Building Resilience in the Guyanese Banking System

By

Dr. Gobind Ganga
Deputy Governor
Bank of Guyana

1.0 Introduction

During the last few decades, a large number of developed and developing countries have reported individual institutional banking problems, systemic banking crises, currency crises and a combination of the last two. The most recent is the subprime mortgage[1] crises in the United States that has had major adverse effects on banks, financial markets and economies and has spread to countries with no apparent vulnerabilities and evolved into a global financial crisis. Banking and currency crises have had substantial impact on the economies of these countries with downturns lasting an average of 2-3 years and costing between 5-10 percent of Gross Domestic Product (Bordo, 2008). The crises have been traced to weak macroeconomic conditions, external shocks, liberalization and model change, weak regulatory and supervisory frameworks, institutional weaknesses and poor internal governance (Demirguc-Kunt and Detragiache, 1997). Historically, the lessons from financial crises suggest that countries with a robust financial and regulatory system, sound macroeconomic environment, fundamental infrastructure requirements and effective banking regulatory principles are likely to minimize future crises and adverse impacts associated with such crises.

The ongoing subprime crises, its origin, impact and contagion effects, suggest that: financial systems, even in developed countries, are prone to periodic breakdown; banking crisis can occur abruptly and forcefully; anticipation of the full ramification of financial crisis is difficult; and there is need for a reassessment of certain principles and practices

[1] This "subprime" mortgage crisis was triggered by a dramatic increase in delinquencies on these risky mortgages which had been packaged into financial instruments and sold off on the capital market.

in financial sector policy making. It seems obvious, that the crisis has originated in the United States, the country considered to have the most sophisticated financial market in the world is telling enough. In addition, the contagion effects were greatest in countries whose supervision of risks has been rated to be the best in the world and which others, including developing countries, have been asked to emulate. Further, the crises occurred during a period of strong world economic growth and low interest rates and the macroeconomic fundamentals suggest that countries affected had the wherewithal to absorbed and cope with adverse shocks. Instead, the crisis resulted in one of the worst recession since the Great Depression of the 1930s, banks bailout of approximately US$1 to US$2 trillion and fiscal stimulus of about US$1.5 trillion

Guyana has been undertaking economic and financial sector reforms since the mid-1980s in response to the economic crisis the country was experiencing during the late 1970s and most of the 1980s. The reform measures were to achieve macroeconomic stability and to create an enabling environment for financial and private sector development. Financial sector reforms have predominantly been in the banking system as the capital market is small and almost non-existent in Guyana. Reform measures included strengthening the Central Bank’s role and responsibility in monetary and banking matters, strengthening the regulatory framework for commercial banking and building institutional capacity within the sector. These have resulted in creditable macroeconomic performance in the wider economy and positive outturns in the commercial banking system where the direct spillovers from the global financial crises on the banking system in Guyana have so far been limited to slow growth in private sector credit, low asset prices and increased risk aversion.

Notwithstanding, given the high linkages among the world's financial firms and sectors as well as inherent risk of financial activities, Guyana's banking system being similar to those of other countries, is not immune to shocks and contagion. Therefore, there should be increased awareness of the vulnerability of the banking system to incipient distress so as to find ways to correct them. It is against the backdrop of banking crises and their underlying reasons that Guyana's banking system is evaluated and policy recommendations are made to build resilience within the system. Section two discusses some of the major causes of financial crises; section three discusses policies to build resilience so as to help to prevent crises; section four discusses banking system reform measures; section five evaluates Guyana banking system soundness through a macro-prudential approach and; section six provides some policy recommendations and concluding remarks.

2.0 Causes of Financial Crises

Financial crisis is a term that broadly applies to a situation in which several financial institutions or assets within a trading space lose a large part of their value. Generally, financial crises are associated with banking crises, currency crises, stock market crashes, sovereign defaults and the bursting of financial bubbles. Two major types of financial crises are banking and currency crises. The former involves insolvency of a large share of the banking system while the latter involves a forced change in parity, abandonment of a pegged exchange rate or an international rescue. They can occur independently of each other but can be a trigger by the other and are mutually reinforcing especially in fixed or semi-fixed exchange rate regimes. Kaminsky and Reinhart (1999) find that banking crises have often been accompanied by currency crises.

Banking crises can occur under a variety of monetary and regulatory regimes and are due to a number of interrelated factors. One view is that banking crises occur as a result of microeconomic structural and institutional problems. Moscow (1998) argued that poor management practices and corporate governance as well as substandard regulation of banks have increased the vulnerability of the banking system because of poor lending practices, excessive risk taking, mismatched of liquidity and the importance of market shares rather than profitability. The consequence is that banks' buffer stocks of capital and liquidity are small in relation to the risk associated with their assets and funding sources (Gavin and Hausman 1998).

Blundell-Wignall, Atkinson and Lee (2008) argued that the current financial crisis originated from distortions and incentives created from past policy actions, poor regulatory framework and weak governance. They posited that the Basel II accord on international bank regulation opened an arbitrage opportunity that caused banks to accelerate off-balance sheet activity with mortgage securitization which carried zero capital weights[2]. The business model based on securitization enabled banks to increase earnings and economize on capital but at the same time increased risk taking. To capture the benefits of this model, compensation had evolved for executives to increase mortgages and hence to subprime borrowers. In addition, other banks found it easy to increase there securitized products to close revenue gaps.

A second view of banking crises is that they arise as a result of liquidity problems when banks failed to deliver funds that the depositors are entitled on demand. Banks' experienced runs when depositors rush to withdraw their deposits because they expect the bank to fail due to real or imaginary solvency problems. This may also arise from excessive external debt and a sudden stop in capital flows.

Another view is that banking crises result from macroeconomic developments which adversely affect banks balance sheets as well as solvency in large parts of the banking system. It is argued that macroeconomic shocks such as a major recession, substantial decline in terms of trade, high fiscal deficits and public debt, excessive lending in times of economic boom, currency crises as well as overvalued exchange rate regimes can create difficulties for borrowers from banks to repay their loans, thus increasing the vulnerability of banks and fostering crises. Recessions, it is argued, can reduce domestic incomes and therefore create difficulties for borrowers to repay their loans in full or on time, thereby threatening the solvency of banks. Similarly, a sharp decline in the terms of trade can reduce the debt servicing capacity of domestic bank borrowers. Fiscal shocks

2 This is explained by the capital weigh given to mortgages that would fall from 50 percent under the Basel I to 35 percent under simplified Basel II. A lower weigh raises the return for a given mortgage while greater concentration is low-capital weighted mortgages improves the overall bank return.

and high public debt can also increase the vulnerabilities of banks through destabilizing increases in interest rates and inflation expectations. High interest payments reduce cash flows of borrowers which may lead to a deterioration of banks balance sheet. Credit booms during macroeconomic expansion often create information and incentive problems for banks that lead to a deterioration of portfolio quality[3].

Currency crises may also lead to banking crisis when banks accumulated large currency exposure based on the belief that there had been little exchange rate risks. When exchange rates collapse, banks suffer large losses due to their currency exposures. A long period of overvalued exchange rates may also affect banks balance sheet through pressure on producers of tradable with distress borrowing and inability to repay loans.

The macroeconomic policy regime of the country when a shock occurs also has implications for the transformation of the shock into a banking crisis. The exchange rate regime at the time of an adverse external shock is quite important as such shocks can reduce the real value of domestic borrowers' assets and the capacity to repay their debt. Under a fixed exchange rate regime, the external shock will not have any effect on liabilities but on assets. The latter will be lower than the former, thereby requiring

[3] This is usually in the form of adverse selection and moral hazard problems caused by information asymmetries. Adverse selection is a problem that arises because of asymmetric information between buyers and sellers of assets before any purchase agreement takes place. Specifically, in financial markets, borrowers (sellers of assets) generally have private information that is more accurate than the information possessed by lenders (buyers of financial assets) regarding the attributes and prospects of borrowers.

Moral hazard problem is said to exist in the context of a financial market if, after a purchase agreement has been concluded between a buyer and a seller of a financial asset, the seller changes his/her behaviour in such a way that the probabilities (risk calculus) used by the buyer to assess the quality of the financial asset are no longer accurate. The buyer of the financial asset is only imperfectly able to monitor this change in the seller's behaviour.

Banks were also accused of making too many bad loans. Moral hazard was also blamed because it was generally accepted that since most banks would be rescued if they ran into trouble, the incentives were created for banks to take on too much risk.

restructuring of banks assets and liabilities. Under flexible exchange rate regime, the adverse external shock is expected to lead to a depreciation of the exchange rate and a write down of the real values of both liabilities and assets.

Blundnell-Wignall et al (2008), argued that the current financial crisis that has the global economy in turmoil was also caused by global macro policies that affected liquidity. Specifically, interest rates at one percent in the United States, zero percent in Japan, along with China's fixed exchange rate and the accumulation of reserves in sovereign wealth funds led to the overflowing of the liquidity reservoir which in turn got the asset bubbles and excess leverage underway.

3.0 Policies to Build Banking System Resilience

The banking system is extremely important in the socio-economic development of countries as the main vehicle of capital intermediation. This in itself provides a strong incentive for avoidance of the massive costs and dislocations associated with banking crises. The lessons for authorities are that crisis prevention efforts should focus on strengthening macroeconomic policies and provision of key infrastructure requirements for maintaining prudent financial institutions, fostering efficient markets and promoting a well functioning regulatory and supervisory structure.

Sound macroeconomic policies are critical to prevent a banking crisis from occurring in any economy. The policies should include stable fiscal policy over the business cycle and non inflationary monetary policy. These policies must be used to promote sustainable economic growth and low inflation. In addition, they should avoid overvaluation of the currency, unstable fiscal and external current account deficits, unsustainable debts and excessive capital inflows.

The provision of key fundamental infrastructure requirements is critical to maintain prudent financial institutions and encouraging efficient markets so as to alleviate banking system fragility. This includes adequate prudential supervision and regulation, a system of laws and rules for corporate governance and property rights. In addition, there should be a uniform set of transparent accounting standards, a set of rules for public disclosure of nonproprietary financial information and a facility that provides for external bank auditors and examiners.

Bank regulatory principles are seen as important for the sector stability. The new approach to banking regulation and supervision is that it should be dynamic and evolving with technology, new competitive forces and new products. One important element is that of capital adequacy standards which should be complemented by large exposures rules. The latter is important to ensure that the cost of leverage is sufficiently high to contain risk taking activities as well as to address risks from an unforeseen event and frequent and large adverse shocks that may cause a bank to incur loss. Liquidity standards are also important to help banks to meet their obligations under conditions of stress, when dealing with contagion problems and when banks are unable to access funds from the interbank market. The building of a sizeable buffer of both capital and liquidity can help banks to withstand shocks that threatened its solvency. Other new tools of prudential regulations are standards on market and foreign currency risks exposure. With respect to the latter, the norm is that net foreign dominated assets may not exceed, in absolute value, 20 percent of capital and reserves

Information generation and disclosure on banks policy, portfolio and performance are critical components of the new regulatory approach. These will provide for better monitoring of the financial conditions of banks and would lead to market discipline. Specifically, the idea is that depositors will avoid weak banks and thus limit their expansion which otherwise might turn into a crisis. Accounting standards and auditing are important in market discipline as they simplify otherwise complex balance sheets and allow for easy evaluation of risks taken by banks.

Globalization and international banking, investments in overseas subsidiaries and branches as well as cross border banking have introduced new sources of risk for banks and economies as the recent financial crisis has demonstrated. The growth of financial conglomerates, hedging transactions and electronic banking has introduced technical difficulties for effective supervision. The new regulatory framework that will emerge will have to cover these new types of operations with appropriate safeguard against contagion arising from international financial market volatility.

Having a strong and efficient financial market infrastructure is imperative to reducing banking system vulnerability, building robust infrastructure and helping to reduce risks from cross border transactions. Financial markets are not only useful for the mobilization of domestic financial resources but for risks pooling, promoting efficient governance and control, facilitating international capital flows as well as enhancing contractual efficiencies and regulatory efficiencies. These require that the role of government be that of a strong regulator and to only deal with problems related to asymmetric information and moral hazard through disclosure and direct surveillance. This will foster an environment of transparency and bolster investor confidence. In this regard, it is crucial that legislation for speedy contract enforcements, debt recoveries and bankruptcy are in place (Haque, 2002). Investments in resilience and risk mitigation are important in the provision of infrastructural services and to avoid market failures.

Efficient exchange and payment systems also play a critical role in financial market infrastructure and hence the importance that there are no unnecessary costs, risk or frictions to trading and post trading processes is necessitated. Appropriate payment system designs can help lower or mitigate the impact of systemic risk. Collateralization, lost sharing rules as well as guidelines to promote efficient liquidity recycling can help reduce systemic risks.

The identification and assessment of major vulnerabilities of the banking system is crucial for building resilience. This can be done through regular financial stability analysis using both micro prudential and macro economic variables. Stress testing is seen as an important step in this regard to highlight liquidity conditions and other tail end risks. These would help lower and contain potential vulnerabilities and threats to the financial system by evaluating the quality of portfolio under various assumptions, especially in the context of the external environment or the so- called contagion risk.

4.0 Guyana’s Banking System Reform Measures

Prior to the reforms that begun in 1988, Guyana’s banking system was characterized as highly regulated and repressed with interest rates controlled, financial resources allocated by government directive to priority sectors, the pursuit of quantitative loan targets, intensive financing of fiscal deficits, entry regulations and strict branching licensing requirements. State-owned banks were highly inefficient and unprofitable. Reform efforts focused on modernising and deepening the financial system and implementing policies to promote a resilient financial sector in line with the International Monetary Fund (IMF) prescriptions. The main elements of financial sector reforms in Guyana can be analyzed under three (3) broad categories: adjustments in the policy framework; improvements in the stability and soundness of the financial institutions; and building institutional capacity in the sector.

(i) Adjustments in the policy framework

The central feature in policy reform was the removal of restrictions on interest rates, credit and foreign exchange transactions, and the introduction of indirect instruments of monetary policy and financial control by the Bank of Guyana. The primary objective was to bring about an improvement in the allocation of funds and to eliminate market fragmentation. A related purpose was to provide an enabling framework, within which banks could operate, keeping in view the principles of viability and sustainability. The overall intent was to improve efficiency standards and productivity in banks.

The move towards interest rate liberalization began in 1989 which saw an almost three fold increase in the level of interest rates in Guyana. In 1991, steps were taken to develop and free the domestic money market with the introduction of regular auctions of government treasury bills. The Bank of Guyana introduced a competitive bidding process for 91-day treasury bills in mid-1991. All other major rates, such as commercial bank rates, rediscount rates; etc was determined and influenced by the market determined treasury bill rates. These started as monthly auctions, which moved to bi-weekly auctions in 1995 and then to weekly auctions in February 1996. The 91-day treasury bill rate has since emerged as the market reference rate, influencing the level of interest rates in the economy. Since interest rate reforms were accompanied with the introduction of prudential norms, a major safeguard exists against ‘adverse selection’, i.e., a desire to lend to higher risk borrowers at high interest rates. Banks are being compelled to take on risk which bears a close relationship with its capital base and financial ability.

Resource pre-emption, through reserve requirements on commercial banks have become a relatively less important instrument of monetary policy in the recent period. In the past, the cash reserve ratios and liquidity ratios had to be maintained, particularly because of the needs for directed credit and financing of government deficits. With reductions in fiscal deficit and the removal of directed credit, the pre-emption of deposits has been partly lowered and not varied much. In mid-1991, reserve requirements on demand deposits were increased from 6.0 per cent to 11.0 per cent and on savings and time deposits from 4.0 per cent to 9.0 per cent. In April 1994, the reserve requirements went up from 11.0 per cent of demand deposits and 9.0 per cent of savings and time deposits to 16.0 per cent and 14.0 per cent respectively, essentially as a measure to mop up excess liquidity available in the system. The ratio has remained at the same level since then. The liquid assets ratio has remained at 25.0 per cent of the banks' demand deposits and 20.0 per cent of time deposits since May 1991.

Reforms in the external sector included the abolition of exchange control and the establishment of a market determined exchange rate system. In 1990, both banks and non-banks (cambios) foreign exchange markets were allowed to operate. Partial convertibility of the Guyana Dollar was introduced during the same year. In February 1991, the exchange rates in the two markets, the banks and the cambios, were unified. The Bank of Guyana, to meet its official reserve targets began inter-bank cambio market operations in 1993. The regime of exchange control was discontinued in December 1995.

(ii) Improving the stability and soundness of financial institutions.

The financial sector reform embraced by Guyana was also aimed at institutional strengthening and modernization of the system. This was brought about by effecting fundamental changes in the legal and regulatory framework with the enactment of the Financial Institutions Act (FIA) in March 1995. This Act requires all institutions carrying out banking and financial businesses to be licensed by the Bank of Guyana and also centralizes the surveillance responsibility over all licensed financial institutions to the Bank of Guyana.

To improve the soundness of the financial system and to allow for greater transparency and accountability in banks financial operations, a major element of the reforms were the introduction of prudential norms and regulations. The norms were aimed at highlighting the true position of the banks' loan portfolios and to help arrest their deterioration. It should be noted that the absence of an effective prudential framework can jeopardize efforts to liberalise the financial sector. Similarly, a proper definition of income ensures that banks take into account only income which has actually been realised. Banks in Guyana now have a clear definition of what constitutes a 'non-performing' asset. Prudential regulations also include norms relating to capital adequacy and a capital risk weighted asset system has been introduced more or less in conformity with international standards. The Financial Institutions Act (FIA) also addresses issues of large exposures, sets limits on investment in non-banking companies, liquidity ratios, minimum capital for the setting up of a bank; allows for licensing of new banks, is clear on what is insider lending; defines prohibited operations, how loans should be classified; and determines provisioning and capital adequacy.

In May 1996, the FIA was amended to promote competition and eliminate concentration of interests in the financial sector. A person who owns or acquires control of a licensed financial institution which accepts deposits is not allowed to acquire control of another such licensed financial institution. In addition, no person is allowed to acquire shares in one or more licensed financial institutions, which accepts deposits, in excess of 20.0 percent of the total paid up capital of all such licensed financial institutions, except for capital expansion of the financial institution in which the person has acquired control.

The FIA remains substantially unchanged since its enactment in 1995 until November 2004 when amendments were made to the Act by way of modification of some sections and the inclusion of new emergency provisions to deal with temporary control.[4] The 2004 amendments of the Act were to prevent abuse of the financial institutions by insiders, enhance corporate governance and strengthen the powers of the Bank of Guyana to deal with problematic licensed financial institutions. Specifically, Section 14 of the FIA was amended to prohibit the granting of loans by a licensed financial institution for the purpose of purchasing shares in the said licensed financial institution or its related companies. In addition, Section 29 was amended to prevent insiders from colluding with others to obtain credit facilities by fraudulent means. Section 30 of the Act was also amended to strengthen corporate governance by making all officers concerned with the management of the financial institution responsible for taking all reasonable steps to secure compliance by the financial institution with the requirements of the Act and directions of the Bank and attaching liability for failure to do so. The Act was also amended by the inclusion of six new sections to improve the Bank of Guyana's ability to deal with problematic licensed financial institutions, particularly in relation to unsafe or

[4] This was in response to misconduct and eventually bankruptcy and closure in September 2001 of Globe Trust and Investment Limited which was licensed by the Bank of Guyana in 1999.

unsound practices which would pose a threat of loss or actual loss to depositors and/or shareholders.

Prudential supervision and regulations have been strengthened with support from the IMF/World Bank Financial Sector Assessment Programme (FSAP). The FSAP provided a confidential evaluation of Guyana's prudential financial regulation and supervision. The Bank of Guyana has adopted most of the recommendations as they relate to regulations based on the Basel I System core principles for supervision. Further support to strengthen the financial sector in Guyana will come under the Inter-American Development Bank (IDB), Financial Sector Reform Programme which seeks to improve regulatory framework, increase the system's solvency and improve efficiency of credit entities. Key financial ratios of licensed deposit–taking financial institutions are to be published on a timely basis; information among supervisory authorities are to be shared; risk management and supervision are to be improved; the largest mortgage institution, the New Building Society is to be brought under the direct supervision of the Bank of Guyana. The technical capacity of the banking supervision department of the Bank of Guyana is also to be enhanced.

(iii) Building institutional capacity in the financial sector.

Along with relaxing of the external constraints and introducing the prudential norms, a major effort was made to strengthen the financial system through appropriate institution building measures such as (i) instilling a greater element of competition (ii) promoting market discipline and (iii) strengthening the supervisory process.

Encouraging private ownership of banks was a major reform element to increase competition in the banking sector. In October 1994, two private banks - Citizens Bank and Demerara Bank Limited were licensed to operate. The government also divested its equity shares in the two largest commercial banks – Guyana Bank for Trade and Industry (GBTI) in 1994 and National Bank of Industry and Commerce (NBIC) in 1996. In July 1995, the management system was further strengthened with the merger of a state-owned development bank (GAIBANK) with the state-owned commercial bank Guyana National Cooperative Bank (GNCB). In 2002, GNCB was privatized and acquired by NBIC.

To further strengthen the banking system, several measures have been introduced to enhanced information disclosure requirements for banking institutions. These institutions are now required, in addition to publishing half yearly and annual financial statements, to publish data on key indicators of financial soundness in every quarter. Simultaneously, efforts have been made to improve corporate governance and guidelines on corporate governance and management standards have been issued to all licensed financial institutions.

It cannot be overstressed that financial reform and liberalization must be accompanied by an alert and vigilant system of supervision. A credible mechanism has been put in place to monitor compliance with prudential regulations and directives from the Bank of

Guyana and other regulatory agencies. The Bank of Guyana has been providing an exclusive focus on supervisory issues. On-site examinations and off-site surveillance are in effect. In addition, Stress Testing results by the Bank of Guyana have been shared with individual banks. The Bank of Guyana works towards ensuring compliance with regulations and guidelines and take disciplinary action in instances of breaches. It must, however, be noted that supervision is at best, a second line of defense; the main mechanism of compliance and control must operate within the financial institutions themselves.

5.0 Evaluation of the Banking System

The analysis of the stability of Guyana's banking system is more effectively undertaken through a macro-prudential approach rather than a micro-prudential approach. The macro-prudential approach focuses on macroeconomic variables as well as aggregate micro-prudential banking system variables collated from individual financial institutions to determine viability. This approach assesses the strengths and weaknesses of the financial system in contrast to the micro-prudential approach which focuses on microeconomic financial system indicators that assesses the stability of the financial institutions in a country. The macro-prudential approach is seen as an improvement or compliment of the micro-prudential approach (Evans, 2000).

The evolution of a set of macroeconomic variables that may contribute to a banking crisis is summarized in Table 1. Inflation has been very moderate and predominantly single digit during the review period. The inflation rate declined from 82 percent in 1991 to 4.2 percent in 1997. Between 1998 and 2008, inflation remained at relatively low single digit levels, averaging 5.7 percent. In 2007, the inflation rate peaked at 13.5 percent but declined to 6.1 percent in 2008. The reduction in inflation has lowered real interest rates. The real prime lending rate declined from 13.3 percent in 1998 to 7.8 percent in 2008. Lower real interest rates may have contributed to stronger banks balance sheets by increasing the net worth of banks in present value terms by positively affecting the value of longer term assets more than liability of shorter duration. Additionally, lower real interest rates have the potential to increase cash flows to both firms and households and thereby positively affect their ability to service debts. It may also reduce adverse selection and moral hazard issues because of the likelihood of banks curtailing lending to bad creditors.

Table 1

Guyana: Selected Real Sector and Financial Indicators

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Growth Rates of Real GDP (%)	7.96	6.18	(1.67)	2.96	(1.36)	2.28	1.15	(0.66)	1.58	(1.95)	5.13	5.37	3.10
Inflation Rates - end of period (%)	4.51	4.16	4.73	8.68	5.84	1.50	6.10	5.00	5.50	8.20	4.20	14.00	6.40
Overall Fiscal Balances (% of GDP)	(1.60)	(6.94)	(4.63)	(2.46)	(6.50)	(5.61)	(3.13)	(7.11)	(4.83)	(12.58)	(11.94)	(6.59)	(5.52)
External Current Account (% of GDP)	(7.60)	(14.00)	(13.70)	(9.30)	(15.20)	(18.30)	(14.60)	(11.20)	(8.90)	(19.20)	(27.50)	(21.50)	(25.50)
Real Interest Rate (%)	12.00	11.00	11.25	13.25	11.75	8.75	6.25	5.50	6.00	6.00	6.75	6.50	6.75
GDP per capita (US$)	766.00	808.30	777.50	770.30	773.00	777.50	829.20	837.80	862.80	900.90	992.40	1,111.00	1,233.60
Credit Growth (%)	72.02	23.56	15.55	7.69	4.51	1.03	0.44	(17.92)	(0.43)	8.35	17.85	18.71	21.80
Excess/Required Reserve	2.96	27.29	23.81	12.16	30.53	43.03	46.75	44.88	46.26	48.49	22.09	6.20	4.65
Private Sector Credit/GDP	7.19	8.37	9.84	10.29	10.90	10.77	10.69	8.84	8.66	9.57	10.73	12.09	14.29
Bank concentration (index) [1]	2,358.16	2,144	2,120	1,889	2,358	1,504	1,404	2,341	2,271	2,146	2,204	2,155	2,163

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

1) Measured using the Herfindahl-Hirschman Index (HHI). The HHI of a market is calculated by summing the squares of the percentage market shares held by the respective Banks. The HHI indicates: an unconcentrated market when it is below 1000; moderate concentration when it is higher than 1000 but less than 1800; and high concentration when it is above 1800.

During the period 1991-1997, public finance improved significantly with the overall fiscal deficit as a percentage of GDP declining significantly from 33 per cent in 1991 to 1.6 per cent in 1996 but rising to 6.9 per cent in 1997. Between 1998 and 2005, fiscal deterioration led to the overall fiscal deficit as a percentage of GDP averaging 8.4 per cent. The fiscal position improved after 2006 with the overall fiscal deficit as percentage of GDP declining from 11.9 per cent in 2006 to 5.5 per cent in 2008. Although the fiscal position has not always been favourable, it did not pose a threat to the banking system. Specifically, the fiscal deficit did not lead to destabilizing increases in interest rates or on inflation nor did it crowd out private sector credit. This is because commercial banks had significant levels of excess liquidity and the fiscal deficits over the years were mostly funded from external inflows. As already noted, financial deepening is constrained in Guyana because of a weak capital market structure, hence the continuous issue of excess liquidity in the financial sector.

The Guyana economy experienced strong real economic growth, averaging 7.1 per cent during the period 1991–1997. Growth slowed appreciably starting in 1998, with an average growth rate of 0.3 percent between 1998 and 2005, reflecting adverse domestic and external developments. Real growth recovered during the period 2006-2008, averaging 4.5 percent. The sources of growth reflected enhanced contribution from the traditional sectors as well as diversification and a greater contribution from the services sector, especially telecommunication and financial services. Real economic growth contributed to increases in incomes and cash flows to help bank borrowers repay their loans which helped alleviate vulnerabilities in the banking system.

Guyana’s external position has been relatively satisfactory since the mid 1990s. The current account balance as a percentage of GDP stood at a moderate level of 14 per cent between 1998 and 2005. Between 2006 and 2008, the current account balance averaged 25 per cent of GDP, reflecting higher costs for fuel and commodity imports. However, there were no risks that the country would not generate sufficient foreign currencies to meet its trade and foreign investment liabilities because the deficits were financial largely from official inflows, foreign direct investments and debt relief initiatives. Gross International Reserves have been at an acceptable level of three months of import cover averaging US$275 million between 1998 and 2007 and increased to US$355.9 million or four months of import cover in 2008. Exchange rate has remained relatively stable, depreciating at an annual average rate of 1.4 percent between 1998 and 2008. Further, debt relief initiatives have strengthened substantially Guyana's debt sustainability. External debt to GDP ratios has declined significantly from 200 per cent in 1997 to 133 per cent in 2005 and further to 58 per cent in 2008.

This stability on the macroeconomic front with modest economic growth, low inflation, and acceptable levels of internal and external balances, lower external debts, and relatively stable exchange rate has augured well for the economy. It has helped to avert a currency crisis, improved investors and depositors' confidence, reduced vulnerabilities, withstood external contagion and built resilience in the banking system.

Table 2 below displays a set of banking system macro-prudential variables that can be used to assess the strengths and weaknesses of the banking system. The data shows that the banking sector in Guyana was adequately capitalized and was "sound" in the post reform years of 1996-2008. The (CAR), which captures banks' overall financial soundness, has hovered at 14 per cent between 1996 and 2008, well above the 8 percent minimum level required by law. There was, however, significant dispersion among banks, although all of the banks satisfied the capital adequacy requirements. Additional safety nets were high levels of reserves and liquidity. The banking system maintained reserves well in excess of the required amount as is shown in Table 1, thereby suggesting that the system had room for leveraging. The banking system liquidity was also high with the liquid asset to total asset ratio during the 1998-2008 period, averaging 28 per cent. Further, the banking system had a buffer against liquidity shocks with customer deposits to total loans increasing from 148.3 per cent in 1998 to a peak of 282.4 per cent in 2005 before declining to 227.9 per cent in 2008.

The data sets also show that the asset quality of banks improved during the 1996-2008 period. This is reflected in the decline in the levels of non-performing loans. The size of non-performing loans, which was G$4,027 million in 1992, fell to G$264 million in 1994 but went up to G$20,612 million in 2000, mainly as a result of the merger of GAIBANK and GNCB[5]. Non–performing loans declined to G$6,779 million in 2006 and to G$4,547 million in 2008. As a percentage of total loans, non-performing loans declined from 22.7 percent in 1995 to 11.6 percent in 2006 and to 5.3 percent in 2008. Expressed in terms of total assets, there was a decline from 8.7 per cent in 1995 to 4.7 per cent in 2006 and to 2.0 per cent in 2008. Provisions for bad loans as a percentage of non-performing loans were satisfactory, averaging approximately 50 per cent between the 1997 and 2002. This

[5] This outturn can be attributed to the prudent lending of banks, resolution of the rice sector loans and the closure of the state owned Guyana National Cooperative Bank (GNCB) in 2002.

declined to 33 per cent in 2003 but increased to 44 per cent in 2005 and to 79 per cent in 2008.

The composition of the banking system earning assets has changed to vary risks during 1996-2008. Credit to the private sector as a percentage of total bank assets grew from 47.8 per cent in 1996 to 51.7 per cent in 1999 but thereafter declined to 37.4 per cent in 2002 and further to 27.6 per cent in 2008. Diversification of credit across sectors have also taken place with the real estate and the household sectors accounting for about 62 percent of total credit in 2008 compared with 23 percent in 1996. Credit to the agriculture sector declined from 21.4 per cent in 1996 to 13.6 per cent in 2002 and to 6.1 percent in 2008. The decline in the share of private sector credit and the diversification of private sector credit indicates a reduction in the credit risk of banks but this reduces the franchise value of commercial banks.

Table 2												
Guyana: Selected Performance Indicators of the Commercial Banks												
	1997	1998	1999	2000	2001	2002	2003[1]	2004	2005	2006	2007	2008
Capital adequacy												
Capital to risk-adjusted assets	13.3	16.96	16.73	16.15	16.16	14.29	12.73	14.28	14.36	15.47	15.02	14.94
Tier I capital to risk-weighted assets	13.73	16.81	16.67	15.78	16.34	13.39	12.8	14.09	14.5	15.36	14.51	15.01
Tier II capital to risk-weighted assets	0.21	0.18	0.85	0.77	0.7	0.6	0.4	0.4	0.2	0.11	0.53	0.14
Capital to total assets	7.74	10.28	10.59	9.46	9	7.9	6.1	6.35	6.23	6.68	6.90	7.03
Frequency distribution of banks capital ratios[2]	6	7	7	7	7	7	5	6	5	5	6	6
Lending to connected parties[3]												
Related party loans to total loans	3	4	4	5	5	5	6	6	5	3.79	3.67	4.51
Related party loans to capital base	20	20	23	28	27	27	30	26	21	18.23	16.91	22.67
Director exposure to related party exposure	28	20	25	1	3	4	4	1	2	2.03	1.36	1.67
Asset composition												
Business enterprises to total loans	76.2	76.2	76.2	76.6	75.6	72	66.6	61.6	57	54.33	50.68	51.32
Agriculture to total loans	16.3	17.5	14.6	15	14.5	12.9	8	7.3	7.8	6.08	4.90	5.62
Mining and quarry to total loans	2.2	2.4	2.2	1.8	2.5	2.2	2.3	1	1.3	1.70	1.23	1.95
Manufacturing total loans	28.3	26.9	28.7	28.7	27.8	26	23.1	21.4	18.6	18.98	16.84	15.98
Services to total loans	29.6	29.5	30.7	31.1	30.8	30.9	33.2	31.8	29.3	27.57	27.71	27.76
Households to total loans	19.4	19.3	17.9	16.1	14.9	17.2	20.1	17.5	17.1	21.02	22.34	20.22
Top 20 borrowers per total loans	27.6	27.7	26.9	27.9	23.2	25.2	48.5	45.4	44.5	46.69	39.21	33.19
Top 20 borrowers per capital base	192.1	151.6	144.5	146.1	121.6	131.3	239.5	203.2	195	224.43	180.78	166.78
Asset quality												
Nonperforming loans to total loans	24.3	30.3	31.4	35.7	38.2	37.15	23.3	17.8	13.9	11.59	10.65	5.29
Nonperforming loans to total assets	13.1	17	18.6	19.2	18.9	16.2	8	5.7	4.3	3.82	3.65	1.99
Nonperforming net of provisions to capital and reserves	57.2	64.72	67.6	87.53	90	80.5	62.9	41.7	29.4	26.55	19.79	4.53
Provision for loan loss to nonperforming loans	51	56	54.5	49.4	49.1	53.71	33.3	39.7	44.4	41.04	54.20	79.09
Total on balance sheet assets to capital and reserves	891.6	862.1	798.2	901.9	936.4	1076.6	1179.3	1216.7	1224.4	1177.91	1,184.88	1,089.70
Large exposure to capital base	361.5	285.4	276.2	285.2	253.3	267.1	369.3	314.02	305.1	320.48	267.50	195.49
Nonperforming loans [G$ million]	**10,946**	**15,636**	**17,635**	**20,612**	**21,504**	**20,058**	**10,561**	**8,135**	**6,907**	**6779**	**7,288**	**4,547**
Earnings and profitability												
Return on assets	1.4	2.95	1.28	0.65	0.48	0.44	1.21	1.37	1.74	0.59	0.59	0.57
Return on equity	11.7	25.83	10.64	5.57	4.37	4.45	13.68	16.44	21.27	6.92	6.85	6.31
Net interest income to gross income	41.8	35.96	37.85	33	32.5	39.5	44.3	47.4	50	48.61	44.71	46.93
Non interest expenses to gross income	34.26	40.41	42.08	40.8	44.8	53.4	51.9	51.51	44.85	37.77	35.82	38.72
Personnel expenses to noninterest expenses	37.19	34.7	31.21	36.63	33.68	37.07	32.51	36.74	40.58	44.10	38.12	30.31
Net operating income to average total assets	5.72	3.9	1.32	0.83	0.7	0.61	1.37	1.75	2.42	0.87	0.79	0.8
Operating expense to average total assets	9.7	10.1	10.8	10.52	9.9	8.49	6.98	6.65	5.98	1.40	1.82	1.76
Operating expense to total income	79.7	82	89	92.27	93.24	93.55	83.19	79.14	71.15	61.52	69.79	68.8
Liquidity												
Interest expense to average earning assets	15.46	17.62	7.44	7.57	6.73	4.75	3.46	3.24	3.12	0.74	1.19	1.03
Net interest income to average earning assets	15.19	13.85	6.01	4.86	4.5	4.8	5	5.55	5.93	1.51	1.57	1.61
Liquid assets to total assets	30.57	26.16	25.11	25.47	23.5	23.9	26.4	33.3	32.5	33.01	26.47	29.79
Customer deposit to total loans	154.6	148.29	140.86	157.51	169.06	195.13	248.46	272.29	282.38	264.36	256.71	227.85
Customer deposit to total loans and investments	**108.06**	**109.44**	**107.95**	**109.32**	**110.94**	**111.89**	**118.89**	**121.29**	**124.81**	**120.14**	**123.40**	**112.8**
[1] This comprises 6 commercial banks excluding GNCB, which was privatised in March 2003.												
[2] Number of commercial banks with ratios greater than the 8 percent minimum capital adequacy ratio.												
[3] Related parties include directors, senior officers and shareholders with 20 percent or more shares.												
Source: Bank of Guyana												

The holdings of public sector securities (treasury bills) by banks as a percentage of total assets declined from 22 per cent in 1996 to 12.8 per cent in 1999. However, this holding has increased to 22 per cent in 2008. Although the level of exposure of the banking system to government securities is large, default risks have been extremely small but market risks are a matter of concern due to potential changes in relative prices. Banks overseas holdings/investments as a percentage of total assets increased from 4 per cent in 1996 to 21.2 per cent in 2008. Their net overseas holdings as a percent of capital and reserves increased from 15 per cent in 1999 to 162 per cent in 2008. This shift in portfolio reflects the diversification from loans but it has exposed the banking system to contagion from external factors.

The banking system remained profitable during 1996-2008 and this profitability has provided a liquidity buffer against shocks. Banks' ratio of net profit to equity (ROE) was 15 per cent in 1996 and moderated to 4.0 per cent in 2000 and to 6.3 per cent in 2008. Similarly, the ratio of net profit to asset (ROA) which was 1.05 per cent in 1996 moderated to 0.8 per cent in 2000 and to 0.60 per cent in 2008. The level of banks' profitability in Guyana is associated with relatively high interest incomes from wide spreads. The ratio of interest income to gross income has been in excess of 50 per cent during the 1990s and early 2000s. In 2008, net interest income to gross income was 47 per cent. Non–interest expenses to gross income averaged 42 per cent during the 1996-2002. In 2008, this was 38.7 per cent.

Measured by the Herfindahl-Hirschman Index, the level of concentration in the Guyana banking system is quite high. The Herfindahl-Hirschman Index has been above 1800 for all years between 1998 and 2008, except for 2001 and 2002. The high concentration level reflects the small number of banks in Guyana as well as the share of the two largest banks which account for almost 60 percent of total assets. It is important to note that the banking institutions have been facing competition from overseas institutions as well as from non-bank financial intermediaries.

Most banking institutions have adhered to the Bank of Guyana's Corporate Governance Guideline. The banks have adopted internal control procedures, held regular board meetings, formed active audit and financial committees, submitted timely and accurate information, as well as outlined management succession plans and business continuity plans to the authorities. Banks have also complied with laws, regulations and other guidelines issued to them. The public dissemination of economic and financial sector data and policies have helped to foster transparency and accountability of regulatory authorities such as the Central Bank and central government. Timely dissemination of Bank of Guyana reports, Budget Speeches as well as the IMF Public Information Notices have contributed to reducing vulnerability in the banking system by providing reliable and relevant information for undertaking financial activities.

Bank of Guyana has been assessing the health of the banking system quarterly through an analysis of micro prudential indicators. This is been supplemented with stress testing to identify potential vulnerabilities under various scenarios. The Bank's assessment of the risk profile of financial activities in the commercial banking system during the 1997-2009 period shows that the system is exposed to credit, operational, market, legal/compliance, reputational and liquidity risks. Although the severity and directions of these risks vary among banks, they remain modest and stable for the banking system. However, operational and credit risks are the major concerns for the Bank of Guyana.

6.0 Policy Recommendations and Concluding Remarks

Guyana has implemented sound macroeconomic policies since the early 1990s. These have resulted in better GDP and inflation performances as well as an improved debt sustainability outlook. The domestic and external balances have been contained at satisfactory levels while the Guyana dollar has been broadly stable. These outturns have helped the banking system to cope with various shocks and alleviate vulnerability. Notwithstanding, the Government of Guyana is committed to further entrenched macroeconomic stability, to implement structural reforms and to further strengthen the financial system which would undoubtedly help to build resilience in the banking system.

In the area of macroeconomic stability, the authorities are committed, in a transparent manner, to sustain fiscal consolidation efforts, to reduce the external current account deficit and to pursue prudent monetary policy focusing on low inflation. The government will also maintain a flexible exchange rate regime and deepen the foreign exchange market. An active debt management strategy will also be pursued for long term debt sustainability. In the area of structural reform, the government will continue to implement measures to sustain and diversify economic growth, to alleviate poverty and to enhance private sector participation in the economy. To this end, the government is implementing a National Competitiveness Strategy and Low Carbon Development Strategy as well as undertaking the preparation of a new Poverty Reduction Strategy Paper (PRSP).

The extensive financial sector reforms undertaken by Guyana have resulted in positive and encouraging developments in the banking system. The financial performance indicators of banks and the banking system show a positive picture since 1996. Prudential norms are helping the banks to undertake balance sheet adjustments of a structural nature. Surveillance over banking operations has been strengthened through enhanced supervision while identification of potential vulnerabilities is carried out through evaluation of micro prudential indicators and stress testing. A more competitive environment is being created. Banks are facing competition from within the industry as well as from non-bank finance companies. Disclosures of bank specific information are helping to make banks accountable to a wider base of shareholders to enhance performance. Improvements in the efficiency of the banks and their profitability have strengthened the banks' balance sheets to provide greater flexibility in the process of adjustment.

Notwithstanding progress that is being made in the banking system, the authorities are aware that continuous oversight and strengthened prudential regulations are required to maintain banking system stability in light of the existence of risks and lessons from the recent developments in the global financial crisis. The still high levels of non-performing loans require strong regulatory oversight to safeguard banks from insolvency as well as against the expansion and concentration of loans in real estate and consumption. Regulatory oversight also has to be strengthened as it relates to the increases in overseas investments by banks and the contagion effects these bring. In view of the increases in loans to the real estate sector, the risks of the banking system to an asset market boom and bust will have to be closely monitored by the authorities. This will require the traditional measures of inflation by the consumer price index for the conduct of monetary policy to be expanded to include asset price inflation. In addition, paying increasing attention to other macroeconomic variables that may signal banking system weaknesses is important.

The reform measures undertaken so far would serve as a foundation to further enhance the capability and capacity of the banking system to maintain stability. The regulatory and supervision framework will have to be flexible and forward looking with appropriate minimum standards for liquidity and capital. The main objective must be to improve incentives by increasing transparency in supervisory authority and industry alike. This would require institutional strengthening, reliable information and transparency in policy making. There should also be measures to broaden and deepen financial markets and strengthen the financial infrastructure through the development of the capital market as well as new products and management system. The capability in risks management and credit management skills also needs to be strengthened to ensure that there are no excessive risks taking that could result in adverse consequences.

The rapid intensification of globalization in recent years has affected the structure and operations of financial institutions in Guyana. It has also heightened the risks of contagion. While domestic financial institutions need to strengthen their resilience through enhancing their risk management capability, international cooperation can play an important role. This will not only strengthen the global financial system but also improve the soundness of the national banking system in Guyana.

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