Ewart S Williams: Some reflections on the regional banking system

Luncheon address by Mr Ewart S Williams, Governor of the Central Bank of Trinidad and Tobago, at the Financial Institutions Conference "General Financial Sector Issues and Policies", Bridgetown, Barbados, 3 November 2011.

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I would like to thank Governor Worrell for his invitation to address this Seminar. I would also like to congratulate the Central Bank of Barbados for organizing this Seminar which, based on this morning's proceedings is an excellent forum for the exchange of views and for building trust between the Central Bank and the financial sector.

Governor Worrell invited me to speak on whatever topic I wished. Accordingly, I think it is only fair I state at the onset that ***"the views expressed do not necessarily reflect those of my Host."***

It's no secret that the last few years have been a difficult time for the financial services industry all over the world.

In the US, some four years after the financial system faced the greatest crisis in close to a century and after a significant official support, including bouts of quantitative easing, ***banks are still in the process of repairing their balance sheets*** (and remain very vulnerable).

In the Eurozone, sovereign risks have spilled over to the banking system as contagion spread from Greece to Ireland and Portugal and more recently to Spain, France and Italy. Many European banks that are holding risky and volatile sovereign debt are now facing major difficulties.

An agreement reached among EU members late last week calls for banks to accept a 50 per cent principal haircut on Greek sovereign debt with EU Governments providing up to euro 100 billion in loans to help re-capitalize weak banks.

You may have seen that yesterday a major financial institution had significant exposure to EU, sovereign debt went belly-up, underscoring the close links between the US and European banks and the vulnerability of US banks.

And then there is the "Occupy Wall Street" movement which began in New York and has since spread to 70 major US cities as well as throughout Europe. What started as an expression of discontent with income inequality and corporate greed has now expanded into a more general concern about all the ills plaguing the US economy and other advanced economies. Dissatisfaction with the banking industry stands at the heart of the protests. Banking corporations are seen as being increasingly insensitive to the plight of the average customer and overly focused on their bottom line.

Some of you may have read that in September, Bank of America decided to charge customers US$5 per month to make purchases via debt cards. Viewed as a source of customer irritation, client reaction was swift and decisive with large numbers of customers moving their accounts to institutions with less onerous fee structures, such as credit unions.

Fortunately, our regional banking system is in far better shape and enjoying a much greater degree of consumer trust – at least, we hope so.

The regional banking system demonstrated remarkable resilience to the international financial crisis, thanks to the banks' conservative operating policies which left them with limited, if any, exposure to the type of toxic assets that contaminated the balance sheets of the banking system of many of the developed countries. Also, the loan portfolios of our banks were largely funded from domestic deposit mobilization with little exposure to wholesale financing from external sources.

There is the argument in some quarters that the international financial crisis was one of several factors that contributed to the collapse of CL Financial and the Stanford Bank. While this may be true, the demise of these institutions was in the main self-inflicted.

Several macro-prudential indicators paint a fairly robust picture of the regional banking system.

I have sought to show these indicators in comparison with those of the advanced countries in a few slides. I am fully aware of the problems with inter-country comparisons, but I believe that even allowing for definitions and other differences the data provide an interesting picture ……

(i) Table 1 shows that the regional banking system is more than adequately capitalized. Banks in the region maintain capital adequacy ratios in a range of 15 to 20 per cent way above the statutory minimum of 8 per cent. In Trinidad and Tobago the average is 27 per cent.

(ii) Table 2 presents indicators of the profitability of the regional banking sector. ***While profitability, measured both by return on assets and return on equity has declined somewhat*** since the international financial crisis, ***by and large, the regional banking industry is still very profitable*** by international standards. The Trinidad and Tobago banks more so. According to the data Barbadian banks have faced a sharp decline in profitability, as measured by "return" on equity.

A recent article in Latin American Markets Monitor predict ***"tough years ahead" for the banking system in Barbados*** given the rising level of non-performing loans and the expected weak economic recovery. I don't subscribe to an overly pessimistic outlook for the banking system in Barbados. Though I agree that there could be challenging times ahead.

One of the factors behind the "weakening" of the regional profit picture is clearly the sharp increase ***in loan delinquency*** rates which is now apparent, throughout the regional banking system.

As shown in Table 3, here in ***Barbados*** the loan delinquency rate has increased three-fold from around 3 ½ per cent to 10 ½ per cent of total loans.

In Trinidad and Tobago, the relative increase in loan delinquency is even larger – from 1 per cent in 2008 to over 6 per cent currently.

The non-performing loan ratio ***has also risen sharply in Jamaica*** – from a little over 2½ per cent to close to 8 per cent of total loans.

And while we don't have a consistent series for the ECCU, the 2011 IMF Staff Report indicated that ***aggregate NPLs measured 9.6 per cent in June 2010, but were higher for the indigenous*** banks, also ***an issue in the ECCU as provisions cover less than 30 per cent of NPLs. ECCU banks were also heavily exposed to general government debt (to an extent of almost 30 per cent of regional GDP) concomitant with the rise in public sector debt*** and while some of these loans are not being serviced … they are not classified as non-performing.

But even this relatively comfortable macro-prudential picture begs the question as to ***whether our regional banking system should not be making a greater contribution to regional economic development***. I think it should be and I also believe that over the next few years, if we are to enhance our economic viability, our banking system will need to be more innovative and even more supportive than it has been in the past, to our developmental efforts.

As I noted, our Caribbean economies are still digging themselves out of the global crisis of 2008 and unfortunately the recovery of the region is lagging behind that of other developing countries.

According to the World Bank statistics, in 1980, the Caribbean's average per capita income was twice as high as the average for developing countries; today it is only a third higher. Countries in the region have been growing at an average rate of 2 per cent per year while other small island states have been growing at an average rate of 3.6 per cent per year, roughly the average for the world economy.

Unfortunately, as we seek to reverse this trend and address the challenge of long-term viability, ***the region faces the reality that it has lost some comparative advantage at a time when the global economy has become less friendly***. The following examples are worth noting:

(i) First, the traditional preferences for bananas and sugar have ended but the region still finds itself unable to compete with lower-cost producers;

(ii) Second, foreign aid flows to the region (with the exception of Haiti) have all but dried up and FDI has been declining;

(iii) Third, while Caribbean tourism continues to be a viable brand, the ***region is facing stiffer competition from stay-at-home tourism*** in both the US and Europe and will experience even greater competitive pressures when Cuba is fully opened up (as it could in the not too distant future); and

(iv) Fourth, the prospect of continued high unemployment in the US and the UK for the next 2–3 years will have implications for workers' remittances which are very important to some Caribbean economies.

To add to these exogenous factors, most countries in the region already have unsustainably high public debt burdens, which limit the extent to which government spending could lead the recovery.

Some of my countrymen would like to argue that Trinidad and Tobago represents a variation of this theme, given our energy resources, our stronger public finances and our much lower public debt burden which gives us more room to manoeuvre. ***I warn them to be careful about pushing this argument too far since:***

(i) our ***proven*** energy reserves are fast dwindling (though some experts think that prospects for new discoveries are high);

(ii) our fiscal space is being steadily consumed, the more the private sector activity remains subdued and government steps in to lead the recovery; and

(iii) three years of fiscal deficits and the CLF/CLICO bailout are taking a heavy toll on our public sector indebtedness.

The slow recovery of the Caribbean economies is mainly due to the challenges being faced by the regions main export markets – the U.S and Europe. The conventional wisdom is that over the medium term, growth in these traditional markets would continue to lag behind the more dynamic emerging market economies – China, India and Brazil. ***According to this thesis a greater diversification of regional exports of goods and services towards these new growth poles would make regional economies less vulnerable to the kinds of shocks experienced in the past few years***. This, combined with the establishment of greater regional linkages would seem to be a desirable medium-term economic strategy for our regional economies.

With limited fiscal space and with uncertain prospects for foreign direct investment, the private sector would need to play an enhanced role, supported by ***innovative financing mechanisms. And herein lies the challenge for our regional banking system***.

Available data suggests that compared with the more dynamic emerging market countries banking services in our region are relatively high cost and inefficient.

For example, total operating costs for banks in Trinidad and Tobago average about 6 per cent of total assets compared with under 2 per cent in the EU and 3 per cent in the US and about 4 per cent in most emerging markets. Yet, the rates of return in assets and equity for Trinidad and Tobago banks are considerably higher than international norms.

The greater profitability of the local banks is related, inter alia, to the high interest margins. In Trinidad and Tobago the data show that these margins increased from 7 percentage points in 2004 to 10 percentage points in 2009, before declining to 9 percentage points in 2010. ***Barbados has the lowest interest margins at around 6 ½ percentage points.***

The relatively high cost of banking in the region is certainly related to its small scale but also has to do with the limited exploitation of new technologies and the oligopolistic structure of our banking market which limits competition, allowing banks to maintain their profitability without increasing efficiency.

My banking colleagues always remind me that as Regulator I should be pleased when banks make profits instead of having to show losses, and ***I fully agree***. Clearly the large margins are excellent for banks' bottom line, and for bank shareholders but there is a difference between private and social rates of return and particularly, going forward, where banks would be critical to the diversification effort, we need to seek a better balance between one and the other.

In the long term, a diversified economy that facilitates a steady and sustainable rate of growth is better for banking than an economy of anemic growth or stagnation.

Our banks have also been somewhat slow to embrace technology than perhaps they should. Thus, for example, while transactions volumes have been increasing, electronic banking remains rudimentary in Trinidad and Tobago and has not yet started to produce major cost savings for the banks. Our investigations suggest that the still limited acceptance of e-banking has to do with concerns about security, quality of internet connection and a general lack of awareness about internet banking. A recent survey revealed that 75 per cent of those questioned were familiar with debit cards, while only 22 per cent were familiar with internet banking and 27 per cent with tele-banking.

It is noticeable that not only individuals, but businesses and the public sector are still slow to adapt to the electronic environment. If I could cite another example from our experience. The Central Bank, in collaboration with the banking system, has invested considerable resources to establish electronic payments systems – the Real Time Gross Settlement System (RTGS), for large value transactions, and the Automated Clearing House (ACH) for small transactions. However, the transition from cheques (and other paper-based systems) to electronic payments has been very slow even after having sought to advertise the advantage of using electronic payments and have imposed a $100 surcharge on large cheques.

The good news is that the government is now taking steps to change the long outdated legislation to ***facilitate electronic payments*** on its own account. Hopefully, this should set the example and provide the necessary incentive for the private sector to do likewise.

A few words on banking and the consumer.

It is widely agreed that the last decade or so has seen a rapid acceleration in the pace of product innovation in the financial services industry, due in large measure, to advances in information technology. The challenge posed by the proliferation of new financial products and service delivery models, has prompted many jurisdictions to scale up financial education and consumer awareness and to increase emphasis on consumer protection.

In the aftermath of the crisis, in addition to the Dodd-Frank Wall Street Reform, intended to guard against financial instability, the US Government enacted the Consumer Protection Act and created the Consumer Financial Protection Bureau to ensure that markets for financial products and services operated in a fair, transparent and competitive manner and were subject to meaningful oversight.

In the UK, the Financial Services Authority has outlined a new consumer protection strategy aimed at (i) making retail financial services operate better for consumers; and (ii) facilitating the delivery of prompt and effective redress as needed.

In 2003, the Central Bank of Trinidad and Tobago, in collaboration with the commercial banks set up an ***Office of the Financial Services Ombudsman*** to deal with specific complaints by customers against banks (and later against insurance companies). Interestingly enough, perhaps the major impact of the Ombudsman's office is the fact that it has served as a catalyst for commercial banks to upgrade their internal dispute resolution mechanisms to better address complaints before they are allowed to reach the Ombudsman's office. Because of this success the number of complaints against banks currently handled by the Ombudsman's office has declined from a high of 156 in 2004 to about 20 in 2010.

I should note that the Ombudsman's terms of reference do not cover the fees, commissions and interest rates charged by banks. I should note also that the level of fees and commissions remain a principal area of complaints and irritation for bank customers.

Our bankers insist that fees and commissions charged by banks in Trinidad and Tobago are the lowest in the region. If that is correct the level of these fees in Barbados may also be a problem, as indeed they are in Jamaica.

The Central Bank in 2007, also launched (in collaboration with the Central Government and the financial sector) a National Financial Literacy Programme (NFLP) aimed at increasing the level of financial education and awareness of the population. The programme which has been funded by donations from stakeholders has targeted primary and secondary schools; small and micro-businesses; employees in the workplace and community groups. Under the NFLP, the Central Bank has launched a national campaign entitled "Savings for Retirement" and is promoting retirement planning in many communities.

The issue of ***consumer protection*** in the financial services industry is, surprisingly, not a contentious one with some bankers insisting on the free play of market forces and competition. The fact is however, that particularly in small economies like ours, ***where sheer size constitutes a barrier to entry and where there are information asymmetries***, there is a case for the Regulator to intervene to insist on adequate disclosure and to provide some level of protection for the most vulnerable groups.

The challenge is therefore to balance regulation, competition and financial education to achieve the twin objectives of financial stability and consumer protection.

Let me say a few words on financial regulation in the region.

It is a fact that the evolution of the financial sector in the region has outpaced that of the regulatory system. The gaps have been widest in the areas of insurance, credit unions and securities regulations but we are also lagging in respect of bank supervision which is our strongest forte.

I know that many regional jurisdictions are currently in the process of upgrading financial legislation.

In Trinidad and Tobago we recently enacted a new Financial Institutions Act and are about to send a new Insurance Act to Parliament.

As regards supervision our supervisory authorities have taken the initiative to establish a regional Colleges of Regulators to more effectively supervise the international banks that operate in multiple territories.

Our regulators are now working on a Regional Crisis Management Plan that would inter alia:

(i) seek to enhance information-sharing among regulatory authorities;

(ii) introduce a regime of macro-prudential indicators and a framework to be used as ***an early warning system for an emerging crisis***; and

(iii) formulate agreed strategies for the timely and orderly intervention into the affected institutions so as to limit the impact on the regional financial system.

While we can never rule out another regional financial crisis we can certainly be more prepared than we were, when it happens again.

Let me end where I started with reference to the movement – Occupy Wall Street – I think there is a message there for us (and I think that public reaction to the Clico crisis underscores this message). The message is that banks and other financial service industries have a responsibility to the country's development and a sacred obligation to consumer well-being, even as they keep an eye on their bottom line.

I think that regional regulators need to listen to and be responsive to the voices of consumers of financial services if trust in the regional financial system is to be maintained and strengthened.

Thank you.

Table 1: Capital Adequacy Indicators

/Per Cent/

	2006	2007	2008	2009	2010	2011*
	Regulatory Capital to Risk Weighted Assets					
Barbados	14.4	16.4	16.1	17.5	17.1	n.a
Guyana	15.4	15.0	14.9	18.3	18.9	20.0
Jamaica	16.1	14.5	13.9	18.3	17.2	16.3
Trinidad & Tobago	18.0	19.0	18.8	20.5	24.2	27.0
US	13.0	12.8	12.5	13.9	14.8	15.0^
UK	12.9	12.6	12.9	14.8	15.9	n.a
Eurozone#	9.7	8.7	12.2	13.3	14.4	n.a

Source: Financial Stability Report 2010, Central Bank of Trinidad and Tobago; IMF; ECB.
*As at June 2011 ^ As at March 2011 # Tier 1 capital to Risk weighted assets (Average)

Table 2: Indicators of Bank Profitability

/Per Cent/

	2006	2007	2008	2009	2010	2011*
	Return on Assets					
Barbados	2.0	1.7	1.4	1.6	1.3	n.a
Guyana	0.5	0.5	0.5	0.7	0.6	0.5
Jamaica	3.5	3.5	4.1	3.4	2.8	0.5
Trinidad & Tobago	3.4	3.4	3.5	2.7	2.3	3.1
US	1.3	0.8	0.3	0.2	0.2	0.3^
UK	0.5	0.4	-0.4	0.1	0.1	n.a
Eurozone	0.8	0.7	0.2	0.2+	0.8+	n.a
	Return on Equity					
Barbados	17.9	18.8	16.1	16.2	11.7	n.a
Guyana	6.9	6.8	6.3	6.7	6.1	5.1
Jamaica	n.a					
Trinidad & Tobago	25.2	27.7	25.9	20.2	17.2	19.5
US	12.3	7.8	3.3	1.8	1.8	2.3^
UK	8.9	6.2	-10.3	2.6	1.0	n.a
Eurozone	14.6	11.7	-14.7	0.3	6.8	n.a

Source: Financial Stability Report 2010, Central Bank of Trinidad and Tobago; IMF; ECB.
*As at June 2011 ^ As at March 2011 + Return on risk weighted assets (Average)

Table 3: Non-Performing Loans

/Per Cent/

	2006	2007	2008	2009	2010	2011*
	Non-Performing Loans to Total Loans					
Barbados	4.5	2.9	3.4	7.2	10.7	10.3
ECCU1/	7.0	5.8	7.9	7.5	9.6^	n.a
Guyana	11.5	10.6	5.3	8.3	6.5	5.1
Jamaica	2.2	2.0	2.6	4.2	5.4	7.9
Trinidad & Tobago	1.6	1.1	1.0	4.6	5.3	6.3
US	0.8	1.4	2.3	5.0	4.4	4.4
UK	0.9	0.9	1.6	3.5	4.0	n.a
Eurozone	1.8	1.7	2.3	5.2	6.8	n.a

Source: Financial Stability Report 2010, Central Bank of Trinidad and Tobago; IMF Staff Report: St. Lucia 2010; ECB.
*As at June 2011. ^ As at March 2011.
1/ Excludes Montserrat and Anguilla.

Table 4: Interest Rate Spreads* in Selected Countries

/Percentage Points/

End of Period	United States1/	Trinidad & Tobago	Jamaica	Barbados	Guyana
Dec-09	3.84	10.06	16.6	7.01	11.4
Mar-10	3.77	9.89	17.4	6.99	12.4
Jun-10	3.73	9.54	16.8	6.89	12.5
Sep-10	3.70	9.31	16.1	6.76	12.5
Dec-10	3.57	9.08	17.5	6.7	12.4
Mar-11	3.54	8.77	16.16	6.45	12.5
Jun-11	n.a	8.68	n.a	6.6	n.a

Source: BOJ, CBTT, Bank of Guyana and the Central Bank of Barbados.

**Weighted average lending rate minus weighted average deposit rate.*
1/ Net interest margin.