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**THE IMPACT OF PRIVATISATION ON THE BANKING SECTOR  
IN THE CARIBBEAN**



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## Table of Contents

I. Introduction.....	1
II. Rationale for privatisation.....	2
III. International experience of financial sector privatisation.....	3
IV. Privatisation experiences in the Caribbean banking sector.....	5
V. Impact of privatisation on banking sector performance .....	10
VI. The impact of banking sector privatisation on economic growth.....	17
VII. Institutional restructuring and mergers and acquisitions .....	21
VIII. Strengthening of prudential and regulatory standards .....	23
IX. Conclusion .....	26
Annex.....	28
References.....	31

# **THE IMPACT OF PRIVATISATION ON THE BANKING SECTOR IN THE CARIBBEAN**

## **I. Introduction**

With the failure of the import-substituting industrialisation policies of the post-war period, Caribbean countries shifted to an export-promotion strategy in the 1980s. Export promotion inevitably demanded a shifting of the relative price and productivity of tradable goods and services. To provide the necessary incentives for export promotion, countries pursued a mixture of reforms and restructuring to attract investment and to promote the competitiveness of production and exchange. The period also coincided with a shift in the development paradigm of the developed countries and major International Financial Institutions (IFIs). This new development strategy explicitly favoured open markets, a liberalised trading framework and a retreat of the State from productive activity. In fact, the orthodoxy of government failure became so entrenched that many economists argued that the State's role should be confined to regulation and the provision of infrastructure. As a result, the Welfare State, long championed in the post-war period, was deemed an anachronism. In Europe, in particular, the word 'sclerosis' was borrowed from medicine to describe rigidities attributed to 'overactive' government intervention in economic activity and rigid, inflexible markets.

The new policy consensus, which was called the "Washington Consensus", outlined a package of market-oriented policies aimed at resuscitating flagging economies. Important components of the package included price stability, fiscal prudence, trade openness through the reduction of tariffs and elimination of quotas, deregulation and privatisation of State enterprises. Privatisation was established as a particularly crucial plank of the reforms. This was so because it was believed that price incentives would be thwarted if the State were allowed to burden the allocation of resources by siphoning off finance to inefficient State-owned enterprises. Indeed, the evidence in many countries pointed to the crowding out of productive private sector activity by heavy State borrowing on the domestic financial market.

This paper provides an analysis of privatisation in the banking sector in the Caribbean and its impact on the performance of the sector and economic growth. The study attempts to evaluate whether privatisation and liberalisation, in general, have led to significant gains in efficiency and profitability of the sector and whether the depth of the financial system has led to more productive allocation of credit for investment and growth. Section II outlines the rationale that was used to recommend privatisation as an alternate strategy to State ownership of productive activity. Section III of the paper provides an overview of the international experience with financial sector privatisation,

while section IV gives the Caribbean experience. Section V is an evaluation of the impact of privatisation on the performance and growth in the banking sector. Meanwhile, Section VI looks at institutional restructuring and the significance of the rising trend of mergers and acquisitions in the regional financial sector. Section VII underscores the importance of strong prudential and regulatory standards and reform in this area. Section VIII examines the impact of privatisation and liberalisation in the banking sector on economic growth. Finally Section IX concludes the paper with some policy recommendations.

## **II. Rationale for privatisation**

At the height of the so-called Washington Consensus, economists were so enamoured by the market, that privatisation was viewed as an end in itself. However, with empirical evidence showing that privatisation does not necessarily lead to higher growth rates, it is now seen more as a means to an end. The means being making markets more efficient and flexible in the allocation of resources to promote the end of stable and sustainable economic growth. A number of policy considerations have provided the rationale for privatisation. At a broad level, privatisation was aimed at short-term macroeconomic stabilisation and adjustment and also longer-term structural transformation through improving supply-side efficiency.

In the Caribbean, like many other countries, the major short-term goal of privatisation was to rationalise and streamline public finances. Although this was not the case universally, the fact is that many State enterprises in the Caribbean had accumulated significant losses over time. This led to the diversion of government resources to these enterprises to meet contingent liabilities. A number of examples of this abound, including the sugar industry in Jamaica, St. Kitts and Nevis and Trinidad and Tobago and failed State commercial banks, such as the Workers Bank in Jamaica. Privatisation, it was believed, would not only reduce budgetary transfers to these State enterprises, but would also generate proceeds that could be used to finance alternative activities, especially production for export. In this context, privatisation assists in stabilisation by limiting fiscal deficits that could lead to inflation and by dampening the crowding out of private investment, by reducing State demand for resources. In more recent times the efficiency aspect of privatisation has been explained by two major principles - property rights and public choice theory. Property rights principle states that the State sector is inefficient in productive activity because no individual or group has a clear interest or stake in the assets of the enterprise. As a result, bureaucrats operating a business enterprise would tend to produce inefficient, sub-optimal results. Public choice theory complements property rights theory - it argues that politicians and bureaucrats strive to maximise their institutional and individual self-interest and power rather than the wider public interest.<sup>1</sup> The logical conclusion of these theories is that the State should leave productive activity to the private sector.

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<sup>1</sup> See article by Paliwala, Abdul, (2000), "Privatisation in the Developing Countries: The Governance Issue," in "Law, Social Justice & Global Development," January.

The more important long-term objective of privatisation is to liberate supply-side constraints by providing incentives for investment and production by domestic and foreign investors. Privatisation was aimed at increasing factor accumulation in production, especially through foreign direct investment and also at improving productivity as incentives for innovation and research and development are unleashed. In this context, privatisation is promoted as a crucial factor in the process of structural transformation by reducing the microeconomic inefficiencies and unlocking the productive potential of enterprises. This should impact positively on growth and employment.

### **III. International experience of financial sector privatisation**

With the return of market fundamentalism in the 1980s, deregulation, liberalisation and privatisation were championed as necessary, though not sufficient, conditions for growth. At the international level, the financial sector was viewed as a prime candidate for liberalisation and privatisation, as by its very nature, competitive forces were needed to guarantee banking sector efficiency. Theory was partly supported by practical evidence of many unprofitable and poorly run State-owned banks and other financial institutions. Despite its difficulties, however, the financial sector activities were relatively more profitable than other activities and this made it easier for governments to find buyers or shareholders in the private sector. Importantly, liberalisation and globalisation of the financial sector, driven largely by information technology, undermined public ownership of financial institutions. A number of State-owned financial institutions simply could not cope with the competition in the areas of product innovation, customer service, technical productivity and managerial competence.

Major sales of financial institutions have taken place in both developed and developing countries. Developed countries set the stage for major privatisation in the financial and other economic sectors as they were the first group of countries to shift to free market policies. Privatised government-owned financial enterprises included the Bayerischer Versicherungs in Germany<sup>2</sup> in 1995 with sale proceeds of around US\$1740 million. In Italy, the INA 2 bank was privatised and realised sales of US\$1000 million made through a public offer and the Nordebanken bank in Sweden, which offered public shares that amounted to US\$893 million.

Developing countries also pursued financial sector liberalisation and privatisation often under the auspices of the IFIs as part of the conditions for securing loan financing. In any event, a number of countries had already learned the demerits of public ownership of banks the hard way. Inefficient operations and banking failures were enough testimony of the demerits of State ownership of banks in many countries. In fact, in many developing countries, the issue was not whether financial sector privatisation was necessary, but the sequencing and mode of such privatisation in order to maximise the

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<sup>2</sup>See article- Kain, John, "International Privatisation Perspectives: 1995-96, Australian Parliamentary Library.

benefits from the process. In India, the State-owned Industrial Development Bank of India (IDBI) was sold in 1995 for US\$758 million through a public offer.

Latin American countries, with the exception of Mexico and Chile, did not start to privatise banks until the early 1990s. Chile was the forerunner and had privatised 19 of 20 State-owned banks by 1973. However, the initial phase of privatisation in Chile led to a financial crisis, as the prudential and regulatory framework was ill-suited to the fairly rapid liberalisation. This led to renationalisation and eventually to a second wave of privatisation that was more successful. Mexico introduced a programme of deregulation and financial liberalisation by the late 1980s. However, privatisation of commercial banks was undermined by weak prudential and regulatory standards, which contributed to a financial crisis in 1994. Argentina, like other Latin American countries, was affected by banking sector problems, including the low mobilisation of deposits, and non-performing loans provided the impetus to privatisation. Privatisation was so widespread that by 2000, State-owned banks had declined to 15 from 40 in 1990. In Brazil also, the government continues to privatise State-owned banks. In 2000, two large regional banks, Banestado and Banespa were privatised. Meanwhile, in Peru, Banco Continental made a public offering of shares amounting to US\$256 million in 1995.

Even in the Least Developed Countries (LDCs), a number of financial reforms and liberalisation policies were undertaken aimed at deepening the financial sector and increasing available resources for investment (Brownbridge and Gayi, 1997). Almost all of the LDCs have allowed the entry of new private sector banks and non-bank financial institutions. To strengthen prudential standards, however, a number of these countries raised minimum capital requirements, improved legislation and the expertise of managers to enhance the solvency and performance of the banking sector.

Financial liberalisation and privatisation have had varied effects on countries, depending on the stage of development, the consistency of the reforms and the institutional capacity to transform finance into viable and productive investment. In most of the Asian developing countries, increased private sector participation in the financial sector was associated with greater financial depth, measured by growth in bank deposits and broad money supply (M2) to GDP<sup>3</sup>. This was because many of these countries had attained macroeconomic stability, which provided a platform for growth in the financial sector. In Bangladesh and Nepal, for instance, bank deposits grew by around 8 percentage points of GDP between 1985 and 1995. Financial depth improved in some African countries, such as Botswana and Uganda, but weakened in others, including Tanzania, Zambia and Malawi. The worsening situation in some of these countries, in any event, stemmed not from purely financial difficulties, but from macroeconomic instability, particularly high inflation and public sector deficits, and political instability in others.

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<sup>3</sup> See Brownbridge, Martin and Gayi, Samuel K. (1997), "Progress, Constraints and Limitations of the Financial Sector Reforms in the Least Developed Countries, IMF.

#### **IV. Privatisation experiences in the Caribbean banking sector**

The financial system in the Caribbean evolved primarily to facilitate international trade and commerce. In colonial times, branches of international banks, such as Barclays and Citicorp, were set up in the region to provide finance for production and export of commodities, such as sugar, bananas, rum, bauxite and petroleum. These banks provided relatively basic intermediary services, such as loans, lines of credit, export credit and overdraft facilities.

Similar to the current trend, international banks of this era operated consolidated balance sheets and viewed the Caribbean as a small part of their global operations. The banks established strategic networks with the objective of maximising profits, market share and shareholder returns. In fact, there was no real commitment to the development of the region, and banking activity coincided with opportunities to make profits and to export capital. A reflection of this was that foreign banking activity was particularly procyclical. Export booms and improving terms of trade coincided with increased sector investment and lending, while recessions or declining commodity prices led to poor profitability and reduced investment in the local economy.

Moreover, the market structure under which they operated was strongly oligopolistic, providing ample opportunity for banks to capture rent, in spite of widespread inefficiencies in the intermediation process. This was indicative of a small number of players in the market, substantial pre-emptive competitive advantages and poor mechanisms for government regulation and control in the public interest. Furthermore, banks operated more or less as a cartel, colluding in the setting of interest rates and other terms of credit. With limited competition and virtually no regulatory machinery in place, banks were able to make significant profits on account of the large interest rate spreads and the payment of relatively low wages and salaries.

In the post-independence period, in an effort to meet the “legitimate expectations” of the population for a greater share of the economic pie, governments moved to nationalise a number of industries, including banks. A classic case of nationalisation occurred under the Manley Government in Jamaica in the 1970s. Following the failure of liberal policies to bridge the equity gap and to promote balanced growth, government decided to take control of the ‘commanding heights’ of the economy. Nationalisation was also driven by the imminent closure of private enterprises that felt threatened by the socialist policies of the Manley Government. Nationalised enterprises included factories, farms, hotels, utilities and banks. By 1980, the State sector owned 50 per cent of hotel room capacity, 8 out of 12 sugar factories and the State Trading Corporation, which was established to regulate the importation of goods.<sup>4</sup>

The Jamaican Government nationalised Barclays Bank in 1977 and renamed it the National Commercial Bank of Jamaica. Similarly, in Guyana the Burnham Government acquired a number of enterprises in virtually all sectors of the economy, including sugar,

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<sup>4</sup> See Mistry, Percy et al, (1992) “Adjusting Privatization: Case studies from Developing Countries”, Heinemann Publishers

bauxite, distribution, manufacturing and banking. Most of the foreign-owned banks operating in Guyana at the time, including Chase Manhattan, Barclays and Royal Bank of Canada, were nationalised.

By the early 1980s, the pendulum had swung back in favour of liberal market policies. In recognition of the limitations of the State-dominated approach to development, in general, and the glaring inefficiencies of State-owned commercial banks, in particular, a number of Caribbean countries were prompted to privatise a number of State-owned banks. This formed part of the broader programme of financial liberalisation.<sup>5</sup> This has, in many cases, been complemented by measures aimed at liberalising interest rates, directed lending as well as barriers to entry into the banking system and eventually liberalising the capital account of the balance of payments. The overarching and long-term objective has been to increase efficiency of State-owned banks so as to match the demands of an increasingly complex and sophisticated financial system. All these measures are necessary if privatised State-owned banks are to become more efficient, profitable and competitive.

More than 36 State-owned banks were privatised by 1995 with total assets amounting to more than US\$8 billion [Clarke 1997]. This represented approximately three quarters of total commercial banks' assets. As can be seen from Table 1 the countries with the highest number of banking privatisation were Guyana and Jamaica. This is not surprising since these countries implemented socialist policies after independence, which gave the State a pervasive role in virtually all the sectors of the economy, including the financial sector. Guyana started to privatise commercial banks as early as 1985 with the privatisation of one of the largest banks - the Guyana Bank for Trade and Industry (GBTI) - through private and public share offer. Only 35 per cent of the bank's shares were offered for sale. The second phase of privatisation was in 1991 when the bank was privatised through public subscription of 70 per cent of shares with the government retaining the remaining 30 per cent.

With the change in government in 1992, privatisation came to a complete halt because it was felt that there was no clearly defined or articulated strategy for privatisation. After tabling legislation with revised objectives and guidelines for privatisation, the Government of Cheddi Jagan resumed bank privatisation in 1994 with further divestment of the Guyana Bank of Trade and Industry through a public tender offer of 29.6 per cent shares, which was procured by one shareholder. The remaining share of the government in the National Bank for Industry and Commerce (NBIC) was to be divested completely in 1996. Apart from this, efforts are also under way in Guyana to privatise the Guyana National Co-operative Bank (GNCB), the only remaining State-owned bank in the country. Privatisation of that bank has proven difficult for the government compared to the privatisation of the other two banks, NBIC and GBTI. This

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<sup>5</sup> Financial liberalisation in developing countries was influenced by the writing of McKinnon and Shaw and was based on the recognition that the repressed nature of the financial sector impeded the efficient intermediation of financial capital between surplus and deficit entities. In fact, financial repression was viewed as an effective tax on financial intermediation.



is due largely to the weak financial position of the bank and poor loan portfolio. For example, the non-performing loan is estimated at 91 per cent of total loans. In the meantime, the bank has been placed under a management consultant whose responsibility is to prepare it for privatisation. A number of measures have been put in place to clean the balance sheet of the bank so as to increase its attractiveness to prospective investors. Credit extension is being controlled and attempts are being made to recover the non-performing loans.

Jamaica has had perhaps one of the longest record of privatisation in the English-speaking Caribbean, spanning several decades. Jamaica's privatisation of State-owned banks started as early as 1986 under the Seaga Administration with the privatisation of the National Commercial Bank (NCB) of Jamaica. The mode of privatisation was public placement through the Jamaican Stock Exchange (JSE) whereby 51 per cent of government's shares/equity in NCB was divested. Under phase II of privatisation the government further reduced its shares in NCB by selling more than six million shares to the NCB Trust and Merchant Bank, which was the trustee of the NCB employee share scheme (Bernal and Leslie, 1999). The remaining 49 per cent of government's shares in NCB, which was initially planned to be divested through public share offer, were sold through private placement in 1993, during phase III of privatisation. Another bank, the Workers Savings and Loan Bank, was also privatised in early 1991, through public placement on the Jamaican Stock Exchange.

The watershed of the privatisation thrust in Trinidad and Tobago was the establishment of the "State Enterprises Committee" by the National Alliance for Reconstruction (NAR) Government in 1986. Privatisation was a part of the response to financial and economic difficulties of the period. The objectives of privatisation included the freeing-up of resources for government, enhancing efficiency through greater private sector initiative and competition and creating opportunities for employees to own shares in enterprises through share options.

**Table 1: Caribbean commercial banks privatised since the mid-1980s**

<b>Country</b>	<b>Name of the bank</b>	<b>Year of privatisation</b>	<b>Mode of privatisation</b>
<b>The Bahamas</b>	Bank of Bahamas	1994 and 1995	Private placement 49% of shares Government retained 51%
<b>Guyana</b>	Guyana Bank for Trade and Industry	1991	Public Subscription 70% shares Government retained 30%
	Guyana Bank for Trade and Industry	1994	Public tender offer 29% procured by one shareholder Government' shares divested.
	National Bank for Industry and Commerce	1985	Public and private share offer 35% of Bank's share plus new share offering. Government retained 30% plus 17.5 % NIS
	National Bank for Industry and Commerce	1996	Public tender offer.
<b>Jamaica</b>	National Commercial Bank of Jamaica	1993	Private placements 49 % divested by bank. 10 % employees at discount
	National Commercial Bank of Jamaica	1986	Public placement through Jamaican Stock Exchange, 51 % divested by Government.
	Workers Savings and Loan Bank (WSLB)	1991	Privatised through JSE
<b>OECS</b>	National Commercial Bank of Grenada	1992	90 per cent sale of shares.
	Grenada Bank of Commerce	1997	Private and public Placement of shares.
	National Commercial Bank of Saint Lucia	1999	Public subscription of Shares.

Source: Caribbean Centre for Monetary Studies, April 1997

In the banking sector, the privatisation of the National Commercial Bank (NCB) was an important turning point. Government acquired the dominant share in what became NCB, from the Bank of London and Montreal in 1970. Ironically, NCB was not privatised because of performance failures, as it was profitable, even during the economic slump of the 1980s. The privatisation of NCB signalled the influence of the sweeping shift in economic thought in favour of private sector led development. This school of thought was particularly against State ownership of commercial banks, which were deemed to be cardinal private sector institutions. In addition, government policy favoured privatisation as a mechanism for transferring equity to the citizens of Trinidad and Tobago. In fact, in 1988 when government shareholding in NCB fell below 50 per cent, 20 per cent (1,580,996 shares) were transferred from the government to set up an employee share acquisition scheme. The proportionate allocation of shares reflected the high priority given to employees and small investors.

Unlike Guyana and Jamaica, bank privatisation has not been a major component of financial sector reform in the smaller Caribbean countries of the Organisation of Eastern Caribbean States (OECS) and the Bahamas since these countries did not have significant numbers of State-owned commercial banks. The only two exceptions in the OECS were Grenada and Saint Lucia. The Government of Grenada divested 90 per cent of its shares in the National Commercial Bank of Grenada in 1992 through private placement. The majority of shares were acquired by the Republic Bank of Trinidad and Tobago while 10 per cent went to Grenadians. Apart from the privatisation of NCB Grenada, the Government of Grenada began reducing its shares in the Grenada Bank of Commerce (GBC) when it sold 15 per cent of its shares to the National Insurance Scheme in December 1996. Government shareholding was further reduced when the Royal Bank of Trinidad and Tobago (RBTT) purchased 50 per cent in the GBC in June of 1997. By 2000, government share holding was reduced to only 10 per cent with the Caribbean Banking Corporation Limited (the parent company of RBTT) holding the majority shares of 62 per cent. The remainder is held by the National Insurance Scheme (15 per cent) and by the public of Grenada (13 per cent).

In July 1999, the Saint Lucian Government divested its shares in the National Commercial Bank and the Saint Lucia Development Bank through subscription of public offering. The two banks have merged to form the Bank of Saint Lucia which now provides a range of financial services, such as mortgage finance, offshore finance, property and real estate and insurance services.

In the Bahamas, the government privatised the Bank of Bahamas in two phases, first in 1994 and again in 1995. The mode of divestment was through private placement of 49 per cent of shares with the government retaining 51 per cent of shares in the Bank.

As far as the mode of privatisation of commercial banks in the Caribbean is concerned, notable differences have been observed in the modality of divestment in the 1980s and early 1990s and the more recent waves of privatisation. Whilst the first phase of privatisation was characterised by public offering through stock exchanges, the more recent phases of bank privatisation, however, have been done either through private

placements or private tenders. The change in the mode of privatisation probably partly reflected the stagnant organic growth in regional stock/capital markets with little secondary trading and also increased interest by private tenders as banks became more viable. Therefore, the absorptive capacity of these equity markets for newly divested firms remained small. Most of the privatised banks have been sold to domestic buyers, both individuals and corporate. The only exception are the privatisations of the NCB of Grenada as well as the Grenada Bank of Commerce, which were sold to regional investors - the Republic Bank of Trinidad and Tobago and the Royal Bank of Trinidad and Tobago, respectively. Privatisation of State assets through public share offers on capital markets, especially stock exchanges, has also been a popular mode of bank privatisation in the Caribbean. With regard to public share sales in the Caribbean, it was common to allocate shares to employees and managers of the privatised State-owned banks, often on preferential terms. This was the case with the privatisation of Workers Savings and Loan Bank of Jamaica as well as the Grenada Bank of Commerce. This provides a mechanism through which citizens could gain a stake in the patrimony of their countries and earn income.

## **V. Impact of privatisation on banking sector performance**

Assessing the impact of privatisation on banking sector performance is inherently problematic since it is difficult to isolate privatisation specific factors from other factors that may equally have had an impact on the banking sector. Apart from bank privatisation, the liberalisation of interest rates and removal of credit ceilings and directed lending, which formed an integral part of many World Bank and International Monetary Fund (IMF) financial sector reform programmes implemented in the Caribbean may have also impacted on banking sector performance. Other measures complementing banking privatisation, such as the implementation of the Uruguay Round commitments in the financial services sector in accordance with the General Agreement on Trade in Services (GATS)<sup>6</sup>, may have had an effect on banking sector performance and profitability. Notwithstanding these difficulties, an attempt will be made to draw some inferences on the effect of privatisation on the banking sector in the Caribbean.

The impact of privatisation on the banking sector and on individual banks' performance has varied across countries and among banks, obviously depending on, among other factors, management, regulatory and supervisory structures, degree of competition and the differences in the way the banks have responded to competitive pressure. In general, it seems that bank privatisation has had a significantly positive impact on individual privatised banks and, by extension, on the banking sector as a whole. The growth in the size of the banking sector as measured by assets and liabilities of individual privatised banks and the banking sector, as a whole, has been phenomenal.

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<sup>6</sup> A number of Caribbean countries have undertaken market access commitments in many subsectors of financial services including insurance and banking (See ECLAC/CDCC, "Progress made by the Caribbean countries in the WTO built-in Agenda on Services and Intellectual Property Rights", LC/CAR/G.648), June 2001.

However, care must be exercised when interpreting figures on banks' assets and liabilities since, as indicated in Section II, most State-owned banks were profitable and did experience robust growth in assets and liabilities prior to privatisation. The National Commercial Bank of Jamaica, for example, experienced rapid growth in the period before privatisation. Its assets and deposits grew from J\$1,101.0 million in 1982 to more than J\$3,247.0 million in 1986. Total deposits and loans have also grown considerably by 152.4 per cent and 135.3 per cent, respectively, from 1982 to 1986. It remained profitable during the 1980s recording an after tax profit of J\$17.5 million in 1986 compared to only J\$9.1 million in 1982. However, its assets and liabilities grew even more robustly in the post privatisation period, especially during the first half of the 1990s (*See Annex, Figure 1*). The Workers Savings and Loan Bank also experienced significant growth in assets, deposits and profitability especially in the first five years since privatisation. However, performance of the bank has deteriorated since 1996, and has subsequently been taken over by Financial Sector Adjustment Company (FINSAC) (*See Annex, Figure 2*). The National Commercial Bank of Grenada has experienced the fastest growth in assets and deposits of all the banks surveyed in this study. Total assets grew from EC\$127.7 million in 1990 to EC\$417.7 million in 2000. Deposits and advances grew considerably from EC\$109.2 and EC\$88.7 million in 1990 to EC\$373.1 million and EC\$268 million in 2000, respectively. This was similarly the case with banks in Guyana, especially NIBC and GBTI (*See Annex, Figures 4 and 5*). Privatisation and deregulation may have opened up unprecedented opportunities for banks to engage in all types of activities and a wider range of services. The removal of foreign exchange controls has made it possible for banks to offer foreign currency accounts. A number of banks in Jamaica, for example, operate cambios. This in turn has led to considerable increase in banks' assets and liabilities.

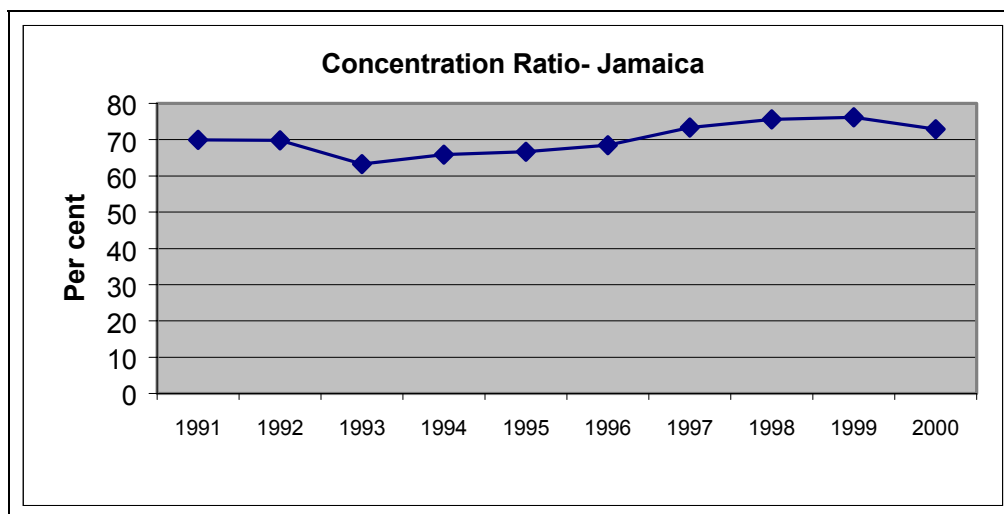
Perhaps, the most significant impact of privatisation on commercial banks in the Caribbean has been in the area of customer service and product innovation. Most of the banks that have been privatised indicate that there has been a considerable improvement in customer service. This has been reflected in better range of products and services to customers. Many banks have now introduced efficient delivery channels, such as Automated Teller Machines (ATMs), debit cards and some are now in the process of introducing internet and electronic banking. All of these have been made possible by the rapid development in information technology. Customer service has become increasingly the main area in which banks in the region compete. The collusive behaviour of banks in determining interest rates as well as the lack of product differentiation have forced the banks to improve their customer service significantly.

As indicated earlier, one of the main reasons for banking privatisation was the need to enhance competition and efficiency in the banking sector. Liberalisation and deregulation of the banking sector were expected to lead to competition in the sector. Competition would have come from the mere increase in the number of banking institutions as well as non-bank financial institutions competing for both deposit and lending. However, there has not been a significant increase in the number of banking institutions in the Caribbean, with the exception of Jamaica, especially in the first half of the 1990s. In the latter, the number of financial institutions grew from 36 in the 1980s to

more than 57 in 1996. However, these have decreased considerably since 1996 as a result of restructuring of failed financial institutions by FINSAC. The number of commercial banks grew from eight in 1980 to 12 in 1995. In Guyana only two new banks have entered the market. The removal of the interest rate ceiling especially on deposit and the lifting of prohibitions on interest payments on demand deposit may have spurred competition in the sector by reducing sources of cheap funding for banks.

However, increased competition has not been reflected in a decline in concentration ratios, especially in Jamaica. The percentage share of the two largest banks in total assets has increased considerably from 69.9 per cent in 1990 to 76.0 per cent in 1999. It seems that the largest two banks have consolidated their entrenched dominance of the market. Further analysis reveals that the substantial increase in concentration ratios reflects consolidation and mergers and acquisitions that have been taking place in the financial sector as a result of restructuring.

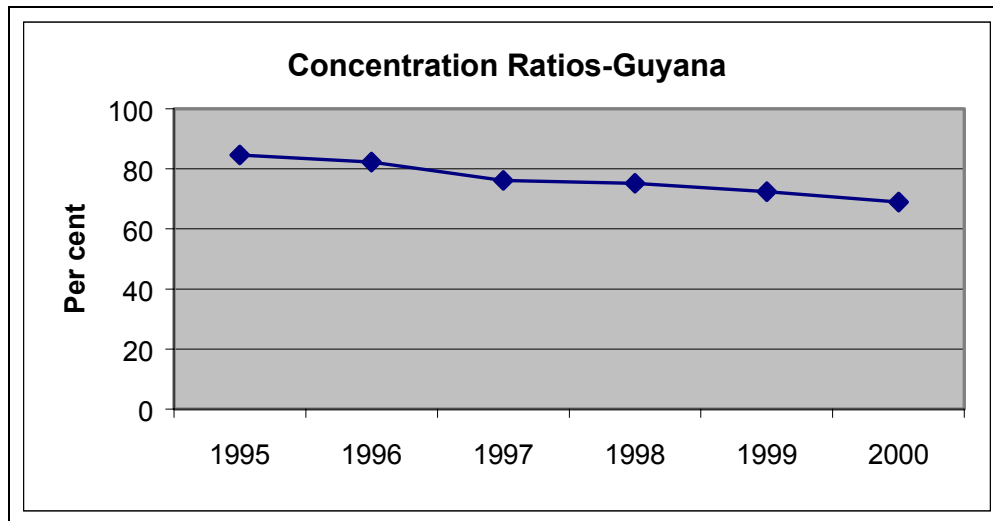
**Figure 1: Concentration ratios - Jamaica  
(Shares of two largest banks in total assets)**



Source: Bank of Jamaica, Prudential Returns, Various Years.

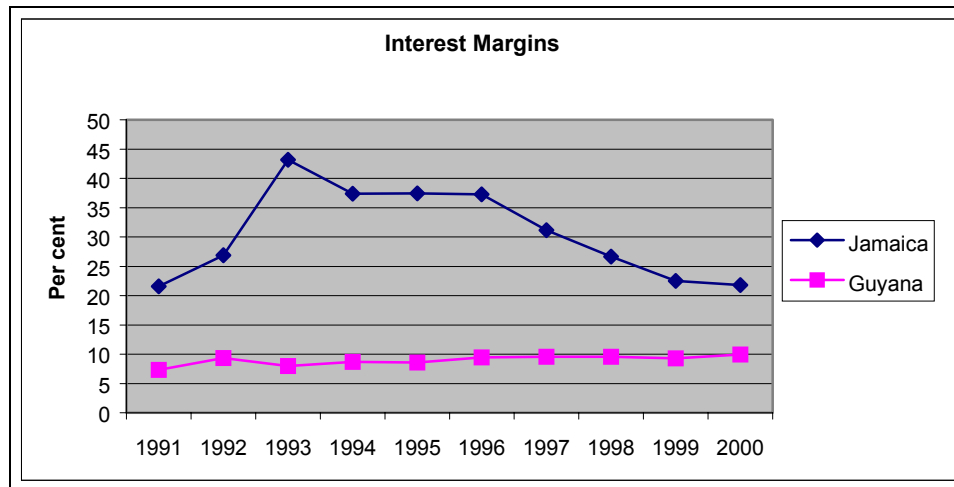
In Guyana, on the other hand, the concentration ratios have declined steadily from around 85.0 per cent in 1995 to 68.9 per cent in 2000. The significant decrease in concentration ratios is partly attributed to the weak assets growth of one of the three largest banks, Guyana National Co-operative Bank, which remains the only State-owned bank in Guyana. To illustrate the point, total assets of the banking industry, as a whole, grew by an average 11.3 per cent during the period 1995-2000. Total assets of the Guyana National Co-operative Bank, however, grew by a mere 1.4 per cent during the period under review. The assets of the other smaller banks, most notably Bank of Nova Scotia and Demerara Bank, have grown much faster by 264.7 per cent and 364.8 per cent, respectively. This points to some degree of competition and penetration taking place in the banking industry.

**Figure 2: Concentration ratios – Guyana  
(Shares of two largest banks in total assets)**



Source: Annual Reports of Various Commercial Banks, Various Issues.

Competition in the banking industry has been non-price, mainly advertising, quality improvement, product packaging and services. This is due to the oligopolistic nature of the banking industry in the region where banks collude in determining interest rates. This has resulted in very high interest rate margins, defined as the spread between lending and deposit rates. Commercial banks in Jamaica enjoy the highest interest margins in the region. As can be seen from Figure 3, interest rate margins increased from 21.6 per cent in 1991 to reach a high of 43.15 per cent in 1993 but have since then steadily declined to 21.81 per cent in 2000. Interest rate margins in Guyana, although much lower than in Jamaica, have increased steadily from 7.32 per cent in 1991 to 9.93 per cent in 2000. The high interest margins in Jamaica could partly be explained by the high inflation period. Tight monetary policy, including high reserve requirements, which was pursued in the 1990s also contributed to high interest rate margins.

**Figure 3: Commercial banks interest rate margins**

Source: Bank of Jamaica and Bank of Guyana, Various Issues

Another apparent reason for the high interest margins is the high operating cost and high percentage of non-performing loans. In Guyana for example, the NBIC has recorded an increase in non-interest expenses as a percentage of total assets, which moved from 4.74 per cent in 1995 to 5.35 per cent in 2000. Similar increases have also been reported for the GBTI, with non-interest expenses increasing from 4.13 per cent in 1995 to 5.24 per cent in 2000. NBIC's provision for loan losses grew from 0.66 per cent in 1995 to 2.33 per cent in 2000. This has had a negative impact on the bank's profitability. For example, NBIC's profit before tax declined from 2.15 per cent in 1995 to 1.08 per cent in 2000. Similarly, GBTI's profitability has declined from 1.96 to 0.57 per cent from 1995 to 2000, respectively. The NCB, Grenada, on the other hand has performed better than all the other banks surveyed in this paper. Better performance has been reflected in improvement in profitability while better management of credit risk seemed to have contributed to the decrease in non-performing loans.



**Table 2: Banking sector performance  
(Per cent of total assets)**

<b>Guyana</b>								
			<b>NBIC</b>				<b>GBTI</b>	
	<b>1995</b>	<b>1997</b>	<b>1999</b>	<b>2000</b>	<b>1995</b>	<b>1997</b>	<b>1999</b>	<b>2000</b>
Net interest income	8.08	6.73	7.22	5.90	5.60	5.74	5.12	3.57
Loans losses	0.66	1.10	2.33	1.11	0	0	0	0
Profit before tax	2.15	1.57	1.08	1.40	1.96	1.67	0.94	0.57
Non interest expense	4.74	4.27	5.59	5.35	4.13	4.06	5.24	4.22
Interest expense	11.56	7.31	10.15	8.16	6.67	5.20	5.29	5.34
<b>National Commercial Bank of Jamaica</b>								
	<b>1994</b>	<b>1995</b>	<b>1996</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>	
Profit before Tax	3.00	1.47	-1.29	0.24	-1.11	0.13	0.43	
Profit after Tax	2.03	0.80	-1.43	0.20	-1.11	0.12	0.37	
Return on Assets	2.0	0.8	-1.43	0.2	-1.11	0.44	1.5	
Return on Equity	42.4	16.98	-44.12	6.08	-25.19	5.45	17.56	
Operating Costs				7.59	7.30	6.51	5.36	
<b>National Commercial Bank of Grenada</b>								
	<b>1991</b>	<b>1992</b>	<b>1993</b>	<b>1995</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>
Net interest Income	4.58	4.11	4.64	5.13	5.51	5.50	5.25	5.25
Operating costs	4.44	4.86	4.91	4.53	4.97	4.84	4.53	4.37
Profit before Tax	0.30	1.03	0.81	1.80	1.92	1.95	1.94	2.01
Profit after Tax	0.00	-1.1	0.40	1.33	1.63	1.57	1.57	1.68
Interest Expense	3.01	3.08	2.81	2.98	3.14	3.22	3.30	3.14
Provision loan losses	0.97	1.55	0.57	0.38	0.24	0.32	0.28	0.46

Source: Calculated from Annual Reports of various Commercial Banks

Notes: NBIC refers to National Bank of Industry and Commerce of Guyana and GBTI denotes the Guyana Bank for Trade and Industry.

Banks in Jamaica suffered huge losses in the late 1990s on account of the financial crisis. High percentage of non-performing loans and large operating costs, especially compensation packages paid to Executives<sup>7</sup>, point to significant inefficiencies in the banking industry. The National Commercial Bank of Jamaica experienced marked deterioration in the rate of return on assets (ROA) and the rate of return on equity (ROE) during the second half of the 1990s. As a result, the bank profitability was compromised (See Table 2).

Although financial liberalisation, including privatisation, has contributed to better portfolio management of commercial banks in some countries, it has also led to banking or broader financial crises in others. This has been particularly the case in Jamaica. Although the Jamaican crisis cannot be attributed entirely to liberalisation, such reforms may have exacerbated problems in the financial sector, especially in the face of prudential and macroeconomic weaknesses.<sup>8</sup> The accelerated liberalisation of the economy coupled with deregulation led to rapid growth in the financial sector, both in terms of assets and liabilities of financial institutions as well as the number of new financial institutions that entered the market. For example, the number of financial institutions reached a high 57 with total assets of more than J\$192.6 billion in 1996 compared to only 36 institutions with assets totalling J\$2.5 billion in 1980. The number of non-bank financial institutions (NBFIs) also grew substantially during this period. In fact, the Jamaican banking sector became over-banked. All these institutions started to compete fiercely against one another for a narrow segment of the market. In response to new opportunities created and increased competition, banks started to offer high interest rates to attract depositors and in turn using the proceeds to expand lending and engage in more risky activities.<sup>9</sup> The banks aggressively expanded loans without paying sufficient attention to internal supervisory measures. There was not proper accounting for non-performing loans.<sup>10</sup> To make matters worse, the prudential and regulatory infrastructures were not equipped to deal with the challenges of an emerging and competitive industry. Poor planning, improper risk assessment, mismatching of assets and liabilities and connected lending contributed to weak loan portfolios. Many indigenous financial institutions faced a high percentage of non-performing loans, high interest rates and ultimately a liquidity crisis.<sup>11</sup> However, the foreign-owned banks remained profitable and

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<sup>7</sup> For example, the ratio of employee remuneration to average assets for the commercial banks averaged 3.3 per cent in the first half of the 1990s, far exceeding the United States benchmark of 2.0 per cent (Bank of Jamaica, April-June 2001).

<sup>8</sup> Financial liberalisation in other Latin American countries, most notably Argentina, Chile and Brazil, in the 1970s has also ended in both banking and broader financial crisis.

<sup>9</sup> Some banks started to engage in foreign exchange trading and other range of securities while others acquired real estate and insurance companies.

<sup>10</sup> For, example, many indigenous banks used 180 days period before recognising a loan as non performing in contrast to an international norm of 90 days.

<sup>11</sup> Some people have argued that the financial crisis was inevitable since the banking sector was over-banked. In other words the large number of financial institutions was not justified by the small size of the economy.

liquid during the same period. What explains the resilience of the foreign banks to the financial crisis has been better management and effective internal supervisory and regulatory standards.

To safeguard the vitality of the financial system the Jamaican Government established FINSAC<sup>12</sup> to recapitalise and strengthen the insurance and banking institutions affected by the crisis. The two banks, NCB and Workers Savings and Loan Bank (WSLB), which were privatised at the turn of the 1990s, have had to be taken over by FINSAC. As a result of consolidation in the banking industry, the number of commercial banks which has grown to 13 in the early and mid-1990s has now declined to only five.

## **VI. The impact of banking sector privatisation on economic growth**

Privatisation and liberalisation, like other market-opening policies, should not be viewed as ends in themselves, but means to the end of stable, sustainable and equitable growth, and development. The transmission process through which privatisation in the banking sector impacts on growth is multifaceted. Moreover, in many instances the process does not entail uniform cause and effect, but tradeoffs. Therefore, the net effect depends on which of a number of processes predominate.

As financial institutions act as intermediaries, transferring resources from surplus economic units to deficit units, they hold the potential to impact on capital accumulation and total factor productivity. For a long time, Caribbean financial institutions have focused on mobilising larger amounts of finance, rather than the efficiency with which these funds are used. This has led to the over-supply of funding to certain sectors of high preference, such as distribution, real estate, mortgages and consumables, while other vital sectors, notably agriculture and small enterprises have faced a severe shortage of financial resources.

An important question is to what extent have privatisation and other liberalisation measures in the financial sector provided a stimulus to stable growth? To assess the impact of privatisation of the banking sector on growth we first need to examine how the sector enhances its productivity and efficiency, and how this is transmitted to improvements in growth in the productive sectors of the economy. Generally, as an economy grows and develops, the banking sector becomes more specialised, sophisticated and cost-effective.<sup>13</sup> This increasing financial depth and efficiency has a positive feedback on capital accumulation, productivity and growth. It must be noted, however, that even though this has been the pattern in developed countries, it is often not replicated to a similar extent or intensity in developing countries. Indeed, the impact of

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<sup>12</sup> FINSAC stands for Financial Sector Adjustment Company.

<sup>13</sup> See Harrison, Sussman and Zeira, "Finance and Growth: Theory and New Evidence", Federal Reserve Board, Washington, DC, July, 1999.

liberalisation of the banking sector on growth depends on a number of factors, including the competition in the sector, concentration, the demand for and direction of credit, the efficiency of investment, among others. This makes it difficult to determine with any precision how these market-driven policies affect financial development.

Generally, though, the evidence in the Caribbean suggests that privatisation and liberalisation have led to improvements in the efficiency of the banking sector in terms of reduced operating costs and higher profit margins, but the impact on growth in output has not been that favourable. This stems to a large extent from certain structural constraints that confront the Caribbean banking sector. Important among these impediments is the small size of the regional market and also of the banks themselves. With the exception of a few large regional banks, such as RBTT and The Republic Bank of Trinidad and Tobago, size constraint means that regional banks benefit significantly less from economies of scale and scope than their counterparts in developed countries.

One important means through which liberalisation and privatisation of the financial sector is expected to contribute to growth is through ‘financial deepening.’ Financial deepening refers to increasing the depth and range of the financial system so as to provide more resources for intermediation and investment. A crucial avenue for enhancing the depth of the financial system is by eliminating interest rate repression, by liberalising controlled interest rates.<sup>14</sup> This strengthens the incentive of households to save in the banking system, rather than hold real assets. Apart from price incentives through interest rates, non-price competition instruments, such as advertising, customer service and convenience, also provide strong inducements to savings mobilisation.

Two basic measures of the impact of privatisation and other reforms on financial depth are growth in bank deposits and broad money, M2 as a percentage of GDP. As indicated earlier, privatisation has generally led to solid growth in banks’ deposit liabilities. Growth in the money supply tends to have a positive impact on growth in real output largely through its impact on interest rates. An expansion of the money supply through purchase of bonds by the central banks leaves the commercial banks with excess reserves. To expand their lending to gain profits, commercial banks lower their loan rates of interests. This decrease in interest rates positively affects interest sensitive investment in areas manufacturing and housing construction.

The ratio of broad money supply (M2) to GDP seems to have been positively affected by banking sector privatisation and liberalisation. However, it is crucial to note that monetary policy, especially the use of open market operations and adjustments in the central banks’ discount rates, also affected growth in money supply. Guyana is somewhat different from Jamaica and Trinidad and Tobago in that financial deepening measured by M2/GDP was badly affected by the slump in growth in the 1980s. This was reflected in particularly high ratios, as high as 114.38 per cent in 1988. In the 1990s, in the wake of reforms and restructuring, growth picked up in Guyana and this led to a reduction of the

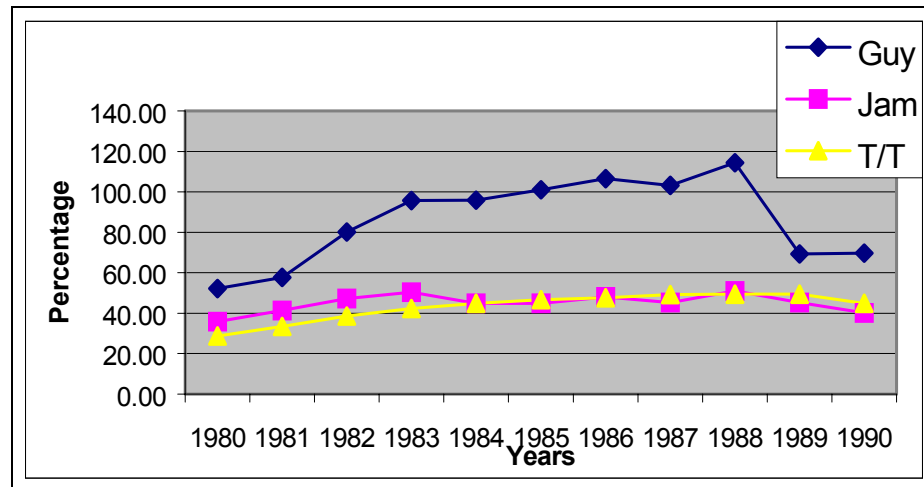
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<sup>14</sup> Interest rate repression refers to financial sector interest rates that are below market rates and which therefore fail to provide a good incentive to saving and investing.

ratios. However, the impact of banking sector privatisation on GDP seems to have set in by the latter part of the 1990s, when the ratio of M2/GDP steadily increased from about 59.5 per cent in 1995 to 79.9 per cent in 1999.

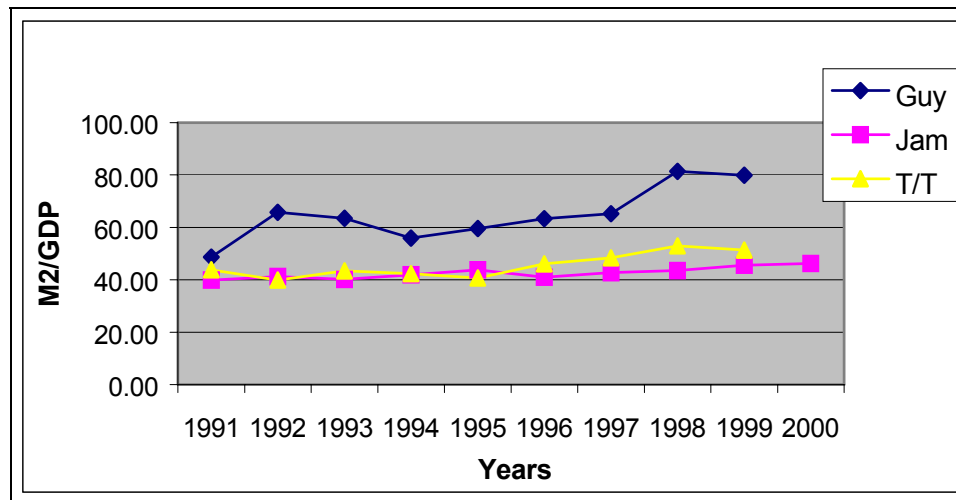
Although the trend in M2/GDP for Jamaica has fluctuated over time, there has been a noticeable upward movement since 1995. In 1996, the ratio fell to 40.9 per cent in the wake of the financial crisis in the country, but has increased to 46.2 per cent by 2000. This suggests that FINSAC and privatisation have renewed confidence in the sector. Meanwhile in Trinidad and Tobago, there has also been steady financial deepening from the latter part of the 1980s and into the 1990s. Improved growth in GDP might have had a positive impact on growth in the money supply and vice versa over the period of the mid to latter part of the 1990s in particular. Growth in the money supply seems to have provided financial institutions with a greater pool of funds for debt-intermediation. This might have had a positive impact on the coefficient of transformation of financial resources into physical capital.<sup>15</sup>

**Figure 4: Broad Money M2 as a percentage of GDP for selected Caribbean countries**



<sup>15</sup> See Shaw, Edward, "Financial Deepening in Economic Development," Oxford University Press, New York, 1973.

**Figure 5: Broad money supply as a percentage of GDP for selected Caribbean countries 1991-2000**



The difference in the growth effect of privatisation and liberalisation, which has led to increased financial depth in the Caribbean, relates importantly to differences in market structure and competition. Whereas banks in the United States and Europe operate in relative strong, monopolistically competitive markets with each bank being able to influence lending costs and conditions in its sphere of influence, in the Caribbean, the market structure is less competitive and although monopolistically competitive is nearer to oligopoly. As Worrel<sup>16</sup> has noted, the widespread observance of oligopolistic behaviour of financial institutions means that competitive models of bank behaviour are inappropriate. Market power gives large Caribbean banks more scope for influencing the cost and terms of credit than their developed country counterparts. Therefore, regional banks have greater scope for making supernormal profits, thereby reducing consumer welfare and restricting the growth impact of their largely consumer-based lending. This is supported by the relatively high interest rate spreads<sup>17</sup> in the region.

Privatisation and liberalisation have led to more market-based instruments for determining the allocation of funds. Generally, interest rates have been liberated, selected credit controls eliminated and State directed credit drastically reduced. These price-based incentives have provided wider latitude for firms to make profits. The profit motive and incentive have acted as strong forces to allocate funds to sectors, such as real estate and distribution, which hold the potential for quick returns on assets. As is expected, this is a rational choice by bankers. However, the corollary to this process has been the neglect of adequate financing for important activities that holds great potential for boosting growth and creating employment.

<sup>16</sup> See Worrel, Delisle, "Bank Behaviour in Small Open Economies", Central Bank of Barbados, October, 1996.

<sup>17</sup> The interest rate spread is the difference between the deposit rates of interest and the loan rates.

Of signal importance, is the fact that privatisation has not led to any major breakthrough in the provision of equity finance for green-field investments. What this means is that new entrepreneurs, inventors and innovators lack adequate capital to carry through their plans. By contrast, in the United States and Europe, privatisation and liberalisation of the banking sector led to a mushrooming of equity, merchant banks and other term finance institutions to provide the long-term growth capital requirements of these countries. But in the Caribbean, as a whole, the unlocking of market incentives has led largely to burgeoning retail banking and attendant innovations in this area of relatively short-term financing. Moreover, the significant risk aversion of the regional commercial banking sector persists in the post-liberalisation period. Therefore, one finds the major anomaly of a significant portfolio in real estate that is profoundly risky, but little term finance for potentially viable projects in agriculture and small-scale manufacturing.

## **VII. Institutional restructuring and mergers and acquisitions**

A decade ago, there was very little foray into the regional financial market by banks, insurance companies and other financial institutions in the Caribbean. Financial institutions were at a relatively nascent stage in their development. Consequently, they lacked the requisite economies of scale, technical and managerial competence to establish successfully in the regional market. Moreover, the market and institutional barriers to the free movement of capital compounded weaknesses at the level of the firm. Important among the constraints to the free movement of capital was State domination of some banks and a reluctance to accede to regional participation by a number of privately owned financial institutions. With increased global competition and the move towards a more universal type of banking, offering an array of services, Caribbean financial institutions have become more amenable to accepting capital and expertise from other regional institutions in order to enhance their competitiveness and profitability. This has led to a number of mergers and acquisitions in the regional financial sector in recent times.

Similar to Europe and North America, mergers and acquisitions in the Caribbean have been driven by the goal of firms to achieve economies of scale and scope, to increase market share and power and to strengthen competitiveness to ensure the longevity of the institutions. Undoubtedly, the overarching processes of globalisation and liberalisation have provided significant impetus to mergers and acquisitions. The rapid spread of information that has resulted from globalisation has allowed regional firms to learn from experiences of firms in foreign countries. This has led to the adaptation of some of the practices of financial institutions in Europe and North America to the Caribbean setting. These include universal banking, involving commercial banking, investment and other financial services, bancassurance that entails banking and insurance services in the same banking institution and other such services. Also, as shareholders have become more sophisticated and have demanded better returns on equity, financial institutions used mergers as a vehicle for improving return on assets.<sup>18</sup>

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<sup>18</sup> See Harewood, Ainsworth, "Opening Remarks," in "Mergers and Acquisitions in the Caribbean Financial Sector," CCMS, 1997.

The experiences of individual Caribbean countries with mergers and acquisitions in the banking sector display certain broad similarities and also differences based on peculiar characteristics of countries. The similarities relate largely to motivations for mergers, which were generally reactions to increased competition and the fear of being overrun by foreign mega-financial institutions and the quest for improved economies of scale and reductions in operating costs. On the other hand, differences relate to the mode of the merger process in individual countries and the success of the process in terms of the attainment of objectives.

In Trinidad and Tobago, the merger of three indigenous banks, namely the Workers Bank, the Trinidad Cooperative Bank and the National Commercial Bank, to form the First Citizens Bank in 1993 provided a major impetus to mergers and acquisitions. Previously, these indigenous banks which advocated a more developmental role took greater risks in lending to sectors, such as agriculture and manufacturing, that led to relatively high loan delinquency ratios. The merger was, therefore, aimed at enhancing their viability by operations that were on strict commercial terms. This underscores the delicate tradeoff that is often required in the Caribbean between strict commercial operations and development credit to small indigenous business, for instance. In keeping with the movement towards universal banking, a commercial bank, the Royal Bank of Trinidad and Tobago, acquired a significant shareholding in the insurance company, Guardian Life, to provide “bancassurance”. Similarly, Colonial Life Insurance Company (CLICO) secured a major stake in the shareholding of Republic Bank of Trinidad and Tobago. While bancassurance can provide a larger pool of investment funds, it holds certain risks since insurance funds provide cover against risks, and are not strictly investment funds. Also, banks could be negatively affected by unsecured connected lending. Therefore, investment decisions using insurance premiums need to be matched by strongly prudential and regulatory safeguards.

In recent years, financial institutions from Trinidad and Tobago, having achieved critical mass in the local market have moved to acquire a number of firms on the regional market. To a large extent, this reflects limited scope for organic growth in the domestic market and weaknesses in some regional financial institutions that made them prone to takeover bids. The Royal Bank of Trinidad and Tobago, for example, had branch operations in over 10 Caribbean countries by 1999. The Royal Bank has fully acquired (100 per cent shareholding) of a number of banks in these countries. Indeed, the total assets of the Royal Bank of Trinidad and Tobago in the Eastern Caribbean in 1999 were over EC\$702 million. In fact in its quest for geographic and portfolio diversification in the region, the bank has become a “regional multinational” corporation. Republic Bank of Trinidad and Tobago has also become a transregional corporation with branches in a number of Caribbean countries.

Mergers and acquisition activity in Jamaica has reflected financial sector performance and susceptibility to leveraged buyouts. In 1996, there was a merger between the National Commercial Bank and the Mutual Security Bank. This involved the exchange of share and assets of about J\$400 million. Although this was an amicable



merger, Jamaica was to experience a number of relatively hostile takeovers in the wake of the financial crisis that occasioned the formation of FINSAC in 1997. Further, a number of banks, including Citizens Bank Limited, Eagle Commercial Bank and Workers Saving and Loan Bank, among others, were merged to form Union Bank of Jamaica in 1999, with assets of over J\$25.9 billion. Union Bank was acquired by the Royal Bank of Trinidad and Tobago in 2001.

The proposed merger of the Caribbean operations of Barclays Bank and the Canadian Imperial Bank of Commerce (CIBC), to be based in Barbados, should be of considerable interest for the region. The merger which is likely to be approved by regulators, will create a new institution - First Caribbean International Bank (FCI) with total assets of US\$9.9 billion. This will make it the largest financial institution in the Caribbean. Both Barclays and CIBC will each have a 45 per cent shareholding in FCI, with the remaining 10 per cent allocated for institutional and individual investors. FCI is expected to have branches in 15 Caribbean countries, making it one of the largest branch banks in the region. As noted by one regional politician, it was unfortunate that the regional indigenous banks did not lobby harder to be get a stake in the merger. This could have made available to them the technical, financial and managerial expertise of these well-established banks and contributed substantially to the performance and competitiveness of the regional indigenous banks. However, this merger needs to be viewed with caution because of its implications for concentration in the banking sector and its potential adverse impact on competition and consumer welfare. This might be offset to some extent by economies of scale and scope and reduced operating costs, part of which could be transferred to customers as lower administrative and interest charges. Notwithstanding this, indigenous banks that will have to face greater competition will face increased competition and will have to restructure their operations to survive. Other smaller mergers include the acquisition of NBIC in Guyana and NCB Grenada by Republic Bank of Trinidad and Tobago and the acquisition of the Grenada Bank of Commerce by Royal Bank of Trinidad and Tobago.

### **VIII. Strengthening of prudential and regulatory standards**

Economists have long noted the importance of properly sequencing financial sector reform and liberalisation. The fairly well received view is that macroeconomic stability, in terms of variables such as price, exchange rate and money supply growth, and fiscal reform and consolidation, should precede the full-fledged liberalisation of the capital account. Also, improved supervision and regulation should be put in place to prevent bank failures and adverse contagion in the financial sector. Unfortunately in a number of Caribbean countries, including Jamaica, the Netherlands Antilles and Trinidad and Tobago, improper sequencing of reforms and regulation led to bank failures that impacted negatively on the financial sector for some time.

The Central Banks in most Caribbean countries undertake the regulation and supervision of the financial system. In the OECS countries, however, the Ministries of Finance perform the regulatory function, while the regional central bank - the Eastern

Caribbean Central Bank (ECCB) - undertakes the supervision of financial institutions. In most countries, supervision and regulation at the country level for the commercial banks is fairly adequate. The real problems relate to the non-bank or near bank institutions and harmonisation of the regulatory framework at the regional level.

Liberalisation and privatisation in the banking sector have provided an incentive for the formation of a number of non-bank financial institutions seeking to take advantage of the more liberal market environment. Important among these institutions are the finance companies, credit unions and building societies. Regulators have always tried to arrive at a harmonious balance between the need for adequate regulation of these institutions, while ensuring that regulation does not act as a disincentive to business activity. However, the relatively low technical reserve requirements for these non-bank institutions compared with commercial banks put the former in an advantageous position and led to their rapid growth. This could lead to a serious case of the moral hazard problem where weak regulation encourages non-bank institutions to engage in risky lending in real estate and other areas, leading to the collapse of some of these institutions. In fact, these forms of high-risk lending practices that resulted in a number of insolvent financial institutions contributed importantly to the Asian Crisis.

In spite of liberalisation and privatisation in the financial sector in the region, a number of outstanding reforms are required to strengthen the banking system. In the first place, the technical reserve requirements of the non-bank institutions need to be the same as for commercial banks, thereby eliminating arbitrage in favour of the non-banks. Some countries have moved in this direction, but the process is incomplete. In addition, the regulatory and supervisory systems for the non-bank financial institutions need to be properly upgraded, especially to monitor off-balance sheet liabilities that could lead to insolvency. All logic suggests that, like the commercial banks, these institutions should be regulated by the central banks, which already have reputable machinery in place to do the job. Further, there is need for greater coordination among the regulatory bodies. However, regulation must be flexible enough to cater to the special needs of these institutions, especially given the fact that they cater to small depositors and enterprises that often do not have access to larger commercial banks.

At the wider regional level, there is a clear need to adequately provide for regulation that can be classified as a “regional public good.” Some progress has been made in this area, but much remains to be done. Importantly, most countries have adopted the Basle Committee Standards on regulation and prudential supervision of the banking system. However, there is still need for harmonisation of standards and systems in some areas. For example, most countries now classify loans as non-accrual loans once they are over 90 days due. However, there is a serious lack of uniformity in the region in classifying loans as ‘doubtful’ or ‘lost.’ This is a major aberration since proper and timely loan loss provisioning is essential to the transparency of banks’ balance sheets.

Fortunately, commercial banks in most countries of the region now adhere to a number of prudential regulations. These regulations are aimed at reducing systemic risks in the banking operations through capital adequacy requirements to prevent overexposure

of banks. An important measure is the limits both on loans to a single borrower and concentration on a class of customers. These mechanisms are complemented by minimum solvency standards, powers of inspection and obligatory requirements to report annual income statements and balance sheets. Structural regulation measures are used to confine banks to banking activity and to prevent ventures into risky non-bank lending. This is crucial for maintaining the integrity and solvency of the banking system. However, by imposing high entry standards, these measures could aggravate concentration in the industry.

In the wake of the Asian Crisis, more pressure has been brought to bear on Caribbean financial institutions to maintain high regulatory standards. An important lesson from the crisis is the need to safeguard the banking system from short-term, speculative capital flows. Although the financial crisis in Jamaica was due to underlying, poor lending practices and weak regulation and not speculative capital flows, improved regulation and supervision are still vital. This requires higher standards of disclosure of information on the banks' true exposure to short-term international borrowing supported by enhanced macroeconomic management. Importantly, Jamaica has moved to strengthen prudential regulations, including the reporting of loan losses and forensic audits.

Although not often discussed in the same vein as the domestic banking system, off-shore banking, which has grown in importance in the region, has serious implications for the domestic banking sector. Lax regulation of off-shore banks could encourage money laundering and other unscrupulous practices that could taint both the off-shore and 'onshore' banking industries. In fact, the Organization for Economic Cooperation and Development (OECD) Harmful Tax Competition Report has underscored the need for the region to tighten regulation of its off-shore jurisdiction to avoid OECD retaliatory action. Although the OECD's stance was somewhat harsh, in that tax competition is a world-wide practice, the region needs to maintain the integrity of its off-shore sector. The Caribbean Financial Action Task Force (CFATF) has designed a number of guidelines to combat money laundering and other malpractices in the off-shore financial services sector. For example, under the Money Laundering Prevention Act, a person who engages in a transaction that involves money or property that is the proceeds of a crime is guilty of an offence and can be subjected to a minimum term of imprisonment.

## IX. Conclusion

Privatisation was an important component of the reforms that Caribbean countries undertook in the latter part of the 1980s and 1990s to liberalise and open up their economies to competition and enhance competitiveness. Indeed, privatisation must always be assessed alongside other liberalisation measures, such as interest rate liberalisation, capital account liberalisation, prudential regulation and competition policy.

At the outset, the banking sector was a prime candidate for privatisation because of its important role in the economy and the perception that it was a cardinal market activity. As expected, the privatisation process became most widespread in countries such as Jamaica, Guyana and Trinidad and Tobago, where State ownership of commercial banks and other financial institutions was most entrenched. An important example of privatisation in the banking sector included the complete divestment of the full 100 per cent of the shares of NCB Jamaica by 1993 through placements on the stock exchange. Other notable examples of privatisation were the Guyana Bank for Trade and Industry and the National Commercial Bank in Trinidad and Tobago.

Generally, the privatisation of financial institutions led to a significant improvement in performance. Therefore, from the standpoint of improvements in price-based efficiency, privatisation seems to have been beneficial. Similarly, privatisation was also associated with product innovation in terms of ATM machines, debit cards and improved customer service and convenience. One crucial drawback of privatisation, however, has been increased concentration in the banking sector in some countries, such as Jamaica, Trinidad and Tobago and possibly Barbados, with the expected merger of Barclays Bank and CIBC to form First Caribbean International which will be the largest bank in the region. Moreover, privatisation has done little to address microeconomic inefficiencies in the banking sector that lead to relatively high operating costs and wide interest rate spreads.

The recent spate of mergers and acquisitions in the region has also increased the market power of large banks. While this might enable these banks to benefit from important economies of scale, reduced competition in the industry could adversely affect consumer welfare. Caribbean bankers have argued that regional mergers are essential to the survival of indigenous banks in the wake of international competition. Although this argument is legitimate, too great a concentration of market power is equally disadvantageous. In light of mergers and also to provide for a sound financial system generally, regulation and supervision mechanisms need to be strengthened and brought in line with the times.

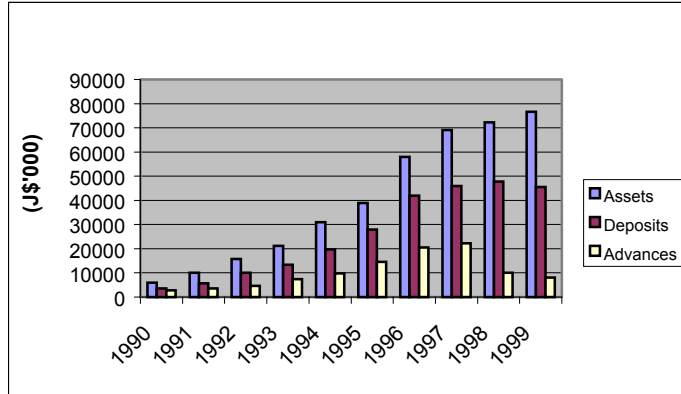
In addition, privatisation and liberalisation have led to increased financial deepening in most countries where these processes were entrenched. This led to increased growth in the broad money to GDP. However, the evidence seems to point to joint causation, with money influencing economic growth and growth leading to greater accumulation of monetary liabilities. Importantly, privatisation has not led to any

significant change in the structure of the banking system, with retail banking still predominating and weak credit allocation to vital sectors, such as agriculture and small industry. This stems in part from the inherent conservatism and risk aversion of commercial banks and the lack of capability of small entrepreneurs to develop proper formal projects to present to the banks. Fortunately some alternative financing mechanisms, including development finance institutions and small enterprise development agencies, have helped to fill the gap in small enterprise financing.

In general, privatisation should not be seen as a panacea for the weaknesses of the banking system, but must be strengthened by adequate regulation and institutional capacity building to enhance the contribution of a liberalised financial system to growth and development.

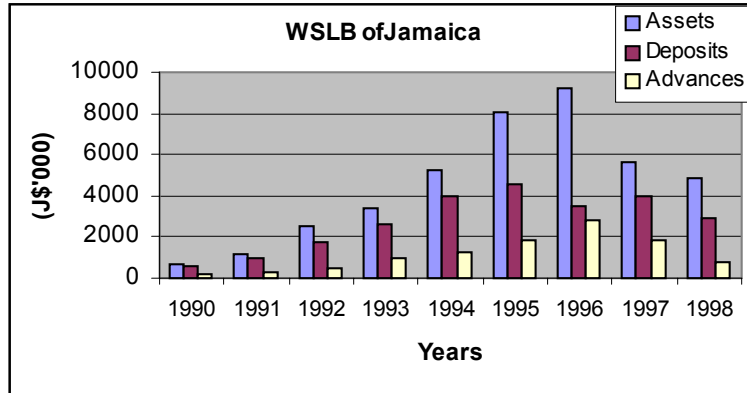
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Figure 6: NCB Jamaica



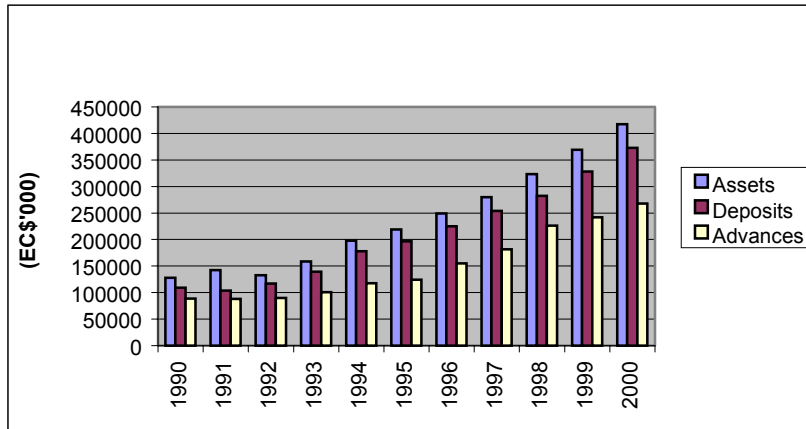
Source: Bank of Jamaica, Prudential Returns, Various years

Figure 7: WSLB of Jamaica



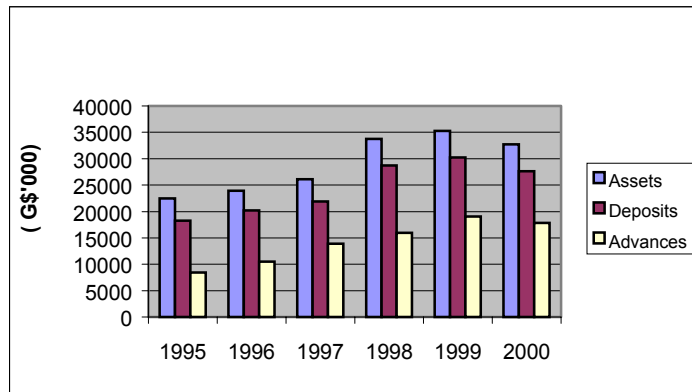
Source: Bank of Jamaica, Prudential Returns, Various years

**Figure 8: NCB Grenada**

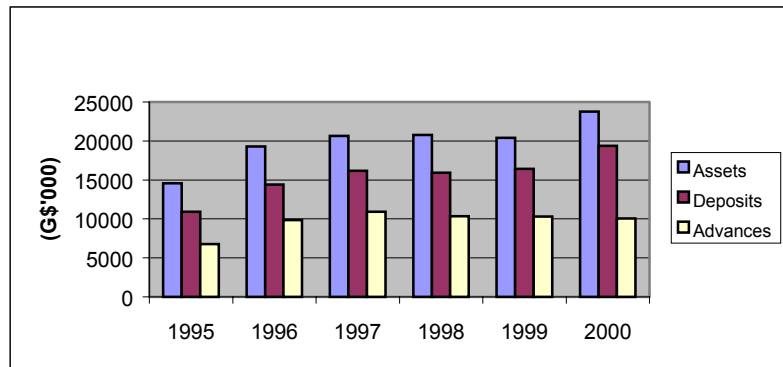


Source: Annual Report of NCB Grenada, Various Years.

**Figure 9: NBIC-Guyana**



Source: Annual Report of NBIC, Various Years.

**Figure 10: GBTI –Guyana**

Source: Annual Reports of GBTI, Various Years.



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