Enhancing Access to Finance in the Caribbean

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Introduction

There is now substantial evidence that without well-functioning financial markets, sustained rapid growth is not possible. As economies are more closely linked through trade, investment, and the startlingly rapid growth in communications, the ability of financial systems to finance trade and investment is an increasingly important factor in fostering countries' competitiveness and growth potential. While governments can almost always obtain financing, the private sector often has more difficulty funding investment and entrepreneurship and depends on a range of factors that affect financial market development. In particular, small- and medium-sized (SME) enterprises struggle to obtain credit.

The private sector's ability to access financing is therefore a central driver of economic growth and is also critically important in facilitating developing economies' ability to take advantage of gains from trade and investment. By promoting a central role for the private sector, long-run sustainable growth is maximized.

The financial sectors of most economies in the Caribbean remain underdeveloped and "thin" because they do not intermediate effectively between savers and investors. Furthermore, factors such as lack of collateral, poor credit information, and legal systems that favor large businesses and those with property particularly impede access to financing in the countries of the region. These factors make it difficult or impossible for many investors and entrepreneurs in the Caribbean to obtain financing for their businesses. While donors have been active in providing funds for investment, their interventions have been ad hoc. Furthermore, donor financing is not sustainable in the long term, and in some cases risk distorting financial systems, thereby hindering rather than encouraging financial market growth.

Currently, the fallout from the global financial crisis is casting further shadows on the economies and financial systems of Caribbean countries. While few economies in the region will experience bank failures, the high dependence on remittances, tourism and, in some cases, natural resources increases the fragility of an already vulnerable group of countries.

The purpose of this chapter is to examine issues that are central to financial market development in the Caribbean region. This report identifies factors that are required for financial markets to function effectively and describes policy options that could be implemented in the Caribbean to make financing more widely available.

Financial Markets and Competitiveness

A Brief Review of the Evidence on Finance, Competitiveness, and Growth

There is extensive evidence that well-functioning financial markets are essential for promoting competitiveness and economic growth. The difference between repressed financial markets and those that work effectively can make a difference in growth rates of as much as two percentage points a year. Financial systems affect the economic behavior of individuals by enabling investors and entrepreneurs to:

- mobilize savings,
- select promising projects,
- monitor investment,

- accelerate transactions, and
- manage risks.

These factors increase the availability of funds for investment, raising the long-term growth rate and enhancing competitiveness. A view of financial markets enhancing competitiveness through renewal has been proposed by Rajan and Zingales. "Free financial markets are the elixir that fuels the process of creative destruction, continuously rejuvenating the capitalist system" (Rajan and Zingales, 2003, p. 25). The importance of access to financing for competitiveness and growth can be analyzed within a general framework that is a variant of Schumpeter's model of creative destruction (Schumpeter, 1911; Gurley and Shaw, 1955; Tobin, 1965; McKinnon, 1973; Shaw, 1973). Economic growth is driven by firms investing in physical plant and equipment, as well as researching and developing new technologies. Investment projects often require large sunk costs for extended periods. Usually, retained earnings are not enough for firms to finance such costly projects and they must resort to tapping the available savings of the households sector through financial intermediaries. However, in converting household savings into assets there are two difficulties:

- The transaction costs associated with collecting savings from different individuals
- The informational asymmetries associated with making savers feel comfortable in relinquishing control of their savings

A developed and effective financial system can help businesses, entrepreneurs, and investors surmount these two obstacles and increase funds available for investment. Well-functioning institutions help reduce information problems and transaction costs, including the costs of acquiring information, enforcing contracts, and exchanging goods and financial claims. According to Khan and Senhadji (2000), financial development encompasses both the *extent* (growth) of the financial system and the *efficiency* of the financial system. The extent of the financial system describes the proportion of firms and households able to easily access the services provided by financial intermediaries and markets. The efficiency of the financial system refers to how effective these markets and intermediaries are in reducing information and transaction costs for their customers.

From an investment perspective, financial intermediaries are able to effectively identify those entrepreneurs with the best chances of successfully initiating new products and production processes (King and Levine, 1993). Because many firms and entrepreneurs solicit capital, financial intermediaries and markets can realize scale economies in obtaining detailed information regarding firms' profitability and investment prospects, thereby greatly reducing verification and monitoring costs (Gale and Hellwig, 1985). With the most promising firms and managers getting funds, improved efficiency of capital allocation fosters faster growth (Greenwood and Jovanovic, 1990). Moreover, financial intermediaries, under the delegated monitor arrangements referred to above, can economize on aggregate monitoring costs and efficiently separate ownership from management of the firm. This leads to specialization in production according to the principle of comparative advantage (Merton and Bodie, 1995: 3–21).[1]

Stiglitz (1994) and Stiglitz and Weiss (1981) argue that financial arrangements that enhance corporate control may facilitate the mobilization of savings from dispersed agents and help capital flow to profitable investments. The other primary function of the financial system is to facilitate trade and competitiveness by extending credit and guaranteeing payments (King and Levine, 1993). A modern and efficient payment system can promote this realization and speed up the circulation of

[1] Regarding the monitor role played by financial intermediaries, there arises yet another question: who will monitor the monitor? The existence of this twist might lead to the inefficiency of capital allocation, especially in countries where the decision-making of major banks is heavily influenced by government and where there is lack of competition within the financial industry.

firms' investment funds. Consequently, increased production and consumption within a given time span result in improved welfare. The development of technology and wide use of information technology, innovation in financial instruments, and more efficient financial markets all mitigate many of the risks associated with individual projects, firms, industries, regions, and countries by providing vehicles for trading, pooling, and diversifying risk, thereby enhancing the ability of firms to compete (Saint-Paul, 1992).

However, even in advanced economies, there are dangers that must be guarded against. Rajan and Zingales (2003) see threats to the evolution of financial markets and their ability to enhance competitiveness arising from within the system itself. "Capitalism's biggest political enemies are not the firebrand trade unionists spewing vitriol against the system, but the executives in pinstriped suits extolling the virtues of competitive markets with every breath while attempting to extinguish them with every action." This sentiment, expressed several years ago, has proved to be prescient to a far greater extent than even the authors might have expected. Clearly, the global financial crisis shows that, although financial markets can allocate capital effectively, regulation that ensures the soundness of financial systems needs to be in place.

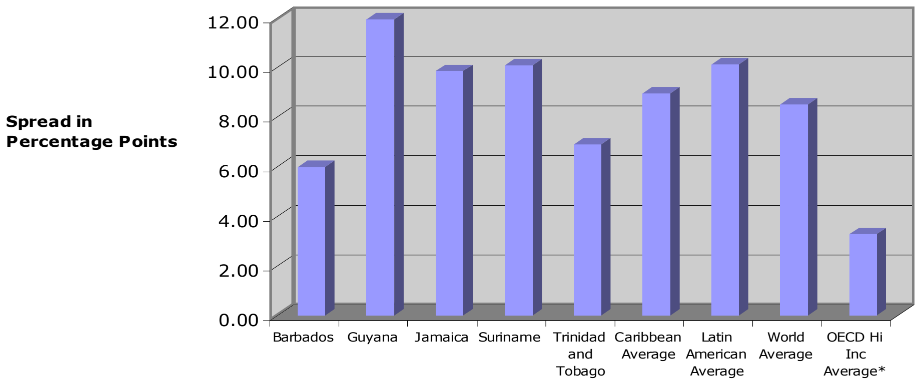
Financial Development and Competitiveness in the Caribbean.

In developing countries, financial markets are both shallow and inefficient. The ratio of private sector credit to GDP is generally low and the range of services offered by financial institutions is limited. Interest rate spreads in the banking system are still many percentage points higher than those in more developed financial markets, which illustrates both inefficiency and the inability of lenders to hedge against risk. Some observers (Holden, 1997) focus on the lack of property rights, and in particular collateral, as one of the primary reasons for the shallowness and lack of breadth of financial markets in most developing countries. Because insecure property rights do not allow lenders to secure their loans effectively, they are unwilling to make loans to any but the largest companies or to individuals who have extensive real estate holdings. To promote competitiveness, improving and deepening financial markets is therefore an urgent policy priority, as is safeguarding competitive processes themselves.

The extent to which financial systems intermediate effectively is largely reflected in the spread between commercial bank borrowing and lending rates.[2] On average, interest rate spreads in the Caribbean are comparable to those of the world as a whole but below the average for the Latin America and Caribbean (LAC) region. They are, however, considerably above the spreads of the high-income Organisation for Economic Co-operation and Development (OECD) countries (Australia; Austria; Belgium; Canada; Czech Republic; Denmark; Finland; France; Germany; Greece; Hungary; Iceland; Ireland; Italy; Japan; Korea, Rep.; Luxembourg; Netherlands; New Zealand; Norway; Portugal; Slovak Republic; Spain; Sweden; Switzerland; United Kingdom; and United States). As shown in Figure 1, there is also considerable variation between the five countries for which comparable data are available from the World Economic Forum *Global Competitiveness Report*.

[2] The difference between borrowing and lending rates is one component of the entire structure of interest rates. The determinants of interest rate margins are described in Annex 2.

Figure 1. Interest Rate Spread

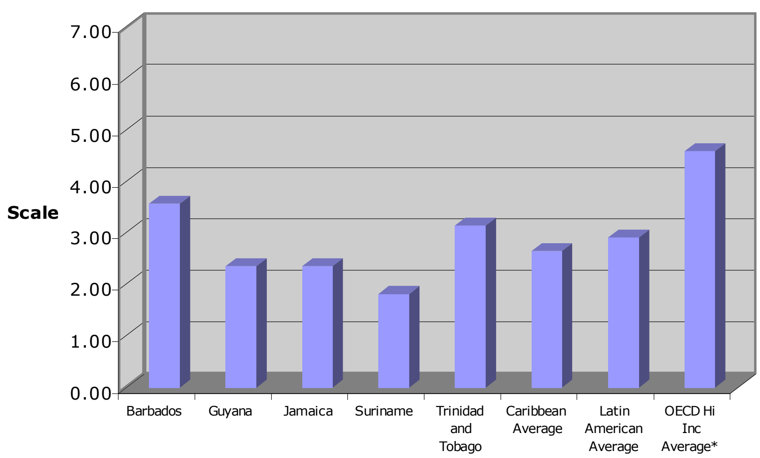


Source: World Bank: World Development Indicators.

While intermediation margins in the region remain high because of the costs of transacting in financial markets, many studies show that it is mainly access to financing rather than financing costs that constrains competitiveness, particularly for smaller businesses.

These observations are supported by Figure 2, which shows that the Caribbean average is below that of Latin America and substantially below that of the high-income OECD countries.

Figure 2. Ease of Access to Loans



Source: WEF/GCR

While access is important, real lending rates also matter, and recent real rates, as reported by the International Monetary Fund (IMF), vary substantially between countries, reflecting macro-economic imbalances as discussed later in this report. Table 1 shows that rates in Trinidad and Tobago, the Bahamas, and Barbados were comparable to or lower than those in the United States and Canada in 2007, while in Guyana, Suriname, and the Eastern Caribbean Currency Union (ECCU) they were significantly higher. Jamaica, with its high debt to GDP ratio and borrowing requirements, is a special case and had a particularly high lending rate, around three times higher than rates in the two lowest countries. These rate differentials, along with differences in ease of access, are important financial factors that affect the relative competitiveness of firms in the respective countries.

Table 1. Real Local Currency Lending Rates of Interest in 2007

	Bahamas	Barbados	Guyana	Jamaica	Suriname	T & T	ECCU	U.S.	Canada
Nominal Lending Rate*	5.50	10.80	14.61	17.20	13.77	11.75	10.19	8.05	6.10
Inflation Rate#	2.48	4.16	12.29	9.29	6.71	7.88	3.96	2.82	2.19
Real Lending Rate	3.02	6.64	2.32	7.91	7.06	3.87	6.23	5.23	3.91

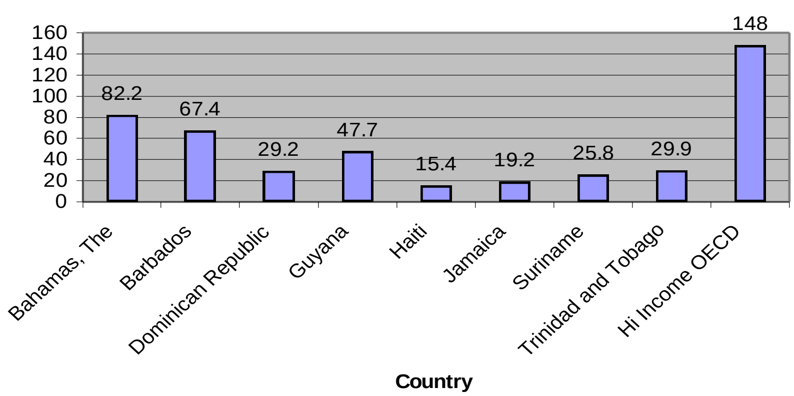
* Local currency: "Bank rate that usually meets the short- and medium-term financing needs of the private sector", IMF *International Financial Statistics* (*IFS)* line 60p

Defined as percent change in Consumer Price Index (CPI) as reported in *IFS* World Tables. (The Eastern Caribbean Currency Union rate is computed as simple average for countries in the Union except St. Kitts & Nevis, which is not available.)

Source: IMF *International Financial Statistics*, February 2009

Another measure of the depth and maturity of a country's financial market is the amount of domestic credit outstanding as a percentage of GDP. In developed countries this ratio often exceeds 100 percent and in some cases is substantially higher. For example, in the United States domestic credit is over 200 percent of GDP, and in Singapore, it is well over 100 percent of GDP. In the Caribbean, however, the average ratio is much lower, although there are substantial differences between countries, as shown in Figure 3 for eight countries for which comparable data are available from the IMF.

Figure 3. Domestic Credit to Private Sector



Source: IMF International Financial Statistics, June 2009.

As discussed in more detail below, Caribbean financial markets are smaller and more fragmented, at least partly because of deficient legal and regulatory environment that exist only in Caribbean countries. For example, property rights are poorly protected and there is only limited reporting of credit history, which drives up costs and limits access to financing in local markets. As a result, Caribbean companies are at a competitive disadvantage compared their foreign and multinational competitors. The latter have access to financing from international and money-center banks, which have greater economies of scale and scope, and more conducive legal and regulatory frameworks.

Financial Institutions in the Caribbean

There are a wide range of financial institutions in the Caribbean. Although commercial banks dominate, there are also development banks in most countries in the region, as well as insurance companies, finance companies, and seven securities markets (Bahamas, Barbados, Guyana, Jamaica, Suriname, Trinidad and Tobago, and the Organization of Eastern Caribbean States [OECS]).

Commercial Banks

Borrowing from banks is the largest source of credit for businesses and consumers in the Caribbean, even though for many, especially smaller businesses, credit is hard to come by. Banks will remain the primary lenders in the region for the foreseeable future. As noted below, credit unions and microfinance institutions are steadily gaining market share, but these are set up to complement banks rather than replace them.

Several Caribbean countries went through a period of nationalizing their commercial banks in the 1970s and 1980s, but in some cases, this contributed to ensuing financial crises and intervention by the authorities. At present, commercial banks are back in private hands in almost all countries, with a strong foreign ownership presence in many of them. Suriname is one country where the government still owns three small, quasi-commercial banks. Sector-wide bank capitalization is low and, although declining from 11 percent of gross loans in 2004, the nonperforming loan ratio remained high at 8.7 percent in 2007 (Suriname, 2008). These bad loans are, however, concentrated in the state-owned banks (nonperforming loan [NPL] ratios of 25 percent), while the private, foreign-owned banks have much better portfolio performance. Lending to the private sector was around 25 percent of GDP in 2006 and was primarily oriented toward short-term trade finance. Only about one-fifth of registered firms have access to credit of any sort.

In the OECS countries, various merchant banks, particularly those based in Trinidad and Tobago, provide financing both through traditional loans and equity investments as well as by underwriting corporate bonds for sale to investors in the region. Banks in Trinidad and Tobago provide most of the financing but stay away from traditional loans because of the high reserve requirements. Instead they structure loans as off balance–sheet transactions based on bond financing. While this eliminates the systemic risk implications of direct lending, it complicates and contributes to transaction costs. All commercial banks in Barbados are privately owned and operated since the government fully divested its interest in the Barbados National Bank after it was restructured in the mid-1990s.

Banks in Guyana suffer from interlocking directorships with large commercial groups to which they lend. Governance structures such as these represent a threat to arms-length decisions regarding who should get loans. In a number of countries, severe systemic distress has been a result of lack of bank independence from borrowers. Ironically this threat has increased due to the otherwise salutary trend toward increased lending to the private sector, up from 40 percent in 1985 to 98 percent by 2001. Nonperforming loans were relatively high at 38 percent of total loans in 2001 compared to 6.2 percent in Trinidad and Tobago in the 1997–99 period. In Jamaica, on the other hand, the government continues to be a major borrower from the banking system to finance the public debt, which is estimated to have been 128.3 percent of GDP for fiscal year 2007/08 (IMF, 2008). This government demand leads to high spreads and a crowding out of the private sector, particularly small- and medium-sized businesses.

The IMF is carrying out assessments of financial system stability in countries throughout the world as part of the ongoing joint IMF/World Bank Financial Sector Assessment Program (FSAP). These assessments offer useful insights into the soundness of the commercial banks, as well as numerous other financial sector issues. To date four English-speaking Caribbean countries have been surveyed and, as noted in the following box, the general finding is that the commercial banks are sound, although there are weaknesses in the indigenous banks in the OECS countries.[3] It should be noted that, in general, foreign banks have a strong presence in most countries and have served as a counterweight to undercapitalized domestic banks in times of stress.

Box 1. Findings of IMF Financial System Stability Assessments on Commercial Banks and Related Issues in Four Caribbean Countries[4]

Barbados (2008)

- The 2008 FSAP update for Barbados took place in the context of considerable turmoil in global financial markets. Encouragingly, the financial system in Barbados has been little affected by this turmoil, and the macroeconomic situation remains robust.
- The domestic banking sector appears sound and profitable and continues to dominate the financial system.
- Stress tests reveal an onshore banking sector that would be resilient to most market shocks.
- Progress has been made in addressing the recommendations of the 2003 FSAP assessment.
- The crisis management framework was enhanced in mid-2007 with the introduction of a compulsory deposit insurance scheme.
- To assure continued financial stability and competitiveness, important regulatory and remaining supervisory weaknesses in the financial system should be addressed.

Jamaica (2006)

- Jamaica has considerably strengthened its financial system oversight following a costly financial crisis in 1996.
- Reported NPLs have shrunk significantly since the crisis, to about 3 percent (of gross loans). (High of 23 percent reached in crisis year, 1998.)
- Financial institutions operate in a risky environment. The very large public debt (138 percent of GDP at end-September 2008), coupled with weak underlying economic growth, is an overarching vulnerability for the economy that constrains macroeconomic policy options.
- Financial institutions are closely linked via conglomerate structures and common exposure to domestic public debt.

[3] Unfortunately there are no comprehensive cross-country-comparable data on banking soundness for the Caribbean countries. The IMF recently began to publish such a series, but the current list of 62 countries does not include any of the countries discussed in this report. (IMF, *Coordinated Compilation Exercise (CCE) for Financial Soundness Indicators (FSIs)*, Last updated: July 22, 2008.)

[4] IMF Reports "Financial System Stability Assessment" for: Barbados (*Country Report* No. 9/64 Feb. 2009); Jamaica (*Country Report* No. 06/156, May 2006); Trinidad and Tobago (*Country Report* No. 06/29, Jan. 2006); Eastern Caribbean Currency Union (*Country Report* No. 04/293 Sept. 2004).

Trinidad and Tobago (2007)

- Trinidad and Tobago's financial system is large and complex and has witnessed rapid structural change over the last decade.
- The immediate-term macroeconomic risks to the different segments of the financial system appear low.
- Stress tests suggest that near-term systemic risks are limited owing to a liquid and well-capitalized banking system and good liquidity positions of the insurers.

Eastern Caribbean Currency Union - OECS countries (2004)

- Financial institutions in the ECCU are relatively well developed.
- An important source of strength of the financial system has been the historical presence of strong foreign banks in the ECCU.
- The banking system is characterized by unacceptably high levels of NPLs.
- While above Basel norms, the quality of capital of a few indigenous banks is uncertain.

Credit Unions

Credit unions are numerous in most Caribbean countries; however, assets tend to be concentrated in a small number and many others may exist in name only. Membership is generally based on a common bond, often place of employment. Though, as noted below, credit unions are playing an important role in some countries, particularly with respect to smaller, underserved borrowers, safety and soundness is not assured because of uneven supervision and regulation.

Guyana has 29 active credit unions with approximately 27,000 members, with the three largest unions serving close to one-third of the total membership. Unlike other Caribbean community (CARICOM) countries, all credit unions in Guyana are closed, lending only to their members. They lend at the legally established rate of one percent per month, regardless of the amount requested and current market interest rates.

Concentration of assets is also great in Barbados where, of the 50 credit unions, the four largest account for about three quarters of the total assets. As of September 2007, delinquent loans represented approximately 6 percent of total loans outstanding (IMF, 2009). By 2007, credit union assets accounted for about 15 percent of the total assets of the banking system in Barbados. The credit unions have been growing rapidly but are faced with problems of limited capacity to manage financial risk, limited understanding of increased credit risk and operational risk associated with growth, and inadequate response to member demand for new products and services. The supervisory staff is inadequate, with only six inspectors for 41 active institutions, thus preventing "…the Registrar's Office from attaining its objective of one on-site inspection per year" (IMF, 2009).

As of 1998, the credit union movement in the Bahamas comprised 13 credit unions with nearly 24,000 members. The credit unions' low average loan size of around $5,000 made them the likely major source of formal credit for small- and medium-sized enterprises in the country. However shortcomings in administration and difficulties in adapting to the changing market environment limited their ability to grow and consolidate.

Credit union membership in Jamaica is one of the highest in the world, with about 760,000 members (60 percent of the adult population). Savings held in credit unions account for only about 4 percent of GDP, but the number of deposit accounts exceeds that of the commercial banks.

Similarly the number of loans outstanding exceeds the number of bank personal loans. Until recently the primary regulator was the Jamaica Cooperative Credit Union League, which also acts as industry advocate, savings insurer, and lender of last resort. In 2006, the Bank of Jamaica was authorized to take over supervision of the credit unions and is currently preparing the comprehensive legal framework to do so (IMF, 2006b; Bank of Jamaica website).

Cambios

Cambios are institutions licensed to buy and sell foreign exchange. They were authorized in countries such as Guyana and Jamaica as a means to eliminate the black market in foreign exchange and establish a market-determined exchange rate. They play an important niche role in servicing tourists' needs for local currency in a number of countries in the Caribbean.

Development Banks[5]

Most countries in the region have first tier (retail) development banks. Although there may be a few notable exceptions, around the world development banks have proved to be of limited efficacy in financing investment and growth. This is not surprising since the incentives for such banks are different than those for commercial lenders. Often, development banks are mandated to lend to certain sectors or groups without significant regard for commercial criteria, with the result that losses are invariably higher than those for commercial banks. In addition, development banks have rarely managed to fulfill their purpose of promoting development, but in many cases have crowded out private lenders.

The Agricultural Development Bank (ADB) in Trinidad and Tobago is one such case. The client base has come to expect subsidized loans, and certain well-connected clients have also come to realize that repayment obligations may be taken lightly, thus contributing to the Bank's high rate of arrears. An attempt at reform by the government in the mid-1990s was unsuccessful. The goal was to de-politicize and professionalize the board and management respectively, but the ADB continues to operate as a classical development bank.

In the mid-1990s, the Barbados National Bank (BNB) was nominally a commercial bank, but it served the development function of supporting the uncompetitive sugar sector. It was highly insolvent and had not had an audited financial statement for several years. As its liabilities consisted in large part of many small deposits, representing life savings of middle income Barbadians, failure of the BNB represented a real systemic risk to the banking system. As part of a government reform program, the BNB spun off its bad assets, was recapitalized and is now a fully viable, private commercial bank. During the same time, the much smaller Barbados Development Bank (BDB) was also providing subsidized directed credit primarily to the artisan fisheries and small tourist hotel sectors. The BDB was highly insolvent and its periodic recapitalization constituted a significant drain on the central government budget. In this case, the government closed the bank and agreed that any future such institution should be majority privately owned. This proved unfeasible and at present there are numerous government-dominated small development funds and trusts that serve specific segments of the small and micro-business sector. Such institutions often crowd out private sector lenders and harm the development of this segment of the market.

The Bahamas Development Bank also experienced chronic losses during the 1990s that it failed to staunch despite periodic recapitalizations and efforts at reform. By the end of 2001, the

[5] The IDB has been actively involved in initiatives to reform development banks throughout the region.

overall recovery rates and financial performance had deteriorated to such an extent that the reform efforts were declared largely unsuccessful.

Microfinance Institutions

The term microfinance institutions (MFIs) is generally used to refer to those financial institutions that are characterized by their commitment to assisting typically poor households and small enterprises in gaining access to financial services. This commitment may replace or supplement other private or public objectives, such as the maximization of shareholder value, the direction of investment into priority sectors, or the mobilization of savings to finance government operations. In common usage, MFIs are distinguished from purely commercial, small-scale, possibly informal financial institutions dealing with the poor (for example, village moneylenders, pawnshops, and informal transfer systems) and from large, perhaps government-sponsored schemes that may hold numerous small accounts more or less as a by-product of their main business (for example, national savings schemes or post office savings banks). Nonetheless, the same public policy issues—especially those related to subsidization and regulation—may arise in connection with these other institutions. Hardy and Holden (2003) discuss appropriate policies for microfinance institutions in their working paper "Microfinance Institutions and Public Policy."

Several studies have been done of MFIs in Anglophone Caribbean; two are summarized here. The first presents region-wide averages on several key indicators of MFIs in the Caribbean and contrasts them with the same indicators for a peer group in Latin America and then provides some explanations for the differences (Wenner and Chalmers, 2001). The second looks at four MFIs in the Caribbean in depth to determine the underlying causes and cures for high loan delinquency rates, the chief deficiency of Caribbean MFIs (Westley, 2005).

In general, Caribbean MFIs are smaller and much less profitable than their Latin American counterparts. The average number of loans for the former is 1,349, while the latter have 15,370 loans. The respective returns on average equity are 4.3 percent and 21 percent. One key difference is the arrears rate on loans; the ratio of loans 30 days past due to total assets is 43 percent among the Caribbean MFIs compared with only 5 percent for the Latin American peer group. In addition, the Caribbean MFIs receive widespread funding subsidies from governments and external donors and thus, were they to pay market rates for their funding, in many cases they would be unprofitable. This clearly unsustainable situation has resulted in the anemic growth of microfinance institutions in the Caribbean and their marginal contribution, if any, to the growth and productivity of their SME clients. In the longer term, development of MFIs in the Caribbean should be driven by the private sector.

The in-depth study of four MFIs argues that "Caribbean MFIs need not simply be prisoners of small markets distorted by government subsidies. They too can implement best practice lending methodologies and achieve low delinquency rates" (Westley, 2005). The causes for high delinquency are found to be essentially internal to the MFIs and therefore could be cured with a management commitment to apply best practices. Three particularly crucial factors are identified: (1) how the MFIs assess the character (willingness to repay) of the loan applicant, (2) how effectively the MFIs follow up on loan delinquency after it has occurred, and (3) whether the MFIs have implemented an appropriate loan officer incentive pay system. Without delving into the details of the needed reforms, the general conclusion is that Caribbean MFIs are in a position to play a more dynamic role in increasing the poor and informal sector's access to finance.

While microcredit appears to play an important role in alleviating poverty, whether it contributes to improved competitiveness is another matter. A recent analysis of factors underlying dynamic capitalist economies—economies that are highly competitive—points out that the type of businesses that micro-credit supports tend to be "(…) replicative rather than innovative. (…) Businesses backed by micro-credit are unlikely to be major engines of sustained economic growth. (…) The ultimate challenge for developing countries is to encourage larger, more established financial institutions to lend to enterprises that have a chance of growing into larger firms" (Baumol, Littan, and Schramm, 2007). One of Baumol et al.'s arguments is that developing economies improve competitiveness by adopting technology and techniques from high-income economies; however, only larger firms with access to capital have the capability to do this. They contrast developing economies with high-income countries, where continued improvement in competitiveness requires dynamic entrepreneurial small firms to push back the frontiers of technology.

Stock Markets and Venture Capital Funds

Securities markets have been growing in size and sophistication in the region, though more rapidly in some countries than in others. As of mid-2009, 22 issues, five cross-listed companies and one junior market company were traded on the Barbados Stock Exchange. Market capitalization is approximately 70 percent of GDP, and transaction volumes remain very low.

In Jamaica, government debt instruments dominate the securities market and have led to rapid growth in the securities dealers sector. These dealers have provided a market for government bonds and have improved secondary market liquidity. These dealers have also encouraged retail investor participation, which has helped to diversify risk directly to public investors. The growth in the securities dealers market has also led to an increase in the number of institutions and the variety of investment vehicles in the market. On a cautionary note, this expansion in number of dealers and the variety of instruments and transactions exposes investors to increased operational and legal risks. Investors are also subject to settlement risks because of the reliance on paper securities and delays in establishing a Central Securities Depository (IMF, 2006b).

Trinidad and Tobago has taken a lead in the regional integration of securities markets, with around 18 percent of new equity issues on the Trinidad and Tobago Stock Exchange since 1997 being cross-listings of companies in other CARICOM countries. Regional investment has also been an increasingly common feature of unit trusts (mutual funds), with foreign issuers representing around 30 percent of such funds by the end of 2003. Foreign bond issuers have also gained a presence, and by September 2004 represented around 13 percent of the market. Over the decade from 1994 to 2004, market capitalization grew precipitously, to 144 percent of GDP from 13 percent. From early 2002 until its peak in mid-2008, average share prices rose 30 to 40 percent per year, with price–earnings ratios increasing correspondingly. Subsequently, however, the market has declined sharply, along with all emerging markets, in response to the global financial crisis. By the end of the third quarter of 2009, the Trinidad and Tobago Stock Exchange had dropped over 25 percent from its peak in mid-2008.

A decline in housing prices could have a significant impact on the mortgage bond market, which is relatively well developed by Caribbean standards as a result of interventions by the Home Mortgage Bank to develop a secondary mortgage market (IMF, 2006a). With housing prices expected to decline by 10 percent or more during 2009, the recent troubles of the CL Financial Group and its affiliates, the Colonial Life Insurance Company (Clico) and the Clico Investment Bank (CIB), indicate the kind of difficulties that can be faced by highly leveraged players in regional capital markets considering declining real estate and other asset prices in the current economic downturn (BBC Caribbean.com, March 2009).

Financial Market Development

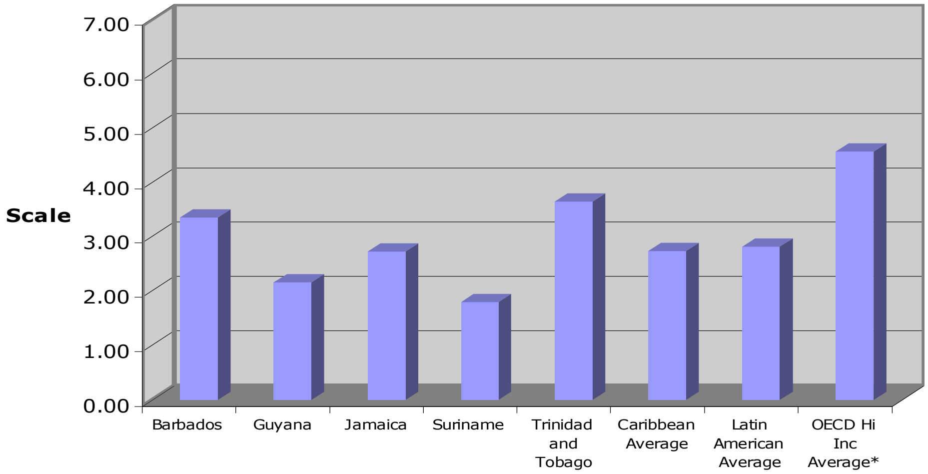
The Eastern Caribbean Securities Exchange (ECSE) has recently been established in the OECS countries, along with the Regional Government Securities Market (RGSM). The combined market capitalization is very low compared to the rest of the financial system and trading is light. As of early 2006, equity listings have not been a source of funding. It should also be noted that the interbank money market is relatively small and inactive (IMF, 2004).

Also established in June 2001 was the Guyana Association of Securities Companies and Intermediaries Incorporated, which operates the stock exchange as a Self Regulated Organization. Currently there are four member firms that provide broker services for customers wishing to trade on the exchange. The members are actively soliciting firms to list on the exchange and see cross-border listings as a major source of potential activity.

Formation of a CARICOM regional stock exchange has been a perennial goal in the area. "In yet another effort to encourage investment in the Region, Heads of Government agreed, at their tenth meeting (1989, Grand Anse), to establish a regional Stock Exchange which would bring together the Stock Exchanges in the Region, namely the Barbados Securities Exchange, the Jamaica Stock Exchange, and the Trinidad and Tobago Stock Exchange. In 1991 these three Stock Exchanges entered into an arrangement for cross-border listing and trading of securities (stocks/shares and/or bonds). This would allow the stocks/shares and/or bonds on the stock exchanges in each of these countries to be listed and traded in each others markets. As other countries establish stock exchanges they too will be eligible to become members of the regional stock exchange" (Caribbean Community Secretariat Web site). Thus far a formal centralized regional exchange has not been formed, and integration has been limited to cross-border listings and trading.

And in spite of attempts to promote venture capital funds, venture capital financing and the number of venture capital funds is limited in the Caribbean, as shown in Figure 4. So far, their viability is questionable. This is not surprising. Venture funds generally expect to lose money on the majority of their investments, while making large amounts on perhaps two out of every 10 companies in which they invest. However, exit mechanisms, an essential facility for venture capital funds, are inadequate because of the generally thin trading of equity issues on Caribbean stock markets. As a result, venture fund investing has basically amounted to subordinated unsecured loans. In addition, in the United States, where venture funds are most developed, they generally provide substantial assistance and guidance to managers. In most countries in the Caribbean region, such expertise is not available and the limited scale of investing is not sufficient to offset the expense of providing it.

Figure 4. Venture Capital Availability



Source: WEF/GCR

Attempts to promote access to more sophisticated financial products have yet to bear fruit. Neither stock markets nor venture capital has resulted in any substantial increase in access to financing in the region. To some degree, outcomes to date promote the view that banks are the prime supplier of funding for businesses for the stage of development of most Caribbean economies. Yet as later sections of this report will show, the institutions that best support bank lending are either inadequate or nonexistent.

Provident Funds and Pension Schemes

Another source of development financing has been state pension funds, which exist in most countries in the region. Many such funds are in a weak financial and even weaker actuarial position as a result of poor investments and an aging membership. In Barbados, the government pay-as-you-go pension system is becoming unsustainable and the bulk of the pensions will have to be paid from reserves of the National Insurance Scheme (NIS), which in turn may not be sufficiently funded for this purpose. The NIS in Guyana was established in 1969 and its current surpluses represent the largest single pool of financial savings outside of voluntary savings in the banking system. In Trinidad and Tobago, after commercial banks, self-administered pension funds, life insurance companies, and trust and mortgage finance companies are the largest groups of financial institutions in terms of assets. Private pensions are provided by insurance companies and self-administered plans of some private companies. Public sector pensions and the NIS pensions, unlike Guyana, are funded on a pay-as-you-go basis and are experiencing problems, as payments outstrip contributions.

Determinants of Financial Development

It is no accident that in the Caribbean, banks often fail to lend to potential borrowers. Frequently, excess liquidity is accompanied by many unsatisfied borrowers, with bankers in the region complaining of a lack of bankable projects and confining their lending to large, well-established companies. The reasons for this failure by financial institutions to lend to newer or smaller businesses are associated with factors that increase financial risk. The most important of these are *asymmetric information*, *adverse selection*, and *moral hazard*.

Asymmetric information exists when one party to a transaction has more information than the other. Any company manager or business owner knows much more about their company than a financial institution. Any borrower, for say, a car purchase knows whether they intend to pay the loan back. This occurs with most financial transactions. While there are ways, such as credit information systems, of reducing the risk inherent in information asymmetries, most Caribbean countries do not have any means of effectively dealing with the problem.

Adverse selection arises because borrowers who are most likely to default are the most eager to obtain loans. Very high interest rates attract the dishonest, those who have no intention of repaying and therefore do not care how high the interest rate is. In the absence of credit information to identify potential defaulters and collateral to reduce or eliminate losses from bad debts, lenders often refrain from lending altogether. Although such a strategy reduces loan losses, it also penalizes good credit risks. For example, in Jamaica, following the financial crisis in the 1990s, many firms went out of business when the availability of credit plummeted and interest rates soared to over 100 percent. For most countries in the Caribbean, the global financial crisis is resulting in sharply higher interest rates that will compromise sound businesses and could force even slightly marginal ones to close down.

Moral hazard is always a risk in loan transactions. Once borrowers have the proceeds of a loan, it is possible that they will engage in risky or undesirable behavior. Loan covenants are designed to reduce the possibility of such outcomes, but in countries with weak institutions, as many are in the Caribbean, loan covenants are often only enforceable after lengthy recourse to the court system.

Calculating the cost of these various components of risk for the region is difficult because of the small size of markets, distortions, and the lack of benchmarks against which to measure specific risk elements. Nevertheless, Annex 2 attempts to disaggregate the various components of risk and illustrate how they are incorporated into the structure of interest rates. In any event, the inherent difficulty lenders have assessing risk of default is made even more problematic in the Caribbean by underdeveloped institutions that do little to attenuate risk.

Problems of asymmetric information, adverse selection, and moral hazard can be reduced by:

- **Screening**: Collecting information before a loan occurs. Credit history information is especially useful in identifying those who are likely to default.
- **Collateral**: Collateral reduces incentives for borrowers to take on too much risk. When collateral is pledged, borrowers have more to lose in the event of a default.
- **Monitoring**: If loans can be monitored closely, the risk of default is reduced. Banks also have a particular advantage because they can monitor the bank accounts of borrowers.

For financial markets to develop and flourish, institutions that allow risk to be managed are needed. Among such institutions, research increasingly points to the importance of property rights and legal traditions as the main determinants of financial depth (Beck, Demirgüç-Kunt, and Levine, 2001).

Indeed, an effective system of property rights, both for fixed and movable property, allows for clearly identifiable ownership, the ability to effectively pledge assets as security for loans, and the ability to repossess security in the event of a default. This in turn requires a stable system of contracting, institutions such as registries to record ownership and security interests, a court system that can adjudicate contracts, and a system for reliably enforcing court decisions.

Some of these institutions are in place in many developing countries, but in virtually all of them, essential elements for a flourishing financial sector are missing. Studies of institutional development in the Caribbean have found that effectively functioning registries, good property rights laws, well-operated registries, and effective enforcement of court judgments are rare.

Property Rights, Collateral, and Lending

Well-developed, secure, and fully enforced property rights allow financial contracts to align the incentives of lenders with those of borrowers. They reduce the ability of borrowers to renege on debt obligations, which in turn lowers lenders' risks so that they become more willing to lend. More credit at lower interest rates permits higher rates of investment and more capital per worker, leading to much higher incomes. Thus, the use of collateral reduces borrowing costs and the likelihood of default and contributes to the deepening of financial systems (EBRD, 2005; Galindo, 2001). Conversely, insecure property rights limit the demand for credit. A study of businesses in Eastern Europe (Johnson, McMillan, and Woodroff, 2002) found that "insecurity of property rights, all else equal, reduces a firm's investment by over a third."

In most industrial countries, a major part of lending is secured by either fixed property—land and buildings—or movable property, such as inventory, machinery, and accounts receivable in the case of businesses, or crops and animals in the case of farms. The Eastern European study confirmed the importance of secure movable property rights for businesses of all sizes. In the United States, where bank credit to the private sector is the equivalent of over 100 percent of GDP, approximately half of all bank lending is secured by movable property. The loan portfolios of finance and leasing companies, which lend nearly as much as the commercial banks, are almost 100 percent secured by movable property. As a result, business financing is readily available.

The inability to broadly use collateral is a major impediment to financial market development in the Caribbean region. The range of assets that can be used is limited, as are the types of legal entities that can pledge collateral within the legal frameworks of most countries in the region.

Execution of collateral in Guyana is stymied by a huge backlog of mortgage notices to be published in the official gazette. This provides opportunities for legal abuse because frivolous objections can be raised, thus causing further delays in the execution of collateral. Also in Guyana, moveable property is generally not accepted as collateral, although some progress is being made through a project to facilitate the registration of both moveable and fixed property in the Deeds Registry. The Multilateral Investment Fund (MIF) is supporting initiatives in Trinidad and Tobago and Guyana to improve registries in these two countries.

Jamaica has collateral instruments, but they are rudimentary and not easy to use. For example, floating charges over accounts receivable are not taken by banks, thus excluding one of the largest assets of many companies from being used as collateral. The U.K. Law of Bailment governing warehousing predates independence and is not suitable for modern practices.

Furthermore, the widespread occurrence of lending secured by movable property in the developed countries contrasts with the situation in nearly all countries in the Caribbean (and developing countries worldwide), where it is difficult or impossible to secure lending effectively using this type of collateral.

In Suriname, clients tend to literally move the moveable assets they pledged against loans so that banks have great difficulty in retrieving them in case of default. Vehicles seem to be an exception since the financial entity is the legal owner of the car until the loan is cancelled or the debtor defaults and the bank seizes the asset.

In the region, there are problems with outdated and outmoded laws, and the enforcement framework seriously impedes the use of collateral, in particular movable property, as security for the granting of credit.

In many Caribbean countries, secured lending for firms is governed by the Companies Acts. This form of securing lending is arcane because in general it requires a charge over all assets of the company offering security interests. The requirement that companies pledge their entire asset base to one lender, with the associated high transaction costs, reduces bank competition by making it costly for borrowers to switch lenders even though interest rates may be lower at other banks.

Registries in the region are chaotic, so that searching for prior pledges is difficult. In some countries, motor vehicle registries, where automobile liens would be recorded, do not exist. Enforcement of judgments is weak so it can take months or years to repossess pledged property, which diminishes the value of collateral as assets spoil or are stolen or, in the case of debtors, disappear. Annex 3 presents the important features of a collateral framework against which the situation in the Caribbean can be compared.

The result of all this is reduced access to credit except for large companies or wealthy individuals with substantial land holdings. Smaller borrowers are essentially excluded from the system. A secondary effect is that the credit chain is shortened. Few businesses extend credit terms to their customers, borrowing against inventories or warehouse receipts rarely occurs, purchase of equipment through leasing is unusual, and specialized financial institutions do not exist. As a result, there is underinvestment in capital equipment and inventories are less than optimal, which imposes high costs in remote countries, where access to resupply is reduced and large stocks are needed.

The conclusion, therefore, is that reform of the system of pledging movable property as collateral for lending (secured transactions reform) is sorely needed in the region. However, the supporting institutions for such reform are weak or nonexistent in virtually all Caribbean countries. To date, there has not been extensive reform of this kind in the Caribbean, though there have been some attempts, particularly in Trinidad and Tobago. These were bogged down by tardiness in the passing of legislation, and anecdotal reports indicate that they have had little impact on lending. A formal evaluation has yet to be done. A bank-sponsored, policy-based loan is supporting the introduction of a secured transaction framework in Jamaica. Considerable resources have been dedicated to the presentation and dissemination of the underlying concepts and potential benefits. While still in progress (as of mid-2009), the response has been favorable among both the public and private stakeholders, once the key players understand the ideas. Support is building to carry out the necessary legal and institutional reform to enable the use of moveable property as practical and low-transactions-cost collateral for loan guarantees.

The Legal System and Financial Markets

Financiers have to bear the risk of a loan not being repaid. In general the degree of risk is reflected in the interest rates charged. However, the price of risk is difficult to assess. If risk is high and concentrated in a particular borrower or economic activity, financing becomes restricted to the few who have large real estate holdings or other assets that give lenders comfort that they will be repaid in the event of default. Unfortunately, local citizens, many of whom have property that is communally or traditionally held, rarely have the type of assets that lenders view as being saleable. In many cases in the Caribbean region, therefore, foreigners or nationals who have substantial real estate holdings are more likely to receive loans. At the same time, banks are highly liquid and complain about the shortage of bankable projects, particularly with regard to citizens of the countries in the region. The inherent difficulty for lenders in assessing risk of default is made more problematic in the Caribbean by underdeveloped institutions that are largely incapable of attenuating risk. However, reform of the collateral framework for lending potentially provides a powerful instrument to greatly increase access to financing across many sectors. Box 2 illustrates this point in the case of Jamaica.

Box 2: How Collateral Reform Could Promote Coffee Finance in Jamaica

An important part of financing available to agriculture in developed economies arises from the use of a financial instrument known as a warehouse receipt. Under this system, an accredited warehouse takes in agricultural products, vouches for its quality and existence, and issues a receipt to the owner that becomes a negotiable instrument. Under a well-functioning system of secured transactions, this receipt can then be used as collateral. No such system exists in Jamaica, but if it were to be established as part of a secured transactions reform, it has the potential to solve a number of problems that exist in the financing of agriculture.

Jamaica's most famous agricultural product is Blue Mountain coffee. Since this coffee can be stored for up to two years without any loss of quality, there is the potential to improve the financing of the sector and perhaps develop a system of self-insurance. If negotiable warehouse receipts could be used as collateral, growers would have the opportunity to store their coffee after it is harvested, obtain financing, and keep back some of their production as a hedge against price fluctuations or even destruction by hurricanes. Since the warehouse would guarantee the existence and quality of coffee, lenders could advance funding knowing that a product that is easily saleable on world markets backed it. A reformed secured transactions system would ensure easy repossession and sale in the event of default.

Furthermore, since the harvesting season is long, if growers were able to store their coffee in an accredited warehouse and obtain funding as they do so, there would be far more funds available to invest back into the industry to ensure continued high standards. In particular, if the warehouse checked quality as the product came in, there would be strong incentives to keep standards high. Once the system was established for the coffee industry, it could be extended to other agricultural products that are not immediately perishable.

Credit Information and Credit Bureaus

A related problem is that the response to issues of adverse selection and moral hazard requires well-developed legal and information technology frameworks. In many Caribbean countries, the legal systems are deficient[6] and not well suited to modern business practices. Further, information technology is frequently a government monopoly, with poor service and high costs.

Until recently, the typical response of both governments and donors to an inauspicious legal framework and insufficient information about client creditworthiness, leading to a lack of lending, was to introduce directed credit, guarantees, development bank lending, and other initiatives in an attempt to broaden access to credit. Unfortunately, the experience of such schemes in the Caribbean has been no different from elsewhere. Bad debts have been high, lending has tended to be politically motivated, and in most countries in the region, development banks are in a weak financial position. Guarantee schemes have also failed to significantly increase access to credit.

6 See *ibid* for an example of underdeveloped legal systems support for private sector development in Jamaica. The systems in Trinidad and Guyana are also known to be inadequate, and their improvement has been the objective of two Bank technical cooperation programs respectively.

Rather than these various ill-fated schemes aimed at broadening access to credit, the countries would be better served with a vibrant system of credit bureaus. The bureaus would provide reliable, information on all current and potential borrowers at low cost to banks and other lenders. This would allow lenders to move beyond their fairly small circle of well-known, and typically higher-income, business clients to lend to the broad strata of small and even micro businesses that represent the vast majority of productive enterprises in the Caribbean.

To be truly useful, credit bureaus should be able to obtain not only bank loan repayment histories but also all hire-purchase, tax, and bill payment histories without the prior consent of the individuals involved. By the same token, each individual should be able to review and challenge the accuracy of his or her record, and the credit bureau should be responsible for correcting any verified inaccuracy on a low-cost and timely basis.

Credit bureaus are a permanent feature of all developed country financial markets and play an invaluable role in mitigating the adverse selection and moral hazard issues mentioned above. Nonetheless, credit bureaus exist in only two countries in the Caribbean. In Barbados (established in 1994), the credit bureau's information is incomplete in that records are collected from hire-purchase, automobile dealerships, and finance companies, but not from banks, although the latter are able to use the information. In Trinidad and Tobago, the bureau has a large and growing database that is actively used.

A credit bureau is being established in Suriname, although implementation is slow. In Jamaica, the right to privacy contained in the Banking Act is an obstacle to mandatory reporting of credit history data to a public credit bureau. Nonetheless, legislation has been drafted to enable credit bureaus to be created that would collect credit histories on a voluntary basis, and recently the Central Bank has been tasked to supervise the private credit bureaus once they are established in that country. In other countries, such as Guyana, where there is no legal objection to sharing information, credit bureaus have still not been established; however, banks informally share information among themselves.

Access to credit is severely hampered in countries where credit bureaus have incomplete information or where the bureaus do not exist at all, which in turn puts these countries' businesses at a competitive disadvantage.

Prudential Regulation and Corporate Governance

In most English-speaking Caribbean countries, the Central Bank is responsible for the supervision of deposit taking institutions. The IMF-sponsored Caribbean Bank Supervisors' Harmonization Project has helped to raise and improve the consistency of regulatory standards throughout the region. The Basle I Capital adequacy criteria are in place in most countries, and several of the more advanced ones are preparing to implement Basle II requirements. However, the global financial crisis is prompting a rethinking of the usefulness and reliability of the Basle II criteria. The development of sophisticated financial instruments and derivatives has led to a huge increase in the difficulty of evaluating systemic risk. Even in sophisticated financial markets, regulators were taken by surprise when the contingent liabilities inherent in these instruments became apparent. It is unrealistic to expect regulators in Caribbean countries to be able to evaluate these risks. Since Basle II essentially allows for a reduction in bank capital, a rethinking of its introduction is warranted.

The securities exchanges of Trinidad and Tobago, Barbados, and Jamaica are supervised by government securities commissions that also have responsibility for oversight of other nonbank financial institutions, such as insurance brokers, private pension fund managers, investment advisors, and unit trust (mutual fund) managers.

Formal deposit insurance does not exist in most Caribbean countries, and the two cases where it does, it was created in response to a financial crisis—Trinidad and Tobago in 1986 and Jamaica in 1998. On the other hand, Barbados is in the process of creating a deposit insurance corporation without having gone through a recent crisis, while the other countries have yet to decide whether and if so when to set up similar institutions. Maximum limits are set on funds insured that are designed to protect small depositors while avoiding creating an incentive for large depositors and the banks themselves to engage in moral hazard–like behavior.

With respect to shareholder protection, legislation in most OECS countries gives minority shareholders the right to call special meetings and propose matters to be raised at such meetings. Voting rights are also protected, including the right to elect directors through cumulative voting and the right to take steps to block takeover bids.

In Guyana, the two major private banks have very close relationships with the industrial groups to which they belong or are affiliated, and interlocking directorships are common. The monetary authorities do not appear to be exercising the necessary monitoring and enforcement mechanisms, and international accounting standards are not universally honored, commonly observed requirements for filing annual returns do not conform to the law, and proxy votes are abused at some corporations.

The Importance of Sound Macroeconomic Management

Poor macroeconomic policy and market failure have been blamed for the failure of financial markets to flourish in low- and middle-income countries. Macroeconomic instability increases credit risk for several reasons. Uncertainty regarding future inflation makes the determination of real interest rates difficult. The information in firms' balance sheets becomes difficult to interpret because of valuation problems associated with the impact of prices on assets and liabilities. As a result, uncertainty increases, which in turn negatively affects financial markets.

In addition, systemic instability and risk in some countries in the region is high. For example, the banking crisis in Jamaica in the mid-1990s led to a massive increase in public debt that has burdened the country since then. Interest rates soared and the resulting liquidity crunch led to many companies failing.

The economic decline of the early 1980s in Trinidad and Tobago led to the collapse of the real estate market and the insolvency or near insolvency of financial institutions. Since then, authorities have liberalized both financial and goods-and-services markets, and in 1993, the exchange rate was floated, leading to one of the most dynamic financial sectors in the region.

Suriname has fluctuated between periods of stability and growth followed by macroeconomic crisis and inflation because of its dependence on a few commodities (gold and bauxite), fluctuations in Dutch development assistance, and poor economic management, a key feature of the latter being a pro-cyclical expenditure policy. High deficits have limited availability of savings for private investment. Capital markets are hindered by macroeconomic instability, small market size, and an inappropriate regulatory framework. Thus what little private investment that does take place relies on bank financing. However bank capitalization is low and nonperformance ratios are high (15.3 percent in 2004). Debt to GDP is only 25 percent compared to the CARICOM average of 62 percent, and only about one-fifth of registered firms have access to credit from financial institutions.

Guyana underwent a major transformation from a highly controlled and state-dominated economy in the 1980s to a much more open and market-oriented economy in the 1990s as a result of the Economic Recovery Program of 1989.

The Global Financial Crisis of 2008/2009

The global financial crisis, which began in 2008, is unfolding around the world. As yet its full impact is not known, but all the developed countries moved into a recession that could be prolonged. So far the financial systems of the Caribbean have been comparatively unaffected; however, risks across the region have risen substantially. The sharp appreciation of the U.S. dollar that began in 2008 has put great pressure on many economies, particularly in those countries that have significant components of their foreign liabilities denominated in dollars. Chief among these is Jamaica, which has one of the largest ratios of foreign debt to GDP in the world.

A detailed analysis of individual countries' risk exposure is beyond the scope of this report, particularly since it is too early to assess the ultimate impact of the crisis on the Caribbean. However, reports from all countries indicate that they are already suffering severely from the downturn in the United States. Many businesses are at risk in the Caribbean countries. Since bank lending is declining across the region, substantial bankruptcies can be expected. While systemic risk appears to be limited, with the possible exception of the heavily indebted countries, the ultimate impact on the Caribbean economies will probably be severe.

Incorporation of Technology

A further reason for limited lending, as well as access to financial services more generally, is that the use of technology is limited. The introduction of services such as cell phone banking and electronic transactions has the potential to expand the range of the financial sector in many countries in the region. The success of using cell phones for electronic banking in countries such as South Africa and the Philippines illustrates how services like these can spread rapidly. However, the embryonic state of technology development in the region is holding back the introduction of technology-based solutions, often because government monopolies are hindering the introduction of competition and the expansion of services. The arrival of Digicel, the cellular phone provider, in Jamaica and other Caribbean countries illustrates how dramatically costs can decline and service can improve. It is an example that should be emulated around the region. Another lag in technology that is holding back financial market development in most countries in the region is high-cost and low-quality Internet service.

A related issue is the regulatory framework for telecommunications, which in most Caribbean countries favors a sole provider, either a state-owned monopoly or a private concessionaire with an exclusive franchise. Jamaica liberalized its telecommunications market in 1999; it was the first CARICOM country to make this move. In 2002, the OECS countries were opened up to competition,[7] while other countries, such as Guyana, have made less progress, due in no small part to the resistance of the incumbent franchisee.

[7] Caribbean Association of National Telecommunication Organizations (CANTO) 23rd Telecommunication Conference and Trade Exhibit (June 2007) home page.

Promoting Financial Development in the Region

As noted in earlier sections of this report, financial market underdevelopment in the Caribbean is preventing countries from reaching their growth potential. Reform is therefore urgently needed.

While previously mentioned difficulties in calculating risk in the region make targeted interventions difficult, policy initiatives need to be focused in the area of institutional reforms within the collateral framework and the financial sector. And, these initiatives must be undertaken in such a way as to better manage risk and fully exploit regional synergies.

Strengthening Property Rights

Property rights are the most important factor in promoting the evolution of financial markets. Secured transactions reform, which is underway in several countries in the region, assists in improving businesses' ability to pledge movable property as collateral. However, the largest asset of most of the citizens of countries in the region is land, and that land is often held by poorer communities in the form of occupational title.

There have been some reform initiatives to strengthen fixed property rights in the region. For example, in Jamaica a pilot program to reduce the cost of titling and registration was implemented in one of the Parishes. However, this initiative, along with most other attempts at fixed property rights reform, failed to make the link between land titling and financial market development. The Government of Guyana is also undertaking to strengthen property rights. These efforts are intended to encourage higher levels of financial intermediation and have three components: (1) improvement of the legal framework, (2) strengthening of the deeds registry, and (3) project management. Progress has been slow and the direct benefit—an expeditious and low-cost mechanism for pledging land as collateral for bank loans—has yet to be realized.

Reform of the secured transactions framework needs to carry with it improved processes for the seizure of assets in the event of default.

Strengthening Prudential Regulation

Even in the developed economies, where commercial banks are relatively less important in the financial system, bank failures can have severe consequences for the whole economy, which in extreme cases can lead to substantial effects on economic activity. In small developing countries, such as those in the Pacific Region, a bank failure could have a far greater impact. The example of Jamaica, which had a major banking crisis in the 1990s, is salutary. By bailing out the entire banking system, public sector debt ballooned to over 150 percent of GDP. A decade later, the country is still laboring under an enormous debt overhang, currently around 133 percent of GDP.

The presence of well-managed foreign banks reduces the potential for such crises because foreign banks are required by their holding companies to follow the prudential norms in the home country. Therefore encouraging foreign banks to remain has a positive effect on regulatory standards.

Nevertheless, in some countries, regulation of financial institutions is not strong. Assistance in promoting transparency and accountability in the management of financial institutions will improve the functioning of financial markets in many of the countries in the Caribbean.

Enhancing the Range of Financial Instruments

Commercial banks are by far the most important financial intermediaries in the region and are likely to remain so in the foreseeable future. Increasing commercial bank lending therefore has the greatest potential to increase access to financing since the cost of funds does not appear to be a major drawback to borrowing.

Loan guarantees have been proposed as an instrument to promote bank lending on the grounds that if a guarantor assumed part of the commercial risk, banks would increase their lending. However, guarantees do not solve any of the problems that underlie financial underdevelopment in the region. If banks do not lend because risks are too high, then the guarantor is taking on risk that banks decline to accept. If guarantors vet loans, processing costs rise, which negates efforts to lower the cost of funds. The typical experience with guarantee schemes is that banks put less creditworthy borrowers up for guarantees, while keeping the most financially sound outside the guarantees. All the problems of adverse selection and moral hazard described earlier apply to guarantee schemes.

One alternative available to regional firms is trade credit. Trade credit is extended between commercial buyers and sellers, as well as to customers by some large retailers in the region. However, trade credit is limited in most Caribbean countries (with Jamaica and Trinidad being the main exceptions), which contrasts with the situation in most developed countries. One reason is that accounts receivable cannot easily be used as collateral because of imperfections in collateral frameworks.

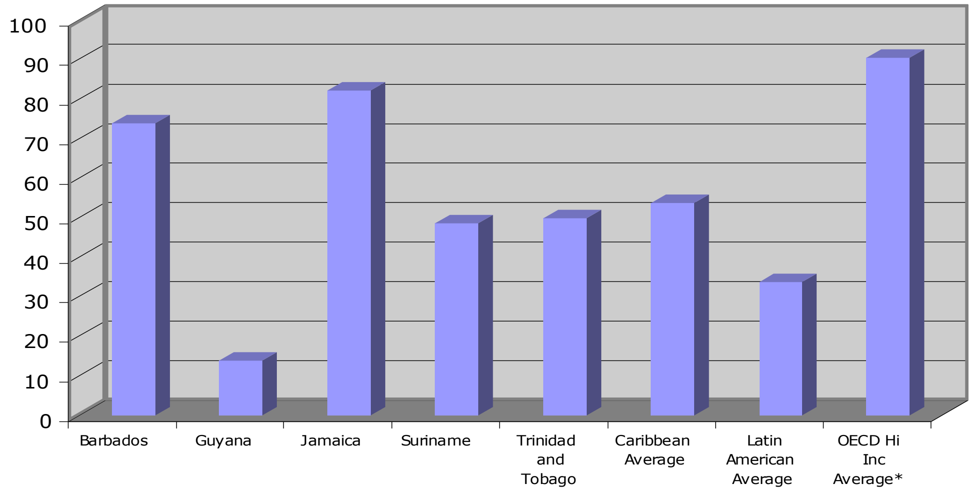
Making Credit Information Available

As discussed earlier in this report, making credit information available helps solve problems of asymmetric information. However, in many countries in the Caribbean, bank privacy laws prevent the sharing of credit information. Therefore, as a first step, privacy laws need to be modified to allow for information sharing. At the same time, encouraging banks to participate in any credit information system will have broader positive effects: the more widely available credit information, the more useful the system.

Introducing E-banking Facilities

Technology has great potential to improve the functioning of financial markets. However, in many countries, telecom services are state-owned monopolies, supplying inadequate services at high prices, which is holding back financial market development. On the other hand, there is widespread access to mobile phones, as shown in Figure 5. As noted above, advances in other regions of the world show the great potential to add access to financial services through the use of mobile phones.

Figure 5. Cellular Subscribers (per 100 inhabitants)



Source: WEF/GCR

Reducing Transaction Costs of Financial Intermediation

In many countries in the region, costs involved in financial market transactions are high. For example, stamp duties on many transactions puts a wedge between the buying and selling price that raises the costs of exchange. Similarly, none of the countries in the region have sufficiently well developed legal systems to consistently use standardized loan contracts. This means that each loan transaction requires a lawyer, greatly raising the costs of borrowing. Standardization of loan contracts as part of the reform of the secured transactions framework would greatly reduce borrowing costs.

Regional Initiatives

There are a number of areas where tapping the potential for regional synergies could greatly enhance the efficacy of individual country reforms. Such initiatives would require harmonization of relevant legislation and regulations in the respective countries.

Sharing Credit Information

Regional registries could provide credit information across the Caribbean and would thereby allow for the sharing of information, which could reduce business risk. By having registries operate regionally, many of the problems that exist in individual countries could be obviated. This is especially important with respect to issues of capacity and cost—skills and facilities that are not available in most countries in the region could be provided economically at the regional level. It would also reduce the cost to individual countries to maintain such information, since regular updates have substantial fixed costs. Having a common information base, particularly if it is also accessible from the United States, Canada, and the United Kingdom, would also provide substantial benefits to foreign investors, most of whom originate in these countries.

Establishing a Regional Trading Platform

To date, efforts to integrate capital markets in the region and establish regional trading platforms have been stymied by differences between the countries in capital control and legal regimes. Also there is a certain amount of rivalry around which country should take the lead in this process. For example, a Regional Technical Cooperation for the Harmonization of Capital Markets project in the 1990s was designed to achieve commonality in clearance and settlement regulations and procedures. The main goals were to improve the clearance and settlement facilities of the various countries' securities markets and to increase their commonality, but the project did not integrate these facilities. Subsequently, country-specific initiatives have been undertaken to foster regional integration. For example, in Barbados, specific incentives have been set up to increase cross listings on the Securities Exchange of Barbados for multi-national firms headquartered in the region.

Intraregional Regulatory Cooperation and Harmonization

The Caribbean Regional Technical Assistance Center (CARTAC), sponsored by the IMF with support from other regional development institutions, including the IDB, is a major forum for identifying and addressing regional and country-specific measures needed to strengthen specific aspects of economic and financial governance. In the areas of financial sector regulation and supervision, and capital markets, the forum provides technical support in strengthening laws and regulations governing financial institutions and capital markets using harmonized approaches where possible, implementing international accounting standards, enhancing corporate governance standards and transparency regimes, assisting with the introduction of depositor protection mechanisms, and supporting improvements related to financial market infrastructure. As well as providing country-specific assistance, CARTAC regularly hosts regional conferences and seminars that provide a venue for countries in the region to coordinate their activities.

Donor Coordination

An overriding principle governing financial sector reform is that it should be market based, eschewing regulation (apart from necessary prudential regulation of financial institutions). In this regard, development banks are not an effective means of intermediating funds. Their lending decisions are often not governed by returns, but rather by political criteria or some type of industrial policy.

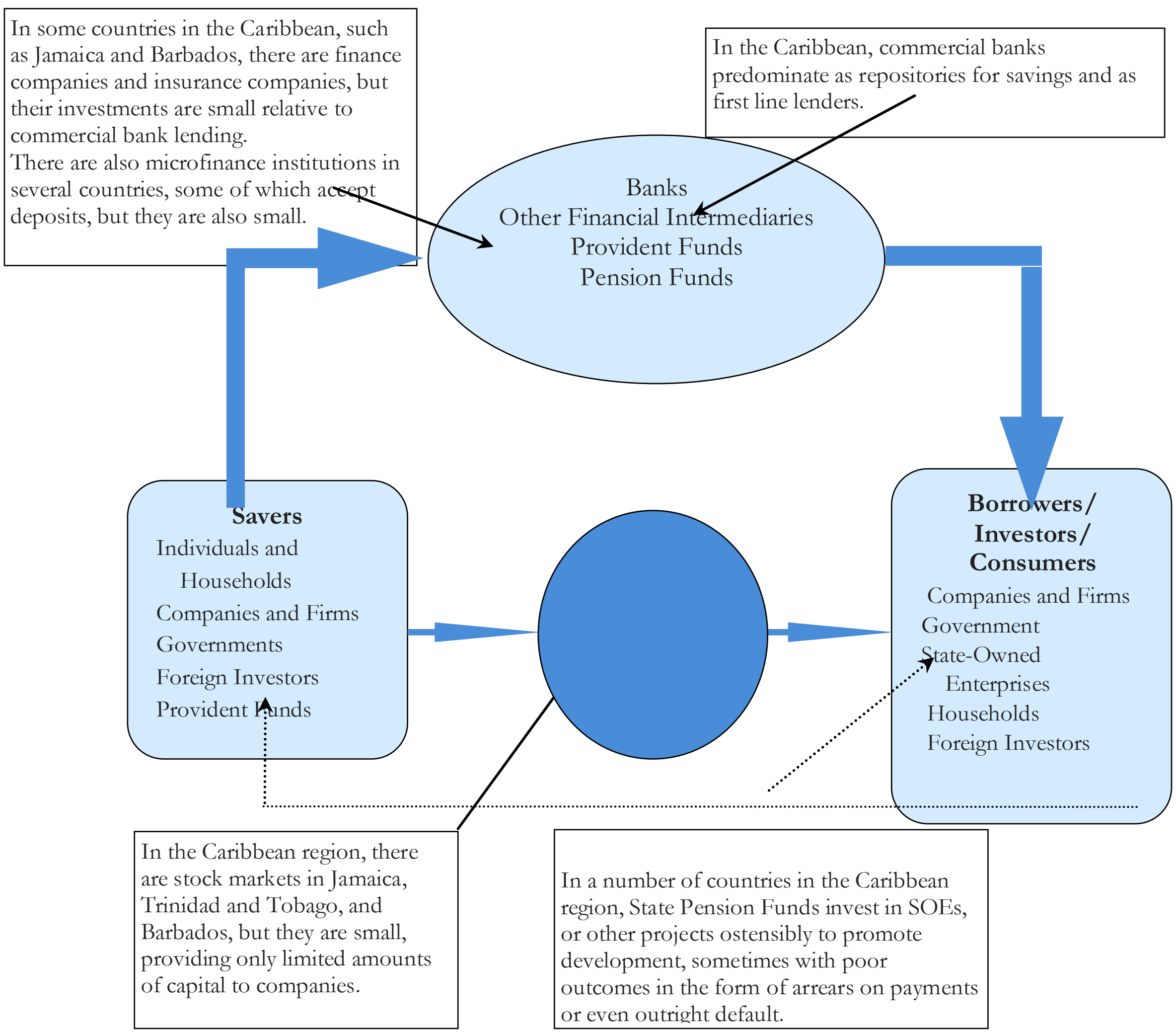
Conclusion

The preceding analysis points out that most of the countries in the Caribbean do not have financial markets that intermediate effectively or efficiently between savers and investors. The goal of improving competitiveness, which ultimately leads to higher growth and the reduction of poverty, cannot be achieved without improving financial markets in the countries in the region. The analysis also highlights the close link between institutional development and financial development, as well as the importance of adopting a regional approach. Ultimately, policy initiatives to increase access to finance will not succeed unless the institutional foundations for finance in the Caribbean are improved at the sector, country, and regional levels.

Annex 1: Flow of Funds in Caribbean Financial Markets

Financing is the exchange of a sum of money in the present (the loan) for the promise of the payment of a larger sum in the future. The interest rate determines just how large that sum is. Many different types of institutions are prepared to enter into such a contract, from pawnshops to the village moneylender to commercial banks to far more sophisticated and developed lenders, such as factors and merchant banks.

Even in highly developed financial markets, commercial banks and other financial intermediaries are the predominant source of financing for companies and households. For example, in the United States, financial intermediaries supply more than 60 percent of all credit to nonfinancial entities. In Canada, commercial banks alone supply nearly 60 percent of all loans, while in Germany and Japan, the amounts are 76 percent and 78 percent, respectively. In the Caribbean, commercial banks supply more than 90 percent of all credit. This is in line with financial markets in most developing countries.



Annex 2: Calculating the Price of Risk from the Structure of Interest Rates

It is possible to calculate the various factors that determine the level of interest rates as well as the spreads between borrowing and lending rates and different types of loans. The Caribbean has typically had high intermediation margins as a result of substantial liquidity in the banking system. In addition, the financial systems of countries in the region have generally been dominated by a small number of banks. In all countries, the high intermediation margins make foreign banks highly profitable, with return on equity of 30 or more percent per annum not unusual. Since lending criteria for the foreign banks match those in the home country, loan losses are low. For example, the bad debt ratios of the Bank of Nova Scotia are no higher than those in Canada. In addition, high transaction costs for securing loans backed by collateral (stamp duties, legal fees, and processing fees) make it costly to change lenders so that borrowers become locked into their relationship with one lender.

	Interest rate	**Spread**	**Risk type**
Government borrowing rate in local currency	A	A - B	The difference between domestic and foreign currency interest rates (A-B) is a measure of systemic risk, which is a combination of macroeconomic risk and political risk.
Government borrowing rate in foreign currency	B		
Lending rate to large customers	X	X-A	The spread over the government borrowing rate indicates the costs of intermediation. In general, these are high in the Caribbean compared with those in developed countries, which is indicative of the lack of competition in the banking systems in the region.
Lending rate to small businesses	Y	Y-X	The discrepancy between the lending rate to large customers versus small businesses represents the risks associated with small business lending. In general the rate for small businesses is substantially above that for large customers. Usually, loans are secured by a general charge against company assets and a guarantee from the owner backed by a pledge of property.
Lending to informal borrowers and consumers	Z	Z-X	The discrepancy between the lending rate to informal borrowers and consumers versus large customers represents the costs of processing small loans and the likelihood of default on unsecured borrowing.
Deposit rates	C		The difference between lending and deposit rates reflects the efficiency of financial institutions and the lack of competition within the banking system.

Annex 3: Important Features of a Collateral Framework

The Difference between Secured and Unsecured Creditors

General creditors have a general claim against a debtor's property. Secured creditors have a claim against a specifically designated piece of property. For example, in bankruptcy, the claims of secured creditors are satisfied first. Then the remaining property is used to satisfy those of unsecured (general) creditors.

Security Interests and Collateral: A security interest is a right to a specified piece of the debtor's property (the collateral) that the lender can dispose of to satisfy a secured debt. It has priority over all other general, or unsecured, claims.

How to Secure Loans

To be effective, a framework for securing loans has the following essential features:

Creation: The process by which the creditor establishes a security interest in property (the collateral). Creation must cover all economically important property, transactions, and agents, and the law must permit creation at a low cost relative to the value of the transaction. This process includes the lender ensuring that the borrower does have legal ownership and that the assets are sound.

Priority: The process by which the lender establishes the priority of the security interest against all other claims in property. A well-functioning system must provide for the unambiguous ranking of priority rules and protect the secured party from hidden claims of third parties, including other secured creditors, unsecured creditors, a trustee in bankruptcy, some purchasers of the collateral, labour claims, and government tax claims.

Publicity (Registration): The legal process that makes public the ranking of the priority of the security interest. It must let a potential lender establish a ranking of priority in collateral by filing a notice of the security interest in a publicly available archive (registry). It must also let a potential lender search the archive easily, quickly, and inexpensively to determine whether other claims exist against a borrower's property.

Enforcement: The process by which, upon the debtor's default, the creditor will seize and sell the collateral to satisfy the secured claim. The process must be sufficiently rapid that the economic life of the property is not compromised, and the cost must be relative to the value of the transaction secured with such property.

In addition:

- Costs of creating security interests must be low.
- Costs of enforcing security interests in the event of default must be low.
- It must be possible to realize financial proceeds from a security interest.
- The security interest must not be open to challenge—it should be possible to easily and inexpensively ensure that there are no prior claims against the security.

Close Monitoring of Reform Initiatives

Once reform gets underway, careful monitoring and evaluation is necessary to ensure that problems in all phases of the collateral framework have been addressed. With such monitoring, necessary additional reform measures to ensure that the collateral framework is functioning effectively can be taken promptly.

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