

DeLisle Worrell: Our financial system – fit for purpose?

Address by Dr DeLisle Worrell, Governor of the Central Bank of Barbados, to the Barbados Association of Insurance and Financial Advisors, Bridgetown, 26 April 2013.

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How well does our financial system suit Barbados' needs? In my address this morning I will examine how the system serves the needs of households and of businesses, and attempt to identify any gaps that should be attended to.

I begin by discussing financial services for households. The main items of household credit are mortgages, and the financing of consumer durables. Households and individuals are well served by banks, credit unions and finance companies, in the provision of financing of housing, durable consumption goods and amenities. Adequate availability of this household finance, on affordable terms, significantly enhances the well-being of the population, which has the benefit of the goods over the period when they are repaying their loans. In an earlier period, before mortgages and consumer credit were widely available, consumers were deprived of the use of goods while they accumulated the funds for cash purchases.

Individuals and households are not as well served when it comes to alternatives for investing their savings. Commercial banks offer poor returns on deposits, invariably below the rate of inflation; the purchasing power of monies left on deposit at a bank is eroded over time. Government paper is the most remunerative financial investment available to individuals. For those with gratuities and large amounts on which they need to earn interest, longer term securities are the best yielding. For those investing funds set aside for contingencies, savings bonds are the best bet. If held to their full term savings bonds carry an interest rate which keeps pace with inflation, and the bonds may be cashed in at any time if needed, albeit with an interest penalty. Credit union shares and deposits at credit unions offer somewhat better returns than at banks, but deposits at credit unions are not yet insured, unlike bank deposits, which are protected up to a value of \$25,000.

Retirement income is vulnerable to inflation

The financial system does not serve the needs of retirees very well because pensions are not adjusted in line with inflation in the typical domestic scheme. In less than a decade after retirement the average pensioner is unable to maintain his or her standard of living at retirement, purely because of the ravages of inflation, unless they have supplementary income. Recent legislation mandating an inflation adjustment is a step in the right direction, but I would like to see a more generous minimum stipulation.

Working capital is no problem for established firms

Working capital financing for well established firms with a solid track record is the bread and butter of commercial banks, along with loans to individuals. These firms have no difficulty in securing adequate bank funding for inventory and other current needs. Interest rate spreads are rather high compared to large industrial countries, but they are about what you will find in other small countries and regions.

Established firms are usually able to secure the financing they need for capital projects and equipment from a combination of sources, with an emphasis on equity and retained earnings. We may infer this from a comparison between identified sources of long term finance from banks, insurance funds and credit unions on the one hand, and annual estimates of capital formation in the country on the other hand. However, among financiers there is an understandable preference for real estate and distribution activity, where perceived risks are lower, and collateral security is more readily available.

The NIS, insurance companies and pension funds are the main sources of long term funds. They need investments which will yield a dependable stream of income over many years. The menu of investment options available to them includes Government securities – the least risky option, investment in real estate (including mortgages), and investment in the production of goods and services – the most risky option. In my view, the most important financial challenge Barbados faces is to ensure the continued growth of these funds, and that a larger proportion of these long term funds is directed towards increasing the country's capacity to produce goods and services. I will return to this issue as I conclude my address.

There should be no scarcity of equity finance for any project which is expected to be sufficiently profitable. If the project is too big to be accommodated by the pool of domestic equity funding, profitable projects will attract foreign direct investment. The challenge for decision makers in Government and the private sector is to present profitable projects to potential investors with convincing documentation and justification.

We should recognise that it has become more difficult to do this, precisely because Barbados has been so successful over time in raising the standard of living of our workers, compared to that of our competitors. As a result, project and operational costs are higher than in other Caribbean countries where workers are not so well off. I believe there is a consensus among Barbadians that we should not take measures that would reduce living standards in Barbados to levels comparable to those in the Dominican Republic and Cancun, for example. Instead we must exploit and develop Barbados' reputation and appeal to the discriminating tourist who will pay a higher price for a more rewarding experience. We must become more adept in demonstrating that potential investments in upmarket projects are eminently profitable, and we must focus our competitive initiatives on countries and areas which serve the traveller who treasures an exceptional vacation experience.

The financing of small business presents special challenges in all economies, not just in Barbados, for reasons that have been aired extensively, and are familiar to all of us. Barbados has borrowed from experiences in the UK and other advanced economies over many years, to establish a variety of funds and support schemes for small business. However, we could unquestionably do a much better job of coordinating services for small business, and channelling finance and support services in ways that are most helpful to each type of activity.

Capital markets have not proven to be particularly useful for small open economies, and very little investment in Barbados has been funded by new issues of stock, over the life of the Barbados Securities Exchange. It has to be admitted that an exchange with as little daily activity as characterises our own, has little potential to contribute to investment in producing goods and services.

All that I have said so far paints a relatively benign picture of the efficiency of the financial services sector, in meeting the needs of Barbadians. However, availability of finance remains number two in obstacles to doing business in Barbados, in the World Bank's Global Competitiveness Index. The reason may be that the sources of available finance do not cover innovation. It is the businesses which aim to break new ground which have difficulty in sourcing finance on terms which they can afford. What such firms need is equity finance, funds from sources which will not expect an immediate return, and can wait until the project becomes profitable. We should give some thought to this problem. It may be argued that there is an adequate supply of funds from sources that are prepared to take the long view, foregoing near-term returns on their investments in exchange for a higher yield over the life of the investment. Insurance and pension funds, for example, may wish to allocate a portion of their portfolio in this way. What they may lack is an appropriate vehicle for channelling those funds in the direction of innovators. The Stock Exchange does not provide such a platform, because innovating firms will not have a track record of success in the intended activity, as the basis for attracting investment in their equity. Investors on securities markets

gravitate understandably toward well established firms with a strong track record in areas with which the investor is familiar. In other words – the antithesis of innovation.

Innovators often complain that commercial banks are reluctant to lend to them. In my view, firms that are breaking new ground should avoid bank debt if possible, because any new activity needs to be generating a reliable on-going stream of income sufficient to meet operational costs, before it begins to take on bank debt, which comes with a monthly service cost. In its infancy the business will not want to deplete its shareholders' equity to service bank debt. Later, when the business is well established, the entrepreneur should have less difficulty securing bank financing for overhead expenses.

It is this disconnect between the financing needs of companies that wish to exploit novel opportunities in areas like cultural industries and green energy, on the one hand, and investors who need long term outlets for their money on the other, that may be the major lacuna in the domestic financial market.

I do not have a ready solution for filling this gap, if indeed I have correctly identified it. I believe the members of your Association would be interested in participating in a national dialogue on this question, because long-term funding is your forte. I am anxious to have your reactions to my thoughts on this matter, and the Central Bank would be willing to facilitate an informed discussion on this question, if there is interest.

To summarise, I believe the financial system serves individuals, households, well-established firms and traditional lines of business very well. However, the further development of our economy requires increasing investment in activities that are innovative in one way or another. I have already mentioned green energy, but there is a myriad of other possibilities related to tourism, international business and finance, and agro-processing. Examples include facilities for sports such as polo and rallying, heritage sites, the production of biodiesel and many more.

For these and similar activities we need to find the appropriate financial channels to overcome the perceived difficulty in securing adequate funding for their implementation.

I invite your suggestions.