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OECS CAPITAL MARKETS AND FINANCIAL INSTITUTIONS PROJECT

Prepared for

THE EASTERN CARIBBEAN CENTRAL BANK

under the auspices of the

U.S. Agency for International Development

March 3, 1989

FINAL REPORT

by

Robert R. Nathan Associates, Inc.

and

Price Waterhouse

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March 3, 1989

The Honourable
Cecil A. Jacobs, Esq., CBE, MBE
Governor
Eastern Caribbean Bank
St. Kitts-Nevis

Dear Mr. Jacobs:

Attached please find the final report prepared for the ECCB and A.I.D. under the OECS Capital Markets and Financial Institutions Project. This final report incorporates comments made by both the ECCB and A.I.D. to the draft final report.

It was a pleasure working with you on this project and we look forward to continuing our relationship in the future.

Sincerely yours,

John Newton
RRNA Principal Associate

Auguste E. Rimpel, Jr.
Price Waterhouse

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EXECUTIVE SUMMARY

I. BACKGROUND

In August 1987, the Eastern Caribbean Central Bank (ECCB), as part of its ongoing analysis of the Eastern Caribbean financial markets and institutions, requested technical assistance from the United States Agency for International Development's (USAID) Public Management and Policy Planning (PMPP) Project to carry out a study of the OECS capital markets and financial institutions. The Capital Markets and Financial Institutions Project was subsequently carried out as a joint venture between Robert R. Nathan Associates (RRNA), prime contractor to USAID under the PMPP Project, and Price Waterhouse (PW), subcontractor to RRNA under the same project.

The mission of this Project is to advance the economic development of the Organization of Eastern Caribbean States (OECS) region through the promotion of a more efficient and unified financial market place. To attain this, the Project focused on the following objectives:

- Reduce and/or eliminate barriers to the intra-regional flow of investment funds
- Facilitate and increase the flow of investment funds into locally-owned and/or joint venture productive enterprises (agriculture, manufacturing, services and tourism; not including housing)

To accomplish these objectives, the Project concentrated on the evaluation, design and implementation of facilities and mechanisms designed to increase and/or facilitate the flow of investment funds into the productive private sectors of the OECS economy. To this effect, the following topic areas were examined by a number of technical experts as to their applicability to the OECS region:

- Loan and guarantee facilities
- Technical assistance and training to the productive private sectors
- Facilities to reorganize, refinance, and takeover enterprises
- Venture capital (equity and quasi-equity instruments)
- Leasing

- Foreign exchange risk management techniques and related mechanisms
- Clearing efficiency of the OECS banking system

In order to attain the objectives set forth for the Project, a detailed work plan was developed. The major tasks contained in this work plan included:

- Project Start Up: Steps were taken to properly initiate the engagement. The Project Team prepared a draft announcement letter, carried out a literature search, developed data collection requirements, refined the project work plan and schedule, and identified and contracted the technical experts to be used during the course of the study.
- Data Assembly: The following types of data and information were assembled by the ECCB Research Department in order to facilitate the fact-finding portions of the Project:
  - Laws, taxes, regulations and fees in each OECS country affecting intra-regional investments and capital movements
  - Economic/financial reports in OECS countries
  - Selected papers and minutes related to the Project's objectives
  - Recent analytical studies of OECS financial institutions
- Field Work and Option Paper Development: A field work effort was orchestrated by the Project Team in order to expose the various technical experts to each ECCB member country as an input to their analysis. ECCB economists participated extensively in the field work. Each ECCB-member country was visited and interviews were held with a representative sample of officials and representatives from government, the banking community and the private sector.
- Forum: After the field work was completed and the initial option papers drafted, a Forum was held in St. Kitts-Nevis to discuss the interim findings and preliminary recommendations prior to the preparation of the final report. Forum participants included representatives from the government, banking and private sectors. The Forum was successful in that it

generated a very penetrating discussion regarding the future of the OECS financial sector, and served as a first step in the consensus building process that will be required to implement many of the steps necessary to unify the financial sector.

- <u>Draft Final Report</u>: A draft final report was prepared for review by both the ECCB and USAID prior to the ECCB Board meeting.

- <u>Presentation</u>: The draft final report was presented to the full Board of the Eastern Caribbean Development Bank in Montserrat on January 20, 1989.

- <u>Final Report</u>: The final report, of which this Executive Summary forms a part, is a stand-alone document drawing extensively on the option papers and other inputs prepared by the technical experts. It presents a synthesis of recommendations and puts forth an implementation program to be followed by the ECCB and other interested parties. The final report incorporates comments and suggestions made by the ECCB and USAID.

Under the general direction of Robert R. Nathan Associates (RRNA), the Project was carried out as a joint venture between Price Waterhouse (PW) and RRNA. Price Waterhouse provided the Project Management Team as follows:

- Dr. Auguste E. Rimpel, Jr., Project Oversight
- Mr. Jorge J.M. Iwaszkiewicz, Project Director (on-site)
- Mr. Mark K. Camstra, Project Manager and Lead Analyst

Price Waterhouse professionals maintained an on-site presence at the ECCB's offices in St. Kitts-Nevis and in the OECS region during the course of the entire engagement.

RRNA provided management and technical inputs as follows:

- Mr. Phillip W. Rourk, Project Oversight
- Dr. Wendell Samuel, Deputy Project Director
- Mr. John O. Schroy, Venture Capital, and Facility to Reorganize, Restructure, Takeover Enterprises

- Dr. Thanh V. Tran, Loan Facilities and Guarantees, and Technical and Training Assistance

- Mr. Sury R. Subban, Leasing

- Dr. Martin R. Barrett, Foreign Exchange Risk Management, and Clearing Efficiency

In addition to the above technical experts, the Project Team drew on the inputs of Dr. Courtney N. Blackman, former Governor of the Central Bank of Barbados, and Mr. Harold L. Russell, former Chairman of the Barbados Development Bank.

A Steering Committee established to provide guidance and to ensure the objectives of the Project were met actively participated in the Project. The Steering Committee was composed of both ECCB staff and consultants, as follows:

- Mr. Erroll N. Allen, Deputy Governor, ECCB
- Mr. Eustace Liburd, Director, Research, ECCB
- Dr. Auguste E. Rimpel, Jr., Director, PW
- Mr. Jorge J.M. Iwaszkiewicz, Project Director, PW
- Mr. Phillip W. Rourk, Vice President, RRNA
- Dr. Wendell Samuel, Deputy Project Director, RRNA

II. ECONOMIC AND FINANCIAL SECTOR REVIEW

The findings, conclusions and recommendations developed as part of this engagement are based in part on a review of the OECS economic and financial sectors. The elements reviewed during the course of the engagement are briefly described in this Executive Summary.

The nature of the OECS economic structure and its recent performance are analyzed. While the mainstay of these economies has been agriculture, accounting for more than half of the region's export earnings, tourism has accounted for an increasing proportion of export earnings in recent years. Manufacturing has remained relatively modest both in terms of foreign exchange earnings and its contribution to GDP. The region is susceptible to natural disasters and is highly sensititve to changes in the terms of trade for commodities, both contributing to limited economic growth in the early 1980s. Real growth in GDP recovered in the period of 1984 to 1987, averaging 5.5 percent over the period, as the upturn of economic activity in the United States resulted in increased tourist arrivals. At the same time, better weather conditions as well as improved methods of production and packaging in the banana industry bolstered agricultural exports. The nature of this recent growth has led to high liquidity in the region.

The institutional makeup of the financial sector indicates that it is still relatively underdeveloped as it continues to be dominated by the commercial banks, particularly the branches of foreign commercial banks. The non-banking sector is nevertheless expanding, providing the OECS financial system with elements of diversification and resiliency. An important gap in the financial structure of the ECCB countries is the non-existence of investment financing institutions, particularly those involved in trading longer-term securities.

A review of the various components of the OECS financial sector was also conducted. The Eastern Caribbean Central Bank, while gradually becoming an integral part of the financial sector, is nevertheless a relatively young institution, still very much in the process of defining and interpreting what its proper role as the region's central bank should be, and to what extent its should become actively involved in promoting the economic development of the region. This process is a difficult one as the ECCB must act as the monetary agent for multiple countries, requiring it to delicately manage relationships with eight sovereign states. Many of the recommendations set forth as a result of this engagement will require that the ECCB think through and make fundamental policy decisions with respect to the exact role that it should play in the region, not only as its principal monetary agent, but as an active catalyst in the overall development process.

The role and functions of <u>commercial banks</u> is discussed since, as noted in the field survey portion of the study, there appears to be, in several quarters, an incomplete understanding regarding the proper function of commercial banks within the economy. While the OECS financial sector continues to be dominated by the foreign commercial banks, the indigenous commercial banking sector is emerging as an increasingly active and organized financial agent in the region, injecting a constructive dose of competition into the OECS financial sector.

A number of <u>development institutions</u> has been established in the OECS region over the recent past to address the issue of channeling funds to the productive sectors of the economy. These include, among others, the National Development Banks (NDBs) and the National Development Foundations (NDFs). The general mandate of these institutions is to provide medium- and long-term financing and technical assistance to the productive sectors and, in some cases, to those areas defined to be of national priority. The NDFs have been particularly successful in channeling much-needed resources to the micro enterprise sector.

The <u>non-bank financial sector</u> has been growing steadily in the recent past. These include financial intermediaries such as savings banks, finance companies, credit unions, insurance companies and building societies. The basic difference between these institutions and commercial banks is that they do not normally accept monetary deposits repayable on demand.

A particularly interesting aspect of the OECS financial sector is the growth of <u>credit unions</u> as non-bank financial intermediaries. Their growth has been particularly exceptional in Dominica, which has the strongest growing movement in the region. The credit unions, like the indigenous banks, represent a constructive expansion and diversification of the the OECS financial sector. The activities of the credit unions, to the extent that their activities can be properly coordinated and integrated into the overall system in a manner consistent with the amount of resources they control, will induce competitive pressures that will tend to expand the financing sources and options to the productive sectors.

Another major development in the financial sector of the region during the last two decades has been the emergence of the <u>National Insurance Schemes (NIS)</u>. While it is clear that the Schemes have had a positive impact on savings in the region, the evidence with respect to their effect on investment is inconclusive to date. This is due to a number of reasons, including the absence of financial instruments to channel savings into long-term investment and the nature of commercial banking practices with respect to long-term investment. The NIS nevertheless represents a powerful instrument for mobilizing domestic savings which, if properly planned and managed, could be effectively channeled into the productive sectors.

There is a wide divergence across the ECCB member countries with respect to the laws and regulations currently in place that govern the financial sector. This situation has numerous detrimental implications for the region in terms of unifying the financial sector and furthering economic development. Many of the recommendations set forth in this report are directed at addressing the legal and regulatory constraints to developing a well-integrated, OECS-wide financial sector.

The level of interest rates continues to be a pressing issue in the region. The ECCB has come under intense pressure from member governments regarding the level of interest rates charged by the banking sector. In the governments' view, lending rates are excessive, particularly in view of the high levels of liquidity in the OECS, and represent a significant deterrent to the growth of the region's productive sectors. According to these governments, the ECCB should take whatever steps are necessary to reduce the level of lending rates in a manner consistent with the needs of economic development. For their part, the banks point to a number of factors which they feel justify the interest rates they charge. The current level of lending rates is necessary to support their operations which, compared to other regions of the world, are extraordinarily small in scale and generate higher than normal costs. The high liquidity in the region, coupled with a lack of viable investment opportunities, creates additional costs as funds lay idle. The bankers further insist that the Central Bank should refrain from imposing any types of administered controls over lending rates, as such actions would be highly detrimental to the viability of the financial sector, and would create an antagonistic situation not in the interest of any party.

It is beyond the scope of this engagement to conduct an in-depth analysis of this interest rate issue and to prescribe policy steps. It is worthwhile to note in the Executive Summary, however, that a number of studies have been commissioned to analyze the lending rate issue. These have, by and large, concluded that, compared to other regions of the world, the interest rate spreads earned by the commercial banks, particularly the foreign commercial banks, are indeed higher than what might be considered "normal" in other settings. A number of proposed solutions have been suggested, ranging from developing a competition policy to implementing various elements of an interest rate policy on the part of the Central Bank (e.g., statutory or voluntary ceilings on lending rates, open market operations and discount rate changes, moral suasion).

Based on the input received during the field work, it is clear that the interest rate issue is a complex one, not amenable to easy or rapid solution, and that there is a need to further clarify the nature of the problem and the range of options available to address the issue. For present purposes, it is not unreasonable to state that the lack of a unified financial sector, a problem rooted in the complex diversity of laws and regulations as they impact the workings of the financial sector, as well as a fundamental lack of competition in the banking sector, in many ways lie at the heart of the interest rate problem, since they render the financial system unresponsive to Central Bank policy actions. Notably, many of the recommendations contained in this report address precisely the problems at the root of the interest rate issue, the implementation of which will tend to produce a more unified and competitive financial sector, thereby creating the conditions within which the Central Bank can affect the level of rates through mainly indirect means.

While the OECS financial sector possesses a number of important constraints and deficiencies that inhibit it from properly facilitating regional economic development, it is important to note that the OECS possesses a number of factors that work to its advantage in the process of developing a well-functioning, unified financial sector. The OECS enjoys relative political and social stability and has governments which by and large support private and financial sector development. The financial sector is made up of financial institutions which provide the basic infrastructure required to develop a well-diversified financial sector. The OECS region has connections to world financial markets via major British and Canadian private commercial banks. The region also has an increasingly active indigenous commercial banking sector operating with strong governmental backing, an emerging non-bank financial sector (particularly in the area of credit unions) and a rapidly growing potential source of long-term funding in the National Insurance Schemes. The region also has a relatively new institution--the Eastern Caribbean Central Bank--which is in a position to grow and play an increasingly important role in the overall process of financial sector development in the OECS region.

III. PROJECT FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

The findings, conclusions, recommendations and implementation steps for each project topic area are summarized below. The following premises were used to develop the recommendations:

- An effective financial sector development strategy should address constraints imposed by restricted market size and limited competition as an alternative to regulation by fiat of the existing commercial banking sector.
- There should be a maximum utilization of existing institutions, particularly in the private sector, and minimal establishment or extension of public sector institutions.
- There should be, to the extent possible, a reduction in the direct involvement of public sector institutions in financial markets.
- Any newly-created public sector institutions should play a catalytic role in the development of a viable financial sector in the OECS region.
- The Central Bank should function primarily as a policy maker, a regulator, and a lender of last resort. It should achieve policy objectives, including being a catalyst for economic development, by increasingly indirect means.
- The development of a unified financial sector in the OECS region will be an essentially long-term exercise. This will require that the region's leadership, both in the public and private sectors, learn through trial and error what will and will not work. A concerted process of consensus building will be required to implement many of the steps necessary to promote the unification of the OECS financial sector.

Our findings, conclusions, recommendations and implementation steps are presented below for the following topic areas:

- Loan and guarantee facilities
- Technical assistance and training to the productive private sectors

- Facilities to reorganize, refinance, and takeover enterprises
- Venture capital
- Leasing
- Foreign exchange risk management techniques
- Clearing efficiency of the OECS banking system

A. Loan and Guarantee Facilities

1. Findings and Conclusions

- There is a perception that the financing institutions providing medium and long-term financing in the OECS region do not fully meet the needs of the productive private sectors. This is because the various local, regional and multilateral financial institutions providing term financing in the region impose limits as to the type of funds they can lend, oftentimes have stringent collateral requirements, are sometimes precluded from providing equity funds, and in many instances can lend only in foreign currencies.

- The financing needs of the large and micro enterprise sectors appear to be reasonably well met. Many firms have little difficulty obtaining any type of financing when they are large and well established. The micro enterprise sector has been well served by the National Development Foundations, which continue to be quite effective in their third year of operations.

- The small- and medium-sized enterprises (SMEs) face the most difficulties in accessing medium and long-term financing. This is due to the generally conservative nature of banking practices in the region, the fact that SMEs oftentimes require loans that are too big for the smaller lending institutions and too small for the multilateral lending institutions, and that SMEs are less likely than larger firms to have available accounting records and other supporting documentation required to obtain term financing, as well as adequate collateral.

- It may be useful to establish special loan and guarantee facilities to better service the needs of SMEs, including a loan guarantee scheme, a special SME loan facility, and a special "credite mixte" facility to fund projects of national priority. Selecting the most appropriate institution or institutions to design and manage the execution of these schemes will be an important consideration.

2. Recommendations and Implementation Steps

- Establish a loan guarantee scheme for the OECS region targetted at the special needs of the SMEs. The objective of this scheme is to provide credit-worthy SMEs having viable projects and good prospects, but limited collateral, with access to medium and long-term financing at reasonable terms. Key considerations in developing the scheme include defining risk sharing arrangements and credit limits;

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establishing credit evaluations procedures, a fee structure, and procedures for handling claims; identifying appropriate sources of financing; and developing a "secondary market" for guarantee instruments to encourage the further recycling of funds to the SME sector. As it is fully consistent with its charter, this scheme should be designed and initially implemented by the the ECCB. The operation of this facility might be transferred to another entity in due course. The Central Bank of Barbado's current scheme would serve as a useful model.

- Explore the need for, and interest in, a special SME loan facility, but do not take concrete steps to establish one at this time. It is our view that existing institutions are generally adequate and current liquidity levels sufficient to address the special needs of SMEs, particularly if a well-functioning loan guarantee scheme is put in place. To the extent that such a facility is deemed necessary in the future (e.g., due to a change in liquidity conditions), it is not appropriate that the ECCB be charged with responsibility for its design and implementation. A different entity, such as one organized to manage an "Eastern Caribbean Development Fund," would be a more appropriate type of institution to establish and operate such a scheme.

- Explore the need for, and interest in, a special "credit mixte" facility to provide financing for projects deemed to be of national priority, but do not take concrete steps to establish one at this time. Such a scheme would be based on access to "soft" funds through some form of "credit mixte" process (i.e., the blending of aid grants or credits with commercial banking credits). Rather than create such a facility as a first step, it would be more appropriate to determine what constitutes a project of "national priority," and whether existing financing sources are sufficient to fund such projects. To the extent that such a facility is deemed necessary as a result of discussions with regional policy makers, it is not appropriate that the ECCB be charged with responsibility for its design and implementation.

- Explore interest in, and the feasibility and modus operandi of, a so-called "Eastern Caribbean Development Fund" (ECDF). It is our view that an OECS-based fund of this nature, organized to address region-specific financing issues, may be useful to OECS policy makers' efforts to promote economic development, to the extent its utilization is governed primarily by market-based criteria. A key objective of this fund would be to complement the efforts of the Caribbean Develoment Bank, particularly in those areas where its capacity to support the financing needs of SMEs, both in terms of debt and equity financing, is limited due to resource and regulatory constraints. Such a fund could provide the region with an effective vehicle to support special financing schemes such as those discussed above, as well as those functions associated with the provision of technical assistance and training. An entity of this type, rather than the ECCB, would more appropriately bear the responsibility of designing and implementing either a special SME loan facility or a "credit mixte" facility, as described above. Key participants in developing an ECDF would include the ECCB, CDB, NIS managers and possibly the insurance companies. Potential sources of funds include those held by the NIS and insurance companies.

Exhibit ES-1 presents a work program to implement the recommendations in the area of loan facilities and guarantees.

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IMPLEMENTATION PROGRAM

LOAN FACILITIES AND GUARANTEES

RECOMMENDATIONS & IMPLEMENTATION STEPS		Lead Implementing Institution	Supporting Institution	Consultant Assistance Envisioned	Donor Agency Assistance Envisioned
1.0	Establish a Loan Guarantee Scheme in the ECCB	ECCB	CBB		To Be Determined
1.1	Get Board Approval to Proceed with Design Efforts				
1.2	Hold Discussion with Central Bank of Barbados (CBB)				
1.3	Design the Loan Guarantee Scheme and Design Business Plan			Yes	
1.4	Get Board Approval to Proceed with Implementation Efforts				
1.5	Implement the Scheme			Yes	
2.0	Explore Interest in/Need for a Special SME Facility	ECCB			To Be Determined
2.1	Select ECCB Staff Member to Oversee Analysis of the Issue				
2.2	ECCB Staff Member Presents Findings/Conclusions at Relevant Fora			Yes	
2.3	Take Further Action, as Appropriate			Yes	
3.0	Explore Interest in/Need for Special "Credit Mixte" Facility	ECCB	OECS Sec.		To Be Determined
3.1	Select ECCB Staff Member to Oversee Analysis of the Issue				
3.2	ECCB Staff Member Presents Findings/Conclusions at Relevant Fora			Yes	
3.3	Take Further Action, as Appropriate			Yes	
4.0	Explore Interest in/Feasibility of an Eastern Caribbean Development Fund (ECDF)	ECCB	CDB NIS Insurance Company		To Be Determined
4.1	Select ECCB Staff Member to Oversee Analysis of the Issue				
4.2	ECCB Staff Member Presents Findings/Conclusions at Relevant Fora			Yes	
4.3	Take Further Action, as Appropriate			Yes	

CBB = Central Bank of Barbados
NIS = National Insurance Schemes
ECCB = Eastern Caribbean Central Bank

B. Technical Assistance and Training to the Productive Private Sectors

1. Findings and Conclusions

- There is a variety of technical and training assistance programs available at the multilateral, regional and local levels, with technical assistance being more abundant and more available across business segments than training assistance. A review of available programs indicates that technical assistance programs are somewhat abundant and were created to address the problems of all business segments. Training assistance is more scarce than technical assistance, and those services available are targetted at the larger enterprises.

- While there are many technical assistance programs available to all business segments throughout the OECS region, their implementation does not appear to have been well coordinated. Due to the large number of technical assistance programs and a lack of an effectively coordinated marketing effort, there has been duplication of effort which has reduced the impact of the region's programs. This suggests that an effort should be made to develop a central coordinating mechanism to orchestrate the allocation of the region's technical assistance resources.

- Training assistance services have not thoroughly penetrated the OECS region and have not been equally available to all business segments. Training services in the OECS region are offered primarily by BIMAP which, due to geography and resource constraints, has been unable to properly focus the provision of its services in the OECS region. In addition, due primarily to the costs of these services, the larger enterprises are better able to take advantage of BIMAP's training services. This suggests that on-the-ground regional training centers should be established in the OECS.

- SMEs appear to benefit least from the technical and training assistance programs available in the OECS region. SMEs do not benefit greatly from the available training services as BIMAP's services tend to be costly relative to the means available to the SMEs, and its services are provided mainly in Barbados. While there are a number of technical assistance programs that SMEs could access, they are not always aware of them, and their cost also tends to be a deterrent.

2. Recommendations and Implementation Steps

o <u>Select a regional mechanism to coordinate all aspects of allocating technical and training assistance in the OECS region</u>. It is essential that the region's technical assistance and training programs be more effectively coordinated. The OECS Secretariat represents a possible vehicle to carry out this function, as its operating mandate is OECS-specific and seems flexible enough to accommodate the responsibility for managing the dissemination of technical and training assistance in the region. It presently provides technical and human resource development assistance in the region and might therefore be in a good position to assume the responsibilities associated with coordinating the technical and training assistance currently provided by various OECS institutions. A second possible alternative would be to coordinate technical and training assistance programs through an OECS sub-regional arm of CAIC. CAIC currently has responsibility for implementing major technical assistance and training programs in the OECS under the SEAP Project and could possibly perform this coordinating function. It might also be possible to structure a joint arrangement between this entity and the OECS Secretariat to facilitate both public and private sectors inputs into the process. Discussions should be held with both the OECS Secretariat and CAIC in this regard. It is also important that a policy statement and implementation strategy be devised to properly carry out coordinating efforts. Irrespective of where the overall responsibility for coordinating technical and training assistance eventually resides, the following types of activities will be necessary:

-- Gaining the support of OECS governments to have a coordinating function for technical and training assistance

-- Determining the specific needs for technical and training assistance in the OECS region, and planning the supply and demand for these services

-- Enlisting the cooperation of, and creatively linking its efforts to, those institutions presently providing technical assistance and training services in order to avoid duplication and increase efficiency

-- Planning and helping to implement the process of creating regional training centers (discussed below)

-- Mobilizing financial resources as necessary.

- <u>Increase the access of OECS enterprises (particularly SMEs) to training assistance by establishing regional training centers</u>. Regional centers which would provide training services to all OECS business segments should be established in selected OECS countries. The establishment of two regional centers, one in the Leeward and another in the Windward Islands, is a logical proposition. These centers could be an extension of the services currently provided by BIMAP, as it has expressed a strong interest in participating in the development of such centers. Discussions should be held as soon as practicable with BIMAP to further establish its interest in such an endeavor. An all-encompassing implementation plan should be developed outlining who would run the centers, how they would be financed, where they should be located, what the nature of the curricula should be, etc. In developing such an implementation plan, it is important to take fully into account the fact that there are many training skills available in the region which could be drawn on in the process of installing and utilizing the regional centers. For example, the ECCB is itself a reservoir of professional talent, including economists, accountants, and managers, which could readily be tapped to support regional training efforts. This suggests that St. Kitts-Nevis may be a logical choice for the "Leeward" training center.

Exhibit ES-2 presents a work program to implement the recommendations in the area of technical and training assistance to the OECS productive private sectors.

IMPLEMENTATION PROGRAM

TECHNICAL AND TRAINING ASSISTANCE TO THE PRODUCTIVE PRIVATE SECTORS

RECOMMENDATIONS & IMPLEMENTATION STEPS	Lead Implementing Institution	Supporting Institution	Consultant Assistance Envisioned	Donor Agency Assistance Envisioned
1.0 Select Central Regional Coordinating Entity	OECS Sec.	CAIC		
1.1 Discuss Concept with OECS Secretariat to get in Principle Agreement				
1.2 Discuss Concept with CAIC to Integrate its Efforts				
1.3 Develop a Policy and Strategy Statement of Proposed Entity			Yes	USAID
1.4 Commence Implementation Efforts			Yes	USAID
2.0 Establish OECS Regional Training Centers	BIMAP	OECS Sec.		
2.1 Discuss Concept with BIMAP to further Determine Interest		CAIC		
2.2 Develop Implementation Plan Specifying Location, Financing, Curricula, Other Elements		ECCB	Yes	USAID
2.3 Commence Implementation Efforts			Yes	USAID

CAIC = Caribbean Association of Industry and Commerce

EXHIBIT ES-2

C. Facility to Reorganize, Refinance and Takeover Enterprises

1. Findings and Conclusions

- There appears to be significant confusion with respect to what is meant by the refinancing, reorganization and takeover of a firm, including why and how these operations are carried out. "Refinancing" normally means renegotiating the terms of a loan with a borrower, and oftentimes is part of normal business practices with no implication of financial difficulty and not necessarily involving new funds. "Reorganizations" may involve agreements to appoint certain persons as directors, or commitments to carry on business in accordance to certain guidelines. A refinancing, restructuring or takeover of a company occurs depending upon the perception of the value of the firm as a "going concern" as opposed to its "break-up" or "liquidation" value.

- Special facilities for the refinancing and reorganizing of firms do not normally exist because they are not necessary to carry out such operations. In highly-developed financial markets, corporate refinancing and reorganization is an arcane, specialized task applicable to a small fraction of companies in financial difficulty. Solutions are tailor-made using ordinary financial instruments and the talents of investment bankers, lawyers, appraisers and other consultants. Formal financial mechanisms and special "facilities" are simply not required to carry out such operations.

- There does not appear to be a need for a special facility to execute such operations as adequate funds are available in the OECS region for viable proposals. Generally speaking, if anyone should put together a bankable proposition, supported by good management capability, there is no reason to believe that funds would not be available as anywhere in the world.

- The very nature of the economic activity of the OECS region limits the need for a special facility to handle refinancing, reorganization and takeover operations. Tourism, tropical agriculture and residential real estate are the major economic activities in the OECS region. The financing of hotels, farms and homes falls into a special category and, unless large and complex enterprises are involved, such ventures are not normally considered appropriate for the special type of corporate financing under discussion. Most other commercial, service or industrial firms in the region are too small for such complex treatment. Much of the financing of the development banks and national foundations within the OECS region is in

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effect personal credit, which is not normally the object of corporate finance in case of problems.

- Refinancing and reorganization efforts require access to an organized stock market. Without an organized stock market in the OECS region and with few large companies, there is no call for a special financing facility for takeovers. The financing or sale of small businesses is handled, as in most developed markets, by seller financing.

- The professional ingredients to carry out such operations are readily available in the region. There is also no manifest need for a special facility or program for refinancing, reorganizing or takeover of firms that are in financial difficulty as there are offices of international and accounting firms and commercial banks that can bring together the necessary know-how and funding to refinance, reorganize, or sell any local venture which is worthwhile.

2. Recommendations and Implementation Steps

- Since special facilities to reorganize, refinance and take over enterprises are not warranted in the OECS region, no special program is proposed.

D. Venture Capital

1. Findings and Conclusions

- There are a number of fundamental factors that must be present for venture capital to work, including profitable business ventures to invest in, the availability of strong entrepreneurial talent to develop viable business projects requiring venture capital funding, and the presence of an active, organized stock market where successful venture capital investments can be sold at a profit. Other factors of great importance include a legal and regulatory environment conducive to business development and ample sources of venture capital funding.

- A number of misconceptions were discovered regarding the definition and role of banks, capital markets and venture capital which need to be clarified. Commercial banks are deposit-taking institutions whose principal responsibility is to protect their depositors' funds and to produce profit for their shareholders. As such, they tend to make loans of a short-term nature for self-liquidating, commercial transactions. Development banks are institutions normally created by government to make available non-depository funds on a long- term basis to finance the accumulation of fixed assets in a manner consistent with public policy priorities. Investment banking is a special type of banking operation designed to supply equity and long-term loans to business ventures and which requires an active market for stocks and bonds, making it quite different from commercial banking. Rarely do commercial bankers serve as good investment bankers or venture capitalists. Venture capital is funds put up by a special type of investment banker whose objective is to provide equity financing to start-up ventures of untested entrepreneurs with the expectation of getting a very high rate of return in a relatively short period of time. A capital market is an organized market for trading securities designed to produce a fair balancing of interests between the suppliers and takers of equities and other instruments. A capital market is not an all-encompassing method by which entrepreneurs raise funds, including short- and medium-term bank loans and private deals with partners.

- There appears to be a shortage of qualified takers of venture capital in the OECS region. With few exceptions, commercial bankers, development bankers, leading businesspersons, and chamber of commerce officials reported that a qualified entrepreneur would have no more trouble raising funds in the OECS region than in any other market. The lack of new venture financing would therefore appear to reflect a shortage of qualified takers, not funding. This is not to say that current sources of funds are sufficient

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relative to the goals of economic development, but rather that they are more than adequate relative to current absorptive capacity.

- <u>A lack of entrepreneurs is an important reason why there is limited use of available venture capital funds</u>. It has been duly noted by many informed persons from the region that the OECS lacks sufficient entrepreneurs. A number of factors associated with the nature of the OECS economies has been identified as inhibiting the development of entrepreneurship, including small size of population and economies, high labor costs, limited movements of workers, etc. Another major factor influencing a potential entrepreneur to choose a non- business career or decide to emigrate while still young, which is seldom mentioned, is the lack of larger-scale companies that provide prospects for advancement and that serve as incubators for developing and retaining business talent. Measures which encourage larger, widely-held enterprises might therefore be regarded as a useful way to retain talent in the region and to encourage the formation of new businesses which could then make use of venture capital financing.

- <u>In addition to making entrepreneurial training available, the best way to address the entrepreneurial problem is to provide a business environment which attracts and utilizes valuable entrepreneurial talent</u>. An important component of a strategy to foster a better entrepreneurial climate in the OECS region is to create a framework for the development of larger, private, open enterprises with trans-regional and international operations. An important result, among others, is that these entities would serve as a training ground for entrepreneurial and managerial talent, helping to retain these skills in the region.

- <u>An independent capital market or stock exchange is not currently feasible in the OECS region</u>. The conditions do not currently exist that would allow the OECS region to develop either an internal capital market or one tied to the world capital market. The OECS regional economy is too small to support an independent, internal market that would have a significant impact on economic development since there would not be enough investors internally to maintain an independent, liquid market. And in order to act as a feeder into the world capital market, an OECS stock exchange would have to generate a sufficient volume of securities to merit the attention of international investment managers. The small size of the OECS economies again limits the ability of the region to participate in such a manner. Additionally, successful participation in world capital markets requires freedom from exchange controls, lack of barriers to transfer of ownership, and fair, non-discriminatory treatment of foreign investors. Many of these pre-conditions are not currently present in the OECS region. Despite the many obstacles, there may nevertheless be merit to the idea of developing a regional capital market, tied to others in the region, in an effort to use world markets more effectively.

- <u>The best available way to deal with the problem of no organized capital market through which venture capital can be recycled is to develop strong linkages with world financial markets</u>. Perhaps the most effective way to open regional capital markets to the world is for the OECS region to work through the Barbados Stock Exchange. The intent would be to foment greater liquidity and better prices for local equities. The long-term objective would be for the OECS to form a single capital market with Barbados and to have this market freely open to the world.

- <u>The multiplicity of differing laws and regulations throughout the OECS region is a major deterrent to economic development, the development of a unified financial sector, and the effective use of venture capital as a means of assisting start-up ventures</u>. Present legal and regulatory barriers in the OECS tend to encourage local, protected micro-businesses and dissuade the development of larger, more competitive organizations with the depth of management, sophistication and market scope needed to access capital markets. Laws exist that hinder the free flow of labor and association of capital. A number of regulations impede efficient, region-wide operations. OECS rules also give precendence to duties and front-end taxation that increase the need for equity of an island venture as compared with similar businesses in large, developed nations. The existence of alien land laws, which can require governmental approval of any transfer of equity or debentures to a national of another island, are particularly inhibiting vis-a-vis developing the use of venture capital in the region.

- <u>There are ample sources of venture capital funding available in the OECS region</u>. The US$ 22.5 million of potential venture capital funding available through CFSC and HIAMP alone is, relative to the population, over five times the funds available in the United States through Small Business Investment Corporations and over 50 percent of the total U.S. venture capital funds of all types. Additionally, long-term loans to new ventures are available through the CDB. And the European Investment Bank (EIB) also has made equity funds available in the past and is currently considering an additional line of US$ 3.5 million for the region. Development funds are also available to entrepreneurs from a variety of public and private programs in Canada, the United States and the United Kingdon.

- <u>A special type of enterprise--the OECS Corporation--could be created as a means to overcome those factors currently impeding the development of venture capital operations in the OECS region</u>. In order to effectively address the various impediments to venture capital utilization, efforts could be concentrated on encouraging OECS entrepreneurs and businesspersons to join together in larger, more efficient, trans-OECS enterprises possessing the depth of management needed to access world financial and equity markets, while reducing the need for equity by changing the methods of collecting tax revenues. The pooling together of resources in this manner could result in new ventures that could make effective use of venture capital resources currently available in the region. Larger entities could also serve the important function of acting as incubators for managerial and entrepreneurial talent, while providing investors with firms of a size that can attain liquidity in the stock market and, consequently, equity prices that are above book value, thereby making venture capital operations possible.

- As the situation currently stands in the OECS, there is little prospect to applying venture capital financing in the region due to a lack of potentially profitable business ventures, a lack of entrepreneurs to develop profitable business ventures, the absence of an active securities market where successful investments could be sold at a profit, and a highly inhibiting legal and regulatory framework. The recommendations presented below attempt to address these problems.

2. Recommendations and Implementation Steps

- Assess the applicability and feasibility of an OECS Corporation. This includes initiating a consensus-building process by holding discussions with relevant officials from the OECS, CARICOM Secretariat, and the ECCB. If agreed to in principle, a fiscal and legal analysis should be undertaken to assess the viability of such an entity. If viable and agreeable, a consensus ratification process should be initiated whereby the fiscal study and model legislation is reviewed and revised by government and business groups with a view to formally adopting model legislation by countries in the OECS region.

- Take steps that would allow OECS companies and investors to access organized regional stock exchanges linked to world markets. In addition to the OECS Corporation, steps should be taken to increase the liquidity of equities traded on the Barbados Stock Exchange and to promote the listing of OECS firms on this market. It is important to note that the fundamental objective of this effort is to provide OECS companies with access to organized exchanges for equity financing purposes, as well as to provide venture capitalists with a mechanism to recycle their investments. This does not necessarily require that an OECS stock market be created as a stand-alone entity as a first step, to subsequently be linked up to Barbados and world exchanges. Efforts to list OECS companies on the Barbados Stock

Exchange, and to organize the Barbados Exchange so that it can be integrated with world exchanges, could be initiated as a first step and need not wait for the creation of a OECS Stock Exchange. To the extent that an OECS Stock Exchange is created as part of this effort, it is important that it be designed and implemented with the fundamental objective of becoming integrated with the Barbados and world stock exchanges, as it is not likely to be a viable undertaking on a stand-alone basis. We recommend that discussions be held at the OECS level and then with the Barbados Stock Exchange to obtain an in-principle agreement to assess the viability of OECS companies accessing the Barbados Stock Exchange and developing an OECS Stock Exchange, as appropriate. If agreed, the objectives and scope of a study should be developed, and an implementation plan devised and executed, as appropriate. Implementation efforts should include the training of people in the OECS region in the skills associated with trading stocks as a prerequisite to having brokers located in the OECS countries to be seated on the Barbados Stock Exchange.

Exhibit ES-3 presents a work program to implement the recommendations in the area of venture capital.

IMPLEMENTATION PROGRAM

VENTURE CAPITAL
(EQUITY AND QUASI-EQUITY INSTRUMENTS)

RECOMMENDATIONS & IMPLEMENTATION STEPS	Lead Implementing Institution	Supporting Institution	Consultant Assistance Envisioned	Donor Agency Assistance Envisioned
1.0 Assess Applicability and Feasibility of an OECS Corporation	ECCB	OECS Sec.		
1.1 Initiate Consensus Building Process		Caricom Sec.		
1.2 Conduct Fiscal Analysis, As Appropriate		CBB	Yes	USAID
1.3 Conduct Legal Analysis, As Appropriate			Yes	USAID
1.4 Initiate Consensus Ratification Process, As Appropriate			Yes	USAID
2.0 Develop Access to World Markets through Regional Stock Exchanges	ECCB	OECS Sec.		
2.1 Discuss Concept at OECS Level to Obtain in Principle Agreement to Proceed		CBB		
2.2 Discuss Concept with Barbados Stock Exchange to Obtain in Principle Agreement to Proceed		BSE		
2.3 Develop an Implementation Plan			Yes	USAID
2.4 Commence Implementation Efforts			Yes	USAID

CBB = Central Bank of Barbados

E. Leasing

1. Findings and Conclusions

- There appears to be a lack of understanding in the region regarding the nature, benefits and methods of leasing, indicating that an effort must be undertaken to communicate the benefits of leasing. Conceptually, a lease is a contract by which one party conveys the use of an asset to another for an agreed term at a specified rental. This concept is fundamentally rooted in the notion of "use" rather than "ownership." Using equipment rather than owning it allows businesspersons to focus on what the equipment should be doing for them (producing profits) rather than to them (exposing them to the risk of ownership). The "ownership psyche" is strong in the OECS region and represents an important impediment to developing leasing in the region. Bankers and other financial institutions, as leasing develops in the region, should endeavor to educate the public as to the advantages of lease financing.

- The demand prospects for leasing in the OECS region do not appear wholly unreasonable at this time. There are a number of industry sectors in the OECS region that are amenable to lease financing. Transportation is a promising sector as distribution is a major activity in the islands. Trucks, containers, and passenger ships represent good leasing opportunities in this area. In the tourism sector, tourist buses could readily be operated on a lease basis by tourist operators with a centralized facility provided by lessors. The construction sector is quite active in the OECS region. Mobile concrete mixers and excavators are good targets for lease financing. While the manufacturing sector is not as well developed in the OECS region as the other sectors, factory shells could, for example, be constructed and then leased to assemblers of electronics, etc. This assessment, while indicating that leasing could be applicable in selected industry sectors, is very preliminary in nature. A more detailed analysis regarding the full extent of the demand for lease financing is in order. Nevertheless, it is not unreasonable to state that there could be a level of demand sufficient to sustain leasing activities in the region, subject to the removal and/or adjustments to a number of laws, regulations and banking practices.

- A number of adjustments need to be made to the OECS legal and regulatory structure in order to accommodate the use of leasing in the region. The fiscal and regulatory framework in the OECS region is not conducive to the development of leasing as a viable means to promoting the development of the productive private sectors. Current tax laws are not uniform and must be standardized and redefined to make leasing work. Tax laws are also silent on what benefits are to accrue to the owner in instances where the owner and the end user are distinct entities. As such, the following types of fiscal elements must be examined and adjusted in a manner consistent with fundamental leasing economics: accelerated depreciation, capital allowance, tax rulings regarding the nature of a "lease contract." A framework of lessor's and lessee's rights should be established, and a universal commercial code should also be developed since one does not currently exist. Provisions of tax holidays to encourage utilization of certain types of equipment might also be considered.

- <u>The absence of a "secondary market" for equipment is an important impediment to the development of lease financing the OECS region</u>. The success of leasing depends greatly on the ability of the lessor to sell used equipment once it comes off the original term lease. A secondary market must be present for the lessor to dispose of the equipment in case he is not able to re-lease it. Such a market could be developed in the OECS region if lessors were able to transport leased equipment freely within the OECS region. The OECS governments would need to adopt a common policy of reducing and/or eliminating customs duties, excise taxes, import restrictions, etc. for leased equipment that has already entered the region through another jurisdiction. This would promote the unrestricted movement of capital throughout the islands thus enhancing the market and creating favorable conditions within which a viable secondary market might develop.

- <u>Active utilization of leasing in the region will require that a number of adjustments be made to banking practices</u>. A number of actions may be taken with respect to the banking sector to advance the prospects of lease financing in the region. First, consider allowing trading houses to participate in leasing. This could be done by allowing these institutions to fund their operations through local deposits raised by providing a premium above established deposit rates, subject to regulatory requirements set forth by the ECCB. Second, allow bankers to provide facilities to lessors to discount their pool of rental contracts. A discounting option of this type would provide a good avenue for investment for all bank and non-bank financial intermediaries, particularly in view of the high liquidity situation in the region. Third, restrict the amount of residuals that a bank-affiliated leasing operation can assume.

- <u>The active cooperation of all participants in the OECS financial sector will eventually be necessary in order to make leasing a viable form of long-term financing in the region</u>. Some resistance was encountered within the foreign financial community regarding the viability of leasing in the OECS region, as representatives of these institutions felt that the market was not sufficiently mature to sustain leasing activities at this time. As such, it may be necessary to initiate leasing efforts through the indigenous banking community, as it demonstrated a keen interest in leasing. The introduction of leasing in the OECS region will require a close partnership between the indigenous banks and their respective governments in order to effectively address the many impediments currently facing the use of lease financing. It may be useful for governments, as part of a broader strategy to develop leasing in the OECS region, to provide the indigenous banking sector with incentives to take the lead in this area.

2. Recommendations and Implementation Steps

- Develop a detailed assessment of the nature of the demand for lease financing in the OECS region. As the indigenous bankers have demonstrated a keen interest in leasing, it is necessary to discuss with the Caribbean Association of Indigenous Bankers (CAIB) its interest in overseeing the execution of a demand assessment in the leasing area. If agreeable, the objectives and scope of such an engagement should be devised, and the assessment subsequently carried out under CAIB's guidance. Of particular importance will be determining the prospects of a "secondary market" for leased equipment. The results of the study should be used to develop a regional leasing prototype arrangement, as discussed below.

- Define the specific legal and regulatory adjustments needed to make leasing a more viable proposition in the OECS region. The OECS Secretariat should be approached to oversee the review of the legal and regulatory adjustments needed to promote the use of leasing in the region. The results of the assessment should also be used to develop a leasing prototype arrangement, as discussed below.

- Define the specific adjustments to banking practices needed to make leasing work in the region. The ECCB, in its capacity as Central Bank, should oversee the analyses associated with identifying and making banking-related adjustments to better accommodate the use of leasing in the region. The results of the assessment should also be used to develop a leasing prototype arrangement, as discussed below.

- Develop and implement a prototype leasing arrangement in selected countries for replication throughout the OECS region. The objective of developing a leasing prototype arrangement is to select countries where the viability of leasing could be fully tested in a controlled manner. For example, based on the demand study, two countries with the greatest prospects for leasing could be selected within which to test the implementation of legal, regulatory and banking practice changes. To the extent that leasing proves workable, the changes could subsequently be replicated throughout the OECS region.

Exhibit ES-4 presents a work program to implement the recommendations in the area of leasing.

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IMPLEMENTATION PROGRAM

LEASING

RECOMMENDATIONS & IMPLEMENTATION STEPS		Lead Implementing Institution	Supporting Institution	Consultant Assistance Envisioned	Donor Agency Assistance Envisioned
1.0	Further Assess the Nature of Demand for Leasing	CAIB			USAID
1.1	Discuss with CAIB its Interest in Overseeing the Demand Assessment				
1.2	Develop Objectives and Scope of Demand Assessment				
1.3	Carry out Assessment/Develop Findings, Conclusions, Recommendations			Yes	
1.4	Integrate Assessment Results and Implementation Steps with Prototype			Yes	
	Development			Yes	
2.0	Define/Specify Required Legal and Regulatory Adjustments	OECS Sec.	ECCB		USAID
2.1	Discuss with OECS Secretariat Interest in Overseeing Assessment				
2.2	Develop Objectives and Scope of Legal and Regulatory Assessment			Yes	
2.3	Carry Out Assessment/Develop Findings, Conclusions, Recommendations			Yes	
2.4	Integrate Assessment Results and Implementation Steps with Prototype Development			Yes	
3.0	Define/Specify Required Banking Adjustments	ECCB	CAIB		USAID
3.1	Discuss with ECCB/IBA Interest in Oveseeing Banking Assessment				
3.2	Develop Scope and Objectives of Banking Assessment			Yes	
3.3	Carry Out Assessment/Develop Findings, Conclusions, Recommendations			Yes	
3.4	Integrate Assessment Results and Implementation Steps with Prototype Development			Yes	
4.0	Develop and Implement a Prototype Leasing Arrangement	OECS Sec.	CAIB		USAID
4.1	Select Target Countries to Test Applicability of Leasing			Yes	
4.2	Draft and Enact Legal and Regulatory Adjustments in Each Prototype Country			Yes	
4.3	Draft and Enact Adjustments to Banking Practices in Each Prototype Country			Yes	
4.4	Replicate Legal Regulatory, Banking Adjustments throughout OECS, as Appropriate			Yes	

CAIB = Caribbean Association of Indigenous Bankers

EXHIBIT ES-4

F. Foreign Exchange Risk Management Measures

1. Findings and Conclusions

- The scope of the foreign exchange exposure problem is limited to those borrowers not normally earning foreign exchange who must take term financing from financial institutions which on-lend donor funds in the form of foreign currency-denominated loans. On the supply side, the problem of foreign exchange rate risk in the OECS region applies to the activities of primarily two financial institutions that receive foreign currency funding from international development agencies for on-lending within the region: The Caribbean Financial Services Corporation (CFSC), and The Caribbean Development Bank (CDB). On the demand side, the problem is primarily limited to those companies that do not earn foreign exchange and who must take foreign currency denominated term loans from these institutions. For borrowers with long-dated obligations, the foreign exchange risk is very real, all the more so because there is no easy or obvious way to lock in the local currency cost of servicing foreign debt. The unfortunate result is that otherwise well-managed projects or companies may be vulnerable to substantial losses, simply because there is no way to manage exchange exposure in the OECS.

- The market-based instruments normally used to hedge foreign exchange risk in developed economies are not applicable in the OECS region because the Eastern Caribbean Dollar is not an actively traded currency on world markets. Many of the instruments that are often used to hedge exchange rate risk, namely, exchange-traded foreign currency options and futures contracts, are of no avail to companies in the OECS region. Without exception, all of these contracts are priced in terms of exchange rates between major international currencies, and those relationships are determined quite independently of the parity of the Eastern Caribbean dollar (EC$). Consequently, there is no reason to expect that any devaluation of the EC$ dollar in terms of the United States dollar (US$) would be reflected in an equivalent appreciation of the US$ in terms of any other major currency. This implies that an option or commitment to purchase US$ for future delivery would fail to provide assured protection against the possibility of a devaluation of the EC$.

- There are a number of viable, non-market methods that could be applied to protect the ultimate borrower from foreign exchange risk in the OECS region, including currency collateralized loans, exchange rate swaps, and outright forward sales by the Central Bank. In the absence of any ready-made, market-based hedging instruments, there appears to be no alternative but to introduce non-market arrangements to accommodate the needs of OECS borrowers. A currency collateralized loan is a form of back-to-back loan in which two parties (company-to-company or company-to-bank) in different countries make loans to one another of equal value, each denominated in the currency of the lender. Currency collateralized loans are normally arranged where the capital markets are not well developed or where alternative sources of local finance may not be available to finance a foreign subsidiary. An intermediary institution (i.e., a lender) could be used to execute the transaction and absorb the foreign exchange risk, with the lender pricing both the loan and deposit to make full provision for its currency exposure. Alternatively, international banks may be willing enter into a forward contract on an exchange rate swap basis, arranged as a single transaction with a single party. This means that they would sell US$ forward against EC$ only if they could simultaneously sell EC$ for US$ on spot delivery. When done on a swap basis, the international bank is fully covered, since it contracts to both pay and receive the same amount of foreign currency at specified rates. A swap of this type is, in effect, a simultaneous borrowing and lending operation in which the effective cost of funds depends on interest rates and the gain or loss on exchange transaction. An outright forward sale of currency would essentially involve the ECCB exchanging a fixed amount of EC$ for a foreign currency at a negotiated price at a specified future date. Under this type of transaction, the Central Bank may be vulnerable to pressures to absorb all or part of the cost of exchange rate cover, and to provide cover for contract maturities that may be inconsistent with the need to invest foreign exchange in largely short-term liquid assets. The only way to avoid these pressures is to incorporate interest rate differentials between currencies into an agreed-upon forward rate of exchange, and to limit contract maturities to the term of the investments in which exchange reserves are normally held.

2. Recommendations and Implementation Steps

- Execute a currency collateralized loan transaction with a selected OECS financial institution. Of the three non-market ways of hedging exchange rate risk, the most appropriate method to apply in the OECS region at this time is a currency collateralized loan, as it does not require the participation of outside banks. We recommend that the ECCB continue current negotiations with CFSC to execute such a transaction and bring closure as soon as practicable. This will permit CFSC to better service the term borrowing needs of the SMEs in the OECS region, as these companies will not have to bear foreign exchange risk.

- <u>Identify and assess the need for additional foreign exchange risk coverage in the OECS region</u>. This involves discussing with CDB, USAID and other donor agencies the extent to which foreign exchange risk hinders their efforts to assist the region's productive private sectors. This process also involves discussing with foreign money center banks their interest in participating in such schemes. To the extent that there is a further need to manage foreign exchange risk, the output of this effort should be a plan to design and execute those transactions needed to properly hedge the ultimate borrowers' foreign exchange risk, which would serve as an input to the ECCB's policy making process, as noted below.

- <u>Develop a policy statement outlining ECCB's position with respect to its participation in foreign exchange risk management schemes, including a determination of the legal implications of carrying out such schemes</u>. The previous recommendation will highlight the extent to which foreign exchange risk coverage is required in the region and, hence, the extent to which the ECCB should develop a policy position with respect to its participation in foreign exchange management schemes. As the active implementation of any of these alternatives or combination thereof is likely to require the active participation of the Central Bank, it is important to know if this may call for a modification of the statute or treaty that governs the ECCB's operations. The Central Bank should therefore ascertain the legal implication of carrying out such schemes. While transacting a currency collateralized loan does not appear to pose fundamental legal questions to the ECCB, the other two methods might, as they require the participation of foreign banks.

Exhibit ES-5 presents a work program to implement the recommendations in the area of foreign exchange risk management.

IMPLEMENTATION PROGRAM

FOREIGN EXCHANGE (FX) RISK MANAGEMENT MEASURES

RECOMMENDATIONS & IMPLEMENTATION STEPS	Lead Implementing Institution	Supporting Institution	Consultant Assistance Envisioned	Donor Agency Assistance Envisioned
1.0 Execute Currency Collateralized Loan Transaction with CFSC	ECCB	CFSC		
1.1 Continue Current Negotiations with CFSC				
1.2 Bring Closure to Loan Transaction as soon as Practicable				
2.0 Identify/Assess Need for Additional FX Risk Coverage in the OECS Region	Consultant	ECCB	Yes	USAID
2.1 Discuss CDB FX Risk Problems/Needs/Opportunities				CDB
2.2 Discuss USAID FX Risk Problems/Needs/Opportunities				OTHER
2.3 Discuss Other Donor Agency FX Risk Problems/Needs/Opportunities				DONORS
2.4 Approach Regional and Foreign Money Center Banks, as Appropriate				
2.5 Prepare Business Plan/Strategy to Execute Needed Transactions, as Appropriate				
3.0 Develop Policy Statement Regarding ECCB Role in FX Risk Management	ECCB	OECS Sec.		
3.1 Assess Legal Implications of Carrying out Schemes			Yes	
3.2 Prepare Policy Statement Setting Forth ECCB Position on FX Risk Management, Incorporating Results of Demand and Legal Analysis			Yes	

CFSC = Caribbean Financial Services Corporation

EXHIBIT ES-5

G. The Clearing Efficiency of the OECS Banking System

1. Findings and Conclusions

- As in other areas, the OECS region has a paper-based payments system. In the OECS, as in other areas, the payments system is dominated by the use of checks, and the essential mechanics of the clearing process resemble practices elsewhere. Unlike other areas, however, the number of depository institutions in the OECS is quite small, and in some respects this simplifies the check-clearing process.

- While the prevailing view in the region is that the present clearing system appears workable and that transaction costs are low, there is some evidence that suggests that the operating expenses of the banks in the OECS region are high by international standards. Conversations with payors, payees, and depository institutions all suggest that the system is workable, and transactions costs involved in transferring funds within or between any of the territories in the OECS are inconsequential. Yet the efficiency and reliability of the payments system is not something to take for granted, and there appear to be indications that some deficiencies in the system exist. Specifically, there is evidence to suggest that the costs associated with the payments system, particularly bank operating expenses, are extraordinarily high by international standards. For all banks in the region, non-interest expenses, exclusive of provisions for loan losses, amount to roughly 6 percent of total assets, about double the ratios for similarly-sized institutions in the United States. Whether and to what extent this kind of disparity can be attributed to differences in payments practices within the OECS is difficult to assess, since there is no information available on the distribution of costs by functional activity. Put another way, there is no way to disentangle the costs associated with the payments mechanisms from other operating expenses. Still, the question arises whether there is any room for significant reduction in the costs of originating, tendering and collecting checks in the region. And if so, what kinds of changes in payments practices might lead to the development of more efficient, or more reliable, arrangements. These questions indicate the kind of information that needs to be developed, and then monitored, in order to evaluate the performance of the payments system on regular basis.

- Problems were identified in the clearing mechanism of the region that are a by-product of government-imposed regulations maintained independently of payments practices. With respect to checks drawn on banks outside a given territory, the collection process is almost invariably somewhat longer, since the check may have to be routed through a correspondent for collection. In this case, the delays reportedly range from 5 to 7 business days, and where inter-regional transfers are subject to regulation, the delays may be even longer. Thus, checks drawn on St. Vincent are simply not negotiable outside that territory, with the result that the bank of deposit can accept such checks on a collection basis only, resulting in a process that may take anywhere from 10 to 14 business days. This entails some incremental costs to the payee and, while this is not a problem inherent in the clearing mechanism, it is a by-product of government-imposed regulations maintained independently of payments practices.

- While the safety of the OECS clearing system appears adequate at this time, data and information need to be collected that will allow the Central Bank to better assess and monitor the safety of the system on an ongoing basis. The present system does not, on the surface, appear overly inefficient, vulnerable to settlement risk, or to pose any kind of fundamental impediment to intra-regional transactions. Nevertheless, the efficiency and reliability of the payments system is not something that the Central Bank can take for granted, and steps should be taken to ensure that it has sufficient information on hand to assess and monitor the safety of the system in an ongoing, systematic manner. At the very least, the Central Bank should begin to develop data on the volume of transactions effected by check to get some indication of the number of on-us items, as well as transit checks for both intra- and inter-island payments. In addition, information is needed on the costs of credit check deposits, processing and transporting transit items, and returning cancelled checks to the payor. Perhaps most importantly, the ECCB should begin to monitor the lags involved in the collection process and, in close consultation with the clearing banks, should make every effort to minimize those delays. The issue of lags is critically important in any attempt by the Central Bank to monitor the safety of the system. The safety of any system rests fundamentally on the extent to which the maker or recipient of a payment has confidence that payment can and will be honored since this process by its very nature entails timing gaps of varying duration. In turn, these timing gaps necessarily imply that the process of making and receiving payment is in effect a process of extending credit, even if that credit is extended only for a day or two. And given the linkages in the clearing system, a serious credit problem at any institution could be quickly transmitted to other participants as well. While the likelihood of any such disturbance appears remote, the fact remains that if such a problem were to develop its consequences could be very destabilizing, not just for banks, but also for their customers who must look to financial institutions to provide the credit and control checks which they cannot reasonably provide on their own.

It seems essential, therefore, that the amount and incidence of credit generated as a by-product of payments practices should be regularly reported to the Central Bank so that the authorities are in a position to make prompt and informed decisions in the face of problem situations before they become worse.

- In view of the relatively high levels of bank operating expenses, it may be useful to assess the relative virtues of alternative payment arrangements to enhance the OECS region's clearing efficiency and reduce high operating costs. In view of the relatively high levels of operating expenses in the region, it seems important to take a long hard look at the costs involved in transferring value by check and under alternative delivery mechanisms. The principal aspect of alternative delivery mechanisms is that they are designed to replace paper as the medium of conveying payment information with its equivalent in the form of machine- readable electronic images, and at the same time divorce the movement of funds from the supporting documentation. The technical feasibility of electronic funds transfer is no longer in doubt. Nor is there any question about the ability of these systems to process high transactions volumes at relatively low costs. Quite obviously, transactions volumes in the OECS region are much smaller, and whether alternative forms of electronic payments mechanisms would be cost effective is an open question. But it should be emphasized that scaled-down versions of larger systems are available, and that the computational capability of the current vintage of microcomputers is much greater than many of the mainframes used two decades ago for much larger funds transfer systems. With this in mind, some of the alternative possibilities that might be explored as part of a larger examination of the payments mechanism in the OECS include (1) automated clearing house (ACH) transfers, and (2) automated check collection. And it may be useful to study these mechanisms in light of practices of Canadian banks, as the Canadian banking system has features similar to those of the OECS region, including the use of regional settlement points (similar to local clearing houses), and a banking market which is highly concentrated.

2. Recommendations and Implementation Steps

- Collect the data needed to assess, and develop the systems required to monitor, the safety of the OECS clearing system. We recommend that the ECCB select a staff member to organize and oversee the data collection effort, and to develop and present conclusions and recommendations with respect to the fundamental safety of the system, as well as to outline steps that may be taken to monitor it on an ongoing basis.

- <u>Review the applicability and viability of alternative payments arrangements in the OECS region</u>. We similarly recommend that the ECCB select a staff member to organize and oversee an alternative payments systems analysis as discussed above, and to develop and present conclusions, recommendations and possible next steps in this regard.

Exhibit ES-6 presents a work program to implement the recommendations in the area of the clearing efficiency of the OECS banking system.

IMPLEMENTATION PROGRAM

CLEARING EFFICIENCY OF THE OECS BANKING SYSTEM

RECOMMENDATIONS & IMPLEMENTATION STEPS	Lead Implementing Institution	Supporting Institution	Consultant Assistance Envisioned	Donor Agency Assistance Envisioned
1.0 Collect Data Needed to Assess and Monitor Safety of the Banking System	ECCB	Banking Sector		
1.1 Select an ECCB Staff Member to Organize the Data Collection Effort				
1.2 Plan and Execute the Data Collection Effort				
1.3 Analyze Collected Data and Prepare Findings and Recommendations			Yes	
1.4 Develop and Implement a Safety Monitoring System, as Appropriate			Yes	
			Yes	
2.0 Review Applicability and Viability of Alternative Payments Arrangements	ECCB	Banking Sector		
2.1 Select an ECCB Staff Member to Organize and Oversee Analysis				
2.2 Develop Objective and Scope of the Analysis Effort			Yes	
2.3 Carry out the Alternative Payment Systems Analysis			Yes	
2.4 Prepare Findings, Conlcusions, and Recommendations for Board Review			Yes	
2.5 Implement Recommendations, as Appropriate.				

I. INTRODUCTION

A. Background

In August 1987, the Eastern Caribbean Central Bank (ECCB), as part of its ongoing analysis of the Eastern Caribbean financial markets and institutions, requested technical assistance from the United States Agency for International Development's (USAID) Public Management and Policy Planning (PMPP) Project to carry out a study on the OECS capital markets and financial institutions.

The Central Bank sought to undertake a comprehensive study of financial intermediation in the ECCB Area and was seeking funding from the resources of the PMPP Project for the finance of specialized expertise and logistical support for carrying out the investigations. The ECCB sought funding for a project director and for six to twelve months of short-term technical assistance on specialized topics. The Board of Directors, anxious to develop these investigational skills within the region, requested that a Caribbean researcher be involved at the level of Deputy Project Director. The Capital Markets and Financial Institutions Project was subsequently carried out as a joint venture between Robert R. Nathan Associates (RRNA), prime contractor to USAID under the PMPP Project, and Price Waterhouse (PW), subcontractor to RRNA under the same project.

B. Project Description

1. Mission and Objectives of the Project

The mission of this Project is to advance the economic development of the Organization of Eastern Caribbean States (OECS) region through the promotion of a more efficient and unified financial market place. To attain this, the Project focused on the following objectives:

- Reduce and/or eliminate barriers to the intra-regional flow of investment funds
- Facilitate and increase the flow of investment funds into locally-owned and/or joint venture productive enterprises (agriculture, manufacturing, services and tourism; not including housing)

2. Project Financial Instruments and Study Areas

To accomplish these objectives, the Project concentrated on the evaluation and preliminary design of facilities and mechanisms to increase and/or facilitate the flow of investment funds into the productive private sectors of the OECS economy. To this effect, the following topic areas were examined by a number of technical experts as to their applicability to the OECS region:

- Loan and guarantee facilities
- Technical assistance and training to the productive private sectors
- Facilities to reorganize, refinance, or takeover enterprises
- Venture capital (equity and quasi-equity instruments)
- Leasing
- Foreign exchange risk management techniques and related mechanisms
- Clearing efficiency of the OECS banking system

3. Major Project Tasks

In order to attain the objectives set forth for the Project, a detailed work plan was developed. The major tasks contained in this work plan included:

- Project Start Up: Steps were taken to properly initiate the engagement. The Project Team prepared a draft announcement letter, carried out a literature search, specified data collection requirements, refined the project work plan and schedule, and identified and contracted the technical experts to be used during the course of the study.
- Data Assembly: The following types of data and information were assembled by the ECCB Research Department in order to facilitate the fact-finding portions of the Project:
  - Laws, taxes, regulations and fees in each OECS country affecting intra-regional investments and capital movements

- -- Economic/financial reports in OECS countries
- -- Selected papers and minutes related to the Project's objectives
- -- Recent analytical studies of OECS financial institutions

o <u>Field Work and Option Paper Development</u>: A field work effort was orchestrated by the Project Team in order to expose the various technical experts to each ECCB member country as an input to their analysis. ECCB economists participated extensively in the field work. Each country was visited and interviews were held with representatives from government, the banking community and the private sector.

o <u>Forum</u>: After the field work was completed and the initial option papers drafted, a forum was held in St. Kitts-Nevis to discuss the interim findings and preliminary recommendations prior to the preparation of the final report. Forum participants included representatives from the government, banking and private sectors (see Exhibit I-1).

o <u>Draft Final Report</u>: A draft final report was prepared for review by both the ECCB and USAID prior to the ECCB board meeting.

o <u>Presentation:</u> The draft final report was presented to the full Board of the Eastern Caribbean Development Bank on January 20, 1989 in Montserrat.

o <u>Final Report</u>: The final report is a stand-alone document drawing extensively on the option papers and other inputs prepared by the technical experts. It presents a synthesis of recommendations and puts forth an implementation program to be followed by the ECCB and other interested parties. The final report incorporates comments and suggestions made by the ECCB and USAID.

4. <u>Project Staffing and Management</u>

Under the overall direction of Robert R. Nathan Associates, Inc. (RRNA), the Project was carried out as a joint venture between Price Waterhouse (PW) and RRNA. PW provided the Project Management Team as follows:

o	Dr. Auguste E. Rimpel, Jr.	Project Oversight
o	Mr. Jorge J.M. Iwaszkiewicz	Project Director (on-site)

LIST OF PARTICIPANTS ATTENDING FORUM ON OECS CAPITAL MARKETS AND FINANCIAL INSTITUTIONS

NAME	DESIGNATION	INSTITUTION/AGENCY
Arnaldo Bailey	Manager	St. Kitts Nevis Anguilla Nat. Bank
John Benjamin	Manager	Antigua Commercial Bank
David O Best	Manager	CIBC Antigua
Ronald W Blackman	Manager Credit	Bank of Nova Scotia
Charles M Brisbane	---	O D Brisbane & Sons St Kitts
Ronald Charles	Manager/Director	Grenada Development Bank
David Dacosta	Managing Director	Caribbean Financial Service Corp
Desiree Field-Ridley	Economic Advisor	CARICOM Secretariat
Karl J Haywood	Manager	Barclays Bank PLC, St Kitts
Auckland Hector	General Manager	Development Bank St Kitts Nevis
Hazel Highland	Project Analyst	CFSC
James A Hixon	Chief Executive Officer	Montserrat Building Soc. Ltd
Heather James	Economist	OECS/EAS, Antigua
Michael Julien	Project Director	HIAMP
Alick Lazare	Financial Secretary	Dominica
Vaughan Lewis	Director General	OECS
Gary Mallalieu	---	Sealy Mattress Co Antigua Ltd
Ninian Marie	Managing Director	Harris Paints Dominica
Keith McNalley	Manager	Royal Bank of Canada
Peter Medford	Program Specialist	USAID
Gillian Nanton	Economist	Government of St Vincent
Michael Newton	Manager	Bank of Nova Scotia, St Kitts
Orlando Richards	Certified Accountant	Dominica Co-op Credit Union
Ricky Skerritt	Chaiman	St Kitts Nevis IPA
Angus Smith	Director, Budget & Planning	Grenada
Mr. Tin Tun	Advisor to the Governor	ECCB
Dwight Venner	Director of Finance	Government of St Lucia
Ira Walwyn	Assistant Manager	Nevis Co-op Banking Co Ltd
Delisle Worrell	Director, Research & Information	Central Bank of Barbados

o Mr. Mark K. Camstra — Project Manager/Lead Analyst

PW professionals maintained a permanent presence at the ECCB's offices in St. Kitts-Nevis and in the OECS region during the course of the engagement.

RRNA provided management and technical inputs as follows:

o Mr. Phillip W. Rourk	Project Oversight
o Dr. Wendell Samuel	Deputy Project Director
o Mr. John O. Schroy	Venture Capital, and Facility to Reorganize, Restructure, and Takeover Enterprises
o Dr. Thanh V. Tran	Loan Facilities & Guarantees, and Technical and Training Assistance
o Mr. Sury R. Subban	Leasing
o Dr. Martin R. Barrett	Foreign Exchange Risk Management, and Clearing Efficiency

In addition to the above technical experts, the Project Team also drew on the inputs of Dr. Courtney N. Blackman, former Governor of the Central Bank of Barbados, and Mr. Harold L. Russell, former Chairman of the Barbados Development Bank.

The Project was actively overseen by a Steering Committee established to provide guidance and to ensure the objectives of the Project were met. The Steering Committee was composed of a mix of ECCB staff and the consultants, including:

- Mr. Erroll N. Allen, Deputy Governor, ECCB
- Mr. Eustace Liburd, Director, Research, ECCB
- Dr. Auguste E. Rimpel, Jr., Director, PW
- Mr. Jorge J.M. Iwaszkiewicz, Project Director, PW
- Mr. Phillip W. Rourk, Vice President, RRNA
- Dr. Wendell Samuel, Deputy Project Director, RRNA

The Project Team was also assisted by ECCB Research Department personnel during its field trips as follows:

- Mr. Carlton J. Augustine, Economist
- Mrs. Sheila M. Williams, Economist
- Mr. Arthur M. Williams, Economist

C. Organization of the Report

Chapter II of the report presents a description of the characteristics of the OECS financial sector. This includes a discussion regarding the nature of the OECS economies, the OECS financial sector, and the OECS legal and regulatory structure. This Chapter effectively provides an analytical framework to develop the Project's findings, conclusions and recommendations.

Chapter III contains a synthesis of the findings, conclusions, recommendations and implementation steps developed as a result of the Project. These include findings and conclusions reached during the course of the Forum, as well as those developed by the various technical experts utilized during the course of the Project. Specific implementation steps associated with the recommendations have been laid out to help guide regional decision-makers in implementing the Project's recommendations. This has been done in an effort to increase the likelihood that the recommendations developed as a result of this Project are implemented and that efforts to achieve the overall mission of the Project--to advance the economic development of the OECS region through the promotion of of a more efficient and unified financial market place--are begun.

II. CHARACTERISTICS OF THE OECS FINANCIAL SECTOR

A. Introduction

As the field survey portion of the project evolved, it became increasingly apparent that there existed some fundamental misconceptions regarding the role of the financial sector in the process of economic development, including a lack of common understanding regarding the role of capital markets and the responsibilities of financial institutions. This introductory Chapter, in the process of setting the stage for properly analyzing and presenting the options available to policy makers to unify the region's financial sector, attempts to briefly describe and clarify certain key elements of the workings of the financial sector.

Section B presents a brief description of the OECS economic structure and recent performance, framing the overall context within which the OECS financial sector operates. Section C describes the nature of the OECS financial sector, including the role of the ECCB, commercial banks (both foreign and indigenous), the development institutions, the National Insurance Schemes, and the non-bank financial institutions. Section D presents a brief review of the OECS legal and regulatory structure in order to highlight the various constraints that currently exist to the development of an integrated regional financial sector. Section E explores an important issue facing the region--the level of lending rates--within the broader context of financial sector integration.

B. OECS Economic Structure and Recent Performance

1. Background

The OECS countries are broadly similar in terms of size, resource base and structure of production. They are all very open economies, and depend heavily on a narrow range of exports of goods and tourist services to support a much wider range of imports needed for consumption, production and investment. Exhibits II-1 to II-3 present highlights of data on various aspects of the OECS economies.

Agriculture is the mainstay of these economies and accounts for more than half of export earnings. The major export commodities are bananas, sugar, cocoa and nutmeg. Tourism, the second largest foreign exchange earner, has accounted for an increasing proportion of export earnings in recent years, while manufacturing has remained relatively modest both in terms of

SELECTED ECONOMIC INDICATORS OF THE OECS AND OTHER REGIONS

Country	Area (km sq)	Mid-year Population (1986) ('000)	Annual Rate of Population Increase (1983-86) (%)	Average Labour Force (1986) ('000)	Average Unemployment Rate 1986 (%)	Annual Change in Consumer Prices (1986) (%)	GDP Current Market Prices (1986) ($m)	GDP per Capita at Current Prices (1986) ($)	Rate of Growth in Real GDP (1986) (%)
Non-OECS (Total/Average)	**245,895**	**4,816.5**	**1.2**	**2,049.2**	**22.0**	***	**11,252.4**	**2,336**	***
Bahamas	13,942	234.0	1.8	110.9	12.2	5.5	2,214.1	9,462	3.5
Barbados	431	253.1	0.3	116.9	17.8	1.3	1,338.5	5,288	4.7
Guyana	214,970	794.0	0.8	291.2	29.9	7.9	519.4	654	1.4
Jamaica	11,424	2,336.2	1.4	1,059.0	23.7	15.1	2,433.3	1,042	2.0
Trinidad and Tobago	5,128	1.199.2	1.5	471.2	16.6	7.1	4,747.1	3,959	(6.3)
OECS (Total/Average)	**2,910**	**569.4**	**1.6**	***	***	***	**838.1**	**1,391**	***
Antigua	440	81.0	1.2	***	***	2.0	237.7	2,935	7.0
Dominica	750	78.1	0.7	***	***	3.0	111.1	1,423	5.0
Grenada	345	102.1	3.6	***	***	(0.3)	103.4	1,013	4.5
Montserrat	102	11.9	0.6	5.3	4.2	3.1	42.3	3,555	5.2
St. Kitts and Nevis	269	45.8	0.2	***	***	(0.3)	76.5	1,670	3.5
St. Lucia	606	139.5	2.0	***	***	2.2	193.6	1,388	5.8
St. Vincent and the Grenadines	388	111.0	1.3	***	***	1.0	98.0	883	3.1
Other LDCs (Total/Average)	**918**	**50.1**	**3.2**	***	***	***	***	***	***
Anguilla	91	6.8	0.6	2.8	7.0	***	***	***	***
British Virgin Islands	150	12.0	1.2	***	***	1.8	98.0	8,167	2.1
Cayman Islands	260	21.3	4.0	***	***	2.6	275.4	12,930	11.7
Turks and Caicos Islands	417	10.0	5.6	4.7	***	***	44.9	4,490	7.1

SOURCE: CDB Annual Report (1987)

EXHIBIT II-1

SELECTED ECONOMIC INDICATORS OF OECS AND OTHER SELECTED REGIONS

Country	Rate of Growth in Real GDP 1983-86 (%)	Value Added in Agriculture as % GDP 1984-86	Value Added in Mining as % GDP 1984-86	Value Added in Manufacturing as % GDP 1984-86	Value Added in Construction as % GDP 1984-86	Gross Domestic Savings as % GDP 1984-86	Central Gov't Current Revenue as % GDP 1984-86	Central Gov't Current Expenditure as % GDP 1986
Non-OECS (Total/Average)	...	...	...	...	...	**19.0**	**27.7**	**30.1**
Bahamas	4.2	...	...	...	...	27.2	18.4	17.4
Barbados	3.0	6.8	1.6	10.9	5.7	22.1	25.0	23.4
Guyana	0.9	25.8	4.7	4.0	7.1	13.9	42.3	55.6
Jamaica	(1.5)	6.0	6.4	20.2	8.4	15.8	30.8	27.8
Trinidad and Tobago	(3.6)	2.9	25.0	7.9	11.2	22.7	32.5	32.6
OECS (Total/Average)	**4.4**	**14.4**	**0.7**	**8.1**	**7.8**	**5.6**	**29.5**	**27.0**
Antigua	6.7	4.8	1.2	4.3	8.1	11.1	23.2	17.8
Dominica	5.9	28.7	0.7	8.5	6.7	12.3	28.9	28.4
Grenada	2.8	18.7	0.3	4.8	8.2	4.5	34.8	35.4
Montserrat	3.9	4.8	1.3	6.2	7.7	(13.5)	22.6	22.0
St. Kitts and Nevis	2.5	10.7	0.3	13.5	8.7	(1.3)	24.2	25.4
St. Lucia	5.6	15.0	0.6	8.4	7.0	9.4	32.5	29.6
St. Vincent and the Grenadines	3.1	18.0	0.2	10.8	8.3	16.6	40.7	36.8
Other LDCs (Total/Average)	...	...	...	...	...	...	...	...
Anguilla	...	...	...	...	...	...	...	...
British Virgin Islands	2.4	4.5	0.2	2.9	7.7	...	21.6	19.2
Cayman Islands	7.4	1.4	1.5	3.4	15.8	26.7	27.5	21.8
Turks and Caicos Islands	11.9	9.2	2.1	0.7	12.4	9.9	19.2	24.7

SOURCE: CDB Annual Report (1987)

EXHIBIT II-2

SELECTED ECONOMIC INDICATORS OF THE OECS AND OTHER REGIONS

Country	Central Gov't Current Account Surplus % GDP '86	Exports of Goods and Services 1986 ($m)	Imports of Goods and Services 1986 ($m)	Tourist Expend-tures 1986 ($m)	Current Account Balance 1986 ($m)	Change in Net Foreign Assets December 1986 ($m)	Outstand-ing External Public Debt 1986 ($m)	Debt Service Payments External on Public Debt 1986 ($m)	Ratio of Debt Service to Exports of Goods and Services 1986 ($m)
Non-OECS (Total/Average)	**(2.4)**	**5,621.3**	**5,707.0**	**•••**	**(865.2)**	**(619.3)**	**5,842.3**	**•••**	**•••**
Bahamas	1.1	1,607.5	1,293.6	1,105.0	(24.3)	20.8	211.2	141.5	8.8
Barbados	1.6	790.6	706.1	323.7	(5.2)	6.9	276.8	41.5	5.2
Guyana	(13.3)	247.9	301.1	•••	(140.3)	(66.1)	772.3	31.0	12.5
Jamaica	3.0	1,280.8	1,286.9	486.2	(99.3)	(44.1)	3,520.3	•••	•••
Trinidad and Tobago	(0.1)	1,694.5	2,119.3	83.9	(616.1)	(536.8)	1,061.7	191.8	11.3
OECS (Total/Average)	**2.5**	**•••**	**•••**	**268.6**	**•••**	**49.8**	**•••**	**•••**	**•••**
Antigua	5.4	178.8	237.6	93.9	•••	1.7	119.3	•••	•••
Dominica	.05	51.6	70.6	10.6	(15.9)	7.2	53.2	4.7	9.1
Grenada	(0.6)	62.0	•••	38.4	(10.5)	0.2	43.2	8.4	13.5
Montserrat	.06	4.3	22.8	8.1	•••	0.0	•••	•••	•••
St. Kitts and Nevis	(1.2)	47.8	68.2	22.6	(10.1)	2.2	22.0	2.1	4.4
St. Lucia	2.9	164.4	•••	68.0	(11.6)	22.3	48.2	0.8	0.5
St. Vincent and the Grenadines	3.9	77.4	87.0	27.0	0.8	16.2	38.0	3.1	4.0
Other LDCs (Total/Average)	**•••**	**•••**	**•••**	**256.4**	**•••**	**•••**	**24.7**	**•••**	**•••**
Anguilla	•••	•••	•••	16.4	•••	0.0	1.4	0.0	•••
British Virgin Islands	2.4	•••	•••	119.0	•••	•••	6.6	•••	•••
Cayman Islands	5.7	171.2	233.7	93.5	(70.2)	•••	14.0	1.2	0.7
Turks and Caicos Islands	(5.6)	34.6	42.0	27.5	•••	•••	2.7	0.2	0.6

SOURCE: CDB Annual Report (1987)

EXHIBIT II-3

foreign exchange earnings and its contribution to Gross Domestic Product (GDP).

The region is susceptible to natural disasters. The OECS countries have in recent times suffered the effects of hurricanes. The most severely affected by hurricanes have been Dominica in 1979 and 1980 and St. Lucia in 1980, while St. Vincent and the Grenadines suffered the effects of volcanic eruption in 1979. These disasters caused severe damage to agricultural crops and to infrastructure, and the replacement costs of the latter have accounted for a substantial proportion of gross domestic investment.

These shocks were accompanied in the early 1980's by a decline in the terms of trade as the prices of the area's major exports fell relative to the import prices of manufactured goods. The export prices were also affected by the recession-induced slow-down of world trade and demand for primary commodities. Accordingly, real GDP stagnated in most of the countries and in some instances became negative in the period 1980 to 1983. Indeed, in this period, the average annual rate of growth was less than 2 percent.

Real growth in GDP recovered in the period 1984 to 1987, averaging 5.5 percent, as the upturn of economic activity in the United States resulted in increased tourist arrivals. At the same time, better weather conditions as well as improved methods of production and packaging in the banana industry bolstered agricultural exports. Conditions in the manufacturing sector remained depressed as the demand for OECS manufactured exports in CARICOM markets and enclave sector exports to the United States market contracted.

2. The External Sector

The external balance deteriorated considerably in the years 1980 to 1983 as imports rose substantially due to the rehabilitation requirements following effects of the natural disasters in that period. Large deficits were incurred on current acount averaging 28 percent of GDP over the period, and in terms of the overall balance the deficit averaged 2.4 percent of GDP. The external accounts improved progressively from 1983 and acheived overall surplus by 1984. The surplus was equivalent to 4.7 percent of GDP in 1984 and grew to 6.4 percent in 1986 before falling to 2 percent in 1987.

Much of this improvement resulted from a sharp increase in tourism receipts and, to a lesser extent, increased volumes and values of merchandise exports even though, in general, prices of commodities in world trade declined. In the improvement in the external trade sector, world recovery was important but the role of the exchange rate was not insignificant. As European currencies strengthened in relation to the dollar, the earnings from commodity exports to the United Kingdom increased while European tourism found the OECS countries relatively cheaper. Recourse to external grants and external loans to finance overall fiscal deficits and significant inflows of private direct investment and remittances also contributed to the growth in reserves.

3. Monetary Policies within the OECS

Following the establishment of the Eastern Caribbean Central Bank on October 1, 1983, monetary policy has been concerned primarily with issues related to interest rates, the efficiency of resource allocation and preserving the stability of the financial sector through the establishment of bank reserve requirements.

Interest rate policy was geared principally towards narrowing the spread between lending and deposit rates. Accordingly, the ECCB in January 1985 introduced regulations prescribing a minimum rate of interest of 4 percent to be paid on savings deposits. This measure was also intended to assist financial intermediation and reward and encourage saving by small depositors. While no ceilings have been introduced with respect to lending rates, two OECS governments have Money Lending Statutes that prescribe a maximum lending rate.

Legal minimum required reserves for commercial banks were introduced in April 1984. Previously, commercial banks held reserves with the Monetary Authority on a voluntary basis. In 1986, an Inter-Bank Market mechanism was introduced to recycle liquidity in the banking system and provide revenue earning opportunities for excess commercial bank funds held at the ECCB. Prior to the development of this mechanism, commercial banks wishing to adjust their liquidity positions had either to liquidate assets or borrow from the ECCB at the penalty rate.

The introduction of a Treasury Bill Market in January 1988, extended the range of options available to the banks in the management of their liquidity positions. As is also the case with the Inter-Bank Market, the Treasury Bill Market facilitates the intra-regional flow of money market funds.

To support the growth in exports, thereby improving resource allocation and increasing investment, the ECCB established a Pre-Shipment Export Finance Guarantee Scheme in July 1984 to enable exporters to procure financing more easily from commercial banks for the purchase, processing or manufacture of goods to be exported against orders. As a further enhancement of this scheme a Post-Shipment Discounting Guarantee Scheme was introduced in September 1988. This Scheme will enable exporters to provide an element of suppliers credit into their marketing strategy and thereby compete more effectively in overseas markets.

4. Fiscal Policies within the OECS

The primary objective of fiscal policy in the 1980's has been the attainment of a high level of employment and balanced growth. It is generally the view of ECCB member governments that the private sector should be the main vehicle of economic growth and that the role of the public sector should be to create appropriate conditions for private sector activities by providing adequate infrastructure, institutional support, as well as incentives for saving and investment.

Public sector involvement in directly productive activities has been limited to investments that would help to achieve the countries' economic objectives but were not likely to be initiated by the private sector.

The economic features and structural characteristics of the OECS countries have had an important bearing on the conduct of fiscal policy. Natural disasters in recent years caused severe damage to infrastructure, whose replacement has accounted for a substantial proportion of gross domestic investment. The small size and narrow resource base of the OECS economies limit tax revenues, and thereby the amount of resources that can be mobilised domestically to produce basic items of infrastructure essential to growth and development.

Due to these constraints, the countries incurred overall fiscal deficits throughout the 1980's. These deficits, which amounted to the equivalent of 19 percent of GDP in 1982, declined steadily to 9.9 percent in 1985, but rose again in 1986 to about 20 percent of GDP. Fluctuations in the deficit have tended to reflect the unevenness of public sector investment, which is in turn determined primarily by the availability of financing. Because these investments generally involve economic and social infrastructure which generate little or no direct revenue, external funding has been the predominant means of financing, mainly in the form of grants and concessionary loans. Commercial loans have traditionally not been a popular source of financing, but these have been resorted to increasingly in recent times.

C. Nature of the OECS Financial Sector

1. Introduction

Developing countries face many impediments to the orderly development of the financial sector, some of which include:

- A lack of political and social stability that contributes to economic instability. The shifting of government policy can have a detrimental effect on the development of the financial sector.

- Inconsistent economic policies that can limit financial sector growth. Economic policies that apply to other related sectors can also have a negative effect on the supply and demand for credit and securities.

- Regulation of the financial sector that is redundant and fragmented. The overall responsibility for regulating financial institutions is often distributed among different agencies such as the Central Bank, Controller of the Currency, and Ministries of Planning, Finance, Economics, Commerce and Industry.

- Regulatory and fiscal policies that are inappropriate for financial sector development. Complex legal, regulatory and fiscal barriers inhibit the free flow of funds and encourage the development of local, protected companies. Tax policies are put in place that often favor borrowing, especially by government, and discriminate against shares and the equity market. Foreign exchange regulation tends to be very stringent.

- An absence of financial intermediaries that can operate efficient securities markets. The financial sector of many developing countries is made up primarily of commercial banks, which are deposit-taking institutions not ordinarily geared to operating as professional brokers and dealers in securities or a stock market.

- Stock markets characterized by an insufficient supply of tradeable securities. While many developing countries operate a stock exchange, the level of activity on these exchanges is low and typically involves trading by a small number of individuals. The "issuance" of stock is often limited to private placements to close associates or family living offshore. The result is that the primary market is small, and secondary trading and deep securities markets do not develop.

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- o A lack of information regarding financial sector activities. Because of the importance of financial information for decision-making, an unstable accounting environment can pose a serious threat to the development of a mature financial sector. The absence of equitable disclosure requirements or stringent enforcement tends to undermine investor confidence in financial statements and reduces the attractiveness of stock ownership.

- o Limited dialogue between public and private sectors. At the same time that the government may complain about the business sector's unwillingness to contribute to the economy, the private sector may have solid reasons to believe it is being slighted by the government in its regulatory treatment of business, including private financial concerns.

In short, the important function fulfilled by capital markets in developed countries--raising equity for business formation and expansion through private placements and public offerings--occurs only rarely in developing countries. The OECS region is not an exception to this generalization. Many barriers exist in the region that inhibit the development of a unified financial sector that would contribute significantly to the economic development of the region. The most detrimental of these barriers are regulatory and fiscal policies that greatly inhibit the intra-regional flow of funds.

However, it is important to note that the region possesses many factors that work to its advantage in the process of developing a well-functioning, unified financial sector. The OECS region enjoys relative political and social stability and possesses governments that by and large support private and financial sector development. The financial sector is made up of financial institutions which provide the basic infrastructure required to develop a well-diversified financial sector. The OECS region has connections to world financial markets via major British and Canadian private commercial banks. The region also has an increasingly active indigenous commercial banking sector operating with strong governmental backing, an emerging non-bank financial sector (particularly in the area of credit unions) and a rapidly growing source of long-term funds in the National Insurance Schemes (NIS). The region also has a relatively new institution--the Eastern Caribbean Central Bank--which is in a position to grow and play an increasingly important role in the overall process of financial sector development in the OECS region.

Prior to presenting the findings, conclusions, and recommendations designed to improve the workings of the OECS financial sector, it is important to gain a fuller understanding of this sector as it currently operates. As such, the following sections of this Chapter include a brief description of (a) the overall institutional makeup of the financial sector, (b) the commercial banking sector (both foreign and indigenous), (c) the development institutions of the region, (d) the National Insurance Schemes (NIS), and (e) the non-bank financial institutions.

2. The Institutional Makeup of the OECS Financial Sector

The OECS financial system is still relatively underdeveloped in terms of the range of functions performed or in the type of financial assets available.

The OECS financial sector is currently comprised of the commercial banks (both foreign and indigenous) and the various non-bank financial intermediaries spread throughout every ECCB member country (see Exhibit II-4). The most organized and cohesive group of financial institutions in the region is made up of seventeen commercial banks. The second largest group consists of the various development banks linked under the umbrella organization of the Caribbean Development Bank (CDB). No other financial group claims any significant organized function within the region as yet.

As can been seen in Exhibit II-4, the overall financial system is largely dominated by the branches of the foreign commercial banks. The branches of the four foreign banks, which are not locally incorporated and constitute only a small proportion of the world-wide operations of their respective banks, dominate the banking system. At the end of 1987, the branches of the foreign commercial banks held assets amounting to 65 percent of the region's total assets. The remaining balance is held largely by the indigenous commercial banks, with a minute share held by the relatively new foreign-owned, locally incorporated banks.

The number of non-bank financial institutions varies considerably among the countries. They include credit unions, found mainly in Dominica, development banks, which exist in almost all countries, savings banks, and mortgage and finance houses. One mortgage finance company which operates in a majority of the countries is a subsidiary of one of the foreign commercial banks. A foreign-owned finance company also operates in Antigua and Barbuda and St. Lucia. Except for these, the non-bank financial intermediaries are locally incorporated and have geared their operations to the local market.

STRUCTURE OF THE OECS FINANCIAL SECTOR

NUMBER OF FINANCIAL INSTITUTIONS IN ECCB MEMBER COUNTRIES

FINANCIAL INSTITUTION	Anguilla	Antigua	Dominica	Grenada	Montserrat	St. Kitts/ Nevis	St. Lucia	St. Vincent & Grenadines	OECS Region
1. Commercial Banks									
- Foreign (branches)	1	4	4	2	2	3	4	3	23
- Locally Incorporated	2	4	1	2	1	3	2	2	17
2. Non-Bank Financial Intermediaries									
- Development Banks		1	1	1	1	1	1		6
- Savings Banks/Finance Co's[1]		3	3	1	1		2	4	14
- Building and Loan Societies[1]				1			1		2
- Credit Unions and Coops	1	7	22	20	2	3	15	7	77
- Insurance Companies/Agencies[1]	2	25	13	24	5	9	19	24	121

EXHIBIT II- 4

SOURCE: ECCB and Field Trips

[1] Estimated

Other important types of financial institutions include life insurance companies, predominantly foreign and/or CARICOM based, and the national insurance (social security) schemes which mobilize significant amounts of resources in the region.

An important gap in the financial structure of the ECCB countries is the non-existence of investment financing institutions, particularly those involved in issuing and trading stocks and other long-term securities.

While in the ECCB area as a whole the foreign commercial banks control approximately two-thirds of the assets and liabilities, the situation varies from country to country. In Anguilla, Montserrat, Dominica, St. Kitts-Nevis, St. Lucia and St. Vincent, the foreign commercial banks outnumber the indigenous commercial banks. Only in Antigua and Grenada do the foreign and indigenous banks have equal numerical representation. The indigenous commercial banks are, however, beginning to play an increasingly important role in the region, with the result that they are now firmly established in all territories except Montserrat.

Data on the operations of financial institutions other than commercial banks are not readily available. The financial assets of the commercial banks increased rapidly in recent years, particularly since the economic recovery of 1984. Total assets which amounted to EC$ 1.6 billion at the end of 1983, grew to EC$ 2.7 billion by the end of 1987. The indigenous banks at the end of 1987 accounted for 37 percent of total assets as compared with 34 percent at the end of 1983.

There are significant differences in the liability composition of the two groups of banks. The deposit portfolio of the indigenous banks, which mobilised 38 percent of the total deposits of EC$ 2,096m at the end of 1987, contained a significantly greater proportion of higher-cost fixed deposits, 58 percent of the total compared with 31 percent for the foreign branch banks. Cost-free demand deposits constituted 16 percent for the indigenous banks and 22 percent for the foreign banks, while the proportion of savings deposits were 26 percent and 47 percent respectively.

The proportion of assets allocated to loans was 53 percent for the indigenous banks as against 57 percent for the foreign branch banks. However, in terms of loans distribution there was a higher concentration of public sector loans in the portfolio of the indigenous banks. At the end of 1987, the ratio of public sector loans to total loans was 25 percent for the indigenous banks compared with 9 percent for the foreign branch banks. This does not, however, take into consideration sovereign risk lending transacted through the foreign bank branch's head office. Within the context of the OECS, in absolute terms loans extended by indigenous banks to the public sector was about 58 percent more than that extended by the foreign branch banks.

In terms of their lending activity in the private sector, all commercial banks have historically exhibited a preference for financing short-term, self-liquidating loans, which has tended to bias their loan portfolios in favor of loans to the distributive trades and consumer sectors, while loans to the productive sectors (manufacturing, agriculture and tourism) were given a relatively low priority ranking. It should be noted, however, that credit to the distributive trades may indirectly be financing imports for the productive sectors, while about 54 percent of lending for consumer or personal use was for the purchase and/or construction of residential housing, which in part represents additions to physical wealth, and should strictly be regarded as investment rather than consumption.

Quite a different picture emerges when consideration is given to the productive sectors namely, agriculture, manufacturing and tourism. For the area as a whole these sectors together absorbed credit amounting to just 16 percent of the outstanding total at the end of 1987. Of the three productive sectors, agriculture at 3.3 percent received the smallest share of bank credit. When this is compared with the contribution of this sector to GDP, which amounted to approximately 18 percent, the discrepancy becomes apparent. Tourism received 7 percent of total credit and the manufacturing sector 5.5 percent.

3. The Eastern Caribbean Central Bank (ECCB)

The Eastern Caribbean Central Bank (ECCB) was established on October 1, 1983 as successor to the Eastern Caribbean Currency Authority (ECCA). The ECCB was created as a result of an agreement between seven member governments under the ECCA designed to establish a Central Bank to "facilitate economic stability and growth through the maintenance of a sound monetary, credit and banking system within the territories of the the member governments." Anguilla became a member on April 1, 1987, rounding out the current eight ECCB member countries.

The ECCB has wide-ranging powers and responsibilities consistent with those powers generally granted to a central bank, including:

- To be the sole issuer of the Eastern Caribbean (EC) currency

- To maintain the value of the EC currency
- To regulate the supply and demand of money and credit
- To promote monetary stability and economic development in the participating member countries

Three operational areas of responsibility of the ECCB include:

- Managing foreign exchange reserves
- Granting short-term credit to member governments
- Regulating and monitoring deposit-taking institutions

With respect to the latter category, the Central Bank may, upon authority of the Monetary Council, apply different credit and interest rate policies for each territory provided that such government supports such action. Within its broader mandate, the ECCB can also act as agent for the member states in the licensing of offshore financial institutions, administering bank deposit insurance schemes, and providing export credits guarantees and other credits or credit enhancements for the development of the region.

In an effort to become a catalyst in the economic development of the region by strengthening the position of OECS exporters, the Central Bank, on September 1, 1988, brought on stream two facilities to enhance the flow of working capital from the regional commercial banks to export manufacturing and export trading enterprises. These include (1) the Pre-Shipment Finance Guarantee Scheme (PSFG), and (2) the Post-Shipment Discounting Guarantee Scheme (PSDG).

Exhibit II-5 presents an organization chart of ECCB. The highest governing body of the ECCB is the Monetary Council comprised of one representative from each member country. The Council sets guidelines on monetary policies and other matters related to the economic development of the region. The Board of Directors acts as the implementing body that carries out the policy guidelines and directives set forth by the Monetary Council, and is responsible for the proper administration of the Bank.

The ECCB is a relatively young institution, still very much in the process of defining and interpreting what its proper role as the region's central bank should be and to what extent it should become actively involved in promoting the economic

ECCB ORGANIZATION CHART

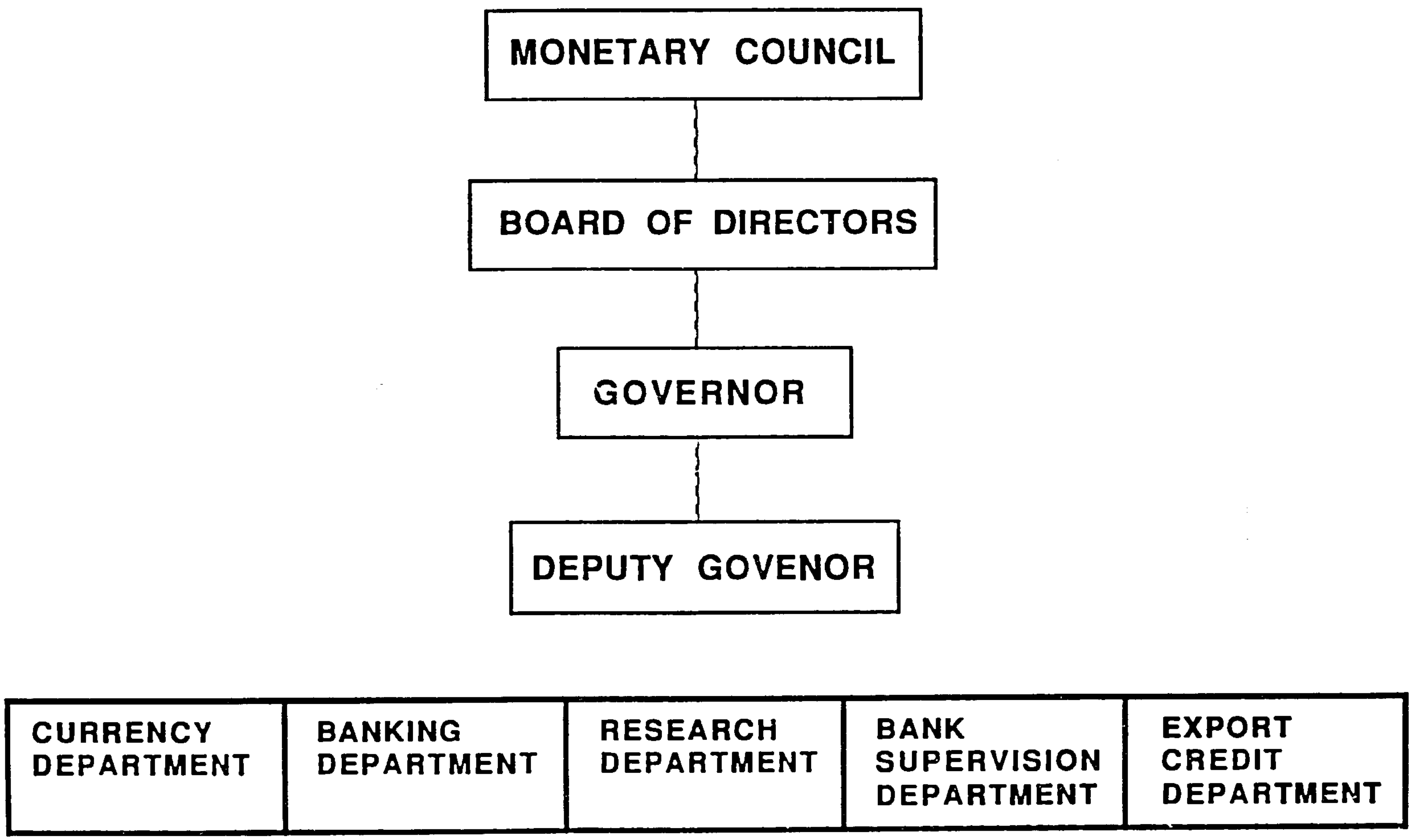

EXHIBIT II-5

development of the region. This process is a difficult one, as the ECCB must act as monetary agent for multiple countries, requiring it to delicately manage relationships with eight sovereign states. This project, as will be noted in later chapters of the report, has led to a number of recommendations and related implementation programs regarding the region's financial sector that will require that the ECCB think through and make fundamental policy decisions with respect to the exact role it should play in the region, not only as its principal monetary agent, but as an active catalyst in the overall development process.

4. Commercial Banks

a. Introduction

As the field work was performed during the course of the Project, it became evident that there was, in several quarters, an incomplete understanding of the traditional economic function of commercial banks. In order to avoid confusion and to properly set the the stage to present the project's conclusions and recommendations, this introductory section attempts to briefly outline some basic information regarding commercial banking practices.

(1) The responsibilities and functions of commercial banks

Commercial banks are institutions which receive demand and time deposits from the public. Demand deposits are usually accessible by check. Time deposits bear a higher rate of interest and can only be withdrawn under certain conditions. The major responsibility of the commercial banker is to be able to pay checking accounts on demand and time deposits according to the terms of specific contracts. Banks are said to fail when this cannot be done. Banks usually accept deposits many times greater than their capital, so that unless these resources are kept in a safe, liquid form, the bank is likely to fail. The availability of "surplus" funds to lend does not in and of itself guarantee profitability.

Commercial banks, in addition to providing a depository service, must attempt to produce profits for their shareholders. They do so by carefully investing depositors' funds. Usually about twenty to thirty percent of assets are kept in cash reserves or highly-liquid treasury bills as reserve against sudden withdrawals by depositors. Rarely do depositors wish to withdraw their funds at the same time and banks usually have arrangements with a central bank to provide liquidity in case of

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such emergencies. Based on years of experience with depositor behavior, commercial bankers lend some of their funds to well-established businesses to finance self-liquidating, short-term commercial operations. A large bank with substantial time deposits may feel safe lending a small percentage of deposits for longer periods, even five to ten years. However, what appears to be "excess lendable funds" to the layman, may not be so regarded by the banker who must think in more stringent terms. So-called "excess money" which is lent for five years may suddenly be required by depositors if crops fail in the next twelve months.

(2) Lending criteria of commercial banks

Bankers are taught to lend on the basis of the "Five C's":

- Character of the borrower
- Capacity to repay the loan incurred
- Capital of the borrower
- Collateral of the borrower
- Condition of the loan granted (terms and maturities)

In developing countries another factor plays an important role in the granting of credit: Managerial, technical and entrepreneurial expertise of the borrower.

Since the capacity of a new business to repay a loan is difficult to predict, bankers are careful not to grant loans to new ventures unless backed by adequate collateral. Additionally, most bankers do not expect a borrower to present a "project" per se. Rather, they look for financial statements showing a history of successful operations. Bankers tend to deal with new clients with caution, building credit lines as they gain actual experience.

(3) Interest Spreads

Bankers earn money on the spread, the difference between the amount paid depositors and the interest charged borrowers. Often, bankers do not have precise information on the exact amount of the current spread, nor any assurance that it will stay constant during the term of an operation. This is because banks borrow and lend at a variety of interest rates and maturities, in constantly shifting proportions. Also, part of the money lent is the bank's own funds with an elusive "cost of capital" element involved, while some assets yield no return, sitting in safekeeping as cash reserves. A further complication is that interest rates change over time for different maturities and types of risk. Since most bankers are not able to match the maturities of assets and liabilities, they can never be sure what they are earning. It is also difficult to quantify the factor of risk that is associated with the non-payment of loans. The cost of processing loans and deposits must also be deducted from the spread. These costs are proportionally higher the smaller the loan.

(4) Types of lending done by commercial banks

The type of lending done by commercial banks tends to conform more to the nature of local economies than to practices in a bank's home country. It should be noted that in most developing countries in the world, commercial bank credit plays a much more important role in financing their economies than it does in highly developed economies. Other private sources of capital--public equity and bond markets, nonbank financial institutions, other institutional investors--do not begin to have the capacity they do in countries with highly developed economies. And generally, the less developed a country, the greater the reliance on bank credit. Moreover, most of the credit is short term, with 90-day "evergreen" loans being rolled over endlessly to finance fixed plant and equipment as well as working capital. As would be expected, therefore, the most common form of local lending by foreign bank branches is short-term loans to industrial and commercial enterprises in support of trade-related activities. The OECS region is no exception to this rule.

It is not generally the business of commercial banks to provide equity or other high-risk, long-term financing. Some extremely large banks are able to provide "project financing" and other long-term loans with a very small percentage of their assets. These are the exception rather than the rule. Banks that have not followed cautious policies, such as those placing a substantial part of their assets into large real estate projects or loans in the Third World, have suffered great losses. One should not expect the local branch of an international commercial bank to have a project loan officer.

The basic material for any banking transaction is the acceptance of customer deposits. Such low-cost funds generate earning assets and generally the more its lending operations are funded with locally available deposits, the greater the profit margins banks will be able to generate. This is true for both local and foreign bank branches. However, this profitability is also dependent on the bank's structure of deposits, management capability and competitive environment.

(5) The nature of commercial bank branching

A commercial bank branch in a foreign country is generally an implementor and executor of policy decisions made at headquarters. Each branch forms part of, and its behavior in a local market can be affected by, the parent banks's overall strategy on international asset and liability management. Asset and liability management is a global operation with the strategic objective of accessing, on a short-term basis, all pools of liquidity wherever they appear. This overall process provides the branches of foreign banks with additional money management flexibility not available to local commercial banks.

b. The Foreign Commercial Banks

As previously noted, the OECS region's commercial banking sector is dominated by four foreign banks through their branch banking system. While only one foreign commercial bank is represented in each ECCB member country, the foreign banks manage approximately two-thirds of the region's assets and liabilities. This situation does, however, vary from country to country depending on the degree of competition in the banking sector.

Some of the key characteristics of the foreign commercial banks are outlined below:

- They control some 65 percent of the region's financial assets and liabilities. They manage the largest pool of short-term deposits.
- They have an extensive branch network system allowing them to manage their portfolios more effectively.
- Given their degree of market penetration and expertise in portfolio management, they have consistently reported higher levels of profitability and developed a higher degree of involvement in handling the region's foreign exchange operations.
- They have less credit risk exposure when dealing in sovereign risk lending. This is due to the global nature of these banks' operations and their ability to integrate their portfolio management activities. Almost all such lending is handled by the head office of each bank based on perceived country risk, limited by each borrower countries' projected foreign exchange income and export earnings.

- They have little or no foreign exchange risk exposure and restrict their lending operations to the local government level.

- They have a better mixture of deposit maturities and greater access to low-cost funds. Field interviews highlighted the fact that such branches have to maintain balanced positions; i.e., local deposits should be utilized to fund local lending operations which obviates the need to bring in "hard currency" into the region.

- They tend to provide the traditional, "bread and butter" banking services normally provided by the branches of foreign commercial banks around the world. These include letters of credit, foreign drafts, collections, international money orders and transfers, foreign exchange and, more generally, short-term loans to self-liquidating business transactions.

- Given the region's tradition of branch, versus unitary, banking, the foreign commercial banks are not locally incorporated. As such, audited statements of these branch banks are not available on an individual and/or an OECS regional basis. Indeed, given the nature of how branch banks form part of a broader process of asset and liability management as conducted by the parent office, it is unlikely that the foreign commercial banks in the OECS region are aware of the exact financial performance of each branch.

- They have little or no special tax considerations or privileges directed toward them. In fact, certain governments impose restrictions (legal and regulatory) that they do not impose on locally-incorporated institutions.

- Foreign bank branches generally have higher operating expenses due to factors such as expatriate staff, computerization, head office and regional operating expenses, larger premises, etc.

c. The Indigenous Commercial Banks

With the region's national governments taking more control of their internal affairs following independence, there developed a movement to establish local financial institutions more closely attuned to national priorities. This movement closely paralleled the establishment of national development banks and the incorporation of locally-owned national banks.

The so-called indigenous commercial banks possess the following characteristics:

- o Like the foreign commercial banks, the "raw material" for their operations is deposits from the public.
- o They operate as single units within a given national territory, with little or no linkage with other institutions within the OECS banking community to date.
- o They control a lower percentage of the region's assets and liabilities. This is because they are relatively new institutions and the fact that their access to deposits is limited to their country of incorporation.
- o They handle a lower percentage of the traditional areas of commercial banking activity (trade and commerce), particularly in the area of foreign exchange operations. This is due to the foreign commercial banks predominance in these areas.
- o As local institutions promulgating national priorities, they have been given certain privileges, particularly in the areas of corporate taxation and in the access to short-term pension funds held by government.
- o The indigenous banks have, to a certain extent, developed a mismatch between their deposit base and their lending operations as these short-term deposits have been tied to specific, longer-term investment purposes (e.g., mortgage lending).
- o The indigenous commercial banks, as opposed to the foreign commercial banks, are required by government to publish financial statements.
- o In view of the fact that indigenous commercial banks are expected to be more attuned and supportive in promoting the economic objectives of the countries, they have been somewhat less stringent in judging the credit-worthiness of local businesses and have been more accommodating in the amount and quality of collateral accepted.
- o In order to better compete with the foreign commercial banks, the indigenous commercial banks have offered higher deposit rates to attract new and hold current customers. This has helped the indigenous banks become more firmly established in all ECCB member countries.
- o The indigenous banks within the CARICOM/OECS area have recently created "The Caribbean Association of Indigenous Banks" to promote and enhance its members' goals and objectives within the region. The

Association is composed of thirteen member banks from the OECS, Barbados, Guyana, Jamaica, and Trinidad and Tobago.

5. Development Institutions

a. Role and Functions of Development Institutions

Over the course of the last thirty-five to fifty years, many developing countries have actively promoted the establishment of development institutions. Development institutions have been established for a number of reasons. One is to assist governments in the overall process of capital mobilization. Capital mobilization in an economy encompasses the transfer of financial assets from surplus (saving) units to deficit (investment) units. Streamlining this process is the primary goal of any country because the greater the efficiency of capital transfers, the greater the prospects for economic growth and development. Development banks were in many instances established to act as intermediaries in this process.

A second reason is to make available funds on a longer-term basis in order to finance the accumulation of fixed assets (land, machinery, buildings) deemed so important to the development process. Long-term funds are not normally readily available in developing countries; individual savers possess a short-term horizon in view of oftentimes uncertain political and economic conditions.

A third reason is to make available short-term (working capital) funding to those enterprises subject to variations in their production cycles. And a fourth reason has been to help a country overcome a lack of entrepreneurial initiative. Development institutions in many countries have provided easy access to funds in the hope that some worthwhile businesses will be created, with entrepreneurship being fostered as a consequence.

Despite the common reasons for their creation, development institutions have varied tremendously with respect to how to handle various operational aspects of development lending (e.g., ownership, sources of finance, degree of government control, objectives and methods of operation).

b. Development Institutions in the OECS Region

Within the OECS region, a number of institutions have been established over the years to address the issue of channeling funds to the productive sectors of the economy. The general mandate of these institutions is to provide medium and long-term financing and technical assistance to the productive private sectors and, in some cases, to those areas defined to be national priorities. They also perform a wide range of services associated with the project life cycle. These include pre-feasibility and feasibility studies, and project implementation and management services. These services are very important in the Caribbean where there is a shortage of skills needed to perform these tasks in the private sector. These services are especially important to small businesses which cannot maintain the in-house capability necessary to perform these tasks.

There have been a number of institutions in the region acting as development institutions, including the national development banks (NDBs) and national development foundations (NDFs).

(1) National Development Banks (NDBs)

Of particular importance are the national development banks (NDBs). Within the Caribbean region, the NDBs receive most of their funding from the Caribbean Development Bank (CDB) and their respective governments. In addition to their share of capital, the rest of their funds are obtained from an assortment of other international development finance institutions, including the European Investment Bank (EIB), the Canadian International Development Agency (CIDA), and the Agency for International Development (AID). A miniscule part of their loan funds come from local sources. Development institutions have not yet, however, carried out any determined effort to generate funds locally.

The NDBs make loans to enterprises in the agricultural and fisheries, manufacturing, tourism and housing sectors. Loans are also made to university students. In 1986, the last year for which data for all ECCB member countries exists, the development banks in the region extended a total of EC$ 63.5 million in loans, broken down as noted on the following page.

The NDBs do not currently take equity positions in private enterprises, although this is not ruled out by their regulations. In fact, some of the development banks have negotiated a line of credit from the European Investment Bank which enable them to take equity positions in productive enterprises. However, this facility has not been used for want of qualified takers to date. Both the development banks and the firms prefer to work with direct lending because the equity option is more complex to administer and may strain the limited accounting capabilities of the enterprises involved.

	EC$MM	%
Agriculture & Fisheries	11.1	17.5
Industrial	16.3	25.6
Housing	28.3	44.5
Education	5.8	9.1
Other	2.0	3.2
Total	63.5	100.0

The national development banks in the region are beset by a number of problems which have made their track record not as good as hoped. Based on numerous interviews throughout the OECS region, these problems appear to include poor management, political interference and inability to generate their own funds locally. They also have to combat the feeling among some borrowers that borrowed government money need not be paid back. Accordingly, the lending record of development banks in the OECS, just like their counterparts in other developing countries, has not always been as good as expected. Most of their loan portfolios, for example, have been plagued by higher-than-expected loan losses.

Some of the NDBs indicate that they have not seriously thought about raising funds locally. Others have thought about it but feel that the institutions are too small to successfully float bonds regionally or internationally and the domestic financial markets are too small. This problem can be addressed in one of two ways: (1) the development banks can compete with commercial banks for deposits in the individual territories, or (2) an OECS regional fund can be established.

The first option is attractive for it will help to channel some of the excess liquidity in the banking system into productive enterprises. However, making the development banks deposit-taking institutions will tend to sidetrack them from their main purpose, which is to provide development finance and technical assistance.

The second option, the establishment of an OECS regional development fund with sufficient market power to issue bonds regionally, is a more practical alternative. It would help to channel some of the excess liquidity into productive enterprises since, presumably, potential investors and institutions in the region will purchase some of these bonds with funds withdrawn from the commercial banks. These funds could then be channelled through the national development banks to the ultimate borrowers without the strings attached to the other funds which they receive. More is said about the creation of such fund later in this report.

(2) The National Development Foundations (NDFs)

The National Develement Foundations were established under the aegis of the USAID Small Enterprise Assistance Project (SEAP) to provide financing and technical assistance to small enterprises which were unable to tap into traditional sources of financing. The SEAP funds are provided over a five-year period for loans to (a) new and established enterprises, (b) loan processing costs, (c) technical and managerial support for the NDF's clients, and (d) administrative support.

SEAP commenced operations in February 1986. Since then US$ 3.02 million has been disbursed and 2,913 jobs have been created in the OECS region and Barbados (see Exhibit II-6) as a result of its effort. The NDFs deal mainly with micro and small businesses (sales of US $35,000 or less, and 10 employees or less).

SEAP is financed through a US$ 10 million grant to the Caribbean Association of Industry and Commerce (CAIC), which is the umbrella organization coordinating all such activities for the foundations. The field survey conducted as part of this engagement indicated that this amount does not appear sufficient to meet the demand for funds from the foundations. Prior to SEAP, the NDFs received funds indirectly from USAID through the Pan American Development Foundation under the Small Enterprise Development Project and the National Foundation Assistance Project. Additional funds also come from the Foundation for International Training (FIT), a program sponsored by CIDA. The NDFs in Antigua and Grenada have also received funds from the Barclay's Bank Development Fund, and St. Kitts-Nevis, St. Lucia and Dominica have applied for allocations under this scheme.

The primary focus of the NDFs is direct lending to micro and small businesses. Loans from the NDFs have a maximum repayment period of five years. Funds are lent at market rates which vary from island to island and a grace period is usually offered. The applicant is required to contribute at least 20 percent of the real cost of the project and must be judged to be of good character. Collateral is not a dominant factor in loan appraisal

NDF PERFORMANCE

JOBS AFFECTED BY NDF'S LENDING PROGRAM
(through 9/30/87)

	Male	Female	Total
Antigua	107	68	175
Dominica	557	327	884
Grenada	320	128	448
St. Kitts	167	78	245
St. Lucia	204	68	272
St. Vincent	41	20	61
	1,396	689	2,085

SUMMARY OF NDF'S LENDING
(through 9/30/87)

Country	Number of Loans	Amount U.S. $	Average size	Amount Arrears	Arrears percent
Antigua	70	207,213	2,960	3,276	3
Dominica	491	605,576	1,233	26,250	14
Grenada	191	385,081	2,016	27,044	9
St. Kitts	232	335,639	1,446	8,591	5
St. Lucia	117	271,388	2,319	9,960	6
St. Vincent	30	42,799	1,426	1,331	11
Total:	1131	1,847,696	1,634	76,452	7

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although it is often required, primarily to engender a commitment on the part of the borrower. The repayment record to date is strong, with the arrears rate ranging between 3 and 14 percent in the OECS countries (See Exhibit II-6). This payment record is attributed to the high level of contact between the Foundations' extension officers and clients.

The NDFs also operate small business counseling units which are staffed by project officers. They offer business counseling and technical assistance in the setting up of the projects. There are also field extension services where the project officers visit the applicants on the site of their projects. The small business counseling units sometimes package projects and recommend the applicants to the commercial banks for financing. In cases where the applicants cannot meet the commercial banks' collateral requirements, the foundations will guarantee 80 percent of the value of the loans. In this way the foundations take most of the risk and underwrite the costs involved in packaging the project.

6. The National Insurance Schemes

One of the major developments in the financial sector of the region during the last two decades has been the emergence of the National Insurance/Social Security schemes, or simply the National Insurance Scheme (NIS). Some of the OECS countries established Provident Funds initially, which offered limited benefits, but which subsequently developed into full-blown NIS.

With the attainment of associated statehood by most of the territories in the late 1960s, and the consequent reduction of British grants-in-aid, OECS countries took on greater fiscal responsibilities. It became quite clear that the provision of support for the elderly could no longer be financed out of general budgetary resources. Thus, Provident Funds were established with the technical support of the British Government in order to induce people to save for their retirement.

Contributions to the Provident Funds were made by both employers and workers. In most cases employers and employees paid the same percentage, which was initially set at 5 percent in all countries. Membership was usually extended to agricultural workers and self-employed persons.

The benefits of these funds were limited. At retirement the participant would receive his accumulated contributions plus accrued interest. If the participant died before retirement, the benefits would go to the next of kin. There were no unemployment benefits or disability compensation.

The continuing disintegration of the extended family meant that government was called upon to provide more services for the elderly and other disadvantaged groups. This put greater pressure on already limited government resources. One logical solution was to provide these services under an extended NIS program.

The Provident Funds and the NIS programs were established as follows:

	Provident Fund	NIS
Antigua	1970	1972
Dominica	1970	1976
Grenada	1978	1983
Montserrat	1972	1986
St. Kitts-Nevis	1968	1977
St. Lucia	1970	1978
St. Vincent	1970	1986

The New NIS's have the following characteristics:

- They manage two sets of resources: the resources which participants had in the old Provident Funds and the contributions under the extended NIS.
- A typical NIS scheme consists of three components: a retirement fund, a sickness and disability fund, and an unemployment fund.
- The NIS programs are financed by payroll taxes in all the islands. All the countries require that employers pay part of the tax.
- The tax is withheld at the source by the employers and transferred to the Scheme, thereby bringing in a large amount of the revenue with relatively low adminstrative and compliance cost.
- The social security schemes in the region have mobilized in excess of EC$ 300 million worth of resources and maintain an investment portfolio of about EC$ 277 million.
- About 65 percent of the NIS funds are held in commercial bank deposits, 25 percent in government

paper (treasury bills, bond debentures, etc.), and 5 percent as the obligations of statutory corporations.

It is clear that the Schemes have had a positive impact on saving in the region. The evidence with respect to its effect on investment is, however, inconclusive to date. This appears to be due to a number of reasons, including the absence of financial instruments to channel savings into long-term investment and the nature of commercial banking practices with respect to long-term investment.

Nevertheless, the availability of NIS funds is a positive feature of the OECS financial sector. The NIS program represents a powerful instrument for mobilizing domestic saving which, if properly planned and managed, might be effectively channeled to the productive sectors. Appendix B presents some additional findings and conclusions with respect to the NIS, and sets forth some proposed solutions to make the Schemes more effective.

7. Non-Bank Financial Institutions

a. Description of the Non-Bank Sector

The remainder of the OECS financial sector is comprised of so-called "non-bank" financial institutions. These include financial intermediaries such as savings banks, finance companies, credit unions, insurance companies and building societies. The basic difference between these institutions and commercial banks is that they normally do not accept monetary deposits which are repayable on demand. Non-bank financial institutions concentrate, rather, on taking savings and time deposits and are usually not owned by stockholders.

Savings banks, building societies, finance companies and credit unions generally raise funds directly in the local market or borrow from established commercial banks. Their lending operations are traditionally geared to home mortgages and consumer loans. Life insurance companies, on the other hand, are more specialized institutions, providing a combination of life insurance protection and long-term savings services. As such, life insurance companies are an integral part of the OECS financial community and in promoting the economic development of the region.

It should be noted that information and basic statistical data on the non-bank financial sector is lacking. Our meetings throughout the region with various public sector officials and private sector representatives revealed that information on this sector was simply not readily available. In many instances, such financial data was not actively collected by the designated local authorities and, if available, was incomplete. In other instances, we discovered that certain financial data and information was not subject to legal or public reporting requirements.

b. The Growing Role of Credit Unions

A particularly interesting aspect of the OECS financial sector is the strong and growing movement of the credit unions. Credit unions are non-profit, non-bank financial institutions owned by their members and are operated along democratic principles. Each credit union is an autonomous entity operated by a management team appointed by the board of directors, which is democratically elected by its members.

Credit unions in the OECS region are increasingly commanding enough resources to make a significant impact on the region's economies. In 1987, the credit union movement in the OECS region had total shares and deposits worth EC$ 55.8 million. Their combined shares and deposits have been growing at an average rate of 31.7 percent over the last five years.

The credit unions are gradually expanding the range of financial services they provide to their members. Although they primarily provide consumer loans to their members, they are expanding their services to include checking accounts, fixed deposits, lines of credit, consumer loans and mortgage loans. A recent meeting of the Caribbean Credit Union Association advocated an extension of the financial services offered by the credit unions to more effectively compete with the commercial banks.

The latter is particularly true of the credit union movement in Dominica, which is the strongest movement in the region. It controls approximately 52.5 percent of the total shares and deposits and the larger credit unions offer a full range of financial services. The credit unions have been slowly changing the financial picture in Dominica. The commercial banks did not start offering mortagage loans until the larger credit unions led the way. They have also had an impact on the lending rates of the commercial banks.

In order to exert an influence on the OECS financial sector commensurate with the amount of total resources they control, their actions will have to be better coordinated. Currently, each credit union is a separate entity driven by a sense of communal spirit. The Caribbean Credit Union Association represents an attempt to better integrate the efforts of the credit unions in the region.

The credit unions, like the indigenous banks, represent a constructive expansion and diversification of the OECS financial sector. The activities of the credit unions, to the extent that they can be properly integrated, will induce competitive pressures that will tend to expand the financing sources and options to the productive sectors.

c. The Insurance Companies

The insurance companies in the OECS are a vehicle through which savings are accumulated. The life insurance companies in particular represent a potentially important source of long-term financing in the region. The field survey portion of this project indicated, however, that the role of the insurance sector is not well understood or appreciated. This is partially due to the fact that the insurance industry in the Caribbean has not been well researched by local economists in view of the lack of statistical and other data on the sector. OECS data on the industry as a whole is lacking to properly evaluate their impact on local economies.

All insurance companies in the OECS are regulated and governed by local Insurance Acts administered by the various Ministries of Finance. In order to transact business in any territory, insurance companies are required to maintain statutory reserves according to guidelines set forth by the various Registrar of Insurers in the form of cash, deposits, and/or prescribed securities, the latter including:

- Treasury Bills issued by the local government
- Bonds, debentures or other stock issued by the local government
- Fixed deposits held at the national development bank
- Bonds, debentures or other stock issued by the Caribbean Commonwealth Governments and/or the Caribbean Development Bank.

Most life insurance companies provide a combination of life protection arrangements and long-term savings opportunities to their clients. An important activity of the life insurance companies is to invest their accumulated savings holdings.

Non-life insurance companies, on the other hand, sell straight protection against loss of property. As such, these companies have no savings element and their principal concern is to effectively manage and invest premiums until such a time as they are needed to settle claims.

Non-life insurance companies thus have higher liquidity requirements and tend to hold larger amounts of their funds in short-term investment instruments. Life insurance companies generally need less liquidity since their cash requirements are more easy to predict. And because they operate with relatively low capital requirements, the safety of assets is their main concern. Additionaly, since their liabilities are denominated in local currencies, they naturally gravitate to investing such funds in long-term, fixed-rate assets. Long-term bonds and mortgages therefore comprise the bulk of the portfolios of the life insurance companies.

While insurance companies do build up savings reserves which form a potentially important source of long-term financing in the region (part of their funds are earmarked for economic development efforts), their investment opportunities have been limited to date as they tend to invest their funds conservatively. Based on a review of available investment data, insurance companies on average hold somewhere between 30-40 percent of their portfolio in mortgages, 10-20 percent in government bonds, 25-30 percent in local deposits, and a miniscule proportion in property and/or in a few corporate shares. The insurance companies are simply protecting the parties they insure by investing their funds in a manner that minimizes risk and provides a reasonable rate of return. The insurance companies have nevertheless demonstrated a willingness to explore any new schemes or instruments devised as part of this Project to channel funds to the productive private sectors.

D. Nature of the OECS Legal and Regulatory Structure

The scope of this engagement did not include an in-depth analysis of the tax treatment of savings, financial assets and financial institutions. Issues such as tax reform, investment incentives, etc. have been covered in other regional and individual country reports. A brief overview of the OECS legal and regulatory structure has nevertheless been undertaken in an effort to highlight the various fundamental constraints inhibiting the efficient functioning of the OECS financial sector and to bring into focus the key issues that must be addressed in order to develop financial mechanisms and instruments designed to facilitate the flow of funds into the private productive sectors.

Legal and regulatory measures are tools by which governments raise revenue on the one hand, and provide mechanisms by which government can mobilize resources in pursuit of public policy objectives on the other. Within the OECS, the formulation, implementation and supervision of laws and regulations as they affect the financial sector is wholly within the local government's jurisdiction and is the responsibility of the Minister of Finance. Exhibit II-7 highlights those laws and regulations of each ECCB member country that impinge on financial institutions and their operations. Appendix A presents a more detailed compilation of relevant laws and regulations for each member country as prepared by the ECCB Research Department.

At a glance, Exhibit II-7 yields the following observations:

- Two countries (Grenada and St. Vincent-Grenadines) have statutory regulations (Money Lending Acts) that govern interest rate ceilings for lending purposes.

- All ECCB-member countries appear to be complying with the minimum rate payable on deposits as set forth by the ECCB (4 percent).

- Three countries (Anguilla, Montserrat, St. Vincent-Grenadines) impose witholding taxes on interest-bearing deposits, ranging from .5 percent to 2 percent. While these taxes, fees and imposts apply across the board to foreign institutions, such restrictions are not generally applicable to local indigenous institutions.

- There is a disparity across countries with respect to the witholding tax on interest, ranging from a 25 percent (Dominica and St. Lucia) to 15-20 percent (Montserrat), with three governments (Grenada, St. Kitts-Nevis, Antigua) having abolished such a tax.

- Different taxes and fees are imposed on the number of commercial bank branches operating within a given national territory.

- The OECS countries have different prevailing rates of corporate income taxes ranging from 35 percent to 50 percent. In addition to being comparatively high, corporate income tax rates appear to be structured in such a way that the effective rate of taxation on the income of financial institutions is relatively higher than on the corporate sector.

- One country (St. Kitts-Nevis) applies a withholding tax of 2.5 to 5 percent on bank loans to aliens.

- Two countries apply a value-added tax on bank services (Grenada 20 percent, Montserrat .5 percent).

LEGAL AND REGULATORY STRUCTURE OF THE OECS FINANCIAL SECTOR

ITEM	Anguilla	Antigua	Dominica	Grenada	Montserrat	St. Kitts/ Nevis	St. Lucia	St. Vincent and the Grenadines
STATUTORY REGULATIONS								
AGREEMENT	1987	1983	1983	1983	1983	1983	1983	1983
BANKING ACT/ORDINANCE	1987	1969	1974	1978	1978	1967	1969	-
RESERVE REQUIREMENTS ON BANKS DEPOSITS (%)	5	5	5	5	5	5	5	5
CASH (%)	1	1	1	1	1	1	1	1
INTEREST RATE PAYABLE OR RESERVE REQUIREMENTS OF BANKS								
LOAN RATE MAX. REGULATION (%)	-	-	-	YES:16[6]	-	-	-	YES: -[6]
DEPOSIT RATE MIN.(1985) REGULATION (%)	4	4	4	4	4	4	4	4
TAX STRUCTURE								
TAX ON INTEREST-BEARING DEPOSITS (%) MAX	1	-	-	-	.5	-	-	2
TAX ON INTEREST (%) MAX	-	(abolished)	25	(abolished) 1986	15 - 20	(abolished)	25	20
TAX ON A PER BRANCH BASIS	-	YES	-	-	-	-	YES	YES
TAX ON FOREIGN EXCHANGE OPERATIONS (%) MAX	2[1]	1	(abolished) 1988/89	5	1.75	2	1	2
TAX ON INCOME (%)	-	(abolished)	35	35[3]	40[2]	(abolished)	45	45
TAX ON BANK LOANS TO ALIENS (%)	-	-	-	-	-	2.5 - 5	-	-
VALUE ADDED TAX - BANK SERVICES (%)	-	-	-	20	.5[4]	-	-	-
DEPOSIT LIABILITIES RATIO - MAXIMUM (%)	-	-	-	-	-	-	-	-
RESERVE FUND RATIO	-	-	-	-	-	-	-	-

1 Class B - banks excepted
2 Gross Profit
3 Net Profit (Business Levy Act)
4 On average deposit balances
5 Grenada and St. Vincent and the Grenadines are the only countries within the OECS to have a Usury Lawa as follows:
Grenada - Money-Lending Ordinance 1984
St. Vincent - Money-Lending Act 1985 (Amendment)

Note: This chart is an update from what is contained in the appendix.
The above information has been obtained fom official documents. No claims are made as to its accuracy or completeness.

EXHIBIT II-7

- Two OECS governments (Grenada and St. Vincent-Grenadines) have regulations that govern the outflow of local currency funds outside their own national territory. Such controls deprive OECS members the advantages of belonging to one monetary union.

- A number of countries have Alien Landholding Laws. These laws restrict or prohibit the ability of "aliens" (which includes persons from another OECS country) of owning a country's "property" (which includes financial instruments). This effectively inhibits the ability of the OECS region to develop or participate in a regional capital market in which equity and debt instruments are traded.

Such a wide divergence in laws and regulations has numerous practical implications for the region in terms of unifying the financial sector and furthering economic development. Many of the recommendations contained in this report are directed at addressing legal and regulatory constraints to developing a well-integrated, OECS-wide financial sector.

E. The Setting of Interest Rates in the OECS Region

1. Introduction

The ECCB has come under intense pressure from member governments regarding the level of interest rates in the region; or, more precisely, the spread between lending rates and the cost of money borne by the region's commercial banks. In the governments' view, lending rates are excessive, particularly in view of the high levels of liquidity in the region, and represent a significant deterrent to the growth of the region's productive sectors. Many believe that the Central Bank should take whatever steps are deemed necessary to reduce the level of lending rates in a manner consistent with the needs of economic development.

For their part, the banks point to a number of factors which, in their view, justify the interest rates they are charging. Indeed, they believe that the current lending rates are necessary to support their operations which, as compared to other regions of the world, are extraordinarily small in scale and generate higher than normal costs. The high liquidity in the region, coupled with a lack of viable investment opportunities, creates additional costs as funds lay idle. The bankers further insist that the Central Bank should refrain from imposing any type of administered controls over lending rates, as such actions would be highly detrimental to the viability of the financial sector, and would create an antagonistic situation for all parties.

A number of studies have been commissioned to analyze the lending rate issue. By and large these studies have concluded that, compared to other region's of the world, the interest rate spreads earned by the commercial banks, particularly the foreign commercial banks, are indeed higher than what might be deemed "normal" in other settings. Additionally, apart from the relatively large spreads apparent in the ECCB area as a whole, there appears to be a significant difference in the interest rate structures among the islands as well as between banks on each individual island. A number of solutions have been proposed to manage the interest rates, ranging from developing a competition policy to implementing various elements of an interest rate policy (statutory or voluntary ceilings on lending rates, open market operations and discount rate changes, moral suasion).

It is beyond the scope of this engagement to conduct an in-depth analysis of the interest rate issue. Based on the input received during the course of our field survey efforts, however, we believe that there is a need to clarify the nature of the problem. Specifically, there appeared to be a lack of understanding regarding the full range of factors that influence the level of interest rates in an economy. It is important to clarify how interest rates that represent the fair value of money are "normally" set in a developed economy, and how those circumstances differ from those of the OECS region. The differences may serve to clarify the dimensions of the lending rate problem and point to the most appropriate range of viable solutions.

It is important to recognize that the lending rate issue is a complex one not amenable to easy or rapid solution. It is important, however, that all parties be clear on the dimensions of the problem and what range of possible solutions are open to policy makers. The objective of this section is to clarify the situation and, in view of the scope of this engagement, does not propose to prescribe solutions. It is not unreasonable to state, however, that the lack of a unified financial sector, a problem rooted in the complex diversity of laws and regulations as they impact the workings of the financial sector, as well as a fundamental lack of competition in the banking sector, in many ways lie at the heart of the interest rate problem, since it renders the financial system unresponsive to Central Bank policy actions. Many of the recommendations contained in this report address precisely the problems lying at the root of the interest rate problem, the implementation of which will tend to produce a more unified and competitive financial sector, thereby creating the conditions within which the Central Bank can affect the level of rates through mainly indirect means.

2. The Setting of Interest Rates in Developed Economies

In developed economies, interest rates representing a fair value of money are set as a result of the complex interplay between a number of factors. These are simplified below to include three basic factors.

First, developed economies possess active, well-organized capital markets open to the world where the supply and demand for funds interact in a relatively unhindered manner. In the United States, for example, there are various organized capital markets where the suppliers of funds interact at "arms-length" with the users of funds. In this type of setting, the interest rates which are "negotiated" between the two parties will tend to reflect the fair value of money at any given time.

Second, the actions of central banks in developed economies have a reasonably strong effect on actual levels of credit in the financial system, and can thereby affect the level of interest rates. The U.S. Federal Reserve Bank (FED), for example, has at its disposal the various instruments required to implement monetary policy, including:

- Open market operations, which affect the composition and volume of commercial bank liabilities.
- Discount rate policy, which affects how much banks have to pay for funds borrowed from other banks.
- Reserve requirements policy, which can be used to regulate the money supply (rarely used).
- Credit control policy, which can be used to impose by fiat levels of interest rates (rarely used).

Importantly, given the relatively dynamic capital markets in the United States the actions taken by the FED have a true economic effect on the supply and demand for money, and the FED can affect interest rates through indirect, market-based means. Furthermore, banks in the United States are very sensitive to changes in the federal funds rate, as it is taken as an indicator of upcoming monetary policies.

Third, the nature of banking practices in developed countries is conducive to the setting of fair-value interest rates, particularly since they are carried out within a highly competitive environment. Specifically, the very process by which banks manage their assets and liabilities will tend to produce a cost of money which fairly represents its value. Asset and liability management is the means through which any financial institution plans, implements and manages the volume, mix, maturity, rate sensitivity, quality and liquidity of its assets and liabilities. The principal task of a bank is to raise funds at the lowest possible cost at an acceptable level of risk and to maximize the use of these low cost funds to achieve the highest possible returns commensurate with the risk taken. This process, linked to a parallel process carried out by the users of funds that seeks to minimize the cost of funds, will tend to result in fair-value interest rates. This is particularly true if highly competitive capital markets exist that provide users of funds with a number of alternative sources of funds.

3. Interest Rates in the OECS Region

Based on the above, it is apparent that many of the fundamental factors that influence the level of interest rates to produce a fair-value cost of money in the more developed economies are currently absent, or are not yet sufficiently developed, in the OECS region. In an effort to clarify the dimensions of the interest rate problem in the OECS region, a number of these missing factors are briefly outlined below.

- A competitive banking and capital market environment does not currently exist in the OECS region.

Prior to 1976, interest rates in the region were directly influenced by the financial markets in the United Kingdom and the monetary policies of the Bank of England. Also, there was freedom of movement of capital within the region, exposing the financial institutions to the strong competitive pressures of the world capital market. The movement of capital is currently circumscribed by a number of legal and regulatory barriers. The termination of such linkages shifted the determination of interest rates from a competitive market environment to the region's banking sector, which is primarily controlled by the commercial banking sector. The level of interest rates also became subject to the liquidity position of the relatively self-contained financial sector.

- The OECS banking sector lacks the competitive pressures necessary to influence interest rates.

Except for a relatively small number of non-bank financial institutions in Dominica, the OECS financial sector lacks the institutional and legal framework necessary to generate the competitive pressures that can affect interest rate levels. Since foreign banks dominate the OECS financial sector and hold

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the largest pool of short-term deposits, they tend to have the greatest influence on the interest rate structure. In effect, they set the bench mark rate for all banks in the region. Simply stated, foreign banks will tend to choose an interest rate structure that will achieve a desired rate of growth of bank resources and a desired rate of return on capital. This involves fixing lending rates at what the market will bear (which will be high when there is a lack of competition) and determining deposit rates in line with the desired growth in bank deposits (which will tend to be low in times of high liquidity).

The indigenous commercial banks, in turn, operate mostly within restricted national boundaries and are unable, due to local regulations and other regional factors, to effectively compete for deposits and lending opportunities within the wider concept of a unified "OECS financial sector". The indigenous banks, in order to compete more effectively, have generally tended to offer deposit rates higher than the going market rates. Such efforts have only been partially successful to date in attracting deposits away from the established foreign commercial banks. There are indications, however, that the OECS banking sector is sensitive to competition. For example, when indigenous commercial banks have lowered mortgage rates in certain OECS countries, the foreign commercial banks have found it necessary to lower their rates to remain competitive.

- <u>The ECCB is not yet in a position to influence interest rates to the same extent as central banks in more developed economies</u>.

As with any central bank in the more developed countries, the ECCB is provided by law with the responsibilities and powers to implement monetary policy and affect the supply and demand for credit in the OECS. The ECCB has, in fact, instituted a number of monetary policy instruments, including the reserve requirement, a minimum interest rate on savings deposits, an inter-bank money market, and a Treasury Bill market. While these policy steps have either had an effect or are off to encouraging starts, they have yet to allow the Central Bank to materially affect the cost and availability of funds within the economy--and hence the level of interest rates--for a number of reasons.

For example, open market operations or the use of rediscount facilities--the most important means available to a central bank to influence credit availability and the level of interest rates in an economy--are not yet significantly effective in the OECS region because the financial sector is not yet sufficiently diversified and open to competitive pressures on the one hand, and simply does not depend on the Central Bank for credit on the other. Another tool available to the ECCB to affect lending rates--its ability to set minimum deposit rates--has also not been fully effective in view of the high liquidity in the region. Until the OECS financial sector develops to the point that the traditional credit control tools available to a central bank can begin more fully to affect economic activity, the ECCB will not be able to materially affect interest rate levels through indirect means.

- Commercial banking practices, coupled with a lack of financial sector sophistication, will tend to produce relatively higher lending rates.

As noted in earlier sections of this report, the responsibility of commercial banks is to safeguard clients' deposits (which are normally short term in nature) while at the same time providing them--and the bank's stockholders--with a reasonable return on their money. As such, commercial banks will tend to execute conservative lending policies, mainly in the area of self-liquidating, short-term commercial transactions. The very fact that commercial bank credit is the predominant source of financing in the OECS region obliges these institutions to carefully manage their credit exposures and assets and liabilities and to minimize interest rate fluctuations to the extent possible. Until such a time that the financial sector gains greater sophistication and alternative sources of finance become available through increased competition, the normal practices of the commercial banks will continue to dominate financial activity in the region, producing higher than normal interest rates.

- The demand for money by private enterprise in the OECS region does not appear to be strong and varied enough to affect the level of interest rates.

Low deposit rates tend to reflect the lack of available bankable projects since a lack of investment alternatives limits the avenues for investing locally-generated funds and fails to provide investors and bankers with an appropriate rate of return. Until such a time that the demand for money by private enterprise becomes greater and more diverse--coupled with increased competition and greater diversification in the financial sector--interest rates will tend to remain at levels set by the commercial banking sector.

4. Proposed Solutions

In view of the nature of the interest rate problem as described above, several proposed solutions have been put forward to address the interest rate issue, with each having its advantages and disadvantages. These can be catalogued as follows:

- Competition policy:
  - Encourage more competition from existing commercial banks and other financial institutions
  - Encourage more competition from new and/or other financial institutions
  - Create a legal and regulatory framework consistent with enhancing competition in the region
- Interest rate policy, or any official action designed to influence the level and structure of rates of interests through a number of means, including:
  - Statutory ceilings (e.g., usury laws and control of money lending)
  - Statutory or voluntary inter-bank agreements on deposit and loan rates
  - Open market operations and discount rate changes
  - Subsidization or regulation of specific rates (e.g., on small savings, export or housing finance)
  - Moral suasion
- Additional considerations include:
  - Reducing barriers to intra-regional flow of funds to better develop the region's financial sector.

The ECCB has already taken a number of important policy steps (creation of reserve requirements, minimum deposit rates, inter-bank and Treasury Bill markets) that, in due course, will tend to affect the cost and availability of credit within the economies, particularly if member governments take a number of concrete steps in an effort to reduce legal and regulatory obstacles that impede the unification of the OECS financial sector.

It is our view that the Central Bank and its member governments should continue to develop the conditions within which interest rates can be influenced primarily through indirect means. Interest rate ceilings and subsidies should not be applied as a matter of policy, as they tend to distort financial markets, introduce rigidity, and inhibit cooperation among OECS Member States. The Central Bank should resort to these only when the pragmatic circumstances of the situation leave it absolutely no alternative course in view of its mandate to protect the public interest.

Furthermore, we believe that the ECCB should endeavor to further refine its interest rate policy, and to develop a comprehensive strategy to properly manage the interest rate issue in the years ahead as the OECS financial sector becomes more integrated and hence more responsive to Central Bank policy actions. This strategy should be developed in line with the recommendations set forth in this report which attempt to better unify the OECS financial sector, to develop new financial instruments, and to promote greater competition in the banking sector.

Throughout this process, it is important that member governments recognize that the ECCB is still evolving in a system where the commercial banks have made decisions solely on the basis of what is good for the banks. With time, and with important adjustments to the financial sector, the Central Bank will be in a better position to effect actions and policies more in line with serving the public and national interest.

III. PROJECT FINDINGS, CONCLUSIONS, RECOMMENDATIONS, AND IMPLEMENTATION STEPS

A. Introduction and Premises

The ECCB and member governments can select among a broad range of actions and utilize a variety of policy and regulatory instruments to achieve the objective of promoting the growth and efficiency of the OECS financial sector and increasing the flow of financial resources into the productive sectors of the region's economies. As indicated in the preceding Chapters, the primary constraints to accelerated financial sector development in the region derive from restricted market size, an inhibiting legal and regulatory structure, and a relative lack of competition within the industry, as well as from constraints and deficiencies within the enterprise sectors of the economies in the region. In our view, there is little to be gained and, potentially, much that could be lost, from the implementation of a financial sector development strategy for the region that is fundamentally premised on regulation by fiat of the existing commercial banking sector.

Rather, we would propose a strategy designed to address directly the constraints imposed by restricted market size and limited competition. Many such constraints go beyond the physical dimensions of the region's economies, and are in fact the result of, or are compounded by, existing legislation and regulation that discourages the growth of regional institutions operating in a more fully integrated regional market. Removing the impediments to regional operations will go a long way towards encouraging the expansion of existing financial institutions and the achievement of greater efficiencies and reduced costs for the users of financial services through diversification in the range of financial products offered and the achievement of economies of scale and of scope. In addition, the ECCB and its member governments can have a direct impact on the competitive environment within the region's financial sector through the facilitation and support of new mechanisms and institutions positioned to provide services that are currently in deficient supply. A number of specific alternative components of a competition and growth-oriented financial sector development strategy were analyzed during the course of the present study. This Chapter presents a synthesis of the findings, conclusions, recommendations and implementation steps for each of these areas as follows:

- o Loan and guarantee facilities
- o Technical assistance and training to the private productive sector

- o Facilities to reorganize, refinance and takeover enterprises
- o Venture capital (equity and quasi-equity instruments)
- o Leasing
- o Foreign exchange risk management measures
- o Clearing efficiency of the OECS banking sector

The findings and conclusions are based primarily on information gathered by the technical experts during an extensive field survey effort orchestrated by the Project Team. Every ECCB member country was visited, and a conscientious effort was made to interview a wide spectrum of public sector officials and private sector representatives. The findings and conclusions also incorporate the results of the Forum on OECS Capital Markets and Financial Institutions held in St. Kitts-Nevis on September 12-13. The Forum convened a representative cross-section of individuals from the governmental, financial and private sectors to discuss the status of the financial sector. A very frank and penetrating discussion was held regarding the preliminary findings and conclusions of the project as presented by the experts. In many respects the Forum served to initiate the all-important process of consensus building with respect to the future direction of the OECS financial sector.

The recommendations and related implementation steps are in turn based on a number of fundamental premises, as follows:

- o There should be a maximum utilization of existing institutions, particularly in the private sector, and minimal establishment or extension of public sector institutions.
- o There should be, to the extent possible, a reduction in the direct involvement of public sector institutions in financial markets.
- o Newly-created public sector institutions should play a catalytic role in the development of a viable financial system in the OECS region.
- o The Central Bank should function primarily as a policy maker, a regulator, and a lender of last resort. It should achieve policy objectives, including being a catalyst for economic development, by increasingly indirect means.

- The development of a unified financial sector in the OECS region will be an essentially long-term exercise. This will require that the region's leadership, both in the public and private sectors, learn through trial and error what will and will not work. A concerted process of consensus building will be required to implement many of the steps necessary to promote the unification of the OECS financial sector.

B. Loan and Guarantee Facilities

1. Introduction

In both developed and less-developed countries, small enterprises have difficulty in obtaining financing from established lending institutions. Many studies have demonstrated that most of these small enterprises commence operations by tapping funds from personal savings or close family. Once this entrepreneur has been able to establish himself, further growth of the enterprise requires funds from outside sources, including the more established financial institutions.

In order to help overcome this difficult transitional step for first-time borrowers or new enterprises, and to minimize a financial institutions' risk in financing such ventures, various credit guarantee facilities have been established in both industrialized and non-industrialized countries. A basic feature of these facilities is that the risks associated with losses is distributed in an agreed-upon proportion between the lending institutions and the guarantor, whoever it may be. Past experience has also demonstrated that for guarantee schemes to operate as they are intended to, they should only be extended to credit-worthy borrowers who have viable projects but who are unable to obtain the required financing because they lack the required collateral.

The main objective of this option paper is to assess the viability of introducing loan and guarantee facilities in the OECS region with a view to increasing the flow of medium and long-term funds to entrepreneurs and thereby stimulate the development of the private productive sector. The introduction of such facilities will take into consideration the requirements and needs of the small- and medium-sized entreprise and encompass the financing of fixed assets, risk and/or working capital, refinancing, etc.

2. Findings and Conclusions

- There is a perception that the financing institutions providing medium and long-term financing in the OECS region do not fully meet the needs of the productive private sectors.

  Medium and long-term financing is presently provided through a variety of local and regional financial institutions, such as the Caribbean Development Bank (CDB) and its local counterparts, the Caribbean

Financial Services Corporation (CFSC), the commercial banks, and the various multilateral agencies. Despite the fact that many entities provide medium and long-term financing, there is a perception that they do not fully meet the needs of the productive sectors. This is because some of these institutions impose limits as to the type of funds they can lend, and oftentimes have stringent collateral requirements. Additionally, institutions funded by multilateral donor agencies are often precluded from providing equity funds or funds for financing the purchase of real estate directly connected to productive endeavors, loan refinancing and working capital needs. And many of these institutions are able to lend only in foreign currencies.

- <u>The financing needs of the large and micro enterprise sectors appear to be reasonably well met</u>.

Large, well-established enterprises usually do not have difficulties obtaining any type of financing to fund their operations. Interviews conducted with the owner-operators of such entities confirmed this fact. Additionally, the micro enterprise sector has been well served by the National Development Foundations (NDFs), which continue to be quite effective in their third year of operation. The main problem faced by the NDFs is obtaining additional funds, which they feel could be readily absorbed by their many applicants.

- <u>The small and medium-sized enterprises (SMEs) face the most difficulties in accessing medium and long-term financing</u>.

The SMEs are the least-favored recipients of medium and long-term financing in the OECS region. There appear to be a number of reasons for this, including:

-- Commercial banks specialize in consumer financing and are not always interested in supplying term financing for capital investment purposes.

-- Commercial banks are generally not geared to provide project financing, so they impose relatively stringent collateral requirements.

-- The development banks have a limited amount of medium and long-term funds to lend, their main source of funding being the CDB.

- -- The development banks are precluded from making certain types of loans for purposes oftentimes required by the small and medium business sector (e.g., cannot make loans to purchase land or provide refinancing).
- -- SMEs oftentimes require loans that are too big for the NDFs and too small for other financial institutions.
- -- SMEs are less likely than larger firms to have available accounting records and other supporting documentation required to obtain a term loan.

Additionally, SMEs have a greater number of obstacles to overcome in their initial stages of development than either micro or large enterprises. For example, project preparation costs are limited for the micro-entrepreneur, while the larger enterprises can access and more easily afford services of professionals or consultants. In view of the difficulties encountered by the SMEs in the OECS region, especially in the area of financing, there is a need for special facilities geared for their needs.

- o <u>It would be useful to establish special credit and guarantee facilities to better service the needs of SMEs</u>.

Three separate schemes are envisioned:

- -- A credit facility designed specifically to satisfy the medium and long-term financing needs of the SMEs
- -- A credit guarantee scheme to ameliorate the relatively stringent collateral requirements required of SMEs
- -- A scheme to access "soft" funds to finance projects of national priority through some form of "credit mixte" process (the blending of aid grants or credits with commercial banking credits).

- o <u>Identifying the most appropriate institution to manage the implementation of these schemes is an important consideration</u>.

The schemes listed above would have to be managed through a central organization which would be responsible for raising the required funds and overseeing their disbursement through the banking system to the ultimate end-users. Two options appear the most viable at this time. One option is to place these schemes with the ECCB. The ECCB could undertake this task in line with its present Charter, which stipulates that the Central Bank may, with the approval of the Council of Ministers, administer or participate in such schemes. The ECCB might operate these schemes, or any combination thereof, in a manner similar to the Export Guarantee Scheme. The Central Bank could also assume a more direct role in implementing such schemes, similar to that of the Central Bank of Barbados.

A second option is to create an Eastern Caribbean Development Fund which could, in addition to other tasks, assume responsibility for managing the implementation of these schemes. Such a fund could provide the region with an effective vehicle to manage schemes of the sort proposed above, as well as other functions associated with the provision of technical and training assistance.

3. Recommendations and Implementation Steps

- Establish a loan guarantee scheme for the OECS region targetted at the special needs of the SMEs.

The objective of this scheme is to provide credit-worthy SMEs that have viable projects and good prospects, but limited collateral, with access to medium and long-term financing at reasonable terms. Key considerations in developing the scheme include:

-- Defining risk sharing arrangements and credit limits

-- Establishing credit evaluations procedure, a fee structure, and procedures for handling claims

-- Identifying appropriate sources of financing; and developing a "secondary market" for guarantee instruments to encourage the further recycling of funds to the SME sector.

As it is fully consistent with its charter, this scheme should be designed and initially implemented by the the ECCB. The operation of this facility should be transferred to another entity in due course. The Central Bank of Barbado's current scheme would serve as a useful model.

- _Explore the need for, and interest in, a special SME loan facility, but do not take concrete steps to establish one at this time_.

It is our view that existing institutions are generally adequate, and current liquidity levels sufficient, to address the special needs of SMEs, particularly if a well-functioning loan guarantee scheme is put in place. To the extent that such a facility is deemed necessary in the future (e.g., due to a change in liquidity conditions), it is not appropriate that the ECCB be charged with responsibility for its design and implementation. A different entity, such as one organized to manage an "Eastern Caribbean Development Fund," would be a more appropriate type of institution to establish and operate such a scheme.

- _Explore the need for, and interest in, a special "credit mixte" facility to provide financing for projects deemed to be of national priority, but do not take concrete steps to establish one at this time_.

Such a scheme would be based on access to "soft" funds through some form of "credit mixte" process (i.e., the blending of aid grants or credits with commercial banking credits). Rather than create such a facility as a first step, it would be more appropriate to determine what constitutes a project of "national priority," and whether existing financing sources are sufficient to fund such projects. To the extent that such a facility is deemed necessary as a result of discussions with regional policy makers, it is not appropriate that the ECCB be charged with responsibility for its design and implementation.

- _Explore interest in, and the feasibility and modus operandi of, a so-called "Eastern Caribbean Development Fund" (ECDF)_.

It is our view that an OECS-based fund of this nature, organized to address region-specific financing issues, may be useful to OECS policy makers' efforts to promote economic development, to the extent its utilization is governed primarily by market-based criteria. A key objective of this fund would be to complement the efforts of the Caribbean Development Bank, particularly in those areas where its capacity to support the financing needs of SMEs, both in terms of debt and equity financing, is limited due to resource and regulatory constraints.

Such a fund could provide the region with an effective vehicle to support special financing schemes such as those discussed above, as well as those functions associated with the provision of technical assistance and training. An entity of this type, rather than the ECCB, would more appropriately bear the responsibility of designing and implementing either a special SME loan facility or a "credit mixte" facility, as described above. Key participants in developing an ECDF would include the ECCB, CDB, NIS managers and, possibly the insurance companies. Potential sources of funds include those held by the NIS and insurance companies.

Exhibit III-1 presents a work program to implement the recommendations in the area of loan facilities and guarantees.

IMPLEMENTATION PROGRAM

LOAN FACILITIES AND GUARANTEES

RECOMMENDATIONS & IMPLEMENTATION STEPS	Lead Implementing Institution	Supporting Institution	Consultant Assistance Envisioned	Donor Agency Assistance Envisioned
1.0 Establish a Loan Guarantee Scheme in the ECCB	ECCB	CBB		To Be Determined
1.1 Get Board Approval to Proceed with Design Efforts				
1.2 Hold Discussion with Central Bank of Barbados (CBB)				
1.3 Design the Loan Guarantee Scheme and Design Business Plan			Yes	
1.4 Get Board Approval to Proceed with Implementation Efforts				
1.5 Implement the Scheme			Yes	
2.0 Explore Interest in/Need for a Special SME Facility	ECCB			To Be Determined
2.1 Select ECCB Staff Member to Oversee Analysis of the Issue				
2.2 ECCB Staff Member Presents Findings/Conclusions at Relevant Fora			Yes	
2.3 Take Further Action, as Appropriate			Yes	
3.0 Explore Interest in/Need for Special "Credit Mixte" Facility	ECCB	OECS Sec.		To Be Determined
3.1 Select ECCB Staff Member to Oversee Analysis of the Issue				
3.2 ECCB Staff Member Presents Findings/Conclusions at Relevant Fora				
3.3 Take Further Action, as Appropriate			Yes	
			Yes	
4.0 Explore Interest in/Feasibility of an Eastern Caribbean Development Fund (ECDF)	ECCB	CDB NIS Insurance Company		To Be Determined
4.1 Select ECCB Staff Member to Oversee Analysis of the Issue				
4.2 ECCB Staff Member Presents Findings/Conclusions at Relevant Fora			Yes	
4.3 Take Further Action, as Appropriate			Yes	

CBB = Central Bank of Barbados
NIS = National Insurance Schemes
ECCB = Eastern Caribbean Central Bank

EXHIBIT III-1

C. Technical and Training Assistance to the Private Productive Sectors

1. Introduction

The main objective of this option paper was to review the adequacy of the technical assistance and training programs presently offered throughout the OECS region by the educational institutions and other local, regional and multilateral organizations. A secondary objective was to determine means through which to better coordinate the educational services available throughout the OECS in order to maximize their impact. An effort was also made to determine those business segments requiring special attention.

2. Findings and Conclusions

- There is a variety of technical assistance and training programs at the multilateral, regional and local levels, with technical assistance being more abundant and more available across business segments than training assistance.

Technical assistance programs are somewhat abundant and were created address the problems of all business segments. Training assistance is more scarce than technical assistance, and the available services are more targetted at the larger enterprises. The key CARICOM/OECS technical and training assistance programs can be categorized as follows:

At the multilateral level:

-- Caribbean Project Development Facility (CPDF)

-- Caribbean Technological Consultancy Services (CTCS)

At the regional level:

-- Regional Management Training Pilot Project (RMTPP)

-- International Executives Consulting Services (IECS)

-- The High Impact Agricultural Marketing and Production Project (HIAMP)

-- Small Enterprise Assistance Project (SEAP)

-- The Caribbean Association of Industry and Commerce (CAIC)

-- The Barbados Institute of Management and Productivity (BIMAP)

In addition to the institutions offering technical assistance and training services at the regional level, there are others involved in promoting business development and encouraging investments into the region. These include: (a) IDCs (Industrial Development Corporations), (b) ECIPS (Eastern Caribbean Investment Promotion Services), (c) OPIC (Overseas Private Investment Corporation), and (d) CCAA (Caribbean Central America Action).

At the local level, organizations providing some technical assistance in the OECS include the national development foundations (NDFs) and the national development banks (NDBs). The NDF's assist micro-business throughout the course of the project life cycle and have been quite effective in supporting the micro sector. The NDB's, on the other hand, assist their clients primarily in the preparation and reviewing of project proposals. They do not work as closely with their clients during the entire project cycle as the NDFs do.

- <u>While there are many technical assistance programs available to all business segments throughout the OECS region, the implementation of the various programs does not appear to have been well coordinated</u>.

The field interviews indicated that the multiplicity of technical assistance programs has resulted in some duplication of effort, thereby reducing the effectiveness and impact of such programs. This may be due in part to the fact that technical assistance programs have not been marketed in a coordinated manner throughout the OECS region. This suggests that a centralized coordinating mechanism established to orchestrate the allocation of technical assistance resources to their most effective use might be a useful consideration.

- <u>Training assistance services have not thoroughly penetrated the OECS region and have not been equally available to all business segments</u>.

Training assistance services in the OECS region are offered primarily by BIMAP, whose activities have to date been limited primarily to Barbados. Due to geographical factors, the services provided by BIMAP to the OECS have been described as

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insufficiently focused. Furthermore, due primarily to financial reasons, it is the larger enterprises that benefit the most from the training services offered by BIMAP.

BIMAP does not meet the needs of the OECS private and public sectors since its services are not available to all OECS member states as extensively and intensively as necessary. BIMAP claims that it does not currently have sufficient resoucers to either establish regional centers or to give as many seminars as it would like. In addition, BIMAP also indicated that the SMEs in the OECS region could generally not afford the cost of the institution's training services. It is clear that regional centers of some type must be set up in the OECS to provide training assistance services on a sustained basis, particularly to the SMEs. BIMAP has indicated a strong interest in exploring any possibilities in this regard.

- <u>SMEs appear to benefit least from the technical and training assistance programs available in the OECS region</u>.

SMEs do not appear to benefit extensively from the available technical assistance and training programs, due to a number of reaons, including cost and geography-related factors. More specifically, SMEs do not appear to benefit greatly from the available training assistance, as BIMAP's services tend to be costly relative to the means the SMEs have at their disposal, and their services are provided mainly in Barbados. And while there are a number of technical assistance programs that the SMEs could access, the cost of these also tends to be a deterrent.

- <u>There is a need to better coordinate, target, and market technical assistance services</u>

Measures need to be taken to ensure greater coordination between the various institutions providing technical assistance and training services, and to direct the available services to those OECS territories and business segments that need them most. A better-coordinated marketing effort of the various programs throughout the region is required as an integral part of the overall process of coordinating these programs.

3. Recommendations and Implementation Steps

- <u>Select a regional mechanism to coordinate all aspects of allocating technical and training assistance in the OECS region</u>.

It is essential that the region's technical assistance and training programs be more effectively coordinated. The OECS Secretariat represents a possible vehicle to carry out this function, as its operating mandate is OECS-specific and seems flexible enough to accomodate the responsibility for managing the dissemination of technical and training assistance in the region. It presently provides technical and human resource development assistance in the region and might therefore be in a good position to assume the responsibilities associated with coordinating the technical and training assistance currently provided by various OECS institutions.

A second possible alternative would be to coordinate technical and training assistance programs through an OECS sub-regional arm of CAIC. CAIC currently has responsibility for implementing major technical assistance and training programs in the OECS under the SEAP Project and could possibly perform this coordinating function. It might also be possible to structure a joint arrangement between this entity and the OECS Secretariat to facilitate both public and private sectors inputs into the process. Discussions should be held with both the OECS Secretariat and CAIC in this regard.

It is also important that a policy statement and implementation strategy be devised to properly carry out coordinating efforts. Irrespective of where the overall responsibility for coordinating technical and training assistance eventually resides, the following types of activities will be necessary:

-- Gaining the support of OECS governments to have a coordinating function for technical and training assistance

-- Determining the specific needs for technical and training assistance in the OECS region, and planning the supply and demand for these services

-- Enlisting the cooperation of, and creatively link its efforts to, those institutions presently providing technical assistance and training services in order to avoid duplication and increase efficiency

- -- Planning and helping to implement the process of creating regional training centers (discussed below)

- -- Mobilizing financial resources as necessary.

- o <u>Increase the access of OECS enterprises (particularly SMEs) to training assistance by establishing regional training centers</u>.

Regional centers which would provide training services to all OECS business segments should be established in selected OECS countries. The establishment of two regional centers, one in the Leeward and another in the Windward Islands, is a logical proposition. These centers could be an extension of the services currently provided by BIMAP, as it has expressed a strong interest in participating in the development of such centers. Discussions should be held as soon as practicable with BIMAP to further establish its interest in such an endeavor.

An all-encompassing implementation plan should be developed outlining who would run the centers, how they would be financed, where they should be located, what the nature of the curricula should be, etc. In developing such an implementation plan, it is important to take fully into account the fact that there are many training skills available in the region which could be drawn on in the process of installing and utilizing the regional centers. For example, the ECCB is itself a resevoir of professional talent, including economists, accountants, and managers, which could readily be tapped to support regional training efforts. This suggests that St. Kitts-Nevis may be a logical choice for the "Leeward" training center.

Exhibit III-2 presents a work program to implement the recommendations in the area of technical and training assistance to the OECS productive private sectors.

IMPLEMENTATION PROGRAM

TECHNICAL AND TRAINING ASSISTANCE TO THE PRODUCTIVE PRIVATE SECTORS

RECOMMENDATIONS & IMPLEMENTATION STEPS	Lead Implementing Institution	Supporting Institution	Consultant Assistance Envisioned	Donor Agency Assistance Envisioned
1.0 Select Central Regional Coordinating Entity	OECS Sec.	CAIC		
1.1 Discuss Concept with OECS Secretariat to get in Principle Agreement				
1.2 Discuss Concept with CAIC to Integrate its Efforts				
1.3 Develop a Policy and Strategy Statement of Proposed Entity			Yes	USAID
1.4 Commence Implementation Efforts			Yes	USAID
2.0 Establish OECS Regional Training Centers	BIMAP	OECS Sec.		
2.1 Discuss Concept with BIMAP to further Determine Interest		CAIC		
2.2 Develop Implementation Plan Specifying Location, Financing, Curricula, Other Elements		ECCB	Yes	USAID
2.3 Commence Implementation Efforts			Yes	USAID

CAIC = Caribbean Association of Industry and Commerce

EXHIBIT III-2

D. Facilities to Reorganize, Refinance and Takeover Enterprises

1. Introduction

There is an almost total absence of finance for the reorganization, recapitalization or sale of existing enterprises in the OECS region. As such, this paper examines the need for special facilities for refinancing, reorganizing and the take-over of companies in financial difficulties. This required an examination of existing financial, legal and management consulting facilities and practices in the region and how other areas of the world address this issue.

2. Findings and Conclusions

- There appears to be confusion with respect to what is meant by the refinacing, reorganization and takeover of a firm, including why and how these operations are carried out.

A refinancing, restructuring or takeover of a company occurs depending upon the perception of the value of the firm as a "going-concern" as opposed to its "break-up" or "liquidation" value. For an enterprise to have value as a "going-concern" it must have a clientele and a market and there must be a potential return-on-assets that, after refinancing, can pay an adequate return-on-equity to owners and market interest rates to creditors. In many instances this is impossible and the company is worth more through a liquidation than as a "going-concern".

Furthermore, there is no standard way in which such operations are handled. Transactions are tailored to fit the circumstances. Terms such as "refinancing" or "reorganizing" are imprecise. For example, "refinancing" may mean the renegotiating of the terms of a loan with the borrower, or paying off one borrower and arranging another. Sometimes "refinancing" is part of a normal business, with no implication of financial difficulty, such as when a real estate developer substitutes a short-term construction loan from a commercial bank by a long-term "take-out" mortgage with an insurance company. Often no new funds are involved, simply a modification of terms, rates, collateral and other details. "Reorganizations" may involve agreements to appoint certain persons as directors, and commitments to carry-on business in accordance with certain guidelines.

- <u>Special facilities for the refinancing and reorganizing of firms do not normally exist because they are not necessary to carry out such operations</u>.

Special facilities for such operations usually do not exist. In highly developed financial markets, corporate refinancing and reorganization is an arcane, specialized task applicable to a small fraction of companies in financial difficulty. Solutions are tailor-made, using ordinary financial instruments and the talents of investment bankers, lawyers, appraisers and other consultants. Formal financial mechanisms and special "facilities" are not required. It is true, however, that in major world financial markets, certain investment bankers may specialize in these transactions and advertise their expertise, giving laymen the false impression that a formal lending facility is involved.

- <u>There does not appear to be a need for a special facility to execute such operations as adequate funds are available in the OECS region for viable proposals.</u>

Generally speaking, if anyone should put together a bankable proposition, supported by good management capability, there is no reason to believe that funds would not be available as anywhere in the world.

- <u>There is more of a need for negotiating skills, patience and financial and legal acumen than funds to execute such operations</u>.

The investment banker may be confronted with many conflicting and competing parties, a highly emotional atmosphere, and often times, unreasonable demands. Negotiations usually take months and sometimes years. Due to the human factor, it is sometimes as difficult to handle a very small deal as a large one. Smaller firms often cannot afford the services of experienced investment bankers and usually rely upon local commercial bankers, lawyers or other consulting services.

- <u>The very nature of the economic activity of the OECS region limits the need for a special facility to handle refinancing, reorganization and takeover operations</u>.

Tourism, tropical agriculture and residential real estate are the major economic activities in the OECS region. The financing of hotels, farms and homes falls into a special category and, unless large and complex enterprises are involved, such ventures are usually not considered appropriate for the type of special corporate financing under discussion.

Additionally, most other commercial, service or industrial firms in the region are too small for such complex treatment. Such operations normally have a single proprietor, minimal accounting data, and extremely thin margins of equity. Furthermore, such firms would not normally have any "going-concern" value and must be sold for whatever the assets will bring in in the case of financial difficulty. The purchaser of such an enterprise would usually expect a discount price and full financing by the seller. As such, ordinary legal procedures of liquidation and receivership as currently available in the OECS region are sufficient and appropriate.

Furthermore, much of the financing of the development banks and national foundations within the OECS region is in effect personal credit, hardly the object of corporate finance in case of problems. For example, two-thirds of the development loans of the Grenada Development Bank in 1986 were for under EC$ 10,000. Only three were for over EC$ 100,000. There seems to be few industrial or commercial enterprises which have the size and "going-concern" value that might be eligible for reorganization or takeover financing. These are usually the leading businesses in each OECS country which not only have sound financial positions but also are avidly solicited by commercial bankers as clients.

- <u>Refinancing and reorganization efforts require an organized stock market</u>.

Without an organized stock market in the OECS region and with few large companies, there is no call for a special financing facility for takeovers. The financing of the sale of small businesses is handled, as in most developed markets, by seller financing.

- <u>The professional ingredients to carry out such operations are readily available in the region</u>.

In the region, there are offices of international consulting and accounting firms and commercial banks that can bring together the necessary know-how and funding to refinance, reorganize or sell any local venture which is worthwhile. These, essentially, are the same elements that would be available to a businessman in the United States, Canada or the United Kingdom. As such, the absence of a formal facility/program for refinancing, reorganizing or takeover of firms that are in financial difficulty does not appear to be a serious problem in the region and thus no special action should be contemplated.

- <u>There is no manifest need for a special facility or program for refinancing, reorganizing or takeover of firms that are in financial difficulty</u>.

This option paper was undertaken with the assumption that since there was no formal program in the OECS for refinancing or reorganizing companies in financial difficulty, that such a program might be useful. While there is evidence of many firms in financial difficulty, it is not clear that any appreciable number of these firms have no other options and would be suitable candidates for a special facility of this type.

3. Recommendations and Implementation Steps

Since special facilities to reorganize, refinance and take over enterprises are not warranted in the OECS region, no special program is proposed.

E. Venture Capital

1. Introduction

Bankers in the OECS region have frequently cited cases where apparently sound loans have to be declined because of a too thin equity capital base. An important objective of this study was to determine the frequency of this particular obstacle and to structure, as possible and appropriate, alternative arrangements for providing additional equity and quasi-equity capital to businesspersons in the ECCB member countries. As such, the topics examined to develop this option paper included:

- The reduction of barriers to the intra-regional flow of investment funds
- The need of start-up companies for seed capital and management assistance
- Current sources of equity financing
- The feasibility of a regional capital market or stock exchange
- The role of the national development banks as sources of capital
- The possible application of venture capital financing in the region

2. Findings and Conclusions

- There are a number of fundamental factors that must be present for venture capital to work.

In order for a venture capital operation to work, at least three things must be present:

- -- There must be a supply of high-potential new businesses in the market
- -- There must be an active securities market where successful investments may be sold at a profit
- -- There must be entrepreneurs who are willing to work in a company in which they are not, in fact, their "own bosses"

Other factors of great importance include a legal and regulatory environment conducive to business development and ample sources of venture capital funding.

- <u>A number of misconceptions were discovered regarding the definition and role of banks, capital markets and venture capital</u>.

There was a frequent misreading of the position and role of commercial banks, confusing banks with development institutions. Commercial banks are deposit-taking institutions whose principal responsibility is to protect their depositors' funds and to produce profits for their shareholders. As such they tend to make loans of a short-term nature for self-liquidating, commercial transactions. Development banks are institutions normally created by government to make available non-depository funds on a long-term basis to finance the accumulation of fixed assets in a manner consistent with public policy priorities.

There is a large difference between deposit banking, which is the predominant activity of the OECS financial sector, and investment banking, which is a special type of banking operation designed to supply equity and long-term loans to business ventures and requiring an active market for stocks and bonds. The activities of the investment bankers and commercial bankers are different in many respects and rarely do commercial bankers serve as effective investment bankers.

The term "capital market" meant different things to different people in the OECS region. A capital market is an organized market for trading securities designed to produce a fair balancing of the interests of suppliers and takers of equities and other instruments. It is not an all-encompassing method by which entrepreneurs raise funds, including short- and medium-term bank loans and private deals with partners.

The term "venture capital" was often misdefined as a type of low-interest, contingent loan that is only repaid if a new venture goes well. Venture capital is funds put up by a special type of investor whose purpose is to provide equity financing to the start-up ventures of untested entrepreneurs with the expectation of getting a very high return in a relatively short time frame. The venture capitalist, as a special type of investment banker, differs significantly from a development banker in that he is not restricted by arbitrary rules as to what types of investments he can make, and is not expected to pursue objectives tied to public policy priorities (e.g., the generation of employment and foreign exchange).

- <u>There appears to be a shortage of qualified takers of venture capital in the OECS region</u>.

With few exceptions, bankers, development bankers, leading businessmen, officials of chambers of commerce and public accountants reported that a qualified entrepreneur would have no more trouble raising funds in the OECS region than in any other market. Despite the availability of funds, CFSC and HIAMP report a shortage of qualified applicants. CFSC, although established to make equity investments, had by its fourth year directed most of its resources to loans. One St. Kitts-Nevis bank stated that equity funds made available through the European Investment Bank (EIB) were not being utilized due to a lack of takers. In contrast to venture capital funds in the United States, neither of these companies had a glut of business plans from which to choose--the doors of both these operations are always open.

The lack of new venture financing would therefore appear to reflect a shortage of qualified takers, not funding. This is not to say that current sources of funds are sufficient relative to goals of economic development, but rather that they are more than adequate relative to current absorptive capacity.

- <u>A lack of entrepreneurs is an important reason why there is limited use of available venture capital funds</u>.

There are many reasons why current applicants are not considered qualified. From comments of bankers and businessmen, the following common arguments for turning down a request for funding:

-- Unsuitable credit histories and attitudes

-- Lack of management depth

-- Lack of adequate collateral

-- Lack of financial sophistication

-- Lack of entrepreneurial capability

The issue of entrepreneurship in many ways lies at the heart of the problem of not having sufficient qualified takers to make use of available venture capital funding. It has been duly noted by many informed persons from the region that the OECS lacks sufficient entrepreneurs.

A number of factors associated with the nature of the OECS economies has been identified as inhibiting the development of entrepreneurs, including small size, high labor costs, limited movement of workers, etc. Another major factor influencing a potential entrepreneur to choose a non-business career or decide to emigrate while still young that is seldom mentioned is the lack of management training programs with prospects for advancement. Many entrepreneurs start by working for an established company to learn more about business. If most enterprises in the region are small, family-owned firms, there is little to hold ambitious, talented people.

Large, professionally-managed enterprises with diversified ownership are important incubators of business talent. Such firms, even if unrelated to classical development goals of import substitution and foreign exchange savings, can be as important to economic growth as universities or business schools. Therefore, any measures which encourage larger, widely-held enterprises might be regarded as useful to retain talent in the region and to encourage the formation of new businesses.

- <u>In addition to making entrepreneurial training available, the best way to address the entrepreneurial problem is to provide a business environment which attracts and utilizes valuable entrepreneurial talent</u>.

There are three basic approaches to the entrepreneurial problem. The first is to provide easy access to funds in the hope that some worthwhile businesses will be created, with entrepreneurship being fostered as a consequence. This is essentially the path being followed today by many of the development banks in the region. A problem is that such an approach is self-limiting as bad or indifferent investments deplete available funds. Sooner or later the losses are absorbed by the public sector, resulting in higher taxation and renewed appeals to international development agencies. The practice of supplying financing while overlooking the defects of management also sends the wrong message to would-be entrepreneurs.

The second is to provide training in entrepreneurial skills to people who want to go into business. A problem with this approach is that its effectiveness is uncertain. Business skills such as accounting, office management, and sales are essential to the success of an enterprise. However, such skills are not equivalent to entrepreneurial talent. Most people with business skills are not entrepreneurs. The ability to conceptualize and start a new venture in the face of great uncertainty is more a matter of personality and attitude than special know-how. Efforts at general entrepreneurial training, such the young peoples' program at the St. Kitts-Nevis Chamber of Commerce, should nevertheless be encouraged. It would also be useful to include entrepreneurial subjects in local management courses. However, unless such measures are nurtured in an open business environment with the development of entrepreneurial role models, they are likely to bear little fruit and will tend to lead to more emigration.

The third is to provide a business environment that attracts and utilizes valuable entrepreneurial talent. The available evidence indicates that this is a more effective means of fostering entrepreneurship than either the availability of special funds or training and will tend to lead to better, more sustainable results. An important component of a strategy to foster a better entrepreneurial climate in the OECS region is to create a framework for the development of large, private, open enterprises with trans-regional and international operations, without necessarily attempting to define the specific activities of these entities. An attempt to define the activities of such an entity would restrict competition and discourage the innovative environment in which entrepreneurial activity flourishes. It would serve to encourage, however, the reorganization of existing businesses, including commercial and service activities, in a manner more consistent with the needs of regional and world markets. An important result is that these entities would serve as training ground for entrepreneurial and managerial talent, helping to retain these skills in the region.

- <u>An independent capital market or stock exchange is not currently feasible in the OECS region</u>.

The conditions are not currently present that would allow the OECS region to develop either an internal capital market or one tied to the world capital market. The OECS regional economy is too small to support an independent, internal capital market that would have a significant impact on economic development. This is because there would not be enough investors internally to maintain an independent, liquid market. And in order to act as a feeder into the world capital market, an OECS Stock Exchange would have to generate a sufficient volume of securities to merit the attention of international investment managers. The small size of the OECS economy again limits the region to participate in world capital markets in such a manner. Additionally, successful participation in the world capital market requires freedom of exchange controls, lack of barriers to transfer of ownership, and fair, non-discriminatory treatment of foreign investors. Many of these pre-conditions are not currently present in the OECS region.

Since some companies in the OECS region have public shareholders, access to the Barbados Stock Exchange would be useful. But the Barbados Exchange currently operates behind a wall of foreign exchange controls. OECS companies would need to make special arrangements with the Central Bank of Barbados in order to have their securities traded and would also have to come to terms with their own alien land laws. The combined population of the OECS and Barbados would nevertheless not be sufficient to create a significant internal regional capital market. The prospect is even more unlikely with the area compartmentalized by foreign exchange regulations, alien land laws and conflicting tax regulations.

It is theoretically possible that the OECS could be the home of a capital market serving the wider region, such as the entire Caribbean. However, restrictions on foreign capital and labor would have to be removed, communications and transportation improved, and resolution of disputes would need to be under a court system that has the confidence of foreign investors.

The lack of a regional capital market is not necessarily a disadvantage. Most places in the world do not have a local stock market that is of any importance. Rather, the norm is to rely upon the financial services of a few major centers such as New York, London or Hong Kong. The OECS already does this--the capital of large foreign banks in the region is traded on the London and Toronto exchanges. In practical terms the question is not how to create an internal market, but how to use world markets more effectively.

- <u>The best available way to deal with the problem of no organized capital market through which venture capital can be recycled is to develop strong linkages with world financial markets</u>.

Perhaps the most effective way to open regional capital markets to the world is for the OECS region to work through the Barbados Stock Exchange. The intent would be to foment greater liquidity and better prices for local equities. The long-term objective would be for the OECS to form a single capital market with Barbados and to have this market freely open to the world.

Opening up the Barbados Stock Exchange to world capital markets would contribute significantly to the liquidity of the Exchange; that is, it would tend to generate a sufficient level of buying and selling of stocks to affect their prices in a constructive manner. To the extent that a sufficient level of liquidity in the Barbados Exchange can be generated, it is likely that stocks would come to be traded above book value (stocks on the Exchange traded at about 55 percent of book value in 1987).

And if a venture capital firm were able to keep losses to reasonable levels of book value in a sufficiently liquid exchange, a healthy venture capital fund would be possible.

The ECCB could work together with the Central Bank of Barbados to open regional capital markets to the world. Local governments should encourage the listing of larger OECS companies on the Barbados Stock Exchange, while arranging with the Barbados Central Bank that portfolio investments in stocks be exempt from OECS alien land laws or other restrictions on the free transfer of securities. This policy should have two objectives that would make venture capital operations feasible:

-- Prices on the Barbados Stock Exchange (including the above-mentioned OECS stocks) should be at least double the current level in terms of earnings

-- Volume of trading on the Barbados Stock Exchange of the OECS stocks should be at least US$ 3 million per stock per year, or about four times current liquidity levels.

o <u>The multiplicity of differing laws and regulations throughout the OECS region is a major deterrent to economic development, the development of a unified financial sector, and the effective use of venture capital as a means of assisting start-up ventures</u>.

Legal and regulatory barriers currently in place throughout the OECS region tend to encourage local, protected micro-businesses and dissuade larger, competitive organizations with the depth of management, sophistication and market scope needed to access capital markets. Laws exist that hinder the free flow of labor and association of capital. A number of regulations also impede efficient, region-wide operations. Additionally, OECS fiscal rules give precedence to duties and front-end taxation that increase the need for equity of an island venture as compared with similar businesses in large, developed nations. The multiplicity of differing laws and regulations across the OECS region are a major deterrent to progress and economic development generally and the development of a unified financial sector in particular.

Specific factors hindering the flow of intra-regional funds can be summarized as follows:

-- Geographical barriers including distance, less than efficient transportation links and costly

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communications

- -- The OECS region is divided into eight tax jurisdictions requiring that special arrangements be implemented to conduct business across the OECS countries (e.g., accounting systems that have to take into account the peculiarities of eight separate countries).

- -- Alien land laws require special permits and impose extra taxation on citizens of one island who do business in another. Some alien land laws require government approval of any transfer of equity or debentures to a national of another island and even regulate aliens acting as corporate directors.

- -- Work permits that further restrict business expansion across the islands

- -- A business that expands to another island becomes subject to another legal jurisdiction.

The net effect of these barriers is that they create a business climate which places enterprises in the OECS region at a competitive disadvantage to others in the world market, and greatly limit the utilization of venture capital as means to funding start-up operations.

o <u>There are ample sources of venture capital funding available in the OECS region</u>.

There are two venture capital enterprises located in Barbados that serve the OECS region: the Caribbean Financial Services Corporation (CFSC) and the High Impact Agricultural Marketing and Production (HIAMP) Project. The first has assets of US$ 10.5 million and the second has access to US$ 12 million. The US$ 22.5 million in potential venture capital and/or debt financing with equity component available through these two firms is, relative to the population, over five times the funds available in the United States through Small Business Investment Corporations and over 50 percent of the total U.S. venture capital funds of all types.

Additionally, long-term loans to new ventures are available from the Caribbean Development Bank (CDB), directly and indirectly through the national development banks. The European Investment Bank (EIB) also has made equity funds available in the past and is currently considering an additional line of US$ 3.5 million for the region. Development funds are also available to entrepreneurs from a variety of public and private programs in

Canada, the United States, and the United Kingdom.

There is no organized securities market in the OECS region. Consequently there are no venture capital companies that operate in the same way as those in the United States. Without an active and broad securities market, and with restrictions on foreign capital impeding access to world capital markets, it is not clear how these various entities offering venture capital would be able to recycle their funds.

- <u>A special type of enterprise--the OECS Corporation--could be created as a means to addressing all factors currently impeding the development of venture capital operations in the OECS region</u>.

It is suggested that, in order to more effectively address the various impediments to developing venture capital operations in the OECS region, efforts be concentrated on encouraging OECS entrepreneurs and businesspersons to join together in larger, more efficient, trans-OECS enterprises possessing the depth of management needed to access world financial and equity markets, while reducing the need for equity by changing the methods of collecting tax revenues.

The pooling together of business resources in this manner would result in new ventures that could make effective use of venture capital resources currently available in the region. Larger business entities also serve the important function of acting as incubators for managerial and entrepreneurial talent, while providing investors with firms of a size that can attain liquidity in the stock market and consequently, equity prices that are above book value, thereby making venture capital operations possible.

A special type of enterprise--the OECS Corporation--could be subject to a model law and could be authorized in any country in the OECS. The OECS Corporation could benefit from the CARICOM Enterprise Regime, which it could complement by providing a practical framework for joining investors in different countries.

Four special objectives of the OECS Corporation would include:

-- <u>Reduced capital requirements</u>: Equity needs in the OECS include high import duties (sometimes called "consumption taxes" or "value-added taxes") which are due on most assets essential to establish and run a business. The OECS would permit the deferral of such taxes and duties with payment contingent upon profits.

-- Uniform operations: Multiple jurisdictions and many government approvals and licensing increase the cost of doing business and impede innovation. The OECS Corporation would have uniform treatment throughout the region in many respects (e.g., free movement of workers using only ID cards).

-- Freedom from exchange controls: The OECS Corporation would be free to maintain foreign exchange assets. The corporation would be able to issues debentures or shares denominated in any currency. The ECCB would not support foreign exchange availability for such corporations. These provisions would facilitate access to international capital and financial markets.

-- Freedom to specify legal jurisdiction: The corporation would be able to specify for disputes among shareholders, classes of shareholders, or bondholders prior to issuing such instruments.

The OECS Corporation should not be considered a "fiscal incentive," or special privilege, but rather a practical commercial vehicle for anyone able to meet minimum capitalization requirements (e.g., EC$ 100,000). The OECS Corporation simply represents a way to reorganize firms into more efficient configurations and encourage the creation of larger enterprises that provide role models for would-be entrepreneurs and serve as sources of practical management training and vehicles to attract capital.

- As the situation currently stands in the OECS, there is little prospect to applying venture capital financing in the region.

As has already been noted, many informed observers in the OECS point to a lack of new business opportunities, or bankable projects, in the region. The problem is not one of funding, but of having sufficient takers of currently available venture capital funds. Additionally, there is no organized securities market in the OECS region. Without an active and broad securities market, it is not clear how venture capital firms will be able to recycle their funds. Furthermore, there is a lack of entrepreneurial talent in the region. Given the current situation, a rational entrepreneur will in most cases choose a non-business career or emigrate while is still young. This is not to say that there is an absolute dearth of business leaders in the area, but rather that the opportunities open to the entrepreneurs in the region are as yet underdeveloped.

All these factors would seem to indicate that there is little possibility of effectively applying venture capital financing in the OECS region. There are, nevertheless, a number of concrete steps that could be taken to address these problems, as outlined below.

3. Recommendations and Implementation Steps

- Assess the applicability and feasibility of an OECS Corporation.

Four steps are recommended in this regard:

-- Consensus Building: Before proceeding to the technical implementation of the OECS Corporation, a consensus should be created in the private and public sectors of the region that such a measure is worthwhile. The Central Bank should play a lead role in encouraging discussion groups among those who wish to participate constructively. The seminar held in St. Kitts-Nevis on September 12-3, 1988 could be considered the first step in this process.

-- Fiscal Analysis: Considering recommendations made during the consensus-building phase, a group of experts in taxation, fiscal policy and financial markets should project the impact of of the OECS Corporation on regional public finance, elaborating a detailed tax plan for the OECS Corporation and the financing of deferred revenues.

-- Legal Analysis: A team of lawyers, in conjunction with financial experts, basing their work on proposals developed during the consensus-building phase and the fiscal study, should prepare a draft of the OECS Corporation model law to be promulgated by each country in the region. A sub-section of this study would be to work with Barbadian officals on removing foreign exchange and other barriers to listing OECS Corporations on the Barbados Stock Exchange.

-- Consensus Ratification: Under the leadership of the Central Bank, the fiscal study and model legislation should be revised and reviewed by business and government groups throughout the region. Final changes in the model law should be made and then the Central Bank should formally propose the legislation as a model to be adopted by countries in the region.

- <u>Take steps that would allow OECS companies and investors to access organized regional stock exchanges linked to world markets</u>.

A primary consideration in evaluating the possibility of creating an OECS Securities Exchange is market liquidity. Investors require not only access to high-quality securities offering attractive returns, but the ability to liquididate an investment, when necessary, relatively quickly and at a fair price. It would take considerable time for an OECS Stock Market to develop the liquidity needed to attract a significant level of investment.

An alternative readily at hand is for the OECS governments and the ECCB, as part of the process of reviewing the viability of an OECS Corporation, to attempt to facilitate access to existing securities exchanges in the region for OECS companies that wish to have their stock or other securities listed and traded. A reasonable first step would be to arrange for such OECS companies to be listed on the nearby Barbados Stock Exchange. OECS companies would have to be informed of listing requirements set by the Barbados Stock Exchange, and assistance could be provided them in preparing disclosure statements and in complying with whatever accounting standards might be required. Listing on an established exchange in the region would be a productive first step in providing OECS companies with expanded access to capital.

A second necessary step would be to arrange for brokers located in the OECS countries to be seated on the Barbados Exchange. Technical assistance may again be required to enable newly-established OECS brokerages to comply with the requirements set in Barbados to qualify members and ensure that the public is served by brokerages that have the requisite technical competence and integrity. Prices of OECS securities could be quoted in EC dollars, and those of Barbadian securities in Barbados dollars. Lack of investor confidence in convertibility, to the extent that it existed at any given time, could restrict the volume of cross-currency trading, but would not limit the ability of OECS investors to invest in OECS companies or the ability of Barbadian investors to invest in Barbadian companies. Over time, the convertibility question and the limits it might impose on the overall growth of trading volume can and should be addressed through appropriate monetary and exchange rate policies.

It is important to note that this recommendation--taking steps to allow OECS companies and investors to access organized regional stock exchanges linked to world markets--does not necessarily rule out the creation of an OECS Stock Exchange. Rather, the fundamental objective of this effort is to provide OECS companies with access to organized exchanges for equity financing purposes, as well as to provide venture capitalists with a mechanism to recycle their investments. This does not necessarily require that an OECS stock market be created as a stand-alone entity as a first step, to subsequently be linked up to Barbados and world exchanges. Efforts to list OECS companies on the Barbados Stock Exchange, and to organize the Barbados Exchange so that it can be integrated with world exchanges, could be initiated as a first step and need not wait for the creation of a OECS Stock Exchange. To the extent that an OECS Stock Exchange is created as part of this effort, it is important that it be designed and implemented with the fundamental objective of becoming integrated with the Barbados and world stock exchanges, as it is not likely to be a viable undertaking on a stand-alone basis.

We therefore recommend that discussions be held at the OECS level and then with the Barbados Stock Exchange to obtain an in-principle agreement to assess the viability of OECS companies accessing the Barbados Stock Exchange and developing an OECS Stock Exchange, as appropriate. If agreed, the objectives and scope of a study should be developed, and an implementation plan devised and executed, as appropriate. Implementation efforts should include the training of people in the OECS region in the skills associated with trading stocks as a prerequisite to having brokers located in the OECS countries to be seated on the Barbados Stock Exchange.

Exhibit III-3 presents a work program to implement the recommendations in the area of venture capital.

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IMPLEMENTATION PROGRAM

VENTURE CAPITAL
(EQUITY AND QUASI-EQUITY INSTRUMENTS)

RECOMMENDATIONS & IMPLEMENTATION STEPS	Lead Implementing Institution	Supporting Institution	Consultant Assistance Envisioned	Donor Agency Assistance Envisioned
1.0 Assess Applicability and Feasibility of an OECS Corporation	ECCB	OECS Sec.		
1.1 Initiate Consensus Building Process		Caricom Sec.		
1.2 Conduct Fiscal Analysis, As Appropriate		CBB	Yes	USAID
1.3 Conduct Legal Analysis, As Appropriate			Yes	USAID
1.4 Initiate Consensus Ratification Process, As Appropriate			Yes	USAID
2.0 Develop Access to World Markets through Regional Stock Exchanges	ECCB	OECS Sec.		
2.1 Discuss Concept at OECS Level to Obtain in Principle Agreement to Proceed		CBB		
2.2 Discuss Concept with Barbados Stock Exchange to Obtain in Principle Agreement to Proceed		BSE		
2.3 Develop an Implementation Plan			Yes	USAID
2.4 Commence Implementation Efforts			Yes	USAID

CBB = Central Bank of Barbados
BSE = Barbados Stock Exchange

EXHIBIT III-3

F. Leasing

1. Introduction

This paper explored the possibility of introducing "lease financing" as an alternative to "bank financing" in view of the current reluctance of commercial bankers to lend to thinly capitalized firms in the region. Lease financing is also reviewed in the broader context of advancement and economic development of the OECS region through the promotion of a more efficient and unified financial marketplace. This involved and examination of the following:

- A review of the various types of "lease products" currently in use in mature economies and the selection of such instrument as a viable alternative to financing
- The economics of "lease financing" both from the perspective of both the lessor and lessee
- The identification of specific sectors where leasing could be applied in the OECS region
- The review of the OECS's taxation laws as it affects the establishment of such a facility
- An examination of current laws relating to secured (collateralized) financing and the need for laws for such instrument
- The accounting implications of lease financing in the lessor's and lessee's balance sheets.

2. Findings and Conclusions

- There appears to be a lack of understanding in the region regarding the nature, benefits and methods of leasing.

The concept of leasing did not appear to be well understood in the OECS region. This could be due in large part to the "ownership psyche" which is strongly ingrained in the mind of Caribbean citizens, and the fact that there has been no significant leasing activity in the region in the past.

Conceptually, a lease is contract by which one party conveys the use of an asset to another for an agreed term at a specified rental. The notion of "use" rather than ownership is more than

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2,000 years old. Using equipment rather than owning it allows businesspersons to focus on what the equipment should be doing for them (producing profits) rather than to them (exposing them to the risks of ownership).

The benefits of leasing were also not clear to a number of companies. By leasing, a company can:

-- Avoid the many risks associated with ownership

-- Allow specialists to take care of buying and selling equipment

-- Better manage technological obsolescence risk

-- Increase operating flexibility in the face of business cycles

-- Shift market risks (changes in supply and demand) that can affect the value of equipment

-- Avoid financial risks associated with holding loans for equipment

-- Help a company conserve cash, which is particularly important in start-up ventures

-- Keep a balance sheet free of debt.

There was also limited understanding with respect to the types of "lease products." There are five basic types of leases:

-- Full Pay-Out Finance Lease (FPFL): The lessor (an individual or company who buys the equipment and leases it to a user) recovers his entire investment during the life of a lease through the receipt of rentals.

-- Lease with a Purchase Option: The lessor recovers fully his investment in the cost of the equipment during the term of the lease through the receipt of rentals plus an agreed-upon purchase price option.

-- Lease with Third Party Put: Same as a lease with purchase option, except that the purchase price option is guaranteed or insured by a third party.

-- Operating lease: Leases where the lessor maintains, pays taxes and insurance premiums.

-- Sale and Lease-Back: A transaction by which a lessee sells his assets and leases them back for a certain period at an agreed rental.

o The demand prospects for leasing in the OECS region do not appear wholly unreasonable at this time.

There are a number of sectors in the OECS region that are amenable to lease financing. Transportation is a promising sector as distribution is a major activity in the islands. Trucks, containers, and passenger ships are good leasing candidates. In the tourism sector, tourist buses could readily be operated on a lease basis by tourist operators with a centralized facility provided by lessors. The construction sector is also quite active in the OECS region. Mobile concrete mixers and excavators are good targets for lease financing. While the manufacturing sector is not as well developed as the other sectors, the building of "factory shells" might be constructed and then leased to assemblers of electronics, apparel, etc.

A preliminary survey of the OECS region indicates that the most promising areas for developing lease financing include:

-- Antigua & Barbuda: Construction equipment, automobiles and refrigerated trucks, passenger boats, tourist buses

-- Dominica: Trucks (to transport bananas)

-- Grenada: Trucks (to transport spices)

-- St. Kitts-Nevis: Manufacturing shells and mini-vans

-- St. Lucia: Construction equipment, trucks, concrete mixers, refrigerated trucks

-- St. Vincent-Grenadines: Passenger mini-vans

It is important to note that a more detailed analysis regarding the full extent of the demand for leasing is in order. It is not unreasonable to state at this preliminary stage, however, that there could be a sufficient level of demand to sustain leasing activities in the region, subject to the removal and/or adjustment of a number of laws and regulations, as noted below.

- <u>A number of adjustments need to be made to the OECS legal and regulatory structure in order to accomodate the use of leasing in the region.</u>

The fiscal and regulatory framework in the OECS region is not conducive to the development of leasing as a viable means to promoting the development of the productive private sectors. Current tax laws in the OECS are not uniform and form a major impediment to developing leasing in the region. More specifically, tax laws in the OECS countries are silent as to what benefits are to accrue to the owner in instances where the owner and the end user are distinct entities. For a lessor to assume all risks associated with leasing, it is essential that such party get the depreciation benefits to make lease financing attractive. Whether a contract is a "Lease Contract" (where the risk ownership rests with the lessor), or where a contract is a "Conditional Sale Contract" (where the risk of ownership rests with the lessee), the distinction should be clearly defined under the tax laws.

The following types of fiscal elements must be examined and adjusted in a manner consistent with fundamental leasing economics: accelerated depreciation, capital allowance, tax rulings regarding the nature of "Lease Contract." Under the CARICOM Scheme for the Harmonization of Fiscal Incentives to Industry, the issue of accelerated depreciation and tax rules governing lease financing may require updating. Additionally, a framework of lessor's and lesse's rights must be established. A universal commercial code must be also developed as one does not currently exist.

More generally, OECS tax laws need to be standardized and redefined to allow leasing to work. In order to accommodate leasing as a financial tool for the recycling of funds into the private productive sector, a number of changes would have to be made to the legal and regulatory structure of the OECS region. The types of adjustments that need to be made include:

- Changes to the capital allowance
- Definition of rules for a "Lease Contract"
- Removal of customs duties, excise taxes, import restrictions, etc. for leased equipment throughout the region with a view to creating a larger secondary market
- Provision of tax holidays to encourage utilization of certain types of equipment.

- The absence of a "secondary market" for equipment is an important impediment to the development of lease financing the OECS region.

The success of leasing depends greatly on the ability of the lessor to sell used equipment once it comes off the original term lease. A secondary market must be present for the lessor to dispose of the equipment in case he is not able to re-lease it. Such a secondary market does not currently exist in the OECS region.

A secondary market for leased equipment could developed in the OECS region if lessors were able to transport leased equipment freely within the OECS region. For example, the owner of construction equipment in one jurisdiction should be able to lease such equipment to another party in another jurisdiction within the region when economic circumstances change in that locality.

For a healthy secondary market to develop, the OECS governments would need to adopt a common policy of reducing and/or eliminating customs duties, excise taxes, import restrictions, etc., for leased equipment that had already entered the region through another jurisdiction. This would promote the unrestricted movement of capital equipment throughout the islands, thus enhancing the market and thereby creating favorable conditions within which a viable and thriving secondary market can develop.

- The active utilization of leasing in the region will require a number of adjustments in the banking sector.

A number of actions might be taken with respect to the banking sector to advance the prospects of lease financing in the OECS region. First, consider allowing trading houses to participate in leasing operations. In order to further promote the use of leasing throughout the OECS region, it may be useful to allow reputable trading houses to participate in leasing activities. This could be done by allowing these institutions to fund their operations through local deposits raised by providing a premium above going deposit rates, subject to regulatory requirements as defined and monitored by the ECCB.

Second, allow bankers to provide facilities to lessors to discount their pool of rental contracts. Given the current liquidity in the financial sector and lack of long-term investment opportunities for banks, a discounting option would provide a good avenue of investment for all bank and non-bank financial intermediaries for the following reasons:

- -- The risk is spread, since all the lessees are unlikely to become insolvent simultaneously
- -- Equipment risk is spread over different sectors and industries
- -- Such contracts are self-liquidating

Third, restrict the amount of residuals that a bank-affiliated leasing operation can assume. The assumption of residuals by bank-affiliated leasing operations should be restricted to 20 percent, as they are only financiers and not equipment specialists. Such companies should also be prohibited from making operating leases for the same reason.

- o <u>A number of legitimate concerns were voiced regarding certain operational aspects of leasing, including the risk of physical abuse and loss of control due to the mobility of equipment</u>.

Businesspersons who are willing to take the risk of buying equipment and leasing it have expressed concern that the equipment may become so abused that the residual value once the lease terms ended would be negligible. This concern can be addressed in various ways, the most common being the use of an "operating lease" whereby the lessor undertakes to maintain the equipment.

Bankers, in turn, have expressed concern that, in the event that they enter into leasing arrangements involving the use of mobile equipment, they may lose control of such equipment, particularly in view of the fragmented nature of OECS markets. There are a number of ways of dealing with this issue, including the establishment of a centralized recording of leased equipment, or attaching a plaque to mobile equipment specifying that it is leased equipment owned by the lessor.

These are legitimate concerns. It is important to note that situations that give rise to concerns like those above have precedent in other parts of the world, and that leasing arrangements can be quite flexible in addressing such problems.

- It is important to develop a better understanding of the purpose and benefits of leasing throughout the OECS region.

The "ownership psyche" is strong in the OECS region and represents an important impediment to developing leasing in the region. A possible solution to this problem is have the banks and other financial institutions educate the public as to the advantages of leasing. Leasing can provide the use of the right equipment for the right business at the right time and place and, most importantly, at the right price with the normal risks. Given the current reluctance of bankers to lend to thinly capitalized firms, leasing presents a potentially viable alternative.

- The nature of the demand for leasing in the OECS region needs to be examined in more detail.

While the development of a unified OECS financial market is still in its initial stages, certain market segments have been identified in the region wherein elements of leasing could be initially tested and implemented. These areas include transportation, tourism, and construction. This assessment, while indicating that leasing could be applicable in selected industry sectors, is very preliminary in nature. It is important that the full extent of the demand for leasing be better understood.

- The active cooperation of all participants in the OECS financial sector is necessary in order to make leasing a viable form of long-term financing in the region.

Some resistance was encountered within the foreign financial community for this type of operation, as representatives of these institutions felt that the market was not sufficiently mature to sustain leasing activities at this time. As such, it may be necessary to initiate leasing efforts through the indigenous banking community. The introduction of leasing in the OECS region will require a close partnership between the indigenous banks and their respective governments to address the many impediments to leasing. It may be useful for governments, as part of a broader strategy to develop leasing in the OECS region, to provide the indigenous bankers incentives to take the lead in this area (e.g., provide them with a higher capital allowance for equipment leased by them).

3. Recommendations and Implementation Steps

- <u>Develop a detailed assessment of the nature of the demand for lease financing in the OECS region.</u>

As the indigenous bankers have demonstrated a keen interest in leasing, it is necessary to discuss with the Caribbean Association of Indigenous Bankers (CAIB) its interest in overseeing the execution of a demand assessment in the leasing area. If agreeable, the objectives and scope of such an engagement should be devised, and the assessment subsequently carried out under CAIB's guidance. Of particular importance will be determining the prospects of a "secondary market" for leased equipment. The results of the study should be used to develop a regional leasing prototype arrangement, as discussed below.

- <u>Define the specific legal and regulatory adjustments needed to make leasing a more viable proposition in the OECS region.</u>

The OECS Secretariat should be approached to oversee the review of the legal and regulatory adjustments needed to promote the use of leasing in the region, as fully discussed above. The results of the assessment should also be used to develop a leasing prototype arrangement, as discussed below.

- <u>Define the specific adjustments to banking practices needed to make leasing work in the region.</u>

The ECCB, in its capacity as Central Bank, should oversee the analyses associated with identifying and making banking-related adjustments to better accommodate the use of leasing in the region. Some of these adjustments have been discussed above. The results of the assessment should also be used to develop a leasing prototype arrangement, as discussed below.

- <u>Develop and implement a prototype leasing arrangement in selected countries for replication throughout the OECS region.</u>

The objective of developing a leasing prototype arrangement is to select countries where the viability of leasing could be fully tested in a controlled manner. For example, based on the demand study, two countries with the greatest prospects for leasing could be selected within which to test the implementation of legal, regulatory and banking practice changes. To the extent that leasing proves workable, the changes could subsequently be

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replicated throughout the OECS region.

Exhibit III-4 presents a work program to implement the recommendations in the area of leasing.

IMPLEMENTATION PROGRAM

LEASING

RECOMMENDATIONS & IMPLEMENTATION STEPS	Lead Implementing Institution	Supporting Institution	Consultant Assistance Envisioned	Donor Agency Assistance Envisioned
1.0 Further Assess the Nature of Demand for Leasing	CAIB			USAID
1.1 Discuss with CAIB its Interest in Overseeing the Demand Assessment				
1.2 Develop Objectives and Scope of Demand Assessment			Yes	
1.3 Carry out Assessment/Develop Findings, Conclusions, Recommendations			Yes	
1.4 Integrate Assessment Results and Implementation Steps with Prototype Development			Yes	
2.0 Define/Specify Required Legal and Regulatory Adjustments	OECS Sec.	ECCB		USAID
2.1 Discuss with OECS Secretariat Interest in Overseeing Assessment				
2.2 Develop Objectives and Scope of Legal and Regulatory Assessment			Yes	
2.3 Carry Out Assessment/Develop Findings, Conclusions, Recommendations			Yes	
2.4 Integrate Assessment Results and Implementation Steps with Prototype Development			Yes	
3.0 Define/Specify Required Banking Adjustments	ECCB	CAIB		USAID
3.1 Discuss with ECCB/IBA Interest in Oveseeing Banking Assessment				
3.2 Develop Scope and Objectives of Banking Assessment			Yes	
3.3 Carry Out Assessment/Develop Findings, Conclusions, Recommendations			Yes	
3.4 Integrate Assessment Results and Implementation Steps with Prototype Development			Yes	
4.0 Develop and Implement a Prototype Leasing Arrangement	OECS Sec.	CAIB		USAID
4.1 Select Target Countries to Test Applicability of Leasing			Yes	
4.2 Draft and Enact Legal and Regulatory Adjustments in Each Prototype Country			Yes	
4.3 Draft and Enact Adjustments to Banking Practices in Each Prototype Country			Yes	
4.4 Replicate Legal Regulatory, Banking Adjustments throughout OECS, as Appropriate			Yes	

CAIB = Caribbean Association of Indigenous Bankers

EXHIBIT III-4

G. Foreign Exchange Risk Management Measures

1. Introduction

This section studies measures that would permit local entrepreneurs to reduce or eliminate their exposure on loans denominated in foreign currencies.

2. Findings and Conclusions

- <u>The scope of the foreign exchange exposure problem is limited to those borrowers not normally earning foreign exchange who must take term financing from financial institutions which on-lend donor funds in the form of foreign currency-denominated loans</u>.

On the supply side, the problem of foreign exchange rate risk in the OECS region applies to the activities of primarily two financial institutions that receive foreign currency funding from international development agencies for on-lending within the region: The Caribbean Financial Services Corporation (CFSC), and The Caribbean Development Bank (CDB).

On the demand side, the problem is primarily limited to those companies that do not earn foreign exchange and who must take foreign currency denominated term loans from these institutions. Some companies that borrow in foreign currencies have no need to arrange exchange rate cover, since their sales are largely export-oriented and receivables are denominated in the same currency as their debt. Still other borrowers, especially those with short-term obligations, are willing to assume the exchange rate risk in the confident expectation that the exchange rate will remain unchanged over the term of the loan. However, for borrowers with long-dated obligations, the foreign exchange risk is very real, all the more so because there is no easy or obvious way to lock in the local currency cost of servicing foreign debt. The unfortunate result is that otherwise well-managed projects or companies may be vulnerable to substantial losses, simply because there is no way to manage exchange exposure in the OECS.

- <u>The market-based instruments normally used to hedge foreign exchange risk in developed economies are not applicable in the OECS region because the Eastern Caribbean Dollar is not an actively traded currency on world markets</u>.

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Many of the instruments that are often used to hedge exchange rate risk, namely, exchange-traded foreign currency options and futures contracts, are of no avail to companies in the OECS region. Without exception, all of these contracts are priced in terms of exchange rates between major international currencies, and those relationships are determined quite independently of the parity of the Eastern Caribbean dollar (EC$). Consequently, there is no reason to expect that any devaluation of the EC$ dollar in terms of the United States dollar (US$) would be reflected in an equivalent appreciation of the US$ in terms of any other major currency. This implies that an option or commitment to purchase US$ for future delivery would fail to provide assured protection aginst the possibility of a devaluation of the EC$.

- There are a number of viable, non-market methods that could be applied to protect the ultimate borrower from foreign exchange risk in the OECS region, including currency collateralized loans, exchange rate swaps, and outright forward sales by the Central Bank.

In the absence of any ready-made, market-based hedging instruments, there appears to be no alternative but to introduce non-market arrangements to accommodate the needs of OECS borrowers. Three generic approaches are possible and are briefly described below.

-- Currency collateralized loans

For many years international banks have utilized currency-collateralized loans to accommodate customer's needs for foreign exchange financing. A currency collateralized loan is a form of back-to-back loan in which two parties (company-to-company or company-to-bank) in different countries make loans to one another of equal value, each denominated in the currency of the lender. Currency collateralized loans are normally arranged where the capital markets are not well developed or where alternative sources of local finance may not be available to finance a foreign subsidiary. An intermediary institution (i.e., a lender) could be used to execute the transaction and absorb the foreign exchange risk, with the lender pricing both the loan and deposit to make full provision for its currency exposure.

Essentially the same kind of approach could be employed to transform the foreign currency-denominated loans of CFSC and CDB to a resident borrower into an EC$ denominated obligation. For example, CFSC, which currently borrows and lends in US$, instead of lending directly to the borrower, could place part of the proceeds of its USAID loan in a US$-denominated deposit with a OECS-based bank, and instruct the bank to advance the EC$

equivalent to the borrower. The borrower bears no risk as its loan is denominated in EC$. CFSC is hedged in both currencies since its EC$ debt to the bank is matched by a claim in EC$, and its US$ denominated debt with USAID has its counterpart in a US$-denominated deposit. The bank lender bears the foreign currency risk since it now carries an additional US$ obligation to CFSC. The cost of this risk would be reflected in the terms negotiated for the loan. Importantly, the credit decision and risk is borne by CFSC, as the bank lender would be fully collateralized by the deposits placed with it by CFSC.

For most banks in the OECS, the use of currency collateralized loans appear to be an alien practice. This may be due to an unwillingness to assume exchange rate risk or the reluctance to increase the size of the balance sheet. As such, the Central Bank seems to be the appropriate institution to provide this service since it need not be concerned about the size of its balance sheet or potential for dilution of the return on average assets.

-- Exchange rate swaps

As matters now stand, the option of using forward markets to hedge foreign exchange risk is of little use to borrowers in the OECS region since very few banks stand ready to enter into an outright commitment to deliver US$ against EC$, except at a substantial premium.

International banks may, however, be willing enter into a forward contract on a swap basis, arranged as a single transaction with a single party. This means that they would sell US$ forward against EC$ only if they could simultaneously sell EC$ for US$ on spot delivery. When done on a swap basis, the international bank is fully covered, since it contracts to both pay and receive the same amount of foreign currency at specified rates. A swap of this type is, in effect, a simultaneous borrowing and lending operation in which the effective cost of funds depends on interest rates and the gain or loss on exchange transaction.

This type of inter-bank swap transactions requires that foreign banks be allowed to borrow EC$, and may also require the participation of the ECCB as it is best positioned to arrange exchange rate cover on a swap basis because of its ability to perform under the terms of a spot or forward contract.

The ECCB, perhaps more than any other institution in the OECS, is best positioned to arrange exchange rate cover on a swap basis, because of its ability to perform under the terms of a spot or forward contract. The drawback to this option is that the maturity of the forward contract is likely to fall far short of the original or remaining term to maturity of the foreign currency debt of local borrowers. Under ideal conditions, forward contracts generally do not exceed one year. An alternative to this is to regularly renew the forward contract until the debt is paid or until the borrower decides the facility is no longer needed.

-- Outright forward sales

An outright forward sale of currency would essentially involve the ECCB exhanging a fixed amount of EC$ for a foreign currency at a negotiated price at a specified future date.

Under this type of transaction, the Central Bank may be vulnerable to pressures to absorb all or part of the cost of exchange rate cover, and to provide cover for under contract maturities that may be inconsistent with the need to invest foreign exchange in largely short-term liquid assets. The only way to avoid these pressures is to incorporate interest rate differentials between currencies into an agreed-upon forward rate of exchange, and to limit contract maturities to the term of the investments in which exchange reserves are normally held. In the absence of an active OECS inter-bank deposit market or market for government securities, it may be difficult to gauge interest rate differentials on instruments of comparable maturity.

This option also exposes resident borrowers to some uncertainty as forward rates will vary over time, but there appears to be no alternative, unless as a matter of deliberate policy a decision were made to provide cover for extended periods of time and on terms that tranfer an implicit subsidy to borrowers.

3. Recommendations and Implementation Steps

- Execute a currency collaterialized loan transaction with a selected OECS financial institution.

In one way or another, each of the alternatives described above could be utilized as a means to insulate OECS borrowers from exchange rate risk. Each is designed to facilitate the use of foreign currency financing as available through regional development institutions able to provide loans denominated in foreign currency, and in ways that seem fully consistent with other policy objectives. Of the three non-market ways of hedging exchange rate risk, the most appropriate method to apply in the

OECS region at this time is a currency collateralized loan, as it does not require the participation of outside banks.

It would be useful for the ECCB to execute a sample non-market transaction with a selected financial institution. Under the present situation, and given that this exchange rate risk applies to only one or two Caribbean/OECS based financial institutions that receive foreign currency funding from international development agencies for on-lending within the region, the most effective non-market arrangement to implement would be the currency collateralized loan facility. The others measures require either the active participation of an outside bank (exchange rate swap) or that the ECCB take on undue risk and cost (outright forward sale). The two latter transactions also raise fundamental legal questions that will require time to study and settle.

The most appropriate financial institution for the ECCB to work with is CFSC. The Corporation has indicated an interest in participating with the Central Bank in a currency collateralized loan as it has been actively looking for viable ways to relieve OECS borrowers from foreign exchange risk. We recommend that the ECCB continue current negotiations with CFSC to execute such a transaction and bring closure as soon as practicable. This will permit CFSC to better service the term borrowing needs of SMEs in the OECS region, as these companies will not have to bear foreign exchange risk.

- o <u>Identify and assess the need for additional foreign exchange risk coverage in the OECS region</u>.

This involves discussing with CDB, USAID and other donor agencies the extent to which foreign exchange risk hinders their efforts to assist the region's productive private sectors. This process also involves discussing with foreign money center banks their interest in participating in such schemes. To the extent that there is a further need to manage foreign exchange risk, the output of this effort should be a plan to design and execute those transactions needed to properly hedge the ultimate borrowers' foreign exchange risk, which would then serve as input to the ECCB's policy making process, as noted below.

- o <u>Develop a policy statement outlining ECCB's position with respect to its participation in foreign exchange risk management schemes, including a determination of the legal implications of carrying out such schemes</u>.

The results of the previous recommendation will highlight the extent to which foreign exchange risk coverage is required in the region and, hence, the extent to which the ECCB must be prepared to develop a policy position with respect to its participation in foreign exchange management schemes. As the active implementation of any of these alternatives or a combination thereof is likely to require the active participation of the Central Bank, it is important to know if this may call for modification of the statute or treaty that governs the ECCB's operations. The Central Bank should therefore ascertain the legal implications of carrying out such schemes. While transacting a currency collateralized loan does not appear to pose fundamental legal questions to the ECCB, the other two methods might, as they require the participation of foreign banks. At this stage, moreover, the terms on which exchange rate cover might be arranged remain to be explored. That calls for discussions with market participants, and the ECCB should initiate those discussions as quickly as is practicable.

Exhibit III-5 presents a work program to implement the recommendations in the area of foreign exchange risk management.

H. The Clearing Efficiency of the OECS Banking Sector

1. Introduction

This section reviews the nature and viability of current clearing arrangements in OECS banking sector, including an analysis of Central Bank clearing facilities, commercial bank practices, and government laws and regulations as they affect the speed and efficiency of commercial banking transactions. The objective is to highlight any barriers or underlying safety threats to the fundamental viability of the system, and to identify some of the alternative payments practices that might be introduced, if the need arises.

2. Findings and Conclusions

- <u>In the OECS region, as in other areas, the payments system is a paper-based system, dominated by the use of checks, and the essential mechanisms of the clearing process also resemble practices elsewhere</u>.

In the OECS, as in other areas, the payments system is dominated by the use of checks, and the essential mechanics of the clearing process resemble practices elsewhere. Unlike other areas, however, the number of depository institutions in the OECS is quite small, and in some respects this simplifies the check-clearing process.

Within any given territory, the number of "on-us-checks," or items deposited with the same bank on which it is drawn, is relatively high, so clearing the check involves just one bank, and if the check is deposited before an institution's cutoff time, the payor's account can be debited and the payee's acount credited on the same business day.

By contrast, transit items, where the relevant accounts are at different institutions, require inter-bank as well as inter-account transfers. In those territories where informal clearing arrangements are in place, checks need not be routed through third parties, but can be presented directly and settled through changes in clearing balance and/or overdraft facilities, subject to whatever bilateral credit limits each depository may establish vis-a-vis any other bank. When those limits are exhausted, net transfers are usually settled through accounts maintained with other clearing banks, or through an institution's account with the Central bank. Checks drawn on banks outside a given territory are typically deposited with correspondent banks or presented to the Central Bank for collection. The correspondent

IMPLEMENTATION PROGRAM

FOREIGN EXCHANGE (FX) RISK MANAGEMENT MEASURES

RECOMMENDATIONS & IMPLEMENTATION STEPS	Lead Implementing Institution	Supporting Institution	Consultant Assistance Envisioned	Donor Agency Assistance Envisioned
1.0 Execute Currency Collateralized Loan Transaction with CFSC	ECCB	CFSC		
1.1 Continue Current Negotiations with CFSC				
1.2 Bring Closure to Loan Transaction as soon as Practicable				
2.0 Identify/Assess Need for Additional FX Risk Coverage in the OECS Region	Consultant	ECCB	Yes	USAID
2.1 Discuss CDB FX Risk Problems/Needs/Opportunities				CDB
2.2 Discuss USAID FX Risk Problems/Needs/Opportunities				OTHER
2.3 Discuss Other Donor Agency FX Risk Problems/Needs/Opportunities				DONORS
2.4 Approach Regional and Foreign Money Center Banks, as Appropriate				
2.5 Prepare Business Plan/Strategy to Execute Needed Transactions, as Appropriate				
3.0 Develop Policy Statement Regarding ECCB Role in FX Risk Management	ECCB	OECS Sec.		
3.1 Assess Legal Implications of Carrying out Schemes			Yes	
3.2 Prepare Policy Statement Setting Forth ECCB Position on FX Risk Management, Incorporating Results of Demand and Legal Analysis			Yes	

CFSC = Caribbean Financial Services Corporation

EXHIBIT III-5

banks effect settlement of their respondent banks' checks through accounts maintained with them, while the Central Bank effects settlement through the reserve or clearing accounts of its members. When cleared through the Central Bank, moreover, settlement takes place on a same-day basis. On presentment of check or cash letter, the payor bank's account is debited immediately, while the payee's account is credited at the same time.

From the point of view of the payee, however, there is almost inevitably some lag between the time of deposit and the time when funds are available. Most banks view availability as a contractual obligation, but the availability delay appears to be somewhat variable, depending in part on the location of the bank on which the check is drawn and in part of how the collecting banks values the customer relationship. Since there are no uniform availability schedules (i.e., time of deposit and time when value is given) within the territories of the OECS, it is difficult to generalize about delays in funds availability or about the implicit interest costs incurred by payees, but the costs appear to be quite small. Checks drawn on banks within the same territory are usually cleared within one or two business days and the payee is given credit within that time frame.

- <u>While the prevailing view in the region is that the present clearing system appears workable and that transaction costs are low, there is some evidence that suggests that the operating expenses of the banks in the OECS region are high by international standards</u>.

Conversations with payors, payees, and depository institutions all suggest that the system is workable, and transactions costs involved in transferring funds within or between any of the territories in the OECS are inconsequential. If this view is correct, then the obvious implication is that the clearing arrangements should be left undisturbed, and official attention should focus on other matters.

Yet the efficiency and reliability of the payments system is not something to take for granted, and there appears to be indications that some deficiencies in the system exist. Specifically, there was some evidence--perhaps no more than circumstancial--to suggest that the costs associated with the payments system should perhaps be subject to serious examination. The plain fact is that operating expenses of banks in the OECS are extraordinarily high by international standards. For all banks in the region, non-interest expenses, exclusive of provisions for loan losses, amount to roughly 6 percent of total assets, about double the ratios for similarly-sized institutions in the United States. Whether and to what extent this kind of disparity can be attributed to differences in payments practices within the OECS is difficult to assess, since there is no information available on the distribution of costs by functional activity. Put another way, there is no way to disentangle the costs associated with the payments mechanisms from other operating expenses.

Still, the question arises whether there is any room for significant reduction in the costs of originating, tendering and collecting checks in the region. And if so, what kinds of changes in payments practices might lead to the development of more efficient, or more reliable, arrangements. These questions are more easily asked than answered, yet serve to indicate the kind of information that needs to be developed, and then monitored, in order to evaluate the performance of the payments system on regular basis.

- Problems were identified in the clearing mechanism in the region that are a by-product of government-imposed regulations maintained independently of payments practices.

With respect to checks drawn on banks outside a given territory, the collection process is almost invariably somewhat longer, since the check may have to be routed through a correspondent for collection. In this case, the delays reportedly range from 5 to 7 business days, and where inter-regional transfers are subject to regulation, the delays may be even longer. Thus, checks drawn on St. Vincent are simply not negotiable outside that territory, with the result that the bank of deposit can accept such checks on a collection basis only, resulting in a process that may take anywhere from 10 to 14 business days. This entails some incremental costs to the payee and, while this is not a problem inherent in the clearing mechanism, it is a by-product of government-imposed regulations maintained independently of payments practices.

- While the safety OECS clearing system appears adequate at this time, data and information need to be collected that will allow the Central Bank to better assess and monitor the safety of the system on an ongoing basis.

The present system does not, on the surface, appear overly inefficient, vulnerable to settlement risk, or to pose any kind of fundamental impediment to intra-regional transactions. Nevertheless, the efficiency and reliability of the payments system is not something that the Central Bank can take for granted, and steps should be taken to ensure that it has sufficient information on hand to assess and monitor the safety of the system in an ongoing, systematic manner.

At the very least, the Central Bank should begin to develop data on the volume of transactions effected by check to get some indication of the number of on-us items, as well as transit checks for both intra- and inter-island payments. In addition, information is needed on the costs of credit check deposits, processing and transporting transit items, and returning cancelled checks to the payor. Perhaps most importantly, the ECCB should begin to monitor the lags involved in the collection process and, in close consultation with the clearing banks, should make every effort to minimize those delays.

The issue of lags is critically important in any attempt by the Central Bank to monitor the safety of the system. The safety of any system rests fundamentally on the extent to which the maker or recipient of a payment has confidence that payment can and will be honored since this process by its very nature entails timing gaps of varying duration. In turn, these timing gaps necessarily imply that the process of making and receiving payment is in effect a process of extending credit, even if that credit is extended only for a day or two. And given the linkages in the clearing system, a serious credit problem at any institution could be quickly transmitted to other participants as well. While the likelihood of any such disturbance appears remote, the fact remains that if such a problem were to develop its consequences could be very destabilizing, not just for banks, but also for their customers who must look to financial institutions to provide the credit and control checks which they cannot reasonably provide on their own. It seems essential, therefore, that the amount and incidence of credit generated as a by-product of payments practices should be regularly reported to the Central Bank so that the authorities are in a position to make prompt and informed decisions in the face of problem situations before they become worse.

- <u>It may be useful to assess the relative virtues of alternative payment arrangements to enhance the OECS region's clearing efficiency and reduce high operating costs</u>.

In view of the relatively high levels of operating expenses in the region, it seems important to take a long hard look at the costs involved transferring value by check and under alternative delivery mechanisms. The principal aspect of alternative delivery mechanisms is that they are designed to replace paper as the medium of conveying payment information with its equivalent in the form of machine-readable electronic images, and the same time divorce the movement of funds from the supporting documentation.

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The technical feasibility of electronic funds transfer is no longer in doubt. Nor is there any question about the ability of these systems to process high transactions volumes at relatively low costs. Quite obviously, transactions volumes in the OECS region are much smaller, and whether alternative forms of electronic payments mechanisms would be cost effective is an open question. But it should be emphasized that scaled-down versions of larger systems are available, and that the computational capability of the current vintage of microcomputers is much greater than many many of the mainframes used two decades ago for much larger funds transfer systems.

With this in mind, some of the alternative possibilities that might be explored as part of a larger examination of the payments mechanism in the OECS include (1) automated clearing house (ACH) transfers, and (2) automated check collection. And it may be useful to study these mechanisms in light of practices of Canadian banks, as the Canadian banking system has features similar to those of the OECS region, including the use of regional settlement points (similar to local clearing houses), and a banking market which is highly concentrated. For more on these alternatives, see Volume II.

3. Recommendations and Implementation Steps

- Collect the data needed to assess, and develop the systems required to monitor, the safety of the OECS clearing system.

We recommend that the ECCB select a staff member to organize and oversee the data collection effort, and to develop and present conclusions and recommendations with respect to the fundamental safety of the system, as well as to outline steps that may be taken to monitor it on an ongoing basis.

- Review the applicability and viability of alternative payments arrangements in the OECS region.

We similary recommend that the ECCB select a staff member to organize and oversee an alternative payments systems analysis, and to develop and present conclusions, recommendations and possible next steps in this regard.

Exhibit III-6 presents a work program to implement the recommendations in the area of the clearing efficiency of the OECS banking system.

IMPLEMENTATION PROGRAM

CLEARING EFFICIENCY OF THE OECS BANKING SYSTEM

RECOMMENDATIONS & IMPLEMENTATION STEPS	Lead Implementing Institution	Supporting Institution	Consultant Assistance Envisioned	Donor Agency Assistance Envisioned
1.0 Collect Data Needed to Assess and Monitor Safety of the Banking System	ECCB	Banking Sector		
1.1 Select an ECCB Staff Member to Organize the Data Collection Effort				
1.2 Plan and Execute the Data Collection Effort			Yes	
1.3 Analyze Collected Data and Prepare Findings and Recommendations			Yes	
1.4 Develop and Implement a Safety Monitoring System, as Appropriate			Yes	
2.0 Review Applicability and Viability of Alternative Payments Arrangements	ECCB	Banking Sector		
2.1 Select an ECCB Staff Member to Organize and Oversee Analysis				
2.2 Develop Objective and Scope of the Analysis Effort			Yes	
2.3 Carry out the Alternative Payment Systems Analysis			Yes	
2.4 Prepare Findings, Conlcusions, and Recommendations for Board Review			Yes	
2.5 Implement Recommendations, as Appropriate.				

EXHIBIT III-6

DOMINICA

Summary of the Tax System related to Banks & Non-Bank Financial Institutions

(All amounts in Eastern Caribbean Dollars)

TAX	NATURE OF TAX	EXEMPTIONS & DEDUCTIONS	RATES
2. Licences and Fees			
2.1 Bank License	License fee for commercial banks	None	a) In respect of its main place of business where total deposits in current, time or savings accounts. i) Exceed $20m - $50,000 ii) Are $20m or less - $10,000 b) In respect of any branch - $5,000
2.2 Companies' License Registration	Annual registration license for companies.	None	a) Where registered capital is $100,000 or less, $500 per annum. b) Where registered capital is more than $100,000 - $500 plus $50 for each $100,000 or part thereof in excess of $100,000 $500 per annum.
2. Insurance Companies License Registration	Annual registration license for insurance companies.	None	

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GRENADA

GRENADA

Index of Laws, Taxes, Fees and Regulations Pertaining to Banks, Non-Financial Institutions and Intra-Regional Capital Movement

		Reference No.
1.	Bankers Protection Ordinance Cap. 28	1/213
2.	Banking Act Amendments 1978-1982	
3.	Bankruptcy Ordinance (Cap. 29)	1/24
	Amendment 1959	14/1959
	Amendment 1967	7 to 23/1967
	Amendment 1967	10/1967
	Amendment 1967	App/1967
	Amendment 1968	39/1968
	Amendment 1971	17/1971
4.	Co-operative Societies Ordinance (Cap. 10)	1/630
	Amendment 1959	1/1959
	Amendment 1959	14/1959
	Amendment 1964	33/1964
	Amendment 1967	7 and 23/1967
	Amendment 1967	App/1967
	Amendment 1971	17/1971
	Amendment 1980	PL34/1980
5.	Grenada Agricultural and Industrial Development Corporation Act 1975	20/1975
6.	Grenada Agricultural and Industrial Development Corporation Act 1976	11/1976
	Amendment 1977	2/1977
	Amendment 1980	PL33/1980
	Amendment 1985	7/1985
7.	Grenada Bank of Commerce Ltd (1983)	PL10/1983

		Reference No.
8.	International Financial Organisations Act 1975	11/1975
	Amendment 1977	8/1977
9.	Money Lending Ordinance (Cap. 192)	2/2524
	Amendment 1981	PL19/1981
	Amendment 1984	10 and 11/1984
10.	National Commercial Bank of Grenada	PL8/1980
11.	Savings Bank Ordinance (Cap. 273)	3/3301
	Amendment	14/1959
	Amendment	7 to 23/1967
	Amendment	39/1968
	Amendment	30/1969
	Section 14 has been amended further as follows:	
	Amendment	17/1971
12.	Exchange Control Ordinance (Cap. 110)	2/1476
	Amendment	14/1959
	Amendment	7 to 23/1967
	Amendment	App 1967
	Amendment	36/1968
	Amendment	39/1968
	Amendment	17/1971
	Amendment	13/1975
	Amendment	14/1977
	Amendment	10/1984
	Section 2 Authorised Dealers Orders	41/1969
	do	19/1970
	do	4/1978
	Amendment	PL60/1979
	Amendment No.2	PL77/1979
	Applications for Exchange Control Approval	G8/1982
	Relaxation of Certain Exchange Control Notices	G47/1984
	do	G52/1984

GRENADA

Summary of Tax System

Tax	Nature of Tax	Exemptions & Deductions	Rates
1. Taxes on Domestic Goods and Services			
1.1 Value Added Tax	Applies to all sales of goods and services	Selected food items, public utilities, accommodation, education, health, land and transportation	Banks: 20% on service charges excluding interest. Locally manufactured goods: 8%. Insurance Agents: 5% on premium income. Other: 20%.
1.2 Business Levy	Levied on all business firms on the sale of goods and services	None	Either 2.5% of gross sales or 33 1/3% of net profits whichever is the greater
1.3 Foreign Company Levy	This levy was introduced by an amendment to the Business Levy Act. It provides for a tax on net profits of foreign companies to avoid double taxation of their profits		35%
1.4 Foreign Exchange Levy	Levied on the purchase of foreign exchange from authorised dealers	Payments for imports of basic foodstuffs and drugs	5%

		Reference No.
13.	Foreign Exchange Tax Act 1977	3/1977
	Amendment	5/1978
	Amendment	PL9/1980
	Amendment	11/1986
	Amendment	1987
	Section 6 Foreign Exchange Tax Exemption Orders	6/1977
	Amendment	22/1985
14.	Business Levy Act 1986	16/1986
	Amendment	28/1986
	Amendment (No.2)	1987
15.	Value Added Tax Act 1986	
	Amendment 1986	
	Amendment 1987	
	Value Added Tax (Insurance Companies) Regulations 1986	
	Value Added Tax (Banks) Regulations 1987	

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GRENADA

2.0 Data Assembly

2.3 Compilation & Analysis of Regulations: (COUNTRY)

PRODUCT	AMOUNT
1.0 Withholding Tax on Interest	Abolished in 1986
2.0 Withholding Tax on Dividends/Remittances	Abolished in 1986
3.0 Levy on Foreign Exchange Transactions	5%
4.0 Value Added Tax (VAT)	20%
5.0 Stamp Tax on ...	Abolished in 1986
6.0 Cheque Transactions	
7.0 Business Levy	33 1/3% of net profit or 2.5% of gross trading receipts
8.0 Foreign Company Levy	35% of net profit

2.0 Data Assembly

2.3 Compilation & Analysis of Regulations

COUNTRY/PRODUCT	W/T on Interest	Foreign Currency Purchases	W/T on Div. & Rmts
1.0 Anguilla			
2.0 Antigua			
3.0 Dominica			
4.0 Grenada	-	5%	-
5.0 Montserrat			
6.0 St. Kitts			
7.0 St. Lucia			
8.0 St. Vincent			

MONTSERRAT

MONTSERRAT

Revenue relating to the Financial Service Industry

1.	Taxes on Companies	40%
2.	Withholding Tax	15% - 20%
3.	Bank Deposit Levy	1/2%
4.	Foreign Exchange Levy	1%
5.	Stamp Duties	$1.00 - $3.00
6.	Banking Licence	Annual Fees - Class A - Banks $15,000.00 Annual Fees - Class B - Banks $10,000.00
7.	Insurance Licence	
8.	Insurance Company Levy	

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MONTSERRAT

Acts, Ordinances and Regulations relating to the Financial Service Industry

1. Eastern Caribbean Central Bank
2. The Companies Act Chapter 308
3. The Banking Ordinance, 1978 No. 14 of 1978

   Amendments: No. 25 of 1970
   No. 14 of 1980
   No. 18 of 1980
   No. 6 of 1982
   No. 20 of 1985

4. Bank Interest Levy Ordinance, 1978 No. 17 of 1978
5. The Insurance Ordinance, 1977 No. 2 of 1977
6. The Insurance Levy Ordinance, 1982 No. 12 of 1982
7. Foreign Currency Levy Ordinance, 1980 No. 13 of 1980
8. Savings Bank Ordinance Chapter 116
9. Exchange Control Ordinance Chapter 115
10. Trust Corporation (Probate & Administration) Ordinance Chapter 80

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MONTSERRAT - Summary of Tax System

TAX	NATURE OF TAX	EXEMPTIONS & DEDUCTIONS	RATES
1. Tax on companies	vied on the profits of companies		40% of the gross profit
2. Withholding Tax	Tax on the following payments to non-residents;- dividends, interest, rents, royalties, premiums including life insurance premiums, annuities, alimony, pension fees and commissions;		The rate vary from 15%-20%
3. Bank Deposit Levy	An annual levy on average deposit balances		1/2% on average deposit balances.
4. Foreign Exchange Levy	A charge on foreign exchange sales		1% of the value of the transaction.
5. Stamp Duties	Ad Valorem and specific taxes of instruments (written documents)		Rates range from $1.00 to to $3.00

ST KITTS & NEVIS

2.0 **Data Assembly**

2.3 Compilation & **Analysis of Regulations:** (COUNTRY) ST KITTS & NEVIS

PRODUCT	AMOUNT
1.0 Withholding Tax on Interest	10%
2.0 Withholding Tax on Dividends/Remittances	10%
3.0 Levy on Foreign Exchange Transactions	2%
4.0 Value Added Tax (VAT)	-
5.0 Stamp Tax on Loans to Aliens	2½% and 5%
6.0 Cheque Transactions (Stamp Duty)	5¢

2.0 Data Assembly

2.3 Compilation & Analysis of Regulations

COUNTRY/PRODUCT	W/T on Interest	Tax on Foreign Currency Purchases	W/T on Div.&Rmts
1.0 Anguilla			
2.0 Antigua			
3.0 Dominica			
4.0 Grenada			
5.0 Montserrat			
6.0 St. Kitts	10%	2%	10%
7.0 St. Lucia			
8.0 St. Vincent			

COUNTRY: ST KITTS & NEVIS

Index of Laws, Taxes, Fees and Regulations pertaining to Banks, Non-Financial Institutions and Intra-Regional Capital Movements

		Reference Number:
1.	The Banking Act, 1977	19 of 1967
	- The Banking (Amendment) Act 1968	3 of 1968
	- The Banking (Amendment No. 2) Act 1972	18 of 1972
	- The Banking (Amendment) Act 1974	8 of 1974
	- The Banking (Amendment) Act 1980	9 of 1980
2.	The Banking Act (Regulation of Business Hours) Regulations, 1973	18 Of 1973
	- The Banking Act (Regulation of Business Hours) (Amendment) Regulations, 1975	25 of 1975
3.	The Fees (Miscellaneous Amendments) Act, 1985	1 of 1985
4.	The Confidential Relationships Act, 1985	2 of 1985
5.	The Income Tax Ordinance (Amendment) Act 1980	14 of 1980
6.	The Foreign Currency Tax Act 1977	4 of 1977
	- The Foreign Currency Tax (Variation of Rate) (Amendment) Order 1983	43 of 1983
	- The Foreign Currency Tax (Variation of Rate) (Amendment) Order 1986	12 of 1986
7.	The Development Bank of St Kitts & Nevis Act, 1981	1 of 1981
	- The Development Bank of St Kitts & Nevis (Amendment) Act 1983	2 of 1983
8.	The Law Reform (Miscellaneous Amendment) Act 1983	11 of 1983
	- The Law Reform (Miscellaneous Provisions) Act 1986	13 of 1986

COUNTRY: ST KITTS & NEVIS (Cont'd)

9.	Chapter 335 - Companies Act		
	- The Companies (Amendment) Act, 1980	Reference No.:	5 of 1980
	- The Companies (Amendment) Act, 1982		5 of 1982
	- The Companies (Amendment) Act, 1982		19 of 1982
	- The Companies (Amendment) Act, 1984		5 of 1984
10.	Memorandum and Articles of Association of St Kitts - Nevis - Anguilla National Bank		
11.	Exchange Control Ordinance - Chapter 115		
12.	The Currency Ordinance, 1965		1 of 1965
	- The Currency (No. 2) Ordinance 1965		2 of 1965
	- The Currency (No. 2) Ordinance (Amendment) Act, 1969		2 of 1969
	- The Currency (No. 2) Ordinance (Amendment) Act, 1974		11 of 1974
	- The Currency (No. 2) Ordinance (Amendment) Act, 1976		1 of 1976
13.	The Licenses on Business & Occupations (License Fees) Order 1976		36 of 1976
14.	The Insurance Act, 1968		14 of 1968
15.	The Stamp (Amendment) Act 1982		4 of 1982

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ST KITTS & NEVIS: SUMMARY OF TAX SYSTEM (RELATED TO BANKS & NON-BANK FINANCIAL INSTITUTIONS)
(EC$)

TAX	NATURE OF TAX	EXEMPTIONS & DEDUCTIONS	RATES
Income Tax (Income Tax Ordinance Amendment Act, 19[illegible] - 14)	Tax on corporate profits - Base of assessment is the previous calendar year.	Approved enterprises under Fiscal Incentives Act, 1974. Some portion of company profits derived from interest on desposits in local banks will be exempt from tax.*	45%
Insurance Companies Tax	Tax on Insurance Companies on non-life premiums and fee for registration of Insurance Policies		Tax equivalent to 5% on all non-life premiums; and a fee for the registration of Insurance Policies of $2.00 for every $1,000 of insurance.
Withholding Tax	Tax on the following payments to non-residents: profits; administration; management or head office expenses; technical services fees; accounting and auditing expenses; royalties; non-life insurance premiums; rent.		10%
Foreign Currency Tax (Statutory Rules & Orders 12 of 19[illegible]6, and 43 of 19[illegible]3; Foreign Currency Tax Act 1977)	A tax on the purchase of or other dealing with foreign currency, excluding sale other than in respect of any transaction on which the tax imposed under the Stamp Tax Act has been paid.		2% of the gross value of the transaction.

*It was also proposed to give all Banks tax relief on income from loans to finance the purchase of or land mortgages for construction, provided the length of the mortgage is over 15 years.

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ST KITTS & NEVIS: SUMMARY OF TAX SYSTEM (RELATED TO BANKS & NON-BANK FINANCIAL INSTITUTIONS) (EC$)

TAX	NATURE OF TAX	EXEMPTIONS & DEDUCTIONS	RATES
Banking License (The Fees Miscellaneous Amendments Act, 1985)	License to carry on the business of banking.		$5,000.00
Insurance Companies License (The Fees Miscellaneous Amendments Act, 1985)	License to carry on the business of insurance		Life: $4,500 p.a Non-Life: $4,500 p.a Marine: $ 300 p.a
Offshore Companies Fee	Fee for registering any document required on authorized to be registered other than the Memorandum of Association.		$1,000
Bank loans to Aliens Stamp Duty (The Stamp Amendment Act, 1982)	Payment of Stamp Duty by a Bank which provides loans to Aliens.		2 1/2% p.a.
Bank loans to Aliens Stamp Duty (The Law Reform Miscellaneous Provisions Act 1986)	Payment of Stamp Duty by any Bank which provides a loan to any alien for the purpose of acquiring or leasing any property whatsoever in any special Development area.		5% p.a.

ST LUCIA

ST LUCIA

2.0 Data Assembly

2.3 Compilation & Analysis of Regulations: (COUNTRY)

PRODUCT		AMOUNT
1.0	Withholding Tax on Interest	25%
2.0	Withholding Tax on Dividends/Remittances	25%
3.0	Levy on Foreign Exchange Transactions	1%
4.0	Value Added Tax (VAT)	
5.0	Stamp Tax on	
6.0	Cheque Transactions	

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ST LUCIA

Index of Regulations, Laws, etc., pertaining to financial institutions available in the library.

1. Banking Act No 13, 1969
2. Cooperative Societies Regulations - Statutory Instruments No. 2 of 1980
3. ECCB Agreement Act No. 23
4. Insurance Act No. 3, 1968
5. Insurance Act No. 4, 1972
6. Insurance Premium Tax Act No. 5, 1980
7. NIS Act No. 10, 1978
8. National Insurance Regulations - Statutory Instruments No. 37 of 1981
9. Laws of St Lucia - Ordinance and Subsidiary Legislation Relating to Currency and Banking, Loans and Loans (Repayment)
10. St Lucia Development Bank Lending Policy
11. Memorandum and Articles of Association of the St Lucia Cooperative Bank Limited (1976)

ST LUCIA

2.0 Data Assembly

2.3 Compilation & Analysis of Regulations

	COUNTRY/PRODUCT	W/T on Interest	Foreign Currency Purchases	W/T on Div. & Rmts
1.0	Anguilla			
2.0	Antigua			
3.0	Dominica			
4.0	Grenada			
5.0	Montserrat			
6.0	St Kitts			
7.0	St Lucia	25%	1%	25%
8.0	St Vincent			

ST LUCIA: Summary of Tax System, December 1986

TAX	NATURE OF TAX	EXEMPTIONS & DEDUCTIONS	RATES
1. Taxes on net income and Profits			
1.1 Taxes on Companies (Income tax ordinance No. 39 of 1965 as amended)	Taxes on income of resident companies earned from all sources and on income of nonresident companies earned from carrying on business in St Lucia. The of assessment in income of the previous accounting year.	The income of nonprofit institutions is exempt. All expenses which are wholly and exclusively incurred in the production of income are allowable deductions. Capital allowances in the form of initial and annual allowances are allowed on plant and equipment and on industrial buildings. The rates range between between 5% and 20%. Contributions to non-profit institutions can be deducted. St Lucia has double taxation arrangement with all Caribbean Common Market (CARICOM) countries, the United States, Canada, Japan, and the United Kingdom, and a number of other Western European countries.	45%. Undistributed profit of a company by no more than five persons maybe deemed income of share-holders and taxed as provided it could be distributed without detriment to the company's existing business.
1.2 Taxes on Individuals (Income Tax Ordinance No. 39 of 1965 as amended: No, 4 of 1986)	Residents are subject to income tax on income wherever earned and non-residents on income earned from employment or carrying on business within St Lucia. The basis of assessment is income of the previous calendar year except that wage and salary earners are subject to a PAYE system. Separate assessment of husband and wife can be made.	Exemptions include: emoluments of the Governor General and permanent consular members, wound and disability pensions, income derived from any allowance to public officers, scholarships, educational allowances, and income derived from approved superannuation funds. Income arising outside St Lucia, and which is earned income, is taxed only to the extent that it is received in St Lucia. A wide range of deductions is allowed. These include: Personal Allowance: EC$3,000 Wife Allowance: EC$1,500 Each Child: if (a) below 16 years or (b) 16-25 attending college: EC$600 (limit EC$600 on child's income); if (c) 16-25 attending university outside of state: EC$1,500 (limit EC$1,500 on child's income). Other allowances for alimony, housekeepers, dependent relatives, life assurance premiums, and medical expenses. Interest on bank deposits is exempt. Contributions to nonprofit organizations are deductible.	Income (In EC$) / Percent $ 1- 4,000: 5 4,001- 9,000: 10 9,001-15,000: 25 15,001-20,000: 40 20,001-: 50

ST VINCENT AND THE GRENADINES

ST LUCIA: Summary of Tax System, December 1986

TAX	NATURE OF TAX	EXEMPTIONS & DEDUCTIONS	RATES
1.3 Withholding Tax (S.R.O. 73/82)	A nonresident withholding tax on dividends, leases, premiums, royalties, management fees, commissions, annuities, or any other payment of an income nature.	None	Dividends: 25 percent Rents: 25 percent Other: 25 percent
2. Bank Licence No. 14 of 1980	Licence fee for commercial bank	None	$20,000 per annum for a main office and $1,000 for each branch or agency
4. Insurance Company Licences No. 1 of 1985	Registration Licenses for insurance companies	None	Foreign Companies Life $2,000 Motor $2,000 Other $1,500 Broker $ 800 Agent $ 500 Local Companies Life $2,000 Motor $2,000 Other $ 800 Broker $ 500 Agent $ 500
4. Foreign Currency Exchange Tax	Levied on transactions which result in the remittance of foreign currency from St Lucia.	All public bodies, representative of regional and international organizations, and governments, individuals studying or seeking medical attention abroad, imports from non-profit organizations are among the persons exempt from the payment of this tax.	1% of the value of the transaction.

Life General

		Reference Number
9.	Fiscal Incentives Act, 1982	5 of 1982
10.	Money Lending (Amendment) Act, 1985	10 of 1986
11.	Exchange Control Ordinance, 1951	28 of 1951
12.	Currency Export Tax (Amendment) Act, 1987	19 of 1987
	Export Tax (Amendment) Act, 1988	5 of 1988
13.	Bank Undertaking (The Royal Bank of Canada St Vincent & The Grenadines Operations) vesting	8 of 1985
14.	Agricultural Cooperative Bank (merger with Development-Corporation) Act, 1986	6 of 1986
15.	Development Corporation Act, 1970	7 of 1970
	Development Corporation (Amendment) Act, 1982	4 of 1982
16.	National Provident Fund (Amendment) Act, 1982	2 of 1982
17.	Cooperative Societies Ordinance, 1963	11 of 1963
18.	Agricultural Development Corporation (Dissolution) Act, 1988	10 of 1988
19.	National Insurance Scheme Act	33 of 1986

ST VINCENT AND THE GRENADINES

Index of Laws, Taxes, Regulations and Fees relating to Banks, Non-bank Financial Institutions and Capital movements for St Vincent and the Grenadines.

		Reference Number
1.	Currency Ordinance, 1965	1 of 1965
	Currency (No. 2) Ordinance, 1965	2 of 1965
	Currency (No. 2) Ordinance (Amendment) Ordinance, 1965	33 of 1968
	Eastern Caribbean Central Bank	2 of 1983
2.	Income Tax Act, 1979	2 of 1979
	Income Tax (Amendment) Act, 1979	
	Income Tax (Amendment) Act, 1985	14 of 1985
	Income Tax (Amendment) Act, 1987	22 of 1987
3.	St Vincent Trust Authority Act, 1976	31 of 1976
	St Vincent Trust Authority (Amendment) Act, 1982	18 of 1982
4.	Interest Levy Act, 1975	15 of 1975
	Interest Levy (Amendment) Act, 1975	
	Interest Levy (Amendment) Act, 1984	3 of 1984
	Interest Levy (Amendment) Act, 1986	5 of 1986
5.	International Companies Act, 1982	12 of 1982
	International Companies (Amendment) Act, 1982	3 of 1983
6.	Banks (Special Deposits) Act, 1975	13 of 1975
7.	Insurance Act, 1970	10 of 1970
8.	International Companies Act, 1982	12 of 1982
	International Companies (Amendment) Act, 1982	5 of 1982

ST VINCENT AND THE GRENADINES

2.0 Data Assembly

2.3 Compilation & Analysis of Regulations: (COUNTRY)

PRODUCT		AMOUNT	OTHER
1.0	Withholding Tax on Interest	20%	
2.0	Withholding Tax on Dividends/Remittances	15%	
3.0	Levy on Foreign Exchange Transactions	2%	
4.0	Value Added Tax (VAT)	-	
5.0	Stamp Tax on ...		
6.0	Cheque Transactions		

ST VINCENT AND THE GRENADINES

2.0 Data Assembly

2.3 Compilation & Analysis of Regulations

	COUNTRY/PRODUCT	W/T on Interest	Foreign Currency Purchases	W/T on Div. & Rmts
1.0	Anguilla			
2.0	Antigua			
3.0	Dominica			
4.0	Grenada			
5.0	Montserrat			
6.0	St Kitts			
7.0	St Lucia			
8.0	St Vincent	2%	2%	15% on div. 20% on p'ments to non-residents

ST VINCENT & THE GRENADINES

Summary of Taxes affecting Financial Institutions - 1986

Tax	NATURE OF TAX	EXEMPTIONS & DEDUCTIONS	RATES
Withholding Tax	Tax on all payments to non-residents of dividends, interest, rentals, etc., for real property, royalties, fees, and annuities. Profits of non-resident companies liable to tax as if such profits paid out in dividends. Insurance premiums transferable abroad.	In calculating liability to tax non-residents companies can deduct 10% on rental payments. 20% on interest on mortgages. 25% on all other payments.	15 % on dividends and 10% on rental payments, 20% on interest on mortgages 25% on all other payments
Alien Land Holdings	Tax on holdings and transfers of land in St Vincent by aliens.		10% on sale of land; 10% of annual rental for land that is leased annual license fee of $500
Bank Deposit Levy	Tax on credit balances in all interest bearing accounts of all banks operating in St Vincent. The basis of assessment is the average balance in the preceding calendar year.	All monies loaned out for mortgages financing can be set off against balance subject to tax.	2%
Insurance Premium Tax	Tax on insurance premiums perceived by companies for liabilities in St Vincent.		3%

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ST VINCENT & THE GRENADINES

Summary of Taxes affecting Financial Institutions - 1986

	NATURE OF TAX	EXEMPTIONS & DEDUCTIONS	RATES
[illegible] Licence	Tax on Savings and Deposits Banks		$1,000 per annum for main office and $300 per annum for each office branch.
[illegible] Tax	Tax on payments to persons residing outside St Vincent and for which a cheque, draft or other negotiable instrument is transferred by a bank to a place outside St Vincent. The basis of assessment is the value of the transaction.	Payments of less than $100; transactions by banks that are in ordinary course of business and not on behalf of a customer and of public bodies, representatives of Governments, and international organizations, and organizations granted exemption from taxation are exempt.	2%
[illegible] Income Tax	Tax on income of resident companies accrued from all sources and an income of non-resident companies accrued from carrying on business within St Vincent. The basis of assessment is the previous calendar year. Income include all accrued gains or profits.	The income of pension funds; building societies non-profit making institutions; local authorities, statutory bodies, and regional and regional organizations is exempt. The income of international companies which do not engage in trading in St Vincent and which are not required to distribute more than 10% of dividends, etc., to residents is exempt. In addition certain hotels, pioneer industries, development activities in Mustique and income from certain residential constructions are exempt for a limited period. In calculating chargeable income, including interest on borrowed capital can de deducted. Also, any expenditure incurred by way of the interest levy Act, 1975 is deductible against chargeable income. In addition, initial allowances of 10% on plant and machinery and annual allowances ranging from 4% to 50% depending on the type of asset can be deducted. Losses may be set against income from other sources in the same year or against income from the same source in later years. Agreements for relief from double taxation are in force with many countries.	45% - Companies which are owned or controlled by not more than five shareholders may be subject to an additional tax at a rate of 15% if the distribution of dividends is deemed insufficient.

ANTIGUA & BARBUDA

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APPENDIX A

SUMMARY OF OECS LAWS AND REGULATIONS AFFECTING THE FINANCIAL SECTOR (AS PREPARED BY THE ECCB RESEARCH DEPARTMENT)

ANTIGUA & BARBUDA

Laws and Regulations Relating to Financial Institutions

1. Currency Ordinance No. 1 of 1965

2. Currency (No. 2) Ordinance No. 6 of 1965

   The Currency (No. 2) Amendment Act No. 29 of 1968
   The Currency (No. 2) Amendment Act No. 2 of 1976

3. Insurance Ordinance No. 10 of 1967

   The Insurance (Amendment) Act No. 15 of 1968
   The Insurance (Amendment) Act No. 16 of 1977
   The Insurance (Amendment) Act No. 19 of 1977

4. The Insurance (Licence) Ordinance No. 11 of 1967

5. Insurance Regulations (Statutory Rules and Orders) No. 18 of 1969

6. The Coinage (United Kingdom Coins Denomination) Act No. 40 of 1967

7. The Banking Act No. 28 of 1969

   The Banking (Amendment) Act no. 23 of 1976
   The Banking (Amendment) Act No. 10 of 1977
   The Banking (Amendment) Act No. 19 of 1981
   The Banking (Amendment) Act No. 6 of 1987

8. Banking (Statutory Deposit) (Variation) Order 1983 S.I. 24/1983

9. Building Societies (Amendment) Act No. 12 of 1974

10. Inland Revenue Administration Act No. 23 of 1976

11. Eastern Caribbean Central Bank Act 1983, No. 10 of 1983

12. International Business Corporations Act 1982

    International Business Corporations (Amendment) Act No. 3 of 1984

ANTIGUA & BARBUDA

Revenue Relating to Financial Institutions

1. Tax on Income - Companies
2. Foreign Currency Levy
3. Banking Licenses and Fees
4. Professional Licence Fees
5. Insurance Levy

ANTIGUA & BARBUDA: Tax System - July 1986

	NATURE OF TAX	EXEMPTIONS & DEDUCTIONS	RATES
Taxes on Income	Income Tax is levied on the income of any company registered in Antigua and on the income of foreign companies which is generated in Antigua.	Deductions: Include normal operating costs, rent of land and industrial building offset against income, income coming under the Hotel Aid Ordinance Act 1952, the Fiscal Incentive Ordinance 1976. Contributions to charitable, religious, education and scientific institutions. Dividends are taxable in the shareholders hand.	50%
Taxes on Interest, Rents, Royalties, Premiums and annuities payable to Non-Residents.	Tax on interest paid to non-residents is deductible for companies and credited at source against the recipients liabilities for the relevant year of assessment.		
Non-Resident withholding on account	Payments made to a non-resident in the form of a dividend, interest on discounts, rental, lease premium on income, royalties, management fees, commission annuities or any other payment of an income nature and subject to withholding on account.	None	Individuals - 20% Companies - 40% All other Income - 25%
4. Insurance Premium Levy	Levied on Insurance policies other than vehicle insurance.		3% of value of premium.
5. Bank Licence	Licence fee for domestic commercial Banks	Antigua Development Bank, Savings Bank	Antigua Commercial Bank $10,000 Other Commercial Banks $20,000

ANTIGUA & BARBUDA: Tax System - July 1986

Tax	NATURE OF TAX	EXEMPTIONS & DEDUCTIONS	RATES
[illegible] the International [illegible]	Annual Licence payable to business registered under the Act.	None	Banks US$5,000 Trust Companies US$2,500 Insurance Companies US$2,500 Others US$ 500
[illegible] Licence	Payable by persons practicing a profession for profit as an annual fee	None	For Insurance Companies US$5,000 For Insurance Agents US$ 500 For Insurance Brokers US$ 500 For Special Insurance Brokers US$[illegible] For Insurance Salesmen US$ 50
[illegible]. Foreign Currency	Tax on sales and purchases of foreign exchange by commercial banks payable by the customers.	None	1%

DOMINICA

DOMINICA

Laws and Regulations Relating to Financial Institutions

1. Banking Act No. 11 of 1974

   Banking Amendment Act 1975
   Banking Amendment Act 1976, Nos. 1& 2

2. Miscellaneous (Financial) Amendment Act, No. 3 of 1978

3. Dominica Agricultural and Industrial Development Bank Act No. 22 of 1971

4. National Development Bank of Dominica Act No. 27 of 1975

5. National Commercial and Development Bank of Dominica Act No. 27 of 1976

6. Dominica Agricultural, Industrial and Development Bank Act No. 2 of 1982

7. Insurance Act No. 17 of 1974

8. Insurance (Forms & Fees) Regulations No. 41 of 1974

9. Government Savings Bank Ordinance Chapter 133 of the Revised Laws of Dominica, 1961

   Government Savings Bank (Amendment) Act 1968

10. Co-operative Societies Ordinance, Chapter 304 of the Revised Laws of Dominica (1961)

11. Companies Ordinance - Chapter 318 of the Revised Laws of Dominica (1961)

12. Friendly Societies Ordinance Chapter 305 of Revised Laws of Dominica (1961)

13. Building Societies Ordinance Chapter 302 of Revised Laws of Dominica (1961)

14. Exchange Control Ordinance Chapter 130 of the Revised Laws of Dominica (1961)

15. Instruction to Banks under Exchange Control Ordinance Chapter 130 - June 1972, September 1979

DOMINICA

2.0 Data Assembly

2.3 Compilation & Analysis of Regulations: (COUNTRY)

	PRODUCT	AMOUNT
1.0	Withholding Tax on Interest	25%
2.0	Withholding Tax on Dividends/Remittances	15%
3.0	Levy on Foreign Exchange Transactions	Abolished 88/89 budget
4.0	Value Added Tax (VAT)	
5.0	Stamp Tax on	
6.0	Cheque Transactions	

DOMINICA

2.0 Data Assembly

2.3 Compilation & Analysis of Regulations

	COUNTRY/PRODUCT	W/T on Interest	Foreign Currency Purchases	W/T on Div. & Rnts
1.0	Anguilla			
2.0	Antigua			
3.0	Dominica	25%	None	15%
4.0	Grenada			
5.0	Montserrat			
6.0	St Kitts			
7.0	St Lucia			
8.0	St Vincent			

DOMINICA

Summary of the Tax System related to Banks & Non-Bank Financial Institutions

(All amounts in Eastern Caribbean Dollars)

TAX	NATURE OF TAX	EXEMPTIONS & DEDUCTIONS	RATES
		Scheme and to approved superannuation funds; losses of previous five years not already offset against income and not to reduce tax liability for any year to less than one half. Dividends are taxable in hands of shareholder with credit given dependent on the rate of tax attributable to the inclusion of the dividend.	
1.2 Non-Resident Withholding Tax	Payments made to a non-resident and which would be assessable as income in Dominica are subject to withholding tax. These include dividends, rents, management fees, royalties, annuities, alimony, interest or discounts, The withholding tax will only be applied when when such profits, dividends or other income are being transferred out of the country.	Interest from moneys in any bank account in in Dominica or from investments sponsored by Government.	Independent personal services Rents - immovable property 10 Movable property 20 Management Charges 25 Royalties, annuities, alimony, or other annual payments 25 Dividends or other income distributions by a company 15 Interest or discounts 25 Public Enter tainers 30 Independent personal services 25 Any other payment of an income nature 25

DOMINICA

Summary of the Tax System related to Banks & Non-Bank Financial Institutions

(All amounts in Eastern Caribbean Dollars)

TAX	NATURE OF TAX	EXEMPTIONS & DEDUCTIONS	RATES
1. Taxes on Income and Property 1.1 Taxes on Income	Liability to Income Tax: Individuals are taxed on income from any source Dominica. Where any trade, profession, vocation is carried on or exercised partly within and partly without Dominica by a resident individual whose home is in Dominica the whole of the gains or profits from such trade etc., is liable to tax in Dominica. Income Tax is levied on the income of any company registered in Dominica and on the income of foreign companies which is generated in Dominica. Basis of Assessment: The basis of assessment is the income of the previous calendar year for individuals and companies. Companies must pay advance taxes on their profits in three equal installments in March, June and September.	Exemptions: Income of statutory bodies, registered agricultural credit, building, or friendly societies or registered trade unions Income of the Dominica Chamber of Commerce, the Government Savings Bank or other government institutions or concern, of any institution established for the encouragement of thrift which Cabinet may declare to be exempt. Income from mortgage financing for residential accommodation provided interest and service charge do not exceed 10% and mortgage does not exceed $150,000; interest in respect of approved debentures borrowings by mortgage companies or building societies for on-lending just mentioned. Income of hotels and industries granted relief Income of hotels and industries granted relief under the Hotel Aids and Fiscal Incentives Ordinances and dividend paid therefrom. Income rental of industrial buildings (including factory shells) of not less than 500 sq ft and for and for a period of ten (10) years after construction; from rental or sale of residential accommodation erected under agreement with Government for ten (10) years after construction.	Income tax is payable at a flat rate of 30% for companies. Companies 35%
1.1 Taxes on Income (Continued)		Deductions include normal operating costs, rents of land and depreciation on agricultural and industrial buildings and on plant and machinery; expenditure for management charges payable to a non-resident or to an overseas head office by a local branch may be restricted to 5% of other expenses; contributions to the Social Security	

APPENDIX B

SEPARATE REPORT ON THE NATIONAL INSURANCE SCHEMES (NIS)

NATIONAL INSURANCE/SOCIAL SECURITY SCHEMES IN THE OECS REGION

By: Dr. Wendell Samuel

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EXECUTIVE SUMMARY

The National Provident Funds in the OECS region were introduced almost two decades ago to provide a greater measure of security for the aged in these countries. The establishment of the National Provident funds was only an interim step and they were subsequently upgraded into full fledged social security schemes.

Although the social security/national insurance schemes are first and foremost schemes to provide security for the aged, there is another dimension to them which is not always recognized. They are a powerful instrument for mobilizing domestic saving which can be used to finance domestic investment. The social security schemes in the region have mobilized in excess of EC$ 300 million worth of resources and maintain an investment portfolio of about EC$ 277 million.

However, these resources, by and large have not been channelled into the productive sectors. The main reason for this is the portfolio mix selected by the people charged with investing these funds is heavily skewed towards commercial bank fixed deposits (approximately 65 percent) and Statutory Bodies & Government debt (approximately 30 percent). Neither of these are very efficient ways to utilize the hard-earned savings of the working population.

Although this situation results from a dearth of high-grade private sector securities in the region, with a little thought more imaginative use can be made of these resources. The following are some suggestions:

- Commercial banks can issue longer-term instruments to ensure the stability of funds and interest payments on those funds.

- The government can make a long-term commitment of the NIS funds for loans to the productive sectors. The government of St. Vincent has committed a pool of NIS money in the National Commercial Bank for mortgage lending. This facility can be extended to loans to agriculture, manufacturing and Tourism.

- This facility need not be placed in the commercial banks, but can be placed in the development banks. This would reduce their dependence on the CDB for funds for on lending.

- The Development banks can issue their own bonds, thus providing an alternative to government paper and commercial banks' deposits for investing NIS funds.

- It may be argued that placing a large amount of NIS money in local assets may over-expose the pensioners to the vagaries of the domestic economic conditions. The funds can still be made available to local enterprise without the excessive exposure. This can be done by the establishment of regional development fund. The economies are sufficiently diverse to spread the risk around.

- Provide more funding for micro businesses by channelling some of the NIS's resources to the National Development Foundations.

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I. INTRODUCTION

One of the major developments in the financial system of the region during the last two decades is the emergence of the National Insurance/Social Security Schemes, hereafter called National Insurance schemes (NIS). Some of the islands established Provident Funds initially, which offered limited benefits, but during the period these were developed into full blown NIS.

In section I of this paper a historical development of the schemes is given, section II describes a typical NIS programme and section III analyses the effects of the schemes on saving and investment behaviour in the OECS countries. The final section offers some suggestions for the more efficient use of these funds in productive enterprises and some conclusions.

II. HISTORICAL DEVELOPMENT

With the attainment of associated statehood by most of the territories in the late 1960's, and the consequent reduction of British grants in aid, the countries took on greater fiscal responsibilities. It became quite clear that the provision of support for the elderly could no longer be financed out of the general budgetary resources. Thus, Provident Funds were established with technical support from the British government, to force people to save for their retirement. The earliest of these funds were established in St. Kitts-Nevis in 1968. Table 1 gives the dates for the establishment of Provident Funds in the other countries.

Contributions to the Provident Funds were made by both employers and workers. In most cases employers and employees paid the same percentage, which was set initially at 5 percent in all countries. Membership was usually extended to agricultural workers and self employed persons.

The benefits from these funds were limited. At retirement the participant would receive his accumulated contributions plus accrued interest. If the participant died before retirement the benefits would go to the next of kin. There were no unemployment benefits or disability compensation.

TABLE 1

DATES OF ESTABLISHMENT OF PROVIDENT FUNDS AND NATIONAL INSURANCE SCHEMES IN THE OECS

Country	Provident Fund	NIS
Antigua	1970	1972
Dominica	1970	1976
Grenada	1978*	1983
Montserrat	1972	1986
St. Kitts-Nevis	1968	1977
St. Lucia	1970	1978
St. Vincent	1970	1986

* This was a non contributory fund for agricultural workers only.

The continuing disintegration of the extended family meant that government was called upon to provide more services for the elderly and other disadvantaged groups. This put greater pressure on the limited government resources. Thus one logical solution was to provide these services under an extended NIS program. The New NIS manages two sets of resources: the resources which participants had in the old Provident Funds in addition to the contributions under the extended NIS. Table 1 also traces the extension of the various provident fund into NIS.

III. A TYPICAL NATIONAL INSURANCE SCHEME

A typical NIS scheme consists of three components: A retirement fund, a sickness and disability fund and an unemployment fund. The retirement fund provides a source of income for retired people and for approved surviving relatives such as spouses and children under a specified age.

The sickness and disability fund provides reduced income to qualifying members of the scheme in the event of illness and disability. Maternity benefits are usually derived from this part of the fund.

Unemployment benefits are provided to qualifying individuals so that they receive temporary remuneration during periods of unemployment. None of the countries in the OECS have started the unemployment fund. However some countries are considering its

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introduction.

The NIS programs are financed by payroll taxes in all the islands. They are operated on a part capitalization basis. That is, part of the current revenue is used to pay current claims on the fund and the rest used to augment the reserves of the schemes. An upper limit is imposed on the insurable income of the member. Thus no tax is paid on income in excess of a specified threshold.

All of the countries require that employers pay a part of the tax. In some cases a distinction is made between the sickness and retirement fund. The employer is required to pay a greater percentage into the sickness fund than the employee. The argument being, that some illnesses may arise out of the working conditions of the employees. Income from capital is not included in this tax base.

The tax is withheld at the source by the employees and paid over to the scheme. Self employed people and agricultural workers are included in the scheme. The tax brings in a large amount of revenue with relatively low administrative and compliance cost.

Self employed people have an incentive to remit their contributions for their benefits depend on it and employees would take steps to ensure that the deducted amounts are remitted to the scheme. However this is not always the case if individuals prefer current consumption to future consumption or people have greater confidence in their own ability to provide for retirement. This feeling may arise because, in some cases an inordinate amount of government paper is acquired by the National Insurance schemes.

IV. THE EFFECTS OF NIS ON SAVING AND INVESTMENT

In addition to providing social security for the aged and disabled, the NIS programs has implications for saving and capital formation in the country. It is argued that NIS may lead to a reduction in saving. If people's retirements are provided for by the state, there will be less incentive for private retirement funds. They save by paying their payroll tax but the funds are not retained by the system, for the pay as you go method of finance require that the funds be used to pay out current benefits. This will result in a net reduction in saving. A fall in saving implies a reduction in capital formation.

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This argument however, does not stand up in face of further scrutiny. First, the NIS are operated on a part capitalization basis. Thus, all current revenue is not used to pay current benefits. This accounts for the significant accumulation of assets in the schemes. Secondly, there is no presumption that people will save less if social security benefits increase people's taste for a better life after retirement, or recognize that their children will reduce support if they know that the aged will receive social security.

The alleged reduction in saving will only be a one shot event at the inception of the system. Benefits which are paid to the retired will be matched exactly by the tax payments of the young, hence there will be no net saving nor dissaving. The same as in the case of private funds. However there will be marginal reductions in saving if the population is growing. Under a private system, the young will save more than the aged dissave. However, under social schemes the contributions only replace old age benefits, thus a fall in saving. A similar result holds if productivity is growing prompting the young to save more than their old generation did at lower levels of income.

In the open economy the assumed link between capital formation and saving is not as tight as suggested. Capital formation can be financed out of savings as well as foreign borrowing. At the same time domestic saving can be invested abroad if the returns are greater.

There is no doubt that the existence of the NIS have had a positive impact on saving in the region. However, with respect to investment, the evidence is inconclusive. St. Rose (1982) estimated that the schemes in the OECS have over EC$ 100 million in assets and mobilize EC$ 16 million per annum. He concludes, "The schemes have not had a deleterious effect on the growth of savings deposits...and during the period estimated balances of the various schemes amount to 37 percent of savings deposit balances which means an increase in financial flows."

By 1986 the total resources mobilized by the schemes in the OECS was EC$ 302.7 million and the schemes had a total investment portfolio of EC$ 274.7 million. This means that over the 20 years of their existence they have increased their assets by EC$ 15 million annually.

The effect on investment is not as encouraging. In fact St. Rose estimates that during the period the ratio of investment to GDP declined. This observation highlights the absence of strong linkages between saving and investment in small dependent economies. One explanation for this observation is the investment of these funds by the NIS schemes. About 65 percent of the funds are held in commercial banks, 25 percent in government paper (treasury bills, bonds debentures etc.), and Statutory corporations account for another 5 percent. The figure for government does not include government arrears.

The social security schemes need to hold some proportion of their reserves with the commercial banks in the form of fixed deposits for prudential reasons. Just in case current payments outstrip current contributions for a prolonged period. However, there is no necessity for them to hold this inordinate amount in the form of low interest bearing fixed deposits whose maturity rarely exceed one year.

The funds so deposited with the commercial banks are not always channelled into the productive sectors. Commercial banks prefer to lend short term mainly to the distributive and personal sectors. That way their portfolio keeps turning over and the goods can be used for collateral. They prefer not to make long term risky loans which is the type of loan which is most frequently demanded by the productive sectors.

Thus as custodians of about EC$ 177 million of NIS funds they have been unable to channel much of these funds into productive enterprises. Even in the face of excess liquidity they prefer to keep the funds idle. Thus, the suggestion here is that the government ought to make a conscious effort to channel these funds into institutions which can utilize these funds more efficiently.

A large proportion of the resources is also appropriated by the government to finance capital expenditure and sometimes current expenditure. When private saving is used to finance current account deficits it defeats the whole purpose of saving. Current expenditure ought to be financed out of current revenues, not saving.

Capital expenditure improves the infrastructure of the country and is not directly productive although it increases the efficiency of private investment. Thus it can be argued that to the extent that the NIS funds are used by the governments to upgrade the country's infrastructure it is being used efficiently. The efficiency argument advanced here is slightly more sophisticated. The government is more efficient than the private sector at obtaining finance, both in terms of the quantity and the terms which can be negotiated. Therefore the government ought not to deprive private enterprise of the limited amount of captive domestic saving.

It may be argued that in small countries like the ones under consideration there is not a great deal of high grade, domestic financial assets other than government paper and that government debt may be safer than private debt. The case may also be strengthened by arguing that domestically generated savings should be used for local development rather than invested abroad. However the acquisition of government debt carries a contingent future liability which will be liquidated by higher taxes in the future, some of which may have to paid by retired people in the form of consumption taxes when they spend their pensions.

The foregoing discussion suggests that there is a need to channel the resources marshalled by the NIS's into long term private investment. The following section offers some suggestions.

V. SUGGESTED SOLUTIONS

One of the reasons given for banks not using the current excess liquidity in the banking system for long term lending is that they are afraid the current liquidity position may prove ephemeral. Crops can fail and people will withdraw the excess funds. To get around this sudden withdrawal of funds the commercial banks can offer longer term instruments to ensure the stability of their of their deposit base.

At present very few banks offer any instruments in excess of one year. Given this state of affairs the NIS are forced to roll over one-year fixed deposits. If longer term instruments were available, the NIS could invest in these, for the funds they have in the commercial banks are essentially long term funds.

If the commercial banks are unwilling to take the first step to issue longer term instruments, the governments, who make the ultimate decision on the use of the NIS reserves can make a long term commitment of the NIS funds for loans to the productive sectors. The government of St. Vincent and the Grenadines has committed a pool of NIS money in the National Commercial bank for mortgage lending. There is no reason why this facility cannot, in theory, be extended to loans to agriculture, manufacturing and tourism.

This facility need not be placed exclusively in the commercial banks, it can also be housed in the national development banks. This would reduce their dependence on the Caribbean Development Bank for funds for on lending. The Caribbean Development bank has been trying to encourage the development banks in the various countries to increase the amount of local funds they have available for lending. To some extent

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the development banks have utilized some of the resources available in the National insurance schemes, but this is a minuscule part of the resources harnessed by the NIS and an even smaller fraction of the loan funds of the national development banks.

As part of their efforts to diversify the sources of their loan funds the individual development banks should be encouraged to issue their own bonds. This would provide an alternative to government paper and commercial banks' deposits for investing the resources of the NIS.

It can be argued that bonds issued by the development banks do not provide an adequate alternative to government paper since they are also guaranteed by the government. However, the bonds issued by the development bank have as a first line of security the assets of the firms to which the development bank has given loans. Whereas in the case of straight government paper taxes will have to be levied.

There is some concern that placing an excessively large amount of NIS resources in local assets may over expose the pensioners to the vagaries of domestic economic conditions. Given the exposed nature of these economies and their susceptibility to natural disasters and adverse external influences, this concern may be well placed. However, this concern must be balanced against the need to use domestically generated savings for domestic investment. The prudent NIS investment specialist must be able to strike that delicate balance.

A look at the investment portfolio of the various NIS schemes reveals that the overwhelming concern has been the need to use domestic saving for domestic investment and very little attention paid to diversification to reduce risk. Foreign assets account for less than one percent of the total resources in the NIS schemes in the OECS.

The establishment of a regional development fund can ensure that the locally generated resources can be made available to local enterprises and at the same time reduce the excessive exposure of a portfolio consisting of purely local assets. An OECS regional development fund can provide a pool of resources which can be used to finance projects in the OECS. Some of the resources in the fund can be raised by issuing bonds regionally. The regional focus of the fund would increase its ability to attract funds. The bonds issued by the regional development fund could prove attractive for NIS investment for the economies of the OECS countries are sufficiently diverse to spread the risk around.

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There is a shortage of feasible projects emanating from the private sector which merit financing. This is due mainly to the dearth of entrepreneural activity in the region. However, one area in which there is no shortage of projects is the very small and micro business sector which demands funds from the National Development Foundations. These are borrowers who are too small to be considered by the commercial banks. The National Development Foundations, in addition to making loans offer assistance in project preparation and business counseling.

These loans are mainly to self-employed people. This a very important area of economic activity for labour market studies in the United States, Jamaica and Trinidad & Tobago reveal that the self-employed sector is the fastest growing sector for employment creation. Thus, an effort should be made to channel more funds into the National Development Foundations. This can prove to be a fruitful area to direct the NIS's resources.

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APPENDIX C

Additional Comments Regarding the Prospects for New Financial Instruments in the OECS Region

APPENDIX C: ADDITIONAL COMMENTS REGARDING THE PROSPECTS FOR NEW FINANCIAL INSTRUMENTS IN THE OECS REGION

I. INTRODUCTION

Generally speaking, financial instruments can be issued by a number of entities under various terms and conditions and form part of the money, bond and equity markets (see Table 1 for a list of financial instruments available in developed countries). Within the OECS region, the issuance of financial instruments is limited to local governments (bonds) and the ECCB (treasury bills and inter-bank operations which are of recent creation). Few, if any, other institutions issue any kind of debt obligations in the OECS.

In conjunction with the stated mission of this Project, to advance the economic development of the OECS through the promotion of a more efficient and unified financial marketplace, this Appendix highlights some of the potential financial instruments which may be introduced within the OECS region to channel savings to the productive sectors. In addition, this Appendix addresses several of the instruments mentioned in the report which reduce lenders' exposure to credit risks through third party guarantees and thereby promote lending and investment. On the whole, however, the OECS financial sector does not currently meet many of the fundamental requirements necessary for the introduction of new, viable financial instruments.

II. COMMENTS REGARDING FINANCIAL INSTRUMENTS IN THE OECS

- There are a number of fundamental requirements for the introduction of viable financial instruments into an economy:

  - There must be viable investment opportunities that create the demand for financing, and hence new financial instruments
  - There must be a competitive financial sector where there is a wide variety of players available to buy and sell financial instruments
  - There must be a number of financial intermediaries which actively seek out investment opportunities
  - There must be a pool of savers who respond favorably to the opportunities brought about by the introduction of new investment instruments

FINANCIAL INSTRUMENTS IN THE MARKET PLACE

ISSUERS	SHORT TERM INSTRUMENTS *Money Markets (up to 12 mos)*	MEDIUM TO LONG TERM INSTRUMENTS *Bonds and Equities*
Governments	• Treasury Bills and Notes • Treasury Certificates • New Issues of Short-Term Bonds	• Bonds (up to 25/30 years) • Indexed Bonds • Local Bonds (states, region ...) • Industrial Development Bonds • Special Savings Bonds for Individuals (up to 7 years)
Banks and Other Financial Institutions	• Negotiable and Non-Negotiable Certificates of Deposit • Bankers' Acceptances • Inter-Bank Market Operations • Promissory Notes or Acceptance Paper	• Mortgage Bonds • Floating Rate Notes • Finance Company Bonds • Development Bonds • Common Shares, Warrants, etc. • Fixed Term Certificates of Deposit
Corporations	• Commercial Paper and/or Promissory Notes • Trade Acceptances • Bills of Exchange	• Corporate Bonds (local or foreign currency denominations) • Convertible Debentures • Commodity Linked Bonds • Common Shares, Warrants
Investment Dealers	• Secured Sale and Repurchase Agreements ("buy-backs") • Financial Futures • Money Market Funds	
International Development Agencies		• Bonds (up to 30 years) • Floating Rate Notes

TABLE 1

- There must be an active, organized securities market where equity shares, bonds, and other financial instruments can be freely bought and sold by a wide variety of investors

- There must be a secondary market where such instruments can be readily availed of and disposed of without undue restrictions or regulations

- There must be a fiscal and regulatory environment conducive to business development and which permits the unhindered buying and selling of instruments

o <u>The current lack of bankable uses of funds limits the requirement for new financial instruments</u>. If there were a greater number of viable projects in the region, this would tend to create a demand for new financial instruments, which would contribute to channeling the excess liquidity in the region to the productive sectors.

o <u>There is a lack of competition in the OECS financial sector</u>. As in other LDCs, the OECS financial sector is fundamentally oligopolistic, reflecting a high concentration of ownership and control over the financial assets of the ECCB member countries. Given that the OECS financial sector is relatively limited and narrow, the total number of buyers and sellers is small and the opportunity to trade, minimal.

o <u>The NDBs and NDFs have yet to actively explore the possibility of issuing financial instruments to raise local funds</u>. The NDBs and NDFs have relied primarily on donor funds and funds from local governments to on-lend to the productive sectors. By issuing their own financial instruments to access local funds, these institutions could decrease their dependence on donor funding, which may not always be forthcoming. In addition, by tapping local funds, the NDFs could better service the financing needs of the microbusiness sector.

o <u>There is no great need to introduce instruments to promote savings at this time given the excess liquidity in the region</u>. There is, however, a need for instruments to channel these savings, particularly the long-term savings generated by the NIS and the insurance companies, to the productive sectors.

o <u>The lack of access to an organized securities exchange in the OECS region limits the possibilities for the introduction of new financial instruments</u>. In the absence of an organized, liquid market, financial instruments are relatively less attractive to prospective buyers because they cannot readily dispose of the instruments, which leaves open the possibility that their funds may be tied up for

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extended periods of time, or that they will be forced to incur significant losses.

The fiscal and regulatory environment in the OECS is not conducive to the development of an active securities market, the existence of which is an important pre-condition to introduce viable, new financial instruments. Some examples of specific barriers to the development of an active securities market include:

-- Alien landholding laws that exist in several of the OECS countries that require government approval of any transfer of equity or debentures to a national of another island and even regulate aliens acting as corporate directors.

-- The division of the OECS region into eight tax jurisdictions requiring that special arrangements be implemented to conduct business across the OECS countries

As the financial sector gains in sophistication it will generate the need for new instruments. The creation of new instruments is normally demand-driven, defined by the requirements of the borrowers and investors working with the financial institutions.

Despite the absence in the OECS region of the fundamental requirements for the introduction of new financial instruments, there are a number of steps that can be taken in line with the recommendations set forth in this report:

-- Regional Development Bonds, backed by the local governments, could be introduced as a vehicle to channel long-term funds held by the NIS and the insurance companies to the productive sectors. Such bonds would be a natural financing vehicle for the national development banks, the NDFs, or an Eastern Caribbean Development Fund (ECDF). Regional development bonds would allow these institutions to draw funds from the local market, which may in turn bring about a demand for a better accounting of their operations and profitability. The form and rate of such bonds would depend on the financial situation of each institution, market receptivity, etc. Given the a small size of the OECS market added protection, in the form of the appointment of a trustee nominated under a trust deed or indenture, may have to be offered the bondholders in case of the default of the issuer.

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-- As detailed in section III-B, a loan guarantee facility could be established to accommodate the financing needs of small- and medium-sized firms. A loan guarantee facility entails an obligation on the part of the guarantor, in this case the government, to redeem a borrowers debt when it becomes due if the borrower is unable to perform. In effect, the guarantor substitutes his credit rating for that of the borrower. A guarantee would enable these borrowers to access bank credit that might otherwise be denied, or made available only for shorter terms at higher rates. An Eastern Caribbean Development Fund that would target the financing needs of the SMEs would be an ideal institution to support these special guarantee facilities.

-- As detailed in section III-F, leasing should be further explored as an option for thinly capitalized companies and SMEs, who may not be able to borrow sufficient funds to acquire needed equipment. Leasing provides protection to the lenders against credit risk. Although lenders have no recourse to the assets of the owner of the equipment, the loan is usually secured by an assignment of the lease, by an assignment of the rental contract, and by a first lien on the equipment. In addition, loans are usually structured to pay down more rapidly than the rate at which the equipment depreciates in terms of resale values. Therefore, if the lessee defaults and the repossession and resale becomes necessary, the sale will provide more than enough to cover the loan taken out to purchase the equipment. In light of the added protection offered by a lease, a financial institution issuing a loan for equipment to be leased to an SME or thinly capitalized borrower carries less of a risk than to extend the credit directly to the lessee for the purchase of equipment.

-- The creation of an OECS Corporation could activate the demand for financial instruments. The OECS corporation could issue its own bonds on a regional stock market to raise funds to support its operations and business ventures.

-- Gaining access to an organized exchange will help create conditions that will lead to the development of new instruments.

-- Eliminating those fiscal and regulatory barriers inhibiting the unification of the OECS financial sector would create a more unified, efficient

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financial sector and an environment more conducive to the development of new financial instruments.

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