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"CHANGES AND CHALLENGES IN THE BANKING SECTOR"

Opening Remarks

at the

"Banking on the Future" Summit

sponsored by
The Bankers Association of Trinidad and Tobago

by

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It's a pleasure to join you all in this summit. This is a very interesting time for the financial sector as it undergoes rapid change in a fairly buoyant economic environment. Your discussions are also taking place in a global environment that's going through its own transition and this is having its own repercussions here at home.

The macro-economic environment in Trinidad and Tobago is in general very robust. Reflecting a booming energy sector and high international energy prices, real GDP growth has averaged 6.5 percent a year over the last five years or so; inflation has been generally subdued though there has been some increase this year, in part due to high food prices. The external sector has never been stronger with oil prices at record levels and with high levels of foreign direct investments.

And like the economy, the **local financial sector** is in very good shape, when judged by historical and regional standards.

(i) **The banks are very well capitalised** with a capital adequacy ratio of over 20 percent, way above the 8 percent statutory minimum;

(ii) **Non-performing loans for the system as a whole average about 3 percent** which, is a marked decline from the double digit levels of the early 1990s;

(iii) Banks have provisions covering in excess of 72 percent of non-performing loans (a healthy standard);

(iv) And above all, banks are recording **healthy profits**, with an average return on assets of about (2.3) percent, compared with (1.4) percent for U.S. banks.

Capital markets are pricing banking sector risk at very favourable levels, with **equity prices** and **debt spreads** suggesting a high level of investor confidence in the financial health of the sector.

Liberalisation and the revolution in information technology have led to widespread structural changes in the financial sector of Trinidad and Tobago. These forces have prompted:

(i) a trend towards mergers and the formation of strategic alliances between units from different niches of the financial sector;

(ii) continuous product innovation and interchange blurring the boundaries between banks and non-banks; and thirdly,

(iii) financial institutions expanding beyond national boundaries into the Caribbean region and beyond. It started with expansion into neighbouring CARICOM territories: it has expanded into the Dominican Republic, Aruba, Curacao and

Cuba, and one of our insurance companies has gone further afield with significant investments in the United Kingdom.

Banks' balance sheets have also evolved in response to these structural changes. For example:

- By our estimate, about 20-25 percent of the income of the two largest banks come from their overseas operations.

- About 15 percent of total bank assets represents overseas exposure: Caribbean territories, particularly Barbados, Jamaica and St. Lucia, account for close to 80 percent of this overseas exposure.

- Banks' asset mix has been changing with the growth in investments, exceeding that of loans. The bulk of these investments are government securities.

- Interest continues to be the major source of bank income but there has been a noticeable increase in income from fees and commissions.

Another interesting change has been the increasing trend towards savings in US dollar-denominated deposits. These dollar deposits now account for 29 percent of total deposits, compared with 23 percent (five) years ago.

Many of these structural changes redound to the benefit of the consumers through, in some cases, a reduction in the cost and improvement in the quality of bank services and certainly through an expanded range of product offerings. The most glaring example is the increased convenience offered by ATMs and by telephone and internet banking.

Some of the changes create regulatory challenges. Thus for instance:

(i) Expansion into new markets has provided the opportunity for banks to overcome the constraints of the small home market, increase critical mass and justify the high cost of cutting edge technology. **But this expansion has also meant an increase in cross-border risks, the full extent of which is not always recognised**.

(ii) **Mergers and acquisitions** have led to a high level of concentration. In our banking system, for instance, the two largest banks now account for 60 percent of total bank assets. In the insurance industry, the two largest companies account for 69 percent of total assets.

There is no doubt that concentration among financial institutions could lead to economies of scale, higher profits and increased franchise value. On the other hand, it increases the vulnerability of the system to any disruption in the dominant institutions. Worldwide experience also shows that over-concentration could lead to an abuse of a dominant market position and could raise moral hazard issues, including the "too big to fail" phenomenon.

(iii) A third issue is the size of the dollar-denominated deposits. Clearly, **our banks are not yet overly dollarised**, in the Latin American sense, where the level of dollar deposits can be as high as 70 percent of total deposits. However, the level of dollarisation of our banking system is increasing, and this carries certain risks when, for instance, firms become highly leveraged with dollar debt or when dollar loans are made to firms that are not earning foreign exchange.

These are but some of the operational and regulatory challenges that both the banks and the Central Bank are seeking to face. I would like to take a few minutes to discuss two challenges that our banking system needs to face to further enhance its contribution to our strategic economic objectives.

The IDB identifies several indicators of banking system development. Some of them have to do with the **number of bank branches per 100,000 of population, the number of ATMs,** etc. Really, these have to do with the banking infrastructure, and we are doing very well on these.

But there are two indicators of banking system development where we are not doing as well and these are, firstly, **the level of interest rate spreads** and secondly, what they call **financial depth**.

I would like to briefly examine the two concepts.

First, let's look at **the intermediation spread**, which is defined as the difference between the average interest rates charged to borrowers and the rates paid to depositors.

One factor that influences this spread is the level of reserve requirements. As you know, over the last few years, the Central Bank has been reducing reserve requirements, and since October 2003 reserve requirements have been reduced from 18 percent to 11 percent. **Even with this reduction, the interest rate spread is now about 7.2 percent. While we are somewhat lower than in the rest of the region, for developing countries in East Asia it is about 5 percent: for developed countries the spread is about 2 percent**.

The high spread, which in practice translates more into high lending rates, reflects in addition to the reserve requirements: the risk of default on loans; the banks' market power; and the level of operating efficiency of the banking sector.

Empirical studies focussing on Latin America suggests that lower deposit rates and higher lending rates characterise highly concentrated markets. The studies suggest that even though banks invested in cost-cutting systems, the savings were not always passed on because of their market power. In principle, easing conditions of entry could encourage new banks, spur competition and reduce spreads. This, however, is a risky strategy since the entry of weak banks could undermine confidence in the entire system.

The second indicator—**financial depth**—measures the ratio of credit and deposits to GDP and points to the level of financial intermediation in the economy.

Data for the last few years indicate that bank credit represents only 26.5 percent in Trinidad and Tobago. This is significantly lower than in several countries of similar GDP per capita income, including Barbados, Chile, Costa Rica, India, Mauritius and Uruguay).

The picture is generally the same when we look at the ratio of bank deposits to GDP. In Trinidad and Tobago, total bank deposits represent about 40 percent of GDP. This compares with 64 percent for India, 84 percent for Mauritius, 68 percent for Uruguay and 89 percent for Barbados.

In economics, international comparisons are always difficult to interpret because the numbers never fully bring out the differences in national circumstances. **Even accepting all this, I think that it is safe to say that in Trinidad and Tobago bank credit is generally scarce and invariably costly. To put it another way, if we are to achieve our 20/20 vision , the banking system needs to play a more aggressive role in searching out avenues for credit expansion, particularly to the sectors of high growth potential**. The disproportionate focus on consumer credit, while profitable in the short term, represents a less than optimal contribution to the economy's long term economic growth.

Banks need to get more involved in the energy sector and in lending to small- and medium-sized businesses. Between 2000 and 2004, loans to the petroleum sector, as a proportion of total loans of the banking system, averaged only **2.7 percent** and this largely represented credit, channelled to small service firms in the sector. The conventional argument is that the investment requirements of the energy companies are so large that they are outside of the capacity of the local banks. Even if that's so (and I am not sure that it is), what about a consortium of local banks? Or what about joint venture arrangements with foreign banks? In an economy which is still heavily dependent on the energy sector, commercial banks need to explore avenues and opportunities that not only finance local content within the energy sector but also support linkages between the energy sector and the rest of the economy.

If we are to be in the big league we need to get in there in a big way – and the energy sector should be an entry point.

I should note that a few institutions have recognised niche opportunities for financing activity in the energy sector and have attempted to develop new instruments to support the financing of activity in this sector. I can think about two mutual funds that invest exclusively in energy and energy-related industries

The SME sector is also pivotal in reducing unemployment and poverty and in diversifying away from the oil economy.

SME entrepreneurs identify lack of the access to credit as the most important obstacle to the development of their businesses. This fact, combined with the sheer size of the SME sector, explains why many countries have specific programmes to support SMEs.

While there are data limitations, the evidence suggests that bank lending to SMEs is limited and that those loans that are extended are done at very high interest rates.

I am fully aware of the greater risks – both real and perceived – of lending to SMEs. However, the importance of the sector is beyond question, and given the overriding role of banks in mobilising savings and financing investment, the SME sector will never develop to its potential without significant participation by the banking system on reasonable terms.

There is much room for innovative thinking about how the issue of financing small business could be approached by the commercial banking industry. Part of this innovation may involve the introduction of a specialised window for small business financing in commercial banks as well as the development of joint venture financing partnership schemes with specialised institutions.

Ladies and gentlemen, this has been quite a mouthful and I sincerely hope that I have not gone outside my terms of reference. Also, the identification of what I have called "two major challenges" by no means nullifies my studied assessment that our banking system is strong, resilient, innovative and the **centrepiece** of what is now widely acknowledged as the financial capital of the pan-Caribbean region.

Clearly the banking system needs to broaden its contribution to the diversification effort. I am confident that, in time, it would do just that.

Thanks for your patience.