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VI. Financial Sector Vulnerabilities and Challenges[56]

123. The Eastern Caribbean Currency Union (ECCU) draws together eight Caribbean countries and territories under a single monetary and exchange arrangement, under the auspices of the Eastern Caribbean Central Bank (ECCB). Even though the current framework was established in 1983, this followed a long history of a currency union arrangement under a pegged exchange rate regime. The currency union arrangement has served the region well, keeping inflation in line with that of the trading partners, maintaining financial stability, and providing an environment of adequate economic growth. These benefits have come in the face of numerous shocks ranging from natural disasters, diminution of concessional financing, and loss of preferential access to commodity markets, and the impact of some structural reforms. However, the recent financial crises in Asia, Russia, and South America have highlighted the risks and potential costs of weaknesses in the financial sector, and highlighted the need for strengthening the sector. In light of this recent experience, several weaknesses emerge in the ECCU's financial sector.

124. This chapter discusses the main areas of vulnerabilities in the ECCU's financial sector. It addresses the issue of how these vulnerabilities could be reduced, hoping to sharpen the policy debate on the sustainability of the underlying institutional arrangements. Specific recommendations are also made to meet the ECCU's challenge of strengthening the financial sector. The next section discusses the financial sector challenges, highlighting the areas of weakness and including some recommendations. The section is organized around two themes; banking sector vulnerabilities, and the efficiency of the financial system. Finally, some conclusions are presented.

A. Challenges in the Period Ahead

125. The currency union arrangement has regularly been assessed as having served the region well, allowing the members to achieve a high degree of economic prosperity in a volatile environment. The ECCB has played the principal role in operating the arrangement, upholding its sustainability—particularly through a strong backing of its currency issue—and ensuring the orderly development of the financial sector. However, as discussed below, several areas of weakness remain which make the currency union arrangement vulnerable to financial crisis. The challenge for the period ahead is to put into place policies and measures that would reduce the existing vulnerabilities and strengthen the financial sector within the currency union. Expectedly, these policies would be set against a backdrop of measures to ensure a sound macroeconomic environment.

126. The most obvious source of vulnerabilities in the ECCU are the acutely weak fiscal positions in some of the member countries, resulting in a marked increase in public debt

[56] Prepared by Patrick Njoroge (WHD). This is part of a longer working paper to be completed later this year.

and also some accumulation of arrears.[57] As elaborated in the literature on the sustainability of fixed exchange rate regimes, sustained deficits represent significant macroeconomic imbalance and undermines the long-term viability of a fixed exchange rate system. Additionally, significant fiscal flexibility is needed within such a regime so as to respond adequately to domestic macroeconomic shocks, including allowing for inter-regional transfers in cases of idiosyncratic shocks within a currency union. This in turn demands a credible commitment to sustainable fiscal positions and debt levels, an issue that is taken up by Pellechio et al. (2002).

127. With regard to the financial sector, vulnerabilities exist to the extent that the financial system and particularly the banking system is not entirely sound or is weakly supervised, and to the extent that the regime does not fully conform to the rigidities of the currency broad arrangement (CBA) under which the ECCB operates. CBAs, with their fixed exchange rates and legislated reserve backing rules that limit the central bank's monetary liabilities to a ratio of its foreign currency reserves, have been used widely as a vehicle for achieving stabilization in the wake of economic crisis and for achieving longer-term stability of the currency with a view to providing an environment for adequate economic growth. However, the strict backing rule limits the issuance of unbacked monetary liabilities, which in turn limits the scope of other central bank functions. In particular, the central bank's role as a lender-of-last-resort (LOLR), its pursuit of active monetary policy and its lending to the government are all sharply constrained. At the same time, the CBA subordinates other policy objectives to the fixed exchange rate objective, and thereby depends on interest rates as the main channel for restoring macroeconomic equilibrium. Consequently, as discussed by Santiprabhob (1997), a sound banking system is essential for the efficient operation of a CBA and its long-term viability: Unsound banks weaken the transmission of interest rate signals, and given their greater willingness to take higher risks, may lead to unpredictable reaction to interest rate changes. This in turn weakens the principal mechanism for adjustment in a CBA, and therefore casts doubt on the long-term viability of the CBA. Given the limited ability of the central bank in providing support to the banking sector, greater reliance has to be placed on the other mechanisms of maintaining bank soundness. As Santiprabhob (1997) argues, this includes establishing stricter prudential regulation, explicit LOLR facilities, a deposit insurance and deposit protection, and an exit policy for banks. In addition, any rigidity that encumbers or distorts the operations of the financial system may introduce additional vulnerabilities to the currency union, and could serve as a channel for the transmission and magnification of incipient financial crisis.

128. The remainder of the paper discusses the financial sector vulnerabilities in the ECCU area, along with the policies that could minimize the vulnerabilities and enhance the

[57] The combined overall deficit for the central governments in the ECCU widened from 5½ percent of GDP in 2000 to about 7 percent of GDP in 2001, and the stock of public debt for countries in the region ranged between 42–134 percent of GDP at end-2001.

credibility of the currency arrangement. The vulnerabilities are grouped according to their source: the banking sector, and inefficiencies in the financial system.

B. Banking Sector Vulnerabilities

129. The unavailability of detailed individual bank data thwarts a robust assessment of the banking sector. Nevertheless, the aggregated banking soundness indicators that are compiled by the ECCB, point at some issues of concern but without suggesting an overall assessment that the banking sector is unsound. For the entire ECCU area, the share of nonperforming loans in total loans has averaged between 12 and 15 percent every year since 1996,[58] improving over the recent years but worsening from 12 percent in 2000 to 14 percent in 2001. Additionally, the banking system's high exposure to the public sector remains a cause for concern; credit to the public sector as a share of total loans has risen from 17½ percent in 1997 to 21½ percent in 2001, and ranged in 2001 in the individual countries from 11 percent in St. Lucia to 40 percent in St. Kitts and Nevis (Table 1). Even though these data do not suggest acute concern of an unsound banking sector, they point to some issues of concern.

130. In addition, there is a need to strengthen the ECCU's banking system in keeping with accepted best practices and thereby reduce the vulnerability to a financial crisis. To this end, the lessons from the recent global and regional financial crises are instructive; Box 1 summarizes the lessons from the Jamaican banking crisis that started in the mid-1990s. The financial system in the ECCU needs to be brought into greater conformity with the reality of the existing currency union arrangement that operates under a currency board arrangement (CBA). In common with other CBAs, the such a regime limits the flexibility of the ECCB to conduct other central bank functions—particularly the function of a lender-of-last-resort and the pursuit of an active monetary policy—and even as a weak banking system would adversely affect the CBA's credibility and consequently its effectiveness. In this regard, the issues for consideration are well described in Santiprabhob (1997). With this in mind, these issues and the related policies are discussed below from the perspective of the ECCU.

Bank Supervision

131. The Uniform Banking Act places the ECCB at the center of the supervisory and regulatory regime of all banking businesses in the ECCU, i.e., commercial banks, finance and trust companies. The regulatory framework is broadly in line with the recommendations of the Basel Core Principles on Effective Banking Supervision and adopted by the Caribbean Banking Supervisors Group, but certain deficiencies remain in spite of the ECCB's recent efforts to improve supervision.

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[58] The ECCB's prudential guidelines for commercial banks require nonperforming loans to be less than 10 percent of total assets.

Box 1. Lessons from the Jamaican Financial Crisis

During the early 1990s, the financial sector in Jamaica expanded rapidly as a result of financial liberalization, in spite of slow output growth, high inflation, and high nominal interest rates, caused by fiscal imbalances and labor market rigidities. This growth was interrupted when a number of financial institutions failed in 1995-96, and investigations revealed an inadequately regulated, largely insolvent financial sector. The cost of resolving the Jamaican financial crisis amounted to about US$2.8 billion (40 percent of GDP). It increased public sector debt, raised interest rates and prolonged the stagnation of the economy. The following are some lessons from the crisis[1]:

- Resolution of financial crises can be very costly and focus should be on their prevention. Early detection of the incipient problems reduces costs, preserves the financial system and gives more policy options.
- Financial liberalization must be preceded by adequate prudential regulation.
- The regulatory framework should create a level playing field for all types of institutions to reduce arbitrage opportunities.
- Integrated supervision of all financial institutions would minimize information asymmetries and scope for regulatory arbitrage. In the aftermath of the crisis, consolidated supervision at the regional level may be advantageous particularly given the greater financial integration that resulted from the sales of the assets of the financial sector to regional firms.
- Foreign commercial banks played a positive role in reducing the adverse impact of the crisis; hence there is some support for a judicious mix of foreign and local institutions in the financial system.
- It is desirable to have a comprehensive exit strategy in place that deals with resolution and orderly exit from the industry before crisis develop.
- The early move to give a blanket guarantee calmed the financial markets and prevented runs on the institutions but may have added to the cost by creating moral hazard.
- Efforts to reform the legal and regulatory environment and the development of deposit insurance were positive steps, which took place after the outbreak of the crisis.
- It is not possible to protect all parties, hence adequate loss-sharing arrangements between the shareholders and the entity charged with resolving the crisis would reduce the burden on the public purse.
- Resolution by a public sector entity creates moral hazard that may increase the cost. However, with assets of 60 percent of the financial sector affected, market-based solutions to resolve the crisis may not have been feasible.

1/ Adapted from "*Lessons from the Jamaican Financial Crisis*," Chapter I of International Monetary Fund (2002).

132. The first issue relates to *the licensing process* (core principles 2 to 5 of the Basel Committee), exemplified in the dichotomy between the licensing and supervisory authorities. As stipulated in the Banking Act, the minister of finance in each country is responsible for issuing bank licenses, after consultation with the ECCB. The Act requires the ECCB to conduct a detailed investigation on the applicant so as to inform its recommendation, but the minister is not required to abide by this recommendation.[59] Thus, the minister is not required to issue a license only if the applicant meets the standards applied in ongoing supervision. Similarly, the minister is not required to abide by the ECCB's recommendations on such matters as the approval of new business premises, change in the structure of the bank, revocation of a bank license, etc. While the bank licensing and supervision may be entrusted to separate authorities, a mechanism is needed for their close collaboration in the exercise of their duties and to ensure that the ECCB's recommendations, based on the clear and objective criteria in the Banking Act, are fully incorporated in the licensing decisions. In particular, this should lead to the strengthening of the ECCB's role in the approval of bank licenses, changes in the structure of a bank and decisions on the revocation of bank licenses, ensuring that no decisions are made that are in contradiction to the ECCB's recommendation.

133. The second issue of concern relates to *the formal powers of the ECCB as a supervisor* (core principle 22). The ECCB has various instruments at its disposal to propose corrective measures to a bank that fails to meet supervisory requirements or engages in unsuitable business conduct. These range from moral suasion to drawing up a memorandum of understanding with the bank, but none of which are coercive or attach penalties. The ECCB does not have formal powers to require corrective action by the bank's management, nor can it intervene in a bank or impose penalties. Thus, the instruments available to the ECCB may not be sufficient to deal expeditiously with a serious crisis and widespread contagion, as would require ensuring that banks undertake certain actions that they would not accept voluntarily. The ECCB also does not have power to close a non-viable bank that has thwarted previous attempts to resolve its problems. The ECCB's supervisory powers would need to be strengthened so as to allow it to require corrective measures to be implemented when weaknesses are not addressed promptly, including by imposing penalties. The ECCB should also be vested with sufficient powers to intervene in a weak bank, and be able to issue a cease-and-desist order.

134. Another issue relates to the constraints on the ECCB's on the *sharing of information with supervisors in other jurisdictions* (core principle 24) *or with international organizations.* The Banking Act provides for only very few cases in which the ECCB could provide information to other supervisors such as on specific bank-clients or depositors

[59] There is already a bank operating in one of the ECCB-member countries as licensed by the minister, but remains outside the ECCB's supervision. The continued operation of that bank misleads the public about how closely it is supervised, since the public believes that it operates under the supervision of the ECCB like all other banks in the region.

without their consent, which falls short of accepted international best practices. These restrictions extend to the sharing of information with international institutions such as the IMF, which severely limits access to bank-specific data and consequently hampers the robustness of any assessment of bank soundness. The current restrictions would need to be amended to allow more transparent practices that are in line with best international practices.

135. Other areas of concern include strengthening the Acts to formally provide for the issuance of prudential regulations and criteria for risk-weighted capital adequacy, requiring banks to regularly publish accurate financial statements, and allowing for consolidated supervision.

The Problem of local banks

136. A potential source of vulnerabilities in the ECCU continues to be the weak locally owned banks, and particularly the four government-controlled banks or national banks.[60] For historical reasons these banks are of systemic importance in the ECCU, in light of their large relative size,[61] greater importance for small depositors, and importance as a source of lending to the public sector. The governments' control of these banks has given rise to their close alignment with the objectives of the government, by acting as the government's lender-of-last-resort and lending to public enterprises including for non-commercial and non-viable projects, which has given rise to a concentration of their lending in the public sector. For instance, the National Bank in St. Kitts and Nevis increases its lending to the insolvent sugar company by about EC$30 million each year, totaling EC$178 million in outstanding credits at end-2001 or 21 percent of the bank's assets, all of which are guaranteed by the government. In addition, the bank's total claims on the public sector were equivalent to 60 percent of its total claims. In Dominica, the National Commercial Bank has recently been the principal source of financing for the budget. Additionally, with regard to the liabilities of the national banks, the principal depositors are the social security boards, which channel their surpluses into deposits.

137. While the prevailing state of affairs of the national banks raises several issues of concern. ***First***, the concentration of their credits in the public sector exposes them to the risk that the governments may not honor their obligations on a timely basis as a result of tight

[60] These are the National Commercial Bank in Dominica (100 percent government owned), the St. Kitts and Nevis-Anguilla National Bank in St. Kitts and Nevis (51 percent), the National Commercial Bank in St. Vincent and the Grenadines (51 percent) and the Bank of St. Lucia (38 percent government ownership but still the largest shareholder. The Bank of St. Lucia was formerly called the National Commercial Bank in St. Lucia, until July 1, 2001, when it merged with St. Lucia Development Bank to form the East Caribbean Financial Holding Co, with Bank of St. Lucia as the primary subsidiary).

[61] These four banks account for a large share of the banking sector. The share of their loans in their respective countries, range from 25 percent in St. Lucia, 37 percent in both Dominica and St. Vincent and the Grenadines, and almost 50 percent in St. Kitts and Nevis.

public finances.[62] All governments have so far honored their debts to the domestic banking sector, in part with additional lending from the banks, earmarking current revenues, and the relief provided by external borrowing. However, some governments have been running arrears in other areas of their budgets, as a result of their weak fiscal positions; the government of Antigua and Barbuda has for several years been running arrears on external payments, estimated at 16¼ percent of GDP at end-2000, and arrears have now extended into all expenditure categories. The government of Dominica has arrears on its social security payments estimated at 4½ percent of GDP at end-2000 and has also been accumulating arrears to local suppliers. In Grenada, the government has been running arrears on its contributions and debt services payments to the national social security board (the National Insurance Scheme), estimated at about 10 percent of GDP at end-March 2002. Thus, even though all governments have so far met their repayments to domestic banks, there is the risk that the weak fiscal finances could give rise to a default on some government credits and result in deterioration in the quality of bank assets. ***Second***, the government's interests as the principal shareholder of any of these banks and a dominant borrower may conflict with its licensing and regulatory responsibilities. This could give rise to such outcomes as excessive regulatory forbearance over unsound decisions or practices by the bank, reluctance to take certain decisions that would improve banking supervision if these were not favorable to the government in its other roles. ***Third***, these banks will come under pressure when the social security boards, the principal depositors, begin to diversify their portfolio and move some of their deposits into other investments within the region and abroad.[63] These boards have in the past been barred from investing outside their own territories but there is already growing pressure to allow them to invest in safe but relatively lucrative foreign investments, in an effort to safeguard the long-term viability of these social boards.

138. The vulnerabilities arising from the close connection between the national banks and the public sector can be dealt with in two ways. More immediately, the ECCB could increase the risk-weight that banks apply to government securities and credits in the calculation of capital adequacy. The current structure applies a risk-weight of 0 percent on all domestic currency claims on the government and on government guaranteed debts, which satisfies the "minimum" recommended by the Basle Accord for such assets. However, within a setting of persistently weak budgetary finances and a central bank that does not accommodate the government's financing needs, it is arguable that a higher risk-weight should apply on all

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[62] There are antecedents of crises that are triggered by a default by the sovereign, the most notable being the Russian crisis that started in August 1998 when the central government defaulted on its domestic securities.

[63] This is reminiscent of the collapse in 1994 of the Social Bank in Estonia (representing about 20 percent of total bank assets), which was triggered by the government's decision to move its deposits elsewhere following concerns about the solvency of the bank. In the end, substantial liquidity support by the central bank, a merger with a smaller private bank, and subsequently with the fourth largest bank could not compensate for the weak management and poor quality of its loans that were at the root of its problems.

claims on the sovereign.[64] Additionally, the risk-weight that applies on claims on public enterprises but not guaranteed by the government should be raised to match the risk-weight on claims to the private sector. These changes could be carried out in the context of an immediate revision of the overall structure of the risk-weights. Less immediately, the government's control of the national bank in each of the countries should be reduced. This can be done by either selling off some of the shares that the government currently holds, selling off new shares to dilute the government's control and increase the capital base, or by a merger with some private bank, which could also be used as a strategy to strengthen management, and lending practices. It is therefore recommended that each of the governments design a time-bound plan of strengthening the practices of the national bank and its transformation into a modern bank.

139. A robust assessment of the soundness of the four national banks requires unavailable detailed information to ascertain the adequacy of capitalization, quality of assets, operating costs, liquidity situation, etc. However, some tentative conclusions can be made from an examination of some available indicators.

Lender of Last Resort Facility

140. The ECCB does not have a lender-of-last-resort (LOLR) facility through which it could extend liquidity support to a troubled but solvent bank. This is distinct from lending as part of the conduct of conventional monetary policy or through the standing facilities, such as through the ECCB's rediscount window for treasury bills.[65] Such a LOLR facility is important in mitigating the impact of a banking crisis and minimizing contagion, but its scope is considerably smaller under a CBA since the backing rule limits the available resources. Two factors may have contributed in the past to minimizing the need of a LOLR in the ECCU: **First**, the dominant presence of foreign-owned banks, which in a case of need could have obtained liquidity support from their headquarters.[66] **Second**, in the absence of extensive financial integration with the rest of the world, the banking sector in the ECCU has

[64] Following the August 1998 sovereign default in Russia, Russian banks are required to apply a risk-weight of 10 percent on claims on the central government and on domestic public sector entities. Other countries that assign non-zero weights to government assets include Ecuador (30 percent), Georgia (2 percent), Lebanon, Ukraine (100 percent), Venezuela (20 percent), and the six member countries of Central African Economic and Monetary Community (CAEMC) where risk-weights vary according to the debtor-country's adherence to defined "convergence criteria." Nicaragua will soon begin applying a 20 percent risk-weight, to be reviewed annually and increased if fiscal balances have not improved.

[65] However, the ECCB has emergency powers to intervene in the case of a bank of systemic importance in any of its territories. Still, in its credit allocation exercise, the ECCB takes into consideration that it may extend credit to a troubled institution.

[66] However, the experience in the recent Argentine crisis has demonstrated that foreign banks are not always willing to provide liquidity support to their local affiliates.

been relatively sheltered from the destabilizing effects of external shocks. However, the impact of both these factors would lessen in the period ahead, in light of the move towards greater integration with global markets, swifter capital flows, and the increasing role of local banks.

141. Given the high backing ratio the ECCB maintains compared to what is required by law and also the operating norm, theoretically the ECCB has a lot of room to extend credit to a troubled bank. However, regardless of the circumstances that would surround a specific case, it is doubtful that the ECCB would be willing to act as the LOLR at a significant level, lest this risked its own credibility and jeopardized the current regime. However, in the absence of formal rules that circumscribe the ECCB's functions as a LOLR, uncertainties remains with respect to the ECCB's reaction to a bank in distress, which weakens the ECCB's credibility of its commitment to the CBA. A formalization of a LOLR facility would therefore also be beneficial to banks in clarifying the incentive structure within which they operate.

142. Current best practices should be considered in designing the LOLR facility.[67] To this end, several issues would need to be taken into account. **First**, the LOLR should be rules-based, clarifying the requirements, terms and mechanisms, but without granting automatic access to the facility. **Second**, clearly defined limits would need to be set on the volume of the operations of this facility, so as to ensure that the credibility of the CBA is not impaired. **Third**, the design of the facility should follow best practices in limiting moral hazard in the behavior of banks. In particular, lending should be collateralized, short-term, at a penalty rate, and should have a clear exit. In addition, the borrowing bank should be subject to enhanced supervision, and consideration should be given for public disclosure of such operations. **Fourth**, if the bank in distress was also deemed to be at risk of insolvency, then the relevant Minister of Finance should also be involved in the decision to extend support.

Exit Policy for Banks

143. In addition to establishing a LOLR facility to deal with banks facing liquidity constraints, the vulnerability to a financial crisis would be further reduced by putting in place an exit policy for banks, to deal efficiently and expeditiously with the closure of an insolvent bank. Such an exit policy would be designed to minimize the risk of contagion from the failed bank to the rest of the financial system, and minimize costs to both the government and depositors.

144. The ECCB Act currently provides the ECCB with broad emergency powers to intervene in a bank, but only when the bank poses a serious risk to the financial system in a given country.[68] However, these powers do not extend to closing an institution. On the other

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[67] See He (2000) for a discussion of the design of LOLR facilities, and Freixas et al. (1999) for a review of the literature on the subject.

[68] ECCB Agreement Act, Part IIA. This was introduced in 1993 as an amendment to the Act.

hand, the Banking Act provides that the Minister of Finance in whose jurisdiction a bank is operating can revoke the bank's license after recommendation from the ECCB, but only upon giving the bank notice of his intentions and awaiting a response for a minimum period of 30 days.[69] Thus, while the ECCB can move expeditiously to intervene in a weak bank of systemic importance, it cannot quickly close the bank if it judged it to be insolvent. Further, in the case of an insolvent bank that does not pose a systemic risk to a country's financial system, the ECCB does not have powers to intervene nor can the operations of such a bank be terminated quickly. Such a delay potentially increases the overall cost that will be borne by depositors and taxpayers, since any delay in closing the bank will allow further losses of the bank's assets.

145. The exit policy of banks in the ECCU is in urgent need of improvement. This should allow the ECCB to intervene on a timely basis in any bank, systemic or not, in cases of serious operational deficiencies. The policy would also allow the timely and orderly closure of an insolvent bank. It would be best if the exit policy was rules-based, allowing only minimal discretion to the ECCB and the Minister of Finance, with triggers that define the steps to be taken at every stage of the intervention. The cost for such intervention should, to the extent possible, be allocated in advance between the ECCB and the relevant government.

Deposit Insurance

146. In addition to a LOLR facility and an exit policy for banks, a well-functioning deposit insurance fund (DIF) would help to reduce the system's vulnerability to a financial crisis. A DIF discourages runs on banks by depositors by enhancing public confidence in the liquidity of bank deposits, and thereby reducing the potential of self-fulfilling bank runs and contagion in the event of a bank failure. A DIF compensates depositors in a pre-defined manner, and can therefore also provide targeted protection to small depositors by providing immediate payout of their deposits. Additionally, compared to an implicit deposit protection system, as arises when the public believes that the government will step in to pay depositors in a failed bank, a DIF is preferred in that it clarifies the authorities' responsibility while limiting discretion, which reduces the government's exposure. However, taken by itself, the introduction of a DIF may exacerbate moral hazard problems by giving banks an incentive to take excessive risks and maintain lower levels of capital, as well reduce the quality of supervision by depositors and other creditors and thereby weakening market discipline. A DIF should therefore be seen as just one facet of the financial safety net and within the context of the supervision and regulatory framework, all of which aim to minimize agency problems maximize social benefits.

147. **There is currently no explicit system of deposit insurance in the ECCU area.** However, it is quite likely that the public perceives an implicit government guarantee on deposits, as was the case during the 1996-97 banking crisis in Jamaica. While a major financial

[69] Banking Act, Section 10.

crisis has not occurred in the ECCU area, increased global integration has increased the banking system's vulnerability. Along with the need to align the safety net and structure of incentives with the supervision and regulatory regime, this provides grounds for the introduction of a DIF. Issues that would need to be addressed in the design of such a DIF include, the disparity of ownership structures of banks in the region which generates different regimes of oversight by owners and depositors, disparity in the strength of individual banks, the need to improve the supervision and regulatory regime, etc. As advocated by the FSF, such an initiative should start with an assessment of the financial sector and its context, which could be done before or in the context of conducting the World Bank/IMF assisted FSAP for the region.

C. Enhancing the Efficiency of the Financial System

148. There is ample evidence of existing inefficiencies in the ECCU's financial sector. This evidence includes the uneven interest rates in the banking system across the ECCU area (Table 2), their rigidity and lack of responsiveness to liquidity conditions, the large spreads, the mandatory floor on savings rates, and a non-banking sector that has hardly innovated its operations and services. The inefficiencies evidenced by the interest rate structure derive in part from bank-specific difficulties, such as high operating costs and the impact of nonperforming loans.[70] Additionally, anecdotal evidence suggests that lenders (and especially banks) utilize the monopolistic power afforded by information asymmetries with respect to their borrowers; lending is based mainly on historical relationships and on collateral lending rather than on robust credit analysis, which provides an informational advantage to the repeated lender and hinders borrowers from switching lenders.[71] Lending institutions may also want to have large liquidity cushions as a protection against potential risks, in the absence of other mechanisms such as a LOLR facility and a DIF. Nevertheless, these inefficiencies represent a cost to the intermediation process, which could be reduced by implementing policies to strengthen the overall financial sector and reducing the barriers to capital movement so as to facilitate regional integration.

Strengthening of the Financial Sector

149. **The implementation of the policies to strengthen the banking sector as elaborated in the previous section, would contribute substantially in reducing the inefficiencies that exist in the banking sector.** In addition, improvements in the lending practices should be supported, aimed at fostering a greater reliance on credit assessments and cash flow analysis while reducing the importance of collateral lending and historical

[70] Randall (1998) identifies high operational costs as a key determinant of the large interest rate spreads in the ECCU area.

[71] The problematic nature of collateral lending was exemplified in the Asian financial crisis, as discussed in Lindgren et al. (1999), pp. 14-15.

relationships. However, while the ECCB can encourage such improvements, fostering such developments necessarily falls beyond its mandate, and may also in turn require improving both the accounting and transparency standards for companies and financial institutions in the ECCU area, to match best international practices.

150. **With regard to the non-bank financial institutions, the most urgent task is the strengthening of the weak and irregular supervision of credit unions, insurance companies, development banks and other financial institutions.** In addition to creating a potential for a crisis in the non-banking sector, the weak supervision increases the potential for regulatory arbitrage with the banking sector, where non-banking institutions create bank-like products that compete effectively against banks, and encourages the development of financial conglomerates that aim to take advantage of their weakly supervised parts. Thus, a high priority should be assigned to developing a regional framework for supervisory activities for non-bank financial institutions, to bring the practices in the non-banking sector in line with best international practices and provide the same high quality of supervision as in the banking sector.

Capital Controls

151. The existing regime of capital controls in the ECCU is summarized in Table 3. These controls are administered in each country by the ministry of finance, and can be characterized as follows: Capital account transactions are *de jure* fairly liberal, largely requiring prior approval for large outward transactions and some restrictions on lending to nonresidents; in practice the controls are administered even more liberally; the controls in any country do not discriminate between transactions with residents of other ECCU countries and residents of countries outside the ECCU; and the controls on transactions with residents of countries outside the region are uneven across the ECCU countries. However, some restrictions also apply on current account transactions, principally in the form of an approval requirement for invisible transactions above a certain limit, [72] and except for Antigua and Barbuda and also Anguilla, surrender requirements apply though these are not enforced.

152. At the outset, the existing regime of capital controls could be brought in line with current practice, and thereby make their administration more predictable. However, the regime could be improved further in three ways: first, capital movements between the ECCU should be fully liberalized, given their close connectedness—through a common regime of monetary policy, pooling their foreign exchange reserves at the ECCB, a relatively integrated banking system, etc.—and that the control of capital flows within the ECCU area cannot be justified on the grounds of safeguarding macroeconomic stability. Whereas these intra-ECCU controls may have arisen because of difficulties in distinguishing capital flows that originate (or terminate) within and outside the ECCU area, the resultant market segmentation gives rise

[72] These restrictions do not formally constitute exchange restrictions under Fund jurisdiction, since *bona fide* requests above these limits are approved.

to economic costs and hampers the development of the financial sector. The elimination of capital controls within the ECCU will facilitate greater financial integration in the region and contribute to enhancing of the financial system's efficiency. Second, given the connectedness of the ECCU members, an uneven regime of capital controls across ECCU member for flows outside the region cannot be justified except by historical circumstances, and from a point of view of safeguarding macroeconomic stability within the region, the effective regime is the most liberal. The current regime of controls could thus be improved by introducing a uniform and fairly liberal regime for capital flows with non-ECCU territories. This would in turn strengthen the credibility of the existing CBA and facilitate greater integration with the rest of the world. Finally, in line with the suggested consolidation of the capital controls, some cost saving could be obtained if the responsibility for their administration and enforcement was centralized within the ECCB, which is also better placed to carry out an effective oversight especially in the extreme cases when the stability of the financial system is in jeopardy.

D. Conclusions

153. Despite the remarkable stability of the financial sector in the ECCU even in the face of financial crises in other parts of the world, some areas of weakness remain that render the sector vulnerable to a crisis that could jeopardize the existing currency arrangement. With regard to the banking system, available data do not indicate an unsound aggregate banking sector but there is particular concern about the national banks. The financial system in the ECCU also needs to be brought into greater conformity with the reality of the existing currency union arrangement operating under a currency board arrangement (CBA). Other banking sector vulnerabilities are mainly structural in nature, and include weaknesses in supervision and the regulatory regime, the absence of a LOLR facility and a DIF, and the lack of a defined exit policy for banks. Additionally, there are significant inefficiencies and distortions in the overall financial system that could serve as a channel for the transmission and magnification of incipient financial crisis. These include those emanating from a weak and irregular supervision regime for nonbank financial institutions, and the existing regime of capital controls.

154. Looking ahead, it is critical that these weaknesses and related vulnerabilities are addressed so that a robust financial system may emerge, which is essential for the preservation of the current exchange rate and monetary regime in ECCU. Additionally a strengthened financial sector would more adequately contend with the ongoing transformation of these economies, including the risks that are borne by a closer integration to the global financial markets and trading structures. The paper has described specific measures, in line with the accepted best practices, that would reduce the vulnerabilities in the financial system. Measures to improve supervision and regulatory environment of banks are elaborated. Other measures include those that would address the weaknesses of the national banks, the creation of a lender-of-last-resort facility and of a deposit insurance fund, improving the regulatory regimes and the supervision of non-bank financial institutions, and enhancing the accounting and transparency practices of businesses and financial institutions.

155. ***Prompt action to address the existing vulnerabilities should be*** **emphasized if the current arrangements of ECCU are not to be jeopardized. To this end, several tasks that fall within the current powers the ECCB and the ministries of finance can be carried out immediately,** while other policies may have to await a consensus among the various governments. Still, it is urgent that all policies that are needed to strengthen the financial sector be implemented as quickly, in light of the paramount importance of a healthy financial system and particularly the banking sector. It is hoped that this paper can help sharpen the policy debate on these issues, and more generally, on the sustainability of the ECCU's institutional arrangements. Finally, we note that a particularly opportune focal point for the debate on financial sector vulnerabilities would be the region's assessment under the IMF and World Bank's Financial Sector Assessment Program (FSAP), expected in the second half of 2003. A detailed roadmap of the policies that remain to be implemented could be drawn up at that stage.

Table 1. Commercial Bank Credit to the Public Sector 1/
(end of period; as a percentage of total loans)

	1996	1997	1998	1999	2000	2001	March 2002	June 2002
Antigua and Barbuda	18.5	17.9	20.1	22.2	21.9	20.6	20.5	19.5
Dominica	21.5	22.0	21.2	22.0	22.2	23.3	22.8	22.5
Grenada	12.5	13.7	13.2	10.3	12.6	15.6	17.0	17.6
St. Kitts and Nevis	33.1	29.0	32.7	35.1	39.0	41.7	41.6	43.9
St. Lucia	9.8	9.9	11.1	10.6	11.5	11.0	11.1	11.6
St. Vincent and the Grenadines	19.4	17.9	17.1	17.1	18.6	20.0	22.0	26.4
All six countries	**18.1**	**17.3**	**18.5**	**18.9**	**20.4**	**21.1**	**21.4**	**22.3**

Source: Calculated from data provided by the ECCB.

1/ Bank sector claims on the central government, local governments and public enterprises as a percentage of all claims.

Table 2. ECCU: Weighted Commercial Bank Interest Rates
(In percent per annum)

	1996	1997	1998	1999	2000	2001
ECCU Area						
Weighted deposit rate	4.1	4.3	4.3	4.3	4.5	4.3
Weighted loan rate	11.8	11.9	11.6	12.0	11.9	11.5
Weighted reducing balance rate	11.1	11.3	11.0	11.6	11.4	11.0
Weighted add-on loan rate	15.2	15.5	15.2	15.1	14.9	13.9
Spread between loan and deposit rate	7.6	7.6	7.3	7.7	7.4	7.2
Anguilla						
Weighted deposit rate	3.7	3.8	3.7	3.8	3.8	3.3
Weighted loan rate	11.8	11.3	11.2	11.3	11.4	10.6
Weighted reducing balance rate	11.1	10.8	10.6	10.7	10.7	10.2
Weighted add-on loan rate	16.0	14.0	14.2	14.2	15.8	13.3
Spread between loan and deposit rate	8.1	7.5	7.5	7.5	7.6	7.3
Antigua and Barbuda						
Weighted deposit rate	4.2	4.5	4.4	4.3	5.0	4.4
Weighted loan rate	12.3	12.1	12.2	12.2	12.2	11.5
Weighted reducing balance rate	11.7	11.7	11.7	11.8	11.9	11.2
Weighted add-on loan rate	14.4	14.5	14.1	13.5	13.6	12.7
Spread between loan and deposit rate	8.1	7.6	7.8	7.9	7.2	7.1
Dominica						
Weighted deposit rate	4.3	4.3	4.0	3.8	3.7	4.0
Weighted loan rate	11.5	11.0	11.2	11.7	10.6	11.0
Weighted reducing balance rate	11.0	10.5	10.5	11.0	10.2	10.4
Weighted add-on loan rate	16.5	16.6	17.2	17.3	16.1	17.3
Spread between loan and deposit rate	7.2	6.7	7.2	7.9	6.9	7.0
Grenada						
Weighted deposit rate	3.8	4.0	4.3	4.3	4.2	4.2
Weighted loan rate	10.1	11.5	11.8	11.7	11.5	10.1
Weighted reducing balance rate	9.7	11.4	11.7	11.6	11.2	9.4
Weighted add-on loan rate	13.7	13.1	13.2	13.5	13.4	11.7
Spread between loan and deposit rate	6.3	7.5	7.6	7.3	7.3	5.9
Montserrat						
Weighted deposit rate	3.3	2.5	2.8	3.3	3.5	3.4
Weighted loan rate	12.2	12.4	12.1	11.4	11.4	11.6
Weighted reducing balance rate	11.9	12.1	11.7	11.0	11.4	11.3
Weighted add-on loan rate	15.2	16.4	15.2	14.4	11.8	13.5
Spread between loan and deposit rate	8.9	9.9	9.3	8.2	8.0	8.2
St. Kitts and Nevis						
Weighted deposit rate	4.0	4.1	4.2	4.3	4.3	4.2
Weighted loan rate	11.0	11.3	11.3	11.2	11.1	11.1
Weighted reducing balance rate	10.7	10.6	10.7	10.7	10.6	10.7
Weighted add-on loan rate	12.1	14.9	15.4	14.9	14.5	14.0
Spread between loan and deposit rate	7.0	7.2	7.1	6.9	6.8	7.0
St. Lucia						
Weighted deposit rate	4.6	4.6	4.8	4.8	4.9	4.8
Weighted loan rate	12.9	12.8	11.2	13.1	13.1	12.8
Weighted reducing balance rate	11.8	11.7	10.0	12.3	12.3	12.1
Weighted add-on loan rate	18.7	17.5	16.7	16.9	16.7	17.5
Spread between loan and deposit rate	8.4	8.1	6.5	8.3	8.1	8.0
St. Vincent and the Grenadines						
Weighted deposit rate	4.1	4.2	4.4	4.6	4.5	4.5
Weighted loan rate	11.2	11.4	11.4	11.6	11.5	11.9
Weighted reducing balance rate	10.6	10.8	11.3	11.4	11.4	11.5
Weighted add-on loan rate	14.5	14.4	14.5	16.5	15.5	18.1
Spread between loan and deposit rate	7.1	7.2	7.0	7.0	7.0	7.3

Source: Eastern Caribbean Central Bank.

1/ Annual averages shown are based on end of quarter rates.

Table 3. ECCU: Controls on Capital and Other Transactions

	Invisible Transactions and Current Transfers	Capital Transactions
1. Anguilla	There are no restrictions, except for a 2 percent levy on foreign exchange purchases from a commercial bank.	There are no restrictions, except for a 2 percent levy on foreign exchange purchases from a commercial bank.
2. Antigua and Barbuda	Payments for invisibles exceeding EC$250,000 requires prior approval for certain categories, e.g. travel, medical and studies abroad. There are no surrender requirements.	The Financial Secretary may phase large outward transfers of direct investment over time. Approval is required for lending to nonresidents.
3. Dominica	Prior approval is required to buy foreign exchange of more than EC$250,000, except for some categories such as pensions, family maintenance funds, subscriptions. The surrender of foreign exchange from invisible transactions is mandatory.	All outward capital transfers in excess of EC$250,000 require prior approval. Approval is required for lending to nonresidents. Also, lending locally in foreign currency is generally not permitted.
4. Grenada	Payments for invisibles exceeding EC$250,000 requires prior approval, except subscriptions and membership fees. The surrender of foreign exchange from invisible transactions is mandatory.	All outward capital transfers in excess of EC$250,000 require prior approval. Local currency lending to nonresidents requires approval but is generally not permitted.
5. Montserrat	Prior approval is required to buy foreign exchange of more than EC$250,000. Payments for invisibles require prior approval. There is a 1.75 percent levy on the purchase of foreign exchange. The surrender of foreign exchange from exports is mandatory.	All outward capital flows in excess of EC$250,000 require prior approval. There is a 1.75 percent levy on the purchase of foreign exchange. Prior approval is required to open a foreign currency account.
6. St. Kitts and Nevis	Payments for invisibles exceeding EC$250,000 requires prior approval. The surrender of foreign exchange from invisible transactions is required.	Outward capital transactions exceeding EC$250,000 require prior approval. Approval is required for lending to nonresidents. Also, lending locally in foreign exchange requires prior approval.
7. St. Lucia	Payments for invisibles exceeding EC$250,000 requires prior approval. The surrender of foreign exchange from invisible transactions exceeding EC$250,000 is required.	Outward capital transactions exceeding EC$250,000 require prior approval. Lending locally in foreign currency is conducted only in U.S. dollars.
8. St. Vincent and the Grenadines	Except for payments for invisibles related to authorize imports, other payments for invisibles exceeding EC$250,000 requires prior approval. The surrender of foreign exchange from invisible transactions is required.	Outward capital transactions exceeding EC$250,000 require prior approval. Lending locally in foreign currency is conducted only in U.S. dollars.

Sources: IMF, *Annual Report on Exchange Arrangements and Exchange Restrictions* (various years); and official websites of the authorities in Montserrat and Anguilla.