

# THE REGULATION OF NON-BANK FINANCIAL INSTITUTIONS IN THE EASTERN CARIBBEAN CURRENCY UNION

by

Garth Nicholls  
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Caribbean Centre for Monetary Studies





## THE REGULATION OF NON-BANK FINANCIAL INSTITUTIONS IN THE EASTERN CARIBBEAN CURRENCY UNION

Non-bank financial institutions (NBFIs) have increasingly come to play a more significant role in the financial systems and economies in the Eastern Caribbean Currency Union (ECCU). The growth of these institutions has improved the depth and breadth of the financial market but this has also increased the potential for problems in these institutions to lead to significant challenges, not only in the financial system but also in the general economy. The fact that many jurisdictions in this region have underdeveloped regulatory and supervisory systems for NBFIs raises serious concerns about the adequacy of the current system to effectively regulate this important part of the financial system. This book critically evaluates the regulatory and supervisory systems in place for NBFIs, identifies the weaknesses and gaps in the current systems, evaluates the special problems faced by regulators in a common currency area, analyses the various options for the improvement of these systems and makes recommendations for the development of appropriate regulatory and supervisory systems for NBFIs in the ECCU.

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## *Preface*

The regulation of non-bank financial institutions within the Eastern Caribbean Currency Union (ECCU) is becoming a critical issue for policymakers in the current environment. The reasons for this emanate from both external and domestic factors. With respect to the former, the international financial community, following the many banking and currency crises in the last two decades and particularly the Asian financial crisis of 1997, has embarked on a programme, not only to create a new financial architecture but also to fill the regulatory gaps across the whole spectrum of financial institutions. This has led to the promotion of a raft of standards and codes covering not only institutions but also processes such as corporate governance.

At the domestic level, there has been significant growth in the market share of non-banks, which is consistent not only with economic growth but with the diversification of the financial sector. Institutions such as credit unions, in particular, have shown significant growth as they attract clients at a particular socio-economic level who have easier access to credit from such institutions than from the commercial banks. This growth, however, presents challenges on the regulatory front to the authorities, based, in the first instance, more on consumer protection than on systemic risk. The fact that these institutions have to interact with the dominant commercial banking system, however, has the potential for transferring crises from such institutions to the arena where significant systemic risks can occur.

The nature of the currency arrangements in the ECCU poses a significant challenge to the implementation of a regulatory system that effectively addresses the issues posed by these non-banks. The multi-country structure and differing levels of regulatory authority present legal and jurisdictional challenges to the countries to maintain safe and sound institutions. This is compounded by the relatively high administrative costs of establishing and maintaining effective regulatory regimes.

In the international financial system, in addition to the range of new standards and codes, the prosecution of Financial Sector Assessment Programmes (FSAPs) has placed increased emphasis on effective regulation of the entire financial system as opposed to selective institutions such as banks and securities markets. The institutional arrangements that have been proposed to meet these challenges fall essentially into two segments, the traditional regulation of each set of institutions by its own regulator, or the combination of the regulation of all institutions under a single regulatory body. A further development has been the separation of these regulatory functions from central banking activities.

In the ECCU we have had to be mindful of the following factors when attempting to create a regulatory regime which covers all institutions and provides a credible guarantee of ensuring a safe and sound financial system: firstly, the sensibilities of local jurisdictions in an environment of multiple sovereignties; secondly, the need to provide the capacity to ensure adequate consumer protection and to guard against systemic risks; and thirdly, the costs and benefits of providing effective regulatory services at the currency union level as opposed to the national level.

As the authors imply in this very important monograph, finding solutions to these problems will become even more critical as progress is made towards the establishment of a single financial space in the ECCU. Suffice it to say, the demands of the international community for higher standards of regulation, the internal dynamic of increasing systemic risks, and the costs of establishing effective regulatory regimes will be critical determinants of the process as we move forward.

*K Dwight Venner, KBE*  
*Governor*  
*Eastern Caribbean Central Bank*  
*May 2004*

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This book is the culmination of many years of research and discussion on the increasingly important area of the regulatory and supervisory framework for non-bank financial institutions in general, but with specific reference to the Eastern Caribbean Currency Union. Although this book represents the views of the authors we would not have been able to bring this publication to fruition without the support and assistance of a number of individuals and institutions. In this regard, we owe a particular debt of gratitude to Professor Peter Blair Henry who served as the external referee for this text and whose pointed and insightful comments significantly enhanced the quality of the final product. Our work also benefited tremendously from Dr. Shelton Nicholls and other colleagues in the Caribbean central banking and university communities who offered comments and guidance during the preparation of the initial research papers. A special word of thanks is also due to Governor Dwight Venner of the Eastern Caribbean Central Bank who, on very short notice, graciously agreed to write the preface to this book. We are grateful to the staff of the Research Department of the Eastern Caribbean Central Bank for their unstinting support in the provision of data and contextual information for the book and to Mrs. Savitri Pargass for her editorial expertise. Finally, no expression of gratitude is too much for the dedicated and meticulous efforts of Mrs. Gloria Lawrence and Ms. Ava Gordon who were responsible for all typing and formatting.

*Dave Seerattan*

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# Chapter 1

## INTRODUCTION

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*N*on-bank financial institutions (NBFIs) in the Eastern Caribbean Currency Union (ECCU) have increasingly come to play a more significant role in the small economies of the Eastern Caribbean. These institutions not only supplement the services provided by the dominant commercial banks but have also expanded the range of financial services available to economic agents and increased the level of competition among financial institutions in the system.

The rapid growth of these institutions also implies that problems and insolvencies within this class of institution may now have implications for the stability of the financial system. The fact that many countries in the region have regulatory systems for non-banks which are either under-developed or in the process of being re-structured raises serious concerns about the adequacy of these systems to protect the stability of non-bank financial institutions and indeed, by extension, the financial systems in the Eastern Caribbean.

In this context, this book seeks to critically evaluate the current systems in place for the regulation and supervision of non-banks in the ECCU to determine the gaps and weaknesses inherent in these systems and the requirements for an appropriate and effective regulatory framework for NBFIs in this region. The book

## 2 *Non-Bank Financial Institutions in the ECCU*

also looks at incentive contracting issues, the optimal institutional framework for the regulation of NBFIs and issues related to the efficiency of the financial system.

This book, therefore, explores the rationale for the regulation of NBFIs in the ECCU, reviews the structure of the NBFIs and their impact on the financial system in the region, critically evaluates the systems in place for the regulation and supervision of NBFIs and examines the special problems faced by policy makers in their attempts to devise a regulatory framework for NBFIs in a common currency area. In particular, the book considers how the traditional problem faced by the regulatory authorities, that of the trade-off between efficiency and safety, is compounded by the developmental role regulators in these jurisdictions have to play, and how this additional responsibility complicates the regulation and supervision of financial institutions and indeed the design of an appropriate regulatory and supervisory system for NBFIs in the ECCU. The book concludes by looking at the pros and cons of the Eastern Caribbean Central Bank (ECCB) being formally involved in the regulation and supervision of all NBFIs in the ECCU.

## *Chapter 2*

# **FINANCIAL INSTITUTIONS AND THE RATIONALE FOR THEIR REGULATION**

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**F**inancial institutions and markets have gone through much change in the last decade. The revolution in information technology, financial innovation, globalization of financial markets and increased competition have led to the continuing erosion of the traditional lines of demarcation between financial products and the institutions that provide these services.

These developments have made it increasingly difficult for regulators around the world to keep pace with the emerging imperatives in the regulation and supervision of the financial sector. The frequency of failures of financial institutions in recent years is testament to the growing challenges to the regulatory and supervisory systems in place for the financial sector. This in turn has intensified the debate about the effectiveness of current regulatory and supervisory structures in maintaining the health and stability of the financial system.

In the ECCU countries, like most other countries where Anglo-Saxon financial traditions exist, the



compartmentalization of operations, functions and scope of financial institutions has been the order of the day. The regulatory framework that evolved in the ECCU therefore reflects this compartmentalization, with bank and non-bank financial institutions generally falling under the umbrella of different regulatory agencies or ministries within government.

This compartmentalization has another dimension, a national dimension, created by the fact that ECCU member countries are part of a monetary union with one Central Bank and one currency. The Central Bank has regulatory responsibility for banks and some non-banks under the Uniform Banking Act but shares this responsibility, especially in the area of non-banks, with multiple national regulatory agencies in each territory. The division of regulatory function is therefore not only in terms of different classes of institutions but also in terms of different countries.

The macroeconomic performance of the ECCU region over the recent past has been relatively good. In particular, important prices and monetary variables have exhibited a level of stability. This stability, combined with a narrow economic structure and a regulatory system that is not onerous, has generated few incentives for financial institutions to take on new or more risks or to circumvent regulations and other perceived obstacles created by the regulatory regime.

In spite of this relatively stable economic and financial environment, however, there is still potential for regulatory problems. There is some measure of financial innovation in the region and competition across functional lines. Furthermore, financial liberalization and gaps in the regulatory and supervisory structure, especially for non-banks, will cause problems in the

future if these issues are not addressed now. In particular, the sometimes ambiguous and informal line of regulatory control between national authorities and the ECCB needs to be unambiguously defined and the obvious gaps in the regulatory infrastructure plugged. This is not, however, going to be easy since the debate about the most suitable regulatory structure is still raging (particularly the pros and cons of a single regulator as against a two-tiered system) and because the regulatory system in the ECCU operates within a monetary union (hence the need to find an appropriate balance between the national and regional regulatory systems).

## **2.1 Defining Non-Banks**

When dealing with the issue of the regulation of non-bank financial institutions, one obviously needs to have a working definition of what we mean by a non-bank financial institution. A review of the literature reveals that there does not seem to be a uniform and generally accepted view of what constitutes a non-bank financial institution. The prevailing definitions often vary from country to country, with many of these supposed non-banks operating in ways very similar to banks.

The International Monetary Fund's classification<sup>1</sup> of financial institutions does, however, provide some guidance. The Fund uses a functional classification with two broad groups, deposit money banks and non-monetary financial institutions. The second category

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1 *Manual on Monetary and Financial Statistics*. International Monetary Fund, Washington D.C., 1996.

is further sub-divided into other bank-like institutions and non-bank financial institutions. The characteristics which seem to distinguish deposit banks from non-monetary financial institutions are that the former accept transferable deposits, operate on the basis of fractional reserves and are governed by reserve requirements. Of course, there are many “near-banks”, as well as other obvious non-banks in the group of non-monetary financial institutions that have many of the characteristics of banks. This is compounded by the fact that in recent years there has been a degree of competition across traditional product lines by financial institutions, the so called “universalisation”<sup>2</sup> of financial institutions, which has contributed to the blurring of the distinctions between banks and non-banks.

Our approach is, therefore, to start with institutions which have the above-mentioned characteristics (particularly those institutions in which transferable deposits are the main liabilities) but which are also defined statutorily as banks, with all other financial institutions being defined as non-bank financial institutions. In the ECCU, therefore, the range of non-bank financial institutions includes development banks, national development foundations, finance companies, building societies, trust companies, credit unions, insurance companies (both life and non-life), friendly societies, a regional home mortgage bank, private pension funds and social security schemes.

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2 The process by which financial institutions move to offer the full range of financial services, regardless of institutional type.

## **2.2 The Rationale for Financial Regulation**

The standard rationale for government intervention in the financial sector has always been the problem of market failure.<sup>3</sup> In particular, the standard theorem of welfare economics asserts that every competitive equilibrium is pareto efficient. This is based on very restrictive assumptions, especially the assumptions of perfect information availability for all agents and complete markets. Economies with imperfect information or incomplete markets have been shown not to be constrained pareto efficient (Greenwald and Stiglitz 1986). Moreover, Greenwald and Stiglitz have argued that appropriate interventions can make all agents better off. Determining which interventions are appropriate is, however, more easily said than done.

It is widely recognized, though, that external or public regulation of financial institutions is an appropriate intervention because without it there would likely be more failures, which could impose significant costs on individuals and the economy. These costs often surpass the purely financial losses incurred from the failures.

More specifically, financial regulations serve to:

- (i) Deal with externalities when private and social costs diverge. In this regard, the

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3 Stiglitz (1993) has identified a variety of reasons for market failure. These include the problem of monitoring solvency, externalities in monitoring, the externality of financial disruptions, missing and incomplete markets, imperfect competition and information inadequacies.

probability of systemic risks is the main externality that needs to be addressed by public regulation.

- (ii) Prevent the exploitation of poorly informed agents and provide investor protection to those who are in a disadvantaged position, especially with respect to the availability of information and the ability to accurately process such information.

In the Caribbean, however, there is a third reason for regulatory intervention, that of market development. As Stiglitz (1993) has noted, government intervention can improve welfare when there are market failures. For instance, in some Caribbean economies no formal markets (stock exchanges) for corporate securities have been established, in this case the market failure of missing markets.<sup>4</sup> This deficiency generates problems in terms of transparency and price discovery, which imposes high transaction costs on agents trading in these instruments.

For this reason, many governments in the region, in an effort to develop their nascent capital markets, promulgated 'merit' regulations that sought to set the price at which assets were bought and sold and the cost of transactions. This was done to reduce the risks associated with this activity so as to attract agents to these new markets and, in so doing, increase their liquidity and efficiency. This regulatory approach would normally give way, as the market developed, to a more

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4 There are rudimentary call exchanges to facilitate securities transactions in some jurisdictions.

open approach, where rules and procedures rather than outcomes are determined. This approach recognises that markets might not have developed without these interventions because the set-up cost was too high (cost of market infrastructure), but once these costs have been reduced by “merit” regulations and a nascent market infrastructure put in place, agents are more willing to participate leading to improvements in the size and liquidity of the market.

Another goal of public regulation is that of preventing monopolies. In small states, however, an oligopolistic structure is likely to develop since the size of the market can only support a few institutions. So apart from allowing competition to determine outcomes by allowing entry and exit, there is no logic in having specific regulations to control monopolistic behaviour (as there are in developed markets) in the ECCU.

An additional rationale for financial regulation is the potential economies of scale in monitoring that could be gleaned from national (or regional) regulation of the financial sector. Continuous monitoring is required for the efficient operation of the financial sector because of the fiduciary role played by institutions and agents providing financial services. Monitoring is also needed since the value of most financial assets is determined by the behaviour of the institution after sale of the asset. Monitoring helps to ensure that institutions behave in ways that do not compromise the value of their clients’ assets. This is particularly true for long-term contracts often sold by non-banks.

Monitoring by consumers is not efficient because of high cost, duplication, lack of expertise and the paucity of information. Individual monitoring will also be subject to the “free rider” problem, where occasional consumers



are able to benefit from the monitoring done by individuals without having to pay any costs. With specialist agencies, consumers delegate the responsibility of monitoring, they reap the benefits of scale economies, and the costs are distributed across all participants in the market. The advantages of delegating monitoring must, however, be weighed against the costs of regulation (Dewatripont and Tirole 1994).

These costs include the cost of establishing regulatory institutions, compliance costs for institutions and agents providing financial services and structural costs. Structural costs emanate from stifling innovation, impairing competition, moral hazard, regulatory capture by powerful interest groups, the escalation of regulation and restrictions on the choice of consumers who may choose to have no regulations. The magnitude of these costs and therefore the strength of the case for financial regulation are dependent on how the regulatory system is structured.

The rationale for financial regulation is probably best captured by Coase (1988), who argues that markets require considerable internal infrastructure and self-regulation to minimize transactions cost and to ensure the smooth functioning of the market. Issues such as the role of various agents, how transactions are registered, the settlement of disputes and the resolution of market failures all have to be formalized in terms of concrete rules and systems. While the major part of this market infrastructure has been built up by private agreement and the actions of private agents, these agreements and systems still need a foundation of laws and institutions to enforce these rules.

Indeed, the case for external or public financial regulation is based on recognition of the fact that if

private players were left free from government intervention, their individual incentive structures could lead them jointly to market failure. Moreover, the bankruptcy cost emanating from any such failures would be incurred not only by the agents directly involved but also by third parties and the economy in general. It is this possibility of losses to third parties and the system in general that is the most powerful reason for having public financial regulations.

### **2.3 The Rationale for the Regulation of Non-Banks**

The issues involved in the regulation of non-banks in the ECCU are still relatively different from those involved in the regulation of banks.<sup>5</sup> Specifically, in non-banks financial institutions:

1. Systemic risks are less evident
2. Contagion is less likely
3. The potential disruption of the payments system does not arise

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5 The special nature of banks flows from the nature of their deposit contracts (the value of deposits is independent of the value of banks' asset portfolio), their interconnectedness (they are at the heart of the payments system) and because a secondary market for loans is generally absent so bank loans cannot be liquidated except generally at a considerable loss. Therefore, while banks are central to the financial system they are also prone to contagion. This drives many of the differences in the way banks are regulated compared to NBFIs.

4. The time frame for portfolio adjustments is much shorter as assets are more marketable and liabilities less volatile
5. Non-banks face mostly market risks and fewer credit risks as compared to banks.

Non-banks still face systemic risks, however, especially when they form part of a financial conglomerate that owns banks as well. Moreover, the growing importance of non-banks around the world and the increasing integration of banking and non-banking services will eventually make the failures of non-banks a systemic issue. Furthermore, if banks are heavily regulated, the principals in these institutions can pursue their risky ventures in non-bank financial institutions, which are generally not so closely controlled. A similar level of regulation should therefore also apply to these non-banks, to prevent opportunities for “regulatory arbitrage” which have had disastrous consequences in other countries (Bonnick 1998).

Regulatory arbitrage can be defined as the process whereby financial institutions siphon off funds to less regulated subsidiaries within a particular jurisdiction and/or to new operations in other jurisdictions which have looser regulatory systems, in an effort to minimise regulatory costs that impact negatively on their competitive position in the local and international markets. This occurs within a jurisdiction where separately and differentially regulated institutions compete in overlapping market segments, but it is much more prevalent in the cross-border provision of financial services.

The rationale for regulations as they relate to non-bank financial institutions therefore centres on the

establishment of rules and guidelines about appropriate practices in the client/institution relationship. These regulations also serve to protect consumers of financial services from abuse, which generally arises from their disadvantaged position in this relationship, flowing from their lack of information on the risk/return dynamics of the financial products/services offered.

The regulation of non-banks is also designed to maintain certain prudential standards to minimise the probability of institutional failure, which can result in significant losses to investors, especially small investors. Losses could also damage confidence in these institutions, further limiting their role relative to the dominant commercial banks. This could hamper the development of a financial system capable of facilitating the full range of financing needs.

Such regulations also serve to enhance the confidence of consumers in this sub-sector and this contributes to NBFIs growth and development. In fact, “merit regulations” which are often found in nascent securities markets are designed to reduce the transaction costs for agents who are likely to be very cautious at the early stages of market development (Seerattan 1997). These regulations help to entice more participants into the market by reducing some of the uncertainties, generally leading to an improvement in the liquidity and depth of the market. These “merit” regulations normally give way to more indirect regulations once the market has attained a reasonable level of development.

## **2.4 Different Types of Financial Regulation**

Regulations are always concerned with the liquidity, solvency and health of financial institutions.

In terms of categories of financial regulations, there are basically three types - prudential regulations, systemic regulations and conduct of business regulations. Prudential and systemic regulations focus on the regulation of institutions rather than on the functions they perform. Systemic regulation is about the health of institutions for purely systemic reasons while prudential regulation is about the health of institutions as it relates to consumer protection. Conduct of business regulations on the other hand focuses on the functions, irrespective of which institution is involved.

Prudential regulations are necessary because of imperfect information and agency problems associated with the provision of financial services. Prudential regulations are therefore necessary, even in the absence of systemic consequences when:

- (i) The institution plays a fiduciary role.
- (ii) Consumers are unable to assess the health of institutions providing financial services to them.
- (iii) The value of the contracts taken out with institutions is dependent on the subsequent actions of these institutions.
- (iv) There are potential claims on compensation on deposit insurance funds.

Systemic regulation is necessary when the social costs of financial institutions' failure exceed the private costs and such costs are not incorporated into the decision-making of institutions. Systemic issues may not, however, relate to all institutions equally. The

rationale for regulation and the form regulations take normally differ significantly between banks and non-banks, especially where long-term contracts are involved. These differences have, however, narrowed over the years as financial institutions competed across traditional product lines.

In the ECCU, however, in spite of some change, these traditional barriers are still intact. The rationale for consolidated regulations or regulation by function in the ECCU may, therefore, not have the same relevance that they do for developed markets where this trend of universalization has taken root.<sup>6</sup> On the other hand, concerns such as the shortage of strong institutions and an adequate skills-base may mean that consolidated regulation may be more cost effective and therefore still relevant to the ECCU.

Conduct of business regulations focus on factors such as information disclosure, the honesty and integrity of an institution's employees, fair business practices and the way financial services are marketed. Conduct of business regulations are therefore designed to establish rules and guidelines about appropriate practices in client/institution relationships. These regulations are especially relevant to the financial services sector where the principal/agent and the asymmetric information problems are very prevalent.

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6 According to King (1990) recent developments in the technology of payments mechanisms and the liberalisation of financial markets mean that it is now difficult to distinguish between banks and non-banks.



These problems are likely to be more acute in the retail rather than the wholesale market for financial services, since the problem of information asymmetry is likely to be more intense between the buyer and seller in the retail market. In particular, a consumer in the retail market makes fewer repeat orders and the relative cost of acquiring information is much higher at this end of the financial market. The retail customers' investments are also likely to be a higher proportion of their wealth than those of customers in the wholesale market, making the act of failure or fraud in this market more costly to them. Moreover, consumers in the wholesale market are likely to be on a more equal footing with the providers of services in terms of expertise than their counterparts in the retail market.

The distinction between the wholesale and retail ends of the financial market must therefore be made in conduct of business regulations. To do otherwise might lead to an over-regulated wholesale market for financial services, assuming the level of regulations in the retail market sets the standard for regulations. If not, the retail market might be under-regulated.

## **2.5 The Effectiveness of Regulation**

A rapidly growing body of work on the economic effects of government regulation is strikingly negative in its conclusions. A careful evaluation of the regulatory process reveals that there are considerable problems with respect to carrying out the intended purposes of the regulatory programme at reasonable costs (Jorden 1972). Specifically:

- (1) Regulatory agencies usually end up suppressing competition beyond the point necessary to carry out the regulatory process.

- (2) Regulators are plagued by problems of ineffectiveness, which can frequently only be overcome by the extension of regulation into new areas. Hence, in order to fulfil its primary purpose, regulation may have to take control of areas that are related to the regulated activity. This occurs because there are always incentives for the regulated to evade regulations (Kane 1977,1981).
- (3) Since regulation is partly politically as well as economically motivated, the thrust towards efficiency that the market generates is blunted. The point is not that regulators waste resources, but that they are often constrained to pursue goals incompatible with efficiency, such as subsidizing indigenous institutions.

It is therefore wise to continually monitor the regulatory structure to ensure that these problems do not outweigh the benefits to be derived from the regulatory structure. By looking at the structure of the regulatory and supervisory system and issues pertaining to efficiency and regulation, one can get an idea of the degree to which the problems mentioned above have stymied the effectiveness of regulations.

## **2.6 Regulation and Efficiency**

Complaints are also widespread that government regulation reduces productivity and raises the costs of borrowing and lending. Regulation is accused of weakening competition and creating a whole range of wasteful non-price competition. It is said that, as the managers of institutions shape their strategies for business, their decisions are warped to circumvent regulatory constraints. Risk taking is artificially reduced

even as capital is wasted (Black, Miller and Posner 1978). Moreover, in attempting to control unsatisfactory practices, regulators may penalize progressive management and reward firms that are mediocre.

Regulation of these institutions, however, did not occur primarily as a result of bureaucratic pressures. They developed because of the recognition that without regulation and supervision major crises can develop in the financial sector. These regulations are imposed to maintain the stability of the system, as instability and failure seem to be the natural consequence of the competitive profit-maximizing behaviour of financial institutions. There is, therefore, a natural trade-off between efficiency and safety in the regulation of financial institutions.

In the ECCU, as indeed in many developing countries, an important part of the regulatory authority's responsibility is to promote the development of the financial sector. The underdeveloped nature of the financial sector usually manifests itself in a paucity of institutions and instruments (Bourne 1985, 1988b). They have to promote prudent behaviour but they also have to ensure that their actions do not damage the development of the sector, since they are interested in widening and deepening the financial sector. They are therefore very averse to letting inefficient and even insolvent institutions fail. The problem of the traditional trade-off between safety and efficiency is, therefore, compounded by another factor, that of market development, which is often at odds with not only efficiency but also safety.

The winding up of an institution is also considered a failure on the part of the regulator. The cost of lax regulation is very apparent but the benefits of greater efficiency are not so easily identified. Given this type of incentive structure, it is natural for regulators to err on the side of caution. This has led regulators to interpret safety and soundness as the prevention of failure of individual institutions and to neglect the efficiency aspects of regulations.

Some authors have attempted to deal with this issue. Santomero and Watson (1977) attempted to analyse capital regulation in the context of its effects on efficiency by incorporating the effects of over-capitalization on the sector. Bourne (1988c) also discussed the effects of regulation on productive and allocative efficiency. He points out that regulations such as reserve requirements can impair productive efficiency as well as allocative efficiency because they are non-earning assets and cannot be transformed into socially productive loans.

In a region such as the ECCU, prudential regulations must always be viewed in the context of how they can aid in the development of the financial sector. The narrow view of how prudential regulation constrains the choices of institutions and thus lowers efficiency must be qualified, not only by the benefit of greater safety, but also by its possible beneficial effect on the development of the financial sector. Decisions concerning the regulatory and supervisory structure in the ECCU must, therefore, always take cognizance of the important trade-offs between safety, efficiency and financial development.

## **2.7 Different Views of Regulation**

An issue that must be dealt with is the perspective different groups have about financial regulation. There are three views of regulation that influence our methods of analysis and policy recommendations. The first is that regulation exists as a public good, usually to correct some deficiency in the private market. Some authors, Diamond and Dybvig (1983), Byrant (1981) and Taylor and O'Conner (1985) have argued that the operation of the free market could generate runs on financial institutions. Hence, regulation could be viewed as providing safety and soundness as a public good.

The second view is that regulation is implemented in the interest of politically powerful groups rather than in the interest of the public. Even if regulation is implemented for the public good, regulatory agencies tend to become captured by the regulatees or by other special interest groups (Stigler 1971, Hilton 1972). Others have argued that the "public interest" theory of regulation better explains the behaviour of regulators than does the "capture" theory of regulation (Edward and Edwards 1974).

A third view extends the second view. It recognizes that regulators are not passive agents of some special interest groups, but that they respond in significant ways to different incentives. Kane, in two papers (1977, 1981), analysed bank regulation and innovation by market participants as a dialectic process. According to this process, regulation generates "regulatee" avoidance and a consequent decreased effectiveness of the regulations. The resulting ineffectiveness leads regulators to modify and adapt regulations in an effort to erase the avoidance behaviour of the regulatees. Hence, the regulatory function could be described as a

cyclical process of regulation, regulatee avoidance and re-regulation.

Moreover, since the managers of financial institutions have greater incentives to avoid regulation than regulators have in building effective regulations, there will always tend to be a gap between the time that managers begin to avoid regulations and when regulators respond to this problem. This dialectic process has accelerated in recent years because of inflation, technical change and financial innovation. The implication here is that regulation, as it is presently structured, is going to be largely ineffective and costly to implement.

Financial regulations in the ECCU do attempt to provide safety but their weakness is that the laws and standards on which they are based are outdated and subjective. These laws and standards have not kept pace with developments that have increased the risk levels faced by institutions. The slow pace of change is partly due to the limited availability of skilled personnel and the relatively slow pace of development of the financial sector, which is dominated by foreign interests. It is also caused by the subjective nature of the regulatory standards that can be easily challenged as inappropriate by the institutions on which they are imposed. This difference of views highlights the need for relevant standards based on some rational methodology.

## **2.8 The Incentive Structure For Financial Regulation**

Financial regulations (and supervision) provide various incentives for economic agents to act in ways that strengthen the financial sector. They can,



however, create perverse effects<sup>7</sup> if not appropriately structured.

Indeed, regulations are analogous to contracts between the regulator and regulated (Bhattacharya and Thakor 1993). When these regulatory contracts are well-designed they provide incentives for economic agents (institutions and other providers of financial services) to act in ways that reduce systemic risks and losses to consumers of these financial services, with minimum costs to the major stakeholders in the financial sector. If they are improperly designed they often fail to address the market failures they were designed to alleviate and may even accentuate these market failures.

The interaction among the main stakeholders in the financial sector also determines to a large extent the effectiveness and efficiency of financial regulations. Moreover, much of the difficulty and the complexity of regulations arise from the fact that each of the parties<sup>8</sup> has imperfect information on other agents' motives, actions and positions. The distribution of information among these stakeholders is affected by financial innovation, communication and information technology and financial liberalization. Traditional supervisory practices (examinations) tend to be too slow to track

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7 Merton (1977) argues that a non-risk weighted deposit insurance premium scheme provides incentives for the insured to engage in risky behaviour, especially if cover is 100%.

8 Regulators, consumers of financial services and financial firms and services providers.

changes in net worth, reducing the ability of regulators to keep the level of risks within prudent limits.

Regulators face three main types of asymmetric information problems. Firstly, there are incentives for high-risk institutions to be selected in the low-risk category, due to regulators' imperfect information on institutions in general. Secondly, there are incentives for institutions to hide facts from regulators, particularly facts on adverse development, because disclosure of these facts often leads to costly censure. There is, in fact, a moral hazard in buying into a regulatory contract since once the contract is entered into, it is not in the regulatee's interest to disclose information on adverse developments, presumably because of the censure inherent in the regulatory contract.

In any case, the contract between the regulator and the regulatee may be time-inconsistent (Kydland and Prescott 1977, Williamson 1985) - that is, the *ex-ante* incentives to adhere to regulations can change *ex-post*, as the dynamics of an institution's position change. In other words, the set of incentives inherent in regulations today may be appropriate and effective today but not so in another time period.

## **2.9 The Institutional Structure for Financial Regulation**

The debate on the most appropriate institutional structure for regulation has now become a major policy debate for many reasons. Chief among these are:

- (i) The structure of regulatory agencies was devised more than three decades ago. Financial innovation, conglomeration and

globalization have now changed the parameters on which that structure was based. The question that naturally arises is whether the amount of change has made the regulatory structure ineffective in the new environment.

- (ii) The institutional structure for regulation has developed mostly in an *ad hoc* manner over time. The issue of a coherent structure for regulation is therefore a valid concern today.
- (iii) The emergence of “financial supermarkets” in which the full range of financial services is offered has challenged the traditional demarcation where different regulatory agencies regulate different sections of the financial market.
- (iv) The objectives of financial regulations have become more complex over the years. In particular, conduct of business regulations have become more important over the years as the choice of financial instruments has expanded and as the risks inherent in various products have become complex. Moreover, systemic regulations may now have to focus on a wider range of institutions as banks and non-banks compete across traditional product lines resulting in hybrid financial products with banking, investment and insurance attributes.
- (v) The increasing globalization of financial markets has increased the importance of the international dimension of regulation.

These developments have raised a number of questions about the institutional structure for regulation and supervision. The main issues include:

- (i) Whether there should be consolidated regulation of the financial sector, specific regulatory agencies for different parts of the financial system or some hybrid of these two polar systems.
- (ii) Whether self-regulation should be given more prominence.
- (iii) Whether formal systems should be put in place for international cooperation among regulatory agencies.

The three broad approaches to the structure of regulation are the institutional, functional and objective forms. In the case of institutional regulations, attention is directed to institutions irrespective of their mix of business and usually there is a specialist regulatory agency for each institutional type.

Functional regulation focuses on the functional areas of operation irrespective of the institutions offering particular services. The distinction between institutional and functional regulation is of little significance when financial institutions are specialized (that is, banks are involved only in banking and insurance companies only in insurance). If institutions are not specialized in particular areas, a purely institutional or functional approach to regulation is likely to create problems. If purely institutional regulation is used problems that may arise include different regulators developing different standards for the same functional areas. Also, this approach is likely to be duplicative

and therefore inefficient in terms of scarce regulatory resources. The problem with the purely functional approach is that the overall health and solvency of institutions are often obscured.

The institutional structure for regulation may have an impact on the overall effectiveness of regulation and supervision because of the expertise, experience and culture that develop in regulatory agencies. It might be that agencies are more effective because their mandate is more clearly defined. There is also the danger that expertise, experience and culture can be lost when changes are made to the regulatory structure.

The structure of the regulatory system normally generates three types of costs: institutional (cost of running regulatory agencies), compliance (cost imposed on regulated firms) and structural (cost of excess burden, the stifling of innovation, moral hazard and regulatee capture). The regulatory structure that minimises these three costs would conceivably be the optimal regulatory structure.

One of the most important debates in the literature is whether there should be a single regulator for consolidated regulation of the financial sector or multiple agencies for different parts of the sector. The arguments in favour of consolidated regulation are:

- (i) There may be economies of scale to be gleaned from a single regulator, especially in terms of skill requirements.
- (ii) There may be synergies between different areas of financial regulation, which could redound to the benefit of the sector.

- (iii) Agents in the market may have a better understanding of the regulatory requirements and procedures from not having to deal with different agencies and rules in similar functional areas.
- (iv) A single regulator would better manage the problems of regulatory arbitrage, duplication and gaps in the system because of its central management authority. In an alternate system, autonomous management systems would have to work out cooperative agreements, which could require considerable time and effort.
- (v) Accountability would be more unambiguous since it would be clear which agency has responsibility when problems occur.
- (vi) Compliance costs for agents and institutions may be lower in a case where they have to deal with only one regulator.

The arguments against consolidated regulation are:

- (i) If the financial sector has not diversified across traditional product lines, a differentiated approach to regulation may be more appropriate.
- (ii) A single regulator may not have a clear focus on the objective of regulation.
- (iii) A single regulator could become overly bureaucratic and confrontational without legal safeguards against abuse of power.

- (iv) The problem of moral hazard could become more intense if the public believes that risk differentials among different institutions have been removed. The public may therefore not take as much care in the selection and management of investments in some institutions as they should.

The choice of institutional structure should of course be based on the individual requirements of particular jurisdictions. The key determinants of institutional structure choice should be the objectives of regulations, the cost of various institutional structures, accountability and the structure of the financial sector.

Closely related to the issue of the choice between either a single agency or multiple agencies is the question of whether the responsibility for the regulation and supervision of financial institutions should be removed from central banks. The determination of whether it is viable to unbundle these functions from central banks does, of course; hinge on the above-mentioned factors, as well as the synergies between regulatory action and monetary policy.

In small systems like the ECCU, it does seem that a central bank should be vested with regulatory authority because any banking or non-banking problem usually has consequences for monetary and exchange rate policies. More critical, however, is the fact that regulatory resources are in very short supply, which means that separating these functions could seriously dilute the regulatory resources on the ground and compromise the quality of regulation and the stability of the system.

## **2.10 Trends in the Regulation of Non-Banks**

There are many international trends that have had, or are going to have, an impact on the regulation of financial institutions. The trend to greater financial market integration has contributed to a growing harmonisation of regulatory standards. As markets have become more interdependent, risks can now be taken on in one jurisdiction and unbundled in another very quickly. Regulators around the world have therefore recognised the need for greater collaboration in the conduct of their regulatory duties. The sharing of information is particularly important. There is already some informal cooperation in this area but formal systems have to be put in place for this, as the trade in financial services across borders intensifies.

As financial markets develop, regulatory systems have also become less direct and invasive, with the use of more indirect mechanisms becoming increasingly prevalent. As such, “self regulation”, where business and other professional associations have themselves established standards and codes of conduct, is being incorporated into the regulatory infrastructure in many countries. Government’s role in this arrangement is more indirect, through the establishment of “rules of the game” and prudential standards.

The above trend to more market-based forms of regulation has been accompanied by the growing impetus for the de-regulation of the financial system, where the multiplicity of regulations is being scaled back. This involves the removal of legal barriers to market access and the elimination of government control on the rate of returns on financial assets.



Financial liberalisation has also led to greater emphasis being placed on the rights of investors and savers in the system. This has manifested itself in rules on information disclosure, accounting standards, insider trading and codes of conduct for financial service providers.

There is also a definite trend for the traditional barriers between financial institutions to come down. In particular, banks have crossed into traditional non-banking areas and vice versa, often creating hybrid products (especially between banking and insurance and banking and mutual funds). This apparent universalization of the financial sector has serious implications for the nature of financial regulations around the world, especially the synergies between the regulation of banks and non-bank financial institutions and the suitability of the consolidated regulation model.

These trends have begun to impact on the financial regulatory systems in the Caribbean. As the financial system develops in the ECCU, these factors will increasingly have to be taken into account when designing an appropriate regulatory system for non-banks.

### **2.11 Regulations in Developing Countries**

The general analysis of the rationale for and the principles of financial regulations are not radically different in developing countries. Indeed, differences have been steadily reduced over time by the movement, driven by BASLE accords, to harmonise standards and practices. There still are, however, a significant number of differences between regulation in developed and developing countries. In particular, problems such as a lack of transparency, variegated accounting systems,

underdeveloped data systems and weak legal protection for creditors typically make financial regulations less effective in developing countries than in developed ones. These conditions reduce the ability of regulators to evaluate institutions' performances and make the enforcement of contracts difficult. Legislation prescribing the nature and scope of regulations is also mostly outdated and in some areas non-existent.

Moreover, in many developing countries consumers of financial services are usually less sophisticated in terms of knowledge of products, making the problem of asymmetric information more acute. The need for regulation in these countries is, therefore, more critical to the smooth functioning of the financial sector. The nature of regulations would also have to be more direct and rules-based rather than indirect and discretionary. Additionally, because of the underdeveloped nature of the financial system, the dynamics of the regulatory trade-off (between efficiency and safety) are complicated by the fact that the closure of any financial institution is more of a cost in developing countries, because of the small numbers involved.

Regulators in many instances therefore serve dual roles in developing and policing the financial market. This means that the job of regulators becomes that much more difficult because they must now weigh the trade-off not only between safety and efficiency but also between these two goals and market development. These problems are typically more intense in the non-banking sector in these countries.

## *Chapter 3*

# **THE STRUCTURE OF NON-BANK FINANCIAL INSTITUTIONS AND THEIR IMPACT IN THE EASTERN CARIBBEAN CURRENCY UNION**

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*A*s a country or region develops, the financial and real sectors often seem to grow together. Some have argued that financial development is an important determinant of growth as it promotes efficiency in the mobilisation and allocation of capital (Shaw 1973, McKinnon 1973). Others have argued that causation runs the other way from growth to financial development, that is, as growth increases the financial sector expands to meet the additional demand for financial services (Patrick 1966).

More recently, however, some authors have argued that there is bi-directional causation in this relationship with growth in one sector reinforcing growth in the other (Ireland 1994). In fact, Modeste (1996), in a study of selected Caribbean countries, did find evidence of this bi-directional causation. Regardless of the direction of causation, however, Bryant (1987) argued that as development increases, not only does the total share of

financial assets increase relative to income but there is a decline in the banking sector's share of total financial assets. This occurs as other financial institutions emerge to meet the need for a much wider range of risk/return preferences among increasingly sophisticated clients. This, in turn, manifests itself in the increasing prominence of non-bank financial institutions relative to commercial banks.

In the ECCU, the range of non-bank financial institutions includes development banks, national development foundations, finance companies, building societies, trust companies, credit unions, insurance companies (both life and non-life), friendly societies, a regional home mortgage bank, a small regional stock exchange, private pension funds and social security schemes. Of these, credit unions, insurance companies and social security funds have had the most significant impact, with the first two types of institutions actively competing with commercial banks.

### **3.1 The Structure and Activities of Non-bank Financial Institutions in the ECCU**

The non-bank financial institutions sector in the ECCU mirrors other small developing countries in terms of structure and activities carried out by these institutions. In the ECCU, the range of institutions is probably smaller, with institutions such as mutual funds missing from the range of institutions. The sector in all of the ECCU member countries includes credit unions, development banks and foundations, building societies, finance companies, insurance companies (both life and non-life), social security schemes and trust companies. In terms of size, the social securities scheme, insurance companies and credit unions are the more important

institutions. In terms of activities, these institutions operate in much the same way as they would in other developing countries. There would, of course, be differences in scale and scope of operation between jurisdictions. An outline of these institutions and their main activities is presented below.

**Development Finance Institutions** include national development banks and national development foundations. These institutions were established to facilitate the development effort in situations where enterprises found it difficult to access financing from commercial banks. The development foundations lent primarily to small and micro-enterprises. They not only provided funds but also technical and managerial support. The loans were disbursed for a maximum period of five years with project implementation and monitoring assistance being provided to clients. These development foundations often submitted projects to commercial banks on behalf of their clients and sometimes provided a guarantee of up to 80% where collateral was required. These institutions were externally funded but this source has now dried up and the challenge for these institutions is to become self-reliant.

The development banks serve to facilitate the flow of development finance from the Caribbean Development Bank (CDB) and other multilateral institutions. These institutions make mostly long-term loans to business enterprises and for housing. They also provide technical assistance to their clients in the form of feasibility studies, assistance with feasibility studies and management services.

The main challenges for these institutions are to develop a greater ability to independently finance their operations and to avoid political interference.

**Credit Unions** are indigenous co-operatives that mobilise funds in the form of shares and invest funds so mobilised in loans and other investments. These institutions engage in lending mostly to individuals and of late have begun offering more retail banking services, such as ATMs. The ownership structure of credit unions has resulted in a unique philosophy of joint savings and finance for the development of their members. This, together with liberal lending policies (buttressed by risk capital from borrowing members), other membership benefits and a service orientation have led to increased membership and the provision of services which have often brought them in direct competition with banks. Credit unions are now the fastest growing provider of retail financial services in the ECCU region.

**Insurance Companies** in the ECCU operate in three basic forms. They are either organised as domestically incorporated companies, as agents of foreign companies or branches of foreign companies carrying out life or non-life business or both. As is usually the case, insurance companies replace funds lost as a result of a host of contingencies and are financed via premiums. The region is in a high-risk area for hurricanes and has to pay fairly high re-insurance rates. A proportion of the funds so collected is used to pay current claims while the rest goes to the insurance fund from which the company makes a variety of investments. These investments normally include mortgage loans, investment in corporate and government securities and real estate and infrastructural projects. These companies offer products that protect people and their beneficiaries from loss of income through death and accidents but they also offer hybrid products like annuities which have both banking (saving) and insurance features. These products often bring them into direct competition with commercial banks.

**Social Security Schemes** are financed by payroll taxes and provide pension for the aged, the replacement of income lost in the case of illness, accidents on the job and death. They also provide maternity benefits. These schemes are all compulsory and their membership includes all employed persons; self-employed persons are not normally covered but they can be members if they so wish. The current revenues in the form of contributions are used to defray the costs of current claims and to augment the reserves. The schemes in the region have reserves of over 1 billion dollars. As a result of this, these schemes are significant investment players in the region with most of their funds invested in mortgages, government securities and fixed deposits at commercial banks. The fact that a large portion of their funds is deposited in banks means that these schemes have a huge impact on the profitability and liquidity of banks. The removal of any significant portion of these deposits either because of solvency problems or a decision to invest funds elsewhere can have serious consequences for banks. In spite of their significance to the financial system, these schemes do not have a well-developed regulatory framework. The only oversight comes from the Minister of Finance in the respective territories and a periodic actuarial review the recommendations of which are seldom implemented.

There is also a host of other smaller non-bank financial institutions. Non-banks such as finance companies, trust companies and building societies are significant players in terms of asset size. Finance companies and building societies accept mostly time and savings deposits while trust companies receive funding directly from parent commercial banks. The lending activity of trust companies and building societies

is highly concentrated in housing mortgages. Finance companies focus more on the financing of consumer durables, machinery and vehicles for businesses and providing working capital for enterprises.

There are also very small friendly societies and school cooperative societies but the assets of these institutions, and therefore their impact on the financial system, are negligible.

### **3.2 The Growth and Development of Non-Bank Financial Institutions in the ECCU**

The importance of non-bank financial institutions in the ECCU has grown steadily over the years as evidenced by the increase in total assets and the amount of funds mobilised. Non-banks have increased their relative share of financial assets and are now actively competing with the dominant commercial banks for market share. The institutionalisation of the savings and investment process, a global trend, together with the growth in the money and capital market, also facilitates the growing strength of non-bank financial institutions relative to banks.

The growth in importance of non-bank financial institutions in the financial systems in the ECCU of course has important implications for the design of the regulatory system for financial institutions. In particular, it must be understood that there are still important (although declining) differences in risk profiles between commercial banks and non-bank financial institutions and indeed among non-banks themselves. In particular, commercial banks are more subject to credit risk while non-banks are more subject to market



risks.<sup>1</sup> These factors have serious implications for the design of an appropriate regulatory structure for banks and non-banks, particularly the establishment of prudential standards, the construction of firewalls between institutional types and the decision on the type of agency that will supervise the various institutions.

The development of the financial system is normally associated with growth in the number and variety of financial institutions and their asset bases. It is also usually accompanied by the growing importance of non-bank financial institutions relative to commercial banks. This increasing importance of non-banks can be tracked through indicators such as the ratio of non-bank assets to GDP, the ratio of non-bank assets to total financial assets, the ratio of non-bank financial liabilities to M1 and M2 and the growth in the number and range of non-banks. The movement of these indicators has implications for the efficiency of the financial sector in meeting the increasingly diverse and sophisticated needs of savers and investors. They also indicate the potential impact the health of these institutions can have on the stability of the financial system.

Quantitatively, non-banks constitute the highest number of financial institutions in the ECCU. While

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1 Banks are more exposed to credit risks (and liquidity crises) caused by adverse movements in interest rates because of the predominance of credit instruments in their asset portfolio, while non-bank financial institutions are more exposed to market risks caused by trend decline in the value (prices) of their assets (which usually have well-developed secondary markets) because of the long-term nature of their assets.

there are 44 commercial banks, there are approximately 80 credit unions, 20 finance companies, 67 insurance companies, 7 development banks, 4 building societies and 8 social security schemes. Additionally, there are numerous friendly societies and school cooperative societies but these are very small entities, which have little impact on the financial system.

In terms of asset size, although commercial banks still dominate the financial system, non-banks appear to have increased their share of total financial assets relative to the share of commercial banks over the period 1990 to 2001 (See Tables 3.1 and 3.2). The growth is also reflected in the growth of the ratio of non-banks assets to GDP (See Table 3.2). Non-banks in general and institutions such as credit unions and social security schemes in particular have all experienced high asset growth. In the case of credit unions, these institutions averaged annual growth rates of over 20% between 1990 and 2001. Non-banks as a group averaged asset growth of 10.9% while banks averaged 10.1% for the same period (See Table 3.2).

This development is due in part to improved economic growth in the sub-region in the 1990s, which spurred growth in the financial system. Buoyant growth in turn led to increased per capita income, which facilitated increased financial savings (See Tables 3.3, 3.4 and 3.6). The increasing sophistication of consumers of financial services also led to savers and investors demanding a wider range of financial instruments to satisfy their diverse set of preferences. People now not only looked for a safe depository for their funds but were also interested in higher returns and instruments that hedged a variety of risks, most notably the risk of property damage and the loss of income.

Some non-banks, credit unions in particular, emerged to compete directly with banks, offering many bank-like services such as ATMs and consumer loans. This attracted customers who liked the more accommodating credit procedures and the user-friendly approach of these institutions (Anthony-Browne and Samuel 1997). The average growth rate of personal loans disbursed by credit unions in the 1990s was 10.6%, which matched the dominant commercial banks whose average growth for this category of loans was 10.5% in this period (See Table 3.5).

The increase in the assets of social security schemes occurred as the schemes became compulsory and as incomes and employment increased. The large membership of these schemes have led to their emergence as one of the most important channels through which domestic savings are mobilised in the ECCU, as well as important players in investment activity in the various territories. They also account for a significant proportion of the value of deposits in commercial banks, which means that their financial health has serious implications for the stability of the banking sector (See Table 3.8).

Non-banks not only broaden the options open to savers and investors, they also facilitate the provision of capital, especially long-term capital, to agents in these economies. For example, finance companies facilitate the financing of durable goals while development banks extend longer-term financing to enterprises and take equity participation in these ventures as part repayment for the provision of finance. This venture capital approach to financing has facilitated a number of tourism projects and small businesses in these countries. Insurance companies also facilitate long-term investments in infrastructural and tourism projects. Of course commercial

banks are not ideally suited to serving this longer end of the credit market, so these non-banks help to fill an important gap in the financing of investments in the ECCU.<sup>2</sup>

The development of non-banks in the ECCU was therefore fuelled by buoyant growth, state intervention and the increasing wealth and sophistication of consumers of financial services (who demanded a wider range of financial assets) and competition between banks and non-banks.<sup>3</sup> These developments raised the level of competition between financial institutions, made a wider range of financial services available, increased the impact of non-banks on credit availability and the health of the financial system and increased the range of challenges faced by regulators.

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2 The liabilities of NBFIs are generally longer term and less volatile than those of banks and their assets are usually more marketable because of the existence of secondary markets for these instruments. This combination of features in the portfolio structure of these institutions increases their ability to safely engage in maturity transformation because the maturity profile of their portfolios is naturally suited to longer term investments and because the firm can more efficiently respond to spikes in demand for liquidity.

3 Nicholls (1997) estimated that approximately 16% of the value of indigenous banks' deposits is owned by social security schemes.

### **3.3 The Implications of the Growth of Non-Bank Financial Institutions for the Financial System**

The growth of non-banks has important implications for the efficiency and stability of the financial system, as well as for economic growth. The paucity of data on non-banks does not, however, allow us to fully explore all these issues related to non-banks. In spite of this, we have attempted to demonstrate the impact of these institutions on the financial system. In this regard, we have focussed on three main areas, the savings mobilisation impact of non-banks, their credit activities and the links between banks and non-banks.

In terms of domestic savings mobilisation, non-banks have made inroads into this area, especially social security funds and credit unions. If we consider the funds mobilised by these institutions (in the forms of reserves, shares and deposits) there has been remarkable growth in these savings. They also compare favourably with the growth rate of savings mobilised by commercial banks. The annual average growth rates of funds mobilised by banks, credit unions and social security schemes between 1990 and 2001 were 9.9%, 10.8% and 11.4% respectively (See Table 3.6). The variety of risk/return trade-offs that these institutions offer in their savings mobilisation instruments has been an important competitive advantage to them in their savings mobilisation efforts. Their importance to savings mobilisation assumes much more significance when viewed against the relatively poor savings mobilisation effort of the ECCU countries in the recent past (See Table 3.7).

In terms of competition on the loans market, credit unions have increasingly come to compete with banks in this area. The annual average growth rate of loans

extended by credit unions to the personnel sector between 1993 and 2001 was 10.8% compared to 10.5% for commercial banks in the same period (See Table 3.5).

Another way in which non-banks impact on the financial system is through the magnitude of deposits in the banking system. In 1995, 13.4% of commercial bank deposits came from non-banks (See Table 3.8). The amount of deposits from non-banks placed in banks means that there is a strong link between the fortunes of these institutions and banks. Problems in the non-bank sector can therefore have serious direct implications for the stability of the banking system. Nicholls (1997) alluded to the significant impact social security schemes have on the liquidity and stability of commercial banks in the ECCU. He argues for increased responsibility and prudence on the part of these institutions (or better regulation of these schemes), recognising the important role they play in the financial system. The significance of social security scheme deposits to commercial banks is outlined in Table 3.8. It has already been argued elsewhere (Allen and Gale 1999) that greater connectedness facilitates contagion.

Additionally, the ownership structure of these non-banks, which are in most cases either indigenous or government majority owned, implies that they may not have the well-established management controls, information systems and financial resources of the foreign-owned commercial banks in the region. This therefore increases the need for a suitable system for the regulation of these non-banks. The regulatory structure for these institutions has not, however, kept pace with the growth and development of these institutions. This, at best, could retard the growth of this sub-sector and, at worst, could lead to problems that

severely damage this increasingly important financial sub-sector and, by contagion, damage the health and stability of the entire financial system.

The authorities would not want a situation to develop where lax regulation and supervision in the non-bank sector contributed to problems in that sector which would spread to commercial banks, damaging the stability of, and confidence in, the financial system. Once confidence is damaged, especially in developing financial systems, it is very difficult to rebuild (Seerattan 1997). Since confidence is central to efficiency and development of the financial system, upgrading the regulatory and supervisory system presently in place for non-banks in the ECCU is of critical importance to this sub-region.

We expect that given the importance of these deposits to banks and the greater use of other non-deposit mediums of investment by these schemes, concerns about declining intermediation through banks (which has stability implications for the financial system) and the increasing prominence of non-banks (which are not adequately regulated at present) would increasingly come to occupy the attention of policy makers.

The relative growth of non-banks compared to banks, as well as their ability to satisfy a wide variety of financial services needs, may indeed lead these institutions to be the preferred mobilisers of savings in the future. They are also likely to play an increasingly important role in the provision of credit in ECCU countries. Their growth and development therefore augur well for increased savings and growth in the ECCU. Any hindrance to their development such as an

underdeveloped regulatory system must, however, be removed to realise their full potential.

As mentioned before, the data limitation did not allow us to fully ventilate all the issues relevant to the impact of non-bank financial institutions on the financial systems and economies of ECCU countries. The information that is available, however, does suggest that non-bank financial institutions appear to have a significant impact on the financial system. The nature of the activities of these non-banks and their increasing size and importance imply that they would have a significant impact on the financial system, as well as on economic growth. These institutions not only seem to affect liquidity and credit availability, and hence real economic activity, but their health is also critical to the stability of the financial system. This follows not only because of the special role they play in the savings/investment process but also because of the strong linkages between non-banks and commercial banks. A lax or incomplete regulatory system could lead to problems in this sector negatively affecting the stability of the entire financial system. Gaps and weaknesses in the regulatory structure for non-banks must therefore be dealt with as a matter of urgency.



**Table 3.1**  
**Total Assets of Banks and Non-Bank Financial Institutions**  
**in the ECCU (\$\$ECM)**

Institution	Year						
	1990	1991	1992	1993	1994	1995	1996
Insurance Companies	749.4	867.9	967.0	1116.4	1248.4	1376.6	1548.8
Credit Unions	300 <sup>e</sup>	383 <sup>e</sup>	415 <sup>e</sup>	488.6	476.0	524.9 <sup>e</sup>	578.9 <sup>e</sup>
Development Banks	180.0	226.0	234.0	284.4	328.4	381.3	430.1
Building Societies	242.3	226.9	297.3	322.6	349.3	301.9	321.8
Finance Companies	52 <sup>e</sup>	62.0 <sup>e</sup>	69.0 <sup>e</sup>	76.0	79.0	87.0	107.9 <sup>e</sup>
Mortgage Companies	94.0 <sup>e</sup>	103.0 <sup>e</sup>	113.0 <sup>e</sup>	125.0	137.0	151.0	179.7 <sup>e</sup>
Social Security Schemes	3930.6	4198.9	4700.8	5122.7	5590.7	6232.7	6744.8
Total Non-Banks <sup>2</sup>	195.3 <sup>e</sup>	202.7 <sup>e</sup>	210.4 <sup>e</sup>	218.4 <sup>e</sup>	226.7 <sup>e</sup>	235.2 <sup>e</sup>	244.2 <sup>e</sup>
Commercial Banks	1813.0	2071.5	2305.7	2631.4	2844.8	3057.9	3411.4

**Sources:** 1. Adrian 1995.  
2. ECCB.

**Notes:** 1. e-estimated  
2. Excludes the assets of Pension funds trust companies and the other small entities such as friendly societies.

**Table 3.1**  
**Total Assets of Banks and Non-Bank Financial Institutions**  
**in the ECCU (\$\$ECM)- Continued**

Social Security Schemes	Year				
	1997	1998	1999	2000	2001
Insurance Companies	1716.6	1866.3	2062.4	2245.3	2462.0
Credit Unions	638.4 <sup>e</sup>	704.0 <sup>e</sup>	776.4	856.2	944.2
Development Banks	468.3	513.8	556.4	611.4	683.1
Building Societies	378.3	372.8	350.4	379.5	327.3
Finance Companies	120.0 <sup>e</sup>	133.5 <sup>e</sup>	148.5 <sup>e</sup>	165.2 <sup>e</sup>	183.8 <sup>e</sup>
Mortgage Companies	208.4	269.4	324.5	344.1	544.8
Social Security Schemes	7470.3	8448.5	9525.6	10486.5	11260.5
Total Non-Banks <sup>2</sup>	253.4 <sup>e</sup>	263.0	269.5	282.5	481.4
Commercial Banks	3783.4	4124.8	4488.1	4884.2	5626.6

**Sources:** 1. Adrian 1995.  
2. ECCB.

**Notes:** 1. e-estimated  
2. Excludes the assets of Pension funds trust companies and the other small entities such as friendly societies.

**Table 3.2**  
**Indicators of the Growth of the**  
**Non-Bank Financial Institutions Sector in the ECCU**

Institution	Year					
	1990	1991	1992	1993	1994	1995
Non-Banks (\$ECM) <sup>1</sup>	1813.0	2071.5	2305.7	2631.4	2844.8	3057.9
Banks (\$ECM)	3930.6	4198.9	4700.8	5122.7	5590.7	6232.7
GR of Non-Banks (%)	-	14.3	11.3	14.1	8.1	7.5
GR of Banks (%)	-	6.8	12.0	9.0	9.1	11.5
Share of Non-Banks (%)	31.6	33.0	32.9	33.9	33.7	32.9
Share of Banks (%)	68.4	67.0	67.1	66.1	66.3	67.1
Non-Bank Assets/GDP <sup>2</sup> (%)	45.8	48.6	48.0	52.9	53.7	55.6

**Sources:** 1. Adrian 1995.  
2. ECCB.

**Notes:** 1. Excludes assets of pension funds, trust companies and small institutions such as school co-op. societies and friendly societies.  
2. Ratio computed using the sum of GDP at market prices for all countries except Anguilla and Montserrat.

**Table 3.2**  
**Indicators of the Growth of the**  
**Non-Bank Financial Institutions Sector in the ECCU - Cont'd**

Institution	Year					
	1996	1997	1998	1999	2000	2001
Non-Banks (\$ECM) <sup>1</sup>	3411.4	3783.4	4124.8	4488.1	4884.2	5626.6
Banks (\$ECM)	6744.8	7470.3	8448.5	9525.6	10486.5	11260.5
GR of Non-Banks (%)	11.6	10.9	9.0	8.8	8.8	15.2
GR of Banks (%)	8.2	10.8	13.1	12.7	10.1	7.4
Share of Non-Banks (%)	33.6	33.6	32.8	32.0	31.8	33.3
Share of Banks (%)	66.4	66.4	67.2	68.0	68.2	66.7
Non-Bank Assets/GDP <sup>2</sup> (%)	58.3	61.3	62.0	64.0	66.5	77.3

**Sources:** 1. Adrian 1995.  
2. ECCB.

**Notes:** 1. Excludes assets of pension funds, trust companies and small institutions such as school co-op. societies and friendly societies.  
2. Ratio computed using the sum of GDP at market prices for all countries except Anguilla and Montserrat.

**Table 3.3**  
**Economic Growth Rates in the ECCU**

Country	Year					
	1990	1991	1992	1993	1994	1995
Antigua/Barbuda	3.5	4.3	0.9	5.1	6.2	-5.0
Dominica	6.3	2.3	2.7	1.9	2.2	1.6
Grenada	3.9	3.6	1.1	-1.2	3.3	3.1
St. Kitts/Nevis	3.0	3.9	3.1	5.4	5.4	3.5
St. Lucia	4.4	2.3	7.4	1.1	1.8	1.7
St. Vincent & the Grenadines	7.1	3.1	6.9	1.8	-2.9	8.3
Anguilla	6.6	-3.7	7.1	7.5	7.1	-4.2
Monsterrat	11.2	-23.4	2.7	2.5	0.9	-7.6
ECCU (with Monsterrat)	5.8	-1.3	4.0	3.0	3.0	0.2
ECCU (without Monsterrat)	5.0	2.2	4.2	3.1	3.3	1.3

**Sources:** 1. ECCB  
2. CDB

**Table 3.3**  
**Economic Growth Rates in the ECCU - Cont'd**

Country	Year					
	1996	1997	1998	1999	2000	2001
Antigua/Barbuda	6.1	5.6	4.9	4.9	2.5	1.5
Dominica	3.1	2.0	2.8	1.6	0.2	-4.3
Grenada	2.9	4.2	7.3	7.5	6.4	-3.4
St. Kitts/Nevis	5.9	7.3	1.0	3.7	7.5	2.4
St. Lucia	1.4	0.6	3.1	3.5	0.7	-5.4
St. Vincent & the Grenadines	1.2	3.1	5.8	4.2	2.1	0.2
Anguilla	3.5	9.2	5.2	8.7	-0.7	2.0
Monsterrat	-21.5	-20.0	-10.1	-12.6	-6.7	-4.2
ECCU (with Monsterrat)	0.3	1.5	2.5	2.7	1.5	-1.4
ECCU (without Monsterrat)	3.4	4.6	4.3	4.9	2.7	-0.9

**Sources:** 1. ECCB  
 2. CDB

**Table 3.4**  
**Per Capita GDP for ECCU Countries**  
**(\$US)**

Country	Year					
	1990	1991	1992	1993	1994	1995
Antigua/Barbuda	4985	6591	6769	7083	7702	7690
Dominica	2049	2491	2636	2700	2825	2901
Grenada	2000	2319	2244	2722	2810	2721
St. Kitts/Nevis	3559	3974	3990	3990	4889	5331
St. Lucia	2414	2730	3490	3554	3596	3832
St. Vincent & the Grenadines	1620	2630	2078	2234	2390	2517
Anguilla	5906	6778	6834	6796	6153	5762
Monsterrat	6133	5387	5796	5747	5846	5787

**Source:** CDB's *Annual Reports*.

**Table 3.4**  
**Per Capita GDP for ECCU Countries - Cont'd**  
**(\$US)**

Country	Year					
	1996	1997	1998	1999	2000	2001
Antigua/Barbuda	7951	8484	8903	9189	9216	9055
Dominica	7951	3340	3389	3426	3753	3696
Grenada	2985	3200	3352	3657	4049	3880
St. Kitts/Nevis	5686	6095	7086	7176	7381	7450
St. Lucia	3866	4090	4139	4339	4562	4185
St. Vincent & the Grenadines	2415	2548	2830	2934	3009	3112
Anguilla	7397	9001	7635	8164	7970	9502
Monsterrat	9182 <sup>1</sup>	7249	9915	8329	6841	8063

**Source:** CDB's Annual Reports.

**Note:** 1. Due to unusual circumstances.



**Table 3.5**  
**Loans to the Personal Sector Disbursed by Commercial Banks and Credit Unions**

Institutions	Year								
	1993	1994	1995	1996	1997	1998	1999	2000	2001
Banks (EC\$M) <sup>1</sup>	1545.4	1609.2	1757.3	1985.3	2385.2	2660.2	2950.4	3255.8	3402.9
Credit Unions (EC\$M) <sup>2</sup>	134.4	154.8	177.6	195.1	209.7	230.8	266.4	309.7	300.9
GR of Personal loans by Banks (%)	-	4.1	9.2	13.0	20.1	11.5	10.9	10.4	4.5
GR of Personal loans by Credit Unions (%)	-	15.2	14.7	9.9	7.5	10.1	15.4	16.3	-2.8

- Notes:**
1. Loans to individuals.
  2. Values for the years 1993 to 1997 estimated.
  3. GR = Growth Rate

**Table 3.6**  
**Funds Mobilised by Financial Institutions**

Institutions	Year					
	1990	1991	1992	1993	1994	1995
Banks <sup>1</sup>	3184.9	3457.9	3817.8	4166.0	4563.7	5183.7
Credit Unions <sup>2</sup>	n.a.	n.a.	n.a.	239.0	267.1	312.3
Social Security Schemes <sup>3</sup>	738.8	858.3	971.1	1117.1	1249.6	1379.9
GR of Bank Funds (%)	-	8.6	10.4	9.1	9.5	13.6
GR of Credit Union Funds (%)	-	-	-	-	11.8	16.9
GR of SSS Funds (%)	-	16.2	13.1	15.0	11.9	10.4

Source: ECCB

- Notes:
1. Total Deposits (\$ECM)
  2. Shares and Deposits (\$ECM)
  3. Reserves (\$ECM)

**Table 3.6**  
**Funds Mobilised by Financial Institutions - Cont'd**

Institutions	Year					
	1996	1997	1998	1999	2000	2001
Banks <sup>1</sup>	5496.4	6032.4	6857.1	7701.8	8397.2	8999.8
Credit Unions <sup>2</sup>	349.5	379.0	414.1	447.9	488.7	540.1
Social Security Schemes <sup>3</sup>	1536.4	1698.2	1782.4	1999.6	2208.2	2405.0
GR of Bank Funds (%)	6.0	9.8	13.7	12.3	9.0	7.2
GR of Credit Union Funds (%)	11.9	8.4	9.3	8.2	9.1	10.5
GR of SSS Funds (%)	11.3	10.5	5.0	12.2	10.4	8.9

**Source:** ECCB

- Notes:**
1. Total Deposits (\$ECM)
  2. Shares and Deposits (\$ECM)
  3. Reserves (\$ECM)

**Table 3.7**  
**Savings Rate, Investment Rate and Savings Gap for the ECCU (%)**

Country	Year											
	1990			1991			1992			1993		
	SR	IR	SG	SR	IR	SG	SR	IR	SG	SR	IR	SG
Antigua/Barbuda	34.4	32.4	2.0	37.0	37.6	-0.6	37.6	34.8	2.8	37.2	31.7	4.5
Dominica	14.8	40.8	-26.0	13.1	31.6	-18.5	16.0	29.6	-13.6	18.4	26.8	-8.4
Grenada	16.3	38.1	-21.8	15.1	37.9	-22.8	13.9	29.4	-15.5	11.6	31.2	-19.6
St. Kitts/Nevis	24.0	55.4	-31.4	21.4	43.0	-21.6	31.7	39.0	-7.3	32.5	45.3	-12.8
St. Lucia	16.1	24.6	-8.5	11.9	24.4	-12.5	16.1	23.2	-7.1	19.6	24.6	-5.0
St. Vincent & the Grenadines	20.0	31.1	-11.7	11.7	30.8	-19.1	15.6	26.6	-11.0	9.6	28.6	-19.0

**Table 3.7**  
**Savings Rate, Investment Rate and Savings Gap for the ECCU (%) - Cont'd**

Country	Year											
	1994			1995			1996			1997		
	SR	IR	SG	SR	IR	SG	SR	IR	SG	SR	IR	SG
Antigua/Barbuda	33.6	32.4	1.2	28.2	36.9	-8.7	25.1	39.5	-14.4	31.4	40.8	-9.4
Dominica	10.9	26.9	-16.0	11.2	32.5	-21.3	16.4	29.7	-13.3	20.4	33.0	-12.6
Grenada	22.9	35.8	-12.9	14.6	32.1	-17.5	14.3	35.3	-21.0	11.1	36.2	-25.1
St. Kitts/Nevis	28.2	38.1	-9.9	22.9	46.3	-23.4	18.9	45.8	-26.9	27.3	45.1	-17.8
St. Lucia	18.0	24.4	-6.4	21.8	24.2	-2.4	19.3	25.5	-6.2	16.2	26.8	-10.6
St. Vincent & the Grenadines	7.1	31.3	-24.5	18.7	33.2	-14.5	19.6	31.5	-11.9	7.5	33.4	-25.9

**Table 3.7**  
**Savings Rate, Investment Rate and Savings Gap for the ECCU (%) - Concluded**

Country	Year											
	1998			1999			2000			2001		
	SR	IR	SG	SR	IR	SG	SR	IR	SG	SR	IR	SG
Antigua/Barbuda	39.1	43.0	-3.9	36.8	45.1	-8.3	42.3	48.0	-5.7	44.9	49.7	-4.8
Dominica	19.3	27.3	-8.0	18.8	27.7	-8.9	13.8	28.1	-14.3	6.7	24.1	-17.4
Grenada	11.6	36.3	-24.7	28.2	40.1	-11.9	25.5	42.2	-16.7	14.3	32.2	-17.9
St. Kitts/Nevis	27.9	43.0	-15.1	10.7	35.7	-25.0	16.2	45.8	29.6	27.7	50.6	-22.9
St. Lucia	18.6	25.4	-6.8	17.9	27.9	-10.0	21.3	26.7	-5.4	22.7	26.1	-3.4
St. Vincent & the Grenadines	6.9	35.8	-28.9	13.9	34.5	-20.6	19.0	27.3	-8.3	19.0	29.7	-10.7

Source: ECCB.

- Notes:**
1. Savings = GDP (market prices) – Consumption.
  2. The savings rate is measured as savings as a percentage of GDP (market prices).
  3. The investment rate is measured as gross capital formation as a percentage of GDP (market prices).
  4. The savings gap is measured as the difference between the investment rate and the savings rate.
  5. SR-Savings Rate, IR-Investment Rate, SG-Savings Gap.

**Table 3.8**  
**The Percentage of Total Commercial Bank Deposits Deposited by Non-Banks (%)**

Institution	Years											
	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Social Security Schemes	8.4	8.7	8.9	9.2	9.7	9.8	-	-	-	-	-	-
Other NBFIs	4.5	4.1	4.6	4.2	3.6	4.4	3.8	3.6	4.5	5.0	4.0	5.0

Sources: 1. ECCB.  
 2. Nicholls 1997.

## *Chapter 4*

# **THE EXISTING REGULATORY FRAMEWORK IN THE EASTERN CARIBBEAN CURRENCY UNION WITH SPECIFIC REFERENCE TO THE NON-BANK FINANCIAL INSTITUTIONS SECTOR**

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*T*he Uniform Banking Act is the umbrella regulatory framework for depository and credit financial corporations in the Eastern Caribbean Currency Union (ECCU). The member governments have retained the essential powers as they relate to the supervision and regulation of the entire financial system. This includes the powers of license, foreclosure, liquidation, and cease and desist. Therefore, the ultimate function of the ECCB under the Uniform Banking Act is monitoring and reporting to member governments. Moreover, there concurrently exist individual non-bank sector regulatory bodies. These include agencies to regulate credit unions, building societies, friendly societies and offshore banking. In essence, therefore, the power of regulation rests with the individual member governments within the currency area.



The remainder of this chapter is outlined as follows. In section 4.1, the main elements of the financial system in the ECCU are sectorised based on the IMF (1996) schematic. In this section the structure of the non-bank financial sector for the purposes of this study is delineated. The regulatory provisions within the ECCU are outlined in section 4.2 and gaps in the regulatory framework for NBFIs are identified in Section 4.3.

#### **4.1 Elements of the Financial Sector in the ECCU**

The financial corporations which exist in the ECCU can be divided into five categories. The first is the central bank. The second category is the other depository corporations sector. This category is composed of two elements. The first is the commercial banking system. These institutions can be distinguished by the inclusion in their liabilities of transferable deposits. The second sub-sector is the other depository corporations. These institutions are not allowed to issue transferable deposits. The third category is the insurance companies and pension funds. The fourth category is other financial intermediaries and the fifth category is financial auxiliaries. From an operational and legal standpoint within the ECCB region, a non-bank financial institution can be described as one which accepts non-transferable deposits, that is, it accepts all deposits other than demand deposits.<sup>1</sup> In addition,

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1 This definition, of course, only applies to the ECCB region. In other economic spaces, financial innovations and changes in the law have facilitated a blurring of the distinction between banks in the traditional sense and other financial intermediaries. In these jurisdictions it may not be useful to distinguish between banks and non-banks.

for the purposes of analysis, it includes categories three to five as noted above. The number of these institutions in the ECCU area is outlined by type and geographic distribution in Table 4.1.

Therefore, based on the IMF (1996) classification the non-bank financial sector in the ECCU can be sectorised in the following manner:

### ***Depository Corporations<sup>2</sup>***

1. **Building and Loan Associations.** These are institutions with the specific aim of taking deposits and making loans especially for home construction. These exist in four of the ECCU member countries. These are Dominica, Grenada, Montserrat and St. Vincent and the Grenadines.
2. **Credit Unions.** These are institutions which take both deposits and equity payments from their membership. The aim is to provide general financial services to their membership. These exist in all islands. However, they are most prevalent in Dominica, Grenada, St. Lucia and St. Vincent and The Grenadines.
3. **Friendly Societies.** These are institutions which, through a co-insurance mechanism, provide for the funeral expenses of their membership. These exist in all islands except Anguilla and Montserrat.

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2 Table 4.1 provides an indication as to the number and distribution of the non-banks within the ECCU.

4. **Unit Trusts.** These are institutions that are set up to act as an investment agency for their clients. Currently, none of these exist in the ECCU.
5. **National Development Foundations.** These are institutions set up specifically to finance small business enterprises. They exist in all member states, except Anguilla.
6. **Development banks.** These are institutions that were originally established by the member governments specifically to provide long-term financing and entrepreneurial advice to the domestic private sector. These exist in all islands, except Montserrat.
7. **Offshore Banks.** These are institutions established on the basis of regulatory arbitrage at an international level. Their main customer base is international. These operate in all islands, except St. Kitts and Nevis and St. Lucia. However, they are most prevalent in Antigua, Montserrat and Grenada.

***Insurance Companies and Pension Funds  
including Social Securities Schemes (SSS)<sup>3</sup>***

1. **Life Insurance Corporations.** These are institutions that provide protection to beneficiaries

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3 In the IMF manual on financial and monetary statistics the social security schemes are treated as part of the general government sector. The inclusion here is on the basis of analytical significance to the non-bank financial institutions sector.

of the insured. They provide a mechanism for managing uncertainty and risk to households. These operate in all islands.

2. Other Insurance Corporations (including off-shore). These are institutions for spreading and managing risk. These operate in all islands.
3. Social Security Schemes. These are institutions that provide for the replacement of income lost due to retirement and other specified contingencies. It is based largely on the ability to spread risks facing the population through co-insurance. Membership in these schemes is compulsory.
4. Private pension funds. These arrangements are usually private and institution specific. These exist in all islands. However, information on the number of private pension plans is not currently available.

### ***Other Financial Intermediaries***

Finance companies. These are institutions that do not take deposits, but engage in lending. These currently operate in all islands except Montserrat.

### ***Financial Auxiliaries***

Insurance Brokers. These institutions usually provide advisory services related to intermediation. These operate in all islands.

## **4.2 The Existing Regulatory Framework in the ECCU**

The regulatory framework for the non-banks cover the following main areas in some form or fashion (See Tables 4.2 and 4.3):

- (i) Source of funds
- (ii) Use of funds
- (iii) Ownership and management
- (iv) Examinations and reporting
- (v) Disclosure
- (vi) Granting and withdrawal of business licence
- (vii) Financing of the regulatory framework
- (viii) Penalties for deviant behaviour.

An effective regulatory framework consists of two basic elements: the rules of enterprise operation, and an enforcement mechanism for these rules. We deal first with the rules of the financial system and then turn our attention to enforcement and monitoring in the next chapter.

### **4.2.1 The Rules of The Financial System**

The regulation of the financial system is shared between the ECCB and the member governments (See Table 4.2). The rules of enterprise operation in the financial system consist of three basic groups. These are the Uniform Banking Act, additional onshore non-banking sector and additional offshore non-banking sector regulation.

### ***The Uniform Banking Act***

The umbrella financial regulatory document is the Uniform Banking Act. The Act was adopted by the various member states at different times. While this piece of legislation deals specifically with the commercial banking system, its general thrust is aimed at the entire financial system. Under this Act all financial institutions which conduct banking business are regulated. Banking business is defined as<sup>4</sup>

*...the business of receiving funds through*

- (i) the acceptance of monetary deposits which are payable on demand or after notice or any similar operation;*
- (ii) the sale or placement of bonds, certificates, notes or other securities; and the use of such funds, either in whole or in part, for loans or investment for the risk of the customer; and includes any other activity recognised by the Central Bank as banking practice and which a financial institution may additionally be authorised to do.*

The following therefore fall under this Act:

- (i) other "other" depository corporations;*
- (ii) other financial intermediaries.*

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4 All quotations are from the Uniform Banking Act 1993, unless otherwise specified.

However, under the Banking Act member governments retain significant residual powers in the application of the said Act to elements within their financial system. Moreover, the elements that have been enacted (such as the regulation of the commercial banks) are also shared with the member governments. The ECCB is, in effect, an agent, whose main function is regular monitoring and reporting to the principal.

The actual control of the financial system under the Act rests with the member governments, acting through the Minister of Finance. The governments have retained the most important powers. These include:

- (i) *The granting of banking licences*
- (ii) *Issuance of cease and desist orders.*
- (iii) *Foreclosure procedures.*
- (iv) *Requirements of capital adequacy*
- (v) *Mergers and acquisitions within the financial system*
- (vi) *Liquidation – both voluntary and compulsory*
- (vii) *The appointment of a receiver*
- (viii) *The disposition of remaining property.*

The implications of this distribution of powers (multiple principals) can be significant where speed and unambiguous action are critical. Moreover, the current arrangement makes the framework uneven, as it is subjected to different interpretations in different jurisdictions, and hence the possibility exists that it may be implemented with various degrees of vigilance. This has implications for the entire financial system, since weakness in one part of the system, particularly

in a common currency area, can lead to contagion. The arrangement also requires that the supervisory process be free from political pressure to avoid regulatory forbearance.

### ***Additional Non-Bank Financial Sector Regulation***

In addition to the Uniform Banking Act, there exist individual acts for each class of non-banks. These are currently policed at the member country level. Indeed, this separate non-bank regulation at the individual country level is further segmented between on-shore operation and what has now been classed as the offshore financial services sector. Therefore, while the Banking Act is, in a sense, a blanket document, it has been applied more specifically to the commercial banking system up to this point.

The legislation that governs on-shore non-bank financial institutions is further split by the type of activities in which they are engaged. For instance, as shown in Table 4.2, in addition to the provisions of the Banking Act, those institutions that are classified as other “other” depository corporations are also governed by the following pieces of legislation:

- (i) *The Building Societies Act*
- (ii) *The Co-operative regulations in each country.*

Table 4.4 outlines the departments of government responsible for credit unions under the co-operatives acts in different countries. The other category of non-banks (i.e. non-depository and non-credit financial institutions) lacks a regional regulatory framework. In



the current situation, each country has individual regulatory and supervisory frameworks. These include:

- (i) *Individual statutes for specific institutions, e.g.- social security schemes.*
- (ii) *Insurance regulations - registrar of insurance. The supervisor of insurance in each island is also responsible for insurance brokers.*

Finally, finance companies, which fall under the category of other financial intermediaries, are covered under the Uniform Banking Act. A restricted banking licence governs the operation of these institutions.

#### **4.3 Gaps in the Regulatory Structure for Non-Bank Financial Institutions**

As shown in Table 4.2, however, regulations for certain aspects of the financial sector are missing. This is so in the case of private pension funds. Of all the ECCU countries, only St. Lucia has made provisions for the regulation of private pensions.<sup>5</sup> This provision was enacted in 1995, and it forms part of the general responsibilities of the Supervisor of Insurance.<sup>6</sup>

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5 Currently information on these schemes is generally available from the Inland Revenue departments. The private pension plans which exist tend to seek tax relief and as such, must submit information on their financial operations.

6 There exist plans for all member states to enact similar legislation in the near future.

The regulatory framework for the offshore financial sector is shown in Table 4.2. The activities in the offshore sector are the same as those of the on-shore sector. However, in this sector the major piece of regulation is the offshore financial services acts of the various countries.

Most governments in the ECCU have revamped their offshore non-bank financial sector regulation to cover the various activities. The offshore non-banking sector regulations are of special significance since they effectively create an avenue for international regulatory arbitrage. Regulations in this sector pit the domestic authorities against the international regulatory bodies. Hence it is a channel for international spillovers and therefore a potential source of confrontation. This emerges precisely because developed countries have attempted to tighten up financial regulations and raise revenues. However, because of developments in technology and a general philosophy of economic liberalism being pursued with fervour in the developing world, a number of offshore financial centres are being developed overnight. The main reasons for this development are related largely to international tax arbitrage. However, a new argument/reason is being put forward - criminal arbitrage, where the rules on the legality of funds and enforcement mechanisms differ among countries. This loophole can be exploited to sanitise illegal money flows so that they re-enter the international system as legitimate funds.

The Uniform Banking Act is the umbrella regulatory framework for the depository and credit financial corporations sector. However, there co-exist individual regulations for specific non-banks. Moreover, even under the Banking Act the member governments retain significant non-trivial powers.

Even though the policy authorities are in the process of developing uniform regulations for most of the non-banks, there remain some important conceptual issues to be resolved. Among these issues is the role of information economics in the regulatory process. Also important is the concept of regulation as it relates to what ought to be regulated. In addition, there is the issue of the primary focus of the regulatory framework, that is, should it be on the consumer, the managers of the non-banks or shareholders. The way in which these issues are dealt with will determine the future effectiveness of the regulatory framework for non-bank financial institutions in the ECCU.

**Table 4.1**  
**The ECCU Non-Bank Financial System**  
**Geographical Distribution of Institutions by Type as at December, 1997**

	Anguilla	Antigua & Barbuda	Dominica	Grenada	Montserrat	St. Kitts & Nevis	St. Lucia	St. Vincent & The Grenadines	Total
Building & Loan Associations			1	1	1			1	4
Credit Unions	1	4	21	22	1	4	31	7	91
Friendly Societies									100
Unit Trusts									Nil
National Development Foundations		1	1	1	1	1	1	1	7
Development Banks	1	1	1		1	1	1	1	7
Offshore Banks	2	49	5	10	18			4	88
Insurance Companies/ Agencies	15	27	18	27	7	9	26	20	149
Social Security Schemes	1	1	1	1	1	1	1	1	8
Private Pension Plans									
Finance Companies	1	3	1	1		1	4	2	14
Insurance Brokers	1	1	1	1	1	1	1	1	7

Source: ECCB

**Table 4.2  
REGULATORY FRAMEWORK OF THE ECCU CURRENCY UNION**

<b>Financial Sector</b>	<b>Regional Regulatory Framework</b>	<b>Enforcement/ Monitoring</b>	<b>Domestic Regulatory Framework</b>	<b>Enforcement/ Monitoring</b>
<b>Depository Corporations (Other "other")</b>	Uniform Banking Act			
i. Building & Loans Association	"		Building Societies Act	
ii. Credit Unions	Uniform Banking Act & Harmonized Act	Quarterly ECCB Data Collection/Consultation with Registrars	Cooperatives Act	Quarterly Report
iii. Friendly Societies	"			"
iv. Unit Trusts	"			
v. Development Banks	"	ECCB Data Collection	Statute of Parliament Financial Services - Off-Shore Acts	Annual Audits
vi. Off-Shore Banks	"			
<b>Insurance Companies and Pension Funds</b>				
i. Life Insurance Corporations	Nil	ECCB Data Collection	Registrars/Insurance Act	Annual Reports
ii. Other Insurance Corporations (including off-shore)	"	"	"	Annual Reports
iii. Social Security Schemes	Nil	ECCB Data Collection	Statute of Parliament	Tri-Annual Actuarial Reviews
iv. Private Pension Plans	Nil		Only St. Lucia (1995) Registrar of Insurance	
<b>Other Financial Intermediaries</b>				
i. Finance Companies	Uniform Banking Act	ECCB Data Collection/ on-site Examinations	Companies act/banking act with restricte licence	
<b>Financial Auxiliaries</b>				
i. Insurance Brokers	Nil		Registrars/Insurance Act	

**Source:** Uniform Banking Act and Bank Supervision Department.

**Table 4.3**  
**Regulatory Categories Covered by Existing Non-Bank Regulations**

Categories	Credit Union	Building Societies	Friendly Societies	Life Insurance	Other Insurance	Social Security
Source of Funds	+	+	+	+	+	+
Use of Funds	+	+	+	+	+	+
Ownership and Management	+	+	+	Ownership	Ownership	
Examinations & Reporting	+	+	+	Rep.	Rep.	+
Disclosure	+	+	+	+	+	
Granting & Termination of						
Business Licences	+	+	+	+	+	
Penalties for Deviant						
behaviour	+	+		+	+	

**Source:** *Individual Non-Bank Statutes*

- Notes:**
1. + indicates that regulations exist in the particular category, otherwise no specific regulation exists.
  2. Rep. = Reporting.

**Table 4.3**  
**Regulatory Categories Covered by Existing Non-Bank Regulations - Cont'd**

Categories	Dev. Banks	Finance Companies	Insurance Brokers	Unit Trust	Off-Shore Banks	NDF	Private Pensions
Source of Funds	+						
Use of Funds	+						+
Ownership and Management Examinations & Reporting	+			Rep.		+	
Disclosure					+		+
Granting & Termination of Business Licences		+			+		+
Penalties for Deviant behaviour		+			+		+

**Source:** *Individual Non-Bank Statutes*

**Notes:** 1. + indicates that regulations exist in the particular category, otherwise no specific regulation exists.  
 2. Rep. Reporting.

**Table 4.4**  
**Cooperative Departments by Ministry 1994**

<b>Country</b>	<b>Antigua and Barbuda</b>	<b>Dominica</b>	<b>Grenada</b>	<b>Montserrat</b>	<b>St. Kitts and Nevis</b>	<b>St. Lucia</b>	<b>St. Vincent</b>
<b>Ministry</b>	Labour, Civil Service & Co-operatives	Community Development	Labour, Social Security & Community Development	Agriculture, Trade and Environment	Agriculture, Lands, Housing & Development	Community Development, Sports & Local Government	Housing, Local Government & Cooperatives
<b>Status</b>	Department	Division	Department	Division	Division	Department	Department

**Source:** Adopted from Edwards (1994).



## *Chapter 5*

# **A CRITIQUE OF THE CURRENT REGULATORY STRUCTURE FOR THE NON-BANK FINANCIAL INSTITUTIONS SECTOR**

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*B*y gathering information on their clients, financial institutions are able to considerably reduce the problems of adverse selection and moral hazard in the financial system. However, this does not solve the information problem for the liability holders of these non-banks, that is, the non-banks do not share the information on the quality of their investments with their suppliers of funds. This asymmetric information situation can lead to financial disruption, where the liability holders respond in herd fashion to perceived risks of losses. Moreover, precisely because of asymmetric information, regulation may also be unable to effectively achieve its main objective.

To meet this challenge the policy authorities must design contracts (regulatory frameworks) that yield pertinent information, discourage deviant behaviour,

prevent systemic risks and promote consumer welfare at minimum transaction costs. The authorities must seek to protect the ordinary liability holders without removing incentives for prudent management. Moreover, the regulations should avoid stifling competition by encouraging orderly exit and entry within the financial system.

In what follows, we review the adequacy of the existing regulatory framework for the non-bank financial sector in the ECCU area by using an asymmetric information framework of analysis. We also examine the impact of the existing regulatory structure on the efficiency and stability of the non-bank financial sector and the likely impact of any new non-bank regulatory framework.

### **5.1 The Adequacy of the Regulatory Framework**

Non-bank financial institutions operate in an environment that is characterized by technological advances, improvements in telecommunications and liberalised capital and financial systems. As a result these institutions are experiencing rapid and dramatic growth and development the world over. An important issue, therefore, relates to the general adequacy of the regulatory regime and resources provided to execute their mandates effectively in the current environment. The effectiveness of regulatory oversight can mean the difference between taking simple corrective action in small doses or major restructuring to correct serious structural weaknesses among non-banks, as well as the general financial system, if there is contagion. The adequacy of the regulatory regime would also involve the ability of the supervisory agency to take prompt corrective action to stop undesirable financial activities and, even more importantly, to close down institutions

that do not have sufficient net worth, making sure that equity holders and managers of these insolvent institutions are appropriately punished.<sup>1</sup>

Important factors in this process are the need for independence from the political process, innovative structures for capturing information from regulated institutions and improved incentives for the supervisory agency. Finally, legal issues such as the nature of the bankruptcy and other fiduciary laws need to be amended to reflect and also promote economic development. Of course, this must be done in an environment characterized by asymmetric information and the perverse incentives generated by this condition. The regulatory and supervisory arrangements must, therefore, be cognizant of these difficulties and every attempt should be made to structure the regulatory and supervisory system in such a way as to minimize their impact.

There are a number of problems in achieving governments' goals (economic efficiency, equity and rent extraction) through regulation (Stiglitz 1987). This is especially so in the presence of information asymmetries. Information asymmetries that generate problems of adverse selection and moral hazard are the major cause of market failure in the financial system. This, to a large extent, explains why only a small proportion of firms in both developed and developing countries are able to raise capital in the securities markets. This asymmetric information provides a

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1 Information asymmetries sometimes prevent external regulators from distinguishing between an insolvent and an illiquid financial institution.

reasonable argument for the absence of securities markets generally in the least developed countries such as those in the ECCU area. It also leads to monopoly power and limited competition in financial markets where the asymmetries are more intense. Information asymmetries, therefore, determine the type of regulatory framework and the effectiveness of the system imposed by the government.

In a situation where the firm is a monopoly, it can extract rents from the government, as there are no benchmarks against which performance can be compared. Also, the absence of good risk markets offers one example where market failures influence the degree of regulation. Finally, in the situation where the principal (government) is better informed than the agent and this knowledge is difficult to convey by means other than direct interaction with the producer in the production process, the type of regulation chosen may be one that facilitates ongoing communication. This is especially important in the case of development banks, pension funds and social security. All these are typical examples where maximum rent extraction may be difficult, if not impossible.

Financial institutions such as banks and non-banks are able to considerably reduce the problems of adverse selection and moral hazard through the collection of information (monitoring) on their customers.<sup>2</sup> This, to some extent, explains the dominance of commercial banks and some institutions in the non-bank sector,

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2 Financial institutions are also able to control the use of resources by borrowers thus preventing risks to themselves.

which operate on the basis of their local information advantages. Moreover, because they are able to profit from the information they produce, they are not as subject to the free-rider problem as the securities markets. As a result, the managers of the various non-banks are much better informed about the quality of the assets in their companies and so are in a better position to make a determination, for example, on the provisions for doubtful loans. However, this information is not available to the regulator or liability holders, but would be useful if obtained.

The case of the government acting on behalf of the market is really a principal agent problem. A principal (government) exists, which hires an agent (producer of financial services) to conduct certain activities i.e. produce financial services, that it is unable to perform. The relationship is governed by a contract (regulation), which specifies the output, conditions of work and remuneration. The contract, of course, has to be monitored (supervision) to ensure that the agent conducts its activities as contracted. However, it is expensive to monitor compliance with the contract, since it is difficult to cover every eventuality, including the environment within which the contract is performed (incomplete contracting). Contracting cost and institutional restrictions on feasible contracts limit the government's flexibility in contract design. The institutional restrictions include limits on the liability of producers and limited commitment on the part of the government. Contracting costs arise in part from the difficulty in anticipating all possible contingencies - government may be unable to accurately specify the value of the services that are being produced.

Moreover, the opportunistic behaviour of the agent would tend to lead to the exploitation of any incompleteness in the contract, which includes taking action that is not in the best interest of the principal, and by implication, consumer welfare. Therefore, the design of any contract of this nature must balance the cost of monitoring performance in an uncertain environment against the cost of opportunistic behaviour. Through such opportunistic behaviour the agent earns a rent from asymmetric information. For instance, the contract which the principal proposes may monitor quantity but not quality. There are also problems that arise from the multiple outputs of the agent, for instance, which type of restrictions ought to be placed on the innovative capabilities of non-banks. New products provide new and more intelligence on the workings of the economy and the non-banks in particular, but they also raise risks. However, these outputs are complementary; curtailment of innovation also reduces the information that is obtained. This is another important hindrance to contract implementation.

In the ECCU area, some non-bank institutions are owned by their membership and this in effect usually has a significant bearing on their operations. This is especially so in the case of the credit unions. On the other hand, non-banks such as building societies and development banks have an operational structure, which creates incentive problems for control. A clear example of this is the operation of the development banks, which exist essentially to provide financial services to priority sectors deemed important to the sustainability of economic performance. However, whilst in aggregate their performance has been reasonably good, there are instances where significant problems have emerged related to focus and operational efficiency. These, in

turn, have affected their ability to deliver outputs in required quality and amounts. Indeed, there are problems of significant delinquent and doubtful loan portfolios. This is a case where the monitoring of quality has been a problem. On the other hand, at other development banks some customers have complained of the transactions costs on loans and also the similarity in the cost of credits from these institutions and commercial banks. In such a situation, the development bank may be concentrating on ensuring asset quality ahead of output volume. A related issue is that the operation of the development banks and the type of lending in which they engage are inherently risky. Therefore, the level of risk and the type of lending these institutions undertake can be regarded as complementary outputs. The reduction of risk levels would require a reduction in loans to development projects. Moreover, a number of those institutions, which have experienced high delinquency rates, have also complained of significant political interference.

The major task of the principal (government) must be to design and implement a contractual arrangement which achieves two objectives simultaneously. Firstly, the government ought to seek to achieve fully its stated goals of economic efficiency, equity and maximum rent extraction. Secondly, the contract ought to aim at simultaneously reducing incentives and opportunities for rent extraction on the part of the agent. There are at least two aspects to a contract design, the frequency of the transaction and the extent to which transactions-specific investment is required (Williamson 1983). The frequency of the transaction affects the cost of enforcement. In addition, transaction-specific investment by the agent increases the hold of the principal. Hence, a transaction that possesses any or both of these characteristics may attract a particular type of

contractual framework such as a unified governance structure. In other words, the government may actually determine that it may be in the best position to conduct the activity, given the difficulty of regulating such an activity run by the private sector. This set of issues raises questions related to the economics of regulation in the non-bank financial system. What should regulation focus on? For example, should it focus on the shareholders of these institutions, or should it attempt to protect the depositors and other users of these financial services? The answer to this question lies in an understanding of the forces that drive financial intermediation and financial innovation.

Another issue relates to the scope of the regulatory framework for the non-bank sector. For instance, should regulations cover only a select group of non-banks or should it cover the whole range of non-banks? Moreover, does it promote the objectives of the principal to have several enforcement agencies, as is the current arrangement in the ECCB member countries, or is it better to have one regional enforcement agency? These are some of the questions that must be answered to determine the adequacy of the regulatory arrangements for the non-bank financial sector in the ECCU area. As can be deduced from the discussion thus far, these issues are at the very core of governance. In this regard, an appropriate regulatory and supervisory framework is only one aspect of good governance. Other elements include a vigilant public and a well-developed system for public accountability. The vast majority of the general public is, however, not knowledgeable about investment, money management, risks and other relevant issues in the financial sector. This arm of public accountability is therefore weak. This manifests itself in the annual general meetings of some credit unions, where attendance is usually less than acceptable. In recognition of



this fact, an educational programme has been launched in member states to sensitise members of the public to important information on the financial sector. To be effective, the programme must change attitudes about ownership of financial assets and management of investments and risks. In effect, the people must become participants in the development process.

This is particularly difficult in the case of non-banks. This is so because non-banks are a diverse group of institutions. There are at least three broad categories of non-banks characterized by their liabilities. Firstly, there are *deposit-taking institutions*, which include the following: building societies, credit unions, friendly societies, offshore banks and unit trusts. These institutions may be subject to deposit runs as depositors seek to protect themselves from perceived imprudent financial management. Secondly, in those institutions where *the majority of their liabilities are loans*, the existing legal framework may in fact offer protection. Included in this category would be development banks, national development foundations, and finance companies. Third are those institutions whose *liabilities are contribution-based* and the liability holders may not be in a position to effect disruptions of the institution's operations. Included in this group would be institutions such as insurance companies, social security schemes and private pensions.<sup>3</sup>

This broad classification of non-banks implies that there are two types of responses that are necessary on

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3 The other group of non-bank financial corporations is fee-based organizations providing advice.

the part of the regulatory authorities. The first relates to “deposit runs” on the deposit-taking non-banks. It must be noted that the deposit runs envisaged in this context are not quite the same as those at financial institutions that are directly involved in the payments system. These deposits are non-transferable and so cannot be used directly in the payments system. The second relates to consumer protection, in the situation where consumers are unable to protect themselves. These are the two central issues examined in this chapter, that is, regulations must seek to protect the ordinary liability holders without removing incentives for the non-banks to manage prudently and they must be structured in such a way as to avoid stifling competition and innovation in the financial system.

## **5.2 Regulatory Oversight and Enforcement for Contribution-Based Non-Banks with Special Reference to Private Pension Plans**

Perhaps the most important macroeconomic issue in the consideration of the pension/social security development and reform is the fundamental issue of regulation and enforcement in the private sector. Private schemes require an environment that is transparent with strong regulatory oversight. This does not only relate to pension funds but also to the companies in which the pension funds invest and the tax treatment of contributions. Important also is the treatment of non-compliance, especially as it relates to the government. A general respect for the rule of law is required under both publicly and privately operated systems. Indeed, the privatised arrangement in Chile is still subjected to political manipulation. Of equal significance are the ties that these (Administradoras de Fondos de Pensiones (AFP) – Pension Fund Administrators) funds have developed with Chilean

economic conglomerates. In such a situation, the investment policies of the fund managers are likely to be determined by the conglomerates and may not be in the interest of contributors. Therefore, the important factor of corporate governance must be addressed at the broadest possible level. This would involve such considerations as the role of an information policy, investment managers, corporate managers, shareholders, boards of directors, auditors, regulators, pension fund contributors and the general public.

Currently, a number of private pension arrangements exist in the ECCU area but the systems in place for their regulation and supervision can, at best, be described as lax. This situation obtains precisely because specific regulations on private sector pensions do not exist in any ECCU country except St. Lucia.<sup>4</sup> In any case, the rules under which these funds operate and the specific provisions are not transparent. These arrangements are, therefore, exposed to unnecessarily high levels of risks from fraud, abuse and imprudent behaviour on the part of unscrupulous sponsors, trustees and fund managers. There is need for regulation and enforcement in specific areas. These include:

- (i) Investment of funds
- (ii) Portability and vesting
- (iii) Tax treatment
- (iv) Funding and adequacy of pensions

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4 Pension funds are generally governed by trust legislation. However, this does not prevent fraud or employer tampering. Correcting for such practices and redress can be expensive on the part of the individual especially where there is no regular monitoring.

- (v) Ownership of pension funds
- (vi) Bankruptcy of firms sponsoring a pension fund
- (vii) Information disclosure policy.

The objectives of regulating the private pension market ought to be the following:

- (i) To provide on-going monitoring of firms' performances. This is especially important where complex transactions are contemplated and the capabilities of the producer and the risks inherent in production are difficult to discern.
- (ii) To gather information that can inform policy decisions and limit the rents of the firm.
- (iii) To facilitate risk-sharing in a manner that does not eliminate incentives for efficient performance.

The current environment, in which the rules as regards items (i) to (vii) are unclear, holds a huge moral hazard problem for governments in the ECCU area. If the existing private pension funds perform badly the authorities may be forced to provide for people in their old age.

### **5.3. The Adequacy of the Regulatory and Supervisory Frameworks for Deposit Taking Non-Banks**

The mechanism through which a business licence is issued for the operation of a financial institution is one of the ways in which the policy authorities can reduce the problems of adverse selection in the financial

system. In particular, by preventing undesirable individuals from owning and operating a financial institution, the authorities can remove the potential for excessive risk taking. The power to grant a business licence by several agencies in the currency union effectively weakens this protection device.

Moreover, the mechanism of random examination would allow the regulators to monitor the behaviour of the non-bank financial institutions in respect of their compliance with guidelines on asset holdings and capital base, measures that are designed to reduce the problem of moral hazard in the financial system. However, the resources currently deployed do not allow regular spot checks. Indeed, in some countries the simple reporting of data on operations has been fraught with problems. Of particular significance in this regard is the enforcement and monitoring of the non-banks under the existing regulatory frameworks. The establishment of the required regulatory framework is only part of the arrangement; of even more significance is the compliance of the various institutions that fall under this regulatory system.

The regulations should make provision for disclosure of certain financial information on the operations of these institutions. This would allow the liability holders and the market in general to make more informed decisions about the performance or solvency of these institutions. However, before this disclosure procedure can be put in place, the accounting standards that these institutions adhere to would have to be enhanced. Therefore, the regulatory mechanism ought to be designed in such a manner as to exploit/capture this information.

This raises the issue of the transaction costs of obtaining information on the agent. It is by comparing the transaction costs across alternative arrangements that the policy authorities can arrive at the most effective means of conducting regulation of the non-banks. For example, it may be worthwhile to investigate the feasibility of self-regulatory frameworks within the general regulation of the financial sector. Also important is the role of signalling in providing information on the non-banks' performance. Using this approach, the regulatory authorities could implement a large-scale financial education programme of the general population on all aspects of managing money, existing regulation and financial analysis. The aim of this programme would be to raise the financial awareness and monitoring capabilities of the population. In this way, the different non-banks would have to (voluntarily or under compulsion) signal their soundness to their liability holders.

Another possible method of addressing information asymmetries is through the promotion of non-bank peer group associations. The benefits of such associations include:

- (i) Solving problems of indivisibilities, especially with regard to information economies.
- (ii) Better risk bearing characteristics. This would be realised where the association can discriminate and limit membership, removing opportunities for exploitation due to information asymmetries and thereby deal with problems of adverse selection. The association must also be able to remove incentives for moral hazard, such as malingering. Members of a common or integrated task group possess

certain informational advantages on each other, which result in better risk bearing, superior ex-ante screening and ex-post monitoring capabilities relative to other organizational forms, such as the individuals or markets. For example, precisely because members of a common or integrated task group know the requisite attributes for new membership, they can effectively screen and limit new membership in a discriminating way. In addition, they are able to monitor each other, almost automatically at no extra monitoring expense, given their close working relationship (Williamson 1983).

- (iii) Associational gains could be gleaned from these organisations. These gains include shared training programmes and a common front for lobbying government and other agencies. Such an arrangement exists for some non-banks such as credit unions in the form of the credit union league. However, a number of these associations are effectively non-functional. They also tend to be poorly organised and managed, and starved for resources.

A special difficulty is created by the many different regulations and supervisory bodies which currently exist, each with its own mandate. This situation gives rise to problems related to supervisory hierarchical control. This arises where there are different pieces of regulation, with some element of overlap, for example, the Uniform Banking Act, which can also be interpreted as being relevant to some non-banks. In this situation, the preferences of the different regulators and their principals may not coincide. Of course, the situation is

compounded further by the fact that each regulatory body has at its disposal instruments of policy that can be enforced in isolation. The outcome of such a situation is not pareto optimal.

### ***Enforcement Mechanisms***

An effective enforcement mechanism must involve at least three elements. These are (a) a capacity for monitoring and intelligence gathering, (b) the ability to take corrective or proactive action and (c) a capacity for investigative work. In addition, these agencies must be adequately staffed with competent professionals. As shown in Table 4.2 in the previous chapter, except for those activities that are operational under the Banking Act, the individual member states are responsible for enforcement. At the individual country level, there is no centralised regulatory agency for the non-bank financial sector as a group. In some countries the monitoring is done by the Ministry of Finance, while in others it is housed as part of the general functions of the Ministry of Agriculture and so on (See Table 4.4 in the previous chapter).

The reasons for this may stem from the fact that the on-shore non-bank financial sector, in particular cooperatives, are viewed from the perspective of social development and in fact have been treated with less than urgent priority. In all cases, the legislation provides for a supervisor of cooperatives or insurance and other supervisory officers, whose powers and responsibilities are defined under the appropriate regulations. However, Edwards (1994) has argued that the powers of the Registrars are ineffective, outdated and need to be strengthened. Moreover, there are a number of problems identified, such as tenure and the lack of succession planning in the office of the Registrar, which have com-



promised its effectiveness. In addition, the departments are under-funded. In the case of offshore financial services, most governments have established an offshore financial services authority under the direct authority of the Ministry of Finance, to emphasize the importance with which these are viewed. To complicate issues further, a number of countries have signed mutual assistance agreements with foreign governments with regard to offshore transactions. Moreover, some countries have invited the ECCB to enforce existing regulations on some offshore non-banking financial sector institutions.

In spite of the fact that the non-bank financial sector regulatory framework covers most of the main areas, the two main concerns remain the degree of fragmentation and the ability and/or willingness of the policy authorities to consistently enforce these regulatory measures. The difficulty of enforcement is indicated by the infrequency of contact between the regulatory agency and the non-banks. According to Edwards (1994), in a number of cases for the cooperative movements, simple data collection and record updating are tardy. In some islands audits are twelve months overdue. This also extends to other statutory arrangements such as annual general meetings and monthly reporting requirements. Moreover, the regulatory functions are normally sacrificed when there is a budget crunch. The need for a full time Registrar has also been identified as important for all islands. Additionally, the need for appropriately trained staff is still a burning issue identified for urgent attention in all islands. To compound the problem, self-regulatory frameworks such as the credit union league are generally non-functional.

The individual regulatory/supervisory agencies are also very weak in respect of their investigative

capabilities. Again, this is due to cost considerations and the inadequacy and/or availability of trained and reputable personnel in each country. In addition, much of the non-bank regulations are dated. The modernisation being done is on a piece-meal basis and is concentrated mainly on the offshore financial sector. In addition, the issue of fragmentation is also still a problem in this new thrust, even though efforts have been made to coordinate these regionally.

In general, there have been attempts to create some degree of uniformity in the type of regulation and to upgrade standards across the region. This has been attempted with the credit union and the insurance sectors. There has been some success in this regard as a credit union project to improve standards on a regional basis has been developed and is funded by Eastern Caribbean Economic Management Project (ECEMP).<sup>5</sup> In the case of the insurance sector, model legislation has been devised with the help of the Law Faculty of the University of the West Indies. Uniformity has also been attempted in the offshore financial services industry. However, this is proving to be a challenging task, since each country wants to be regarded as the most accommodating to offshore business activity.

Another area of potential enforcement difficulty lies with the inefficiency of the existing legal framework in these countries. This inefficiency manifests itself in the slow speed with which disputes are settled. This is usually a function of the resources and organisational structures of the different legal agencies. A study

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5 This project is funded by the Canadian Government.

conducted by the legal unit of the ECCB (1998) revealed a number of existing deficiencies in these countries that can hinder further economic development. Among the issues identified were:

- (a) Inadequate administrative procedures that are related to such issues as:
  1. **The law of evidence.** Documents produced by computer technology are not admissible into evidence. The legal system has not kept pace with the trends in technology. In such instances, the inadmissibility into evidence of items such as photocopies may in fact deny or frustrate justice, where business transactions are concerned.
  2. **Speedy settlement of disputes.** In the current environment of limited resources there has been a build-up of pending cases particularly with regards to civil matters before the court system. These delays have resulted in tremendous expense to the aggrieved parties.

According to the report (p. 78),

*It is said that "justice delayed is worse than injustice". The Courts are the cornerstone of the legal system and are responsible for the interpretation and enforcement of the law and the protection of the rights of the parties to a commercial transaction. The slow pace with which justice is administered or dispensed in the member states, in particular the speed with which civil matters, such as recovery of debt and foreclosure suits are*

*settled before the Courts, is an impediment to the viable operations of the financial institutions in the member states.*

*That justice may be deemed to be denied in the member states is evident in the inability of the legal system to respond to the needs of the financial sector and to settle matters of concern within a reasonable time frame. The costs associated with the presentation of a matter before the Court are also increased as a result of the delay in the system as valuable time may be spent in seeking to obtain a decision from the Court on a commercial matter. Investors may therefore be denied the desired protection when matters of concern to them are initiated before the Courts.*

3. **Alternative dispute resolution/arbitration.** As a direct result of the deficiencies of the existing system, the report recommended alternative channels for dispensing justice to reduce costs and time to businesses. For example, in cases of commercial contracts, arbitration can be used to resolve differences in interpretation and disputes. There already exist laws in all member states that recognise this form of dispute settlement as binding on the parties. However, it is felt that the private sector is not currently aware of the benefits of arbitration and also that the limited trained personnel in arbitration law makes its increased usage difficult.

(b) Inadequate administrative structures including:

1. **Deficiencies of Registry of the High Court.** According to the report this office is overwhelmed by the demands placed on it, coupled with the limited resources that are allocated for the execution of its duties. As a result, the office is inefficient in the performance of its functions. According to the report (p. 86),

*Under the UWI/US-AIDE Administration of Justice Improvement Project, Reports have been commissioned and recommendations made to improve the Registry of the High Court and the Magistrate Court systems in the respective member states. The reports revealed, inter alia, that there is generally insufficient and inadequate resources for preserving and storing essential records, which are required to be kept by Statute. This results in the inability of entrepreneurs and staff to retrieve files and documents expeditiously and to an increase in lost documents. Essential and modern equipment to do the work and increase the efficiency of the department is also required.*

*Notwithstanding the apparent implementation of some of the recommendations, deficiencies such as the absence of adequate storage space and safes to secure legal documents and delays in the filing of documents due to insufficient personnel to give due effect to the statutory responsibilities of the Office of Registrar, continue to exist and are impediments to financial and economic developments in the member states. The*

*recommendations in the Reports are still relevant and ought to be reviewed and implemented, as far as practicable, to ensure that the Registry Offices operate efficiently.*

2. **Deficiencies in the Land Registry.** Similar difficulties are faced by the land registry, as there is no quick referencing for transactions. Hence, the purchase of property must involve an extensive title search. A simplification and improvement of the process will go a long way towards improving the speed with which a number of transactions can be effected.
- (c) The lack of sufficient education and human resource development as they relate to the legal system. This is particularly relevant in the case of legal drafting and arbitration law.
- (d) The need for law reform. The problem under this heading relates to the outdated nature of a host of the existing commercial laws, which therefore may not be relevant to a number of existing practices. Additionally, volumes of laws are not always available and sometimes they are out of print. According to the report (p. 93),

*A Law Reform Committee should be established with the authority to make recommendations for the improvements, modernisation and reform of law, including the removal of provisions that are outdated or inconsistent, the maintenance of an improvement of the administration of justice, the review of judicial and quasi judicial procedures under the Acts*

*and the development of new approaches to and new concepts of law, in keeping with and responsive to the changing needs of society and the individual members of society.*

*In the law reform exercise, the relevant ministries would be required to review the legislation which they administer and to recommend changes for the effective administration of the law.*

- (e) The printing and distribution of laws. In respect of the printing of existing laws the report stated (p. 94):

*Unfortunately the constitutional requirement is not adhered to by some member states. Neither is the practice adopted by the Legislatures to print Bills after their introduction or first reading in the House to get feedback from the public. Some of the member states are not required to publish Acts of Parliament in the Gazette, but the Acts are posted in a conspicuous place for the information of the public.*

*Time and cost are usually cited as factors which prohibit the publication of the Laws after they have been introduced in the Legislature or after their first reading. With advances in technology and the existence of appropriate computer software, the establishment of a central printing office in one of the member states may be a viable proposition.*

- (f) There are also deficiencies in the consumer protection legislation for commercial transactions in most of the ECCU member states.

Indeed, except for St. Lucia, which revised and updated its consumer protection laws in 1990, all the other member states are lagging far behind. According to the report (p. 56):

*With respect to consumer protection, there is an absence of general consumer protection legislation. In some jurisdictions there are provisions for the imposition of price control, but consumers who have grievances are forced to rely on provisions not necessarily geared to this purpose. By way of illustration, most member states, like their counterparts in CARICOM, have enacted sale of goods legislation. In almost every instance the legislation has been modeled on the Sale of Goods Act 1893 [U.K.]. When the legislation was first introduced it was not concerned with consumer protection. Increasingly, however, reliance is being placed on such legislation for this very purpose because of inadequate protection otherwise.*

An additional area on which the policy authorities may need to focus is the investigation and prosecution of fraud in the financial system, when the preventive measures have failed. This aspect of the governance framework usually requires international cooperation.

All these areas of concerns are inter-connected, with small-scale and limited means at the domestic level; resources are targeted at the different problems as they arise. The limited resources do not only relate to money, but also extend to technical expertise on regulation and supervision and other related services, which are critical to an effective oversight operation. An alternative is to take a holistic view of regulation



and enforcement of the non-bank financial sector. Such an approach may be better facilitated at the regional level. This is one of the issues discussed in Chapter 6.

#### **5.4 The Impact of the Current Arrangement on Efficiency and Stability**

Efficiency as it relates to the financial sector generally includes the efficiency in asset transformation, as well as maturity transformation and its relationship to liquidity. Finally, it involves the minimization of the cost of the saving and investing – especially the transactions cost. A number of these issues that relate to the efficiency of transformation are relevant to the financial system generally and are not peculiar to the non-bank financial sector. The non-bank institutions perform these functions reasonably well within the confines of the domestic countries in which they operate.

However, except for non-banks such as Barfinco, and some insurance companies, which have branches throughout the entire financial system, they have generally failed to expand their operations to provide these transformation services to the region as a whole. The different rules in each country may affect the transaction costs of operating at the regional level. As a result, the activities of the non-banks, especially the credit unions and finance companies, are largely dependent on the liquidity of the geographic location in which they operate. They have therefore been unable to use liquidity on a regional basis, which means that their assets/liabilities portfolios face concentrated market risks.

The second factor is that of cost efficiency. This refers to the productive efficiency of the non-banks, that

is, their cost to output ratios and profitability. The effect of this is difficult to assess, precisely because of general data unavailability. In any case, size does not guarantee cost minimisation or for that matter the ability to exploit economies of scope and scale even if they exist. Economies of scale and scope are often dependent on the organisation of the firm and the nature of the technology that the firm employs. Indeed, non-banks may be able to exploit operational efficiencies of a region-wide operation even without a single regional firm and in spite of the presence of obstructive rules. All that is required is for the existing non-banks to operate in a contracting framework, that is, contract activities among themselves and share the cost of services, which may be too high for a single institution. However, as mentioned previously, most of the non-banks are not currently engaged in region-wide operations, implying that they are hamstrung by limited resources at the individual country level. In addition, differences in regulatory structures for the non-bank institutions raise the costs of conducting transactions between jurisdictions and also result in high monitoring costs for the individual economic agent, as surveillance is not uniform.

The third factor is efficiency in the integration of financial markets. This can be looked at in two ways. The first is at the geographic level. At this level, the regulations at the country level may raise the transactions cost of using financial services, both at the retail and wholesale levels, across islands. Moreover, because prudential oversight is not uniform, monitoring on the part of liability holders becomes an important part of the consideration in any business arrangement. However, the creation of regional financial institutions such as the Eastern Caribbean Home Mortgage Bank (ECHMB), which is owned by a broad cross-section of

local and international investors, is a mechanism that is designed to facilitate financial integration of these countries. A number of credit unions, social security schemes and development banks also hold equity positions in the ECHMB. Secondly, as the major secondary market institution, the ECHMB provides an opportunity for the banks and non-banks to use regional liquidity.

The second level is on the basis of liquidity, where the existence of separate rules indirectly creates a separation device between financial markets. However, Barfinco have managed their operations from a regional perspective. Therefore, these institutions are able to transfer liquidity balances within the region. Of course, non-banks that concentrate their operations at the local level possess an information advantage that is exploited to their benefit. However, this advantage may be a weakness in other activities which non-banks (credit unions for example) may wish to undertake, especially in non-traditional business activities.

The issue of stability can be analysed from the basis of capital and leverage, which comprise the balance sheets of these institutions. Generally, institutions that have more capital and less leverage are less subject to shocks. The stability of the financial institutions is also affected by their structure. Unlike the commercial banking system, however, non-banks are not obliged to adhere to international agreement on common capital structure and other prudential standards. Therefore, the same institutions operating within the currency area, but in different countries, operate with different levels of capital.

This is compounded by lack of standards in accounting and disclosure requirements, which are

crucial to a healthy non-bank financial sector. Without appropriate accounting standards the market and the supervisors would be unable to adequately monitor institutions and determine whether institutions are taking excessive risks. The other aspect of stability in a currency union is the issue of international externalities. As described previously, precisely because of the segmentation of the non-banks' operations geographically, their localised instability is not transformed into currency union instability. However, instability may originate from contagion effects of agents' reaction to non-bank financial sector developments in their jurisdiction. There is a great possibility of this occurring precisely because of a number of linkages between these countries. Among these are a common geographic location, similar economic structures and a common currency.

### **5.5 The Capital Markets Initiative and the Current Arrangements**

The capital market is essentially a set of rules that govern the intermediation of financial resources for periods greater than one year. To operate efficiently a capital market requires transparent rules and an effective system of institutional monitoring, rule enforcement and sanctions for deviant behaviour. The regional capital market initiative is being coordinated and implemented at the regional level by the ECCB. However, in each member country national steering committees have been established, whose function it is to address the local issues as they relate to participation. These include legislation, mainly local, public education and mobilization. Hence rules and legislation for some regional institutions have been enacted as required. In effect, the capital markets strategy aims to deepen

and broaden the financial space through its integration, that is, the creation of a single domestic financial space.

The development of the regional capital market offers non-bank financial institutions more opportunities for investing their financial surpluses optimally – more opportunities for choosing the best risk-return profiles. It also offers them an opportunity for offering their services to a wider customer base. The development of the regional capital market also presents an opportunity for the regional policy authorities to engage in a coordinated revision and update of existing regulations and supervisory structures in a finite time frame. Indeed, the establishment of regional standards for the operation of the capital market can serve as the benchmark for the individual non-banks to aim at.<sup>6</sup> In fact, this is one of the strategies currently being adopted by the ECCB financial markets initiative. In particular, there are plans to draft and implement the following pieces of legislation:

1. Uniform Securities Law
2. Uniform Corporate Law
3. Uniform Bankruptcy Law
4. Uniform Trust Legislation
5. Nominee ownership status
6. Uniform commercial code.

However, while drafting is the first issue, implementing these laws in a timely fashion is very important. This has not always been easy or timely, precisely because of the reasons outlined previously.

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<sup>6</sup> The only difficulty with this approach is that some institutions would be initially locked out of the process.

There are different levels of inter-face of the non-banks with the capital market. There are at least four categories:

1. Listed entities
2. Lenders/investors
3. Borrowers
4. Third party inter-face as per the ECHMB.

**Listed Entities:** Based on existing deficiencies in the regulatory and supervisory structures, non-banks such as building societies may be prevented from initially listing until they have met certain minimum acceptable standards of operation. This may include having appropriate management in place and adhering to appropriate and acceptable accounting and reporting standards. However, the emergence of the regional capital market may in fact serve to improve the overall regulatory and supervisory structures and experiences in these countries. In particular, it would serve to increase pressures for improved corporate governance and monitoring.

**Lenders:** The main non-banks that fall in this category are life insurance companies, other insurance companies, social security schemes and private pension plans. These are expected to be the main suppliers of surplus financial resources. Other institutions such as unit trusts, credit unions and building and loan associations may also be important in this category of institutions. As lenders, the main factor is the extent to which local regulation prescribes the use of funds. In some instances, even where there are no rules on use of funds, local views are strong on domestic investment. Indeed, the social security schemes are in this predicament, where they follow a particular investment guideline, which prescribes portfolio

allocation. In addition, the existence of the alien land-holding licences may prevent effective cross-border movement of resources within the area unless, of course, these particular rules are repealed. The issue of taxes on interest income may also be significant. However, in the development of the government securities market, the ECCB has coordinated with individual governments on the design and implementation of reciprocal tax agreements, which provide exemptions for citizens of the ECCU member countries that are members of the regional government securities market. A related issue may be stamp duties on cross-border capital flows within the region.

**Third Party Inter-face:** The Eastern Caribbean Home Mortgage Bank (ECHMB) is currently the major secondary capital market institution in the ECCU area. The aim of this institution is to create liquidity for mortgage institutions across the financial system. Hence, there exists on the one hand the regional capital markets infrastructure at the regional level, which inter-faces at the local level with institutions that are up to date as per regulation and supervision and appropriate standards for mortgage lending. The policy authorities at an early stage recognised some of these deficiencies and implemented a number of regional projects aimed at improving regulation and supervision. The most prominent in this regard, aimed specifically at the credit unions, was the Eastern Caribbean Economic Management Project. Moreover, the regulatory deficiencies in the non-bank sector have meant that the commercial banks are the main and sometimes the only truly regional financial institutions. This situation has emerged because the regulatory and supervisory framework for non-banks is dated, segmented and, most importantly, poorly enforced. Therefore, the activities of capital market institutions

such as the ECHMB do not normally extend beyond the commercial banks, even though credit unions also write mortgages. The reason for this is the absence of appropriate verifiable standards for mortgage transactions among these institutions. Hence, the size and activity of the secondary mortgage market is reduced by the exclusion of credit unions for regulatory reasons.

### **5.6 The Impact of the Non-Banks on the Effectiveness of Monetary Policy<sup>7</sup>**

The ECCB monetary arrangement is in effect a quasi-currency board, with a monetary policy regime, which mimics a full-fledged currency board. The monetary policy instruments in use are the required reserves on bank deposits, the minimum interest rate on saving deposits and the discount rate at the Central Bank. None of these instruments are applied to the non-bank financial sector.

#### ***Reserve Requirement***

The reserve requirement is currently imposed at 6 per cent of deposit average over the reference week.

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7 It may be useful at this stage to identify the non-banks which are the subject of this section. For instance, while the activities of the credit unions, finance companies and building societies etc. can be ignored, this is not a sensible strategy to adopt in the case of the social security schemes. Indeed, these must be seen as partners in macroeconomic management, precisely because of their size and, therefore, potential impact on the stability of the financial system.



Most commercial bankers view it as a tax and have publicly complained about its non-application to the non-bank financial sector. This is especially so in cases such as in Dominica where credit unions are dominant. It must be noted that the Basle Arrangements on risk capital and provisioning do not apply to the non-bank sector. In any case, the provisions under this arrangement are of recent occurrence. Whilst *a priori*, given the relatively low rate at which the reserve requirement is applied, it is not expected to impact the banking system, in such a way as to cause financial disintermediation; it is a question which ought to be studied empirically before any definitive statement can be made. The required reserves are not imposed on the non-banks in this context. However, specific non-banks usually must comply with similar obligations aimed at consumer protection. For instance, the insurance companies are required to deposit 40 per cent of their gross (in St. Lucia net) premiums with the treasury. This amount is aimed at securing part of the policyholder's payments in case the companies fail.

### ***Minimum Saving Deposit Rate***

The policy of determining a minimum interest rate on bank savings deposits is not imposed on the non-bank financial institutions. However, to the extent that it exists, it may influence the interest rates which the non-banks can pay their customers. This interest rate policy is essentially a development oriented policy, aimed at encouraging private savings.

### ***Influence of the Social Security Schemes***

This important class of non-banks, because of its size relative to the rest of the financial system - especially the national commercial banks, can single-

handedly affect the availability of liquidity in the financial system. Hence, operations by the social security schemes can seriously disrupt financial stability. Moreover, in their operations these institutions have affected domestic interest rates (within margins) on deposits for large depositors. For instance, incremental deposits of the social security schemes are now distributed among all commercial banks on the basis of an auction system.

Part of the reason for the influence of the social security schemes in the domestic financial system is precisely because these institutions are discouraged from holding a portfolio of foreign assets. Of course, in small financial markets foreign investment would be a useful strategy to diversify risk and return and avoid wasteful investment. In the ECCU area, because of the potential impact of the social security schemes, they are regarded as partners in the macroeconomic management process. Hence, in efforts to promote financial sector stability, the ECCB holds regular biannual meetings with these schemes. During these meetings a host of policy issues are addressed. Among these are the movement of social security deposits and their effects on the liquidity and stability of the financial system. It is in this way that the schemes are viewed as partners in the macroeconomic management of the ECCU area.

A natural question at this stage is whether we can rationalise the emergence of non-banks engaged in mortgages and other non-banks established by commercial banks. In general, there are at least three broad sets of factors in the emergence of non-banks in the ECCU area. There are those factors based on the different characteristics of the financial products that these institutions offer. Secondly, there is the issue of production rationalisation by the existing financial

institutions, in particular, the separation of retail and wholesale banking activities. The third factor is the influence of international trends in the financial services industry such as the increasing use of asset-backed securities in the process of financial innovations, which have helped to increase the influence of non-banks. Finally, there is the natural tendency at all levels in the society to seek empowerment through ownership, cooperation and self-help, which is facilitated by some non-banks.

This chapter had two basic insights. First, it outlined the weaknesses of the existing regulatory structure for non-bank financial institutions. Of particular significance was the fact that the existing regulatory structure is vulnerable to political interference. This may negatively affect them in the performance of their functions where speed and decisiveness are paramount to stave off financial difficulties in the financial system. A second insight relates to the inadequacy of the regulatory and supervisory framework for the non-bank financial sector. In particular, the lack of regular oversight may result in small difficulties escalating into enormous problems of financial stability in the non-bank sector, which may, due to asymmetric information on the part of the general public and linkages between commercial banks and non-bank financial institutions, result in contagion and generalised financial instability.

The policy implications of the analysis outlined in this chapter are as follows. Firstly, there is need for a regulatory framework which, while it facilitates political accountability, prevents political bias in decision making. Secondly, there is need for an effective enforcement mechanism. It is not enough to establish regulatory and supervisory systems, but also to enforce these to ensure they are meaningful and effective. In a sense

this is related to the first point, but it also relates to the lack of financial resources to hire the relevant persons in sufficient numbers. A solution to both of these problems may actually rest with the conduct of regulation at a regional level, as has been done so effectively with the central banking functions. This chapter can be extended by a discussion of the optimal and sustainable regulatory model for the non-bank financial institutions in the context of the currency union. This issue is central to any discussion on the appropriate regulatory and supervisory framework for non-bank financial institutions in the ECCU area and we turn to this in the next chapter.

## *Chapter 6*

# **FINANCIAL INTEGRATION AND THE REGULATORY SYSTEM FOR NON-BANK FINANCIAL INSTITUTIONS IN THE EASTERN CARIBBEAN CURRENCY UNION**

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*T*he regulatory system in the ECCU area is still segmented by barriers to capital flows between member countries, separate regulatory authorities and gaps in the regulatory structure, especially as this relate to non-banks. These features exist in a common currency area with one central bank. When dealing with the issue of the regulation of non-bank financial institutions in this region, therefore, one must invariably deal with issues related to the operation of financial regulations in the context of financial integration. This issue must be addressed if one is seeking to develop a suitable regulatory structure for non-banks in this sub-region. These issues have already been addressed for commercial banks through the Uniform Banking Act (which is law in all member countries), an arrangement where national ministries of finance regulate but the ECCB supervises.

The challenge is therefore to achieve some level of harmonisation<sup>1</sup> of the regulatory and supervisory structure to accommodate the need for coordinated regulation in the common currency area. To this end, some important issues need to be addressed. These issues can be summarised in the following questions. What is the objective of financial regulation of non-banks in the ECCU? Is the division of regulatory responsibility among regulatory entities appropriate? Is there need for the harmonisation of regulatory practice in the region? Is some competition among regulatory agencies desirable or is consolidated regulation the way to go? Many of these issues relate to the institutional structure for regulation, something that is seldom discussed in the region but which tends to have a huge impact on the effectiveness of the regulatory system. At the very least, there is need to have a clear assignment of responsibilities and some level of coordination among regulatory authorities.

This is so not only because institutions have begun to compete across traditional product lines but also because disparate regulatory systems could encourage regulatory arbitrage, where firms choose to set up in the most loosely regulated jurisdiction. This, of course, could not only have severe negative consequences for stability in separate jurisdictions but also for the regional financial system as well. Additionally, in a common currency area, problems in one jurisdiction

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1 Harmonisation in this context refers to harmonisation across institutional type. There are, however, few opportunities for this type of harmonisation; one such possibility is the harmonisation across "near banks" such as finance companies and trust companies.

are likely to impact on other jurisdictions, especially where there are firms conducting business in more than one country.

### **6.1 The Rationale for Coordination and Harmonisation**

The most important factors determining the need for improved coordination and harmonisation include:

- (i) The extent of externalities, that is, the seriousness of the impact of problems in one country on other countries within the region.
- (ii) The scope for regulatory arbitrage.
- (iii) The economies of scale in administering regulations, especially with respect to information collection and analysis.
- (iv) The extent to which benefits can accrue to different jurisdictions from harmonisation (lower compliance costs).

In the first case, if the links between financial units in different jurisdictions within the region are tight, the likelihood of individual problems creating systemic regional difficulties is greater. The need for coordination and harmonisation in regulatory matters is therefore more pressing in such circumstances. Moreover, as Goodhart *et. al.* (1998) argue, collaboration on harmonisation for reasons other than systemic issues are also relevant if the objective is to create a single market in financial services. Harmonisation may also be desirable in situations where cross-border transactions are of a magnitude that requires collaboration, to prevent contagion and protect investors.

Secondly, the greater the differences in regulatory structure between countries and the ease with which services can be provided across borders, the greater the need for cooperation among regulators because there are greater incentives and opportunities for regulatory arbitrage. In regional groupings especially, the financial stability of the whole area may only be as secure as its weakest link. Moreover, technological developments have facilitated the unbundling and re-packaging of financial products and this has undermined the relevance of national regulatory boundaries by making it easier to shift risks between financial products and across borders. Agents can now, therefore, easily avoid onerous regulations or exploit opportunities for regulatory arbitrage by moving across borders. Heightened competition also serves to expose differences in national regulatory systems, particularly those designed to raise revenues or to re-distribute wealth. These are, therefore, becoming increasingly untenable.

Thirdly, there are obvious economies of scale to be derived from having a common system for financial regulation. This is an important factor in a region where there are scarce regulatory resources, especially with respect to skilled personnel and the information infrastructure.

Fourthly, since many of these jurisdictions are now actively pursuing the development of their offshore financial sector, there is a range of international regulatory issues that must be taken into account if they are to succeed in this arena. In particular, how much of the scarce resources should they deploy in the effort to comply with international standards to demonstrate that their jurisdiction is a "quality" offshore centre. This is critical to the establishment of a developed and reputable offshore centre, since large



multinationals increasingly only want to set up operations in well-regulated jurisdictions. This issue of quality also hinges on the strength of professional associations that engage in self-regulation.

Cooperation is also important because survival increasingly depends on a good relationship with the regulatory authorities in the home countries of firms operating in these offshore centres. These agencies are increasingly opposed to lax regulatory practices. They do not subscribe to the view that regulation can be lax at first until the offshore centre has achieved a certain critical mass. They are of the view that jurisdictions must comply with at least the minimum prudential standards. Competition in laxity among members of the regional grouping is, therefore, not likely to be a successful strategy for emerging offshore centres, either because large reputable multinationals choose not to go to jurisdictions where the regulatory system is loose or because the regulatory authority in the home country prevents these firms from going there.

Finally, there are obvious benefits to market participants from a common regulatory system, in the form of lower compliance costs and the ease of transacting business across borders in the region. There are also likely to be dynamic benefits such as better allocation of resources and greater competition. Moreover, in a region where a number of countries have developing offshore centres, a useful strategy is to adopt a common regional approach in the setting of the minimum prudential standards required by home country regulatory authorities and most reputable multinationals looking to set up offshore branches. Countries will then have to compete on the basis of the availability of ancillary services, good telecommunication infrastructure and appropriate taxation regimes.

For a variety of reasons, therefore, it is increasingly evident that some of the objectives of non-bank regulation can be more effectively achieved using a cooperative regional approach. At the very least, the regulatory structure for non-banks in the ECCU should incorporate formal channels for collaboration among various regulatory agencies, within and between countries.

## **6.2 The Problems with Harmonisation**

Harmonisation and a regional approach do, however, have their problems. They may create significant distortions by trying to force different institutions in different countries into the same structure. Different jurisdictions, because of culture and history, may choose to have differential systems that best suit them. Harmonisation for its own sake could destroy these intrinsic preferences, that is, different degrees of risk aversion, different regulatory agencies, and practices which are superior for particular jurisdictions when compared to the harmonised regime. In fact, there is a risk that harmonisation may make regulations uniformly bad (Herring and Litan 1995).

Moreover, common rules and standards, especially with respect to capital adequacy, have attracted the criticism that a common minimum standard is not universally appropriate across all countries and institutional types. Indeed, the capital standard for loans may be adequate in one country but not so in another country where loan demand and quality are related to specific local conditions. Also, some have argued that lower common risk weights for some market activities warp risk/return preferences by creating artificial incentives for institutions to shift into assets that have lower capital standards (Seerattan 1995). In effect, risk positions adopted by agents are not based on potential

risks and returns in the market but on a specific regulatory construct that may in fact lead to lower welfare, by allocating capital to projects with lower returns. Moreover, since common standards are unlikely to be appropriate for each institution or jurisdiction, they can serve to subsidize riskier institutions, which serve to intensify the problem of moral hazard (Seerattan 1995).

The incorrect definition of common standards can also set the standard too high for many firms, leading to the wastage of capital and the perverse result that these firms are put in a weaker position, since less income (the first defence against insolvency) is available. On the other hand, common standards set too low can encourage excessive risk-taking and weaken the capital adequacy of institutions.

The harmonisation of the regulatory system for non-bank financial firms is much more difficult than regulatory harmonisation for banks. Firstly, it is much easier to develop common standards for banks which are more prone to credit risks, since although credit risk levels may vary from bank to bank, the same basic factor impacts on this type of risk in all banks, making it much easier to develop a framework for measuring this risk and defining standards.

Non-bank financial institutions, on the other hand, are more subject to market risk, which is determined by a multifarious set of factors that can be very sensitive to the particular jurisdiction in which the non-bank is located. This makes the development of risk weights and standards much more difficult. The achievement of consensus on these issues is also much less likely. It is no surprise, therefore, that the International Organisation of Securities Commission (IOSC) has been

much less successful at attempts to develop minimum standards for securities firms analogous to those developed for banks by the Basel Committee.

Non-banks are also a more fundamentally diverse group of institutions, straddling near-banks (such as finance companies), as well as insurance companies, mutual funds and stock exchanges. These institutions have different objectives, risk profiles and markets. Harmonisation, if it is to be pursued, must be organised by similar institutional classes within the non-bank sector, since there cannot be the same harmonised regime for all non-bank financial institutions. This increases the amount of preparatory work that will have to be done in any effort to harmonise the regulatory framework for the non-bank sector.

Additionally, there has been very little historical evidence of collaboration among non-banks when compared to banks. There has now been some improvement in this area with respect to securities exchanges with the activities of the International Organisation of Securities Commissions (IOSCO). In the case of credit unions, the Caribbean Confederation of Credit Unions has been around for about 25 years and there is the World Council of Credit Unions. Additionally, in the ECCU there are at present activities ongoing to harmonise the legislative and regulatory systems for Credit Unions in the ECCU under the Eastern Caribbean Economic Management Project.

The problem remains, however, that institutions such as insurance companies, finance companies, mutual funds and pension funds do not have such a strong history of collaboration and this weakens the ability to harmonise their regulatory structures. Social security schemes and development banks have started

to hold biannual meetings under the guidance of the ECCB but this is not an adequate response to the regulatory and monitoring challenges facing these institutions. Much more work, therefore, needs to be done to organise these institutions into national and regional organisations to help build consensus on what is an appropriate regulatory structure, not only for the particular national jurisdiction, but one which also takes account of the need to harmonise across borders to better meet all regulatory objectives. To this end, the encouragement of national and regional conferences organised by professional and institutional associations could be an important strategy to build the consensus that would be needed for some form of cooperation or harmonisation.

In highly interdependent countries, cooperative strategies can enhance the effectiveness of regulation. However, financial integration in itself does not create sufficient conditions for total regulatory harmonisation. The central point is that harmonisation of regulations in the non-bank financial sector should be subordinate to more important objectives of regulations such as minimising systemic risk, preventing contagion of other sectors of the financial system from problems in the non-bank sector and encouraging prudent practices among service providers.

### **6.3 The Feasibility of a Harmonised Regime for the ECCU Region**

It is not clear, however, how workable any such arrangement is going to be in the ECCU area. In this regard, Herring and Litan (1995) suggest that these cooperative arrangements are more likely to work:

- (i) The smaller the group of countries that must agree
- (ii) The broader the consensus on policy issues
- (iii) The greater the pool of experts who share similar views on the subject
- (iv) The more frequent the forums for consensus building
- (v) The more organised the systems in place for cooperation (both formal and informal).

The situation in the ECCU area with respect to these factors is fairly favourable to the potential for cooperation. The number of countries, eight (8), is relatively small. A regional association already exists for credit unions but more needs to be done in this area for insurance companies and social security organisations. There are also many avenues for cooperation on a regional basis, many of these established through the efforts of the ECCB and the OECS Secretariat. This critical mass could be improved upon if there was a concerted effort to form strong associations among similar institutions and if regular conferences and seminars were organised to build consensus by grappling with common regulatory challenges. Based on the dynamics of the situation, there appears to be a base on which a more structured arrangement could be built. The question that remains, however, relates to what form the regional regulatory system for non-banks should take.

#### **6.4 Alternative Frameworks for Coordinated Regulatory Activity**

In spite of these problems and potential pitfalls with harmonisation (or a cooperative approach) of the regulation of non-banks, a region such as the ECCU area, which has to address both the regional and national dimensions of regulation, should seek to develop a regulatory system which takes account of collective action problems, economies of scale in administration and the trade-off between the values of uniformity and diversity.

In fact, once there is a situation where there is a common currency and therefore no foreign exchange rate risk, firms are likely to want to move around the region or provide services across borders. In these circumstances, the critical questions that have to be answered are whose rules apply and who is responsible for enforcing the rules. In principle, these countries can choose to answer these questions in many ways. They can impose and enforce their own rules within their borders, which preserves national autonomy but may not be effective because of regulatory arbitrage. They can also choose to maintain host country rules but coordinate their supervisory duties. They can agree on minimum standards but allow for more stringent requirements for host country concerns. They can accept both the rules and supervision of foreign regulators in countries where firms are headquartered. Finally, they can harmonise rules, standards and supervisory practices to establish a level playing field where a licence in one jurisdiction serves as a passport to other jurisdictions in the regional grouping (the banking sector in the European Union).

In this context, the major challenges for regulators is to determine areas in which cooperation is necessary, in that positive benefits are derived, from those where the cost of harmonisation is too high and where diversity yields greater benefits than it causes problems (Graundfest 1990). In this regard, there is a range of options that can be used to deal with the issues of regulatory cooperation. The full spectrum of such arrangements ranges from systemic harmonisation, international coordination, and cooperation, to international competition (Goodhart *et. al.*, 1998).

*Systemic Harmonisation* implies a high degree of harmonisation of regulation for systemic stability reasons, intended to make common regulatory objectives effective. *Coordination* aims not at harmonisation but at establishing a common set of minimum standards where individual countries can choose to set higher standards. It also aims to remove regulatory inconsistencies and conflicts between different jurisdictions. *Cooperative strategies* relate to enforcement procedures and information sharing. Problems can be encountered, however, in terms of the legality of information sharing as it relates to confidentiality, because there is usually no established law that allows this activity. *International competition* is an arrangement where national jurisdictions design their own specific regulatory structures within which they are the only agent setting, monitoring and enforcing regulations. Under this arrangement, the authorities often pitch their regulations at a level to attract institutions to their jurisdiction, a kind of "competition in regulation" often practised by jurisdictions with offshore financial centres.

Countries locate their regulatory structure for non-banks in this continuum. Once there is a case for some level of collaboration or harmonisation, as appears to



be the case in the regulation of non-banks in the ECCU area, some account should be taken of this need in the design of national regulatory systems for non-banks in the region. Rigid harmonisation may in fact not be the best response. Indeed, the level of cooperation must always be based on specific regulatory issues, but there are some general considerations when dealing with these issues that are of relevance. These include:

- (i) There should be minimum prudential standards for safety and soundness agreed to by the relevant institutions and agencies
- (ii) There should be clear, workable arrangements for sharing information
- (iii) Every institution or individual offering services should have some agency that is clearly responsible for its regulation, monitoring, supervision and enforcement of rules
- (iv) There should be no scope for institutions to escape minimum safety standards, supervision or information disclosure by locating in a lax regulatory jurisdiction.

While these general principles can provide the base on which a suitable regulatory framework can be built, it does not treat with the question of how to design an institutional structure for regulation that would accommodate these principles. The options for an appropriate institutional structure that may work include:

- (i) Consolidated regulation, that is, a single regulator that regulates all classes of financial

institutions across the region. This could either be a new entity or the ECCB

- (ii) A “twin peaks” approach to regulation of the financial system, that is, a separate new regulator for all non-banks across the region with the ECCB continuing to regulate banks
- (iii) Separate regulatory agencies for each type of non-bank with the need for harmonisation across countries accommodated by agreeing that the host or home country would be responsible for regulation and supervision
- (iv) A hybrid of the above mentioned options where each institution is classed according to its primary function and regulated by separate agencies based on this classification. For example, a possible classification could be all insurance-like institutions (insurance companies, pension funds and social security schemes), all near-banks (finance companies, trust companies and building societies) and all institutions that mobilise funds through equity participation (mutual funds, securities firms and credit unions). In such a classification there would be three regulatory agencies for each institutional class for all those institutions across the region.

These options assume that harmonisation is across the region, as well as across institutions in some options. There can, however, be harmonisation *only* across institutions but not across countries. This option would be useful if the barriers between institutions in particular jurisdictions were being eliminated and there were no significant cross-border issues. In the context

of a common currency area and regional integration movement, however, the central concern is the cross-border regulatory concerns and this is where we focus our attention.

The first option of consolidated regulation, where a single regulator is responsible for regulating the full spectrum of financial institutions,<sup>2</sup> has been debated in the ECCU area for some time, especially at the ECCB. One of the main rationale for using this approach is if the traditional boundaries between financial firms are being broken down. As discussed in Chapter 2, however, this is not really the case in the ECCU area but there has been some level of competition across traditional product lines by banks, credit unions and insurance companies. There are, however, other reasons for consolidated regulation, which have already been articulated in Chapter 2.

In the context of a regional integration movement, the advantage of reducing competitive inequalities, duplications, overlaps and gaps could conceivably be better dealt with through one regulator. There would also be economies of scope and scale in the context of scarce regulatory resources, especially skilled personnel. The only institution that can realistically take up such a responsibility in the ECCU area at present is, of course, the ECCB. There are risks,

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2 This obtains in the Cayman Islands and the Netherlands Antilles. In the first case, there are separate pieces of legislation governing different institutions but one regulator responsible for supervision and enforcement. In the second case, there are two omnibus pieces of legislation and the Central Bank is responsible for supervision and enforcement.

however, that this increased responsibility could conflict with its central mandate to maintain the peg value of the EC dollar. Additionally, central bank profits which are shared amongst member countries and which are a not insignificant source of revenue for the respective governments would tend to be smaller.<sup>3</sup> This presents a significant obstacle to the adoption of this option. Of course, a new institution could be created to regulate the financial system, such as in England, where monetary policy has been divorced from regulation and supervision. This approach is, however, not feasible in a situation where there is a limited ability to use independent monetary policy. Moreover, this is likely to be unfeasible in a region with limited resources, especially in terms of trained regulators and supervisors.

If this option (the ECCB as consolidated regulator) was chosen, a clear focus of the objectives of regulation for different institutions might also suffer, with the strong possibility of their losing sight of the special nature of banks in the financial system. Additionally, and probably more importantly, subordinating sovereign national agencies to the will of a regional institution is likely to create political problems for such an arrangement.

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3 There may have to be a clear no bail-out clause to avoid the probability of having to rescue institutions. This risk is, at present, not so much of a problem as foreign institutions dominate the financial sector and the head offices of these branch operations normally deal with liquidity support. Indigenous institutions could, however, create significant problems for the Central Bank if they began experiencing problems.

Another dimension of the consolidated regulation approach is whether laws and prudential standards would be standardised across institutions and countries or whether there should be a system for non-banks that is similar to the system for banks, that is, where omnibus pieces of legislation for each institutional type set a *base* of prudential standards for all non-banks, with national agencies responsible for regulation (i.e. licensing, collecting fees and enforcement) but with the ECCB monitoring and supervising. This will help ensure all areas of the financial system fall under some part of a regulatory umbrella but still leave national authorities with an important role to play. It will also serve to maintain distinctive regulatory features which have worked well and which allow for competitive advantage. Also, by only setting base standards, national authorities can choose to set higher standards in their jurisdiction for domestic and foreign entities.

A separate regional entity could also be developed to regulate non-banks across the region, leaving the ECCB to concentrate on the regulation of banks. This “twin peaks” approach would meliorate the above-mentioned risks associated with the ECCB taking on this additional responsibility, as well as help to avoid the danger of losing sight of the inherent differences between banks and non-banks. However, this would inevitably mean increased institutional costs for the region. Moreover, ECCB staff are already familiar with the financial sub-sectors and seem best placed to take up the responsibility of any such duties. Additionally, in the context of scarce skilled personnel in this field, a new agency may have to poach staff from the ECCB, diluting its supervisory capability.

Another arrangement that might be useful in the ECCU area situation is an arrangement similar to the

one used in the EU.<sup>4</sup> In that system they have established only basic minimum prudential standards for all classes of institutions but with national authorities having the option to have *higher* standards for their domestic entities and with supervision by a *competent* home authority. The competent authority would be designated by national governments but must be a public body authorised by law to carry out this responsibility. Additionally, home country supervision is practised; therefore, an English firm operating in Germany would be supervised by English authorities. The maintenance of minimum prudential standards protects the entire financial system and national systems but maintains the diversity (which has worked for those individual countries) inherent in each national system.

The problem with this arrangement, however, is whether national authorities would be comfortable with national agencies from other countries in the region being responsible for entities operating in their markets, even with common prudential standards region-wide. This problem is likely to be even more difficult in light

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4 In the European Union, the issue of a need for a harmonised regulatory system for non-banks has been dealt with by issuing a set of directives that lays out rules and regulations for all non-banks. These directives seek to set common minimum prudential standards for members but can be made stricter for domestic entities in each member country. They can also have stricter standards for non-EU entities. Institutions licensed in one jurisdiction can then set up operations in any other member country and are subject to home country supervision. Each directive creates a legal obligation for member countries to change existing laws or adopt new laws to conform with the directives.

of the uneven capability among the regulatory structures for non-banks in the ECCU member countries, especially if there is no overarching regulatory presence.

The fourth option of classifying institutions into distinct classes and then assigning a separate regional regulatory agency to each institutional class is probably the least feasible option. This option is a compromise between trying to extract whatever benefits can be derived from scale economies and harmonisation benefits and the need to recognise the inherent differences in different non-banks, which require different regulatory treatment. The additional institutional costs of these new institutions are, however, likely to be prohibitive.

In the context of the need for the regulatory structure for non-banks in the ECCU to incorporate some level of harmonisation, it seems clear from the above that the costs of various options, national autonomy and the constraints placed on policymakers by the monetary arrangements in the ECCU area are the most important factors determining the most workable option. In this regard, it seems on the surface that options that require the creation of new institutions or additional bureaucratic structures are likely to increase institutional costs, as well as efficiency costs. A feasibility study of the various options may therefore be a prudent first step in deciding how to proceed. A feasibility study is beyond the scope of this study so we have confined ourselves to outlining the options available and the pros and cons (abstracting from costs) of each option. In spite of this problem of the measurement of costs, there are some obvious features which any regulatory system for non-banks in the ECCU should have, and these are outlined in the following section.

## **6.5 The Blueprint for a Harmonised Regime**

Any arrangement for the harmonised regime should have the following features:

- (i) Minimum prudential standards for all classes of non-banks in the ECCU to ensure a minimum level of strength. National agencies could, however, specify higher prudential standards for domestic firms. This would have to be incorporated in all relevant national legislation in order to be binding. In cases where there is no relevant legislation, laws will have to be promulgated. Until then, firms from that jurisdiction will not be able to move to or sell products in other member countries.
- (ii) A separate non-bank supervisory entity, whether it is to be a new department in the ECCB or a separate new institution, would be needed to supervise the activities of these institutions. This new entity would of course have to work in conjunction with national agencies, which should still be responsible for the legislative aspect of regulation, for granting licences and for enforcement. This relationship should also be codified in the relevant pieces of national legislation.
- (iii) A strict no bail-out arrangement would be necessary to prevent unmanageable contingent liabilities building up for the supervisory entity chosen (either the ECCB or a new entity).
- (iv) In light of the fact that the non-banks sector in the ECCU area is at a nascent stage of development with a few small institutions, the



failure of an institution would have a disproportionately large negative effect on the development of the financial system. It may therefore be prudent to have the capability to intervene in problem institutions and hence some mechanism to finance intervention. The authority to intervene should ideally be vested in the national authorities but be based on advice from the supervisory authority<sup>5</sup> (ECCB or new entity). Some type of contingency fund for intervention should therefore be structured at a national level for each institutional type, based on contributions from institutions. These funds should be national because the power to intervene is vested in the national authorities, who, in intervening, may often give national considerations primacy over regional considerations.

These features could form the basis for a system that simultaneously deals with the issues of competitive inequality and regulatory arbitrage, ensures that there is a complete regulatory umbrella for all non-banks and facilitates cross-border activity to strengthen the monetary union. It also seems to be the best way to minimise the institutional costs for a complete regulatory system for non-banks.

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5 Advice should be based primarily on the solvency of institutions and on the strategic position of institutions in the development of the financial sector. Insolvent institutions should not be bailed out in most circumstances, and assistance to institutions should be based on well-established guidelines.

## *Chapter 7*

# **CHOOSING A REGULATOR FOR THE FINANCIAL SERVICES SECTOR**

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*T*he rationale for central banking has evolved over time. The modern interpretation of a central bank's role is as a mechanism for promoting price stability (Nicholls 2000). For small economies, such as those of CARICOM, central banks were originally promoted as agents of economic development, and were urged to ignore the short-term needs for price and currency stability.

In some countries, this amounted to the provision of finance to governments and the direction of credit of the central and commercial banks to so-called 'productive sectors'. In addition, a series of exchange control measures was implemented, aimed at 'protecting the foreign exchange reserves'. These policies eventually resulted in the depletion of foreign exchange reserves, first, since un-backed domestic liquidity was being created, second, because sound principles of credit worthiness were eschewed, leading to significant levels of non-performing loans; third, new financial institutions and instruments emerged which were not covered by these controls; finally, private economic agents refused

to surrender their holdings of foreign exchange to the official system, given the difficulties they faced in securing such when required.

This mode of operation assumed a life of its own, for, as the domestic currency became unstable, more draconian regulations were imposed on the banking system to compensate for imprudent monetary and fiscal policies. In response, commercial banks innovated around these restrictions, which in turn led to a further round of wider regulatory measures aimed at these new activities.

Of course, these command and control measures had to be enforced and monitored, a task quite easily assigned to central banks, where monetary policy was effectively conducted by the dictates of the ministry of finance. In contrast, the member states of the ECCB did not pursue this route of financial sector development. Instead, the Central Bank was left independent and sheltered from the need to finance large fiscal deficits. The regulation of the financial system in the ECCU area is shared with the member states. In practice, this has been confined to the regulation and supervision of the commercial banking sector. The non-bank financial institution sector as mentioned previously has its own regulatory framework as designed by each individual country. A number of important policy questions have emerged in recent times within the ECCU area. Should the ECCB regulate the entire financial system, including the non-banks and what is the rationale for such? Also who would finance such an operation and what would be the relationship with the other constituent parts of the arrangement?

The ECCB has a monetary policy framework, which consists of a fixed exchange rate regime in the context

of a partial-currency board. In this framework, monetary policy is required to be consistent with the requirements of external equilibrium. In addition, the Central Bank has been authorized to regulate and supervise the commercial banks, and also non-banks in some jurisdictions. The regulation of the financial system is thought to be an important pillar in the Bank's programme to beef-up its ability to prevent a currency crisis. However, given its partial currency board nature, the authorities may need to find alternative arrangements to provide liquidity support to domestic institutions when required (Samuel and Mounsey, 2001).

The outline for the remainder of the chapter is as follows. In section 7.1 the rationale for the regulatory and supervisory roles of the ECCB is outlined. In this section, particular focus is given to the regulation of the non-bank financial sector. A critique of the ECCB's role in the regulation and supervision of the financial system is provided in section 7.2. In section 7.3, an approach to the supervision and regulation of the financial sector is suggested. Sections 7.4 and 7.5 look at the cost of different regulatory regimes and the options for financing those regimes.

### **7.1 Rationalising the ECCB'S Regulatory and Supervisory Roles**

The regulation of the financial system, the bank supervision function, was partly delegated to the ECCB by member governments and outlined in its 1983 Agreement. The member governments, however, retained non-trivial regulatory authority over the entire financial system. In general, there are three reasons for regulation of financial institutions (Bentson, 1983). These are:

- (i) Protection of the financial system against systemic risks: the maintenance of safety and soundness, as well as the protection of some suppliers of financial services from competition.
- (ii) Consumer protection: the prevention of the centralization of power, the prevention of invidious discrimination and unfair practices, the protection of deposit insurance funds.
- (iii) The achievement of social objectives: the provision of financial services as a social goal, the allocation of credit as a social goal, the taxation of banks as monopoly suppliers of money and the control of the money supply. In the ECCU area, monetary policy is determined largely by the requirements of external equilibrium. Therefore, the money supply is largely endogenous. Individual member governments originally imposed required reserves on banks. These were later harmonised by the ECCB. Finally, domestic credit allocation is left to the commercial banks, even though the development banks engage in some level of policy-based lending.

But which of these reasons suggest that the central bank should conduct supervision of the financial sector? In other words, are there any particular advantages to the combination of supervision and monetary policy functions in the ECCB?

The operation of the payments system provides a rationale for the supervision of the commercial banking system. From this perspective, therefore, the supervision of the commercial banking system ought to be

primarily concerned with controlling/avoiding systemic risk. The most direct interaction the ECCB has with the financial sector is through the payments system; however, this applies only to the commercial banking system that participates directly in the system managed by the ECCB. The other parts of the financial sector do so indirectly through the commercial banks.

### **7.1.1 The Main Features of the ECCB'S Payments System**

The ECCB operates a multilateral netting payments system. In this system settlements are not immediately effected. The actual settlements are accomplished at the end of each working day. The system then calculates the net payments or settlement obligations for each participant. This system operates on what is called conditional finality of payment, depending on the absence of a settlement failure. Moreover, the clearing function and the settlement agent function are conducted by the ECCB.

Commercial banks are the only financial institutions that can legally participate directly in the clearing-settlement aspect of the payments system. To facilitate this process, they are required to hold balances with the ECCB, which acts as the clearinghouse. Banks are required to hold a reserve balance – a minimum of 6 per cent of their total deposits – with the ECCB averaged over the reserve period – usually one week.<sup>1</sup> This

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1 Such averaging lowers the level of liquidity required by the commercial banking system.

arrangement holds for each bank in each country.<sup>2</sup> In addition to these balances, commercial banks are required to provide appropriate collateral as part insurance against payment risks – a net debit position. There are several types of risks inherent in a netting system. In this chapter we focus on settlement risks.

There are three elements of settlement risks: credit risk, unwinding risk, and liquidity risk. There are a number of issues surrounding the operation of a netting system. Firstly, credit risk can occur where a payer loses all or part of his payment due to the counterparty's failure to deliver a promised payment. Unwinding risk arises where previously released payment instructions are revoked. This particular type of risk is most likely to occur in the netting system where payment instructions accumulate during the day. In the netting system, unwinding exposes every user to each other's risk – systemic risk. Liquidity risk emerges where payment instructions cannot be settled because of the lack of liquidity – this also causes systemic risk in a real-time gross settlement system.

In the netting system, which the ECCB operates, this is not a particularly significant concern as the liquidity needs of the netting system are lower when compared to, for example, a real-time settlements system. Nevertheless, banks that are occasionally short on their clearing accounts have been provided with

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2 It must be noted that a bank may obtain a licence to operate, but may not satisfy the conditions required to be part of the clearing process. In this case, it is not allowed to hold accounts with the ECCB.

involuntary overnight liquidity support from the ECCB. In general, however, credit and unwinding risk are the primary sources of risk in netting. Credit risk is a bilateral risk that is usually smaller in netting systems.

In fact, credit risk is ultimately the fundamental source of settlement risk because, without it, there would be no unwinding risk or liquidity risk. Therefore, measures aimed at reducing unwinding risk focus on reducing credit risk. These measures the world over focus on bilateral credit limits for individual participants and multilateral debit limits for the system to control credit risk exposure, collateral requirements, and also loss-sharing agreements to reduce unwinding risk.

These measures, in effect, transform the netting system into a real-time gross system and by implication raises the possibility of liquidity risk. It must be noted, however, that a major overhaul of the large and small value payments system is on the way in the ECCU area. Among the proposed innovations are straight-through processing, queuing, as part of a gross real-time payments and settlement system. The management of settlement risk would be enhanced with the full development of the domestic capital market. In such a situation, the central bank is involved in the payments settlement system and it can use this channel to transmit policy initiatives to the financial system. On the other hand, a payments system that is poorly managed has the potential to destabilise the domestic financial system. Moreover, precisely because of the possibility of systemic risk being transmitted through the payments system, the ECCB may be required to act as a lender of last resort to the commercial banking system.



## **7.2 A Critique of the ECCB'S Regulatory and Supervisory Role**

There are two sets of issues covered in this section. The first is system design where the payments arrangement forces responsibilities on a central bank, that is, if it is a faulty payments arrangement. The second issue recognises the system for what it is, but asks the question whether one institution should perform all three functions, that is, payments system, monetary policy and regulation and supervision of the financial system.

The payments system risk may provide a case for a lender of last resort for commercial banks, but does it provide a case for the ECCB to regulate the entire financial system? There are a number of policy conflicts which can arise from the ECCB's regulatory and supervisory role in the financial system. The first conflict of policy objectives arises where the injection of base money conflicts with the growth target for money. Goodhart and Schoemaker (1995) dismiss this argument in the context of the OECD economies as feeble. In the ECCB arrangement, however, this is a very important possible source of conflict. Given the partial currency board nature of the ECCB, it may not be able to provide direct liquidity support to the financial system (as a lender of last resort for example) as argued by Samuel and Mounsey (2001).

To effectively deal with a banking crisis, alternative arrangements, such as a contingent line of credit from an external source, possibly an international bank, may have to be developed. A system where the authorities in the national jurisdictions provide liquidity support for indigenous banks operating in their jurisdiction could also be an option. Ideally, this support should only be

given to banks experiencing temporary liquidity problems and not to insolvent banks. This system could be buttressed by a deposit insurance system to protect the interest of depositors in the case where the bank is insolvent and has to be closed. However, such facilities may in themselves create other adverse incentive problems. For example, they may serve as incentives for imprudent behaviour by domestic financial institutions, especially if deposit insurance is not priced appropriately.

Another important area of policy conflict involves situations where the central bank has an interest rate target that is inconsistent with the financial viability of the financial system. In such a situation, the central bank may choose to forgo its target for the sake of financial stability. Moreover, whether or not a policy conflict exists in this context depends largely on the manner in which monetary policy affects the economy. The appropriate design of the regulatory system is therefore dependent on the particular financial structure of the country. In particular, where competition among financial intermediaries is fierce and the potential exists for the central bank's actions to have a significant impact on the intermediaries' solvency and long-term survival, it has been argued that these conflicts should be resolved by institutional arrangements, that is, a combination of the two functions. Goodhart and Schoemaker, 1995, pg. 547 argue that

*those banking systems which are primarily financed by a retail deposit base, whose interest rates are unlikely to follow (large) changes in money market wholesale rates, would be better able to cope with (temporarily) tight monetary conditions. Again, where bank loans and mortgages are made on a fixed-rate basis, the system may be less sensitive, both economically and politically,*

to temporary periods of high rates, than when such loans are on a variable rate basis. Furthermore, those banking systems which were effectively nationalised, or where the banks run a profitable cartel, will be inherently better placed to ride out such (temporary) volatility, since their solvency would be less at risk. These examples suggest that the potential for conflict between regulatory and monetary objectives depend to some large extent on the structure of the banking and financial systems. The more such a system involves intermediaries financing maturity mis-match positions through wholesale markets in a competitive milieu, the greater such dangers of conflict are likely to be.

These conflicts of interest are, however, generically different from the standard principal-agent analysis in economic theory. Certainly differences in incentives among personnel with differing responsibilities may often play a role. But one can easily envisage occasions where officials in charge of monetary policy, fearful of systemic instability, will want to rescue a bank which officials responsible for regulation will want to close, e.g. to avoid moral hazard. Such conflicts are thus genuine and cannot be resolved by institutional rearrangements. Indeed there are some, including some central bankers, who see the need to resolve such conflicts as an argument in favour of maintaining regulatory and supervisory functions within the central bank. Clear statutory guidelines for the responsibilities of those entrusted with delegated authority for the several functions of monetary and supervisory management might be a better solution than institutional separation.

It is, therefore, at least possible to argue that where such conflicts really become important (in an open, competitive, market-driven system), they have to be internalised within a single authority to obtain an efficient resolution.

*Where such conflicts have been less pressing, because of a differing structure, e.g. in Germany and Japan, it is easier to maintain the luxury of a separation of responsibilities. One of the reasons why such separation may be regarded as a luxury is that the function of regulation has rarely received plaudits from the public or the politicians.*

In ideal circumstances, the lender of last resort facility, a mechanism used by central banks to avert liquidity crisis, exists only to protect the solvent financial institutions from disruption. In this way it is hoped that this mechanism would protect the overall system from the knock-on effects that the failure of an individual financial institution can have on other institutions. However, the lender of last resort facility has some drawbacks. In the first case, the effectiveness of the central bank in this function depends on the quality of information it possesses to enable it to judge the solvency of the financial institution. If the central bank is faced with asymmetric information, and lends to a financial institution that is insolvent, then it imposes a cost on society. In such a situation, this lending may lead to wealth transfers to the insolvent bank and also enable it to persist with its inefficient investment choices.

Another difficulty is that once it is realised what information is required to make an assessment, the institution may provide signals that lead the policy authorities to mistake it for a solvent institution, when in fact it is actually insolvent. Therefore, because making the distinction between both of these financial states is almost impossible in practice, central bank lending to banks in these situations usually takes place in the context where solvency is in doubt, especially since the time may not be available for verification.

Mistakes can therefore be made as to which institutions should be bailed out.

The question that emerges naturally then relates to the difference in results between central banks that combine these functions and those that do not. In an empirical study of thirty countries, Goodhart and Schoemaker on this very question remarked,

*Reviewing our results, we thus find evidence that bank failures occur less frequently under a combined regime. However, as the trade-off between the efficiency and the stability of particular banking systems is not clear ex ante and, perhaps, difficult to estimate ex post, we do not regard these findings as strong support for the case of combining the functions of monetary policy and banking supervision. In addition, we find weak evidence that a combined regime tends to rely slightly more on central bank/commercial banks funding and less on government funding for the resolution of bank failures. Finally, we observe a trend, although not significant, towards using taxpayers' money.*

They continued,

*So long as rescue and insurance were undertaken on an implicit central bank/commercial bank basis without government finance or involvement, the central bank would normally want to undertake the conjunct function of regulation and supervision, as indeed the commercial banks under its wing would want it to do. But this is increasingly ceasing to be so in many countries. When, and if, the system switches to one wherein the insurance is explicit, particularly when enacted by statute and provided with financial back-stop by the government, then the balance of advantage shifts. If the taxpayer is seen as potentially liable, then the politician will reckon that*

*she or he has the ultimate responsibility, so that the regulatory/supervisory agency should answer to the government. If the central bank wishes to maintain its independence of action in other fields, there is a much stronger case for a separation of function, with a division between the central bank and the agency or agencies charged with regulation, supervision, authorization, closure, and insurance.*

Does the non-bank financial sector require a lender of last resort facility? These institutions from time to time may require short-term assistance; however, the fact that they are not allowed to issue transferable deposits makes the need less urgent. Hence, difficulties that emerge in the non-bank financial sector may not directly affect the payments system. In any case, difficulties in the non-bank financial sector are more likely to be symptomatic of insolvency, which ought not to be the objective of monetary policy. Therefore, any particular difficulties they may encounter would be transmitted through the commercial banking system, which would have been conducting some level of monitoring and screening. The supervision of the non-bank financial sector, therefore, ought to be more concerned with the objectives of consumer protection and the achievement of social objectives. In sum, there is no reasonable systemic risk case for the ECCB to regulate and/or supervise these operations.<sup>3</sup>

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3 Moreover, there is a school of thought that argues that even where there is a failure the authorities should not provide blanket protection to depositors since it provides them with a perverse incentive not to monitor their investments.

What is the likelihood that the ECCB would be required to act as a lender of last resort? The likelihood of this rests with the occurrence of systemic payments risks. The ECCB commercial banking system consists of two distinct sets of banking groups. These are the indigenous banking group, which holds approximately 50.0 per cent of the financial assets in the system and the foreign bank branches. The indigenous banks are, however, essentially unit banks, as they confine their operations to individual territories. Moreover, they are generally characterised by high cost operations.

Within this indigenous group there is a further subdivision between those banks that are owned by the government and those owned by the private sector. In general, the indigenous commercial banks are characterised by high delinquency ratios and low capital provisions. The other half of the banking system consists of six branch banks, operating as branches of foreign multinational banks. These banks operate in more than one territory. These banks secure the benefits of deposit and loan diversification and also capture operational efficiencies from their scale of international operations. Moreover, the capitalisation of the parent bank is much larger than the size of the domestic economies. Of the demand deposits in the system, the indigenous banks hold approximately 50.0 per cent. Therefore, any shock to the financial system is more likely to affect the indigenous commercial banks than the foreign banks.

More importantly, does the ECCB need to be involved in the payments system? If the argument is that only the indigenous bank requires the lender of last resort (LOLR) facility, then we may need to examine the cost effectiveness of the supervisory function. The solution may lie ultimately in the reform of the payments settlement system, which contains the potential for systemic

risk, by limiting exposure of individual banks to each other. In this scheme of things, the mode of supervision and regulation would have to change and the rationale for the central bank's involvement may not exist. This raises the important issues of payments systems design, that is, the ECCB's role in this system and, by implication, its role in the supervision of the commercial banks.<sup>4</sup>

An additional concern with the current style of financial sector supervision is related to financial cost. The level of resources required to operate the Central Bank has been growing at a faster rate than the revenues that the Bank earns. Indeed, this trend is revealed in the uses of seigniorage. It has been revealed that the Bank is retaining an increasing proportion of seigniorage at the expense of the flows to the government (Nicholls, 1997). This increased cost of running the Central Bank is not entirely related to the issue and

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4 The Central Bank can limit the potential for crisis by speeding up the clearing and settlement process in real time. This, however, transforms the risk in the payments system to one of liquidity risk, whereby payments would be held up precisely because banks do not have the resources with the Central Bank accounts to effect their transactions. The logical question, then, is what type of mechanism would best relieve this liquidity pressure – liquidity support from the Central Bank or a queuing mechanism to manage the inflow and outflow of payment instructions relative to available resources? The preferred mechanism seems to be the queuing mechanism. In any case, the Central Bank should avoid providing interest-free and involuntary loans to the financial system by carrying overnight credit balances on its books for individual institutions.



management of the currency that has remained reasonably constant over the period. The extra expenditure has been incurred because the Bank operates as a service centre for the member governments by providing services that are regarded as being too expensive to provide locally.

This increased expenditure by the Central Bank has similar implications for the net domestic assets of the system as does lending to member governments. Therefore, to the extent that a number of activities are financed through the budget of the Bank for member governments and this trend continues, it will hold significant implications for the stability of the domestic currency. In this regard, the Bank may need to rethink its policy as a general service centre and refocus on those particular activities in which it has a comparative advantage.

On the other hand, in a situation where non-bank financial institutions have a significant level of deposits in the commercial banking system (as they do in the ECCU area), emerging problems in the non-bank sector can have serious negative consequences for the commercial banking system and could not only create significant liquidity problems for the banking sector but also systemic problems for the financial system in the ECCU area. In this regard, the regulation of the non-bank financial sector for systemic risk reasons becomes a serious issue. Additionally, in situations where there are significant economies of scale in regulation, as there tend to be in small financial systems, then a single regulator may be desirable. Moreover, in situations where there are complications caused by national as well as regional considerations and agencies involved in regulation, a single regulator may bring some order to the business of the regulation and supervision of the

financial sector (McDonald 1996). When these considerations are juxtaposed against the inadequacy of regulatory resources in terms of skilled personnel and finance, as well as the ECCB's intelligence and knowledge capacity, there still seems to be a role for this institution in the regulation and supervision of the non-bank financial sector.

### **7.3 Alternative Regulatory Structures**

Having looked at the pros and cons of the ECCB's involvement in regulation of the non-banks, we now examine alternative options for the institutional structure for the regulation and supervision of the non-bank sector. In this section we discuss the feasibility of three structural types: (a) a single regional regulatory authority for non-banks, (b) the integrated regulatory structure, proposed by the ECCB and (c) a single regional financial services regulatory authority. The choice between these alternatives ought to be made on the basis of regulatory costs.

#### **7.3.1 *A Single Regional Regulatory Authority for Non-banks in Combination with Self-Regulation***

This institution would be separate and distinct from the ECCB and would also include the regulatory framework for the regional securities market. An important component of this proposal would be the use of self-regulatory frameworks in its quest to improve the information and intelligence infrastructure, which it needs for appropriate regulation and supervision of non-bank activities. This is essential to overcome a number of information asymmetries as they relate to incentives for good governance and the external regulator's ability to monitor. It is to be emphasised,

therefore, that the strengthening of the internal governance at the unit level and the policing of institutions by peer group associations is an important component of this approach.

The role of the regional regulatory authority would be to set and enforce benchmark standards, issue licences and administer sanctions where standards are breached. Given the nature of some non-banks, this regional thrust must go hand in hand with the promotion and upgrading of self-regulated frameworks at the local level for related and integrated activities. This would help the authorities to overcome some of the information difficulties.

In such an arrangement, the regional body would depend on the self-regulating local bodies to keep their members in check. Of course, at intervals the regional authority may conduct on-site visits. Ferracho and Samuel (1997) discussed this aspect of regulation in a regional context, but viewed it as a stand-alone option. As they quite rightly concluded, on its own it is limited, precisely because it is only certain non-banks that are amendable to this particular arrangement. It is the recognition of this diversity among non-banks' and operational constraints related to this approach that makes a combination of approaches, coordinated at the regional level, seem most appropriate.

Such a structure, if adopted and coordinated on a regional basis, would emerge as a big improvement over what currently obtains. As mentioned previously, there are separate regulatory and supervisory frameworks for the offshore non-bank financial sector. In this proposed structure, the same benefits would be offered to all non-banks and thereby remove the artificial distinction between off-and onshore financial transactions.

Indeed, as argued by Ferracho and Samuel (1997), the current situation results in a dual non-bank financial sector development and regulation. A combination of activities in the manner proposed ought to result in economies of scope, scale and information in regulation. Moreover, because of reputational and credibility effects, the policy authorities can no longer pursue modernisation in the offshore financial sector at the expense of the onshore sector, or the converse. Expectations generated by developments in one sector could redound to the benefit or detriment of the entire jurisdiction. This must be viewed in the context of a liberalised capital account and the potential disruptive effects from sudden capital flows.

The non-bank financial sector requires a unified regulatory structure and enforcement agency at the regional level. The first step in this process is for the various pieces of legislation to be brought in line with some regional benchmark. This benchmark may involve identifying the best practice in each piece of regulation for the member countries matched against model legislation and agreeing on a common ranking. The member states would then undertake to bring their regulations in line with the best practice.<sup>5</sup> Out of this process ought to evolve the regional regulatory framework and enforcement agency. One of the main advantages of a regional non-bank financial sector regulatory agency is that it would have the potential to

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5 In a sense the member states are being forced in this direction by the requirement of the Financial Action Task Force (FATF).

draw upon the regulatory and supervisory expertise from around the region. Moreover, there is also the potential for developing a well-defined strategic research agenda and opportunities to coordinate intelligence gathering. The regional regulatory body would form the framework for the regional financial space and form the basis of the capital market.

Regional coordination of regulation and supervision of non-banks makes good economic sense. This is especially important where the region is a fledgling single financial and economic space. Moreover, whichever regulatory framework is chosen, the implementing agency must be provided with the means of effecting change. For instance, it must be empowered to close non-complying institutions. In the context of the ECCU area, however, these are complex and far reaching issues, some of which are still pending in respect of the Uniform Banking Act. As mentioned previously, the regulatory structure of non-banks is much more fragmented. Such an environment holds a huge moral hazard problem for governments, since if any of these non-banks, for example a credit union, were to fail the political pressure for a government bail out might be unbearable.

Another drawback to this approach is that an entirely new institution would have to be created, with a separate top management and ancillary staff apart from the actual regulators, a separate information system would have to be developed and other infrastructure such as accounting, auditing and legal systems would also have to be put in place. Very important also, a new institution would also have to gain credibility in the marketplace, a characteristic that takes time to develop. Credibility is, however, absolutely critical to the success of any regulatory agency and

unless this can be accomplished in a relatively short space of time, the new agency is unlikely to be effective. In the current environment, therefore, where the necessary skills and financial resources are in short supply, creating a new and *effective* regulatory agency for non-banks may prove to be a very difficult undertaking.

### **7.3.2 *An Integrated Regulatory Framework***

In this framework, regulation of the non-bank financial institutions would be shared between the member governments and the ECCB. In particular, the ECCB would maintain a pillar of regulation targeted towards the non-bank sector. In addition, each member government would create a non-bank regulatory unit within the Ministry of Finance. This unit would work with both the ECCB and other regulatory units from other countries within the currency union. This framework has been proposed by the ECCB.

One of the main advantages of this framework is that, if appropriately staffed, it provides at least 45 persons for the regulation of the non-banks in any member country. In this way, it avoids the ECCB carrying the entire cost of the regulation.<sup>6</sup> In addition, it provides an important buy-in element to the conduct of regulation within the Currency Union, that is, the local authorities would now also be on the frontline of responsibility for the credibility of the financial system, but protected from

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6 This assumes that each of the eight countries has a group of five regulators and the ECCB dedicates five regulators towards the regulation and supervision of the non-bank sector.

local political pressure given the integrated nature of the process.

This option also provides benefits such as economies of scale and scope (possible synergies in regulating both banks and non-banks) in regulation, the simplification of the institutional structure for regulation (which reduces compliance costs for the regulated institutions) and the fact that consolidated regulation is made easier.

An important potential draw-back of this arrangement, however, is the assignment of responsibility and lines of command within this structure. For example, what is the limit of authority of the local regulatory body relative to the ECCB? Also, what is the distinction between this framework and that for the commercial banking system?

Many economists are also wary of a central bank being responsible for the regulation of all financial institutions in addition to the power to conduct monetary policy. They argue that this could be dangerous as a central bank with these wide ranging powers would be an extremely powerful institution which may not have to account in full to any agency or body. This problem would be accentuated in situations where the central bank's independence is enshrined in law.

Another potential problem with this option is the conflict of interest between monetary policy and regulation mentioned in the previous section, that is, when financial institutions are experiencing problems the central bank may be tempted to loosen monetary policy, subjugating monetary policy to prudential regulatory ends. This is particularly dangerous if it kept insolvent institutions afloat rather than institutions experiencing temporary liquidity problems. This is not

necessarily a problem if used temporarily when there are extraordinary events which are not related to the inherent strength of financial institutions, such as the economic fall-out from the September 11 terrorist attacks in the United States.

Indeed, given the close link between the economic environment and prudential problems, experience usually leads to a level of cooperation between the authorities responsible for monetary policy and those responsible for the regulation and supervision of financial institutions. This, together with the fact that there have been few cases where concerns for banks' solvency has led to excessively expansionary monetary policy, implies that the risk of these situations developing is not very high. In any event, this policy conflict is likely to arise and must be dealt with irrespective of whether the regulatory function resides in or out of the central bank. The important question is whether transaction costs are going to be higher in one option as compared to the next.

### ***7.3.3 A Regional Financial Services Regulatory Authority***

Under this arrangement the first order of business would be to separate the bank supervision department from the ECCB and transpose it into a regional financial services regulatory authority. Again, under this option, as in the case of a single regulator, self-regulatory frameworks will be required. The only focus of this institution would be supervision of the entire financial system, including the Central Bank. The attraction of this lies in the fact that with the emergence of a single economic and financial space within the Currency Union, institutions that have a similar scope and reach would have to emerge to underpin the system. More-



over, with a reformed payments system and the related considerable reduction in the potential for systemic risks, there would be less of a rationale for the ECCB to regulate the commercial banking system. In this new regulatory structure, the focus would be on other concerns, such as consumer protection.

One of the main advantages of this approach is that it takes regulation away from the ECCB and thereby lessens those potential policy conflicts mentioned above. In addition, it offers a framework for addressing the evolution of the financial system, that is, the emergence of financial conglomerates and other regional financial institutions can be accommodated under such an arrangement without much extra effort. Indeed, such a structure is usually a response to those types of developments in the financial system. On the other hand, this option is likely to suffer from the same disadvantage as the first option, that of greater resource costs because an entirely new institution will have to be created. More importantly, it will start off without the credibility of the ECCB and will have to earn credibility from the market-place over time before it can be truly effective.

One problem with this approach is that the separation of the regulatory and monetary policy functions could eliminate any information benefits that are generated by merging these two functions in one institution. As mentioned above, inevitably there would have to be some level of cooperation between the regulatory and monetary policy functional areas because of the close link between general economic conditions and the health of financial institutions. Another problem with this approach relates to the difference in style and *modus operandi* between banks and non-banks, which will tend to create problems for one regulatory

agency, which does not have the benefit of the experience in dealing with these very diverse institutions. Considerable time will have to be spent in learning how to deal differentially but effectively with these entities. Additionally, regulatory agencies tend to be most effective when they have clearly defined objectives and areas of control. This is likely to emerge as a problem for the mega regulator that has to deal with a range of diverse institutions and multiple regulatory objectives.

There does not seem to be any regulatory model that is universally appropriate for all environments. There are also numerous tradeoffs that will have to be considered when making a decision on the particular regulatory model for non-bank financial institutions. For example, a single regulator may reduce institutional costs but the constraints imposed by a relatively uniform regulatory structure on diverse financial institutions may reduce innovation, increasing dynamic costs and therefore overall costs. Inevitably, therefore, the decision on which of options (1), (2) or (3) is chosen is really dependent on the relative costs, financial structure, size, political structure and historical antecedents.

#### **7.4 Cost of Alternative Regulatory Structures**

According to Foley (1991), the cost of regulation has at least three components: (i) resource costs, (ii) regulatory arbitrage and (iii) dynamic costs. A central issue relates to the relative costs of each of the options proposed above. In terms of resource cost, it is unlikely that options (1) and (3) will be more expensive than (2) since both of these options involve the creation of entirely new institutions with separate top management

and auxiliary staff (in addition to the actual regulators), new management information system and new physical infrastructure.

Regulatory arbitrage cost is reduced in all three options but particularly in options (2) and (3) as the regulator would be in a position to view the financial sector as a whole and can therefore set rules such that they, on balance, do not determine the profitability or otherwise of investment activities. In effect, they would be in a position to have an economy-wide view of the financial system. This in turn will allow them to set rules and standards which limit regulatory arbitrage. This, in a sense, can be viewed as an advantage over option (1) as well as the current system. Option (1) would also have problems related to the limitations of peer groups, especially those without a hierarchical organisation. For example, these groups tend to be vulnerable to free rider abuses. Moreover, collective decision-making processes are often relatively costly, as compared with hierarchical alternatives, by reason of bounded rationality and opportunism. Some of these difficulties can be overcome by the creation of peer group-cum-hierarchical associations.

Dynamic costs refer to the effect which regulation has on efficiency and innovation in the financial services sector and, by implication, its impact on overall economic growth. Dynamic costs, therefore, refers to the possible impairment of competition, constraints on innovation and financial choice, regulatory capture and regulatory escalation (Goodhart *et. al.*, 1998). To the extent that the rest of the world is becoming more liberal, it may be difficult to understand why our regulatory arrangements will aim to stifle innovation. The major problem with the existing structure is the degree of fragmentation and enforcement difficulties. While this does not

prevent innovation, the difficulties may actually affect long-term economic performance, in the same manner that a regulatory system stifles innovation. For one thing, the proposed regulatory structure options generally, and options (2) and (3) in particular, will not be easily open to regulatory capture as the interest of this large group is wider. In addition, they provide a base for the coordination of the various regulatory and supervisory initiatives.

### **7.5 Financing The Regulatory Structure**

A major consideration in the choice of the regulatory structure made by Ferracho and Samuel was the financial cost and source of funds. In their submission, regulation by the ECCB was the least expensive alternative, given available resources. Of course, we are mindful of the difficult financial circumstances which member governments face but this ought not to be the primary or indeed the only consideration. The inclusion of these extra-regulatory functions on the Central Bank's budget creates domestic liquidity in a manner that is no different from lending to other economic agents within the system. Therefore, no free lunch exists if the Central Bank has to finance these operations.

It is proposed that the financing of a regional body ought to come from the annual licence fees and fines paid by all these institutions. Such an approach is the only feasible one if the objective is to have an effective institution in an environment of limited means. A major stumbling block, of course, as identified in the previous chapter, is governments' perception of the onshore non-bank financial sector, in particular cooperatives, as agents of social development. Perhaps a better way of viewing these would be as agents of development

generally, and therefore they require the same assistance to unleash their potential as, for example, the offshore non-banks.

This chapter provided three basic insights. First it highlighted the goals and limitations of the ECCB's monetary policy framework and the payments and settlements arrangement. Second, the involvement of the ECCB in the regulation of the financial system is to prevent the transformation of payments settlement risks to systemic risk. Third, the cost of regulation in the context of a currency union of developing countries is an important consideration in the determination of an optimal regulatory structure.

There are a number of implications for policy which originate from this chapter. First, given the particular circumstances of regulation within the Currency Union and the size of national jurisdictions, the regulatory structure chosen must be such that it minimizes cost whilst maximizing the goals of regulation. Additionally, emphasis should be placed on the type of contractual arrangements which provide the necessary incentives for sound management and voluntary compliance. Third, a precise basis for the regulation of certain activities needs to be clearly rationalized, given the goals of the ECCB and the overall goals of regulation.

Furthermore, since the role of financial sector regulation is to monitor and ultimately control risk, it is suggested that the policy authorities address the issue at two levels. First, the payments settlement system should be reformed in a manner to reduce those elements that have the potential to promote systemic risk. By reducing the potential for systemic risk the need for a lender of last resort facility is correspondingly reduced. Additionally, to the extent that non-banks do

not directly participate in the payments and settlements system, the systemic risk case for the ECCB's direct regulation of non-banks is not strong. Second, based on current practice, the financial cost of conducting regulation of the entire financial system could become a tremendous burden on the resources of the Central Bank, the effect of which would be no different from lending directly to the domestic economy. Another implication of this work is that, in the context of a currency union with a single financial space, the appropriate regulatory structure may well be a single regulatory framework for the entire financial system outside the scope of the ECCB.

# Chapter 8

## CONCLUSION

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The information that is available on the impact of non-banks on the financial systems in the ECCU area suggests that although commercial banks still dominate the financial system in terms of size and impact, NBFIs are growing at a faster pace. As a corollary to this point, it is obvious that the available information on the size and activities of NBFIs is inadequate for any comprehensive analysis of their impact on the economies of the ECCU area. The present efforts on the part of the ECCB to build databases on NBFIs are therefore timely. Much more needs to be done, however, in terms of strengthening the local regulatory authorities' data-gathering capacity. This information, in turn, will provide the basis for the design of appropriate regulations and policies for the NBFIs sector.

NBFIs appear to have moved strongly into some segments of the market that were previously the sole preserve of commercial banks, as well as some areas not traditionally served by commercial banks. Their growth and development have therefore increased the level of competition among financial institutions, made available to agents a wider variety of financial services and increased their importance in areas such as credit creation (especially loans to the personal sector). Their

impact in terms of deposits at commercial banks also requires that suitable and comprehensive arrangements be put in place for the regulation and supervision of these institutions, since problems in this sector now have significance for the banking sector and the economy in general. The financial authorities therefore need to scrutinize these institutions more closely when looking at credit, liquidity and the general health of the financial system.

A review of the current regulatory systems in place for NBFIs also suggests that although there have been some improvements, much more needs to be done in terms of the updating of relevant legislation, as well as moves to create harmonised rules, institutional structures and enforcement procedures. This will not be achieved without an increase in the resources normally allocated to the national regulatory agencies. One of the most serious institutional problems, however, is the relative ambiguity that still remains with regard to the regulatory domain of the ECCB on one the hand and the national regulatory authorities on the other.

Chapter five argues that the present institutional structure is vulnerable to political influence, which could adversely affect the regulatory process in terms of the promptness of intervention. The lack of regular oversight and monitoring also compounds the problem and could result in problems not being dealt with until they reach crisis proportions, when they are less likely to be successfully addressed.

The common currency monetary arrangement in this region also presents special challenges and opportunities for the development of the regulatory framework for NBFIs in the ECCU. This arrangement requires that formal structures be put in place to



accommodate the cross-border provision of financial services and joint action on regulatory issues in the region. The most obvious strategy to deal with this is harmonisation; the dilemma, however, is to determine the appropriate level of harmonisation.

In this regard, the options include the updating and harmonisation of laws and standards while maintaining the current institutional approach of separate national agencies responsible for different institutional classes, an arrangement similar to the one that obtains for commercial banks with the ECCB as the regional supervisor, or a totally new regional regulatory agency for non-banks which is responsible for all aspects of supervision, and monitoring, with the national peer groups assisting by using their self-regulation framework to maintain prudent behaviour. Another option is also possible, that of a regional regulatory agency responsible for all aspects of regulation and supervision in the financial sector. This of course would involve the removal of the bank supervision function from the ECCB.

The factors determining the feasibility and effectiveness of a regulatory and supervisory system for NBFIs in the ECCU area include relative costs (and particularly the potential economies of scale and scope in regulation), the availability of scarce regulatory resources (both human and financial), credibility in the market, the extent to which it would facilitate the single financial market in the region, the size and structure of the market, the synergies and/or conflict between the regulatory and monetary policy functions and political feasibility.

The approach of updating and harmonising rules and standards across institutional classes in the region

(for example, similar rules and standards for all credit unions in the region) while maintaining the current approach where there is a separate national regulatory agency for each class of non-banks would solve some of the problems of the current system. This approach will also fill gaps in the regulatory structure where they exist. There will also be a minimum level of harmonisation so there is little impetus for regulatory arbitrage between different jurisdictions for similar institutions. Moreover, it would ensure that there is a clear mandate and area of control for the various regulatory agencies. It would not, however, be able to deal with regulatory arbitrage across institutional classes and would still present barriers to a single financial market developing in the region. This approach would also not be able to exploit economies of scale and scope in regulation, making it an expensive option. It would also still tend to be plagued by inadequate resources (skills, finance and infrastructure) to effectively regulate the NBFIs.

A new regional regulatory agency for non-banks that utilises peer groups for market discipline would help harmonisation and integration in the non-bank sector. It would also not face the constraints of the ECCB in terms of its monetary constitution. It would also have a much clearer regulatory mandate because it would have a narrower group of institutions under its jurisdiction. Moreover, it would maintain the separation between commercial banks and non-banks, which are still relatively different institutional classes in the context of the ECCU area. It would also eliminate the costs associated with multiple national regulatory agencies, although the cost of the regional regulatory agency could overshadow any cost savings from the elimination of the national regulatory agencies. It would still, however, be faced with the problems of a scarcity of skilled personnel and financial resources, as well as

a lack of credibility. The elimination of national agencies would also create political problems related to the loss of sovereignty. Additionally, since the role of peer groups associations is critical to this option, only institutions with peer groups which are well organised will be able to utilise this option effectively. This option would therefore not be effective across the whole range of non-banks.

The option of using the ECCB would raise certain categories of institutional cost within that institution, reducing profits for distribution to member governments. More importantly, however, the monetary constitution of the ECCB places restrictions on its ability to take up added regulatory responsibilities and the related financial infusions into the financial system, since this may be in conflict with its monetary responsibilities (primarily maintaining the statutorily defined hard currency backing for the EC dollar). On the other hand, there are synergies that flow from having the same institution responsible for monetary policy and regulation because of the links between monetary and economic conditions and the health of financial institutions. This is a double-edged sword, however, since an institution that is responsible for both regulation and monetary policy may tend to subjugate monetary policy to regulatory and supervisory ends. This is an even greater possibility when this institution also has a significant developmental role to play in the financial system. If the ECCB was given the power to licence as well as regulate it would become an enormously powerful institution. Accountability and sovereignty issues would then also pose problems.

On the other hand, there may be synergies in regulating both commercial banks and non-banks where information on related activities is needed for regulating

both types of institutions. The case for this in the ECCU area is not strong, however, since the level of competition across institutional lines is not well developed. The ECCB also has the advantages of an already established human resource base, information systems and knowledge of the financial system in the ECCU area. Very important also is the fact that the ECCB already has credibility in the region.

A new regulatory agency for the whole financial system would also face similar resource and credibility problems identified above. This would be compounded by the need to develop a relationship with the commercial banks accustomed to dealing with the ECCB. This institution would also face the problems of the need to regulate and supervise differentially the commercial banks and the non-banks under its jurisdictions while at the same time maintaining a clear and unambiguous view of its overall regulatory mandate. A clear and unambiguous view of its regulatory objectives could prove to be difficult because of the range and variety of institutions under its jurisdiction. Additionally, if this new institution was vested with powers to grant licences it would face serious political problems from national authorities, since this would involve the ceding of autonomy by national governments to a regional body. On the other hand, this option would provide the basis for developing a single financial space in the region (as would the ECCB option) since it will be in a position to harmonise rules and standards in the region. It would also help to deal with the problems flowing from the combination of the regulatory and monetary policy function in the same institutions already identified above. There will, however, have to be some level of cooperation between the mega regulator and the monetary policy authorities because of the links between

monetary and economic conditions and the health of financial institutions. The choice of whether to separate or combine the monetary policy and regulatory function will therefore hinge on whether the benefits and costs of separation outweigh that of combined functions.

The manner in which the regulatory and supervisory system is financed is also critical to the effectiveness and feasibility of the particular option chosen. Irrespective of the option chosen, the major portion of the costs of regulation and supervision should be borne by the regulated institutions and agents in the market who all benefit from a stable financial system. The funding for the regulatory system should therefore come in large part from annual licence fees, transaction fees for agents in the market and fines paid by the regulated institutions. If the option with the ECCB as lead regulator is chosen, the financing arrangements would be more robust since the ECCB would also have access to funds from seigniorage.

The issue of how to deal with institutions in trouble and the related financial commitments is also of great importance. Most NBFIs pose no systemic risks and, therefore, the lender of last resort issue does not arise. In these cases the regulator should have the protection of a strict no bail-out clause in its charter. Non-banks may, however, indirectly pose systemic risks because of their increasing importance, especially *via* their significant deposits in the banking sector. If the national governments felt that a particular institution warranted assistance for strategic reasons, then public funds *via* a budgetary allocation would have to be sourced. The general principle should, however, be to avoid bailing out insolvent institutions. In any case, there are well-established mechanisms such as funds designed to

ensure that clients' obligations and the health of institutions are not compromised by problems or failure. The first line of defence, however, is to ensure that monitoring and supervision are effective and that prudential standards are adhered to.

The appropriate regulatory system for non-bank financial institutions in the ECCU area should have the following features. It should facilitate the development of a single financial space, as well as minimise regulatory arbitrage. It should also be able to exploit economies of scale and scope in regulation to minimise regulatory costs. Importantly also, the institution should have credibility in the market. The option should also be consistent with the political realities in the region, that is, the national authorities would want to maintain some significant residual powers.

Based on these criteria the option where there is a level of harmonisation of rules and standards by institutional class and the ECCB regulates and supervises but the national jurisdictions are responsible for licensing seems to be the best arrangement. This option has the added advantage that the ECCB already has well developed data, intelligence and monitoring systems that can be deployed immediately. On the other hand, this option would vest in the ECCB a considerable amount of power with few mechanisms for oversight. There is also the related risk that monetary policy (and the stability of the monetary arrangements in the ECCU area) could be subjugated to the needs of regulation and market development.

Irrespective of the particular regulatory model chosen, an explicit mechanism would have to be put in place to deal with problem institutions, whether the decision is to bail out or close the institution. In general,

institutions that are having temporary liquidity problems should be bailed out (but not insolvent institutions). If the national jurisdiction wants to make an exception in strategic instances then that national jurisdiction will have to source funding *via* a national budgetary allocation. Decisions on how to handle problem institutions should, therefore, be made jointly by the regulatory agency and the relevant authorities in the particular national jurisdiction.

These conclusions can provide the basis for developing a comprehensive and effective regulatory and supervisory system for non-bank financial institutions in the ECCU area. A full cost/benefit analysis of the feasible options is beyond the scope of this study; however, this should be an important first step in the development of a strong regulatory framework for NBFIs in the ECCU area.

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