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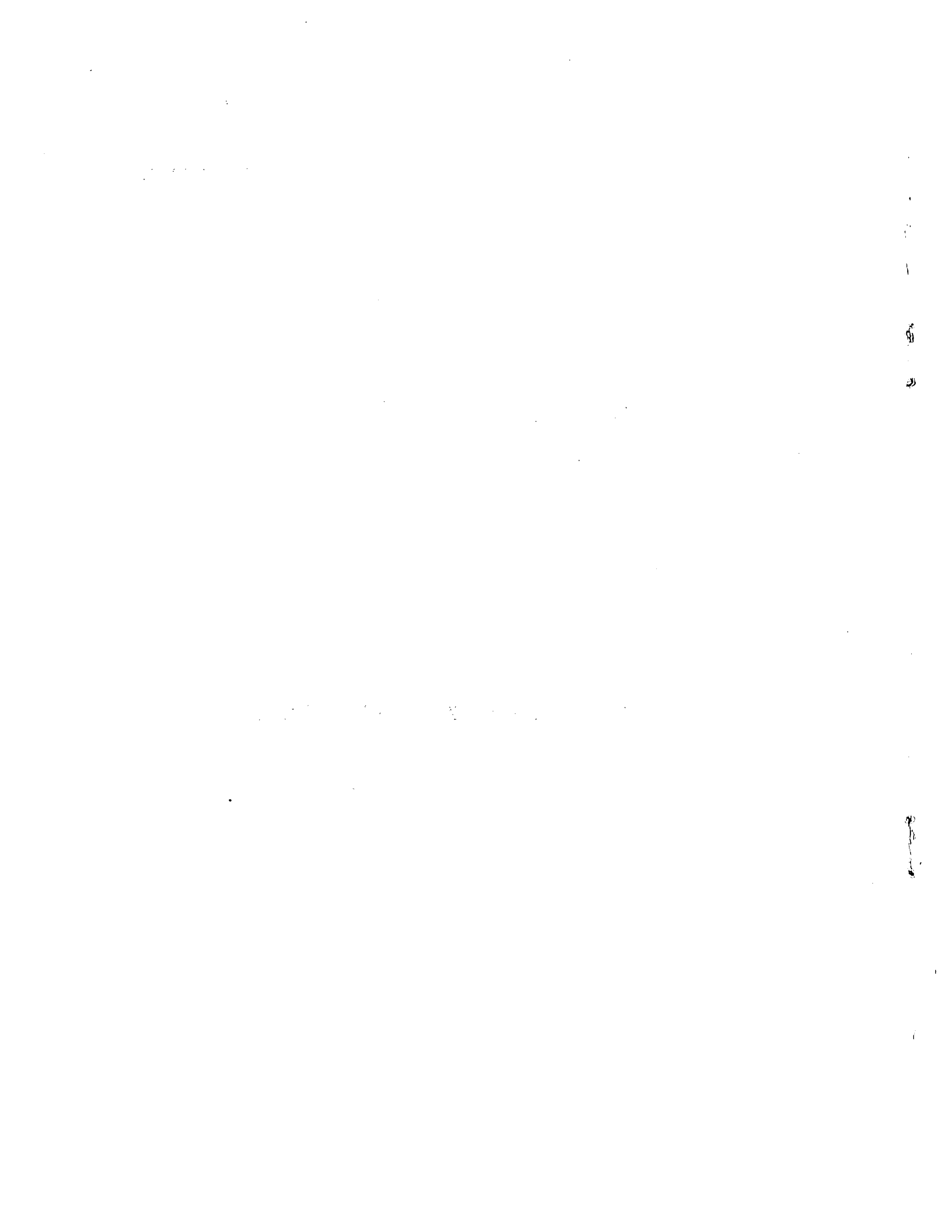
NOTE
ON THE DRAFT BANKING ACT
FOR THE ASSOCIATED STATES AND MONTSERRAT



Note
on the Draft Banking Act
for the Associated States and Montserrat

This note was prepared in response to a request from one of the Associated States by way of comments and suggestions on the Second Draft of the Banking Act 1971 for the Associated States and Montserrat. In view of the fact that these comments would be of interest to the other Associated States and Montserrat, it is being circulated to all the Governments concerned.

1. GENERAL OBSERVATIONS

2. There can be no gain-saying that banking business in each territory should be governed by legislation which is designed not only to protect the interests of the depositors but also to serve the broader national objectives of monetary and economic policies. This holds good regardless of whether the banking business is in foreign or domestic hands. In actual fact, the banking business in these territories is entirely in foreign hands.

3. Nor can there be any question about the desirability of a uniform banking legislation among the East Caribbean Associated States and Montserrat who are all members of East Caribbean Common Market and are, as such, committed to "the co-ordination of currency and financial policies".

4. Under the ECCM Agreement, the Council of Ministers is obliged to "keep under review the monetary and financial situation of individual Member States as well as the general payments system of Member States as a group".

5. All the ECCM Member States are, together with Barbados, parties to the arrangement for a common currency authority, viz, East Caribbean Currency Authority, hereafter referred to as ECCA. Thus, the same currency circulates within the ECCM as a group.

6. But currency in circulation is only one, though important, constituent of money supply. The other equally important constituent of money supply comprises of bank deposits.

7. The enactment of a uniform banking legislation by the ECCM Member States could ensure effective co-ordination of policies with regard to the total money supply including bank deposits within, as well as among, the Member States.

8. Ordinarily, the functions of supervising and regulating banking business are entrusted to the Central Bank. But the East Caribbean situation is somewhat peculiar in that

a) the Member States participating in the Common Currency arrangement are entitled to, and do pursue independent economic policies;

b) one Member State, namely Barbados, is not even a party to the Common Market agreement which enjoins on its Member States common policies in certain specified economic fields.

9. In the circumstances, the Central Banking role of the ECCA cannot be as comprehensive as that of an ordinary Central Bank. Some of the Central Banking functions would be best taken over by the respective Ministers of Finance within each territory even though they are performed within the framework of a uniform legislation. Still the ECCA may have to be entrusted with certain functions over and above those covered by the present agreement under which it was set up.

10. It is in the light of these general observations that comments and suggestions are offered on the proposed banking legislation in the following two parts of this Note. First are offered comments and suggestions on matters of substance and next are offered some comments and suggestions for the redrafting of some of the provisions of the proposed legislation.

II. SUBSTANTIVE PROVISIONS

11. The order followed in this and the subsequent sections of this Note is the same as that of the proposed legislation under review.

Licencing

12. In almost all the territories, banks are required to take a licence but the licence fees payable annually vary from territory to territory. But it should be noted that the requirement to take a licence before a person or company undertakes the business of banking is a type of registration requirement and the licence fee payable is on par with the registration fee as a payment for franchise. The licence fee is not really in the nature of a tax. In any case, this licence fee could never become a major source of revenue for the Government of any territory.

13. As a source of revenue, the licence fee will have to be fixed at very high levels, levels that do not exist anywhere in this region. As a payment for franchise, it can be set at a relatively moderate level, which, even if different from territory to territory, would not make much of a difference.

Distinction between "banking business" and "credit institution business"

14. The proposed legislation seeks to draw this distinction on the basis of the nature of deposits accepted. Those carrying on the former accept deposits "payable on demand or after a fixed period or after notice and which are withdrawable by cheque, draft or order" whereas the latter accept only deposits "repayable after a fixed period or after notice".

15. Having drawn this distinction, however, the rest of the proposed legislation applies in the same manner to both types of business. Take for instance the provision with respect to 'trade investments and immovable property'. A credit institution will, because of the very nature of the deposits

it accepts, tend more to invest long than short whereas a bank would want to do exactly the opposite. But the restrictions proposed on long term investments seem to apply equally to credit institutions as to banks. Unless it is the express purpose of the proposed legislation to discourage credit institution business, restrictions on long-term investments by credit institutions will have to be considerably relaxed. In any event, a main weakness in the region is lack of medium and long-term credit and it could therefore be argued that even the banks should not be subjected to unduly strict controls with respect to local investments, particularly of the medium-term variety.

Minimum Capital Requirements

16. The proposed legislation proposes certain minimum capital requirements. Two interesting aspects of the provisions made in the legislation are:

i) that the minimum paid-up capital, as stipulated, is "invested in such assets as the Minister may approve" and

ii) that where the bank is incorporated and/or controlled abroad, the minimum paid-up capital requirement is set at 5% of its total deposit liabilities in the territory if it is higher than the absolute minimum prescribed for the bank incorporated or controlled within the territory.

17. It is common practice to prescribe minimum capital requirement for a bank. In the context of the East Caribbean, it is also appropriate that a distinction has been drawn, for the purposes of capital requirement, between a domestic bank and a foreign bank. At present, commercial banking in the East Caribbean is entirely in the hands of large foreign banks. For these large foreign banks, any local minimum paid-up capital requirements as such is unlikely to pose any particular problem. Even the somewhat novel requirement that banks must invest their minimum paid-up capital in "approved" assets is unlikely to pose much of a problem by itself for the foreign banks, especially when one considers that over 50% of the assets of these banks are held abroad for them to repatriate one-tenth of these.

18. But if the objective were to promote the evolution of genuinely local banks, not only would the minimum capital requirements have to be set very realistically but also would the requirement for the investment of such capital in "approved" assets have to be relaxed because the latter could be extremely onerous to fulfil for any local bank, particularly in its first few formative years.

19. With respect to minimum capital requirements, it might be worthwhile considering if, as is already done in Barbados, a much lower absolute is prescribed for banks incorporated and controlled locally than for banks incorporated or controlled abroad. For this purpose, it is felt, the banks incorporated and controlled within the territories, singly or jointly, should be regarded as locally incorporated and controlled.

20. Also, if the objective of requiring investment of the paid-up capital of the bank in "approved" local assets is to secure an increase in the banks' local assets, it might well be asked if this could not be secured through more direct and well-recognised methods. This question is taken up a little later in this Note.

<u>Reserve Fund</u>

21. The proposed provision requires the bank or credit institution to maintain a reserve fund and to transfer not less than 25% of its net profits before payment of dividend each year to this fund until the fund equals its paid-up capital. Where, however, the bank or credit institution is incorporated abroad, the transfer to reserve fund has to be made at the rate of 25% of net profits, before deduction of head office expenses and remittance of profits, until the reserve fund equals 5% of the deposit liabilities of the bank or institution, or the minimum paid-up capital requirement set for domestic banks, whichever is higher.

22. This again is a very desirable provision and is in accord with the standard banking practice. Table I below presents a comparison of the yearly transfer required by law to the Reserve Fund in the rest of the Commonwealth Caribbean:

Table I: Comparative Ratio of obligatory transfer of net profits to Reserve Fund

Guyana	Jamaica	T & T	As proposed for the Associated States
15%	10%	10%	25%

23. It will be seen from the above table that the proposed legislation seeks a larger annual transfer to the Reserve Fund than obtains in the larger CARIFTA territories. As a consequence, the locally controlled banks and credit institutions would have to build up their Reserve Fund faster in the Associated States than if they were functioning in the larger territories. As far as the foreign banks and credit institutions are concerned, since they have to relate their Reserve Funds to their deposit liabilities, the transfers from profits may have to continue so long as their deposits are expanding.

24. It is for consideration whether in regard to the transfer of a part of profits to the Reserve Fund, the interests of the depositors would not be better served if the locally controlled banks and credit institutions are also required to relate their Reserve Funds to their deposit liabilities. Possibly, the rate of annual transfer could then be scaled down from 25% to, say, 15% as in Guyana.

Reserve and Liquidity Ratios

25. The proposed legislation prescribes certain cash reserve and liquidity ratios. These ratios are meant primarily to be used as levers which the Central Banks are known to use with a

view to controlling and regulating expansion of bank credit. There is no reason whatsoever why the authorities in the East Caribbean should deny to themselves the use of these important levers of monetary policy. The proposed legislation sets down ratios for both cash reserve and liquidity.

26. Table II below compares the proposed ratios with those obtaining in Guyana, Jamaica and Trinidad and Tobago:-

Table II: Comparative Cash Reserve and Liquidity Ratios to Liabilities

		Guyana	Jamaica	T & T	As proposed for the Associated States
Cash Reserves Ratio	Minimum	-	5%	5%	5%
	Maximum	-	-	-	15%
Liquidity Ratio	Minimum	10% of time liabilities 15% of demand liabilities	15%	-	15%
	Maximum	20% of time liabilities 30% of demand liabilities			30%

27. The requirement that the banks should hold cash reserve balances with the ECCA raises a serious problem. Under the ECCA Agreement, the Authority is required to hold against its liabilities, including demand liabilities, at least 70% of its assets abroad. Since the cash reserve balances with the Authority will increase its demand liabilities, the Authority will have to correspondingly increase its investments abroad. Of course, this assumes that the Authority's present holdings abroad do not exceed 70% of its liabilities. Actually, the Authority's present holdings abroad amount to over 90% of its liabilities. But the problem would at once emerge if the Authority were, as it should, to increase the proportion of its local assets.

28. The proposed legislation prescribes the same liquidity ratios for banks and credit institutions. In view of the fact that the nature of business undertaken by these two types of institutions will be quite different, it could be argued, not without some justification, that the same liquidity ratios might operate somewhat harshly on the credit institutions. It is for consideration, therefore, if lower ratios should be fixed for credit institutions than for banks.

29. With respect to the assets to be treated as liquid under the proposed legislation, they are to include not only the cash reserve balances and local notes and coins held but also i) net balances and other moneys at call with banks in the territory; ii) treasury bills, maturing within 93 days, of participating governments; iii) securities maturing in 5 years of participating governments; iv) securities maturing in 5 years of the Caribbean Development Bank; v) securities maturing in 5 years of the other Commonwealth Caribbean Governments and vi) commercial bills and promisory notes eligible for discount with the ECCA.

30. Firstly, there appears to be no particular reason why the period of maturity should at all be stated with respect to treasury bills. This will leave room for the Governments to issue treasury bills with maturity longer than 93 days if circumstances so demand, as against Government securities maturing in 5 years. In this connection, it must be stated, however, that under the existing East Caribbean

Currency Agreement the treasury bills are defined as those maturing within 93 days for purposes of investment by the Currency Authority although, at the same time, the Authority is authorised by that Agreement to invest in securities maturing in not more than 17 years. There appears to be no particular reason why for purposes of determining the liquidity position of banks and credit institutions, the definition of treasury bills in the proposed banking legislation has to accord with that of the Currency Agreement. In fact, as is evident, the maturity condition proposed for Government securities does not accord with that in the Currency Agreement.

31. Secondly, the maturity condition for Government securities in the proposed legislation appears to be restrictive. If the purpose is to encourage banks and credit institutions to invest more funds in the securities of the Governments of the participating territories where, at their present stage of development, Governments might require most of their funds for longer periods it might be more helpful to the development process to raise the maturity condition for banks to between 7 to 10 years and for credit institutions to between 10 and 15 years.

32. Thirdly, the proposed treatment of the Government securities of not only the participating territories other than the territory in which the bank is operating but also the non-participating Commonwealth Caribbean countries as liquid assets for the territory in question is no doubt extremely well motivated. But care will have to be taken to ensure (a) that this does not cause an unduly large outflow of funds from this group of territories to the more developed Commonwealth Caribbean (in fact the movement of funds should, if anything, be in the reverse direction but this particular provisinn is unlikely to promote this reverse movement of funds) and (b) that even within the territories participating in this uniform banking arrangements there is a broadly even distribution, taking one year with the other.

Local-Asset Ratio

33. As things stand today, the ratio of the local assets of the banks in the Leeward and Windward Islands to their total liabilities works out to less than 50%. The difference i.e. of over 50%, is more or less automatically held as credit with the respective Head Offices of the concerned banks. Thus the commercial banks in these islands operate, to all intents and purposes, as channels for the net transfer of funds to, rather than from, developed metropolises. This is by no means a very satisfactory situation and it cannot be allowed to continue.

34. It is important to make a provision in the proposed legislation whereby the banks and credit institutions can be required to invest a larger and larger proportion of their deposit liabilities in the form of local assets, preferably within each territory. To achieve this objective, it will be desirable to give the banks and credit institutions reasonable time to achieve whatever is the targeted ratio of local assets to their deposit liabilities. Not only that, the Governments of the territories may, within their respective jurisdictions or even collectively, have to go a step further and actually provide, as an interim measure though, appropriate outlets in the form of securities of varying maturities in the absence of appropriate local investments.

35. In this connection, a reference is invited to the provision in the Trinidad and Tobago Central Bank Act, whereby the Central Bank "may, by notice published in Gazette, determine the minimum ratio that after the expiration of six months from the date of service of the notice, Trinidad and Tobago assets held by the commercial banks will bear to their respective liabilities in Trinidad and Tobago; but any variation of such ratio shall not exceed ten percentage points in any one period of six months".

36. A provision on the above lines should, it is felt, be made in the proposed banking legislation and the powers to determine the local asset ratio from time to time should rest with the respective Ministers of Finance in the territories.

Selective Credit Control

37. Closely connected with the power to require banks and credit institutions to hold a minimum proportion of assets locally against their local liabilities, is the power either to direct the flow of bank credit to areas or sectors of the economy which call for higher priority in terms of national development or to deflect the flow of credit from areas where expansion is considered undesirable, or less desirable than in other areas.

38. It is felt that the provision in the proposed legislation dealing with selective credit controls needs being strengthened. In Trinidad and Tobago, the Central Bank has been given the power to impose, if necessary, "controls in respect of the volume, terms and conditions upon which credit may be made available to all or any sectors of the economy, where in its judgement, the imposition of such controls is necessary to restrict or prevent an undue expansion of credit".

39. A provision on the above lines in the proposed banking legislation empowering the Minister of Finance in each Territory to impose control on the flow of credit to various sectors would help the Governments ensure that bank credit expansion, or contraction, takes place in line with the overall economic and developmental policies which the Government is pursuing or wishes to pursue.

Foreign Working Balances

40. The proposed legislation makes a provision with respect to the working balances which banks and credit institutions may hold in foreign currencies. This is a very necessary provision. Also, it rightly confers the power to regulate the holdings of foreign currencies to the Minister of Finance in each territory but this should, it is felt, be supplemented by a provision requiring co-ordination of action between the participating territories in the exercise of this power.

III. SUGGESTIONS FOR REDRAFTING

Section 2:

41. In the definition of the 'bank' and 'credit institution', the words 'any person undertaking or' should be deleted, because Section 5 says that "no person shall be granted or hold a licence under this Act unless he is a company ....". Even otherwise, it is desirable that only companies should be allowed to transact this type of business.

42. It is presumed that the definition suggested for "company" namely "or company registered under the Companies Act of the Territory" will include a company incorporated and/or controlled outside of the territory provided it registers itself in the territory.

43. In the definition of "banking business" and "credit institution business", the words "for the account and at the risk of the person accepting such deposits" seem to be unnecessary and could be omitted.

44. In the definition of "time liabilities", the words "and includes saving deposits" be added at the end. This is necessary to bring it in line with the definition of "time deposits".

Section 4:

45. In view of what has been suggested above, the word "person" will have to be replaced by the word "company" in this and subsequent sections.

46. It is suggested that a sub-section be added, possibly on the lines of Trinidad and Tobago legislation, requiring the application for licence to be accompanied by information such as:

i) a statement giving the names and addresses of the directors and their principal and other business interests;

ii) authorised and paid-up capital;

iii) certified copies of the memorandum and articles of association and other instruments of incorporation;

iv) audited and certified copy of the latest balance sheet

v) and such further information as the Authority and/or the Minister may require.

Section 5:

47. In subsection (2) (a), the words "and invested in such assets as the Minister may approve" may be deleted. This may operate as too onerous a provision for a new domestic banking enterprise to comply with.

48. In subsection (2) (b), the paid-up capital requirement might be put at a sum much higher than for domestic companies.

49. Clause (ii) of subsection (2) (b) will have to be deleted if, subsection (2) (a) is amended as suggested above.

Section 6:

50. As the provision reads, the cash reserve requirement applies to only banks and not to credit institutions. The latter are subject to only the liquidity requirements, under Section 7, whereas banks are to fulfil both cash reserve as well as liquidity requirements.

51. The requirement, however, that these cash reserve balances should be held with the Currency Authority raises the problem that the Authority will, under the present Agreement, in turn have to invest 70% of these balances abroad. It is for consideration if, in the circumstances, the proposed cash reserve requirement be not replaced by a requirement to hold the treasury bills of the territory concerned, at least until such time as the Currency Agreement is appropriately modified.

Section 7:

52. A subsection should be added whereby the Minister can fix different liquid asset ratio for credit institutions as against banks. Also, another subsection be added whereby the Minister can add to, or modify, the list of 'liquid assets' and can even determine, if considered necessary, a list different for banks than for credit institutions.

53. In subsection (1), the words "on the average" are not enough. If they mean taking a monthly average, it is suggested that the following words be added: "taking one month with the other".

54. In the interests of clarity, subsection 6(c) should be modified to read as:

> "balances and other moneys at call with any other bank in the Territory after deducting therefrom balances and moneys at call owed to any other bank in the Territory".

55. In subsection 6(d), the words "within a period not exceeding ninety-three days" be deleted.

56. Subsection 6(e), should be appropriately amended to allow longer maturities, separately for banks and credit institutions.

57. Subsection 6(g) might well be deleted altogether to avoid the outflow of funds to more developed CARIFTA territories.

58. Subsection 8 might have to be suitably modified to give the ultimate discretion to the Minister in taking his decisions under this section.

Section 8:

59. In subsection (1), the words "and controlled" be added after "incorporated".

60. In subsection (2), the words "and/or controlled" should be added after "incorporated" and before "outside the Territory".

61. In both the above subsections, the words "after payment of income and/or corporation tax" should be added after "net profits" to clarify that the required transfer obligations applies to profits after tax.

62. If the suggestion made in Part II of this Note with respect to relating accumulation in the Reserve Fund to the level of deposits is acceptable, the entire section will have to be re-written and no distinction would be necessary to make, for the purposes of this section, between locally controlled and foreign banks except that for foreign banks the stipulated transfer will apply to net profits before deduction of head office expenses and remittance of profits.

63. Also, there appears to be a case for lowering the percentage of net profits to be transferred annually to reserve fund.

Section 9:

64. It is suggested that the word "or" be added after "banks and" and before "credit institutions" so that the Minister can fix separate amounts for the two types of institutions.

New Section:

65. This new section, it is suggested, be added after Section 9 empowering "the Minister to determine the minimum ratio that after the expiry of six months from the date of service of a notice to that effect, the assets of the territory held by the banks and/or credit institutions will bear to their respective liabilities in the territory; however any variation made in such ratio shall not exceed 10 percentage points in any one period of six months.

66. Subsequent sections will have to be re-numbered.

Section 11:

67. As it stands, this section imposes the same prohibitions on the banks and credit institutions with respect to trade investments and immovable property. This, it is felt, will operate harshly on the credit institutions.

68. The prohibition in subsection (1) on trade may however apply to both types of institutions. But the term "at the earliest moment" should be made more definite by setting a time limit for the disposal of assets acquired in the satisfaction of debts with the power to the Minister to extend the period where he is duly satisfied that the extension is justified.

69. The prohibition, as it stands, on the acquisition of the share capital, it is felt, might not serve the developmental interests of the territories. The qualifying provision whereby the prohibition will not apply to shareholdings approved by the Minister no doubt recognizes the developmental view point but the provision will still remain overly restrictive.

70. It is for consideration that the present subsection (b) be replaced by a new subsection/s whereby

i) dealings in the shares of the bank or credit institution itself are prohibited;

ii) dealings in the shares of companies in which the directors individually or collectively of the bank or credit institution itself hold more than, say, 20% of the equity capital are restricted, (not completely prohibited) by stipulating that the bank or credit institution will not hold at any time shares of any such company in excess of, say, 10% of such company's paid-up equity share capital;

iii) dealings in the shares of other companies be made subject to the overall ceiling, applying to all shareholdings, including those mentioned in (ii) above, namely that (a) a bank will hold not more than, say, 15% of its deposits in shares according to their current market valuation and (b) a credit institution will hold not more than, say, 30% of its deposits in shares according to their current market valuation.

The exception provided for in this section, whereby the prohibitions or restrictions of the section will not apply to shareholdings approved by the Minister, could still be retained however.

71. As regards the purchase or acquisition of immovable property, it is again for consideration if this should not apply only to banks in its present form. For credit institutions, a ceiling might be set in terms of a proportion of their respective deposit liabilities. In either case, however, a time limit should be set for the disposal of property acquired in satisfaction of debts.

Section 21:

72. In addition to the requirement of an advance notice for six months for closing of business it may be stipulated, as a safeguard, that arrangements for meeting its obligations to the depositors shall be made to the satisfaction of the Minister.

Section 26:

73. The same provisions for disqualification should, it is felt, be extended to the directors also.

Section 28:

74. A provision could also be made prohibiting a bank from using either of the words 'central' or 'reserve' in its name.

Section 41:

75. The provision requires to be strengthened on the lines indicated in Part II of this Note to give the Minister the power "to impose controls in respect of the volume, terms and conditions upon which credit may be made available to all or any sector of the economy".

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