1. The joint World Bank–IMF FSAP to the countries of the Eastern Caribbean Currency Union (ECCU) was carried out in September and October of 2003. The assessment covered both (i) stability issues, including banking system soundness; supervision and regulation of banking; and the adequacy of financial sector crisis management arrangements; and (ii) structural and development issues, specifically competitiveness, efficiency and reach of the financial system including development of non-bank financial institutions and markets. This Financial Sector Assessment report summarizes the overall assessment, providing additional detail on the structural and development issues, and highlights the main recommendations that have been provided to the authorities.

1 The eight members of the ECCU are Anguilla, Antigua and Barbuda, Dominica, Grenada, Montserrat, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines. Anguilla and Montserrat are dependent territories of the United Kingdom.

2 The mission members were: Messrs/Mmes. R. Barry Johnston (Team leader, IMF) and Patrick Honohan (Deputy leader, World Bank), Ritu Basu, Francisco Figueroa, Patrick Njoroge, Philip Schellekens, Manuel Vasquez, Delisle Worrell (all IMF), Melinda Roth and Craig Thorburn (World Bank), John Aspden (Isle of Man Financial Supervision Commission), Anthony Maxwell (Office of the Superintendent of Financial Institutions, Canada), Millard Long and Marcel Maes (Consultant Experts); the missions were assisted by Mmes. Sonia Echeverri and Adriana Rota (Assistants, IMF). The team received extensive cooperation from the Governor and staff of the Eastern Caribbean Central Bank as well as the Financial/Permanent Secretaries from each of the ECCU member countries, other government agencies involved in regulation and supervision of the financial system, banks and other financial institutions, and other private sector participants.

3 A full assessment of the Basel Core Principles (BCP) for Effective Banking Supervision was conducted for onshore banking in the Union. BCP assessments in respect of offshore banking in the jurisdictions where that sector is most active were carried out under Fund supervision.

4 Assessments of the AML/CFT regimes of Dominica, Grenada, St. Lucia, St. Kitts and Nevis and St. Vincent and the Grenadines, using the common methodology, were conducted in September 2003 by the Trinidad-based Caribbean Financial Action Task Force (CFATF). The Bank intends to assess the AML/CFT regime of Antigua and Barbuda later in 2004. The AML/CFT regimes of Anguilla and Montserrat were assessed in October/November 2002, as part of the Fund’s OFC Module 2 program.
I. OVERALL ASSESSMENT OF FINANCIAL STABILITY AND DEVELOPMENT PRIORITIES

2. The Eastern Caribbean Currency Union, with its fixed exchange rate peg, has experienced a sustained period of monetary and financial stability for many decades. Its banking sector is relatively deep and, together with the cooperative credit unions, has achieved an impressive reach providing access to some formal financial services for a very large share of the population. Recent developments have included the establishment of a regional securities market on which some of the Union's governments have floated debt. Despite recent macroeconomic pressures, there is continuing confidence in the financial system.

3. The role of the Eastern Caribbean Central Bank (ECCB) in underpinning these strengths has been considerable. It has placed itself at the service of the national governments of the Union in energetically and imaginatively promoting three interlinked prongs of financial sector policy: (i) maintenance of monetary stability; (ii) protection of the safety and soundness of the banking institutions; and (iii) market development. Each of these contributes to financial stability; each is also needed for increasing the contribution of finance to growth.

4. Emerging risks to the ECCU (see Box 1) now call for a renewed effort on the part of the ECCB to take a more forthright role in protecting the soundness of the financial system of the Union as a whole. This effort will require a refocusing of its resources.

5. Not only is the recoverability of private loans being challenged by the deterioration in the external environment and an apparent deterioration in the quality of loan appraisal reflecting governance issues. Nor is it only the heightened risk coming from the entry of more aggressive regional banks and the partial retreat of the old-established foreign-bank parents. Perhaps most important among the emerging risks are those associated with the fiscal pressures in the region that are beginning to impact the financial system. Several indigenous banks are highly exposed to their local public sector, and the rapid build-up in government borrowing in some jurisdictions, combined with sizable domestic arrears by these governments, raise a key concern that, if the current situation continues and deteriorates, the central bank would be called upon to meet a liquidity need attributable, directly or indirectly, to government arrears. Such support could pose a threat to the credibility of the currency peg that is the basis of the stability in the ECCU.

6. Several warning signs of the emerging risks to the financial system have been identified by the FSAP team. Any one alone would not be enough to cause concern; together they add up to the diagnosis of fragility in the system. In addition to exposure to the public sector, these include: (i) weaknesses in the regulatory and supervisory framework for bank supervision, relative to the requirements of the Basel Core Principles, including lack of enforcement capacity; (ii) weaknesses in follow-up actions, as well as inadequate frequency of onsite inspections; and (iii) substantial levels of non-performing and other unsatisfactory or worrisome loans in the system as a whole.

7. To address the emerging risks and in the absence of a credible crisis management framework, the efforts of the ECCB need to emphasize enforcement of banking governance and prudential standards. Moreover, given that national governments are the source of some
of the financial fragility, it is important to strengthen the ECCB's independence of action vis-à-vis individual governments.

8. Access by households and small business to at least some financial services appears to be relatively high in the region, with, for example, a majority of households having at least one account at a bank, credit union or other nearbank.

9. Despite the large number of banks and the contribution to competition from, on the one hand, the credit unions and, on the other, the presence of foreign-owned banks, banking is far from perfectly competitive in the region. While some of the high bank spreads reflect the costs of small-scale operations, foreign-owned banks in particular appear to enjoy some market power, and there is little cross-border competition between the different islands. As the foreign banks continue to roll-out cost-saving technology from their parents, the pressure on locally-owned banks will increase. The local banks' cooperative cross-border efforts to seek scale efficiencies will become increasingly important if they are to compete more effectively and contribute to long-term economic growth on a sustained basis. Weak competition between insurance companies also is reflected in high premia.

10. The investments of the national insurance schemes are dominated by short-term assets in banks, exposures to local governments and statutory authorities, and are socially oriented rather than being optimized against risk and return. This undermines their potential role as providers of long term, venture and development funds on proper commercial terms.

11. Development and integration of the Union-wide financial market has been a central theme of the ECCB's activities in the last several years. This has been a well-conceived and generally well-executed program, which is now beginning to bear fruit, notably in terms of the emergence of a transparent securities exchange.

12. The limited activity of the organized ECCU securities markets reflects the small number and size of securities and the lack of active domestic institutional investors. Access to such markets is important, though even when the financial market within the Union is more fully integrated, it will remain small in absolute terms without the ability to achieve on its own the economies of scale offered by the global financial system. International linkages in what has long been a relatively open system will remain important.
Box 1: Checklist of risks to financial stability

Credit quality
High level of NPLs due variously to weak economic performance, related lending, lending in excess of regulatory limits, and difficulties of foreclosure.

Public sector debt and deficits
Some indigenous banks exposed to a deterioration in their government’s fiscal position especially where arrears are involved. A broader risk to the sector as a whole if fiscal position impinges on the ability of other sectors to service their debts and on confidence.

Quality of banks’ capital
While above Base1 norms, the quality of capital of a few indigenous banks is uncertain reflecting, inter alia, the high levels of un provisioned NPLs, the practice of some banks of taking accrued interest on government loans in arrears into income; and the zero risk weights applied to public sector debt in arrears.

Lack of contingency plans
The ECCB would benefit from the exercise of developing contingency plans to deal with deposit withdrawals and capital flight.

Weakness in the domestic banking regulatory regime
ECCB lacks the necessary enforcement powers, reflected in incidents of regulatory forbearance. While the proposed revisions to the Banking and ECCB Acts will help, there are areas where the powers could be further strengthened. Off site monitoring is hampered by some deficiencies in the quality, timeliness and availability of key data. More resources need to be devoted to on-site monitoring of weak institutions and to institutions that pose systemic risks to the financial system.

Weaknesses in supervision of NBFIs and offshore banks
Weak supervision of NBFIs and offshore banks is another source of vulnerability, though, with a few exceptions, the systemic relevance of these financial institutions is considerably less than the domestic banks.* The shortcomings in the supervision and regulation of offshore banking are similar in nature to those identified for domestic banks but are more acute for offshore than domestic banking in the jurisdictions assessed. Although the ECCB has agreed to assist in the supervision of offshore banks, its authority, responsibilities and accountability in these matters is unclear in several cases. There is one jurisdiction where the ECCB has not been involved in the supervision of offshore banks (including a very large one) that are affiliated with domestic banks. Without the assignment of adequate powers and resources, the ECCB faces reputation risk.

* The offshore sector has also been shrinking, in response to the various international initiatives of recent years. Currently there are 53 offshore banks (ten of which are currently under some form of supervisory intervention) which is about one-third of the number of just a couple of years ago.
II. STRUCTURAL AND DEVELOPMENT ISSUES

13. The ECCU financial system has several distinctive features, in terms of its depth and reach, and the diversity of institutional type and ownership. It remains commercial bank dominated, each jurisdiction having at least four banks. In all there are 39 (onshore) commercial banks, though this counts separately each national branch or subsidiary of the six international banking groups present in the Union. Four of the locally-owned banks are fully or majority government-owned. The ratio of M2 to GDP is estimated at up to 95 percent, a relatively high figure for this level of development.

14. In addition to the commercial banks, the sector includes a sizeable number of nearbanks whose total assets are equivalent in size to about 24 percent of GDP. The most important of these are the 71 cooperative credit unions. The insurance sector is somewhat more developed than has been reported by previous commentators, with annual premium income of between 4 and 7 percent of GDP, in the jurisdictions for which data is available, and total assets on the order of 12 percent of GDP. Each country has a sizable and growing partly funded national insurance system, whose total assets amount to about 15 percent of GDP.

15. Thanks largely to the initiative of the ECCB, there is now a regionwide Eastern Caribbean Securities Exchange (ECSE) and a Regional Government Securities Market (RGSM). However, market capitalization is still small in comparison to the rest of the financial system and trading is light; no funds have been raised through the equity listings.

A. Access and Social Finance

16. The widespread access to at least some financial services is chiefly related to the remarkably high penetration of the cooperative credit unions. Banks and some of the finance companies serve wealthier clients. Most of the nearbank financial intermediaries, including the credit unions, mortgage institutions, and development banks and foundations have, as their stated primary objective, to finance development activities or to provide financial services to their members, who are largely drawn from middle- and lower-income groups. However, it needs to be stressed that these institutions also provide residential mortgage finance for upper-middle income groups and credit unions can and do finance fairly substantial business ventures.

17. The national insurance schemes represent the most substantial collection of long-term funds in the ECCU. Their investment policies have been advancing in their sophistication and the transparency of fund operations is, in most cases, in line with other countries at similar levels of development. However, investments are dominated by short-term assets in banks, exposures to local governments and statutory authorities, and are socially oriented rather than being optimized against risk and return. In several jurisdictions, and to varying degrees, the investment operations are mixed with a government role in providing subsidized funding for government projects or acting as a supplier of funds to government or to particular interests within society. This undermines their potential role as long-term investors and providers of venture and development funds on commercial terms.
18. Several of the national development banks and similar institutions have had, as in other parts of the world, a somewhat checkered career, and many are considering their future. While merging or closing are options that can be considered, there may be several legitimate reasons for continuing to have an independent development bank. It is easier for a government-owned bank to arrange loans with multi-lateral and bilateral lenders that require a government guarantee. Second, there may be non-commercial social lending programs, such as student loan programs, that the commercial banks would be reluctant to administer. Third, lending programs administered by ad hoc government agencies tend to have even worse records than those administered by development banks managed by financial professionals.

19. For those ECCU countries opting to continue to operate a development bank, it is of paramount importance to improve the financial performance of such an institution. However, development banks should not be encouraged to diversify into lending and other activities simply to improve their financial performance. Indeed, the need for public sector support of such development bank programs as housing finance, now competitively provided by many intermediaries, should be reassessed.

B. Competitiveness

20. Continued openness to foreign ownership of financial institutions has played a role in ensuring some competition. The relatively large number of banks present on each island despite the tiny market size is testimony to this. Nevertheless, the banking sector is far from perfectly competitive.

21. Changing ownership and technology in banking will alter the competitive environment in banking. Segmentation likely will diminish further, enhancing the range of services available to SMEs, while presenting challenges to the local institutions, already experiencing narrower margins and inadequate scale. Small financial systems usually suffer from lack of competition, though in the ECCU the complaints of users more often focus on the lack of patient capital, and on the keenness of the banks to foreclose, not a shortage of competition. This perception may reflect the comparative proliferation of, and low concentration among, financial service providers.

22. Although data on broad sectoral lending patterns provide little indication of a segmentation in the market as between foreign-owned, government-owned and other banks (except that government-owned banks lend more to the public sector), there is evidence of segmentation along other dimensions. The old-established foreign banks focus more on larger customers and foreign-owned concerns, and discourage small customers with high, fixed transactions charges. Furthermore detailed analysis of the distribution of interest rates charged by different banks suggests that each exploits niches and local market conditions. Overall spreads are high, and differ as between different categories of ownership. One striking feature is that the main foreign-owned banking groups have managed to retain a higher interest spread than the privately-controlled local banks, which in turn have had higher spreads than the government-owned banks. The composition of this differential helps to reveal contrasting strategies: foreign banks pay less for their deposits but they also charge less for their loans than the locally-owned private banks, suggesting that they concentrate on a lower-risk borrowing clientele.
23. It is also evident that strong banking competition does not yet extend across borders within the Union. There is little cross-border lending. Even within the same banking group, the reported pattern of lending interest rates is different from country to country, suggesting that each bank responds to local market conditions in setting rates. Furthermore, the recent insensitivity of local wholesale interest rates to movements in international US dollar interest rates is suggestive of a banking market which, despite fairly liberal capital controls, remains somewhat insulated from the rest of the world, likely reflecting inertia by large depositors in the face of what might be relatively short-lived differentials. Such inertia can be expected to diminish over time.

24. As the foreign banks continue to roll out cost-saving technology from their parents, competitive pressure on locally-owned banks will increase. Their cooperative efforts to seek scale efficiencies will become increasingly important. A cross-island merger of the larger locally-owned banks, diluting the ownership share of any individual government and perhaps ultimately leading to full privatization, seems to be both a likely future scenario and one that would offer good potential for achieving minimum scale economies and enhanced risk-management, while continuing to provide competition on a Union-wide basis for the foreign-owned banks by serving the locally-owned banks' existing clientele.

25. Insurance is still in the market development phase, where it is "sold not bought." Therefore, competition between insurance companies is for the most effective sales agents, and not on price. Premia are high and will not settle until the market achieves wider penetration.

C. Capital Market Development

26. Transparent securities markets not only perform a useful governance role and generate competitive pressure on the banks, but also provide liquidity, and a basis for pricing government and other debt. Access to such markets is important, though whether the route chosen by the ECCU, namely to build the markets at home (rather than working on enhancing access to international markets), is ultimately the most cost-effective for a small economy today could be questioned.

27. The limited activity of the organized ECCU securities markets reflects the small number and size of securities and the lack of active domestic institutional investors. In addition to the five companies currently listed on the ECSE, 25 other public companies now considered "reporting companies" have the obligation to provide semi-annual and annual reports to the regulatory authority. These companies, along with several parastatals and government-owned companies (and stakes of companies) that might be privatized, represent a potential pool of additional equity securities for the ECSE. At present, the prospects for an active two-way market in any of these securities is somewhat remote, although some eventual widening of the scope of the market to the Caribbean region, and developing other international connections, is plausible. Growth in debt issues is more likely, through the development of a deeper government bond market and extension of the current maturities of

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5 In the three years to end-2003, mean quoted deposit rates in the ECCU area -- which had been below U.S. rates -- fell by only about 70 basis points as compared with about 500 basis points in U.S. rates.
bills and bonds. Without an increase in activity, administrative costs will continue to be a concern as they are for small markets around the world; to date, the ECCB has been subsidizing the operating costs of the ECSE.

28. The Eastern Caribbean Home Mortgage Bank (ECHMB), established in 1996, with the active support of the ECCB has successfully initiated the process of bringing a wholesaler approach to residential mortgages. To date, the purchase of mortgages has been with recourse back to the originating bank. The ECHMB has attempted to contract for fixed-rate mortgages, although the decline in mortgage rates during 2002–3 led in practice to a sharing of the resulting loss of interest between the originating bank and the ECHMB, an experience that serves to illustrate some of the risks involved in mortgage intermediation and the difficulty of ensuring that risk mitigation through contract is watertight in all circumstances. Because there is recourse, ECHMB has not helped to expand capital, although it has contributed to liquidity. Further steps, such as securitization of mortgages without recourse and listing of the mortgage-backed securities on the ECSE, hold the potential for bringing further transparency as well as replenishing the capital of mortgage lenders. However, the degree to which the current success of the ECHMB in profitably selling more than ECS 100 million worth of bonds has been attributable to the tax-free status of their bonds is unclear.

29. Further proposed capital market-related initiatives (sponsored, as with the others, by the ECCB), include an ECCU Enterprise Fund and an ECCU Unit Trust. Greater transparency and assurance of good corporate governance would be needed for an unit trust investing in unlisted securities to be assured of success; it is unclear whether the market is sufficiently well-equipped yet in this regard.

D. Taxation

30. Tax issues have been significant drivers of certain market and banking practices. The implicit tax on banks through the unremunerated six percent reserve requirement is perhaps the most significant regionwide financial tax distortion. Adding perhaps 30 basis points to the intermediation spread – and in effect to the average cost of credit – this quasi-tax also has resulted in regulatory arbitrage by smaller intermediaries opting not to choose a full banking license. As such, it contributes to the fragmentation of the system and should, over time, be reduced, e.g. through the remuneration of required reserves.

31. As a protection for small savers, the concept of a minimum savings rate does not represent a serious distortion. The present floor of three percent (reduced from four percent in 2002) applies, on average, to only about a fifth of the total deposit base, though to much more for some banks. The present rate is rather high relative to wholesale rates in the region, although it benefits small depositors in the short run. As a quasi-tax, it also could contribute de facto to a restriction of access by small savers to banking services. Therefore, the floor rate should be reviewed periodically and adjusted in line with wholesale market rates.

32. It has been widely noted that credit unions benefit from a number of tax privileges, including exemption from income tax. However, applying income tax to the unions in an nondistortionary way would require special treatment; most of the dividends paid to members are more in the nature of interest than a distribution of profit and, as such, should not be
subject to taxation at the level of the credit union if the goal is to level the playing field with banks.

III. MAIN ELEMENTS OF RECOMMENDED ACTION

A. Immediate priorities

33. Preventative measures for ensuring financial stability need to be strengthened. Given the concerns about the adequacy of the existing organizational arrangements for protecting the Union against the threat presented by banking weakness and especially the pressures on the banking sector from the fiscal side, early action on this front is urged. The provisions of the ECCB Act (even after proposed amendments) are not sufficient to guarantee protection of financial stability. A more proactive agency of restraint, free to act with a greater degree of operational independence from national authorities, is needed. The ECCB needs to (i) refocus on its core mandate to promote financial stability and (ii) be provided with adequate powers to achieve that end.

34. Part of the needed response is organizational. In particular, the ECCB should:

- Reprioritize its resources and work program to reflect the relative importance of different sectors and institutions in the risks posed to the Union. In particular, resources should be reassigned to a more structured program of supervision that focuses on the risks inherent in domestic banking institutions.

- Strengthen data integrity and collection practices to improve the accuracy and completeness of prudential returns submitted by the institutions, especially with respect to capturing all on- and off-balance sheet exposures.

- Strengthen prudential regulations: set minimum capital requirements commensurate with the risks of each institution; revise guidance on accruals of interest; and provide regulations on market (e.g., foreign exchange) risk.

- Address the Union-wide risks entailed in government borrowing from banks by assigning risk weights for the purpose of establishing minimum capitalization, suspending accrual of interest on non-performing government debts and requiring provisioning on non-performing government debts.

- Give greater attention to financial sector governance, including the composition of boards of directors and internal audit and control.

35. In addition, in order to be able to function more effectively, the ECCB requires some enhanced powers for the regulation of onshore banks. In particular the granting and withdrawal of domestic bank licenses and other bank regulation enforcement powers presently assigned to national authorities should be transferred to the ECCB.

36. The ECCB, in consultation with national authorities, should improve its crisis management capacity. An operational plan of action should be established to deal with systemic crisis contingencies. Such framework should acknowledge the inherently limited
resources of the ECCB for lender of last resort (LOLR) operations and the constraints on the fiscal authorities to provide credible guarantees.

37. Adherence to a sustainable path for government debt and borrowing in all of the member states is a pre-requisite for effective functioning of the Union’s financial system. In addition, though, management of these debts needs further improvement, notably in improving the quality of recording, monitoring and reporting. This would require strengthening of the debt units, improving the information flow, and setting standards for regular reporting. Coordination between the national authorities and the ECCB, especially on debt activities outside the RGSM, should be enhanced.

B. Refining the regulatory architecture for the remainder of the financial system

The role of the proposed unified national regulators needs to be carefully considered to ensure that, where possible, economies of scale at national and regional levels are exploited. This should help improve the present, quite inadequate, degree of supervision — especially of the larger nonbanks — without, however, overburdening the ECCB. In particular:

- Transferring the lead responsibility to the ECCB for the supervision of the nearbanks identified as systemically important (two credit unions) should be considered.

- The national regulators should contribute to a strengthening of supervision of the smaller credit unions and other nearbanks at the national level, by ensuring comprehensive coverage, enhanced staffing and building on external technical assistance.

- A strengthening of the regulation of the insurance industry, which currently falls well short of international benchmarks, can be realistically hoped for only through increased cross-border regulatory cooperation, using more formal and structured cooperative arrangements with overseas supervisors (e.g., with Barbados and Trinidad and Tobago insurance supervisors). This, necessarily, will be a step-by-step process.

38. Even though the offshore banking system is not as large as it was, further action is needed:

- The supervisory and regulatory system for offshore banks should be strengthened by aligning the prudential regimes of offshore banking laws with those in the domestic Banking Act; issuing and enforcing a comprehensive set of prudential guidelines; establishing uniform reporting requirements; ensuring that legislation and guidelines are enforced in a consistent and timely manner.

- The ECCB’s role in offshore banking supervision should be realigned in light of its resources and priorities. It is the national authorities that should be responsible for finding the resources to ensure effective compliance of offshore banks with international standards.
C. Structural issues

39. The ECCB has mapped out an effective long-term plan for institutional development of the ECCU financial system, building missing markets and infrastructures, fostering competitiveness and undertaking educational efforts. Considering how small the Union is, the goal of ensuring greater financial market integration across the Union (the “single financial space” project) has been especially worthwhile, without neglecting the need for an appropriate integration with global finance. Considerable progress already has been made on these fronts, and continuation along this path is strongly endorsed, subject to availability of the necessary human and financial resources.

40. Because competitive pressure on local banks is likely to intensify, their cooperative efforts to seek scale efficiencies will become increasingly important for their survival and could be encouraged by the authorities. Fewer but stronger banks could enhance competition and efficiency in the Union’s banking system.

41. The investment strategy of the national insurance funds should be rethought, with greater focus on exploiting the long-term nature of their investment needs and optimizing against risk and return. They should not be required to perform the role of providing subsidized financing for government projects and should not be distracted from their core function by being asked to administer retail lending programs.

42. While there may be good reasons to retain government development banks in the region, their role should be confined to services that are not otherwise effectively being provided.

43. Work should continue to improve the effectiveness of the legal and judicial system in debt recovery, especially where the underlying legal code has proved to be problematic.

44. The strengthening of linkages with a wider region, and with the global financial system, will be as important for the development of the capital market as for insurance.

45. Certain distorting financial sector quasi-taxes should be kept under review and reduced as fiscal opportunities allow.