

# **Financial Restructuring in the OECS Countries**

by

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## ABSTRACT

*The process of political decolonisation has triggered significant changes in the institutional arrangements in the OECS<sup>1</sup> countries. The post-war period has produced an enlarged, and a relatively diversified and sophisticated financial system.*

*A number of non-bank intermediaries are supplementing the services offered by banks and competing with banks on the retail and wholesale markets. There is evidence of a shift from the dominance of banks in intermediation to non-banks, as well as a broadening of the functions of banking institutions into non-traditional banking business.*

*These developments could have serious implications for the monetary authority, as the unpredictability of non-bank activity could frustrate monetary policy.*

*This paper examines the process of financial restructuring in the OECS financial system, and articulates some policy issues with respect to the development of the financial system.*

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<sup>1</sup>*The member countries of the Organisation of Eastern Caribbean States (OECS) are Anguilla, Antigua and Barbuda, Dominica, Grenada, Montserrat, St Kitts and Nevis, St Lucia and St Vincent and the Grenadines. The British Virgin Islands is an associate member and developments in that jurisdictions are analysed.*

## INTRODUCTION

Economists are divided on the importance of the financial system for economic growth, and are engaged in a lively debate on the nexus between financial intermediation and economic growth. Joseph Schumpeter (1912) observed the role of the financial system in igniting the process of industrialisation in England by facilitating the mobilisation of capital. Joan Robinson (1952) declared that economic development creates demands for particular types of financial arrangements, and the system tends to respond to these demands. Some economists (Lucas, 1988; Meir and Seers, 1984), however, attribute no particular importance to the relationship.

Since the publication of Raymond Goldsmith's *Financial Structure and Development* (1969), the literature on the nexus between finance and growth has become very voluminous. In some cases, the "debates focussed on the role of the interest rate as a tool for mobilising savings, encouraging investment and consequently enhancing economic growth" (Sandiford, 1994:1). McKinnon (1973) and Shaw (1973) stimulated these discussions at a time when some of the central tenets of the Keynesian paradigm were being reviewed.

Economists and economic historians agree that the process of economic growth is closely associated with expansion of the financial intermediation.<sup>2</sup> Some authors including McKinnon, (1973) and Shaw (1973) "developed theoretical models for an economic development strategy based on the development of the financial sector" (Sandiford, 1994:5). The parallelism however involves complex causal relationship, some of which are not well understood.

The pioneering literature on the financial aspects of the growth process is dominated by the work of Goldsmith and John Gurley and Edward Shaw.<sup>3</sup> The ideas, which emerged from that

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<sup>2</sup>According to Bryant (1987:6), "financial intermediation, broadly conceived, is the complex process through which the differing needs of ultimate savers and ultimate investors are reconciled. Financial intermediaries, such as banks, savings and loans associations, insurance companies, and financial markets, such as stock exchanges and interbank overnight-funds markets, are institutions that facilitate this reconciliation.

<sup>3</sup>The generalisations are taken from Goldsmith's *Financial Structure and Development*; *A Survey of Savings in the United States*; *Financial Intermediaries in the American Economy Since 1900*; *The determinants of Financial Structure*; *The National balance Sheet of the United States, 1953-1980*, and *Comparative national*

literature and subsequent elaboration, are summarised. First, Goldsmith, who produced the seminal work, *Financial Structure and Development* (1969), concluded that the financial superstructure tends to expand as economic development proceeds. That is to say, the network of financial interrelations among decision-making agents acquires greater density at a more rapid rate than the network of goods and services transactions.

Literature on the financial system in the OECS suggest that the direction between financial growth and economic growth is uni-dimensional, as developments in both the real sector and in the financial sector were significantly influenced by the colonial experience. This was fuelled by openness and fluctuating fortunes of the economies, the process of political decolonisation, fiscal incentives legislation; and the development of the money and capital markets.

As development advances, the financial superstructure may grow about the same rate with the real sector. Gurley and Shaw arrive at almost similar conclusion when they conclude that “the ratio of outstanding primary securities to income rises sharply in the early stages of the financial development of a capitalist economy, but then eventually reaches a plateau’ (Bryant, 1987:11).

Second, as economic growth proceeds, financial institutions tend to increase in relative importance, as reflected in the share of financial intermediaries both in the issuance and ownership of financial assets.

Third, the link between financial and economic development is reflected in an increasing diversity in the types of financial institutions as well as the types of instruments in which they specialise. At the early stage of development, commercial banks tend to dominate the financial structure. “As economic and financial growth proceed, there is a decline in the banking system’s share of the assets of all financial institutions and a corresponding rise in the share of newer

types of institutions, such as thrift intermediaries, insurance companies, government and private retirement funds, investment companies, finance companies, and securities brokers and dealers”(Bryant, 1987:12).

The negative view with respect to the nexus between the contributions of banks and other financial institutions is associated with the work of Gurley (1967).<sup>4</sup> In his studies of the experiences of socialist economies and developing economies, he expressed skepticism about the prominence attached to a separate choice made by other institutional decision-makers in the goal to promote growth must be considered. He noted that some countries have realised growth through other methods such as foreign savings, central planning and fiscal measures. The decentralisation of decision-making, specialisation of savings and investment and emphasis on external and internal financing of investment cause financial institutions to flourish.

While economics have made important advances and the preponderance of theoretical reasoning and empirical evidence do suggest a positive relationship between finance and growth, the debate remains inconclusive, as additional research is required to establish the links between the functioning of the financial system and economic growth. There is need for more rigorous understanding of the emergence, development and economic implications of different financial structures.

It is worth noting that most of the studies undertaken on finance and development were done in market economies and were long-run studies involving multiple cases. Goldsmith utilised data on 35 countries over a period of one hundred years. King and Levine (1993) studied 80 countries over a period of 29 years.

Both the scope of this study and the narrowness of the data series do not allow us to contribute meaningfully to the debate on the nexus between finance and growth in the context of

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<sup>4</sup>See Gurley, J. G. 1967. “Financial Structures in Developing Economies”, in *Fiscal and Monetary Problems in Developing States*, (Ed) D. Krivine (New York: Praeger), and Gurley, J. G. 1967. “Review of Banking in the Early Stages of industrialisation, (Ed) R. Cameron, *American Economic Review*, 57, No.4, (September). pp.950-53.

OECS countries<sup>5</sup>. Relative to the cases discussed in the literature, the OECS economies are very small and exhibit a lot of similarities. More importantly, the available financial statistics restrict any comparison between the commercial banking sector and the Non-Bank Financial sector to only five years, 1990-1995. While the issues relative to the direction of finance and development could prove useful, any generalisation would be suspect.

This research contributes primarily to the discussions on financial structure and financial intermediation. This concept is used in the literature to refer to the relation of total financial assets to total tangible assets, the distribution of the total financial assets among the types of financial instruments, and the distribution of the total financial assets amongst financial intermediaries.

This study attempts to explore three of the assumptions, which emanate from the debate with respect to financial restructuring. Financial restructuring denotes a rearrangement of the structural relationship between financial assets and tangible assets; a re-organisation of the distribution of the aggregate financial assets in the financial system amongst the financial intermediaries; particularly between banks and non-banks; and the changing importance of the financial institutions (banks and non-banks) in the process of economic development.

In the context of the debate on finance and development, the analysis will seek to examine three assumptions emanating from the literature on financial structure. They are:

- i. The financial superstructure expands with economic growth. Financial intermediaries get larger as measured by the total assets or liabilities of financial intermediaries relative to GDP.

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<sup>5</sup>As at December 31, 1995 the population of the OECS countries was estimated at 633,023 and real GDP was estimated at EC\$1,553 millions.

- ii. The structure of the financial system changes with growth as evidenced by an increasing diversity in the types of financial institutions as well as the types of instruments in which they specialise.
- iii. The character of intermediation changes, reflecting a shift from the dominance of traditional commercial banks to non-bank financial intermediaries. That is to say, non-banks financial institutions increase in relative importance.
- iv. Non-banks assume an increasing important role in economic development as intermediation changes.

The analysis seeks to resolve two main issues:

- i. Is there empirical evidence of a restructuring of the financial OECS system?;
- ii. What are the forces, which contributed to the structural rearrangement?

The rest of the paper assumes the following organisation. Section II, which immediately follows, presents an overview of the OECS financial system. Section III, the analytical section, examines the three assumptions in the context of changing market share, and relative contribution to economic growth. The policy issues are articulated in Section IV.

## **SECTION II:**

### **AN OVERVIEW OF THE OECS FINANCIAL SYSTEM**

#### **(i) The Economic Context**

The economies of the OECS sub-region are mainly dependent on agriculture and tourism, with tourism activity mainly concentrated in the Leeward Islands and agricultural activity the

primary focus of the Windward Islands. More than 80 percent of labour force is dependent on these two sectors for gainful employment.

Developments in the OECS financial system in the period 1975-1995, took place against the backdrop of economic crises or recession, brief periods of economic upswings and a short but sustained period of growth driven by robust performance of the banana industry in the Windward Islands. The period of banana boom is often referred to as the era of “Green Gold”.

The economies of the OECS countries were severely affected by the global recession of the 1970's. The small, dependent, vulnerable economies had to battle with stagflation, rising unemployment and persistent balance of payments problems. Added to these problems, the banana industry of the Windward Islands, the major foreign exchange generator was adversely affected by prolonged drought, leaf spot disease and hurricanes. The low level of national savings meant a contraction in private sector investments and public expenditure.

During the 1970s, respective governments were forced to trim the social services, thereby making many social goods and services inaccessible to many within the lower income group at a time when households' real income was shrinking. Moreover, many in that same income class enjoyed virtually no access to credit facilities in the banking system.

The 1980's were a period of transition and recovery. In the main, the first half of the decade saw the economies experiencing a deepening of the recession which began in the 1970's while the second half witnessed a period of economic growth. The stability of the pound sterling in the latter half of the 1980's along with the absence of severe winters in Europe contributed to the rising price of bananas on the United Kingdom market. High levels of capital formation gave rise to expanding investments in the building and construction sector. Increases in the level of national deposits resulted in high levels of liquidity in the banking system.

Developments in the OECS economies reflected a general slowdown in economic activity in the global economies. Despite the fact that inflation was kept at an annual growth rate

of less than 5 per cent, economic activity in the United States remained weak throughout. In the Canada, company profits remained below pre-recession levels. In the United Kingdom, sharp declines in output, automobile production and exports led to rising unemployment.

Throughout the period, economic activity in the sub-region slowed significantly reflecting for the most part, a contraction in export agriculture and near stagnation in construction and investment spending. Stimulus to growth was provided largely by increased tourism and consumption expenditure. The estimated average growth rate for the OECS economies was about 3 per cent.

Agricultural output was low and shortfalls in banana production were recorded in all four exporting countries (Dominica, Grenada, St Lucia and St Vincent and the Grenadines). Banana export receipts, the largest contributor to foreign exchange earnings for Dominica, St Lucia and St Vincent and the Grenadines was low. Nutmeg earnings previously the biggest contributor for Grenada fell primarily as a result of a persistent fall in market price consequent on the breakdown of the marketing arrangement between Grenada and Indonesia. The damage to the sugarcane crop by hurricane Hugo in 1989 impacted negatively on St Kitts' export receipts in the immediate period.

Anguilla and Antigua and Barbuda, two countries that depend heavily on tourism, suffered from fluctuations in the number of stay-over visitors. The general slow-down in economic activity in Montserrat prior to 1989 was followed by a massive reconstruction programme, which following the passage of hurricane Hugo, provided the stimulus for economic growth.

Sharp increases in the price of oil and the price of imported goods contributed to relative high inflation rates in the 1980. Inflation ranged from 18 per cent in St Kitts to 42 per cent in Dominica. However by 1995 had been reduced to single digit. From a low of 2 per cent in 1992, it reached 3 per cent in 1995. Money supply expanded significantly in the Windward Islands relative to the Leeward Islands.

Although data on the labour force and on employment were unavailable, the general slow-down in economic activity suggested that unemployment increased, as the economies were unable to absorb the growing number of school leavers entering the labour market.

## **(ii) The Financial System**

The Eastern Caribbean Central Bank (ECCB), the monetary authority for the Eastern Caribbean Currency Area<sup>6</sup>, stands at the apex of the financial system in the OECS region, often referred to as the ECCB Area. Established in 1983, the multi-state central bank is empowered to regulate banking business, monitor the availability of money and credit, promote and maintain monetary stability and economic development. It is an atypical central bank, in the textbook sense, as the Banking Act, which governs its operations, gives it jurisdiction over all registered and licensed financial institutions.

The rest of the formal financial system includes commercial banks (referred to in this paper as banks), a newly established Eastern Caribbean Home Mortgage Bank (ECHMB), Development Banks, National Development Foundations (NDFs), Finance Companies, Building Societies, Credit Unions, Life and Non-life Insurance Companies, Social Security Schemes, Friendly Societies and School Cooperative/Thrift Societies. (Table 1.1). In addition, there are a number of private pension funds established by private business houses, and a few other savings banks and finance houses, which supplement the investment services offered by the established financial institutions. Consistent with the uniform 1991 Banking Act, some of the cooperative banks are classified with the NBFIs.

Banks are the most important financial enterprises in the financial system, that is, with respect to savings mobilisation, credit creation, investment and other retail and wholesale banking business.

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<sup>6</sup>*The Eastern Caribbean Currency Area is the financial space which includes all the British dependencies and former British colonies of the Eastern Caribbean. It includes Anguilla, Antigua and Barbuda, Dominica, Grenada, Montserrat, St Kitts and Nevis, St Lucia and St Vincent and the Grenadines. It is the only monetary union in the Caribbean and Latin America.*

The ECHMB was established to purchase residential mortgage loans from primary lenders and, thereby assist these institutions in providing more mortgage financing on better terms to homeowners.

Developments Banks are significant financiers of development projects. They finance educational, housing and agricultural projects, and extend credit to enterprises involved in productive activities. Inasmuch as they do not generally function as depositories, in this paper, they are classified as non-banks.

National Development Foundations (NDFs) and Development Banks are the two major types of Development Finance Institutions (DFIs) operating in the OECS countries. The NDFs provide short to medium-term funds mainly to micro and small businesses. They package projects for micro and small entrepreneurs for funding by commercial banks, and may guarantee up to 80 per cent of commercial bank loans to small enterprises, which lack the required collateral.

Finance Companies and Building Societies raise funds directly in the local market, concentrating on savings and time deposits. For example, mortgage institutions obtain funds to offer loan-term real estate loans and finance companies, extend loans to households, and differ from commercial banks in that they do not offer chequeing facilities. Building Societies like Savings and Loans Associations mobilise funds for lending to the housing sector. They are retail lenders and supplement the housing services offered by mortgage institutions and development banks.

Credit unions are important NBFIs, competing with commercial banks offering retail-banking services, and supplementing the financial services offered by other financial intermediaries.

The insurance industry is the largest and most important sub-sector of the Non-Bank Financial sector. The market is dominated by agencies of companies incorporated in other

CARICOM countries or in the metropolitan centres. Life insurance companies mobilise large volumes of funds and play an important role in domestic capital formation.

Social Security Schemes (SSS), formerly National Provident Funds, are among the largest Non-Bank Financial institutions (NBFIs) in the OECS countries. They are capitalised by compulsory payroll deductions. These funds are used for claims payments, for meeting operations costs and for building reserves, and, as is the case in most countries, some of the funds are utilised for development purposes. These schemes mobilise domestic savings, which are used to provide a measure of security for the aged, and for financing investment.

Friendly Societies are welfare institutions established mainly in social organisations to provide for the precautionary demands of members of the fraternity. Most societies are formed within religious organisations and function, to some extent, as an insurance carrier, providing sickness and death benefits among other services. There are also a number of informal and non-formal financial and welfare institutions<sup>7</sup> providing a measure of security to persons in the lower income group.

School Savings Cooperatives or Thrift Societies, as they are called in different jurisdictions, are financial cooperative enterprises organised to promote thrift and to encourage savings mobilisation amongst minors.

In the OECS countries, financial intermediation is no longer the sole preserve of banks. The financial system includes a large number of non-bank intermediaries which are at varying stages of development and sophistication.

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<sup>7</sup>*Sou Sou, called by other names in some countries, is one such important informal arrangement among individuals who have entered into informal contract to contribute a fixed amount of money in a set period to a collective fund. The savings mobilised are distributed on a rotating basis to contributors. There is no administration cost and the contract is based on trust.*

## **SECTION III**

### **FINANCIAL RESTRUCTURING**

The literature uses a number of yardsticks to measure financial structure. In this paper we utilise four of these tools to measure financial structure: 1) the change in the number of and size of financial institutions; 2) the shift in the distribution of financial institutions; 3) the change in the share of the financial institution in the stock of financial assets and; 4) the change in the ratio of financial assets to GDP.

#### **a) Market Penetration**

Like the other former British jurisdictions, the rudiments of the formal financial system was established during the British occupation. As satellite states the financial systems in the respective OECS countries were designed primarily to advance commerce with the metropolitan centre, and to facilitate intermediation.

Financial intermediaries, mainly banks and insurance companies were established primarily to supply the increasing demands of expatriate personnel for depositories, credit institutions and insurance facilities. The banking and insurance industries were dominated by Multi-national Financial Corporations (MNCs), as they tended to follow Multi-national Corporations (MNCs) overseas because of their preference in dealing with businesses in which they developed an expertise.

Initially the OECS region was dominated by foreign entities. The market was dominated by a few subsidiaries of parent firms located in Europe, and later on, in North America.

Originally, foreign banks issued their own notes that circulated side by side with coins issued by the United Kingdom government. Later on, the British Caribbean Currency Board (BCCB) was established in 1950 as the sole issuer of notes and coins. The quasi-monetary authority issued local British West Indian currency equivalent to any intake of foreign exchange.

The banks however served primarily as a “store of savings and a source of short-term working capital” for the small mercantile class. The growth of the financial system already evident in the immediate post-war period, with the expansion of the banking and insurance industries, and the entrance of more foreign banks and insurance companies from Europe and North America. In most cases, the only indigenous financial institutions were co-operative banks and savings banks (usually referred to as penny banks) and credit unions which provided retail services to those in the lower income group.

**Table 1.1**  
**Number of Financial Institutions, 1997**

<b>Banking Institutions</b>	<b>Number</b>
Central Bank	1
Home Mortgage Bank	1
Commercial Banks	44
<b>Non-Bank Financial Intermediaries</b>	
Credit Unions	78
School Co-operatives	282
Friendly Societies*	100
Building Societies	4
Finance Companies	20
Insurance Companies	62
Development Banks	7
National Development Foundations	7
Social Security Schemes	8
<b>ECCB AREA</b>	<b>614</b>

Source: ECCB Statistics, \* Number understated

(CORRECTED)

The landscape of the financial system was radically altered with the process of decolonisation. The restructuring of the financial system was already evident by the 1970's, with the expansion of the credit union sector, the registration of a number of indigenous non-life insurance companies, and the licensing of local banks in several of the jurisdictions.

With the establishment of local banks, the dualistic nature of the banking system became more evident. Six foreign-owned and controlled banks operated forty branches while eight newly

established locally owned and controlled banks operated ten branches<sup>8</sup>. Lewis (1970) argues that the volume of savings mobilised partly depends on the geographical spread of savings institutions. People save more when the saving institution is close to them. The growth of credit unions, for example, has been significantly influenced by the formation of enterprises in factories, organisations, and communities.

By 1995, the OECS financial system had expanded significantly with economic growth and development. Compared with the few dominant foreign subsidiaries of the pre-war period, the system comprised more than 621 financial entities and more than 12 types of financial institutions. The rapidly expanding financial system included one (1) multi-state Central Bank, the Eastern Caribbean Central Bank (ECCB) - the monetary authority for the Eastern Caribbean Currency Area, one (1) newly established Mortgage Bank, the Eastern Caribbean Home Mortgage Bank (ECHMB), forty-four (44) commercial banks<sup>9</sup>, seven (7) Development Banks, seven (7) National Development Foundations (NDFs), thirteen (13) Finance Companies, four (4) Building Societies, eighty (80) Credit Unions, sixty-seven (67) Life and Non-life Insurance Companies, eight (8) Social Security Schemes (SSS), more than one hundred (100) registered Friendly Societies and two hundred and eighty-two (282) School Cooperative/Thrift Societies. (Table 1.1).

As noted above, there are also a number of private pensions, savings banks, and a few other finance houses, which supplement the services, offered by the established financial institutions. Consistent with the uniformed 1991 Banking Act, some of the cooperative banks are classified with the NBFIs.

The expansion of the financial superstructure is reflected in the degree of institutional penetration. The penetration rate reflects the relative presence and importance of the financial institutions in the financial system. The institutional penetration is discussed with respect to the

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<sup>8</sup>*Three of the locally owned and controlled banks were fully and largely public owned; five were fully and largely privately owned and controlled.*

<sup>9</sup>*There are twenty-three licensed banking institutions and twenty-one branch banks. The central bank supervises the branch banks as separate institutions. Therefore, in this paper, the banking sector includes forty-four banks.*

changes in the clientele base, and the expansion of financial services as reflected in the changes in the asset size of the respective institutions.

**Table 1.2**  
**Number of Customers by Financial Sector,**  
**1990, 1995**

	<b>1983</b>	<b>1995</b>	<b>%Change</b>
<b>Commercial Banks</b>	503,478	823,681	63.60
<b>Non-Banks</b>	137,220	231,506	68.71
	<b>640,698</b>	<b>1,055,187</b>	<b>64.69</b>

Source: Quarterly and Annual Reports

(CORRECTED)

While the number of persons accessing the services offered by all financial institutions increased by 35 per cent in the period 1990-95, the customer base of banks grew by 38 per cent relative to 32 percent for the non-banks<sup>10</sup>. (Table 1.2). The customer-base of the banking sector is a reflection of its dominance, its historical role in the financial system, and the wide variety of financial services its offers. But the growing importance of the non-banks is evident.

Changes in the geographical spread of the banks and non-banks in the period under review also reflect the rearrangement of the financial system. While there were 42 banks offering banking services to 598,766 clients in 1990, five years later, there were only 44 banks serving 823,681 customers. The non-banks were more widespread. In 1990, some 600 non-banks provided services to 175,923 clients compared to 619 serving 231,605 customers in 1995.

Two issues are significant with respect to the discussion of geographical spread. First, the smaller number of banks reflects the ownership structure, the field of membership as well as the

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<sup>10</sup>Figures were only available for credit unions, life insurance companies, building societies and national development foundations. Moreover, for comparative purposes, only non-bank institutions involved in deposit-taking and/or credit creation are analysed. For, example, the activity of the Home Mortgage on the credit market is excluded, since as a secondary mortgage institution, it does not add to the stock of financial assets through its lending activity.

size off their operation and the range of services offered. Insofar as most banks are involved in retail and whole business, they tend to benefit from economies of scale and economies of space.

The issue of the field of membership is particularly important. The field of membership of a financial institution is its geographical boundary from which it draws its clientele. In our jurisdictions, their common bond to a particular geographical region or particular locale to do business limits some non-bank institutions, such as credit unions. Banks on the other hand, are not limited by geographical boundaries, and serve the entire population.

Second, the size of the customer base is likely to be overstated due to the problem of dual and multiple accounts. The concern is even more pronounced in the non-bank sector where dual and multiple membership is prevalent. While Table 1.3 confirmed the increasing importance of the credit union sector, the problem of dual and multiple membership is clearly evident in the case of Dominica where the penetration rate was 132 per cent.

**Table 1.3**  
**Membership/Population 15+, 1975 and 1995**

	1975	1975	%	1995	1995	%
Country	Mem	Pop	MP	Mem	Pop	MP
Antigua	504	38,084	1.3	9,796	46,259	21.2
Dominica	12,892	40,186	32.1	59,112	44,750	132.1
Grenada	3,649	49,839	7.3	16,613	51,632	32.2
Montserrat	-	6,938	0.0	2,858	7,838	36.5
St Kitts/Nevis	202	25,855	0.8	9,240	30,100	30.7
St Lucia	2,556	57,530	4.4	18,651	94,685	19.7
St Vincent	2,227	43,958	5.1	16,532	69,546	23.8
<b>Total</b>	<b>22,030</b>	<b>257,611</b>	<b>8.6</b>	<b>132,802</b>	<b>633,023</b>	<b>21.0</b>

Source: ECCB Statistics; Central Statistical Offices

(CORRECTED)

Between 1975 and 1995, membership grew by 546.6 per cent, from 20,646 to 133,492. That is to say, the number of persons who accessed credit union services in 1995 was more than six

times that of 1975. The area penetration rate moved from 8.6 per cent in 1975 to 21 per cent in 1995, which was 14 percentage points higher than the global rate<sup>11</sup>.

What are the factors, which accounted for the expansion and diversity of the financial superstructure in the OECS countries? While there is an obvious relationship between the development of the financial system and the changes in aggregate economic activity, there were several factors of an institutional and financial nature, which contributed to the financial restructuring in the post-war period. As the economies “took off” in the 1960's, the financial system became more varied. The banks extended their branch network, new banks from North America entered the market, and a few mortgage and finance companies were licensed, thereby supplementing the services offered the established banks.

Second, with the process of decolonisation, the state assumed a more active role in the market. In the territories, which were given internal self-government and later independence, the state became more interventionist in its posture. This led to the establishment of National Insurance schemes, national banks, mortgage and finance companies and development banks in the 1970's and 1980's.

Third, the insurance industry expanded in the 1970's and 1980's with the registration of a number of indigenous non-life companies, and an expansion in the geographical spread of the operations of foreign and CARICOM companies.

Fourth, credit unions, initially established in the immediate post-war period, mushroomed in the 1970's and 1980's supplying the demand for additional sources of credit from mainly working class, and lower middle income population.

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<sup>11</sup>See 1995 Statistical Report, World Council of Credit Unions, Inc.

Fifth, the serious housing shortage in the OECS countries led to the establishment of the Eastern Caribbean Home Mortgage Bank (ECHMB) in the first half of the 1990's to create a pool of funds for financing home construction, house and land purchases and home improvements.

Sixth, in addition, the 1970's and the 1980's saw the setting up of national development foundations to finance micro and small business ventures.

The changes in the number, and type of financial institutions indicate the growth, competitiveness and differentiation of financial system.

Developments in OECS financial system was therefore accelerated by the pace of economic growth, influenced by the changing posture of the state, and fueled by an expansion of the financial services industry in the global economy. The diversity of financial institutions reflected the modernisation of the regional financial system, increasing demand for financial products and financial instruments, and the increasing sophistication of a number of the non-bank financial institutions.

## b) Growth in Financial Assets

In this sub-section, we examine changes in the growth of financial assets of the institutions and the sectoral share of the total assets. These indicators show the relative importance of the two sectors in the financial system.

**Table 1.4**  
**Total Assets of Financial Institutions (EC\$M), 1983-1997**

	1983	1986	1989	1992	1995	1997	83/97
Commercial Banks	1480	2207	3551	4701	6232	7471	404.8%
Social Security Schemes	249	426	655	967	1377	1717	420.6%
Insurance Companies*	126	173	237	325	452	547	334.1%
Finance Companies*	75	94	117	145	180	208	177.3%
Building Societies *	29	36	46	76	89	97	234.5%
Development Foundations	5	6	8	14	19	24	380.0%
Development Banks	31	96	186	297	302	344	1009.7%

Credit Unions	99	136	186	256	381	468	372.7%
Friendly Societies	1.3	1.5	1.9	2.4	3.7	4.9	276.9%
Schools Coop Societies	0.7	0.9	1.1	1.4	1.7	2.1	200.0%
<b>Total</b>	<b>2096</b>	<b>3176</b>	<b>4989</b>	<b>6784.8</b>	<b>9037.4</b>	<b>10883</b>	<b>381.1%</b>

Source: Annual and Quarterly Reports; \*Estimated figures for 1990-1992

(CORRECTED)

The value of the stock of financial assets appreciated by 63 per cent in 1990-1995. While total assets of banks grew by 59 per cent, aggregate assets of non-banks grew by 111 per cent, reflecting triple figure growth rates registered by NDFs, Credit Unions, Friendly Societies and School Savings Cooperatives. Banks, the most significant actor in the financial system, hold the largest share of the asset stock, followed by Social Security Schemes, the largest mobilisers of compulsory savings. Credit unions, development banks and life insurance companies have also accumulated significant assets. The evidence confirms that the NBF sector enjoys the faster growth rate in financial assets, suggesting that the sector may have the locomotive effect on the rest of the financial system.

The relative sectoral share of the total assets in Table 1.5 gives an indication of the rate of growth of the two sectors non-bank in a particular period.

**Table 1.5: Share of Total Assets 1983-1997  
(Percentage)**

	1983	1986	1989	1992	1995	1997
Commercial Banks	70.6	69.5	71.2	69.3	69.0	68.6
Non-Banks	29.4	30.5	29.8	30.7	31.0	31.4
Total	100	100	100	100	100	100

Source: Computed from Table 1.4

(CORRECTED)

The banking sector remains relatively more significant than the non-bank sector, accounting for more than 68 per cent of total financial assets in 1995. Despite the fact that the share of the banking sector fell by 2.6 percentage points in the period under review, banks remain the most important intermediaries in the financial system. Commercial banks have held

their own largely because they are depositories for the rest of the financial system. The loan portfolio of commercial banks would be significantly reduced if social security funds were deposited elsewhere.

However, the increasing significance of the non-bank sector is conclusively established. The increasing activity of non-banks is evident in the growth of the sectoral share of the total financial assets from 29.1% to 31.7%, that is, by 2.6 percentage points in the same period. Inasmuch as loans and investments are the major components of the asset portfolio of banking institutions, the analysis tend to suggest a slower growth rate for the banking sector in the five years relative to the non-bank sector in the same period.

A useful indicator of changing market share is the changes in commercial banks' savings and loans and non-banks' savings and loans. The unavailability of data from the rest of the financial system [prevents that level of analysis. However the trend in the credit union sector, which supplement and compete with commercial banks in the retail savings and loans markets, is rather instructive.

**Table 1.6**

**Deposits of Commercial Bank and Selected Non-Banks (EC\$M), 1983-1997**

	1983	1986	1989	1992	1995	1997	83/97
Commercial Banks	1111	1682	2867	3818	5184	6032	442.9%
National Commercial Banks							
Social Security Schemes	116	196	219	318	541	672	479.3%
Credit Unions	66	97	142	209	312	379	474.2%
<b>Disaggregated Data</b>							
Commercial Banks Deposits less Social Security and Credit Union Deposits	929	1389	2506	3291	4331	4981	436.2%
National Banks Deposits Social Security Deposits							

Source: Annual and Quarterly Reports; \*Estimated figures for 1990-1992

Credit union activity in the retail savings and loans markets<sup>12</sup> has been particularly significant in the last twenty years. Retail savings grew from EC\$1.9m in 1975 to EC\$310.3m in 1995, and loans expanded from EC\$1.8m to EC\$299m in the same period. This strongly suggests a significant increase in credit unions' market share in the retail savings and loans markets.

Credit union activity in these two markets between 1985 and 1995 compared favourably with that of the commercial banks. While commercial banks' retail savings and private loans grew by 315.9% and 209.3% respectively, credit unions' savings and loans expanded by 588.9% and 486.3% respectively in the same period. This suggests that credit unions compete with commercial banks offering retail-banking services.

Moreover, the changes in the share of the two sectors are analytically instructive in the light of the short period for which the analysis is done. There is no doubt that the changes would have been more indicative, if a long-run study (as are the cases in the literature) were possible. Furthermore the percentage changes are very enlightening given the historical dominance of the banking sector.

### **(c) Sectoral Contribution to Economic Growth**

A useful indicator of financial structure is the relationship between financial intermediation and economic growth, as the ratio indicates the growth in the size of the financial sector relative to the real sector. This ratio is comparable to the financial interrelation ratio (FIR)<sup>13</sup>, and is used interchangeably in the literature. The ratio also points to the relative importance of each institutional type.

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<sup>12</sup>*Credit union activity is largely restricted to the personal saving and private loan markets, as it transacts primarily with the households. Comparisons with commercial banks are therefore restricted to these markets.*

<sup>13</sup>*The FIR is a measure of the degree of institutionalisation in a financial system. It may be defined as the ratio of intangible assets to tangible assets. In some cases, the FIR is discussed as being reflective of the economic structure of a country.*

**Table 1.7**  
**Total Stock of Assets to GDP, 1983, 1992 and 1997**  
**(Percentage)**

	1983	1992	1997
Commercial Banks	78	92	114
Non- Banks	32	41	52

Source: Calculated from Table 4; ECCB Statistics

(COMPUTED)

The rate of change in the total stock of banks' assets to GDP for the period 1990-1995 was 21.3 per cent compared with 32.7 per cent for non-banks, suggesting a faster growth rate for non-banks. However it must be noted that the relationship between the financial system and the real economy would be influenced by the degree of monetisation of the economy and the size and the maturity (in terms of age) of the sector would influence the growth rates. Unlike the cases in many developing countries, the OECS economies are highly monetised,<sup>14</sup> and the non-bank sector is small and immature (in terms of age) relative to the banking sector.

The slower rate of growth in the banking sector does not necessarily indicate a decline in importance, rather, the increasing competitiveness and differentiation of the financial system. Haynes and Craigwell (1991:33) noted that "crude indicators of their economic importance are the ratio of their assets to national income and the ratio of loans and advances to national income." The difference however would be marginal in the case of the OECS economies, given their size and volume of economic activity.

Developments in the financial system in the OECS countries were influenced by a number of economic, financial and institutional factors. First, growth in national income and in commercialisation increased demand for outlets and loanable funds. This created the conditions

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<sup>14</sup>The degree of monetisation is conventionally measured as the ratio of the broad money stock to GDP. In most developing countries a low degree of monetisation is associated with the underdevelopment of the financial system. The large number of financial institutions in the OECS countries contributes to the relatively high degree of monetisation.

for new financial intermediaries to enter the system and the opportunities for enterprises to differentiate their products to ensure a greater share of the savings and loans market.

Second, the credit union sector became entrenched in the 1970's and 1980's. Credit union customers increased from 21,000 in 1972 to 133,000 in 1995, competing with banks providing retail-banking services. Unlike banks, credit unions maximise services, and the services offered to customers in addition to intermediation give them added advantage in the market. While banks charge their customers separately for services provided, until recently, credit unions provided services "free" or charged at less than the full cost, thereby building stronger "customer relationship" among their members who are their shareholders. Moreover, their liberal loan policy and their emphasis on systematic savings induced increases in future deposit supplies. Credit unions' ownership structure, philosophy of operation, liberal lending policy and service-orientation, ensured them a continuing business relationship with their customers, and persistent growth.

Third, the entrance of a number of insurance companies from the wider Caribbean region resulted in a rapid expansion of the insurance industry in the same period. A period of sustained growth was evident in the non-life industry, and the life insurance companies benefited from certain advantages over banks, such as the ability to combine life insurance with savings. By 1993, there were 152 entities (companies, branches and agencies) providing insurance services in a jurisdiction of 500,000 people. Premium income was in excess of US\$75m and assets were more than US\$150m. Insurance companies were involved in mortgage lending, investing in securities and real estate.

Fourth, during the 1970's and 1980's, the government became more active in the marketplace. Development Banks and Social Security Schemes were established. The former was set up to provide funds on suitable terms and conditions for the private sector, and to create additional sources of productive enterprises. The latter was established by governments to provide a measure of security for the aged, and became one of the largest mobilisers of funds. Between 1989 and 1995, SSS deposits as a percentage of banks deposits increased from 8.7 per cent to 9.8 per cent.

Fifth, entry in the OECS banking system became more restrictive with the establishment of the central bank in 1983. Entry requirements as stipulated by the new legislation acted as a barrier to entry<sup>15</sup> and also ensure that banks were well capitalised” (Bank Supervision Department, 1992:3) The paid up capital of fourteen of the seventeen locally incorporated banks was less than the minimum capital specified by the Act. Banks were obligated to keep reserves against their deposits and “required reserves” became mandatory. The mandatory “required reserves,” a percentage of the total deposits, of course, limit the banks’ lending capacity.

Sixth, the non-bank sector, on the other hand, remained relatively unregulated. Operating in a relatively lax regulatory and supervisory environment, the credit union and insurance sectors in particular mushroomed as the customer-base expanded significantly. As the institutions became more sophisticated, business confidence and customer confidence increased. The result was a shift from banks to non-banks for retail banking services. The developments therefore allowed non-banks to compete freely with banks on the retail savings and credit markets.

Seventh, with increasing demand for funds for infrastructural development in the 1980's, some governments begun to borrow from the local banking system came, and begun to crowd out other users of funds by borrowing from the domestic banking system and selling treasury bills and bonds.

## **SECTION IV**

### **CONCLUSION/POLICY ISSUES**

The financial system in the OECS countries has undergone a radical restructuring. The rudimentary system established by the colonial powers to facilitate cross-border commerce and to provide basic banking facilities to the local community, has been transformed into a relatively

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<sup>15</sup>*With the enactment of the Banking Act 1991, bank supervision was enhanced, as stricter prudential guidelines were put in place.*

modern financial system, and with development in telecommunication and computerisation, is rapidly being metamorphosed into a sophisticated financial system.

The financial landscape of the OECS countries has been significantly altered in the last two decades:

- i. The financial superstructure is much more diversified; the operations of the financial institutions are more complex;
- ii. The institutions have moved way from the pure function of intermediation, and like other firms, are seeking profit from any function for which there is a demand. Some of the non-traditional functions include, risk management, trading in assets, and participating in non-financial companies;
- iii. While the banks remain the most important intermediaries, they are losing their dominance, as non-banks intermediaries are becoming more and more important in the financial system.

The customer-base of the non-bank intermediaries has broadened to include all income groups, as these institutions increase in modernity and become more sophisticated. The last vestige of the traditional distinction between banks and non-banks is already being eroded; the boundaries are indeed becoming very blurred.

#### **b) Some Policy Issues**

The liberalisation of the financial markets has become the accepted policy prescription for stimulating domestic savings for investment. The OECS countries may need to place more emphasis on the mobilisation of private domestic savings to supply this demand.

Savings mobilisation must also be rationalised so those funds could be properly utilised. That is to say, savings vehicles must be developed in order to allow financial intermediaries to allocate resources efficiently among competing users.

The openness of the economies, the adoption of a fixed exchange rate, the access of branch banks to idle reserves from parent bodies, and the network of informal and non-formal institutions which mobilise funds outside of the control of the monetary authority, could have implications for the monetary policies of the central bank, as ‘monetary policy is facilitated by, among other things, the maturity and depth of the financial market’ (Sandiford, 1994:27).

The policy mix of the monetary authority and the governments must seek to develop the financial system and to increase its competitiveness. To ensure efficiency in the system, institutional strengthening and institutional integration would be necessary in the non-bank sector given the large number of intermediaries in that sector. Monetary policy could be frustrated by the existence and unregulated activity of non-bank of financial intermediaries, many of them with weak managerial and technological capability. In light of the fact that the financial system is relative under-developed and the financial intermediaries are at varying stages of development, efforts at developing money and capital markets must be carefully, if not judiciously, pursued. The system must be brought to a certain level of sophistication to ensure participation.

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## APPENDIX I

**Number of Intermediaries (Sector) to Adult Population, 1990 and 1995**

	<b>1990 Adult Population/Number</b>	<b>1995 Adult Population/Number</b>
Commercial Banks	8,142	14,304
Non-Banks	3,717	6,052

**Sectoral Contribution to GDP, 1990 and 1995  
(EC\$M)**

	<b>1990</b>	<b>1990</b>	<b>Ratio</b>	<b>1995</b>	<b>1995</b>	<b>Ratio</b>
	Assets	GDP	Assets/GDP	Assets	GDP	Assets/GDP
Commercial Banks	3,926	3,775	104.0	6,232	4,940	126.2
Non-Banks	1,664	3,775	44.1	2,888	4,940	58.5
OECS	5,590	3,775	74.0	9,120	4,940	92.3

## APPENDIX II

### OECS Commercial Banks' Depositors 1990

	Anguilla	Antigua	Dominica	Grenada	Montserrat	St Kitts/Nevis	St Lucia	St Vincent	Total
Barclays Bank	2,877	14,602	19,359	19,754	4,128	11,386	31,574	18,501	122,181
Car.Com Bank	6,811						380	12,658	6,811
Bank of Anguilla	6,536								6,536
Scotia Bank	1,214		6,546	11,257		11,705	34,331	8,734	73,787
CIBC		11,598					14,656	10,552	36,806
Antigua Com Bank		25,238							25,238
Antigua Investment Bank		-							0
Bank of Antigua		16,982							16,982
Royal Bank		14,655	13,093		9,537	8,938	16,124		62,347
Swiss American Bank		1,907							1,907
Banque Francaise			5,427						5,427
National Com Bank (D)			14,679						14,679
Grenada Banking Corp				20,619					20,619
Grenada Coop Bank				29,994					29,994
National Com Bank (G)				31,826					31,826
Bank of Montserrat					4,797				4,797
Bank of Nevis						2,443			2,443
Nevis Coop Bank						7,546			7,546
National Com Bank (SKN)						27,436			27,436
National Com Bank (SL)							35,945		35,945
St Lucia Coop Bank							23,059		23,059
National Com Bank (SV)								29,362	29,362
ECCB Area	17,438	84,982	59,104	113,450	18,462	69,454	156,069	79,807	598,766

Source: ECCB Bank Statement #4, 1990

### APPENDIX III

#### OECS COMMERCIAL BANKS' DEPOSITORS 1995

	Anguilla	Antigua	Dominica	Grenada	Montserrat	St Kitts/Nevis	St Lucia	St Vincent	Total
Barclays Bank	4,189	18,239	19,447	22,177	5,163	114,897	42,331	16,657	243,100
Car.Com Bank	8,522	3,653					7,230	14,646	34,051
Bank of Anguilla	8,719								8,719
Scotia Bank	4,040		9,963	14,755		17,208	41,490	11,447	98,903
CBC		3,653					7,230	14,646	25,529
CIBC		13,671					24,537	14,171	52,379
Antigua Com Bank		32,724							32,724
Antigua Investment Bank		5,477							0
Bank of Antigua		11,703							11,703
Royal Bank		17,568	16,290		9,304	12,420	22,009		77,591
Swiss American Bank		4,537							4,537
Banque Francaise			9,915						9,915
National Com Bank (D)			20,120						20,120
Grenada Banking Corp				24,226					24,226
Grenada Coop Bank				30,888					30,888
National Com Bank (G)				39,187					39,187
Bank of Montserrat					5,472				5,472
Bank of Nevis						3,887			3,887
Nevis Coop Bank						7,363			7,363
National Com Bank (SKN)						34,075			34,075
National Com Bank (SL)							48,963		48,963
St Lucia Coop Bank							32,986		32,986
National Com Bank (SV)								28,928	2,892
ECCB Area	25,470	111,225	75,735	131,233	19,939	189,850	226,776	100,495	849,210

Source: ECCB Bank Statement #4, 1995