COMMENTS ON

"The Effectiveness of Cuba's Banking Sector Reforms" by Linde

Manuel Lasaga

Armando Linde's paper provides an excellent overview of recent measures taken by the Cuban government as well as substantive advice on what needs to be done to ensure that those measures have a lasting impact on the banking system. In my comments, I would like to expand on some of the issues raised by his analysis, and in some cases differ with his conclusions. Mr. Linde's reference to the IMF Managing Director's comment on how history has taught us that countries should not resist change, was well chosen. I would also like to begin with another lesson of history: history repeats itself. The experience of economic transitions has underscored this point. A country has to learn from its own mistakes, and Cuba will be no exception.

My principal comments as well as other issues indirectly raised by Linde's paper are as follows:

- **The macro environment is just as important as the micro environment, and perhaps more important.** In this regard I concur strongly with Mr. Linde. The key to a stable banking system is a stable economy characterized by sustainable economic growth, stable and predictable inflation, and a realistic currency policy. Countries that have achieved this status can boast of an excellent economic policy management team that has attained a high degree of credibility for management of fiscal and monetary polices. With a stable macroeconomic environment it is easier to make good loans since borrowers are less vulnerable to the economic cycle, and thus bankers are better able to manage risks. Thus it is better to work for a stable macroeconomic environment so that all bankers can make good loans and maintain healthy profitability for their business. Microeconomic factors can also be highly relevant despite the macro environment. For instance, it is not unusual to find banks that are profitable in highly unstable economies. The success of these institutions is also attributed to an excellent management team that understands the risk of that environment, and pursues conservative business practices commensurate with those risks. In these countries it pays to focus on how many years the bank has been in business and on the average tenure of its management team.

- **It is a misnomer to refer to the 1997 banking measures as reforms.** I refer to them as a reorganization of the same state-owned banks with new names. Economic reforms imply a change in the structure of the economy. Market-based reforms imply the withdrawal of the state from economic activities in favor of the private sector operating freely and efficiently according to market signals. For any banking sector reform to be meaningful, it must be accompanied by these types of market reforms. Without structural change, as is the case of Cuba, the so-called reforms are like having a Jaguar without the engine. There is no local private sector initiative in Cuba which could support a commercially viable banking system. By this I mean the possibility of establishing profitable production enterprises. The self-employment gimmick is mainly for the tourists. One exception are foreign investors, who operate within an enclave, detached from the rest of the economy. On the other hand, a country can have a state-of-the-art Central Bank organic law, but as Mr. Linde pointed out, no governance structure to implement it. Unfortunately, the 1997 banking measures are simply the creation of new shells to house the same questionable banking institutions.

- **It is a contradiction to liberalize the banking system in the current environment in Cuba.** Subjugated to a totalitarian dictatorship, which does not accept local private sector initiative, the so-called liberalization of the banking system is tantamount to placing an S.A. after the names of the same state-owned banks that will continue to serve the same user: the State.[1] However, if the creation of new banks — as envisioned in the 1997 measures, with the capability to finance commercial enterprises, although local private sector companies as such do not exist in Cuba — is viewed as an instrument of so-called "change" that will contribute to the eventual dismantling of the current totalitarian regime by a democracy movement, then the proponents of this new banking scheme need to recognize that when the transition to democracy begins, these banks will have to be written off as insolvent. They will have no value in a truly private enterprise economy, since by then they will have sunk into a quagmire of worthless loans to bankrupt state enterprises. These banks will become the sacrificial lambs for democracy, and thus we should not expect them to take a leading role during the transition. The value of the losses from these banks will have to be accounted for as part of any reconstruction strategy.

- **We should avoid the naive and simplistic notion that all state banks need to be liquidated.** Most state-owned banks have had a dismal record, and I agree that government banks should not be in the commercial banking business. However, multilateral agencies only lend to governments, therefore, every country needs at least one development bank to channel loans from these agencies, but hopefully only one development bank. Market failures are a compelling reason for a development bank. For instance, some bankers consider lending to micro-scale enterprises as a form of public relations, or as community-minded work, not because they find it a profitable market, at least in the strict commercial sense. For this reason, a government development bank can make a difference by supporting special lending vehicles for micro- and small-scale businesses.[2] Requiring that all state banks be eliminated is an extremist policy that should be avoided. There have been cases where a government is instructed by international agencies to close down a development bank, only to find out later that they have established a new, sometimes bigger, development bank. The real world is much more complex than saying government banks are bad and private banks are good. In fact, some of the most spectacular, catastrophic bank failures in recent history in Latin America have been caused by private sector banks, with the government absorbing all their losses. So who is perfect? It is better to have a development bank that is subject to the same rules of the game as private sector banks, than to insist on the unrealistic goal of eliminating all public sector banks.

1. In Cuba the buzz word to describe an innovative enterprise is to refer to it as an S.A., which stands for *Sociedad Anónima*, or Corporation. In the United States, anyone with about $100 can establish a corporation. On the other hand, the real value of an S.A. is determined by the economic value of the productive activity performed by the enterprise. Therefore, placing an S.A. after a bank's name does not by itself constitute a reform, much less a market-oriented reform.

2. For further discussion see *Cuba: Past, Present and Future of its Banking and Financial System*, by the Cuban Banking Study Group, 1995.

- **One useful indicator to measure the health of a banking system is to construct what I call the RBTI index.** The Regulator-Banker Tension Index (RBTI) could be based on periodic surveys. According to this index, the best banking system would be the one with the highest degree of tension in regulator-banker relations. For example, I have encountered comments by bankers throughout Latin America that regulatory reforms have strengthened supervision. In some countries bankers point to numerous visits by examiners as a sign that reforms are working. Unfortunately, in these cases there does not appear to be much tension in the relationship between bankers and regulators—banks are just being visited more often by the examiners. In fact these regulator-banker relations may be characterized as amiable. A banking system where regulators and bankers agree may be ready for another crisis. On the other hand, in the United States I encounter frequent complaints by bankers of how regulators make their life difficult, and how they are constantly developing new products to offer their clients that will avoid the high costs of regulation. At the same time, regulators are always insisting that banks need to pay more attention to risks, and they are constantly devising new mechanisms to identify those risks. It is precisely this type of tension that keeps both sides on their toes.

- **Ideally, the Superintendency of Banks should be independent of the Central Bank, with each reporting to a different authority**. The goal of the Central Bank is to manage the money supply and other aspects of monetary policy in order to assure macroeconomic stability. But if the Central Bank has the double identity of monetary authority and banking supervisor, it could be subject to serious conflicts because its decisions involving the management of monetary policy could be affected by its commitment as a regulator to banking system stability. For example, the Central Bank may hesitate to raise interest rates for fear that it would jeopardize the debt servicing capacity of the banks' borrowers, and as Superintendent it would have to downgrade the banks' ratings and, in some cases, take costly disciplinary actions. Of course, during a transition, it may not be realistic to insist on developing a separate and independent Superintendency, this may have to wait until after the economy has successfully completed the initial phase of transition.

- **There is a lot of discussion about supervision, but not enough about the quality of bankers**. During the past decade, many new banking laws have been enacted in emerging markets. After a transition to democracy, Cuba will be in a position to write its own modern banking legislation. With an abundance of good banking laws in different countries, it will be relatively easy for the Cuban legislature to pick and choose the best each has to offer. However, in drafting the legislation, careful attention has to be paid to the capacity of Cuba's bankers to operate according to the rules of the game. For example, requiring that any loans past-due 15 days be placed on non-accruals would create havoc. Requiring that banks have to prepare the duration of each asset and liability and calculate the interest rate gap on that basis would only lead to mismanagement. It would be advisable to draft a simple bank law to begin with, and then adopt a mandatory 5 year re-writing rule for that law that would increase in complexity reflecting the evolutionary process of the Cuban banking system.

- **Education should be a critical component of any reform strategy.** One of the best ways that the Cuban government could spend its money during the reconstruction of the economy will be to fund a banking institute offering BA and MBA degrees in banking and finance, as well as special bank training courses. Such a program could be established as part of the University of Havana or some other appropriate university. International funding could be used to attract top faculty and practitioners from around the world as visiting professors. Bright students should be given full scholarships with the condition that they work at a national bank for two years after graduation.

With respect to the measures adopted in 1997 to reorganize the banking sector in Cuba, it appears more smoke and mirrors than substance. The overall condition of the current financial system is questionable. Reliable information on the financial condition of the banks is almost non-existent. The government cannot expect to gain credibility by withholding financial information on the state of the banks. While the restructuring of 1997 created new institutions, it did not add to the dimension of services provided nor did it deal with the fundamental problem of economic stagnation.[3]

The current structure of the Cuban banking system is highly compartmentalized. As the attached list of Key Financial Intermediaries demonstrates, each entity appears as one piece of the whole, with extensive overlapping in terms of the banks specializing in foreign exchange operations. This structure reflects the holding company model, where the State is the holding company that owns all of the banks. These financial intermediaries capture deposits or borrow funds and then lend them to the State, without applying any commercial criteria and with little real collateral to back up the loans. With the State as the principal client of the banking system, banks are not able to diversify their risk.

The banking system operates as an accounting vehicle and as a paying/collection agency for the State. Banking personnel have been given limited training in their field. Operating procedures are inadequate, and thus the quality of the financial system's assets are highly questionable. At the same time, banking supervision is basically non-existent.

KEY CUBAN FINANCIAL INTERMEDIARIES

Banco Central de Cuba

A new institution, the Banco Central de Cuba was established as the monetary authority. Previously, this function had been carried out by the BNC, which also acted as State bank, and commercial bank.

Banco Nacional de Cuba (BNC)

Up to 1996, BNC acted as fiscal agent for the government. The bulk of Cuba's external debt has also been negotiated through BNC. The quality of BNC's balance sheet is highly questionable. A good part of its liabilities are external debts, on behalf of the government, which it has not been able to service. As the government's banker for more than three decades, BNC is the principal lending institution in the country, particularly to state enterprises. While no information is available on the quality of the loan portfolio, the country's dire economic conditions would suggest that a large part of this portfolio is non-performing and of marginal recoverable value.

Banco Popular de Ahorro (BPA)

As the name implies, this bank specializes in the retail market, offering a very limited menu of services to individuals. The restructuring of the banking sector in 1996 reaffirmed BPA's target market, while expanding its services to state companies, cooperatives and the self employed. The lending activities of BPA are very limited. As a result, the bank usually has huge excess liquidity, about 90 percent of assets, which are then transferred to BNC at a minimal rate of interest.

Banco de Crédito y Comercio (BCC)

Established in 1996, BCC assumed the existing branch network of BNC, about 200, to provide

3. For additional discussion see: *Transition Project Report on Cuba's Financial Sector*, U.S.-Cuba Business Council, February 1999.

commercial and industrial financing with emphasis on the agricultural sector.

Banco Financiero Internacional, S.A.(BFI)

Established in 1984, BFI specializes in foreign exchange and trade financing mainly to the commercial and the production sectors. The shareholders of this bank are Panamanian corporations. BFI is fairly active in trade financing.

Banco Internacional de Comercio, S.A. (BICSA)

Established in 1994, BICSA specializes in foreign exchange transactions. It is expected to become the primary bank for foreign trade financing and to manage correspondent relationships with banks overseas.

Financiera Internacional, S.A. (FISA)

FISA was created in 1996 to focus on foreign exchange operations. The bank handles trade financing as well as project financing, leasing, and factoring.

Banco Metropolitano, S.A. (BMSA)

BMSA was established in 1996 to serve the diplomatic and foreign community residing in Cuba as well as Cuban nationals who earn foreign exchange.

Banco de Inversiones, S.A. (BISA)

BISA was established in 1996 to provide medium- to long-term project financing and financial advice to local companies in the production sectors. Most of the activity of this finance company has been in the tourism industry.

Cadenas de Casas de Cambio (CADECA)

The CADECA consist of a national network of foreign exchange houses situated in urban areas and are open to the general public for the purchase and sales of foreign exchange, buying foreign exchange mostly from tourists.