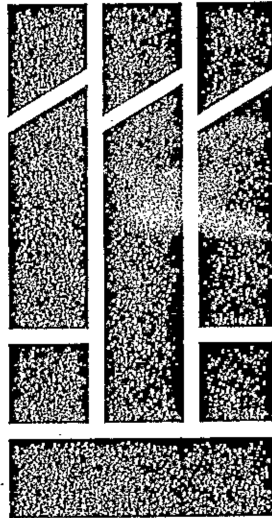

THE REGULATORY FRAMEWORK FOR FINANCIAL INSTITUTIONS IN THE OECS Presented by Eustace Liburd

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Introduction

The OECS financial sector is comprised broadly of three categories of institutions at various levels of development. The commercial banking sector, in which both foreign and indigenous banks operate, provides the basic infrastructure to the financial system and is well linked to the world financial markets. An emerging non-bank financial sector which includes credit unions, and finance companies. The third category relates to the providers of long term funds, namely: the development banks and the national insurance schemes. Except for one mortgage and one general finance company, the non-bank financial intermediaries are locally incorporated and operate only within their country. The commercial banks and the non-bank financial institutions tend to operate in different segments of the market with the result that there is little competition between the two groups of institutions.

Inherent in banking are two factors which give rise to the need for regulations. The first involves the bank's loans and investment which lead to the creation of deposits. Since these deposits make up the major portion of country's money supply, the quality of bank credit underlies the value of money. The second factor is the nature of the financial intermediary role that banks fulfill in the economy. Banks receive deposits that are highly liquid. These deposits are invested by banks in other less-liquid assets. To prevent a liquidity crisis banks must hold

some liquid assets, have adequate capital and maintain professional management. In the OECS, two agencies have responsibilities in a regulatory process that is just evolving, the Ministry of Finance and the Central Bank.

Existing Legal Framework

In the OECS, Ministers of Finance are entrusted with the power to grant banking licence and generally to implement the respective banking acts of the territories. The acts do not establish a comprehensive framework for the regulation of financial institutions; they govern the operations of banks (including development banks) but do not apply to non-bank financial institutions which are governed by separate pieces of legislation. Generally, the banking acts do not go beyond stipulating the capital requirement for establishing a bank and certain regulatory ratios to be observed[1].

The operating ratios applied to banks include the reserve fund ratio that requires the banks to channel at least 25 per cent of their profits into a reserve fund up to the amount of the paid-up capital. This regulation can be varied by the Minister of Finance for banks that are considered to be in sound financial condition. As a result of this

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1 See Appendix for a comparison of the regulatory ratios to be observed in the different countries.

provision, the foreign banks have generally been exempt from having to comply with this ratio. There is also the deposit liabilities ratio, which stipulates that deposit liabilities may not exceed twenty times the paid-up capital and reserves of the bank. In practice these minimum capital requirements have been applied only to locally incorporated banks. In the case of the branches of overseas banks, the capital of the Head Office has traditionally been deemed to meet the minimum capitalization criteria.

In most OECS jurisdictions the Acts also restrict the size of loan that a bank may grant to any individual customer to certain proportion of the banks capital and reserves. The extent of banks involvement in the equity holding of commercial, industrial, agricultural and other enterprises is limited. Generally, banks are permitted to hold real assets only for their own use.

The Acts do not in general provide a basis for regulating lending policies or influencing the structure of interest rates. In Dominica, Antigua and Barbuda and St Lucia, they provide for regular inspection by a banking inspector appointed by the Minister of Finance. However, prior to the establishment of the ECCB in October 1983 and the subsequent introduction of a Bank Supervision Department in the Central Bank, this provision for inspection was rarely implemented.

The Agreement establishing the ECCB provides the Bank with powers to

regulate the activities of the financial institutions in the area. These powers are derived from Article 3(2) of the Agreement which states that the Bank shall have power to "regulate banking business on behalf and in collaboration with participating Governments." Since licence for establishment of banks is given by the participating Governments in the respective territories, any supervisory role exercised by the Central Bank in this regard has to be with the acquiescence and collaboration of individual participating Government. This comes as a sort of limitation as compared to the independent examination systems followed in countries like U.S.A., where the Federal Reserve Board need not take prior permission of the State or Federal Government to take a close look at the functioning of its member banks.

Other powers to exercise regulation come from Article 35(1) of the Agreement, whereby every financial institution is required to furnish to the Bank at such time and in such manner as the Bank may prescribe, such information and data as the Bank may require for proper discharge of its functions and responsibilities and in order to verify compliance with directions served under Articles 33 and 34 of the Agreement (which deal with reserve requirements, holding of specified securities, stipulation of interest rates on deposits, loans, margins on loans, etc.). The Central Bank may require any person who is or has been made subject to open his books for inspection. A limited supervisory role for the Bank in respect of off-shore financial institutions is indicated in Article 41 (1) and (2) of the Agreement, while Article 42(1) provides for the bank to administer or participate in schemes for the purpose of ensuring bank deposits.

Even though these and others powers conferred in the articles of Agreement are broad, in most instances they do not specify the type of penal action the Bank can take in case any financial institution has failed to observe the regulations. As it stands currently, only participating Governments can take appropriate measures to rectify deficiencies in the operation of banks in their respective jurisdictions, especially when it relates to management of funds.

The Draft Uniform Banking Act

Partly in an effort to overhaul and update the existing legislation and partly to give greater effect to the regulatory powers conferred in the Central Bank Agreement referred to earlier, the Participating Governments have agreed to the implementation of a uniform Banking Act for the area. This upgrading for the regulatory framework which the uniform Banking Act embodies, may be seen as a recognition of the fact that several developments in the financial sector have had important implications for the financial system. These include the establishment of indigenous and other locally incorporated commercial banks in all the countries, which lacked the support and close supervision to which the overseas offices of the foreign banks have been traditionally subjected. There is also the emergences of the non-bank financial institutions (including credit unions and finance houses) to be significant providers of financial services, for which the existing legislation governing their activities is inadequate.

The institutions which are subject to supervision under the Banking Act are categorized broadly as Financial Institutions, all of which conduct banking business. Two categories of financial institutions are identified; (a) banks and (b) credit institutions. A bank is distinguishable from a credit institution by the fact that it accepts deposits which are subject to transfer by the depositor by means of a cheque. If a credit institution were to broaden its sphere of activity to permit the transfer of funds by depositors by cheque, it would then be performing functions akin to those of a bank and must therefore be defined as a bank. While credit unions, building societies, finance companies and other similar institutions will come under the ambit of the Act, it will be left to a decision of the Monetary Council to determine when the relevant provisions relating to such institutions may be invoked.

Implementation of the uniform act will greatly enhance the role of the Central Bank in the supervision of the financial systems. The Authority to grant licences continues to reside with the respective Ministers of Finance but an advisory role is envisaged for the Central Bank in that process. There is provision for the Minister, before the granting of licence, to request the Bank to conduct an investigation into the financial condition and history of the applicant, the character of the persons to be involved in the management, the adequacy of the capital structure, the validity of documents submitted and needs of the community to be served by the granting of the licence. Provision is made for the Bank to examine financial institutions from time to time or whenever it

it necessary or expedient in order to determine whether the institution is in a sound financial condition and has been complying with the requirements of the law.

The proposed Act prescribes new minimum capital requirements for financial institutions, including an assigned capital in the case of financial institutions incorporated abroad. If operating as a bank, the minimum capital is not to be less that EC$5 million, but in the case of credit institutions, the Act empowers the Minister, after consultation with the Central Bank, to prescribe the minimum capital.

Other financial requirements to be observed under the proposed Act includes the maintenance of a Reserve Fund, a total liabilities to paid-up capital and reserves constraint of 20:1; credit limitations to single and interconnected borrowers 15% of capital and reserves, and provisions to limit insider loans. To facilitate monetary policy objectives, the Act also provides that financial institutions can be required to maintain specified assets expressed as a percentage of specified liabilities. This provision reinforces that of Article 33 of the Central Bank Agreement, which deals with minimum required reserves.

The Supervisory Process

The basic objective of regulating the operations of banks is to safeguard the interest of the depositors and to build up and maintain a

sound banking system to meet the social requirements and economic objectives of the particular country. This regulatory framework can be divided into micro and macro aspects. The first aspect is taken care of by periodical inspection of individual financial institutions and setting guidelines on the amount, type and the nature of individual assets banks can acquire with the use of deposit resources. The latter encompasses the type of monetary policy which the Central Bank policy follows, which in turn is dictated by the changing economic environment and individual Government policy stances. It stems from the unique nature of banks and the role they play in money creation and the payments system and hence their impact on the level of economic activity including credit expansion in the aggregate as well as towards specified sectors.

At the monetary policy level there are currently not many regulations in force within which framework the banks are required to operate. The cash reserve requirement stipulates that banks keep a minimum of 6% of their deposit liabilities as balances with Central Bank. Cash reserves are required both as a tool of monetary policy and for the protection of depositors, although these funds provide only minimum backing for deposits and are not generally considered adequate for an institution in crisis. The Central Bank stipulated that banks pay a minimum of 4% rate of interest per annum on savings deposits. The policy stance in relation to interest rates has been that they ought to be established by the free interplay of market forces. However, given the small and imperfect market, it had become necessary for the Bank to seek to influence the

direction of interest through an established minimum rate for savings deposits.

At the ECCB, the micro aspects of the supervisory process at present consists of two parts (1) on-site inspections and (2) analysis of prudential and other returns submitted by banks periodically. At this early stage of development of the Bank Supervision Department, in-depth on-site inspections have been confined mainly, although not exclusively, to indigenous or locally incorporated banks. They encompass besides examination of the quality, and soundness of assets, in particular loans portfolio, a review of capital adequacy, liquidity and external and/or currency exposure positions. Annual meetings with bankers provide an avenue of discussing banking systems general problems and/or specific issues facing individual banks. Inspection reports on individual banks are sent to the respective banks for comments and to the Government of the territory for information and such action as is deemed necessary.

Analysis of monthly balance sheets, quarterly returns on ownership and maturity of deposits, structure of loans and advances, interest rates on deposits and loans provide information on banks activity and progress. They are useful, for example, to know whether any bank has concentrated its lending activity in a particularly risky area which is out of line with the maturity structure of its deposits, given the current economic situation. The interest rates on deposits and advances provide a measure of margin kept by banks. With past experience on current operating

expenditures, they give an indication of the direction in which profitability of the bank is moving. The final picture is of course assessed by the annual return on earnings and expenses submitted by the banks in respect of their operations. Herein, the adequacy of provisions made for bad and doubtful debts in a way gauges the soundness of the bank, which has earlier been inspected in respect of the quality of its assets.

During 1988, banks in the ECCB Area earned a return of 2.5% on assets, well above the rate earned by banks in many countries. For the large majority of locally incorporated banks net worth as a proportion of risk assets was however well above 15% and capital and reserves well above 7% of deposits. A small minority of these banks, however, do need strengthening of capital to meet the standards stipulated by supervising authorities in many developed countries.

In summary, the regulatory framework for the supervision of financial institutions in the OECS is just evolving. To date, the efforts at prudential supervision by the Central Bank has been concentrated mainly on the commercial banks. This is justifiable on the basis of the need for widespread confidence in banks as the main providers of the community's means of payment. There is also the recognition that a safe and well run banking system is central to the economic and financial health of the countries.

Taking into account that the ECCB, due to the absence of uniform banking legislation, is unable to articulate an independent and comprehensive supervisory role in respect of financial and management systems, and performance of banks, it appears banks in the territories are acquitting themselves well, and following sound practices. There is scope for improvement. This should come when ECCB takes on new powers envisaged in the uniform banking legislation.

Appendix

Legal Framework (Summary)

	Antigua	Dominica	Montserrat	St Kitts-Nevis	St Lucia	Uniform Act
Banking Law	1969 Act	1974 Act	1978 Act	1967 Act	1969 Act	To be implemented
Licensing Authority	Minister of Finance	Minister of Finance		Minister of Finance	Minister of Finance	Respective Ministers of Finance
Paid-up Capital Required (Min.)	$500,000	$300,000	$400,000	$500,000	$300,000	$5 million
Required Reserve Fund as % of Capital	100%	100%	100%	100%	100%	100%
Percentage of profits transferred to Reserve Fund	25%	25%	25%	25%	10%	20%
Deposit Liabilities to Capital and Reserves Ratio	....	20:1	....	....	20:1	20:1
Provision for specified Liquid Assets	....	Yes[1]	....	....	Yes[1]	40% (max.)
Credit limits to Single borrower % of Capital and Reserves[2]	25%	10%	25%	25%	10%	15%

[1] Percentage to be determined by Minister

[2] In the cases of Dominica and St Lucia the limits pertain to unsecured credit. Under the Uniform Banking Act the stated limit may be exceeded with the approval of the Minister after consultation with the Bank.