Inter-American Development Bank

Macro-Critical Issues and Implications for the Financial Sector in CARICOM

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POLICY BRIEF Nº
IDB-PB-272

April 2018

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Cataloging-in-Publication data provided by the
Inter-American Development Bank
Felipe Herrera Library

Grenade, Kari
Macro-Critical Issues and Implications for the Financial Sector in CARICOM /
Kari Grenade, Allan Wright.
p.cm. — (IDB Policy Brief: 272)
Includes bibliographic references.
1. Financial services industry-Technological innovations-Caribbean Area. 2. Financial risk management-Caribbean Area. 3. Correspondent banks-Caribbean Area. I. Wright, Allan. II. Inter-American Development Bank. Country Department Caribbean Group. III. Title. IV. Series.
IDB-PB-272

JEL Codes: G20, G41, O54
Keywords: financial sector, financial technology, de-risking, climate change, CARICOM

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Abstract:

Risks from climatic changes, advances in financial technology, de-risking activities by correspondent banks, and changing lifestyles and expectations of millennial customers are deemed to be macro-critical issues with the potential to trigger a creative disruption in the financial sector in CARICOM in the not-too-distant future. This Policy Brief examines these issues and discusses their implications for the region's financial sector as we know it. The salient message from this Brief is that the financial sector in CARICOM must accept the inevitability of change and effectively position itself both strategically and operationally so as to remain relevant and to be fit for the future.

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1. Introduction

Commercial banks dominate the financial sector in the Caribbean.[1] Ogawa et al. (2013) reported that banks account for 91 percent of the financial system, while non-bank financial institutions, such as credit unions and insurance companies, comprise the rest of the system. On the whole, the financial sector is large relative to the gross domestic products (GDP) of Caribbean economies. Total assets of the sector amounted to 124 percent of regional GDP at the end of March 2012.[2] Foreign-owned and locally-owned banks accounted for 45 percent and 20 percent, respectively, of total financial system assets at the end of March 2012 (Ogawa et al., 2013).

This policy brief examines four macro-critical issues and discusses their implications for the financial sector in the Caribbean Community, or CARICOM. The key question that it seeks to answer in relation to the Caribbean is: What will the financial sector of the future look like? This question must be answered, especially in the context of macro-critical factors that have the potential to disrupt and/or reconstruct the financial sector and financial services as we know them. This policy brief is an attempt to convince the financial sector to accept the inevitability of change and to develop strategies that will enable it to remain relevant.

2. Macro-Critical Issues and their Potential Implications

The following factors are deemed to be macro-critical because of their potential to significantly reconstruct the financial sector and financial services in the Caribbean as we know them: (i) advances in financial technology; (ii) de-risking; (iii) millennial customers; and (iv) climate change. They are discussed in turn and their potential implications examined.

i. Advances in Financial Technology

Technology has rapidly advanced and evolved. Big data, cloud computing, smart phones, social media, high bandwidth, and now artificial intelligence and robotics are transforming human lives and commercial activities. So, too, is financial technology, or FinTech, as it is commonly known.

According to Mobile Eco-System Forum (2015), 69 percent of mobile media users globally in 2015 carried out a banking activity via a mobile phone, a 3 percent year-on-year increase. In Indonesia, 80 percent of mobile users engaged in M-banking, in Nigeria it was 85 percent, and in Kenya, an incredible 93 percent. Indeed, the use of cash appears to be on the decline. According to Wheatley (2017), in 2015, the number of card transactions in the Netherlands surpassed cash for the first time in the country's history. In Sweden, cash is now used for only 15 percent of transactions at the point of sale.

According to PwC (2016), there are basically three factors propelling the growth of FinTech. They are: (i) customer expectations - customers are demanding seamless and consistently excellent service; (ii) the economic benefits, which allow companies to reduce costs and generate revenue; and (iii) the technology push, which is essentially a virtuous cycle; advances in technology are fuelling innovations, which are driving customer expectations and demands, which in turn propel further innovation.

The use of block chain technology is becoming increasing prominent, not only in the financial sphere, but in other areas as well. Indeed, block chains have the immense potential to be the

[1] Defined as all the member countries of CARICOM.
[2] The latest period for which published data for the Caribbean as a whole are available.

future infrastructure of the financial industry globally. Block chain technology establishes a system of creating a distributed consensus in the digital online world. This allows participating entities to know for certain that a digital transaction has occurred, by creating an irrefutable record in a public ledger.

With a block chain-based digital currency, the transaction itself is the settlement. Therefore, it minimises if not eliminates the role of traditional intermediaries, such as banks. Block chain is a highly disruptive technology that promises to transform the world as we know it and by implication, transform financial services as we know them. It is important to point out some of the concerns that have been raised about block chain-based digital currencies. Williams (2017) cited some of the risks associated with digital currencies, including consumer protection, money laundering, terrorism financing, and the funding of illicit activities outside of regulatory control.

Implications

Technological advances carry potential implications for the financial sector in the Caribbean. First, the FinTech revolution poses a substantial challenge to contemporary models used to deliver financial/banking services, but it does not spell the end of traditional financial services per se. Rather, traditional financial institutions in the Caribbean will have to transform their modus operandi to harness the power of technology to re-engineer themselves into high-value and high-functioning operations, as well as to become significant digital players. Indeed, the financial institution of the future will be digitally driven. Financial institutions have to decide how much should be invested in maintaining core platforms versus building new functionalities.

Second, Caribbean policymakers, regulators, and financial institutions themselves all must broaden their knowledge and understanding of what is feasible and practical with respect to FinTech in the region. Measures must be deployed to mitigate potential risks, but first the risks must be defined. Digital and crypto currencies, though not yet systematically important globally, have the potential to become systemically significant. Therefore, regulation will have to be strong, but not too strong to stifle the potential of the underlying block chain technology, which is where the real power to transform the financial landscape in CARICOM lies.

Third, banks, non-bank financial institutions, and FinTech companies across CARICOM will have to forge strategic partnerships. On the one hand, FinTech companies can benefit from the well-entrenched credibility and trust that the public has in traditional banks and non-bank financial institutions. On the other hand, banks and non-bank financial entities can benefit from the power of FinTech companies to curate big data, as well as their ability to offer flexibility in managing money. Forging strategic alliances is important so that the gains to be had from technological innovation or adoption can be shared for the benefit of all stakeholders—including customers, banks, and regulators across the region. On March 13, 2018, the Barbados-based FinTech company, Bitt Inc., signed a Memorandum of Understanding with the Eastern Caribbean Central Bank (ECCB) to conduct a FinTech pilot on block chain technology in the ECCB member countries. The pilot will focus on developing a secure, resilient digital payment and settlement platform with embedded regional and global compliance. The pilot will also focus on digitizing the Eastern Caribbean dollar, which will operate alongside the fiat currency (www.eccb-centralbank.org).

ii. <u>De-Risking</u>

The Caribbean Development Bank (2016: 5) explained that “Correspondent Banking Relationships (CBRs) exist between banks providing financial services (correspondent banks)

and banks receiving those services (respondent banks).” CBRs facilitate cross-border payments and other essential services that aid international trade. Artingstall et al. (2016) defined de-risking as the process of severing CBRs, or the termination by some international banks of relationships with customers, as well as the removal of bank accounts and/or services from customers, which they associate with high money laundering risks. Artingsall et al. (2016) noted that de-risking has been attributed to the increasing overall cost of complying with regulatory requirements.

Wright and Kellman (2017) and the Caribbean Centre for Money and Finance (CCMF) (2016) provide a comprehensive exposition of de-risking and its impact in the Caribbean. Indeed, the loss of CBRs is exacerbating financial sector fragilities in the region. In the IMF’s (2017a) assessment, the fragilities caused by having fewer CBRs have the potential to chip away at affected countries’ long-run growth and financial inclusion prospects. In a case study of Belize (one of the Caribbean countries most affected by the loss of CBRs), the IMF (2017b) conducted stress-test scenarios and found that “real GDP growth could drop by as much as 5.3 percentage points annually relative to the baseline during 2017-2021 and trade (i.e., the value of exports and imports of goods and services) would fall by 23–26 percentage points of GDP during the same period” (p. 8).

Generally, termination of CBR reflects the correspondent bank’s assessment or perhaps perception that the relationship is high risk, high cost, and unprofitable. While the causes of the CBR strain and/or CBR terminations are multifaceted, interrelated, and idiosyncratic to the banking context, it appears that indigenous and smaller banks are more affected by CBR termination than foreign-owned banks. As observed by Williams (2017), one reason could be because smaller banks have less CBR than the larger banks and perhaps they are more high risk.

Potential banking customers are also being affected. Williams (2017) reported that even in cases where banks have not lost their CBR, they are turning away potential customers nonetheless because of fear of losing their CBR and because the potential customer’s business is seen as excessively risky or costly to audit for compliance. Moreover, there is the added risk that financial entities that have been cut off from the formal system, might turn to less regulated and less transparent channels to conduct business.

Implications

The IMF (2017) provides a comprehensive overview of initiatives by themselves, the IDB, the CDB and others to help address the CBR challenge. Nonetheless, there is more to be done. As alluded to by CCMF (2016), CDB (2016), IMF (2017a) and (IMFb), and others, de-risking has serious implications for the financial sector in the Caribbean. An obvious implication of the de-risking challenge is that financial institutions and regulators in the Caribbean will have to become much more innovative in their response. There have been suggestions that the use of block chain technology could alleviate some correspondent banking issues by enabling better risk management, reducing costs, improving “anti-money laundering”/”know your customer” transactions monitoring and providing an alternative payment platform, especially regarding the transfer of small value payments.

According to Williams (2017), block chain technology can address the de-risking challenge in two ways. One, a settlement network based on block chain technology would offer tools to improve surveillance of transactions, which in turn would help to reduce risk and associated compliance costs. Two, a block chain-based network would offer Caribbean banks the opportunity to bypass correspondent banks altogether. Indeed, if Caribbean banks can participate in a system where

value can be directly transferred to other banks rather than having to work through a middleman, the need for correspondent banking services will be diminished.

No doubt there are privacy and security concerns with block chain technology, but the concerns ought not to be used as an excuse to write off the prospects of block chain. Banks and non-bank financial institutions need to broaden their understanding of the capabilities of block chain, and once it can be brought into the regulatory and supervisory framework, it might provide a lasting and durable solution to CBR challenge.

It goes without saying that the ability of block chain technology to address the problem of de-risking is contingent on the extent to which it facilitates effective compliance measures to detect and prevent money laundering, terrorist financing, and the violation of international sanctions.

On the whole, however, as the IMF (2017a) has emphasised, there must be commitment and resolve from public and private stakeholders, with the ultimate aim of bolstering respondent banks' capacities and institutional frameworks to mitigate and manage risks. Indeed, there must be collective responsibility for addressing the CBR challenge because of its far-reaching implications for trade, remittances, financial services, and overall socioeconomic life as we know it (IMFa, 2017).

iii. Millennial Customer

A new generation of customers is emerging. They are becoming a lot more conscious of their individuality and conscientious in their choices, which will drive the way they do business, including banking business. Their attitudes and expectations are shifting, and this shift is redefining the reality and perceptions of the role of banks and their purpose in society, as viewed by this emerging customer. They have high expectations, they demand the best, and they want excellent service. The excellent service they experience in one sector must be matched across all sectors. They are demanding higher levels of service and value.

According to Henry (2016), the new customers are looking to do more than mere banking transactions; they are looking for a relationship with bank officials who understand their individual needs, the needs of their businesses, and the markets in which they operate. They are seeking not just a business partner, but a partner who helps them realise their aspirations; aspirations they have for themselves, for their families and in some cases, for future generations.

Implications

The implications for traditional financial service providers can be potentially enormous. Indeed, the financial services providers that will best navigate the challenges and opportunities of the future will be those that have a deep appreciation of what is in the customers' interest and a culture that is determined to deliver it. Not only is it necessary for banks and financial institutions on a whole to be well capitalised, well structured, stable and profitable; they must also be fit for the future to remain relevant, especially in the minds of transient customers, with ever increasing demands and expectations.

Now more than ever, financial institutions need to innovate and be agile to keep their customers loyal and to meet their differentiated needs. The implication for financial institutions and especially commercial banks is that they must become places where customers get personalised advice, answers to complex financial problems, and specialised services and expertise. Essentially, they

will become hubs, adopting a life-style oriented focus that smartly integrates financial services with other everyday services, engaging customers every step of the way.

iv. Climate Change

According to the United Nations, climate change represents an urgent and potentially irreversible threat to humanity. Indeed, Caribbean countries are extremely vulnerable to the effects of climate change—from rising sea levels, droughts, severe flooding, coastal erosion, storm surges, and hurricanes.

How do climate change, banking, and the financial sector in general relate? Boston Common Asset Management (2015) suggests that they are related in two ways. Firstly, financial institutions are immensely exposed to climate-related risks through their lending to climate-vulnerable sectors. Secondly, through their lending, commercial banks play an indispensable role in mobilizing and allocating financial resources to sectors and industries that can either help to perpetuate climate vulnerabilities or help to promote climate resilience and energy efficiency. Banks in the Caribbean lend to climate-vulnerable sectors such as tourism and agriculture and therefore, they are uniquely placed to support climate adaptation and mitigation, and by extension, promote environmental sustainability. Indeed, in addition to the public sector, the private sector on a whole has a large role to play in climate adaptation and mitigation.

Implications

There is a leadership role for banks and financial institutions on a whole to play in frontally addressing the climate change challenge that confronts the Caribbean. They have no choice but to be part of the solution. Climate change considerations must be incorporated in the strategic plans of financial institutions so that they are well positioned to mitigate its risks and capitalize on its opportunities. Indeed, climate change is a defining issue for financial stability. Public policy is also needed to oblige financial institutions to take into account climate change considerations.

Climate change presents an opportunity for banks and non-bank financial institutions to launch innovative lending products to accelerate the widespread adoption of energy efficiency and promote energy conservation and the use of renewable energy. Each financial institution should aim to become the financial institution of choice for the clean-tech, renewable energy, and energy-efficiency projects. Relevant financial institutions in CARICOM should have some quota of their portfolios earmarked to finance projects that support climate adaptation and mitigation. Banks can facilitate climate-resilient infrastructure by adding an explicit requirement that borrowers consider climate risks.

Banks and non-bank financial institutions should also consider developing climate-positive retail products and services. These can include products such eco-loans for renovation, insulation and other energy-efficiency work and retrofitting. Energy-efficient mortgages that meet certain energy efficiency standards in home construction can also be offered.

To wrap up this section, Table 1 summarizes the preceding discussion.

Table 1. Macro-critical Issues and Potential Implications for the Financial Sector in CARICOM

Macro-critical Issues	Potential Implications for the Financial Sector in CARICOM
Advances in financial technology	✓ Operational re-engineering to maximize benefits of fin-tech ✓ Innovation, flexibility, and agility required to respond to the technology revolution and remain relevant ✓ Decide how much should be invested in maintaining core platforms versus building new functionalities.
De-risking	✓ Be part of regional coordinated efforts ✓ Block Chain technology must be explored as a possible durable solution
Millennial customer	✓ Adopt a life-style oriented focus that smartly integrates financial services with other everyday services ✓ Learn from each customer experience and exploit their differentiated needs
Climate change	✓ Finance climate adaptation and mitigation initiatives ✓ Promote and finance the transition to a "green economy" ✓ Support climate-positive retail products and services - "eco-loans"

3. Conclusion

This policy brief discussed four macro-critical issues and examined their potential implications for the financial sector in CARICOM. Each of the macro-critical issues will have a different impact on specific financial institutions. On the whole, however, these macro-critical issues have the potential to trigger a creative disruption in the financial sector in the region in the not-too-distant future. Therefore, financial institutions must effectively position themselves strategically and operationally to adequately respond to these macro-critical issues.

Banks and the financial sector overall must narrow any relevance deficits that may exist, and simultaneously chart new pathways and new visions and strategies. On the one hand, they must minimize potential threats posed by the macro-critical factors and on the other hand, they must capitalize on potential opportunities. Each financial institution needs to have a clear sense of the posture it wishes to adopt, as well as a coherent vision and realistic strategic plan to navigate the future landscape, which, because of technology, will be fundamentally dissimilar to what currently exits. Transforming that vision into reality will not be quick or easy. Nonetheless, it is a development imperative for the Caribbean.

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