and modest economic growth. Given the stable macroeconomic conditions in the first half of 2005, including a stable foreign exchange market, the BOJ reduced interest rates as well as the special deposit requirement in the first half of the year. However in the second half of the year, given the external shocks to the economy, the Bank halted its series of rate reductions and employed a two-pronged approach to stabilise the foreign exchange market. This involved the sale of securities from its own holdings coupled with sales of foreign exchange. In a context of the financial sector problems in the latter part of the 1990s, the Bank intensified efforts at implementing consolidated supervision by 2005/06.

Encouraged by the favourable macroeconomic environment, the BOJ loosened its monetary policy stance on a number of occasions in 2006. In April, as concerns about real rates dissipated and the general outlook for the economy improved, the BOJ removed the 270-day and 365-day tenors from its OMO menu. In May, the Special Deposit requirement was eliminated, after being in effect since January 2003. These actions by the Bank prompted a fall in market-determined interest rates. Monetary policy was informed by both international and domestic developments in 2007. Despite a reduction in foreign interest rates during the year, there was a widening of the interest rate differential in the context of increased inflation. As a consequence, investors, given depreciating trend of the exchange rate, sought to convert to US dollar instruments which provided a hedge, exacerbating demand pressures in the foreign exchange market. In an effort to temper sharp depreciations in the exchange rate and moderate inflationary impulses, the central bank maintained a conservative monetary policy stance, opting not to adjust interest rates.

The central bank maintained a conservative monetary policy stance throughout 2008 as it sought to moderate inflation and stabilise the financial markets. In the first half of the year, rising global commodity prices, in particular crude oil prices, resulted in pressures in the foreign exchange market and depreciation in the exchange rate. In an effort to limit the pass through of exchange rate depreciation to domestic prices, the central bank reintroduced a 365-day open market operations instrument and offered its own variable rate instruments to the market,

aimed at absorbing Jamaica dollar liquidity. In the second half of the year, with an intensification of the global financial crisis and the spill-over into the domestic market, the central bank increased interest rates on two occasions in the December quarter, and also increased the statutory cash reserve requirement for DTIs from 9.0 per cent to 11.0 per cent. The bank also established a special loan facility for security dealers and DTIs with US dollar liquidity needs to repay margin arrangements on GOJ global bonds. An intermediation facility in both US dollar and local currency was also established to enhance the flow of credit in the domestic financial system. The prudential returns of the DTIs were also subject to more frequent stress testing. For each quarter, tests revealed that the capital adequacy ratios (CARS) for the banking system remained above the 10.0 per cent minimum benchmark despite showing some deterioration in the BOJ's aggregate early warning systems in the second half of the year.

8.4.2 Commercial Banks

At the start of 2000, there were six commercial banks, unchanged from April 1999. FINSAC continued the restructuring of the banking system reorganizing the ownership structure of the largest bank (NCB) and purchasing additional non-performing loans in another. As a result, the sector grew at a faster rate than in 1999 with total assets of $216 618.9 million. In a context of a more stable but competitive financial environment, the number of banks remained at six in 2001. Assets and liabilities grew by 8.4 per cent relative to 15 per cent in 2000, with asset growth-reflected investments. Given the conversion of FINSAC paper to GOJ securities, the latter category dominated the securities portfolio. In 2002, commercial banks registered strong performance characterised by robust loan growth. Three commercial banks remained responsible for 88.5 per cent of the sector's total assets which remained heavily weighted towards Government securities. The banks however, continued to be heavily involved in the foreign exchange market which contributed significantly to profits.

In March 2002, AIC, a Canadian Funds Management Company acquired FINSAC's 75 per cent shareholding in NCB. On 14 October, the amalgamation of selected areas of the Caribbean operations of CIBC Canada and Barclays PLC, under a joint venture agreement by both heritage banks, was effected. The restructured joint venture holding company was named FirstCaribbean International Limited. Accordingly, the Jamaican operations of CIBC Jamaica Ltd, CIBC Trust and Merchant Bank, and CIBC

Building Society were renamed with FirstCaribbean in their titles. The commercial banking sector exhibited significant growth in 2003 driven by robust loan expansion. The banks' balance sheets also reflected a shift in the currency composition consistent with foreign exchange market developments. Assets and liabilities of the commercial banking sub-sector grew by 10.2 per cent in 2004, following growth of 19.7 per cent in 2003. The deceleration reflected net repayments of loans by the private sector following the surge in lending in 2003. In 2005, the pace of asset expansion slowed further to 6.7 per cent. The slower expansion occurred in the context of deterioration in macroeconomic conditions in the second half of the year which required a rebalancing of the banks' portfolio towards hedged instruments. In addition, the relative attractiveness of other investment options and the slowdown in borrowings from overseas banks, given the emergent instability in the foreign exchange market in the latter part of the year, also impacted their operations.

In 2006, commercial banks' assets increased by 17.3 per cent largely reflected in growth in holdings of BOJ securities as well as foreign currency denominated securities. The increase in holdings of BOJ securities was in response to the central government's reduced demand for banking system loans. The increased demand for foreign currency securities was influenced by a narrowing of the interest rate differential between Jamaica dollar and US dollar assets. Growth in 2007 slowed relative to 2006, partly reflecting a deceleration in securities' holdings including GOJ foreign securities, as well as a deceleration in deposit growth. The decline in local currency denominated securities' holdings occurred in a context of an increase in loans and holdings of foreign currency instruments which provide a hedge. During the year, commercial banks aggressively marketed private sector (consumer loans), as they realigned their portfolio of assets. At the end of 2007, holdings of securities as a proportion of total assets fell to 34.3 per cent from 38.8 per cent the previous year. In 2008, the assets of commercial banks grew by 11.6 per cent, relative to a 14.3 per cent expansion in 2007, a slower rate of growth, notwithstanding the addition of a new bank (Pan Caribbean Bank, formerly a merchant bank). The deceleration in assets build-up largely reflected reductions in cash and bank balances, as well as a slowdown in loan expansion. This was in the context of the global financial crisis which forced some banks to unwind BOJ and GOJ securities given increased margin calls on their liabilities by overseas financial institutions. At the end of 2008, there were seven banks in operation, relative to six at the end of 2007.

Deposits
Despite falling interest rates, deposits in commercial banks grew by 18.0 per cent in 2000, relative to growth of 11.2 per cent in 1999. Although domestic currency denominated deposits grew by 15.9 per cent, more significant was the 24.3 per cent growth in foreign currency deposits of which exchange rate movements accounted for more than half of the increase. Following growth of 18.0 per cent in 2000, deposit growth slowed to 6.2 per cent in 2001 in a context of the prevailing competitive environment, reflecting strong growth in foreign currency deposits. Deposit growth accelerated to 12.6 per cent influenced by private sector deposits which grew by 14.0 per cent. Contributing to private sector deposit expansion was a 24.8 per cent increase in foreign currency deposits, while local currency deposits grew by 8.8 per cent. Deposits grew by 11.1 per cent in 2003 influenced by strong growth of 40.1 per cent in foreign currency balances compared to growth of 21.1 per cent in 2002 and 11.9 per cent in 2001. In 2004, deposits, particularly the Jamaica dollar component, expanded by 15.0 per cent reflecting improved confidence in the local currency. There was a slowing in deposit growth in 2005 to 7.9 per cent from 14.8 per cent the previous year, reflected in all categories of deposits held by local residents. Foreign currency deposits, while growing slower relative to the previous year, reflected stronger growth relative to domestic currency accounts, given volatility in the foreign exchange market.

In response to an ease in monetary policy in 2006, commercial bank deposit rates fell. Notwithstanding lower deposit rates, local currency deposits grew substantially contributing to overall deposit growth of 14.9 per cent. The increase in deposits was partly influenced by the higher economic activity and a reduction in the level of unemployment. On the other hand, foreign currency deposit growth slowed, reflecting the relatively stable foreign exchange market conditions. Total deposits grew strongly in 2007 consequent on a 17.2 per cent increase in private sector deposits compared to 11.3 per cent in 2006. The faster growth was buoyed by a significant increase in the stock of foreign currency deposits in a context of investor preference for hedge instruments given the inflation environment and exchange rate depreciation. In 2008, total deposits grew by 4.3 per cent, relative to growth of 13.7 per cent growth in total deposits in 2007, despite the inclusion of a new bank, Pan Caribbean Bank. The slower growth in 2008 was reflected in both local and foreign currency deposits. This was despite an increase in the Jamaica dollar value of

foreign currency-denominated deposits, consequent on depreciation in the exchange rate.

Loan Operations

Following a 14.8 per cent contraction in loans in 1999, credit expanded by 10.5 per cent in 2000, reflected in both local and foreign currency loans. Notably, credit to the private sector was concentrated in tourism, distribution and utilities sectors. The increase in demand for loans was fuelled by falling lending rates. The spread between deposit and loan rates fell by 9.9 percentage points in 2000. Non- performing loans also fell from a share of 12.8 per cent in 1999 to 9.8 per cent in 2000. The improved loan performance contributed to increased profitability of commercial banks in 2000. In a context of a fall in interest rates, loans grew by 26.2 per cent in 2001 compared to 9.7 per cent in 2000, reflecting also further improvement in loan quality. In 2002, interest rates continued to decline albeit at a slower pace. Loans and advances expanded by 50.8 per cent, faster than in previous years. Approximately half of new lending in 2002 was to the public sector. Loan expansion was 34.1 per cent in 2003 and although strong, was somewhat slower than in 2002. This reflected a moderation in lending to the public sector as private sector credit grew by 46.1 per cent. In addition, a sharp increase in interest rates by banks (reflected in a widening of the interest rate spread) consequent on monetary policy tightening by the central bank had a tempering impact on loan demand. In a context of a fall in interest rates and an increase in private capital inflows, loans expansion decelerated to 14.7 per cent in 2004 relative to 2003. Consistent with the stability in the foreign exchange market, foreign currency loans accounted for 57.8 per cent of the increase in loans. The stock of loans and advances reflected growth of 17.2 per cent in 2005 with private sector loans growing by 19.2 per cent relative to 16.5 per cent in 2004. The major impetus came from the tourism sector consistent with developments in the hotel sector (both refurbishing and room expansion).

There was continued robust growth of 16.5 per cent in loans and advances (net of provisioning) in 2006 albeit at a slower rate than in 2005. The deceleration largely reflected slower growth in foreign-currency denominated loans consequent on a reduction in such loans to the public sector which was countered by a 10.9 per cent increase in foreign currency loans to the private sector. The stock of loans grew by 27.1 per cent relative to an expansion of 15.9 per cent the previous year. This reflected a

31.1 per cent increase in private sector loans relative to growth of 25.4 per cent the previous year. Notably, the strongest growth was reflected in personal loans, followed by distribution and tourism. There was also a noticeable fall in interest rate spreads as institutions sought to aggressively market competitive loan packages.

Loans and advances grew at 26.7 per cent in 2008, relative to an expansion of 27.1 per cent in 2007. The slowdown in the growth of loans was reflected in local currency denominated loans as foreign currency loans increased, partly reflecting exchange rate depreciation. In a context of declining economic activity in the domestic and global economy, there was an increase in non-performing loans in 2008. The ratio of NPL/total loans increased to 2.6 per cent at end 2008 from 2.0 per cent at December 2007.

8.4.3 Other Financial Institutions

Licensed Financial Institutions

Against a background of the financial sector restructuring and consolidation, the number of FIA licensees fell to 11 in 2000 from 14 the previous year. In 2000, there was the merger of the operations of two licensees, the merger of another with a commercial bank and the winding up of another. Specifically, in January 2000, the business of NCB Trust and Merchant Bank was transferred to the National Commercial Bank (NCB) under a scheme of Arrangement and Amalgamation (dated 7 December 1999). In February, Eagle Merchant Bank of Jamaica Ltd ceased operations. On 6 April, the ordinary shares of Knutsford Capital Merchant Bank (KCMB) were acquired by First Life Insurance Company Ltd. With the subsequent amalgamation in the year of KCMB and Pan Caribbean Merchant Bank Ltd, KCMB's licence was surrendered. Against this background, the assets of the FIA group fell in 2000 for the fifth consecutive year but rebounded in 2001, experiencing growth for the first time in six years. Notably, the major driver of the expansion was an increase in foreign currency assets, reflected in an increase in foreign currency securities. In 2001, there was a merger between an FIA licensee and an investment company reducing the number of licensees to eleven. In 2002, the number declined to ten as one entity surrendered its merchant banking licence. Similar to the commercial banks, the FIAs were very active in the foreign exchange market and at the end of 2000, foreign assets accounted for 65.1 per cent of the group's total assets. Foreign liabilities reflected growth of 333.0 per cent, marginally above the 332.0 per cent growth in 2001. Although local holdings of GOJ

securities grew by 63.3 per cent, the banks' growth in foreign assets was mainly reflected in increased holdings of GOJ foreign currency securities. In 2002, DB&G limited was granted approval for the acquisition of Issa Trust and Merchant Bank Limited which was subsequently merged with DB&G Merchant Bank in August 2003.

Accordingly, the process of consolidation continued in 2003, with the merger of two licensees (including the DB&G acquisition) and the closure of two others. The International Trust and Merchant Bank transferred all its securities to an affiliate and all remaining deposits to NCB, surrendering its deposit-taking licence in January 2003. The First Caribbean International Trust and Merchant Bank transferred all its deposit liabilities to First Caribbean International Bank Jamaica Limited in July 2003. The entity was renamed First Caribbean International Securities Limited and became operational under the Financial Securities Commission. Notably, the separation of managed funds from core business functions in 2003 influenced the size of FIA licensees' asset portfolios. Following the BOJ monetary policy action in March, there was a noticeable slowing in the build-up of foreign currency liabilities as Jamaica dollar denominated assets became more attractive. As a consequence, foreign liabilities' growth was 49.6 per cent in 2003 relative to 333 per cent in 2002.

During 2004, the number of licensed financial institutions fell to five from seven the previous year with completion of the merger of George & Branday (a FIA licensee) with First Global Bank. Manufacturers Sigma Merchant Bank Limited was also merged into Pan Caribbean Merchant Bank Limited. Concurrently, the asset base of the FIA licensees grew by 15.3 per cent following an expansion by 58.3 per cent the previous year. The increase in assets was largely underpinned by growth in investments and loans, with foreign currency investments accounting for 87.6 per cent of the increase in investments while growth in loans was largely influenced by local currency loans. Notably, the FIA licensees were heavily dollarised with 73.4 per cent of their assets denominated in foreign currency (62.2 per cent in 2003). In 2005, the total assets of the FIA licensees fell by 11.8 per cent largely reflected in an unwinding of foreign currency securities acquired under margin financing arrangements by one financial institution. Concurrently, the FIA institutions increased their holdings of GOJ foreign currency securities by 40.8 per cent, with most of the increase occurring in the last three months of the year when these instruments were considered

more attractive given the relatively unstable foreign exchange environment.

The assets of the FIA licensees grew by 2.6 per cent in 2006 influenced by expansions in three institutions. The increase in assets was largely reflected in loans and advances and securities purchased for resale. In a context of the need to remain viable, one institution expanded its capital base in 2006. Growth among FIA licensees slowed in 2007 partly influenced by the closure of one entity in March. The closure reduced the number of institutions in operation to four at the end of 2007. Accordingly, assets and liabilities were 2.1 per cent higher relative to 2006. The slowdown was largely reflected in a decline in investments and receivables and lower growth in loans and advances. Indications were that the sub-prime mortgage crisis in the US also had an impact on borrowings from overseas financial institutions. With the conversion of Pan Caribbean Merchant Bank (PCMB) to a commercial bank, the number of FIA licensees fell to three in 2008 from four the previous year. Abstracting from PCMB, the assets and liabilities fell by 13.9 per cent in 2008 also reflecting the realignment of another entity towards core business. The realignment of one institution coupled with the impact of a tightening of credit in global financial markets were reflected in declines in securities sold under repurchase agreements as well as in borrowings from overseas financial institutions. The impact of the decline in these securities was partly offset by an increase in GOJ foreign currency securities. Cash and balances placed with overseas commercial banks declined in response to the general uncertainty in the global financial markets and intensification of the crisis in the December quarter. As a consequence some institutions unwound domestic cash balances and securities to finance calls on their liabilities in the period. The capital base of the FIA licensees declined by 44.4 per cent in 2008 in contrast with growth by 5.7 per cent in 2007. Abstracting for the impact of Pan Caribbean, the capital base decline was 8.4 per cent relative to growth by 3.2 per cent in 2007.

Deposits

Commensurate with the reduction in the number of FIA licensees in 2000, was a decline in deposit and "other" liabilities (deposits falling by 23.2 per cent). In particular, only one of the wound-up licensees had deposit liabilities as the deposits of the other institutions were previously transferred to a commercial bank by FINSAC. In 2001, due to aggressive

marketing of foreign currency accounts, deposits grew by 83.8 per cent. However growth slowed to 14.8 per cent in 2002. Consequent on the BOJ's monetary policy tightening in 2003, total deposits of the FIA licensees fell marginally by 1.1 per cent. In 2004 however, deposits grew by 38.1 per cent in a context of the realignment of the entities' operations with core business. However, growth slowed sharply to 6.2 per cent influenced by an unwinding of foreign currency deposits in the first half of the year. In the second half of the year, in an effort to acquire instruments with a hedge, the institutions invested heavily in GOJ variable rate instruments. The institutions experienced further deposit growth of 15.5 per cent in 2006, primarily reflected in foreign currency deposits. Deposit grew by 22.4 per cent in 2007 reflecting strong growth in foreign currency deposits.

Deposits became the largest source of financing in 2008 accounting for 52.0 per cent of total liabilities compared to 45.0 per cent in 2007, given the deterioration in global credit conditions. In this regard, deposit liabilities fell by 15.4 per cent of 2008, in contrast to the strong increase the previous year. The decline, which was largely reflected in foreign currency deposits, partly reflected the departure of Pan Caribbean which had accounted for 26.7 per cent of FIA deposits.

Loans

Consequent to the reduction in deposit base in 2000, the loan portfolio of the FIA licensees fell in 2000 with private sector loans declining by 17.2 per cent. However, in 2001, there was a 14.2 per cent expansion consequent on the merger of a licensee with an investment company. The loan stock grew by 17.8 per cent in 2002 with the private sector accounting for 94.4 per cent of the growth in credit. Loan expansion was 66.4 per cent in 2003 reflecting growth of 66.2 per cent in private sector credit. The sharp increase was engendered by the aggressive marketing strategies of these entities. Loans and advances grew by 18.0 per cent in 2004 reflecting an expansion in credit to the private sector as lending to the public sector and financial institutions fell. Construction and land development were the major beneficiaries of the increase in credit (43.0 per cent). The loan portfolio grew by 27.1 per cent in 2005, with the increase largely concentrated in foreign currency loans in contrast to the previous year, when domestic currency loans experienced faster growth. Despite the increase in foreign currency loans, foreign assets fell by 18.1 per cent due to the large reduction in foreign currency securities. Loan growth

accelerated to 28.6 per cent in 2006, with lending to the private sector increasing by 31.6 per cent. On the other hand, public sector loans fell, driven by net repayments. Overall loan quality continued to improve evidenced by a decline in the ratio of past-due loans to total loans. Loan expansion was 27.5 per cent in 2007, reflecting an increase in foreign currency denominated loans. This was in contrast to the previous year when growth was largely in domestic currency loans. The slowdown in loan expansion partly reflected significant net repayments by the tourism and distribution sectors as well as reduced growth in personal loans in a context of aggressive marketing by commercial banks.

Loans and advances fell by 33.7 per cent (abstracting for PCMB) in 2008 reflecting the slowdown in economic activities, partly due to the impact of the global recession and to a lesser extent, tighter credit market conditions. The fall in loans was also reflected in a sharp fall in foreign currency loans and cash balances with commercial banks abroad. At the end of 2008, the quality of the loan portfolio as evidenced by the ratio of past due loans (over three-months) to total loans was 5.4 per cent relative to 4.9 per cent at the end of 2007 (abstracting for PCMB).

Building Societies

The number of building societies operating in 2000 remained at five, unchanged from the previous year. Assets grew strongly, reflecting resurgence in mortgage loans (7.8 per cent growth), and funded by a significant build-up in savings funds. The increase in savings funds followed a fall in the previous year when depositors sought to benefit from higher interest rates offered by other financial institutions. Notably, provisions for building societies to hold cash reserves as low as one per cent of deposits if at least 40 per cent represented mortgages remained in place at the end of 2000. In 2001, with the acquisition of the Jamaica Savings and Loans Building Society (JS&L) by the Jamaica National Building Society (JNBS), the number of institutions declined to four. The building societies experienced 13.5 per cent growth up from 10.4 per cent in 2000. Provisions for the 1.0 per cent cash reserves for institutions with at least 40 per cent of loans in residential mortgages remained in force and in that regard there was a 12.5 per cent increase in loans, 84.6 per cent of which were in primary mortgages. Notably, the market for building societies' mortgages remained highly segmented with different categories of borrowers getting different interest rates.

The assets of the building societies grew by 9.8 per cent in 2002 driven by an expansion in savings funds. Loans, of which 92.4 per cent represented new mortgages, grew by 14.4 per cent, reflecting an increase in housing costs as the number of new mortgages fell. Asset growth was 22.1 per cent in 2003 reflected in investments in Government securities and mortgage loans. The source of the growth was a 14.3 per cent build up in savings funds compared to 11.7 per cent in 2002. Mortgage loans grew by 56.1 per cent reflecting an increase in the number of new mortgages as well as value. Asset growth was 21.8 per cent in 2004, marginally slower relative to 2003, reflecting an increase in loans and investments. The expansion was financed by an 18.9 per cent increase in savings funds, largely reflected in an increase in shareholders' savings, in particular, new business. An increase in assets of the group was also influenced by fair value measurement of listed equity holdings (mainly one society). The societies' maintained their very aggressive marketing strategies to increase mortgage lending in 2004, targeting first-time homeowners with offers of preferential rates.

Against the background of the less favourable macroeconomic environment in 2005, there was slower growth in the assets of the building societies. The deceleration reflected slower growth in investments due to an unwinding of local securities. There was however, acceleration in the growth of mortgage loans to 24.9 per cent relative to 22.9 per cent in 2004. Savings funds grew by 9.0 per cent, slower than the previous year. The assets of the societies grew significantly faster in 2006, reflected in a sharp increase in investments. Mortgage loans remained buoyant although recording slower growth relative to 2005, partly influenced by a fall in mortgage rates due to the ease in the BOJ's monetary policy stance. Overall loans expanded by 21.0 per cent with mortgages increasing by 20.8 per cent. Savings funds grew by 14.8 per cent, much faster than the 9.0 per cent the previous year. Asset growth slowed in 2007, reflecting reductions in securities purchased for resale and balances held in commercial banks. There was also a deceleration in growth in holdings of public sector securities. At the end of 2007, total assets reflected growth of 16.4 per cent compared to an expansion of 18.2 per cent recorded for 2006. The deceleration in growth reflected a decline in foreign currency balances held with other financial institutions. Total loans grew by 35.2 per cent in 2007 however, well above the 20.1 per cent growth in 2006. The growth in loans reflected strong expansion in mortgage loans. Savings funds increased by 14.7 per cent in line with growth recorded in 2006. The performance of

savings reflected a 24.1 per cent increase in shareholders' savings denominated in foreign currency.

The assets of these institutions grew at a slower pace of 12.8 per cent in 2008 relative to 2007 (16.4 per cent). The deceleration reflected a slowdown in domestic economic activity as well as the impact of the global financial crisis. As a consequence, there was some reallocation of assets within the building societies. Cash and bank balances with commercial banks, non-government of Jamaica foreign securities holdings and mortgages fell in 2008. Notably, the value of new mortgages grew at a slower pace reflecting a fall in number of new accounts by 1.2 per cent. (both residential and commercial mortgages). The ratio of NPL to total loans increased to 3.6 per cent in 2008 relative to 3.0 per cent in 2007, reflecting the negative impact of the slowdown in the economy on the ability of some customers to service their loans. Concurrently, there was a build up in balances with the BOJ largely reflecting placements in the foreign currency deposit facility established in November 2008. Notably, the statutory liquid asset ratio was increased to 25.0 per cent from 23.0 per cent by the BOJ as it sought to manage pressures in the foreign exchange market. The assets of the building societies continued to be largely financed from savings funds, although there was a slowdown in the growth rate of this source of financing to 10.6 per cent from 14.7 per cent in 2007. At the same time, there was a 40.3 per cent increase in balances due to both local and overseas commercial banks in the latter half of 2008, compared to a 33.5 per cent increase in 2007. The number of building societies in operation remained unchanged at four in 2008.

Credit Unions

The credit union movement continued to grow in 2000 with membership increasing by six per cent, partly attributable to strong marketing activities to attract new business. Measures by the League to strengthen the movement were reinforced in 2000 following the establishment of an examination unit to monitor the progress of individual entities in attaining required prudential and operational standards. This led to a number of mergers and liquidations resulting in a fall in numbers to 61 from 65 the previous year. The assets and liabilities of the members of the League grew by 19 per cent in 2000 following growth of 28.1 per cent the year before. Total savings grew by 18 per cent (29.4 per cent in 1999) while loans grew by 17 per cent compared to 20.4 per cent in 1999. Despite a further decline in numbers to 58 in 2001 consequent on three mergers, the credit

unions experienced 18.0 per cent asset growth in 2001, reflecting growth of 16.0 per cent in loans and 18.0 per cent in savings. Given the competitive environment for funds, the credit unions continued to offer high rates on fixed deposits.
The credit union movement experienced a 15.8 per cent growth in assets in 2002 despite the exit of two institutions which reduced the number in operation to 56. The decline resulted from the merger of two and dissolution of another institution in the year. Savings grew by 18.1 per cent, due to an increase in membership consequent on a successful national branding campaign. Loan growth was 22 per cent. In 2003, the number of credit union fell by four to 52 consequent on mergers in the year. Notwithstanding the decline in numbers, the overall assets grew by 19.1 per cent to $23.8 billion in 2003, with membership growing by 7.1 per cent. Loan expansion was 19.8 per cent and was facilitated by a 16.4 per cent growth in savings funds. Notwithstanding a delay in the finalisation of legislation facilitating the supervision of credit unions by the BOJ, on-site monitoring commenced in the latter part of 2003 in anticipation of the new licensing regime.

Despite a further contraction in the number of entities to 50 in 2004, total assets increased by 19.8 per cent underscored by a 4.4 per cent increase in membership. Loans increased by 30.8 per cent increasing its share as a percentage of total assets to 60.8 per cent from 55.6 per cent in 2003. Savings funds grew by 18.2 per cent. During the year there was the merger of two small credit unions with one of the larger entities, Churches Cooperative Credit Union, while another (Government Workers Cooperative Credit Union) opted for voluntary liquidation. The continued consolidation of the group reflected the competitive environment that prevailed during the year as well as anticipated more stringent (capital, reserves etc) requirements when supervision falls under the central bank. In 2005, the number of credit unions fell to 48. However assets grew by 14.0 per cent partly reflecting a 6.9 per cent increase in membership. Loans grew by 22.4 per cent primarily funded by a 13.3 per cent increase in savings funds.

The number of credit unions remained at 48 in 2006, however membership increased by 7.7 per cent relative to 2005, contributing to asset growth of $6.0 billion or 18.4 per cent. Loans increased by 21.6 per cent with the stock accounting for 67.1 per cent of the assets portfolio of the group. Savings grew by 19.2 per cent influenced by increased economic output.

The number of credit unions operating remained unchanged in 2007 (excluding a newly registered institution which did not commence reporting in the year). The assets of the group increased by 14.8 per cent as loans grew by 19.6 per cent. Total savings reflected growth of 13.3 per cent in a context a 6.1 per cent growth in membership.

The BOJ continued its dialogue with the credit union industry regarding draft Credit Union Regulations in 2008, with a view to finalisation and submission to the Minister of Finance for tabling in Parliament and subsequent approval. Concurrently, the Bank continued offsite monitoring of the operations of these institutions. In 2008, the number contracted to 48 from 49 in 2007. Of the 48 institutions, two remained outside the umbrella organisation, the Jamaica Cooperative Credit Union League. In 2008, several credit unions obtained approval of their membership to amend their rules to allow for the issue of permanent shares to strengthen capital. This move arose from their recognition that withdrawable share savings do not qualify as risk capital and are not treated as such under the draft BOJ (Credit Unions) Regulations or IFRS requirement. The move sought to facilitate the transition from the long standing tradition and practice of recognising withdrawable members' share savings as part of the credit union's institutional capital. At the end of 2008, the total asset of the group was $50.7 billion, 14.6 per cent above the level at end 2007. Loans expanded by 12.4 per cent, while total savings grew by 15.0 per cent over 2007. The total membership increased 5.4 per cent over 2007.

Development Banks

The Development Bank of Jamaica (DBJ)

In April 2000, the publicly-owned ACB and NDB were merged into the Development Bank of Jamaica (DBJ) in an effort to improve efficiency in development banking. In 2000, 50.0 per cent of the liquidity generated from the reduction in the cash reserve requirement for commercial banks and FIAs was channelled into the Development Bond 2000 of the DBJ. The funds were earmarked for on-lending to tourism, agriculture and manufacturing. In 2000, as was the case with its predecessors, the ACB and NDB, the DBJ channelled funds through People's Cooperative Banks (PCBs) and the Approved Financial Institutions (AFIs). The assets of the DBJ fell by 5.9 per cent in 2001, driven by a 10.6 per cent decline in loans and an 18.8 per cent contraction in investments. Notwithstanding this, loans through

the PC banks grew by 11.9 per cent while bank loans fell by 3.9 per cent. The Development Bond 2000, funded by the commercial banks cash reserve reduction, remained a major source of funds for the DBJ. In January 2002, the DBJ issued a development bond to supplement funding from its traditional sources including the CDB and the World Bank. The bond, which was funded from commercial banks' cash reserve reduction, was used primarily for loans to tourism. Loans to financial institutions grew by 14.3 per cent. Total assets and liabilities grew by 80.5 per cent.

In 2003, the assets and liabilities of the DBJ increased by 16.5 per cent, attributable to a $10.7 billion loan for Highway 2000. There was a noticeable shift in the concentration of assets from 'receivables and prepayments' to GOJ infrastructural loan programmes of which the National Road Operating and Construction Company (NROCC) held the major share. In 2004, the bank's involvement in the organisation of financing for GOJ programmes had a major influence on its asset base, accounting for 37.2 per cent of total assets. Assets fell by 4.0 per cent reflecting a decline in loans outstanding for GOJ infrastructural programmes as well as a fall off in receivables and prepayments. However, loans to financial institutions reflected a 15.3 per cent increase.

The assets of the DBJ declined by 15.0 per cent in 2005, reflecting a 36.7 per cent (net) reduction in the stock of loans for GOJ Infrastructural Loan Programme. Profits were 19.4 per cent below that recorded in 2004. AFI remained the main channel through which loans were distributed. Consequent on the merger with the National Investment Bank of Jamaica (NIBJ), the assets of the DBJ increased by 50 per cent in 2006. Despite the merger, the mandate of the DBJ remained unchanged, providing medium and long-term financing at concessionary interest rates through AFIs and PC banks. Total loans to financial institutions increased by 35.9 per cent reflecting the incorporation of NIBJ loan portfolio. However, loans through AFIs and PC banks fell by 36.5 per cent and 2.1 per cent, respectively. Outstanding loans to the GOJ infrastructural loan programme fell by 44.5 per cent. Loan approvals denominated in local currency increased by 11.3 per cent, those denominated in foreign currency fell by 78.9 per cent, with the shift partly reflective of the more stable foreign exchange environment. The assets of the DBJ grew by 50.6 per cent in 2007, largely due to increases in the GOJ Infrastructural Loan Programmes and Investments. The expansion in infrastructural loans was in a context of rehabilitation following the passage of Hurricane Dean. Loans to AFI fell by 32.8 per cent

while there were offsetting increases in other loans and loans to co-operative banks.

The assets of the DBJ fell by 2.3 per cent in 2008 due to declines of 34.8 per cent and 7.4 per cent in investments and loans to financial institutions, respectively. The contraction in investments was influenced by a call on liabilities due to the National Road Operating & Constructing Company (NROCC). Securities were unwound to finance the repayment of these liabilities. The reduction in loans to financial institutions reflected declines in "other" loans as well as loans to AFIs. These declines were partially offset by increases in the Receivables & Prepayments of 18.6 per cent, as well as increases in GOJ Infrastructural Loan programmes, securities-resale agreements and cash and bank balances of 2.8 per cent, 32.4 per cent and 39.0 per cent, respectively.

The institution continued to provide medium and long-term financing through AFIs[39] and PCBs at concessionary interest rates during 2008. Both loan approvals and disbursements increased during the year relative to 2007, reflecting increases to small and medium sized enterprises (SME). Local currency loan approvals increased by 22.0 per cent, mainly related to the SME line of credit which commenced during the year and accounted for the majority of local currency loan approvals. On a sector-basis, local currency loan approvals for Mining and Quarrying, Agro-Industry and Tourism increased during the year, however, Agriculture, the second largest beneficiary of loans, Other Services and Manufacturing all recorded declines in the value of loans approved. Local currency loan disbursements increased 5.9 per cent relative to 2007, reflecting an increase in disbursements to Other Services and to a much lesser extent Mining and Quarrying, SME and Tourism. Of note, Other Services and Agriculture accounted for 51.5 per cent and 20.4 per cent of disbursements made during the year, respectively. All other sectors recorded declines in disbursements. Foreign currency loan approvals and disbursements increased during the year to US$8.9 million and US$8.0 million, respectively from US$2.1million and US$1.9 million respectively in 2007. The increases were both related to loans for tourism and agriculture.

[39] AFIs include commercial banks and merchant banks.

Trafalgar Development Bank (TDB)

The TDB recorded growth of 17.6 per cent in assets and liabilities in 2000. The bank also commenced arrangements for the sale of its 51 per cent interest in the Trafalgar Commercial Bank (TCB) and the purchase of 100 per cent in Pan Caribbean Merchant Bank (PCMB). The latter move was aimed at enhancing productivity. With the acquisition by Pan Jamaican Investment Trust Fund of controlling interest in the TDB, the development banking operations were phased out in 2001 and the bank was re-branded as a financial services company – Pan Caribbean Financial Services Ltd in 2002.

The National Export Import Bank of Jamaica (Ex-Im)

The Ex-Im Bank continued to be challenged in 2000 as it sought to fulfil its mission by providing financing and export credit to the productive sector, consistent with the Government's objective of stimulating and expanding non-traditional exports. In this regard the institution devised two new programmes namely, The Factoring of Export Receivables and the Co-Pack Facility through export trading houses. The receivables programme is aimed at providing continuous working capital to exporters against the presentation of export receivables to a factoring house overseas. The Co-Pack Facility provides working capital loans to backward linked agro-processing companies which produce under contractual arrangements with export trading houses. As in previous year, the Ex-Im bank remained profitable, recording moderate increase in profits.

Whereas local currency business fell in 2000, consistent with the macroeconomic environment, foreign currency loan disbursements were at a similar level relative to the previous year. Loan disbursement continued to grow in 2001 and 2002, largely achieved through a mixture of initiatives including new loan programmes and modification of existing ones. In 2002, in an effort to stimulate the demand for medium term loans, the institution relaxed its collateral requirements which allowed for a lowering of the amount required to guarantee a loan from 40 per cent to 25 per cent. This resulted in an immediate increase in the demand for medium-term loans. Local currency loans grew modestly, while foreign currency disbursements increased significantly relative to 2001. At the start of 2003, there was a sharp increase in the utilisation of loan programmes and various lines of credit, in particular the Cuban Line of Credit (CLC), as the bank further expanded its medium-term loan facilities. However, utilisation was

significantly greater than expected, especially in respect of the CLC. This prompted immediate suspension of medium-term lending as the institution sought to ensure that its short-term lending window was not compromised. In an effort to increase its ability to meet the increased demand for medium-term loans, the bank in 2003 successfully negotiated additional resources from external sources, including Cuba, and also secured additional financing from local financial institutions and the Government. Nonetheless, the bank maintained its local currency lending at the previous year's level and increased it foreign currency lending by 6.5 per cent. The profits of the Ex-Im Bank increased by 32.8 per cent in 2003, relative to the amount in 2002.

Despite challenges brought on by globalisation and the imminent removal of special and differential trade protection measures, the institution's profit further increased in 2004. The bank expanded its loan facilities with a programme for the information, communications and technology sector. Foreign and local currency loan disbursements however fell in 2004 given dislocation of productive activities following the passage of Hurricane Ivan in September. Whereas local currency disbursements fell by 6.2 per cent, foreign currency loans increased by 22.1 per cent in 2005. By 2006 however, loans in both denominations grew by a combined 78.0 per cent. The expansion in foreign currency loans was driven by the Ex-Im's financial support for the importation of cement given a severe shortage economy-wide, which influenced a 109.6 per cent increase in Lines of Credit. Additionally, the bank recorded increased utilisation for the CLC. Simultaneously, there was strong demand for pre-shipment financing and medium-term loans to the productive sector.

The Ex-Im Bank embarked on a new three-year strategic plan in 2007 which maintained a focus on loan portfolio growth, particularly in the area of small and medium sized businesses. During the year, plans were advanced towards the launch of the Trade Credit Insurance (TCI) for mid-2008 aimed at boosting the demand for this aspect of insurance coverage. In a context of developments in the external and domestic macroeconomic environment as well as an ease in the local cement crisis, domestic and foreign loans fell by 2.5 per cent and 17.5 per cent respectively, in 2007. The Ex-Im Bank continued to record strong growth in its loan portfolio in 2008 in line with its three-year plan. In this regard, the bank increased funding to tourism, agro-business, manufacturing, mining and quarrying. To further assist its development process, the bank introduced Trade Credit

Insurance (TCI) in August 2008, an enhancement on the previous Export Credit Insurance (ECI) product. A corresponding Insurance Policy Discounting Facility (IPDF) that allowed for discounting of up to 80 per cent of insured receivables was made available to policy holders requiring working capital. The bank also broadened its reach to include emerging sectors such as the creative industries. Domestic and foreign currency disbursements increased by a combined 35.0 per cent in 2008. The agro-processing and food and beverage industries continued to be the main recipients of funding in 2008, collectively accounting for 79.4 per cent of total local currency approvals. Local currency disbursements grew by 29.0 per cent while foreign currency loan disbursements increased by 65.2 per cent primarily reflecting an increase in lines of credit to finance the construction and hardware industries.

Insurance Companies

The insurance industry experienced further consolidation between 2000 and 2007, both in terms of general and life insurance business. Against a background of the financial sector problems in the latter half of the 1990s and the prevailing macroeconomic climate (particularly inflation trends), insurance companies were challenged to find creative ways to grow their business. In addition, with investors more sensitised about risk and the implementation of new rules towards pricing of assets (market to market) of insurance companies under the IFRS, the pace of asset expansion slowed. Notwithstanding this, both the general and life insurance segments grew in 2007, with net premium income increasing by 31.0 per cent over 2006, to $11.3 billion. Concurrently, there was a 53.3 per cent increase in net profits to $1.7 billion in 2007. The ownership structure of a number of insurance companies also changed between the end of 1999 and 2008 with the involvement of investors from other Caribbean territories, particularly with the sale of some FINSAC entities. In early 2008, there was the acquisition of Life of Jamaica by Sagicor Financial Corporation of Barbados and the subsequent acquisition by Sagicor Life Jamaica Limited of Blue Cross of Jamaica in July 2008. In April 2008, the insurance industry launched a new umbrella group – the Insurance Association of Jamaica (IAJ) – the result of a merger of the Jamaica Association of General Insurance Companies (JAGIC) and the Life Insurance Company Association of Jamaica (LICA). The new association, the IAJ, seeks to promote adherence to actuarial and accounting standards among its members as well as timely dissemination of industry information. At the

end of 2008, there were 17 members of the IAJ, of which four companies offered life insurance (two exclusively).

People's Cooperative Banks (PCBs)

Against the background of restructuring efforts that commenced in the 1990s, there was significant progress in the operations of PCBs in the early 2000s, despite the many macroeconomic and environmental challenges in the agricultural sector. In 2003, the existing PC banks were merged into one entity, the National People's Cooperative Bank of Jamaica, with a network of 38 branches. The National PCB of Jamaica lends from its own resources as well as on-lends funds from the Development Bank of Jamaica (DBJ). Both membership and savings showed significant growth from 84,000 in 1982 to 170,000 by 2003. Savings, which amounted to $2.0 million in 1984, grew to $609.0 million by 2003, while the loan portfolio expanded to $814.0 million from $200.0 million in 1982. As a part of its strategy to grow its membership, the National PCB in 2003 formed an alliance with Grace Kennedy Remittance Service to facilitate money transfer. The PCB also facilitates bill payment services though arrangements with Paymaster and Bill Express payment services.

Appendix 8.1 a: Growth and Evolution of Jamaica Financial Sector (1961-2008)

	1961	1971	1981	1990	1996	2000	2002	2004	2006	2008
Commercial Banks (1836)										
No. of Banks	6	6	8	11	9	6	6	6	6	7
No. of Branches										
(Including main branches)	69	131	179	170	188	128	136	126	124	131
Assets/Liabilities	-	517.3	2634.2	17327.5	135986.0	221705.2	262577.9	344378.6	429969.2	544653.4
Deposits	-	406.1	2102.6	12097.5	94103.3	149666.7	178979.5	228190.5	282925.5	333960.0
Loans	-	330.4	1495.1	8997.2	54721.0	40573.8	73943.3	113368.8	153449.2	242479.4
Merchant Banks (1969)[1]										
No. of Institutions	-	3	6	21	-					
Assets/Liabilities	-	12.4	92.7	4526.9	20149.0	7680.0	24800.7	49478.0	44863.2	
Deposits	-	1.8	35.3	2842.6	6760.8	3492.0	6553.0	10448.7	13095.1	
Loans	-	10.2	38.1	2862.6	7376.2	2351.2	2817.2	6430.5	10591.6	
Trust Companies										
No. of Institutions	2	6	10	3	-	-	-	-	-	
Assets/Liabilities	-	23.6	162.6	109.1	-	-	-	-	-	
Deposits	-	13.9	125.8	86.4	-	-	-	-	-	
Loans	-	13.9	103.5	74.8	-	-	-	-	-	
Finance Houses										
No. of Institutions	-	-	10	5	-					
Assets/Liabilities	-	-	59.4	265.8	565.7	815.6	3054.3	1167.0	1098.9	
Deposits	-	-	47.3	156.6	235.6	474.0	1818.7	987.7	921.9	
Loans	-	-	32.5	167.6	185.1	298.4	746.4	422.1	555.1	

Appendix 8.1 b: Growth and Evolution of Jamaica Financial Sector (1961-2008)

	1961	1971	1981	1990	1996	2000	2002	2004	2006	2008
Consolidated FIA Licencees[2]										
No. of Institutions					27	11	10	5	5	3
No. of Branches							8	6	10	5
Assets/Liabilities					23828.2	8495.7	27699.9	50545.0	45908.3	32655.3
Deposits					6941.4	3966	8371.7	11436.4	14017.0	14519.4
Loans					7068.4	2649.6	3563.6	6789.2	11098.0	10710.2
Building Societies (1800)										
No. of institutions	7	16	7	6	13	5	4	4	4	4.0
No. of Branches						13	46	48	47	47.0
Assets/Liabilities	17.0+	57.4	387.6	3058.1	35926.2	44290.4	55261.6	80589.8	106219.2	138531.8
Savings Fund	14.2	53.0	366.5	2666.8	28765.4	35196.3	43233.6	58792.3	73585.1	93285.3
Loan Outstanding	14.0	46.1	271.0	1596.1	15570.2	15571.4	20042.0	29243.6	44035.7	75415.4
Credit Unions (1941)										
No. of institutions	110	127	95	80	77	61	56	50	48	48
Assets/Liabilities				812.2	5832.6	14642.7	20002.7	28548.2	38528.0	50710.0
Total savings	2.3	9.6	185.1	694.2	4681.4	12003.8	16363.7	22480.3	30332.2	39540.0
Total loans	1.1	9.2	184.1	652.1	3652.3	7870.7	11130.2	17356.2	25932.8	34840.0
Life & General Insurance Companies					29	22	22	21	18	17
Life Insurance Companies										
No. of institutions[3]	16	20	13	10	10	5	5	5	5	4
Assets	61.2	129.2	403.2	2072.3[a]	-	-	-	-	-	-
Gross premium	6.6			450.7	-	-	-	-	-	-
Policy loans[4]	-	-	-	-	-	-	-	-	-	-

Appendix 8.1 c: Growth and Evolution of Jamaica Financial Sector (1961-2008)

	1961	1971	1981	1990	1996	2000	2002	2004	2006	2008
Government Savings Bank (1870)										
No. of Branches	0	255	-	-	-	-	-	-	-	-
Assets/Liabilities	9.7	13.9	-	-	-	-	-	-	-	-
Deposits	9.7	14	-	-	-	-	-	-	-	-
Withdrawals	12.7	23.4	-	-	-	-	-	-	-	-
Development Banks										
No. of institutions	1	1	2		3	1	1	1	1	
J.D.B.										
Assets/Lilabilities	-	-	-		-	-	-	-	-	
Loans	-	-	-		-	-	-	-	-	
A.C.B. (1981)[5]										
Assets/Liabilities	-	-	14.3[b]		-	-	-	-	-	
Loans	-	-	10.1		-	-	-	-	-	
N.D.B. (1981)[5]										
Assets/Liabilities	-	-	0.5		-	-	-	-	-	
Loans	-	-	0.4		-	-	-	-	-	
Trafalgar Development Bank (1981)[6]										
Assets/Liabilities	-	-	-		3378.1	-	-	-	-	
Loans	-	-	-		1461.6	-	-	-	-	
Peoples Co-operative Banks (1905)[7]										
No. of institutions	-	-	39		18	18	1	1	1	
Branches							38	38		

Appendix 8.1 d: Growth and Evolution of Jamaica Financial Sector (1961-2008)

	1961	1971	1981	1990	1996	2000	2002	2004	2006	2008
Jamaica Mortgage Bank (1971)										
Assets/Liabilites	0	0	179.7		-	-	-	-	-	
Loans & Mortgages	0	0	122.9		-	-	-	-	-	
Development Bank of Jamaica										
Assets/Liabilities		-	-		11427.7	21764.5	24362.8	31070.2	45726.0	
Loans		-	-		8618.5	8393.8	7311.0	9575.2	9313.0	

1 The data for merchant banks from 1996 reflects conversions and consolidation of many trust companies and finance houses into merchant banking/ trust operations Notably the data since 1996 has been extrapolated from the consolidated report for FIA licencees for analytical purposes only

2 The FIA licensees data reflect the consolidated information for institutions perviously classified as merchant banks, finance houses and trust companies

3 Number relates to companies located in Jamaica, hence excludes CUNA Mutual Insurance Society located in the USA but offers insurance through the Credit Union Movement

4 Data unavailable after 1966

5 Merged into DBJ in the year 2000

6 Operations phased out and re-branded as Pan Caribbean Merchant Bank in 2000

7 In 2000 the PC banks were consolidated to 18 individual banks. In 2008 the PC banks were merged into one entity the National People's Cooperative Bank of Jamaica with 38 branches

a December 1988

b March 1993

9

The Evolution of the Surinamese Financial Sector (1996-2008)

Saira Jahangir-Abdoelrahman

Developments in the financial sector of Suriname in the period 1996-2008 evolved largely in accordance with macroeconomic developments. The performance of the Surinamese economy improved markedly in the new millennium following more than a decade of instability. In the early 1990s Suriname suffered from an episode of near-hyperinflation, devaluation and subsequent depreciation of the exchange rate, dwindling international reserves and declining output. After a few years of fairly good performance in the mid-1990s, Suriname's economy faced a second episode of high inflation towards the end of the decade.

The first episode of near-hyperinflation emerged from exogenous shocks that were exacerbated by inadequate macroeconomic policy responses. Large movements of world prices for bauxite and its derivates, at that time being almost the sole export earner, caused large swings in fiscal revenues and the overall fiscal balance. This highlighted the economy's vulnerability to international commodity price developments. The fiscal balance was further negatively affected by the suspension of Dutch development aid. As the ensuing shortfalls in financing were offset by financing from the Central Bank of Suriname (CBvS), rapid price inflation and exchange rate depreciation followed. The second high inflation episode was mainly caused by very expansionary fiscal stance and the accommodating monetary policy. Exogenous shocks contributed in a relatively small degree to the macroeconomic imbalance.

A new administration, headed by President Venetiaan, took office in August 2000 and introduced strong measures to restore macroeconomic stability. It devaluated the Surinamese guilder by almost 90%, stopped excessive central bank lending to the government and gradually relied on treasury bills as a source of financing, removed subsidies and raised tariffs on petroleum products and utilities. The Venetiaan administration successfully stabilized the economy in 2001. However, in 2002 loose fiscal policy, mainly as a result of the government's decision to meet civil servants demand for higher wages, destabilized the exchange rate and increased inflationary pressures. In late 2002, the authorities tightened macroeconomic policies and stabilized the economy again. The authorities also strengthened budget discipline.

After these stabilization efforts, the CBvS replaced the Surinamese guilder (Sf) by the Suriname dollar (SRD) at a rate of Sf 1.000 per SRD on 1 January 2004. Since then the currency has been stable.

The Venetiaan administration was re-elected in 2005. Aided by strong commodity prices and prudent fiscal and monetary policies, macroeconomic performance strengthened markedly in the period 2003-2008. During this time the economy was on a steady growth path, international reserves increased significantly, the exchange rate remained stable, inflation declined and public debt as a share of GDP fell. As a result, the credit rating of the country has been improving gradually. First rated in 1999 at B-/stable by Standard and Poor's, Suriname was rated B+/stable in 2008.

The macroeconomic developments had their impact on the financial sector, which grew significantly during recent years.

The financial system has also been through a process of liberalization. The authorities liberalized banking transactions in foreign currency in the early 1990s. The deregulation process resulted in increased dollarization of the financial system. Dollarization accelerated further during the second near-hyperinflation episode as a result of the credit ceiling on commercial banks' credit in local currency and the loss of confidence in the currency, which encouraged foreign currency intermediation.

In 2002, the authorities eliminated foreign exchange surrender requirements for all exporters except from the bauxite and oil sectors,

enabling them to hold export proceeds in foreign currency deposits. This liberalization further boosted deposit dollarization.

9.1 Macroeconomic Developments

9.1.1 Real Sector

The Surinamese economy grew at a steady pace in the new millennium. Real GDP growth averaged 3.8% a year in 1996–2008 compared to 1.2% during 1970–1995. While real GDP grew from 1.9% a year during 1996–2000, the annual rate increased to 5% during 2001–2008. Economic growth peaked in 2003 and 2004 (6.3% en 8.5%, respectively), mainly due to mining output and the effects of macroeconomic stability on public confidence. A new gold mine became operational in 2004.

Consequently, the terms of trade have improved significantly since 2005, leading to a fairly good increase in real income. In fact, GNP per capita increased from US$ 1.909 in 1996 to US$ 2.573 in 2000 and to US$ 5.894 in 2008.

However, Suriname's economic base remains narrow making it prone to macroeconomic volatility. Three commodities (alumina, gold and oil) accounted for 80% of export receipts and 50% of GDP, and generated 25% of government revenues in 2008. Bauxite has been Suriname's principal industry and export earner for decades. However, its relative importance has been declining since 2004 in favour of oil and gold.

Inflation averaged 24% between 1996 and 2008. However, within this period substantial variability prevailed. Inflation accelerated in 1999 and 2000 reaching an annual average of almost 80%. The high inflation experience of Suriname finds its roots in the pervasiveness of central bank financing of fiscal needs. During 2004-2008 inflation fell to an average of 10%.

9.1.2 Fiscal Sector

Fiscal revenues rely heavily on the extractive industries. Shocks to the prices of bauxite, gold and oil caused significant volatility in tax revenues, complicating fiscal and monetary policy management.

The fiscal balance during 1996–2008 registered an average deficit of 3.1% of GDP. During this period, the overall fiscal balance deteriorated from a

surplus of 0.8% of GDP in 1996 to a deficit of 31.6% in 2000. Between 2006 and 2008, the fiscal balance recorded a surplus, averaging 2.3% of GDP. Booming commodity prices and a prudent fiscal stance contributed to this improvement.

In order to avoid the loose fiscal stance exhibited in the late 1990s, the authorities enacted legislation setting limits on government debt. The Act on Public Debt of 2002 establishes ceilings for domestic and external public debt at 15% and 45% of GDP, respectively. In addition, it establishes severe penalties to the Minister of Finance if the limits are exceeded. The penalties include imprisonment (up to ten years), financial penalty (up to SRD 2 million), deprivation voting rights and exclusion from public positions.

9.1.3 External Sector

The level of net international reserves increased significantly during the 2000s. In 1996 the level of reserves stood at US$ 180.4 million, but dwindled to US$ 14.8 million in 2000. In 2001, reserves resurged due to a foreign loan, reaching US$ 113.8 million. The Surinamese authorities used part of the 'guarantee' funds under the Independence treaty with the Netherlands to refinance the large government debt built up over the period 1997-2000, which helped to reconstitute the reserves of the CBvS. Soaring export prices resulted in a buoyant growth of international reserves, reaching a level of US$ 495.9 million at the end of 2008. This level was sufficient to cover more than three months of imports of goods and services. The external current account has improved accordingly.

9.1.4 Monetary Sector

Fiscal dominance of monetary policy has been a key determinant of monetary fluctuations in Suriname. The unsterilized accumulation of foreign reserves has been another important source of growth in the money supply. Most changes in broad money are accounted for by fluctuations in the monetary base.

Between 1997 and 2000 broad money growth averaged 110% per year, reflecting the monetization of large fiscal deficits. Money growth decelerated during 2001-2008, averaging 57% per year. In this period the money growth resulted primarily from the increase in international reserves.

Table 9.1: Selected Economic Indicators 1996-2008

Year	Real GDP Growth %	Inflation Rate %	Exchange Rate (SF or SRD Per USD)[1,2]	Fiscal Deficit as a % of GDP	Public Debt as% of GDP[1]		Net Foreign Reserves (USD)[1]
					Local	Foreign	
1990	-0,2	21,7	1,80	-2,7	80,5	5,2	21,2
1996	1,0	-0,7	406,00	0,8	1,5	14,0	180,4
1997	5,7	7,1	406,00	-3,4	3,7	16,2	164,5
1998	2,3	19,0	406,00	-6,6	12,9	19,4	90,0
1999	-1,4	98,8	995,00	-3,2	15,0	33,5	34,9
2000	1,9	59,3	2200,00	-31,6	37,2	55,7	14,8
2001	4,6	38,6	2200,00	3,7	7,8	46,1	113,8
2002	2,6	15,5	2550,00	-5,3	14,1	70,9	98,2
2003	6,3	23,0	2650,00	1,7	14,4	31,5	104,2
2004	8,5	9,7	2,75	-2,4	13,3	25,5	142,2
2005	4,4	9,5	2,78	-1,2	14,2	21,0	162,1
2006	3,8	11,3	2,78	1,8	11,2	18,0	261,2
2007	5,2	6,4	2,78	1,3	8,8	12,1	435,9
2008	4,7	14,7	2,78	3,7	7,6	10,2	495,9

1 End of Year

2 1990-2003: SF per USD, official selling rate
2004-2008: SRD per USD, official selling rate

Sources: Centrale Bank of Suriname/General Bureau of Statistics/Suriname Debt Management Office/Ministry of Finance

9.2 Financial System

The financial system of Suriname consists of the CBvS, commercial banks, investment and finance companies, pension funds, provident funds, savings funds, insurance companies, savings and credit unions, foreign exchange bureaux (cambios), money transfer houses and a stock exchange.

Table 9.2: Indicators of Financial Sector Development

Description	1996	1999	2002	2005	2008
Total Financial Assets (in millions SRD)	169,3	562,5	1.778,1	3,309,6	6.018,3
Total Financial Assets as a percentage of GDP	49,0	73,8	29,2	67,6	71,5
Money Supply as a percentage of GDP	37,4	45,6	48,7	44,5	46,0
Private Sector as a percentage of GDP	15,5	17,4	14,1	19,7	26,8
Bank Deposits as a percentage of GDP	28,1	33,6	38,0	37,3	39,1

Source: Central Bank of Suriname

The financial system grew substantially between 1996 and 2008. Key indicators of the financial sector development are presented in Table 9.2. The size of the system, measured by the value of assets, had grown from SRD 169.3 million in 1996 to SRD 6,018.3 million in 2008. This change is to a large extent in nominal terms, reflecting episodes of high inflation in that period. Measured by percentage of total assets to GDP, however, the increase was from 49% in 1996 to 71.5% in 2008. Furthermore, financial intermediation, estimated as private sector credit as percentage of GDP, grew significantly, from 15.5% in 1996 to 26.8% in 2008. Similarly, bank deposits rose from 28.1% to 39.1% of GDP.

9.3 The Central Bank of Suriname

The operations of the CBvS are governed by the Bank Act 1956. The Act has been subject to a number of amendments, the latest being that of May 2005. The amendment institutionalizes better governance and allows the CBvS to better pursue the goal of promoting price stability. In this regard, it has strengthened the CBvS president's authority to deny financing to the government beyond the statutory lending limit. The statutory cumulative ceiling for Central Bank financing of the government deficit, set at 10% of budgeted revenues for a fiscal year, has been in place since 1981. In addition, the amendment establishes severe penalties for the Central Bank president (even after discharge) and his/her successors when exceeding the limits. The penalties include imprisonment, financial penalty, deprivation of voting rights and exclusion from public positions.

9.3.1 Monetary Policy

Monetary policy is primarily aimed at promoting price and exchange rate stability. Given the sensitivity of domestic prices to exchange rate movements, developments in the foreign exchange market are an important factor in the formulation and implementation of monetary policy. The Bank Act and the Supervision of the Banking and Credit System Act of 1968 empower the CBvS to employ several monetary instruments, such as credit ceilings, reserve requirements, discount facilities and open market operations. However, the formal use of these instruments has been limited. The main instruments of monetary control consist of reserve requirements and CBvS credit to the government. In the past, the CBvS has not always been able to conduct an independent monetary policy as it was often required to finance the government budget well in excess of the statutory limits or levels consistent with low inflation.

The system of reserve requirements applies to the commercial banks and was instituted in May 2001. It pertains to the domestic currency deposit liabilities of the commercial banks. Before May 2001, monetary policy was conducted mainly through a system of credit ceilings (since 1968). Growth in commercial banks' credit was limited to the increase in their long-term resources. This implies that commercial banks' credit policy was not allowed to lead to net increases in the money supply, intending to mitigate pressures on the balance of payments. However, the ceilings were not strictly observed, because there were no penalties for breaching the ceilings before January 1995.

Under the reserve requirement system the banks are required to maintain reserve balances with the CBvS in the form of non-interest-bearing deposits. The required reserve ratio was initially set at 27½% of the reserve base. In August 2002, the ratio was increased to 35% in response to the financial and monetary conditions prevailing at the time. The reserve requirement on domestic currency deposits has been gradually lowered since October 2004, as the exchange rate stabilized and inflation fell to single digits. Since January 2007, the reserve ratio is set at 25%.

The CBvS monitors the banks' compliance with the reserve requirements on a weekly basis. A bank that does not meet the reserve requirement is subject to financial penalties. The penalty imposed includes interest charges over the period of the shortfall at the highest lending rate of the relevant bank plus two percentage points.

This system favoured foreign currency intermediation. There were no reserve requirements on foreign currency deposits until the beginning of 2003. In February 2003, the CBvS introduced reserve requirements for foreign currency (USD and EUR) deposits of the commercial banks. This prudential measure aims at building a buffer to manage availability risk given the high dollarization of the Surinamese economy. The required reserve ratio was initially set at 17½%. Contrary to the relaxation of the requirements for the national currency, reserve requirements on foreign currency were increased to 22½% in November 2004 and to 33⅓% in February 2005. The required reserves in US dollars and euros are remunerated and can be held abroad at correspondent accounts of the commercial banks. In January 2006, the CBvS extended the range of assets that qualify as liquid reserves. Banks can now invest part of their required reserves in negotiable bonds from issuers with high ratings.

Controlling the credit to the government has been an integral part of the monetary policy strategy of the CBvS in the period 2000–2008. In this regard there has been close collaboration between the president of the CBvS and the Minister of Finance, on their objectives.

9.3.2 Exchange Rate Policy

Suriname has a *de jure* managed float exchange rate regime. The foreign exchange system comprises the official market and the commercial banks-cambios market. The exchange rate *vis-à-vis* the US dollar has been reasonably stable during 2003-2008 (US$ 1 = SRD 2.80) and functioned as a nominal anchor for prices. To reduce short-term market fluctuations the authorities have resorted to moral suasion. In practice, Suriname's exchange rate regime in the stability period can be characterized as a *de facto* peg.

9.3.3 Supervision and Regulation

The CBvS is the single regulator for the financial sector of Suriname. It is responsible for the supervision of the banks, insurance companies, pension funds and credit unions, a task entrusted to the Supervision Department of the CBvS. The Bank Act 1956 as amended in May 2005, the Act on Supervision of the Banking and Credit System 1968 as amended in November 1986 and the Pension Fund and Provident Fund Act 2005 are the main laws governing Suriname's financial sector.

The number of institutions under supervision of the CBvS and the distribution of the total assets in the sector are presented in Table 9.3 and Table 9.4, respectively.

Table 9.3: Number of Institutions Supervised

Institutions	**1996**	**2008**
Commercial Banks	6	8
Life Insurance Companies	5	5
Non-Life Insurance Companies	5	6
Funeral Insurance Companies	2	2
Holding Companies	1	1
Pension Funds	28	32
Provident Funds	6	5
Savings Funds	1	1
Credit Unions	29	29
Other	9	11
Total	**92**	**100**

Source: Central Bank of Suriname

Table 9.4: Distribution of Financial System Assets (in percent of total)

Description	1996	1999	2002	2005	2008
Assets	**100**	**100**	**100**	**100**	**100**
Banks	75	69	66	68	73
Pension Funds	22	24	25	20	17
Insurance Companies	2	5	8	9	7
Credit Unions	0	1	1	2	2
Other	1	1	1	1	1

Source: Central Bank of Suriname

The Bank Act and the Act on Supervision of the Banking and Credit System are the main laws governing Suriname's banking sector. The latter legislation is being revised. This act also governs other bank-like institutions and credit unions.

To start operations in Suriname, banks need to obtain a certificate of no objection from the CBvS. The CBvS will refuse issuing such a certificate when it believes that doing so would be "contrary to a sound banking and credit system or to a sound banking policy."[40] Notice of the CBvS's refusal must be given to the bank requesting a certificate of no objection within 30 days. The criteria to determine whether to grant a certificate of no objection are described in a guideline and cover prudential considerations. In addition to the certificate of no objection by the CBvS, a bank must obtain a license from the Ministry of Trade and Industry. A license of the Foreign Exchange Commission is required to commence business in foreign currency. Banking licenses must be renewed every three years.

In 1993, the CBvS adopted the Basel risk-weighted capital requirement of 8%. Banks that did not meet the requirement were allowed a two-year period to meet the new standards. In January 2003, the CBvS issued five regulations regarding capital adequacy (amendment of the regulation of 1993), classifications of loans and provisioning, large exposures, insider lending, and fixed assets investments. These regulations have enabled Suriname to comply with several of the requirements contained in the Basel Committee's Core Principles for Effective Banking Supervision.

Under the current legislation the CBvS can apply a limited number of sanctions. The five prudential regulations specify a range of administrative sanctions that may be imposed by the CBvS on banks that fail to comply with the regulations. Noncompliance with the solvency and liquidity

[40] Article 5 sub 3 of Act on Supervision of the Banking and Credit System.

guidelines can result in CBvS's advising a certain line of action which has to be implemented within a specific period of time. Noncompliance with this advice can result in publication thereof and of all the related correspondence. There is no bank deposit insurance scheme in Suriname.

A Self-Assessment of the Basel Core Principles was conducted in 2000. This resulted in the conclusion that Suriname was largely compliant. The new legislation should address most, if not all, of the outstanding issues.

Box 9.1: Prudential Regulations for Banks

Main Provisions/Relevant Regulation	Frequency of Reporting Requirement to the CBvS
Capital adequacy; based on Capital adequacy regulation	
The minimum capital requirement for banks, to commence operations, is primary, unimpaired paid-up capital of SRD 4.5 million as of 2004; in addition, all banks have to maintain a risk-weighted capital ratio of 8% or such higher level determined by the CBvS. Minimum Tier 1 ratio is 4%. The following scale has been introduced to calculate the risk-weighted capital ratio: 0% for cash and equivalent riskless items; 20% for assets with little risk and a high degree of liquidity; 50% for assets with a moderate degree of risk and a higher credit and liquidity risk; 100% for the remaining assets typically found in the portfolio of a bank.	Monthly
Classification of loans; based on Classification of loans and provisioning regulation	
Banks must adopt a loan policy approved by their Board and establish a review system to identify risk and ensure the adequacy of its allowance for loans losses. Non-performing loans are defined as loans in respect of which any payment of principal or interest is in arrears for 90 days or more; the regulations specify minimum standards for the accounting treatment to be applied to non-performing and renegotiated loans and minimum provisioning requirements for non-performing loans.	Quarterly
Large exposures; based on Large exposures regulation	
The maximum exposure limit to any single person is fixed at 25% of a bank's capital. The aggregate of a bank's deposits with another bank, corporation, or financial institutions cannot exceed 100% of a bank's capital unless the institution has received an "investment" grade from a major rating agency. A bank's large exposures (i.e. loans or deposits of a bank to or with any person or common enterprise that equals or exceeds 10% of the bank's capital) cannot exceed, in aggregate, 600% of its capital.	Monthly
Insider lending; based on Insider lending regulation	
Aggregate lending to a single insider or the insider's related interest is limited to 25% of the bank's capital; the aggregate of all loans to all insiders and their related interests cannot exceed 100% of the bank's capital.	Quarterly
Fixed assets investment; based on Fixed assets investments regulation	
Direct or indirect investments by banks in fixed assets are limited to 100% of their "adjusted" capital.	Bi-annually

9.4 Commercial Banks

Since 1996, the banking sector experienced a number of changes. As of 2008, the number of commercial banks has increased from six to eight. Other changes include the ownership structure, the services offered and the soundness of the sector.

The two new commercial banks are Finabank N.V. and Surichange Bank N.V., both privately owned. The Finabank N.V. was established on 24 April, 1991. After a period of inactivity the bank recommenced operations in 1998. The bank is fully privately owned. As of end 2008, the Finabank had two branch offices. The head office and a branch are located in Paramaribo and one branch in Nickerie, Suriname's main rice-producing district.

The Surichange Bank N.V. was established on the 2 May 1996. However, it effectively started banking operations in September 2005. The shares are fully owned by four private enterprises. The partner of the bank in the Netherlands is the licensed money transfer company Surichange B.V. The target market of this company consists of persons of Surinamese descent who transfer funds to their families in Suriname.

Over the past years banks have been introducing new banking products and services. The more traditional services are: domestic payments, foreign payments, corporate and consumer loans, mortgages, motor vehicle loans, local and foreign currency deposits (demand, savings and time), letter of credit, buying and selling of foreign currency and transfers. Relatively new innovative services over the past years are: issuance of debit and credit cards, Automated Teller Machines (ATM), Point of Sale (POS), phone banking, and internet banking.

Most of the commercial banks are currently accessible via the internet and have their own websites.

Since the introduction of the ATM in March 1993, ATM services gradually spread throughout the country. In order to enable interconnectivity, a local network switch was established in 2005. Four commercial banks, namely the Surinaamsche Bank N.V., RBTT Bank (Suriname) N.V., Hakrinbank N.V. and Surinaamse Postspaarbank jointly incorporated a new company, the Banking Network Suriname N.V. (BNETS). This made it possible for clients to use their debit cards at any ATM or POS machine of

the participating banks, for a nominal fee. Other banks can join in. Per 2008, the clients had access to a total of 113 ATM machines.

Financial institutions from the region have shown interest in setting up a branch in Suriname. After the RBTT Bank (Suriname) N.V., the Development Finance SA Incorporated (DFL SA), a non-depository financial corporation, was established in 2006 as a branch of the Guyanese subsidiary of Development Finance Incorporated. DFL Caribbean Holding Ltd, which is the Holding Company in Trinidad and Tobago, is the main participant in DFL SA Incorporated Guyana. The main goal of Development Finance Incorporated Guyana is to provide loans for small and medium sized industrial and trade companies in Guyana and Suriname with terms of five to 15 years. This company is funded through long-term loans from the European Investment Bank (EIB), the Inter-American Investment Corperation (IIC) and the Multilateral Investment Fund of the Inter-American Development Bank (MIF-IDB).

In October 2005, a new finance company named Fatum Investments N.V. was established. Fatum Investments is a subsidiary of Fatum Schadeverzekering N.V., a local insurance company. The objective of the investment company is to invest capital in different financial portfolios and international trades at stock exchange markets.

9.4.1 Ownership and Structure

The government holds an interest in five of the eight commercial banks operating in Suriname. Government participation ranges from 10% to 100% (Table 9.5). Only one bank, RBTT Bank (Suriname) N.V., is fully-owned by foreign capital. It operates as a wholly owned subsidiary of RBTT Financial Holdings Limited, a bank whose activities span Trinidad and Tobago and other Caribbean countries.

In November 2000, RBTT Bank established in Suriname by acquiring the Surinamese branch of ABN-AMRO N.V., an international Dutch Bank. ABN-AMRO N.V. also owned part (49% of the shares) of De Surinaamsche Bank N.V. until July 2001, when it sold its interest to Assuria N.V. (a Surinamese insurance company). De Surinaamsche Bank was established on 19 January 1865 and is the largest bank in Suriname. The government owns 10% of the shares, 49% are owned by Assuria and 41% are widely held by other shareholders.

Table 9.5: Structure of the Commercial Banking System in 2008

Commercial Banks	State Ownership	Foreign Ownership
De Surinaamsche Bank N.V.	10	0
RBTT Bank (Suriname) N.V.	0	100
Hakrinbank N.V.	51	0
Surinaamse Volkskredietbank	100	0
Landbouwbank N.V.	100	0
Surinaamse Postspaarbank	100	0
Finabank N.V.	0	0
Surichange Bank N.V.	0	0

Source: Central Bank of Suriname

Due to the takeover of the RBTT group by the Royal Bank of Canada in 2008, the Surinamese subsidiary of RBTT was affected and went through some changes.

The wholly state-owned banks – Landbouwbank N.V., Surinaamse Volkscredietbank, and Surinaamse Postspaarbank – were established to provide financial services to the disadvantaged segments of society and to some of the sectors considered by the government as important for the country's overall development. The main focus of the Landbouwbank N.V. is on loans to the agricultural, fisheries and forestry sectors, whereas the Surinaamse Volkscredietbank and the Surinaamse Postspaarbank offer loans to low-income households. Over the years, the activities of these banks have shifted to other target markets and sectors.

The government also owns the Nationale Ontwikkelingsbank N.V., a development bank established with the purpose of funding the development of national industries that contribute to the social and economic development of Suriname.

9.4.2 *Soundness and Performance*

The Surinamese banking system is highly concentrated. The three largest banks - De Surinaamsche Bank N.V., RBTT Bank (Suriname) N.V. and Hakrinbank N.V. - account for some 80% of the total assets and deposits of the banking system. As of December 2008, the total assets of the banking system amounted to approximately SRD 4.4 billion. Between 2004 and 2008 the loan portfolio of the banking sector in Surinamese dollars expanded at an annual average rate of around 29%. Foreign currency loans grew at a rate of 21% over the same period.

The financial positions of the three largest banks are relatively sound, as

reflected by their capital adequacy ratios, which exceeded the 8% norm.

Before 2004, the state-owned banks performed poorly. They had negative capital adequacy ratios and a high level of non-performing loans. The Ministry of Finance requested the Inter-American Development Bank to assist Suriname in developing a strategy for the reform of the state banks. In 2003, the IDB approved a technical cooperation project called 'Financial Sector Strengthening and Rationalization' in order to make a financial evaluation of the state banks and identify reform options. One option was to merge these state banks. After a change of government these plans were put on hold. Over the years, the financial position of most of these banks has improved significantly, although some may still need additional capital to meet the minimum requirements.

A significant risk in the banking system is the high financial dollarization. Prudential regulations need to be adopted against liquidity and solvency risks. Foreign currency deposits as a percentage of total deposits rose from about 20% in 1996 to 55% in 2008, while credit dollarization (foreign currency loans as a percentage of total commercial bank loans) increased from 15% to 46%.

More recently, the pace of dollarization has subsided, probably signalling a gradual restoration of confidence in the domestic currency and economic policy. Prudential regulations, however, need to be adopted to control liquidity risks, including currency mismatches.

9.4.3 Balance Sheet

Table 9.6: Commercial Banks: Balance Sheet (as percent of total assets/liabilities)

Description	1996	1999	2002	2005	2008
ASSETS					
Liquid Assets	28,7	44,3	38,1	31,2	32,6
Bankers local and foreign	5,9	6,4	18,3	15,7	8,8
Net Loans	42,7	39,5	30,1	41,0	49,7
Other assets	22,7	9,8	13,5	12,1	8,8
LIABILITIES					
Deposits (>1 year)	50,7	44,2	43,3	27,7	29,0
Short term liabilities	31,4	44,1	44,4	58,0	55,9
Bankers local and foreign	0,0	0,1	0,0	1,5	2,3
Other Liabilities	10,9	6,3	5,6	5,2	5,9
Profit/Loss	2,4	1,4	1,3	1,7	1,6
Capital	4,6	4,0	5,4	5,9	5,3

Source: Central Bank of Suriname

The composition of the balance sheets of commercial banks has shifted over the described period. The main asset on the balance sheet remains the loans (Table 9.6). On the liability side, there has been a gradual shift from deposits with a maturity of more than one year to shorter term liabilities.

9.4.4 Financial Soundness Indicators

The capital adequacy ratios of the commercial banks have improved and are above the regulatory minimum of 8%, except for the state banks which are improving but still had solvency problems during the period 1996-2008 (Table 9.7).

Table 9.7: Commercial Banks: Financial Soundness Indicators (%)

Description	1996	1999	2002	2005	2008
Capital Adequacy					
Regulatory capital to risk-weighted assets*	5,2	7,5	14,8	10,1	10,1
Regulatory Tier I capital to risk-weighted assets*	n.a	n.a	8,6	8,1	8,7
Capital (net worth) to assets	2,7	3,1	6,0	5,0	5,6
Asset Composition					
Sectoral Distribution of loans to total loans*					
Agriculture	20,0	19,7	7,0	5,1	4,2
Manufactring	12,7	8,7	8,0	9,6	7,9
Commerce	36,7	24,1	34,1	32,9	26,9
Housing construction	5,2	10,2	11,5	14,4	17,5
Other	25,3	37,3	39,4	38,0	43,5
Asset Quality					
Foreign currency loans to total loans	n.a	n.a	41,5	49,6	45,8
NPLs to gross loans*	n.a	n.a	8,7	13,5	7,9
NPLs net of provisions to capital*	n.a	n.a	14,7	80,2	49,8
Large exposures to capital*	n.a	n.a	33,7	55,7	104,5
Earnings and Profitability					
ROA*	2,8	1,8	1,6	3,0	2,8
ROE*	42,6	33,0	27,0	40,8	52,7
Interest margin to gross income*	n.a	n.a	66,9	73,0	72,9
Noninterest expenses to gross income*	n.a	n.a	68,9	63,0	56,2
Personnel expenses to noninterest expenses	n.a	n.a	58,7	59,6	59,8
Trading and fee income to total income	n.a	n.a	33,1	31,0	28,1
Spread between reference loan and deposit rates	n.a	n.a	12,9	10,5	8,1
Liquidity					
Liquid assets to total assets*	28,7	44,3	29,5	31,1	32,6
Liquid assets to total short-term liabilities*	91,3	100,5	66,9	52,8	58,4
FX liabilities to total liabilities	n.a	n.a	42,7	48,6	49,6

* included in the 'core set' of financial soundness indicators identified by the IMFs Executive Board

Source: Central Bank of Suriname

Nonperforming loans have been declining but the NPL ratio remains relatively high by the standard of 5%, mainly due to the non-performing loans of the three state owned banks. It should be noted that bank lending in general is backed by strong collateral. Since the introduction of the loan classification regulations in 2003, banks have improved their lending policies and procedures.

The spread between lending and borrowing rates (11 percentage points in 2004) had dropped to 8.1 percentage points in 2008. However, the earnings and profitability of the banks were not negatively affected because of the growth in the loan portfolio, averaging 35% a year.

Between 1996 and 2008 there has been a significant change in the distribution of bank credit to the agriculture and fisheries sectors. The share of agriculture and fisheries in the total bank credit, which in 1996 amounted to around 20%, dropped to 4.2% in 2008. The share of manufacturing declined from 12.7% to 7.9%. On the other hand, the share of bank credit to housing construction increased significantly. In 2004, the CBvS allowed commercial banks to use up to 7% of their deposit liabilities (reserve base) to finance low-interest, 7% p.a., mortgages. The usable part of the required reserves was gradually raised to 10% in January 2007, which corresponds to a reduction of the effective reserve requirements. This housing facility was introduced for the middle income class in order to help ease the housing problem in Suriname.

Overall, the Financial Soundness Indicators of the Surinamese banking sector have improved over time. However, specific problems, particularly in the state banks, still need to be addressed.

9.5 Other Financial Institutions

9.5.1 Pension Funds

As of December 2008, 31 pension funds and one pension fund for civil servants were under the supervision of the CBvS. The Pension Act was adopted in 2005. Prior to this Act, pension funds were governed by the Act on Supervision of the Banking and Credit System, which did not meet the specific needs of pension supervision. Based on the new Act several guidelines have been introduced, including the investment and solvency guidelines. The investment guidelines aim to achieve a well-balanced spread in the investment portfolio of pension funds. Risk, liquidity and return are

decisive factors in the execution of a prudent investment policy. Considering the paramount importance of guaranteeing the pension benefits, pension funds must abstain from investments with a risk profile of eroding the pension reserve. Pension funds report to the CBvS on a quarterly and annual basis.

Table 9.8: Summary Balance Sheet of Pension Funds (in millions of Surinamese dollars)

Description	1996	1999	2002	2005	2008
ASSETS					
Total investments	34	119	383	601	891
Cash	1	9	29	21	40
Other assets	3	9	26	49	48
TOTAL ASSETS	**38**	**137**	**438**	**671**	**980**
LIABILITIES					
Porv. Pension comm.	24	96	316	577	738
Others	14	41	123	94	242
TOTAL LIABILITIES	**38**	**137**	**439**	**671**	**980**

Source: Central Bank of Suriname

Suriname has gone through a period of high inflation. Consequently, the values of the pension allowances of the pensioners eroded significantly and many people who worked all of their lives may be receiving extremely low pension payments. Most pension funds lacked adequate means to address the issue and adjust the payments. With a few exceptions, funds are based on the final pay method. Funds without a resilient investment policy saw their investments decrease in value. Some of the more substantial employers have contributed towards the expenses enabling the funds to adjust the pension claims.

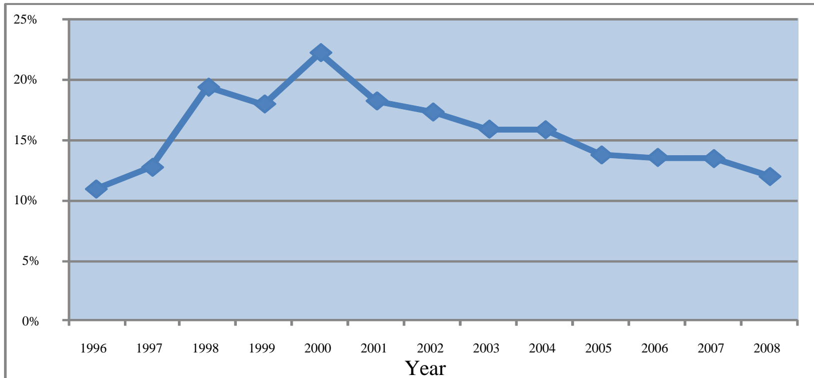
The increasing costs of maintaining a pension scheme and the requirements of new IFRS standards resulted in a tendency that employers will not or cannot continue to finance the deficit of the scheme. There is a growing trend of adjusting the pension scheme rules and regulations.

Most of the pension funds are still solvent. To a large extent the solvency can be attributed to the absence of indexed payments. The effect of salary adjustments over the years has been limited. Some funds have a policy to periodically adjust the pensionable salaries in consultation with the actuary. Other pension funds did not adjust the pension allowance in time.

The total assets of the pension funds increased from SRD 38 million in 1996

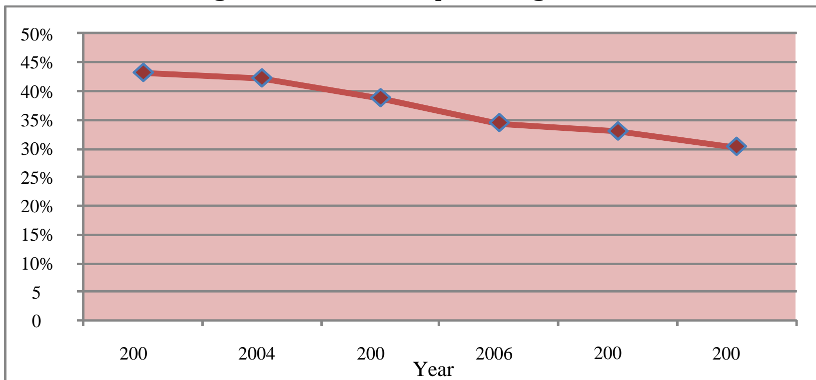
to SRD 980 million in 2008 (Table 9.8). In terms of GDP, the assets grew from 11% to 12% of GDP. A significant part (on average 91%) of the total assets consists of local and foreign investments. In 2008, the foreign investments comprised around 30% of the total investments.

Chart 9.1: Total Financial Assets as a percentage of GDP



Source: Central Bank of Suriname

Chart 9.2: Foreign Investments as a percentage of Total Investments



Source: Central Bank of Suriname

Between 1996 and 2000, the total assets of pension funds as a percentage of GDP increased significantly. In this period the nominal value of foreign investments grew sharply due to high inflation. Since the exchange rate stabilized, the nominal increase in foreign investments has been negligible. In fact, the ratio has been falling as GDP grew relatively faster than the total assets during recent years.

9.5.2 Insurance Companies

The insurance sector of Suriname can be divided into three distinct categories: life, general and funeral insurance companies. General insurance dominates the overall market. Suriname's life insurance market is very small, while the products offered are traditional. There is one specialized medical insurance company. Most insurers offer a range of medical insurance products including specialist coverage, such as dental treatment and maternity care, as part of their products. Personal Accident and Healthcare are considered part of the general market.

There are two funeral insurance companies, namely 'Stichting Uitvaartverzekering Hamdard' en 'Hennep Verzorgende Verzekering N.V.', the latter being extremely small.

In 1996, the Surinamese branch office of Clico Life and General Insurance Co. Guyana (S.A.) assumed the portfolio of British American Insurance Company Ltd. Since Clico combined both life and general insurance in one company, it had to separate into a life insurance company and a general insurance company to comply with Surinamese regulations. The process of separation started in 1999 and was completed in 2004. With this separation, the Surinamese insurance market acquired two more insurers, namely Clico Life Insurance Company Suriname N.V. and Clico General Insurance Company Suriname N.V.

In 1997, Assuria Reassurantie N.V. ceased its reinsurance activities. The statutes of this company, including its name, were amended in 2000, and Assuria Medische Verzekering N.V. became the only specialized medical insurance company.

In 1998, Fatum Levensverzekering N.V. was placed under supervision and was permitted to sell life insurance in March 1999. This company received in December 2002 a letter of no objection to take over the portfolio of De Nationale Nederlanden N.V., a foreign insurance company.

From 1996 until 2004 the Ministry of Finance in collaboration with the CBvS and the Surinamese Association of Insurance Companies (SURVAM) conferred on the level of the insured sum and the accompanying premium for mandatory third party motor liability insurance (WAM). Until 2004, January 1st was the uniform commencing date for all motor insurance. It proved very burdensome to renew each and every insurance policy in a few

days at the end of December, a traditionally busy period for any company. Since 2004, the insured sum is SRD 10,000.

In 2006, Parsasco N.V. acquired a subsidiary called Montes Auri N.V. This company serves as an agency of The Beacon Insurance Company from Trinidad and Tobago and sells life insurance.

In that same year, Self Reliance Levensverzekering N.V., a 100% subsidiary of Surinaamse Assurantie Maatschappij N.V. (Self Reliance), received a letter of no objection to operate as a life insurer.

The State health insurance fund, Staatsziekenfonds (SZF), serves to insure mainly the civil servants and a number of voluntary private clients. This fund, however, does not fall under the supervision of the Bank.

In 2008, a new general health insurance act, known as the Algemene Ziektekosten-verzekering (AZV), was proposed. The purpose is to restructure the existing system of health provision and improve access to services for all citizens of Suriname. This act has not passed the Parliament yet due to problems with the financing of the proposed system. Over the years, Suriname has become a popular trainee post for Dutch students. Primarily, for this group but also for the growing number of Dutch tourists, Agis Zorgverzekering, a health and medical insurer from the Netherlands, set up a service centre in Suriname. The purpose of this centre is to assist Agis clients whenever they need any medical help in Suriname. This desk does not sell insurance in Suriname.

Life Insurance Companies

The financial crisis of Clico Life Insurance Company Suriname N.V. put a lot of pressure on the financial situation in 2008. Particularly, the general reserves were affected negatively. The increase in share capital in 2004 reflects the establishment of Clico Life Insurance Company Suriname N.V.

Table 9.9: Solvency of Life Insurers (in millions of Surinamese dollars)

Description	1996	1999	2002	2005	2008
Premium reserve minus					
Reinsurance (A)	1,9	7,6	33,9	110,5	260,7
Required minimum solvency Margin 5% of A (1)	0,1	0,4	1,7	5,5	13,0
Free shareholders equity (2)	0,3	1,0	3,3	5,2	-83,7
Solvency surplus/deficit (2-1)	0,2	0,6	1,6	-0,3	-96,7

Source: Central Bank of Suriname

Table 9.10: Profitability of Life Insurers (in millions of Surinamese dollars)

Description	1996	1999	2002	2005	2008
Net profit	0,1	0,3	1,4	-1,4	-90,0
Shareholder equity	0,4	2,1	9,7	12,1	-74,4
Profitability	21%	14%	14%	-11%	-121%

Source: Central Bank of Suriname

Except for 2005 and 2008, all life insurers were solvent in the period 1996-2008 (Table 9.9). Investment revenues constitute the main source of profit. Between 1999 and 2008, mortgages were the most popular investments, increasing from SRD 1.6 million to SRD 67.6 million (Table 9.11).

Table 9.11: Combined Balance of Life Insurers (in millions of Surinamese dollars)

Description	1996	1999	2002	2005	2008
ASSETS					
Cash and Bank balances (liquid assets)	0,4	1,2	5,0	10,1	23,2
Fixed assets	0,1	0,3	2,0	0,8	3,8
Investments					
a) government					
b) private					
-mortgages	0,7	1,6	13,8	40,4	67,6
-other	0,9	5,6	17,4	71,1	89,2
Other assets	0,8	3,0	10,0	14,4	11,4
TOTAL ASSETS	3,0	11,7	48,3	136,8	195,1
LIABILITIES					
Share capital	0,0	0,0	0,0	0,2	0,3
Reserves	0,4	2,1	9,7	11,9	-74,8
Subordanited loans	0,0	0,0	0,0	0,0	0,0
Technical provisions	1,8	8,0	33,1	109,7	259,7
Other Liabilities	0,7	1,6	5,5	14,9	9,8
TOTAL LIABILITIES	3,0	11,7	48,3	136,8	195,1

Source: Central Bank of Suriname

The profitability of the companies registered fluctuations in the described period. In 2001 and 2005, large payments due to higher mortality put pressure on profits. The losses were SRD 0.9 million and SRD 1.4 million, respectively. In 2008, the downfall of Clico Life Insurance Company Suriname N.V. dominated the drastic loss (SRD 90 million) of the insurers (Table 9.12). The gross premiums showed a sharp increasing trend, SRD 1.4 million in 1996 to SRD 82.1 million in 2008.

Table 9.12: Combined Profit and Loss Account of Life Insurers (in millions of Suriname dollars)

Description	1996	1999	2002	2005	2008
Premiums	0,8	2,8	11,7	29,0	70,0
Single Premiums	0,6	0,9	6,7	24,0	12,1
Total premiums + single premiums	1,4	3,7	18,4	53,0	82.1
Premiums reinsurance	0,0	0,1	0,4	0,8	1,2
Premium without reinsurance	1,4	3,7	18,0	52,2	80,9
Change technical provisions	1,0	2,6	12,4	35,0	73,6
Earned premium	0,5	1,1	5,6	17,2	7,3
Gross payments	0,1	0,4	1,9	10,2	18,8
Part reinsurer	0,0	0,0	0,3	0,0	0,1
Net payments	0,1	0,3	1,7	10,2	18,7
Provision and acquisition costs	0,1	0,3	0,9	3,1	5,3
Operating expenses	0,3	1,3	4,0	6,3	82,6
Profit sharing and discounts	0,1	0,4	1,5	4,2	3,3
Technical result	-0,2	-1,3	-2,5	-6,5	-102,5
Investment revenues	0,2	0,9	1,6	6,7	13,7
Balance other earnings and expenses	0,0	0,8	2,5	-1,4	-1,0
Investment expenses	0,0	0,1	0,1	0,1	0,1
Profit before tax	0,1	0,5	1,5	-1,4	-90,0
Tax	0,0	0,2	0,1	0,0	0,0
Profit after tax	0,1	0,3	1,4	-1,4	-90,0

Source: Central Bank of Suriname

Non-life Insurance Companies

Between 1996 and 2008 the total assets of the non-life insurers increased from SRD 0.9 million to SRD 252.3 million[41] (Table 9.13). Following the large depreciation of the exchange rate in 2000, the nominal value of foreign currency denominated assets, in particular the fixed assets and investments in real estate and issued mortgages, rose sharply.

Gross premiums amounted to SRD 149.7 million in 2008 compared to SRD 3.1 million in 1996 (Table 9.14). Growth continued because insurers offered higher coverage for the mandatory motor insurance against a higher premium. In 2001, the gross premiums more than doubled, increasing from SRD 21 million in 2000 to SRD 44.6 million, as local insurers were required to raise the premium following the higher reinsurance premium in the international market, especially after the 9/11 attacks.

[41] Clico General Insurance Company Suriname N.V. excluded.

Table 9.13: Combined Balance of Non-Life Insurers (in millions of Surinamese dollars)

Description	1996	1999	2002	2005	2008
ASSETS					
Fixed assets	0,3	3,2	14,7	19,9	25,2
Investments					
-government					
-private					
a) mortgages	0,0	1,9	12,9	33,3	44,7
b) other	0,3	4,0	30,0	63,2	84,0
Other assets	0,3	2,4	13,2	38,3	74,8
Liquid assets	0,1	3,3	13,4	14,5	23,6
TOTAL ASSETS	0,9	84,3	84,3	169,2	252,3
LIABILITIES					
Share capital	0,0	0,0	0,0	0,6	0,4
Reserves	0,5	6,0	36,4	66,3	107,4
Technical provisions	0,1	5,0	31,3	61,5	94,4
Long term liabilities (including provisions)	0,1	0,1	03	0,1	7,0
Short term liabilities	0,2	3,6	16,3	40,7	43,1
TOTAL LIABILITIES	0,9	14,7	84,3	169,2	252,3

Source: Central Bank of Suriname

Table 9.14: Combined Profit and Loss Account of Non-Life Insurers (in millions of Suriname dollars)

Description	1996	1999	2002	2005	2008
Gross premium	3,1	11,1	46,9	97,1	149,7
Premium reinsurer	0,8	2,9	11,6	19,4	18,6
Premium without reinsurance	2,3	8,1	35,3	77,7	131,1
Change technical provisions	0,2	0,7	4,9	4,1	-1,0
Earned premium	2,1	7,5	30,4	73,6	132,1
Gross payments	1,6	5,5	20,9	51,8	85,6
Part reinsurer	0,1	1,2	1,0	2,6	6,9
Net payments	1,5	4,3	19,9	49,2	78,7
Provision and acquisition costs	0,2	0,3	0,9	3,3	7,3
Operating expenses	0,9	3,0	10,6	21,9	40,4
Other technical earning/expenses	0,0	0,0	0,1	0,0	0,0
Technical results	-0,5	-0,2	-0,9	-0,8	5,8
Investment earnings	0,1	0,7	4,4	8,8	8,1
Other earning/expenses	0,1	0,5	3,3	2,0	1,4
Investment expenses	0,0	0,0	0,0	0,0	0,0
Profit before tax	-0,3	1,1	6,8	9,9	15,4
Tax	0,0	0,0	0,3	0,8	1,2
Profit after tax	-0,3	1,0	6,5	9,1	14,2

Source: Central Bank of Suriname

Due to higher investment and other earnings[42] and an increase in the earned premium in 1999, the profits after tax changed from a loss of SRD 0.3 million in 1996 to a positive result of SRD 1.0 million in 1999. In 2008 the profit after tax amounted to SRD 14.2 million.

Except for 1996 and 1997, the general insurance companies realized an overall solvency surplus in the period under review. The surpluses resulted from unrealized exchange rate differences and investment income. In 2008, the solvency surplus stood at SRD 54.7 million (Table 9.15).

The profitability of the non-life insurers depends primarily on investment revenues. Most investments consist of issued mortgages, which increased from almost zero in 1996 to SRD 44.7 million in 2008.

Table 9.15: Solvency of Non-Life Insurers (in millions of Suriname dollars)

Description	1996	1999	2002	2005	2008
18% of the gross premium (A)	0,6	2,0	8,4	17,5	26,9
Net payments (1)	1,5	4,3	19,9	49,2	78,7
Gross payments (2)	1,6	5,5	20,9	51,8	85,6
Required minimum solvency margin (1/2)*A	0,5	1,5	8,0	16,6	24,8
Paid-up shared capital+free reserved+ added profits	0,1	2,9	20,4	44,6	79,4
Solvency surplus/deficit	-0,4	1,4	12,3	28,0	54,7

Source: Central Bank of Suriname

Table 9.16: Profitability of Non-Life Insurers (in millions of Suriname dollars)

Description	1996	1999	2002	2005	2008
Net profit	-0.3	1.0	6.5	9.1	14.2
Equity capital	1.0	6.0	36.4	66.9	107.8
Profitability	-29%	17 %	18%	14%	13%

Source: Central Bank of Suriname

9.5.3 Credit Unions

In the period under review, the number of credit unions under supervision of the CBvS remained stable. The largest credit union "Coöperatieve Vereniging Spaar- en Kredietcoöperatie Godo GA" was in the process of being transformed into a cooperative bank. At the end of 2008, they were still in the process to meet the standards set out by the CBvS.

Most of the credit unions are close bond: they are restricted to employees of companies or members of certain organizations. This limited pool of

[42] Such as exchange rate differences.

potential members poses its own problems. Over the years, credit unions have been facing more and more problems in recruiting qualified members for their boards and committees. It is a voluntary job and few are willing to invest their time. An important drawback is that noncompliance with administrative and reporting rules has been increasing.

In 2006, credit unions were divided into three categories based on their total assets, namely A for large, B for medium and C for the small credit unions. The CBvS adjusted the reporting requirements accordingly, in which the requirements are less burdensome for the smaller credit unions. In addition, since 2006, the credit unions in category A also report for monetary statistics purposes.

Initiatives of the CBvS in 2001 to improve compliance with reporting requirements were not very successful. In this regard, the CBvS covered the costs of the financial statements for the year 2000 and granted exemption from reports before that year for a number of the non-reporting credit unions. However, at the end of 2008 reporting issues still remained.

The breakdown in the sector is further characterized by the fact that since 1994, the AVKC, the umbrella organization for credit unions, is no longer regarded to be the official representative organization of the credit unions to the CBvS. This organization is no longer active and the credit unions lack an organization to support them with training in different aspects of their activity. The CBvS started a new round of dialogue with the credit unions to address these problems.

Table 9.17: Key Data of Credit Unions (in millions of Suriname Dollars)

Description	1996	1999	2002	2005	2008
Claims on members	0,2	2,5	13,1	50,9	109,1
Liabilities to members	0,2	3,2	20,5	57,1	122,6
Total Assets	0,3	4,4	24,1	65,0	141,9

1996: data of 5 credit unions
1999: data of 12 credit unions
2002: data of 16 credit unions
2005: data of 8 credit unions
2008: data of 6 credit unions
Source: Central Bank of Suriname

Since 2005, the sector has grown rapidly. The number of members has increased, resulting in significant growth of the claims on, and liabilities to, members (Table 9.17). However, the improvement was driven mainly by

one of the largest credit unions.

Furthermore, the larger credit unions in Suriname have worked on their products to suit their members' needs. The Foreign Currency Commission granted two of these credit unions a limited foreign currency license. This limitation means that the credit unions are only allowed to grant loans and accept savings or deposits in foreign currency from their own members.

9.6 Conclusion

Suriname's financial system witnessed significant growth in the period under analysis. Prudent macroeconomic policies and financial liberalization improved the conduct of monetary and exchange rate polices as well as the soundness and stability of the financial system. There are signs that the liberalization of foreign currency banking transactions, combined with a stable macroeconomic environment, has led to a deepening of financial intermediation. Although the share of the other financial institutions has been increasing, the banking sector still dominates the financial system.

The process of dollarization has stabilized in recent years as a result of the increase of confidence in the currency. However, the high level of dollarization has consequences for macroeconomic management and the financial system in Suriname. It has reduced exchange rate flexibility and seigniorage revenue. Furthermore, dollarization has made the financial system more vulnerable because the Central Bank of Suriname cannot function as a lender of last resort for the dollarized component of financial intermediation. In addition, foreign currency lending has increased the vulnerability of the balance sheets in the private sector and the banking system to external shocks. Therefore, it remains a great challenge to tackle these issues.

Overall, the financial soundness of the banking sector has improved in recent years. Nevertheless, the vulnerabilities in the system require strengthening of prudential oversight. The Central Bank of Suriname regards that a top priority in the coming years.

9.7 References

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10

The Evolution of the Financial Sector in Trinidad & Tobago (1996-2007)

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Financial systems in the Caribbean have evolved over an extended period of time – from the rigid colonial monetary arrangements to post-independence growth and development. In some economies the 1980's represented a difficult period of time as several countries undertook structural adjustment programmes which had implications for financial systems. Innovation and liberalization, together with technological change, began to impact financial systems at the start of the 1990's. It is against this background that this present paper examines the evolution of the financial system in Trinidad and Tobago (TT) between 1996 and 2007. The main emphasis will be on developments in the banking system, the insurance industry and mutual funds. The paper closes with a few comments on the Financial Services Ombudsman.

10.1 The Economic Setting

Following a period of stabilization and adjustment (1988-1991) and macroeconomic reform, the economy of Trinidad and Tobago entered an era of sustained economic growth and development starting in the mid-1990's. At the outset, this period of growth was unlike that of the 1970's which had been driven by economic rents from the oil sector. Instead, additions to existing capacity in oil, natural gas and petrochemicals

contributed in a major way to the current buoyancy of the domestic economy, which had experienced 14 years of continuous economic expansion since 1994. Growth occurred in both the energy sector and the non-energy sector and, in the latter case, trends in Construction, Finance, Insurance and Real Estate and the Distribution sectors have been the main drivers of growth. The growth has been accompanied by falling levels of unemployment and, except for the past three years, relatively low levels of inflation. Real GDP growth averaged 3.8 per cent between 1994 and 1999 and since 2000 has averaged around eight per cent. The country has also enjoyed balance of payments surpluses accompanied by a strong foreign reserve position. While the public finances have improved so that there are overall budget surpluses, the continued existence of domestic budget deficits which are structural in nature has created tensions for monetary policy formulation.

Table 10.1: Selected Economic Indicators 1997-2007

	1997	2000	2003	2005	2007
GDP at current market prices (USM)	5,784.0	7,973.0	10,660	12,127	14,266
Real GDP growth rate (%)	7.5	6.9	14.4	6.1	5.5
Inflation Rate (%)	3.7	3.6	3.8	6.9	7.9
Unemployment Rate (%)	15.0	12.5	10.5	8.0	5.5
Fiscal Balance/GDP (%)	0.1	1.6	1.4	5.4	1.8
Current Account/GDP (%)	14.4	13.2	8.7	23.6	25.8
Overall BOP/GDP (%)	3.0	5.9	2.2	9.7	7.3
External Public Debt (US$M)	1,564.8	1,679.8	1,567.6	1,360.6	1,264.7
WTI (US$/barrel)	20.40	30.30	31.70	56.50	72.30
Gross Official Reserves (US$M)	706.2	1,386.2	2,007.5	4,014.9	6,673.5

Source: Annual Economic Survey, Central Bank of Trinidad and Tobago

Alongside the growth and development in the real sector, the financial sector has also experienced a series of changes: the commercial banking system has been characterized by mergers and consolidation; in the credit union sector the top three largest credit unions operate almost as banks; the size of funds under management with the mutual funds industry grew sharply and funds were almost equivalent to that of bank deposits, and the establishment of a credit rating agency (regional) was an important milestone in the history of the financial sector.

The structure and composition of the financial system has changed more dramatically in the last decade (1996-2007) than over the two previous decades as each segment of the system responded to new developments and challenges within its own industry. For the commercial banks, mergers

and conglomerate activity dominated the environment; a process of consolidation and the merging of key business modules occurred as the monetary authorities moved towards a single reserve requirement for both banks and licensed non-banks. By the end of the decade the supervision of insurance companies was transferred to the central bank and a process of consolidation had begun to take place. While at least six new mutual funds domiciled in TT were registered over the decade, the Unit Trust Corporation (UTC) still maintains a dominant share of the market; the Export Credit Insurance Company (EXCICO) is now a fully-fledged Eximbank and the reinsurance company has been dissolved into an ordinary insurance company.

Table 10.2: Number of Financial Institutions in Existence Selected Years

	1996	2000	2004	2006	2007
Central Bank	1	1	1	1	1
Commercial Banks	6	6	6	6	8
(Branches)	(122)	(123)	(120)	(120)	(124)
Finance Companies and Merchant Banks	10	9	11	11	11
Trust and Mortgage Finance Companies	6	5	6	7	7
Development Banks	2	2	2	1	1
Credit Unions	356	356	126	129	131
Insurance Companies	41	40	39	59	59
Thrift Institutions	4	3	3	3	3
National Insurance Board	1	1	1	1	1
Trinidad and Tobago Stock Exchange	1	1	1	1	1
Unit Trusts	1	1	1	1	1
EXCICO/EXIM	1	1	1	1	1
Reinsurance Company	1	-	-	-	-
Deposit Insurance	1	1	1	1	1
Home Mortgage Bank	1	1	1	1	1
Ombudsman Office	-	-	-	1	1
Credit Rating Agency	-	-	-	1	1

Source: Central Bank of Trinidad and Tobago

10.2 Commercial Banking: 1996-2007

The banking sector has undergone significant and complex changes since 1996. Commercial banks grew at an unprecedented rate and adopted several strategies that fundamentally altered the traditional conduct of the business of banking. Some significant features were the emergence of new corporate structures, the increased use of technology, the development of new products to service customers and the formation of associations and task forces to address specific and emerging industry concerns. Commercial banks not only sought to broaden the range of financial

services beyond traditional banking products in the domestic market, but also established a presence in the English, Spanish and Dutch-speaking Caribbean.

For most of the period under review six commercial banks were licensed to conduct the business of banking. On October 1, 1997 Republic Bank Limited acquired Bank of Commerce which led to a reduction in the number of licensed commercial banks to five. In May 1998 Intercommercial Bank Limited, a newly-established foreign-owned commercial bank entered the industry as the sixth licensee. Two new institutions, First Caribbean International Bank (FCIB), formerly licensed under the Financial Institutions Act, 1993 as a non-bank financial institution and Bank of Baroda were granted commercial bank licenses on May 28, 2007 and October 1, 2007 respectively. While the Bank of Baroda is an entirely new entity, FCIB represents the merger of Barclays Bank and Bank of Commerce throughout the rest of the Caribbean. Although FCIB had operated in the region for around five years, the entity did not have a presence in Trinidad and Tobago. The changing composition of the banking industry had little effect on the market share. In 1996, the four largest institutions accounted for 95.8 per cent of the total banking assets and by 2007 this ratio was only marginally lower at 90.1 per cent.

10.2.1 Branch Network

Commercial banks have always maintained an extensive network of branches and as a result, the domestic population has had good access to banking services with a bank branch for every 10,510 persons and branch locations concentrated in predominantly urban areas. Banks however have extended their coverage with the use of technology to offer a wide range of information and transactional services via the internet, automated teller machines, point of sale terminals, and other electronic means. Most banks have websites which offer e-banking and/or telephone-banking to their customers.

By the end of 2007, five of the eight banks were either majority or fully owned by foreign entities.[43] This is in sharp contrast to 1996 when all but one of the commercial banks were either fully or majority held by nationals

[43] Towards the end of 2007 RBTT announced that preliminary agreement had been reached with the Royal Bank of Canada (RBC) on the acquisition of the assets of RBTT Financial Holdings Limited for $13.8 billion.

or domestically owned corporations. Shareholding in the sector has generally not been widely held as only three commercial banks are listed on the Trinidad and Tobago and other regional stock exchanges, and, once an agreement has been reached on the sale of RBTT, the stock was to be delisted. Furthermore, institutional investors make up the majority shareholding in the commercial banks.

The banking sector in Trinidad and Tobago has often been described as oligopolistic given that the industry is dominated by a small number of firms. At December 2007, of the eight participants, the top four retail banks account for 90.1 per cent of commercial bank assets. Each firm is aware of the actions of the others as well as the likely responses of other firms in the industry to any strategic plans on their part; some analysts argue that the industry is highly susceptible to collusive activity. On the other hand, competition between such firms to win or retain market share in an oligopoly can be intense, offering customers a wider range of services at competitive prices.

An important factor in determining whether an oligopoly structure exists is the extent to which the market is contestable. This refers to the ease of entry and exit into the market by new firms. Given the nature of the banking industry, new entrants must meet prescribed legal criteria and explicit approval from the Central Bank to conduct the business of banking. Over the review period, only one new commercial bank entered the market, but with the prevailing levels of profits of the incumbent firms, economic theory suggests that such 'super profits' would attract new entrants into the industry.

The level of competition among existing market players is another determinant of oligopoly. During the review period, firms have generally not been able to increase domestic market share at the expense of other participants. In fact, commercial banks have been aggressively involved in advertisement to promote superior service standards and relationship management, delivery channels, innovative products and services to woo and retain customers. However, while banks tended to be competitive, information on the ability of consumers to exercise a rational choice based on the ability to conduct product and price comparisons, to evaluate long and established banking relationships and a knowledge of switching costs, has not been observed. In 2002 however, there was a public outcry about excessive service charges by commercial banks.

BOX 10.1: Measures of Concentration in the Banking Sector

An industry's structure includes several elements such as buyer and/or seller concentration, product differentiation, and barriers to entry. Common measures of market concentration include the Herfindahl-Hirschman index (*HHI*) and the n-firm concentration ratio (CRn). The *HHI* is one way of measuring the concentration of market share held by firms. This index is defined as the sum of squares of the percentages of the market shares held by firms in the market. The index can take on values ranging from 10,000 to 0 – if a firm is a monopoly the index will be 10,000, and if there is perfect competition with near-zero market share by each firm, the index will be approximately zero. The main virtue of the *HHI* index is that it is easy to calculate and unlike concentration ratios the index uses information on all firms in the industry.

A biannual *HHI* was calculated for the industry based on total bank assets over the period June 1995 to June 2005. Over the period under review the index ranged from 2237 to 2512 which suggests that the industry was highly concentrated. However, the index fell slightly in 1998 following the entry of one new bank. Throughout the period, two banks dominated and maintained an average market share of about 60 per cent.

The CRn is used as an indicator of market power or an inverse indicator of the intensity of competition. An industry's concentration ratio would be the percentage market share of the top firms in the industry. This index approaches zero for an infinite number of equally sized banks and unity if the number of firms included comprise the entire industry.

$$\mathbf{CRn} = \sum_{i=1}^{n} s_i \quad \textbf{where } s_i \textbf{ is the market share of the } \textbf{\textit{i}th firm}$$

A commonly used concentration ratio is the *four-firm concentration ratio* (CR4), which is the percentage of market output generated by the four largest firms in the industry. This ratio is fairly correlated to the *HHI*. A concentration ratio ranging from 0 per cent to 50 per cent (or a *HHI* of 0 to 1000) corresponds to low levels of concentration. A ratio of 50 per cent to 80 per cent (or a *HHI* of 1000 to 1800) reflects medium concentration, and 80 per cent to 100 per cent (or *HHI* of 1800 to 10,000) shows high concentration.

For this study CR2 and CR4 ratios were calculated over the same period as the *HHI* with the same bi-annual asset data. The results of the CR2 show that two firms account for 60 per cent of total market output, whilst the CR4 results show that 93 per cent of market output is generated by four firms. Overall, these results are consistent with the *HHI* and indicate that the industry is highly concentrated.

10.2.2 Service Charges

During the first quarter of 2002, there was a public outcry against the range and level of bank service fees as well as the relatively high and exorbitant profits of commercial banks. Consumers sought redress for fees such as those imposed for the payment of utility bills.[44] In response, the Bankers

[44] Since the mid-1990s banks had facilitated bill payments on behalf of the utilities:- Water & Sewerage Authority (WASA), Telecommunications Services of Trinidad and Tobago (TSTT) and Trinidad and Tobago Electricity Commission (TTEC), on the basis of negotiated

Association of Trinidad & Tobago (BATT),[45] in an advertisement in the print media (December 13, 2002), acknowledged the concerns of customers and indicated that all member banks were committed to an independent review of their schedule of fees. BATT met with the Central Bank and the Consumer Affairs Division of the Ministry of Legal Affairs and gave a commitment to review bank charges and interest fees as well as to improve the level of communication to customers and the general public with respect to the charges. In January 2003 a consultant was hired by the Ministry of Legal Affairs and the Central Bank to determine how banking fees impacted on customers, especially the disincentive fee on payment of utility bills. The consultant found on the question of utility bills, that "banks have sought to transfer the burden of paying the facility from the utilities, the main beneficiaries, to the consumers." He also noted that a significant segment of the population continued to conduct all transactions in cash and had no access to electronic banking facilities which resulted in a high demand on bank teller service. The consultant recommended that the banks negotiate a new arrangement with the utility companies. In June 2003, BATT entered into agreements with the utility companies that each utility company would pay a bank fee of $3.00 plus VAT per transaction and as such customers would no longer be required to pay a service charge for the use of teller services to pay utility bills.

In addition, banks also agreed to remove six other "nuisance" fees. Fees were waived for third party withdrawals, encashment of cheques at different branches of the same bank and deposit items returned, photocopying services related to transactions at the bank, closing accounts and closure of accounts within three months, withdrawals without a passbook and notification / activation of dormant accounts.

The public outcry of 2002 had been the latest in a series of complaints and general dissatisfaction with the level of bank services, nuisance fees, and other charges and provided some of the impetus towards the establishment of the Banking Services Ombudsman in May 2003 (and more

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transaction fees, ranging from $0.65-$1.00. Since the volume of transactions related to bill payment impacted the cost of providing this service, some fees ranged from $3.50 to $4.00 for non-account holders. This charge was two-fold, partly to defray the cost of providing the service and to encourage customers to pay their bills via ATMs or telephone banking services which were free of charge.

[45] In 2002 the member banks of BATT were First Citizens Bank, Intercommercial Bank, Republic Bank Ltd, RBTT Bank and Scotiabank.

recently the Office of the Financial Services Ombudsman). The establishment and operations of this institution will be discussed in Section 10.10 below.

10.2.3 Legislative and Regulatory Environment

The Central Bank introduced several initiatives over the review period in order to ensure compliance with international best practices. One major international standard agreed to was the implementation of the Basel I Capital Adequacy Accord. In March 1995 the minimum capital charge of eight per cent for credit risk was implemented as Capital Adequacy Regulations under Section 38 of the Financial Institutions Act, 1993, (FIA 1993). In September 2000 a minimum capital charge of ten per cent was implemented for foreign exchange risk. The overarching objective of these minimum requirements is to ensure that financial institutions have sufficient capital to support the level of credit and foreign exchange risk exposures involved in either holding or having obligations on assets such as loans and investments. During the period commercial banks have been adequately capitalised for both credit and foreign exchange risk, with the minimum capital charge ratio of 19.07 per cent as at December 2007. In 2006, the Central Bank developed a model to capture market risk to be fully compliant with Basel I requirements. All banks would be expected to implement the market risk methodology in 2008.

A number of important guidelines were developed to provide a standardized framework for addressing pertinent issues relevant to all institutions licensed and regulated by the Central Bank. In May 2005, among three guidelines issued was one which dealt with “fit and proper”. The “Fit and Proper” Guideline applies to persons who hold key positions in an institution such as directors, trustees and senior management, as well as shareholders who exercise control over 25 per cent or more of the voting power at any general meeting. In May 2006, a Guideline on Corporate Governance was issued to set accountability standards for the board of directors and senior management.

On the legislative front, the Central Bank sought to update the Financial Institutions Act, 1993 and this process was initiated in 2002. As is customary, industry comments were sought on the proposed amendments. These amendments were to be presented before Parliament in 2007. However due to the extent of the amendments, two initiatives were taken. Several key vulnerabilities were identified and placed on a “fast track

agenda" resulting in the Financial Institutions (Amendment) Act 2006. This Act was proclaimed into law on September 4, 2006.

The FIA (Amendment) sought to:

- Expand the criteria for becoming a controlling shareholder
- Expand the fit and proper criteria to controlling shareholders
- Institute prior approval from the Minister of Finance in consultation with the Governor for mergers and acquisition where the merged entity would control more than 40 per cent market share
- Facilitate sharing of information between and among local and foreign regulatory bodies

The second initiative involved an entire overhaul of the FIA, 1993 which would result in the repeal of FIA, 1993.[46]

10.2.4 *Financial Overview*

Table 10.3 below contains key balance sheet data for selected years for commercial banks during the period 1996 - 2007.

Table 10.3: Commercial Banks: Selected Years

	1996	2000	2002	2004	2006	2007
Number of Banks	6	6	6	6	6	8
Branches	122	123	120	120	120	124
Balance Sheet Information TT$ Million						
Gross Assets	23,334	33,351	40,713	48,900	68,313	76,191
Loans	8,147	13,205	15,284	21,546	33,604	40,411
Investments	4,957	5,390	7,517	8,529	8,226	10,074
Deposits	12,888	18,517	22,504	27,648	42,283	47,692
Of which:						
Time	*4,515*	*5,996*	*5,585*	*5,558*	*12,042*	*14,540*
Demand	*3,053*	*4,959*	*8,076*	*10,563*	*14,563*	*15,522*
Saving	*5,321*	*7,561*	*8,843*	*11,526*	*15,677*	*17,630*
Total Capital	1,755	3,813	4,775	6,474	7,737	9,421
Of which:						
Retained Earnings	*431*	*1,774*	*2,493*	*4,014*	*5,010*	5,859

Source: Central Bank of Trinidad and Tobago

The total assets of commercial banks grew at an average rate of 11.75 per cent per annum over the decade. However, in absolute terms, assets grew by $52.9 billion over the period 1996 to 2007. The main areas of asset

[46] In December 2008 the FIA 1993 was completely revised and replaced by FIA 2008.

growth were loans ($32.3 billion), liquid funds ($9.2 billion), investments ($5.1 billion) and equity in subsidiaries and affiliates ($678.3 million). Asset growth was largely financed by deposits which increased by $34.8 billion, borrowings ($2.7 billion) and other long term liabilities ($2.4 billion).

Loans were the most significant component accounting for 53 per cent of the asset portfolio of commercial banks by 2007, up from 34.9 per cent in 1996. While in absolute terms all sectors benefited from improved access to funds, the private sector consisting of both firms (48.6 per cent) and consumers (41.4 per cent) were the major recipients of credit.

With financial liberalisation and the removal of exchange controls in April 1993, there has been a fairly steady increase in loans denominated in foreign currency. By 2007, foreign loans ($8.6 billion) represented 21.6 per cent of gross loans compared with ($1.2 billion) or 14.7 per cent in 1996.

Investments grew by $5.1 billion over the decade and represented 13.2 per cent of total assets in 2007, down from 21.2 per cent in 1996. Government paper was the investment of choice for commercial banks averaging 58.0 per cent over the period. At the same time, commercial banks were experiencing excess liquidity and in the predominantly low interest rate environment of the late 1990s and early 2000s, held considerable liquid fund balances. On average, investment denominated in foreign currency accounted for 33.4 per cent of the commercial banks' portfolio, allowing for a greater level of diversification.

Deposits were the primary source of funds averaging 64.7 per cent of commercial bank liabilities over the period 1996 – 2007. Commercial bank deposits recorded an annual average growth rate of 12.1 per cent. The bulk of deposits (averaging 98.7 per cent annually) had a maturity profile of less than a year. In 2007, consumers and businesses provided 45.6 per cent and 25.8 per cent of deposits respectively, compared to 71.4 per cent and 14.8 per cent in 1996. The structure of deposits had also changed: in 1996, savings accounted for 41.3 per cent, followed by time deposits at 35.0 per cent and demand deposits at 23.7 per cent. By 2007, savings accounts accounted for 37 per cent, while demand deposits stood at 32.5 per cent of deposit liabilities, closely followed by time deposits (30.5 per cent). Foreign currency deposits as a percentage of total deposits remained fairly stable, averaging 26.1 per cent over the period.

In general, commercial banks have performed creditably in a dynamic economic, legislative and regulatory environment. As TT seeks to be the financial centre of the Caribbean, the banks are aggressively pursuing opportunities to remain competitive both at home and abroad. Nevertheless challenges lie ahead given the migration towards the New Basel Capital Accord (Basel II), legislative reforms and increased competitive pressure from other regional players.

10.3 Non-Bank Financial Institutions

Since 1996 there have been significant developments among the non-bank financial institutions (NFIs). Tables 10.4 and 10.5 outline the details of some of the changes over the past decade. While there appears to be a marginal increase in the number of institutions, this masks the dynamics which existed throughout the period.

Table 10.4: Non-Bank Financial Institutions – Selected Data

	1996	1997	1999	2000	2001	2003	2005	2007
NUMBER OF INSTITUTIONS								
Finance Houses and Merchant Banks	10	10	10	9	9	11	11	10
Trust and Mortgage Companies	6	6	5	5	5	6	6	7
Total	16	16	15	14	14	17	17	17
NUMBER OF BRANCHES								
Finance Houses and Merchant Banks	13	17	17	12	13	17	18	20
Trust and Mortgage Companies	10	11	13	33	33	34	6	7
Total	23	28	30	45	46	51	24	27
PERSONS EMPLOYED								
Finance Houses and Merchant Banks	182	171	203	213	225	233	260	297
Trust and Mortgage Companies	316	345	370	379	418	399	298	294
Total	498	516	573	592	643	632	558	591

Source: Central Bank of Trinidad and Tobago

Over the decade there were several mergers, takeovers and rationalization of operations among the NFIs, and the total number of institutions remained at around 17. In 1997, the Bank of Commerce's operations were absorbed by Republic Bank Limited. The rationalization of the ANSA group and the revocation of one license led to a decline in the number of NFIs to 15 at the end of 1998. In 2000 the amalgamation of the operations of two licensed subsidiaries of First Citizens Bank Limited was effected, and this led to a further reduction in the number of finance houses. However, as new licenses were issued between 2001 and 2005, by the end of 2007 the number of NFIs stood at 17 with ten trust and mortgage finance institutions and seven finance houses and merchant banks.

Over the same period the number of branches rose from 23 to 51 before falling to 27 in 2007. This reduction was consistent with the merger and rationalization activity and contributed to the decline in the number of NFI branches. Some of the consolidation efforts were also linked to the Central Bank policy which aimed at lowering the reserve requirements of the commercial banks to bring this into line with that of the non-banks. The first phase of this programme was implemented in October 2003 with the lowering of the statutory reserve requirement for commercial banks from 18 per cent to 14 per cent of prescribed liabilities, and again a year after from 14 per cent to 11 per cent. The final phase, in which it is intended to equalise the reserve requirement at nine per cent, is expected to take place at an appropriate time in the near future. Prior to the implementation of the first phase, some commentators argued that removing the distortions between banks and non-banks would have detrimental implications for independent non-banks, that is those which are not subsidiaries of commercial banks. They contended that commercial banks would be positioned to improve upon their competitive advantage and the narrowing of the reserve ratio gap would present an unwelcome threat to the long-term survival of the non-banks. Interestingly, 2005 was a year in which many trust and mortgage companies, particularly those affiliated with commercial banks, transferred some of their operations to their parent companies. As a result they closed down just over 75 per cent of their branch operations.

Table 10.5 shows that the total assets of the NFIs tripled between 1996 and 2007, growing at an average annual rate of just under 30 per cent. However, the noticeable decline in the assets for trust and mortgage companies at the end of 2007 can be attributed to closure of some of the branch operations of these and the transfer of the business to the balance sheet of the banks. The fall-off in the number and value of the deposit accounts is also consistent with these trends.

In 1993, with the flotation of the TT dollar and the liberalization of the financial system, it became possible for citizens to hold foreign currency deposits in the domestic banking system. As a result the number and value of these accounts rose sharply. The majority of the deposits were held in

Table 10.5: Non Bank Financial Institutions: Selected Data

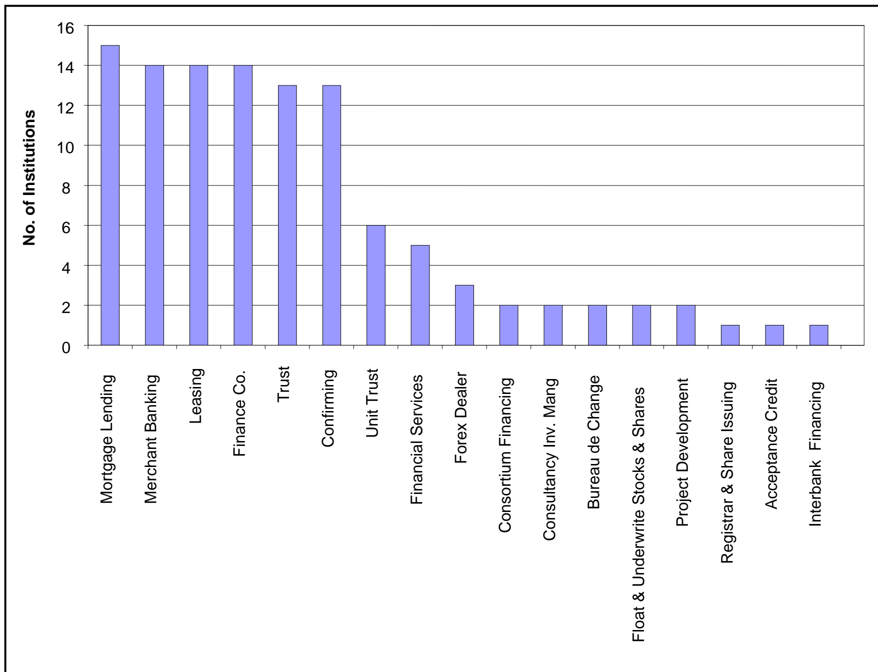
	1996	1997	1999	2000	2001	2003	2005p	2007
AVERAGE TOTAL ASSETS ($Mn)								
Finance Houses and Merchant Banks	2,189	2,296	4,392	4,679	5,327	7,560	13,496	17,291
Trust and Mortgage Companies	4,103	4,946	5,648	7,079	9,062	11,121	10,961	9,406
Total	6,292	7,242	10,040	11,758	14,389	18,681	2,4457	26,697
NUMBER OF DEPOSIT ACCOUNTS								
Finance Houses and Merchant Banks	30,929	33,618	27,073	28,071	26,807	17,634	9,148	2,937
Trust and Mortgage Companies	6,914	6,940	7,310	7,049	6,790	6,285	6,459	7,887
Total	37,843	40,558	34,383	35,120	33,597	23,919	15,603	10,824
AVERAGE TOTAL DEPOSITS ($Mn)								
Finance Houses and Merchant Banks	837	872	2,270	2,598	2,886	3,150	5,394	6,189
Trust and Mortgage Companies	30,929	33,618	27,073	28,071	26,807	17,634	1,151	382
Total	31,766	34,490	29,343	30,669	29,693	20,784	14,542	6,571

Source: Central Bank of Trinidad and Tobago

the commercial banks although by 2005 NFIs held on average 25 per cent of the foreign currency deposits in the system.

The typical services offered by the NFIs include mortgage lending, merchant banking, leasing, finance house operations, trust services and trade confirming. Figure 1 presents a snapshot of the different types of businesses provided by NFIs at the end of 2005, and the number of licensed institutions that provide these services. The data suggests that 72 per cent of the NFIs provide all the services offered.

Chart 10.1: Products Offered



The assets of NFIs are mainly held in investments, loans and other assets. The trust and mortgage group held more than 60 per cent of total assets in investments and loans while finance houses and merchant banks held over 70 per cent in investments and other local assets. In the first half of the decade the assets of finance companies and merchant banks were dominated by the loan portfolio, but this declined steadily after 2000 to approximately 14 per cent of total assets. Similarly, interest payments on loans were the traditional income earner for both categories of NFIs, but fee income now accounts for one third of total income. These changing

Table 10.6: Finance Companies & Merchant Banks: Distribution of Loans (%)

Per cent Of Average Total Loans - (Gross)*	1996	1997	1999	2000	2001	2003	2005	2007
Real Estate Mortgages	5.4	4.8	4.5	3.6	2.6	2.0	2.2	1.5
Public Sector	0.5	0.0	4.6	7.7	4.7	7.3	2.4	7.4
Agriculture	3.2	2.2	2.3	1.1	0.9	0.6	0.6	0.6
Petroleum	2.4	1.3	1.4	1.1	1.1	2.3	9.9	5.0
Manufacturing	27.8	23.8	18	11.6	7.9	4.8	8.0	8.3
Construction	4.5	5.7	7.2	7.1	8.7	8.0	6.5	6.6
Distributive Trades	11.5	9.9	5.6	4.2	4.4	4.7	3.1	2.6
Transport, Communication & Storage	9.7	8.5	8.2	5.1	7.7	4.2	4.4	4.8
Finance, Insurance & Real Estate	11.0	13.5	15	16.1	17.8	26.2	28.9	35.0
Personal Services	2.9	3.2	1.9	0.9	0.6	0.3	1.3	0.5
Leasing	13.1	16.7	8.5	8.5	9.8	10.2	9.1	5.7
Consumer Loans	7.9	10.3	16.7	16.9	17.4	10.9	10.0	17.6
Miscellaneous	0.6	0.0	6.1	16.1	17.2	18.6	14.9	4.3

Source: Central Bank of Trinidad & Tobago

trends suggest that NFIs have transitioned their business operations from traditional loans to other activities.

The loan portfolio of NFIs represents a wide cross-section of the economy. The concentration of lending for trust and mortgage companies has been predominantly in real estate for mortgage lending but for finance companies and merchant banks there has been a wider mix among business activities. The data in Table 10.6 show manufacturing and leasing as the sectors receiving the concentration of loans during the early years while consumers, finance, insurance and real estate, and miscellaneous activities received the greatest proportion in the middle years. Though consumer loans declined in the later period, finance, insurance and real estate continued to account for most of the loans.

10.4 The Insurance Industry

10.4.1 Structure

The insurance industry in Trinidad and Tobago is vibrant with numerous market players. There are two main categories of business, long term and general insurance, and the former dominates the industry. However, in addition to these companies there is also a number of intermediaries such as salesmen, adjusters, brokers and agents. In 2006, an analysis of the distribution of gross premium income showed long term insurance business represented just under 70 per cent of total gross premium income, while motor and property accounted for 10.5 per cent and 10.4 per cent, respectively. A similar analysis in 1996 and 2000 also shows the dominance of the long term segment of the industry.

In both the long term and general insurance business there are numerous market players. The **Report on Insurance and Pensions** notes that at the end of 2006, while there were 24 companies registered to transact long-term business, ten of these firms were not writing new business. The domestic industry is also open to foreign companies, but only one regional company is currently writing new business. The number of registered life insurance companies and the number of companies writing new business have been stable over the past ten years. At the end of 2000, there were 23 companies registered to transact life insurance business, 14 of which wrote new business, while at the end of 1996 there were 26 registered companies, 14 of which wrote new business. In 1996, there were also two

registered regional and three extra-regional companies who wrote new business.

Despite having several active market players, the long term insurance industry is fairly concentrated as the four largest life insurance companies accounted for 87.5 per cent of the industry's total assets in 2005. In 1996 and 2000, the four largest companies accounted for 86.4 per cent and 75 per cent of total assets, respectively. A look at the net premium incomes of the long-term business also shows a high level of concentration. In 2006 the four largest companies by asset size accounted for 87.7 per cent of the net premium income earned by the entire industry. This can be compared with 2000 and 1996 when the four largest life insurance companies earned 79 per cent and 69 per cent, respectively, of net premium income. This level of market concentration suggests an oligopolistic structure, with the industry dominated by three to four large firms.

The Report on Insurance and Pensions classifies general insurance business under two main categories: motor insurance and 'other than motor insurance', which includes property insurance, personal accident, group health, marine, pecuniary loss, general accident and export credit. In 2006 while there were 35 registered general companies, only 26 of these companies were writing new business. The number of registered and active general insurance companies has also remained relatively stable over the past ten years. For instance, in 1996 there were 35 registered and 27 active general insurers as against 33 and 26 registered and active general insurance companies, respectively, in 2000. With respect to motor insurance, 18 companies wrote new business during 2006. This represents a falloff from the number of motor insurance companies that existed between 1996 and 2000 (23). Since then there were several liquidations within the industry while two companies were placed under judicial management by the Central Bank. In the category 'other than motor insurance', there were 19 active companies in 2005, including five long term insurance companies transacting personal accident and group health business. Group health insurance accounted for 41 per cent of the premium income in this category of business. In 1996 and 2000 there were 28 and 23 companies, respectively, active under the broad category of 'other than motor insurance'. In both these years there were six life insurers responsible for transacting group health business, accounting for 40 per cent and 41 per cent of premiums under this category in 1996 and 2000, respectively.

Table 10.7: Participants in the Insurance Industry

	1996	2000	2004	2005	2006
Long Term Companies					
Registered	26	23	24	24	24
Active	14	14	15	13	10
General Insurance Companies					
Registered	35	33	34	35	35
Active	27	26	24	28	26
Intermediaries					
Salesmen	1,021	1,087	1,180	1,617	1,824
Agents	247	292	322	414	466
Brokers	60	71	72	85	87
Adjusters	15	20	21	24	23

Source: Report of the Supervisor of Insurance 1997, and 2001, Report on Insurance and Pensions 2004, and 2006

The motor insurance business is far less concentrated than the long-term insurance business. In 2006, four motor insurance companies accounted for about 55 per cent of the net premium income of the industry. In previous years the industry was even less concentrated, with four companies accounting for 42.2 per cent (1996) and 46.3 per cent (2000) of the net premium income, respectively. However, the 'other than motor insurance' group is fairly concentrated. In 2005, the top four companies accounted for 71.9 per cent of net premium income of the industry, compared with 64.4 per cent and 66.2 per cent in 2000 and 1996, respectively.

Table 10.7 contains data on the number of insurance intermediaries within the industry and the list includes salesmen, agents, brokers and adjusters. As the industry has grown over the years so has the number of intermediaries with the largest increase in salesmen and agents over the past ten years.

10.4.2 *Conduct*

Insurance companies are guided by the Insurance Act 1980 as regulation and supervision of the industry have lagged behind the sector's dynamism. Recent evidence suggests that there are balance sheet mismatches due to innovative funding or cross products that are difficult to recognize. In 2004 supervision of the industry was transferred to the Central Bank under the Insurance (Amendment) Act, 2004. This Act allowed for the following: 1) it transferred responsibility from the Supervisor of Insurance in the Ministry of Finance to the Central Bank; 2) it amended the appeal provision of

Section 205 of the Insurance Act whereby any regulatory action by the Central Bank will now continue to have effect, unless the appellant is granted an injunction by the Court; and 3) it re-defined arrangements whereby regulations under the Act continue to be made by the Minister, but now on recommendations from the Central Bank. A comprehensive review of the Insurance Act 1980 is currently being undertaken. The broad areas proposed for amendments are the supervisory system, the supervised entity, on-going supervision, prudential requirements and markets and consumers.[47]

As noted above, insurance companies offer a diverse range of products to the public. Long-term business companies specialize in life insurance, health insurance and group health insurance, but they also offer non-traditional products such as annuities, fixed deposits and mutual funds. General insurance companies provide coverage on most types of property such as motor vehicles, boats, houses, factories etc. There are some insurance companies that write both long-term and general insurance, others establish separate companies to handle life insurance and general insurance businesses and form a holding company to parent both operations.

In Trinidad and Tobago the insurance companies have generally adhered to the restrictions imposed by the Insurance Act, 1980 and have been prudent in meeting their statutory obligations. This suggests in part a certain level of conservatism in the investment activity of the insurance companies. For long term insurance business, Section 37(4) of the Insurance Act, requires that,

> *"Every company carrying on long term insurance business in Trinidad and Tobago shall place in trust in Trinidad and Tobago assets equal to its liability and contingency reserves with respect to its Trinidad and Tobago policyholders as established by the balance sheet of the Company as at the end of its last financial year".*

Provisional data indicate that life insurers placed $17.5 billion in the statutory fund in 2006, compared with $6.3 billion in 2000 and $4 billion in 1996. The Insurance Act 1980 also requires that life insurance companies

[47] The complete overhaul of the Insurance Act 1980 is still underway, but some critical amendments were introduced in February 2009.

maintain a local assets ratio of at least 80 per cent of its TT dollar liability in the statutory fund. In the ten years to 2006 insurance companies have been able to maintain this ratio, with the exception of 1996 when the ratio fell to 76.2 per cent.

General insurers are required to hold a statutory deposit, a statutory fund for motor vehicle insurers and meet a solvency requirement. Section 29 of the Insurance Act requires that general insurance companies maintain a minimum 40 per cent of their net premium income in a deposit at the Central Bank. As at the end of 2006, funds placed in the statutory deposit amounted to $496.5 million, compared with $220.5 million in 2000 and $160.5 million in 2001 and most of the deposits comprised TT government securities. Motor vehicle business also requires a statutory fund with assets equal to 'liability and reserves less the amount held on deposit' in accordance with Section 29 of the Act. The value of assets placed in the statutory fund in 2006 totalled $334.3 million while the required assets amounted to $342.4 million.

General insurers are also required by law to maintain a solvency ratio greater than 20 per cent. The margin of solvency however is calculated as net admissible assets less the minimum solvency requirement. In 2005, the margin of solvency of the industry was $422.2 million compared with $694.1 million in 2006. High and positive solvency margins indicate a healthy industry. In general the insurance industry has experienced high and positive solvency margins over 1996-2006 although individual firms have been in deficit at times.

Another characteristic of the insurance industry is the level of reinsurance ceded by the domestic insurance industry. In Trinidad and Tobago retention ratios are high for the life insurance segment and low for the property segment of the market. Retention ratios in the life sector averaged well over 90 per cent since 1996. In contrast, for property insurers the net retention ratio (net premiums divided by gross premiums) has averaged around 10 per cent. There are several reasons for low retention ratios in this segment of the market and they include the following:- the large policy values involved in property business; the occurrence of property damage tends to be more widespread and catastrophic in nature. In the event of a natural disaster e.g. a hurricane, earthquake, etc. if the property insurer has a high retention ratio, the local insurer may well face the possibility of bankruptcy.

Since 1996 there have been several important institutional developments in the insurance industry, including mergers, acquisitions, consolidations, expansion of services and re-branding. Some of the more significant developments include the following:- Clico, a subsidiary of CL Financial Holdings, acquiring controlling interest (53 per cent) of Republic Bank Limited in 2004; the formation of Guardian General from the merger of Nemwil and Caribbean Home in 2004; the integration of Tatil and Ansa Finance and Merchant Bank, and the re-branding of B&L Company Limited to Motor One under new ownership. In 2003, the HCU Financial Group of Companies acquired Bankers' Insurance Company Limited while Scotia Life was launched and 'The Mutual' became Sagicor. The change in ownership and structure reflected in part competitive forces at work in the industry.

When the Central Bank assumed the role of supervisor and regulator of the sector the Bank began the process of treating with those companies who were in contravention of the Insurance Act. As a result, the Bank issued notices of intervention to two general insurers in 2006, and both companies were subsequently placed under judicial management.

10.4.3 Performance

In assessing the performance of the insurance industry one must take into account three key factors. First, the format of company financial statements does not lend itself to traditional financial analysis; second, performance ratios usually capture underwriting and claims activity but do not capture other important activities such as investing and reinsurance; thirdly, there is usually a timing mismatch between premium income earned, claims and settlements. The measurement of the insurance industry's performance requires a multifaceted approach, and so performance can be determined by the financial strength of the institutions in respect of growth in assets, premium income and profitability. Alternatively, the performance can be assessed by how well the industry protects the wealth of society, but this is difficult to measure directly. One possibility is the amount of claims paid, as higher claims suggest greater realized protection. Some suitable performance measures therefore may be assets growth, net premium income, profitability, number of policies in existence and the sum of the value assured by insurance companies. Assets and net premium income measure performance in terms of financial strength of the industry while the number of policies and the sum assured measure performance in terms of the level of wealth protection.

The insurance industry generally performed well during the period 1996-2006. Assets of life insurance companies have shown tremendous growth, increasing from $4,946 million in 1996 to $29,364 million in 2006 or 12.6 per cent of the financial system's assets. Over this same period growth in net premium income of life insurers averaged 22 per cent per annum.

Between 1996 and 2006 the sum assured by long-term insurers has more than doubled, from $25 billion (1996) to $58.4 billion in 2006 or 48.4 per cent of GDP. The number of policies in existence has grown from 320,004 in 1996 to 538,950 in 2006. Increases in the number of policies and in the value of the sum assured would result in greater profitability and hence improved performance. The number of new life insurance policies written per year has increased from 40,844 new polices in 1996 to over 66,600 in 2006. Around 90 per cent of the new business each year is written by local companies.

Two profitability ratios that can be used for life insurers are investment income to investment assets and the pre-tax profit ratio. The investment income to investment assets ratio measures the rate of return on investment assets, and is especially important if a large portion of income is derived from investment income. In 2004, the investment income to investment assets ratio measured 9.7 per cent compared with 11 per cent in 2003. The pre-tax profit ratio tells the amount of profit that is generated by sales, for instance a pre-tax profit ratio of 75 per cent shows that for every one dollar of sales 25 cents is kept as profit. In 2004 the pre-tax profit ratio measured 69 per cent while in 2003 the ratio measured 83.9 per cent.

In respect of general insurance business, the main performance measure is the underwriting ratio or the combined ratio, which compares premium receipts to expected claims and expenses. The underwriting ratio is also called the combined ratio because it combines the ratio of policy loss and claims plus related expenses to earned premiums and the ratio of operating expenses to written premiums. An underwriting ratio of one indicates that claims and expenses equal premiums received. A ratio greater than one means that claims and expenses are greater than premiums received and suggests that the company is making losses. On the other hand a ratio less than one means that claims and expenses are less than premiums received and that the company is profitable. For instance, if a company has an underwriting ratio of 96 per cent it means

that the company has made four cents of underwriting profit per premium dollar.

Table 10.8: Insurance Companies: Performance Ratios

	2000	2001	2002	2003	2004
Long Term Business					
Net Premiums Written (% change)	26.9	31.6	10.8	69.5	15.9
Investment Income to Investment Assets	11.0	13.8	9.4	11.0	9.7
Underwriting Profit to Net Investment Income	81.9	83.2	79.9	84.0	45.0
Pre-Tax Profit ratio	99.7	127.8	98.4	83.9	69.0
General Insurance Business					
Net Premiums Written (% change)	21.9	2.4	22.5	1.7	3.9
Combined Ratio	86.5	84.0	84.3	75.4	71.2
Investment Income to Investment Assets	9.2	6.8	8.2	11.6	7.0
Underwriting Profit to Net Investment Income	-23.2	-19.7	-19.4	22.7	36.2
Pre-Tax Profit ratio	8.8	10.0	7.3	15.3	8.7

Source: Central Bank of Trinidad and Tobago

In 2004, the combined ratio for general insurers measured 71.2 per cent compared with 75.4 per cent in 2003, that is that general insurers made 28.8 cents of underwriting profit per premium dollar. Over the period 2000 to 2004 the combined ratio of general insurers averaged 80.3 per cent, a relatively profitable five-year period. There are, however, two main criticisms of the combined ratio as a performance measure; first, the ratio does not take into consideration investment income and secondly, risk distribution is not factored into the calculation. The investment income to investment assets ratio can be used as a measure of investment performance. For general insurers this ratio measured seven per cent in 2004 compared with 11.6 per cent in 2003. The pre-tax profit ratio of the general insurance business is markedly lower than the pre-tax profit ratio of the life insurers. In 2004 the pre-tax profit ratio measured 8.7 per cent lower than the five-year average of ten per cent (Table 10.8).

Another aspect of performance is the growth in net premiums over time. Table 10.9 shows the growth in net premium incomes for long term business, motor insurance and another category and suggests some volatility in the growth for all categories of premium income, with most volatility evident in income from motor insurance. For example in 2006, net premium income of motor insurers grew by 21.7 per cent compared with 24.4 per cent in 2005.

Table 10.9: Trends in Net Premium Income /$M/

	Long Term	Motor	Other
2002	2,360	361	293
2003	4,081	374	325
2004	4,590	421	291
2005	3,993	524	418
2006	4,367	638	558

Source: Report on Insurance and Pensions, Central Bank of Trinidad and Tobago

10.5 Mutual Funds

Following its establishment in November 1982 the Unit Trust Corporation (UTC) operated as a monopoly for eleven years. In 1994 the Minister of Finance opened the industry to other entrants and this resulted in three financial institutions launching their own mutual fund products and family of funds. These were the Roytrin, Republic and Scotia families of mutual funds. The first of the three to be introduced was the Roytrin family of funds offered by the then RBTT Bank (formerly the Royal Bank of Trinidad and Tobago). This was launched in March 1994 and was known as the Roytrin Mutual Income and Growth Fund. RBTT Bank's money market fund was introduced to the market shortly thereafter in February 1996. The First Citizens Bank also launched its money market fund (The Abercrombie Fund) in September 1998. In 2004 two additional funds were also introduced, the First Energy Fund and the Paria Fund.

10.5.1 Product Developments

Over the years the industry evolved and provided an alternative to commercial banks' deposits. In addition to the funds that are domiciled in Trinidad and Tobago, there are several other funds which are registered and traded in Trinidad and Tobago. These funds are traded in six different currencies (Trinidad and Tobago Dollars, U.S. Dollars, Barbadian Dollars, Pound Sterling, the Euro and Canadian Dollars) and have their origination in eight jurisdictions (Trinidad and Tobago, United States of America, Canada, Luxembourg, Isle of Man, Cayman Islands, Barbados and Guernsey).

Despite the existence of approximately thirty foreign funds which are traded in the domestic market, the industry is dominated by the funds which are domiciled in the local market and which account for well over 90 per cent of the market. Table 10.10 contains data on funds under management for the period 1997-2006. In 1997, funds under management amounted to TT$2.2 billion; by 2000 this had more than tripled to TT$6.9 billion. Total funds under management in the industry showed remarkable

growth, with growth averaging 43.2 per cent over the period. As at the end of 2006, funds under management stood at $31.8 billion.

Table 10.10: Funds Under Management 1997-2006 $000

	Mutual Fund Investments		
Year	**Aggregate Fund Value**	**Money Market Funds**	**Equity-based Funds**
1997	2,206.87	998.99	1,207.88
1998	3,374.51	1,539.86	1,834.65
1999	4,387.20	2,894.97	1,492.23
2000	6,928.79	5,023.25	1,905.54
2001	9,095.91	7,615.63	1,480.28
2002	14,155.54	12,092.16	2,063.38
2003	19,510.19	15,822.03	3,688.16
2004	23,962.75	18,334.66	5,628.09
2005	31,281.50	25,004.30	6,277.20
2006	31,834.88	26,145.44	5,689.44

Source: Central Bank of Trinidad and Tobago

This growth has been fuelled mainly by the introduction of new and varying types of funds such as bond funds, hybrid funds, money market funds and, to a lesser extent, equity funds and pension plans. The growth in funds under management is a reflection of the continued economic expansion in the economy in the late nineties and well into the new millennium. In 2003 funds under management surpassed commercial bank deposits ($16,884 million) and the trend continued to 2007 when this was reversed.

To date there is still no clearly defined regulatory structure for the mutual fund industry although the Central Bank has established prudential guidelines for those funds which are managed by licensed financial institutions. The major player in the industry is a creature of statute with certain operating guidelines set out by law.

10.6 Credit Unions

At the end of 2007 the credit union movement in Trinidad and Tobago had an asset base of approximately $8 billion, some 130 active credit unions with a membership of around 500,000 persons.[48] If one were to classify credit unions by size, then 21 large credit unions (assets greater than $100 million) and 13 medium credit unions (assets between $50 million and $100 million) account for well over 90 per cent of the sector.

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[48] Over the years there has been weakness in the data from the credit union movement. These data are based on submissions from the credit unions to the Central Bank.

Over the period 1996 to 2008, the asset base of credit unions grew from just over $2.5 billion to around $8 billion. This growth has been accompanied by a range of products and services offered by credit unions especially in the area of non-financial services. Very many credit unions are industrial, community-based or church-affiliated. While some of the larger credit unions can hire high quality managers and technically skilled individuals, the costs associated with their hiring may be beyond the scope of smaller credit unions. There are some concerns that the non-financial activities may lead to systemic risk and failure.

The **White Paper on Reform of the Financial Services Sector** identified the need "to upgrade the legislation that governs the activities of credit unions so as to …take account of international best practice in the area". Progress on the new legislation has been slow. In 2005 the government announced that the supervision of the financial activities of credit unions was to be placed under the aegis of the Central Bank. Since that time a Policy Proposal Document has been prepared and circulated to the industry for comment. This document is expected to provide the necessary framework for the new Credit Union Act which is currently being developed. It is expected that the Central Bank will have supervisory oversight of the sector. Some of the guidelines to be introduced will focus on risk-based supervision.

10.7 Small Business Credit and Rural Credit

Trinidad and Tobago, via the Vision 2020 framework, has identified entrepreneurship and the development of small business as key drivers in the country's quest to become a developed nation by 2020. This is clearly evident given a number of policy and operational decisions taken, such as the restructuring of the Small Business Development Company and the establishment of the National Entrepreneurship Development Company (NEDCO) in 2002. The main issues for small business have always been access to "cheap" finance and, to a lesser extent, appropriate training. [49]

Those who provide financial assistance to the micro and small business sector could be divided into four groups: government and government-

[49] The Government of Trinidad and Tobago (GOTT) classifies a micro enterprise as an entity with not more than 5 employees and assets or sales of less than $250,000. A business is classified as small if it employs 6-25 persons, has assets (excluding land or building) valued at $250,001-$1.5 million and sales of $250,000-$5,000,000.

funded agencies; international organisations; private financial institutions and community-based organisations. Nonetheless if one examines the evolution of policies for the sector, the state dominates. The state sets the overarching policy framework which guides the operations of the sector and directly intervenes through a number of agencies and state-funded programmes. The banking system, the largest provider of business credit, has not been heavily engaged with the small business sector. Apart from Development Finance Limited, the private sector lags behind the state in its provision of support to micro and small businesses.

The vision of the GOTT for the SME sector is one where the sector would serve as the catalyst for the reduction in unemployment, poverty and the production of sustainable employment and wealth. This would involve, among other objectives, the widening of access to microfinance facilities for the neediest, especially women, youth, rural communities and urban enclaves.

Table 10.11: Evolution of SME Policies

Period	Policy Focus	Institution/Agency
1970s - early 1990s	Small business	Industrial Development Corporation (IDC)
		Management Development Centre (MDC)
		Tourism Development Authority (TDA)
		Development Finance Company (DFC)
Mid 1990s – late 1990s	Small and medium – sized business	Small Business Development Company (SBDC)
		Tourism and Industrial Authority (TIDA)
		Development Finance Limited
Late 1990s - 2000	Small, medium and micro enterprises.	(Same as above)
	Enterprise Development Policy 2001-2005	Launching of the Advisory Council on Micro, Small and Medium Enterprises
2000 - Present	Small and micro enterprises	Business Development Company (BDC)
		Policy Unit, Enterprise Development Division
		TIDCO
	(Cabinet decisions in April 2002)	DFL-CDN, Microfin, NEDCO, CPSL

Source: NEDCO Strategic Plan 2003-2006

The mandate for SME development was initially vested with the Ministry of Enterprise Development and Foreign Affairs in 1999, but the Ministry of Labour is now charged with policy formulation and SME Development. The objective of the Ministry is the establishment of 5,000 new small and micro enterprises annually, an improvement in the business survival ratio and the

stimulation of entrepreneurship within the economy. Each of the programmes outlined below has several eligibility requirements which must be met by applicants for the loan. In the discussion which follows the main highlight is on the facility offered and the amounts available.

The Ministry of Social Development administers three programmes geared to micro enterprises – the Micro-Enterprise Loan Facility, the Regional Micro-Project Fund (RMPF) and the Micro-Enterprise and Training Grant. All three programmes are designed to assist underprivileged persons in their communities. The first programme is managed in conjunction with the United Nations Development Programme (UNDP) and offers assistance to persons who wish to establish a micro business but are unable to accomplish this due to limited financial resources. This service is administered by various community-based organisations (CBOs). Persons applying for this facility are offered assistance in business plan development as well as training in entrepreneurial skills. The maximum loan amount is $10,000.00.

The second programme provides grants to non-governmental organisations (NGOs), CBOs and faith-based organisations (FBOs). These grants can also be used to fund joint projects between civil society organisations and government organisations. Grants requested under the RMPF must not exceed $25,000.00. The third grant is offered to needy persons who are interested in undertaking a small business venture or skills training. The maximum amount of the grant is $5,000.00. The grant is paid directly to the supplier or suppliers of the goods or services required to start the business.

In August 2002, the Business Development Company Limited (BDC) was established as part of government's continued thrust to encourage entrepreneurship.[50] Unlike its predecessor, the Small Business Development Company (SBDC)[51] which concentrated on start-ups, the mission of the BDC is the enhancement of growth and competitiveness of existing enterprises. The BDC however is not classified as a lending institution since financial support services are related to the acquisition of machinery and equipment and assistance with working capital funding.

[50] The Government of Trinidad & Tobago owns 85 per cent of the BDC.
[51] The SBDC was designated as the implementing agency in respect of Government's policy for the SME sector in 2000.

The former is facilitated through the Caribbean Leasing Company Ltd. (CLCL) and the latter through BDC's Loan Guarantee Programme. The focus of CLCL is the provision of lease financing for equipment and machinery. During the period October 2002-July 2007, CLCL and its predecessor SBDC Leasing, received 318 applications for lease financing representing a total value of $155.8 million of which 178 were approved at a value of $56.5 million.

The Loan Guarantee Programme is specifically designed to assist businesses (existing/expanding, new or start-up) in securing loans from lending agencies by providing partial collateral. Guarantees are provided for funding purposes upon qualification for a loan from the lender and the BDC. The loan repayment period is a maximum of seven years while the maximum guarantee is set at $500,000.00 or 85 per cent of the loan amount, whichever is greater. For the period October 2002-July 2007, the BDC received 621 applications for loan guarantees of which 533 were approved. Total loans supported were in the amount of $46 million of which the total loan guarantee amount was $29.1 million.

Although the ratios in Table 10.12 do not conform to conventional benchmarks, the data show that BDC's financial performance improved between 2004 and 2006. As a state organization, measurement of financial performance in isolation does not give a true representation of overall organizational effectiveness. A balanced scorecard approach which examines internal processes, workforce learning and development and the customer in addition to finances may be better suited.

Table 10.12: Financial Performance of the BDC

Financial Ratios	2004	2005	2006
Liquidity			
Current ratio	5.95	4.79	3.66
Efficiency			
Income/Average total assets (%)	0.05	0.07	0.08
Profitability			
Return on Assets (%)	4.10	5.71	6.40

Source: Business Development Company

The National Entrepreneurship Development Company Limited (NEDCO) was established in August 2002 and provides funding and training to start or enhance small and micro enterprises. The lending limit was initially $50,000 for first-time clients, but this was increased to $100,000 in 2006,

while the ceiling for existing clients was also raised to $250,000. In order to access financing prospective borrowers must undergo business training. NEDCO has been successful at facilitating 7,600 clients since its launch, with a loan repayment rate of 86 per cent[52]. Approximately 13,300 jobs have been created and 4,600 persons have also been trained. During the period August 2002-September 2004, NEDCO approved 2,981 loans at a value of $52.4 million via ten regional centres. Sixty-eight per cent of the loan portfolio is geared towards non-traditional activity while females accounted for 51.6 per cent of recipients. After receiving $45 million from stakeholders for fiscal 2005, the loan portfolio grew to $82 million which represented 5,000 businesses. Un-audited figures suggest that the loan portfolio has grown further to $162 million at the end of June 2007, although the delinquency rate also rose, to almost 25 per cent.

Several international organisations also support the SME sector through grants and investment, for example, the Inter-American Development Bank (IDB) Multilateral Investment Fund (MIF) – Small Enterprise Investment Facility. The objective of the IDB/MIF is to promote private sector growth through grants and investments. While the IDB is not directly engaged in lending to SMEs, funds are utilised for institutional strengthening. In 1996, the MIF supported the SME sector through strengthening of the credit union industry, with a facility valued at US$1.28 million which was closed in December 2004. The MIF also supported the development of micro, small and medium-sized businesses through the purchase of Caribbean Microfinance bonds from DFL. The purchase in the amount of US$2.86 million in September 2001 allowed Caribbean Microfinance to commence operations. The Dynamic Equity Venture Fund is also financed in part by the MIF. Approved in July 2001 at US$3.372 million, the Fund invests in companies with no more than 100 employees and US$5 million in sales. Although all the beneficiaries do not fall within the strict definitions of micro and small businesses, the sector stands to reap the majority of the benefits. As at July 31, 2007 there remained US$773,000 in un-disbursed funds.

There are also three small CBO's which provide loans to residents of specific districts who are unlikely to qualify for loans from commercial banks. The loans range in value from as low as $2001-$100,000. The lending programme of one such group is based on the Grameen Bank

[52] The international benchmark success ratio is 33 per cent.

model and since its inception in 2001 a total of 3,162 loans ($6.3 million) were granted between 2001 and 2007.

10.8 Agricultural Development Bank (ADB)

The Agricultural Development Bank was established in 1968 with the objective of providing credit for the sustained development of the agribusiness sector. Although the bank's function is sector specific, the majority of its clients could be classified as micro and small enterprises using the standard definitions. Since 1968, the ADB has provided over 40,000 loans or almost $3 billion in credit to the agricultural sector which encompasses the entire food chain from primary production to agro-processing, marketing and other support services. The ADB has also facilitated the direct employment of at least two persons per loan. ADB loans, which are fully insured, could be utilised for project establishment, project rehabilitation, project expansion, purchase of equipment, machinery and vehicles, farm house construction, working capital, operating costs and infrastructural development.

The financing facilities offered by the ADB include the following: **Regular loans**, as well as a **Same day/Package loan** (Loans with no up-front fees and minimal security granted in one day to specific farmers, for example, dairy farmers requiring cash urgently). **Youth Window** (Loans up to $25,000 targeting individuals 18-35 years of age). The loan size is usually based on the total project cost and repayment is structured to fit the product cycle. Some features of a typical loan include: *moratorium, flexible repayment terms, and competitive interest rates calculated on the declining balance (amortized).* In the 2007/2008 budget, the ADB's prime lending rate was reduced to six per cent. The ADB also provides refinancing, loan rescheduling and life insurance for all loans. With the increased focus on the agriculture sector, the ADB is poised to become one of the most significant providers of funding to micro and small business enterprises.

Table 10.13: Financial Performance of the ADB

Financial Ratios	2002	2003	2004
Liquidity			
Current ratio	46.07	15.56	12.42
Efficiency(%)			
Income/Average total assets	6.15	7.96	9.80
Profitability			
Return on Assets (%)	10.73	5.42	5.01

Source: Agricultural Development Bank

The financial performance of the ADB was affected by high loan loss expenses because of a high proportion of non-performing loans. This led to the revision of the Loan Loss Provision Policy in 2004. The data in Table 10.13 show the ADB as a profitable enterprise between 2002 and 2004.

10.9 Venture Capital Incentive Programme

The Venture Capital Incentive Programme (VCIP) was introduced to address the lack of equity capital available for small business financing as set out in the Venture Capital Act of 1994 and amended in 1997 and 2005. The VCIP commenced operations in October 1996. The prime objective of the VCIP is to increase the supply of risk capital to the entrepreneurial small business sector, thus fostering the expansion and preservation of small businesses as well as creating new jobs. This objective is achieved by tax credits that are granted to investors in qualifying companies.

Those companies seeking to make investments in a small or medium business venture must first be registered as a Venture Capital Company (VCC) in order to receive tax credits. Those entities seeking to obtain financing from a VCC must first obtain Qualifying Investee Company (QIC) status. Qualifying Investee Companies have access to advisory services and pre-investment technical support through the AMU. This assistance is necessary for QICs to secure funding for their projects. The GOTT provides investors in registered venture capital companies with an incentive equal to the highest marginal tax rate for individuals and companies in effect. VCIP administers a tax credit incentive of 25 per cent to investors of registered venture capital companies. The venture capital company must subsequently invest in one or more QIC. Where the amount of the tax credit cannot be wholly set-off against the tax accessed for that income year, the amount of the unclaimed tax credit may be carried forward and set off against tax accessed for succeeding years of income until fully utilised.

The industry is comprised of three venture capital companies under the purview of the VCIP and two private venture companies registered as issuers under the purview of the Securities and Exchange Commission. At the end of 2003, the total amount of funds available for investment was $15.3 million. VCIP has facilitated the raising of $15 million in equity capital from individual and institutional investors and at the end of 2005 venture capital companies invested $5.3 million in ten businesses.

10.10 The Financial Services Ombudsman (OFSO)

In May 2003 the Office of the Banking Services Ombudsman was established to handle the complaints from customers of the commercial banks. The Office was established by an agreement between the Central Bank and the commercial banking sector. In April 2005 the office was rebranded the Office of the Financial Services Ombudsman (OFSO) to include the insurance industry. The main objective of the OFSO is to receive complaints from individuals and small businesses and to facilitate the settlement of these complaints. The OFSO investigates complaints with respect to products and services (deposit and loan accounts; life insurance policies, individual annuity contracts). However the Office will not handle complaints in respect of actuarial calculation, insurance premium rates, the general interest rate or the pricing of products.

Table 10.14: Banking Sector: Complaints Received

	Complaints Received		
	Total	of which Qualifying	Non-Qualifying
2003*	154	25	129
2004	156	20	136
2005	73	36	37
2006	40	17	23
2007	26	12	14

* *For eight months of operation*
Source: OFSO Annual Reports

Over the four years of operation to 2007 the OFSO experienced a gradual reduction in the number of complaints from both commercial banks and insurance companies. Table 10.14 below contains data on the number of complaints received in respect of the banking system. With respect to the insurance industry however the OFSO noted that there continued to be a core group of companies – motor vehicle insurers – against whom complaints are lodged and who take an inordinate amount of time to settle claims. For example, April to December 2005 the OFSO received 298 complaints, 86 per cent of the complaints were in respect of motor vehicle insurers and 13 per cent in respect of life insurers. In 2006, there were 480 complaints, 95 per cent of which were in respect to motor insurance and four per cent life and health insurance.[53] Most of the complaints in respect

[53] The 2008 Report of the OFSO points to a decline in the number of complaints from the financial services sector. However the Report notes that there are five insurance companies which continue to account for over 70 per cent of complaints received.

of banking services relate to unauthorized transactions in customers' accounts, excessive fees and credit policies of banks.

10.11 Conclusion and Afterword

This paper has examined recent trends in the financial system in Trinidad and Tobago with special emphasis on developments in commercial banking, insurance companies, mutual funds, credit unions, and small business. These are important financial intermediaries as they match funds between deficit and surplus spending units, mobilize savings and manage wealth accumulation. The period 1996-2007 represented one of continuous growth and expansion in the economy, which was reflected in the financial sector as well – institutional growth and deepening, portfolio diversification among savers and some development of the capital market.

This paper does not focus directly on monetary or financial policy; nor does it address additions to the financial architecture such as the establishment of a real time gross settlement system and that of an automated clearing house; the introduction of a regional credit rating agency or developments in pension funds (both public and private). For the most part, each one of these topics belongs to a separate study. In 2005 the Bank introduced a Public Education Pamphlet Series which has addressed some of these topics.[54]

While the financial sector developed over the period, the slow pace of regulatory reform continued to be a challenge. Major revisions to FIA 1993 for example would take close to five years before they were completed in 2008. Although the White Paper on Financial Sector Reform outlined a fairly ambitious agenda for the pace of revision to legislation, there has been some slippage to date.

The end of 2007 represents a natural cut-off date for the conclusion of the study for several reasons. As already indicated, major revisions to the Central Bank Act and the Financial Institutions Act were introduced in 2008 and 2009. In addition the international financial crisis, which erupted in late 2008 and turned into a global recession, ushered in a new debate on financial sector reform. The CL Financial debacle of 2009 has brought into sharp focus the issues of cross border supervision and financial holding

[54] The Public Education Pamphlet Series has three issues devoted to the mortgage market, the government securities market and the payments system in Trinidad and Tobago.

companies. Over the short to medium term, legislative changes which focus on consolidated supervision as well as crisis management should be in place to guide the financial services industry in the second decade of the millennium. The outlook for the sector is still promising despite the adverse developments of 2008-2009.