CENTRAL BANK OF BELIZE

PERSPECTIVES ON SAFETY AND SOUNDNESS -

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INTRODUCTION

It is an honour for me to speak to you today on the occasion of the 36th Annual Convention of the Caribbean Confederation of Credit Unions. I speak to you, not only as central banker/economist but also as a credit union member.

I am pleased to say that I first learned of the principle of saving for the future when, as a child, I joined a credit union for the first time. Over the years, as I have become familiar with how credit unions work, I have learned to appreciate the principles of cooperative self-help and management by consensus as practiced by the credit union movement.

Throughout the Caribbean, and elsewhere, credit unions are facing increasing difficulties in adhering to the fundamental principles of co-operative self-help and management by consensus. Not only are some credit unions becoming so large as to make co-operative self-help and management by consensus difficult to implement efficiently, but the search for solutions to these difficulties is being carried out in a world moving quickly away from such approaches, particularly in the financial sector.

There is growing pressure on credit unions, from within the credit union movement itself, to improve their operational efficiency and increase their interface with the rest of the financial market.

These developments are seen as necessary if the movement is to survive and keep its fundamental principles intact. There is also growing pressure from outside the credit union movement on governments to implement meaningful supervision and regulation of credit union activities, particularly as credit unions venture into areas which are traditionally the purview of institutions which have to submit to such regulation and supervision.

Credit unions are therefore faced with the challenge of keeping up with developments in the financial world while keeping to the principles which underlie the "credit union way".

Today I want to briefly explore some of these issues by looking at:

- 1. the evolving role of credit unions as financial intermediaries and their impact on the economy;
- 2. the most important elements of safety and soundness [which is the focus of your attention at this convention]; and
- 3. the development of a strategy for the future.
- 1. The Role of Credit Unions as Financial Intermediaries and their Impact on the Economy

We will look first at the role of credit unions as financial intermediaries and the impact of credit unions on the economy.

a. Clients

Credit unions across the Caribbean have traditionally been dominated by middle and lower income persons. In many instances

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these are persons who would not find it so easy to steadily accumulate the quantum of deposits which commercial banks and other financial institutions would define as the minimum indication of a good credit risk. By their activities, therefore, credit unions have given access to the financial system to a significant group of persons who otherwise may not have had such access.

Credit unions have tended to be started within groups of persons sharing a common employer, industry, church or geographical area. The nature of these groupings has allowed credit unions to build their clientele on the basis of character references. Credit unions have protected the quality of their loan portfolios by keeping to the practice of requiring new members to accumulate a certain amount of shares and/or to establish a savings record before qualifying for loans and limit loans to new members in accordance with their level of shares and savings.

When credit unions have remained relatively small, they have been able to practice this "know your customer" rule with some success. Those credit unions which are growing large, however, are finding it increasingly difficult to maintain the close personal contact between management and membership which is necessary for t his approach to work well. This is because there is a trade off between the size of the institution and the extent to which personal contact is possible. It is therefore important for credit unions to develop more objective methods for assessing credit risk as membership increases. The long term survival of the movement may well depend on it.



b. Sources of Funds

The traditional source of funding for the lending activities of credit unions has been the shares and savings of their membership. For the smaller institutions, these continue to be the main sources of finance. In more recent times, however, there have been two developments to note in the credit union movement, particularly with the larger credit unions.

The first development is the general easing of the emphasis on members increasing their ownership of the institutions through the acquisition of shares. This has been accompanied by a move towards encouraging savings and other kinds of deposits and has been explained by a need to present a choice of more flexible financial instruments for members as a result of the increased competition for financial surpluses in the economy. Credit unions are been increasingly portrayed and seen as comparable with banks when in fact their organization as "credit co-operatives" has traditionally been their most attractive attribute.

The second development is the movement towards non-traditional sources of finance for the lending activities of credit unions. These sources include lines of credit from multi-lateral or bi-lateral agencies for on-lending to members and the introduction of deposit instruments which are new to credit unions such as time and demand deposits. These developments are also leading to increased demands for tighter regulation of credit unions.



The greater problem for credit unions which this development may highlight, however, is the conflict between the traditional "credit union way" and the requirements of the new sources of finance.

Funds on-lent from multi-lateral and bi-lateral agencies, for example, may have restrictions on qualifications for use which would exclude a sizable portion of a credit union's membership or require a level of formal process which a credit union may normally not require.

In the case of the new kinds of deposits, these may increase the average cost of funds to credit unions which, if a decline in operational costs cannot be also achieved, would result in a decline in net income or operational losses.

Credit unions, therefore, must undertake to improve efficiency in operations if they intend to increase their access to non-traditional sources of funding. This is not only because the new sources of funding will demand this improvement, but also because without this improvement the net effect on their operations may be negative.

I would also like to suggest here that as credit unions have begun to compete with other financial institutions by introducing those instruments which other institutions deal in, rather than by stepping up the marketing of the credit unions' own advantages, the call for increased regulation of credit unions will become more strident.



c. Uses of Funds and Economic Impact

Credit unions have traditionally made loans to members to finance household appliances and other consumer durables, home improvement, education, land purchases and home construction. Through the accumulation of shares and deposits in credit unions, credit union members have been able to create a base against which they can borrow for these purposes. In many instances, these are persons who would not be able to access funding from the commercial banks and other financial institutions.

In this way, credit unions over the years have successfully allowed middle and lower income persons to improve their standard of living through encouragement of thrift and borrowing against accumulated savings in a sensible way. This contribution to the economy and society has been significant and cannot be overemphasized. Unfortunately, it is only recently that the positive social and economic impact of credit unions in the region has begun to be seriously studied by professionals from outside the movement.

These studies are important not only because they document for the policy-makers and the general public the positive role of the credit union movement, but also because the credit union movement would find these studies useful as they prepare strategies to guide is future development.

More recently, credit unions have begun to broaden their lending portfolios to include financing of small businesses and this



has led to some concern on the part of banking supervisors, competitors in the financial system and credit union members themselves. This concern arises for several reasons.

From the banking regulators point of view, as credit unions broaden their scope of activities, there is a growing portion of the financial sector which is excluded from the monetary policy net as defined by the financial institutions laws of the region. This means that the extent to which a government's policy actions can meet set targets is likely to be reduced by the relative size of the credit union activity.

Regulators are also concerned that the larger credit unions become, the greater is the potential burden on the public purse in the event of failure. These are the two main reasons why banking regulators throughout the region are looking at the activities of credit unions more closely at this time.

From the point of view of other institutions in the financial system, such as commercial banks, there seems to be an unevenness in the supervision of financial institutions which are conducting similar business. This view is premised on the fact that whereas the lending activities of banks is generally strictly supervised, there is no comparable supervision of credit union lending.

From the point of view of some credit union members, the areas into which credit unions are broadening their lending activities are those areas of higher risk which other institutions of



greater institutional capacity and stronger capitalization tend to avoid. Furthermore, these new areas are not necessarily in keeping with the credit union tradition of lending for personal as opposed to business purposes.

The issues which have been outline above arise largely because there have traditionally been fundamental differences between credit unions and other financial institutions on the level of philosophy and approach to business - differences which have more recently become blurred as credit unions have sought to adapt to the developments in the financial system.

Whereas the fundamental philosophy of credit union activity is based on the promotion of thrift and co-operative self help, the philosophy of other financial institutions is based on maximizing profit through intermediating between savers and investors.

Therefore, credit unions encourage their members to acquire shares and accumulate savings against which they can borrow "on a rainy day", while other financial institutions mediate between those who accumulate savings and those who wish to use these savings.

In the case of other financial institutions, it is usually the case that the owners, the savers and the borrowers are three distinct groups of persons. Because these groups are different, and because the most vulnerable group among the three is the savers, the responsibility for protecting their interest has been charged to governments who exercise this responsibility through the Central Banks or other supervisory authority. In the case of credit unions,



however, the owners, the savers and the borrowers are the same group of persons - that is, the members. Therefore, to the extent that the institutions remain small and are managed by consensus among the members, a need to place credit unions on the same regulatory footing as other financial institutions has not been seen.

This fundamental difference between credit unions and other financial institutions has to be borne in mind as credit unions seek to grow and expand into new areas of activity. Where these new areas of activity imply competition with other financial institutions which must meet regulatory requirements of the authorities, and where these activities result in a separation of savers, members and borrowers into divergent groups, credit unions must expect that both competitors and regulators will sit up and take note with a view to planning an appropriate response.

2. SAFETY AND SOUNDNESS

I now turn to the specific issue of safety and soundness. This is the theme of this year's convention and it echoes the concern for the safety of depositors of funds and the overall soundness of all financial institutions. This concern has deepened in recent times because of the significant failures of financial institutions in the region and internationally. These failures have resulted in increasing demands first, on governments, to meet the cost of failures and, second, on regulators and supervisors to strengthen their activities so as to reduce the incidence of failure.

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With specific reference to credit unions, the growing concern, from the banking regulators point of view, arises from a recognition that the existing arrangements for supervision are not adequate to meet the demands of the rapidly evolving financial system.

When credit unions are small, the impact of failure, which happens from time to time, is fairly localized. Therefore the potential cost of inadequate supervision is assumed to be relatively small. When, however, credit unions grow in size to rival banks and engage in financial activities which the present supervisory authority may not have the skilled personnel to oversee, then the risks increase and the high cost of potential failure is more immediately apparent. This is a source of rising concern of regulators for the safety and soundness of credit unions.

From the attention which this gathering is paying to the issue of safety and soundness, it is clear that credit unions in the region have seen the need to develop strategies to address the growing concerns.

There may be a need, however, to underscore the point that the fundamental premises of the principles of safety and soundness are the same for all financial institutions. This is so, notwithstanding the fact that these principles may be practiced in widely differing ways across the financial system. Banking supervisors respond to these differences by developing different standards and procedures to meet the needs of each category of

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institution. But the fundamental concerns are the same across the financial system. For all categories of financial institutions supervisors are concerned about:

- 1. the adequacy of the capital base;
- 2. the level and management of liquidity;
- 3. the soundness of management practice; and
- 4. the adequacy of supervision.

I would like to suggest that these areas be targeted for attention, not only at this gathering, but within an ongoing process of developing strategies geared to meeting the specific needs of credit unions as they grow and expand into new areas.

With regard to capitalization, credit unions are to be encouraged to develop strategies to strengthen overall capitalization through the traditional source - members shareholdings - first and foremost, if the traditional credit union way of saving for "a rainy day" is to be promoted.

The practices of building reserves and providing for bad debts are also to be encouraged. At this time, these basic procedures which are designed to promote safety and soundness are not being broadly followed within the credit union movement. This raises considerable concern among those of us who study the financial system.



Credit unions also should focus attention on developing liquidity management tools which would allow them to meet their daily needs with some measure of ease while minimizing the quantum of their assets which is held in low earning liquid forms. Proper liquidity management could allow a greater return on assets generating a larger surplus to be cycled through to members.

Perhaps, however, the single most important principle which the credit union movement should seek to develop at this time is that of good management practices. And here I do not necessarily mean the adaptation of management methodologies which could be largely irrelevant to the needs of the credit union community. Rather, I mean the implementation of organizational arrangements which facilitate efficient decision-making and which lead to the development of proper systems and procedures to guide the most important areas of operations such as loan processing and the development of systems of internal controls which will reduce the level of losses due to dishonesty and inefficiency. Well documented systems and procedures and strong internal control are fundamental to the safety and soundness of all financial institutions - including credit unions.

The Strategy for the Future

If the credit union movement is able to convincingly develop strategies to strengthen capital, manage liquidity and strengthen management and internal controls, the issue of regulation and supervision would become much easier to resolve. At this time,



with these issues as yet outstanding, there is a major concern within the credit union movement that the strengthening of regulation and supervision, which appears to be on the horizon, will allow forces outside the movement to determine its future direction.

If, in fact it is inevitable that regulation and supervision of credit unions will be strengthened, the onus is on the credit movement to lead the development of the strategies to promote safety and soundness of the institutions which comprise the credit union movement.

It should be recognized, however, that successfully developing strategies along the lines being suggested here will not eliminate the call for stronger supervision and regulation of credit unions activity. These calls will continue and will increase as long as credit unions continue to broaden their scope of activities.

What successful development and implementation of these strategies will do is to strengthen the position of the credit union movement in the on going debate over the perceived need for increased supervision and regulation. In other words, the best way to ensure that the credit union movement is not made subject to rigid supervision and regulation is to demonstrate that it is not necessary.

CONCLUSION

In conclusion, I would like recognize that the credit union movement has begun to face up to the task of improving the



operational efficiency of credit unions. Plan 2000, which is guiding the development of strategies for the future, is a major step and the movement will be the better for its successful implementation.

I hope that I have presented some ideas which will feed positively into your deliberations over the next several days and offer my best wishes for the success of the convention and for the future.