

Cuba: Elements for a Modern Financial System

Fernando A. Capablanca, EXTEBANDES

Introduction

The Cuban Banking Study Group, Inc. ("CBSG") is a non-profit association incorporated in Florida in December, 1992. It is comprised primarily of professional bankers of Cuban origin with diverse backgrounds and experience. Our common denominator is our interest in the future of Cuba and overseeing an orderly development of its banking industry in a democratic and market-oriented economy. CBSG is not affiliated nor sponsored by any political action group or party. We intend to remain active beyond the conclusion of the Study in order to continuously update our recommendations as circumstances dictate. Furthermore, we propose to conduct research in the areas of insurance, creation of a capital market and handling of the external debt of Cuba.

For the record, our Group consists of 94 members, mostly professional bankers active in the industry. We are honored to have as members such distinguished persons as Dr. Felipe Pazos, Dr. García-Rayneri, and the late Dr. Justo Carrillo, who participated in our first meeting shortly before his death. Our Board of Directors (which I am equally honored to preside) is made up of 14 members divided between bankers from institutions based in England, Israel, Latin America and the United States, and non-bankers from various related professions. Our current Chairman, Gen. Brent Scowcroft, was former Chairman of the National Security Council under Pres. Bush's administration and is president of Scowcroft & Associates in Washington, D.C.

Our Study consists of two parts. In Part One, we cover the necessity for an independent Central Bank, which we call Banco Central de Cuba, as an autonomous agency of the government. Implicit in this are four recommendations of Mr. Gerald Corrigan (former President of the New York Federal Reserve Bank), namely:

1. That responsible senior executives enjoy secure terms of office.
2. That it have fiscal independence.
3. That its Articles of Incorporation prohibit direct or indirect financing of budget deficits.
4. That its emphasis should be in the area of inflation control.

In Part II, we studied the history of banking in Cuba from 1832 to date. We conclude by making certain recommendations for a modern and efficient banking system in a free market economy which is the subject of my presentation today.

Our basic general premise is that a solvent and economically rational banking system is a *sine-qua-non* condition for an effective market economy. The classic intermediation role of financial institutions is essential to make sure that funds flow freely into economically viable enterprises, appropriately priced for risk and within a proper regulatory framework.

Unlike Eastern European countries under the former Soviet Union, Cuba had a developed banking system which traced its roots back to 1832, and which functioned fairly well until 1958. The Banco Nacional de Cuba, founded in 1948 and which operated as a central bank from 1950 until the revolution in 1959, was a highly regarded institution. Its biggest shortcoming was being under too much political influence. To be fair, however, even today many central banks of industrial nations (not to mention a large number of LDCs) are still functioning as a political arm of the government. In this regard, the independence of the Federal Reserve system in the United States is admirable and worthy of

consideration. At the same time, the 49 private banks which operated 204 branches in Cuba in 1959, were remarkably well-managed and a source of pride, which must be recaptured and allowed to flourish again.

Simultaneously with the development of the industry, the banking system must be subject to adequate prudential regulation and effective supervision. We must quickly adopt a uniform set of accounting standards and a flexible commercial code, including rules for public disclosure of financial information which is critical to economic development. Accounting standards are an integral part of the resource allocation process which permits banks to compare the merits of one borrower over another. In fact, everyone needs reliable financial data in order to make business decisions, especially for long-term strategic planning. Implementation of GAAP should be fairly easy since new managers will be familiar with the concept.

I. The Future Banking System

The types of banks that can or should exist in the new Cuba will necessarily have to be consistent with the banking systems that have evolved in the Western Hemisphere and particularly in the United States, although they do not have to be a clone of the American system. In fact, the dual banking system in the United States with its four regulatory agencies (Federal Reserve Bank, Office of the Comptroller of the Currency, Federal Deposit Insurance and State bank examiners) is arguably a very inefficient system and uniquely complex. Furthermore, it is equally clear that the future cannot possibly be a copy of the past, no matter how good that past may seem to us.

The world's banking system is increasingly globalized, and the new Basle Guidelines for Capital Standards and Supervisory Principles is in the process of being implemented in about 80 countries as of this date. Furthermore, technological advances and a desire to serve its multinational clients have forced banks to continue expanding in different markets around the world. As these banks have expanded, host countries have liberalized their own foreign investment laws in order to take advantage of the economic benefits presented by the competition offered by foreign banks. Cuba should not be an exception to the models currently used by other nations.

The CBSG has considered the development of the banking system in two stages. Stage I we will call a "transition period." During this stage, which may last anywhere from 6 months to 3 years, the new Cuban Government will be creating the base for an orderly growth and development of the industry. The new Banking Act should be drafted and the supervisory institutions must be put in place. During this stage, we recommend that only certain financial institutions should be permitted to operate in Cuba to ensure basically that foreign aid and emergency loans are being properly channeled. These institutions, or institution, should be selected beforehand and should have an emergency operations manual prepared and ready to be implemented on short notice. The two possibilities in this regard are the creation of a multinational consortia-type bank, whose shareholders will be institutions having expressed an interest in establishing branches or subsidiaries in Cuba at a later period. Alternatively, the Federal Reserve Bank of Atlanta should consider the possibility of establishing a temporary emergency banking facility in various parts of Cuba in order to aid in this process. There are historical precedents for this, as we will see in the history of the Cuban banking and financial system. Once the new government is freely elected, and Cuba establishes its own currency, these FRB branches can be closed. Likewise, the consortia bank could be the forerunner of the Cuban Bank for Reconstruction and Development. It is clear, however, that during this transitional period no financial institution should be allowed to operate or open a branch or subsidiary in Cuba, in the absence of a regulated financial market. This will prevent a repetition of the debacle in Russia and the former Soviet Republics. Stage II, which we call the "post transition", deals with the types of banks that should operate in Cuba and defines the parameters within which they should operate.

The recommendations for the transition period are based on the premise that many institutions will want to operate in Cuba, and that a significant number of investors (primarily from Florida) will also want to establish a banking presence in the new Cuba. It is not wise nor fair to allow a "free for all" dash into a highly sensitive industry, until and unless the rules have been clearly established and everyone interested has had an opportunity to prepare for it. Once this is done, however, Cuba can and must have its own independent and healthy financial system capable of financing the economic reconstruction of the country and servicing both public and private sectors. This must be an efficient and dynamic industry, second to none in the hemisphere in terms of financial strength, management capacity and technological features. These institutions must operate in a concise regulatory framework and be separate from political influence in order to maintain its financial integrity and avoid the pitfalls of the past and of other models in the hemisphere. At the same time it must take into consideration that a large percentage of the Cuban population will, at first, be isolated and outside the money economy and, therefore, we must establish a "social conscience" within the system to help those who remained behind and who have no hope of owning a lucrative foreign franchise. We must also be careful in considering the creation of an "international banking center" that may encourage the creation of so called "class B" or "offshore" banks in our desire to see the country actively competing in the international arena. Cuba has lost much ground in the last 33 years, but it definitely can "catch up," if we are judicious and do not try to compress it all in to the first few years of reconstruction. The fact that there is nothing now is better than having a complex and archaic system to modify. Furthermore, Cuba had a fairly efficient and modern banking system by 1958 standards and Cuba has both human and financial resources to accomplish the task.

II. The New Banking System

A. Introduction

In general terms, we envision a banking system consisting of the following:

(1) A Central bank, which we are calling "*Banco Central de Cuba*," to replace the *Banco Nacional de Cuba*. This will be the sole bank of issue and the sole determinant of monetary policy for the country. It should be an autonomous agency free from politics and should operate in a manner similar to the Federal Reserve Bank or the German Bundesbank.

(2) There should exist a bank regulatory and licensing agency, which we are calling *Comisión Nacional Bancaria* (National Banking Commission) to supervise, regulate and license all private banks in the country. This should be an independent agency, with proper funding to accomplish its desired objectives. The regulators working for this agency should be properly compensated and trained professionals. We suggest that proper consideration be given to having these regulators sign non compete agreements in order to avoid the problems that we have seen in other countries of Latin America.

(3) In order to make sure that as many persons as possible participate in the reconstruction and recapitalization of Cuba and enjoy its benefits, Cuba should have its own "social bank", which we are calling *Banco de Reconstrucción y Capitalización*, patterned on the experiences of various social banks in India and Bolivia (*Banco de Solidaridad*). This bank will be limited to making small personal loans, and small loans to small business enterprises, and will be funded initially by the government with additional capital to be contributed by USAID, Inter-American Development Bank, World Bank, OPIC and by all private banks in Cuba.

(4) The creation of a *Fondo de Seguros de Depósitos* to cover certain (but not all) banks in the country.

(5)The fifth component of this system will be the private banks, both foreign and domestic, which we cover separately.

We have avoided mentioning the possibility of re-creating development banks because their record is not clear. However, the evidence we have from other countries in Latin America suggests a pattern of abuse and inefficiency which we would like to avoid. If it should become necessary, the *Banco Central de Cuba* can easily establish a *Fondo de Desarrollo Económico* (or something similar) in order to address this issue. Likewise, we have not seen the necessity for now to recommend a bank for the explicit purpose of promoting (i.e. subsidizing) exports. These issues may be addressed by the private banks with guidance and assistance from the *Banco Central de Cuba*.

B. Private Banks

1. Cuban Banks

Cuba should develop legislation allowing the creation of "universal banks" under a holding company concept. These holding companies could be permitted to have subsidiaries in various industries closely related to banking including ~~of course~~ commercial banking.

The amount of capitalization of the holding company will be directly related to the number and type of subsidiary that it has. A capitalization formula based on risk will be consistent with the new worldwide regulatory concepts. To encourage Cuban groups to seek foreign partners expertise in these areas, we recommend that foreign participation at the subsidiary level be permitted up to 50 percent of the capital of the subsidiary. The capital of such holding companies should not be below US\$5 million and must be 100 percent owned by Cuban nationals. However, the Board of Directors may have non-Cuban nationals as long as they are properly qualified individuals.

Independent banks may be created with an authorized capital that will vary from US\$1 million to \$2.5 million, depending on where the bank is located. Here we have made a distinction between banks that expect to be operating in Havana and other major metropolitan areas, and banks simply interested in servicing a particular region or community in the interior of the country which the committee believes should be encouraged. For such banks, a smaller capital of US\$1 million will be sufficient, of which 50 percent needs to be paid in cash initially. The balance must be paid over the subsequent 5 years.

To be consistent with commercial bank subsidiaries of holding companies, these banks may also have foreign participation of up to 50 percent of its capital. However, until such time as the independent bank has reached its minimum capitalization target, we suggest a risk weighted capital standard slightly higher than the Basle guidelines (for example 10 percent instead of 8 percent). Furthermore, we suggest that only those banks or commercial bank subsidiaries with foreign participation of 10 percent or less enjoy the following:

< deposit insurance;

< access to rediscount window of the Banco Central de Cuba;

< other possible benefits in the areas of reserve requirements, taxation or branching throughout the country, and unlimited dividend payments.

These formulas will encourage the creation of Cuban-owned banks without ignoring safety and soundness issues.

To limit the risk for financial institutions, opting for the holding company concept, the separation

between commercial and investment bank activities should be encouraged by some type of "firewalls." Commercial banks which attract retail individual deposits should be prevented from participating in the restructuring and privatization of government-owned enterprises. This role should be preserved for independent investment banks. However, commercial banks might be able to participate in the ownership of investment banks, provided they meet prudential regulations limiting commercial banks risk.

2. Foreign Banks

CBSG strongly believes that foreign banks can and must contribute to the economic development of Cuba. However, because of the proximity to the U.S. mainland and the strong ties that Cuba will have with South Florida (and therefore with the foreign banks operating in that market) we must be careful to prevent a foreign bank domination of the Cuban financial system. These banks have significant human and financial resources and could easily undermine an emerging market in Cuba. Foreign banks may be permitted entry as *branches* or as *subsidiaries*. When a bank establishes a subsidiary in a foreign location it must allocate specific capital to that subsidiary and may be legally restricted in its dealing with that subsidiary. Legally speaking, a subsidiary is an entity that can survive or fail independent of its owners if adequate safeguards are in place. By contrast, a branch or agency is an integral part of the bank itself. As a general rule, a branch or agency does not require separate capital of its own and is free to deal with its home office or other branches without restriction. A branch has the entire worldwide capital of the bank behind its transactions, and its lending limit is based on the parent's capital rather than on the capital assigned to the subsidiary. Because of this, a branch or agency can have a larger and more varied business than a subsidiary. A third form of entity would be as a representative office which is not permitted to conduct "banking business," although the definitions vary from one country to another.

CBSG would favor legislation that permits branches of qualified foreign banks provided:

- (a) They cannot take domestic (resident) deposits but may make domestic loans and certain investments.
- (b) They are required to maintain a percentage of their assets (suggest US\$5 million or 8 percent, whichever is larger) in certain defined assets pledged to the *Banco Central de Cuba*.
- (c) Because of their restricted activities, we would suggest a more lenient tax base for these branches than for other Cuban banks.

In addition, qualified foreign banks should be allowed to establish wholly owned subsidiaries on the following basis:

- (a) Minimum capitalization of \$15 million of which 20 percent should be invested at all times in Cuban treasury bonds or special bonds of the Banco Central de Cuba.
- (b) These subsidiaries can take deposits from Cuban residents and make loans without any limitation.
- (c) Any bank or financial institution with more than 10 percent foreign ownership qualifies as a foreign bank subsidiary.

Foreign banks wishing to establish a presence in Cuba should follow the standards established by the 1983 Committee on Banking Regulation and Supervisory Practices of the BIS, namely:

◁ Whether the appropriate authorities in the home country of the foreign bank applicant have consented to the proposed expansion.

◁ The financial and managerial resources of the foreign bank, excluding the bank's experience and capacity to engage in international banking.

◁ Whether the foreign bank has provided adequate assurances that the bank will make available whatever information may be necessary to process the application.

◁ Whether the foreign bank is in compliance with the laws of the host country.

◁ Last but not least, whether the foreign bank is subject to comprehensive supervision or regulation on a consolidated basis by the authorities of the host country.

III. Summary and Conclusions

The biggest danger to world finance and to future Cuban banking regulators may well be an excess of official zeal in the regulation of banks. In the search for "comprehensiveness," many governments (the U.S. included) are establishing rules for financial institutions that are far too restrictive for economic development. In the case of developing nations such as Cuba, this can spell disaster if not balanced properly. Economic growth requires financing. Both involve risk. Any plan to create a risk-free financial system could stifle growth. Financial institutions should be in the business of understanding risk, managing it and spreading it; they cannot be in the business of avoiding it. For this reason also, we have endorsed the creation of Cuban-owned banks. If history is any indication, these banks eventually will accept risks that their foreign counterparts may not even attempt because (a) they do not care, or (b) their home country regulator will not approve, or (c) they don't understand it.

The key to the growth of the new Cuban system should be the word "supervision" and not the word "regulation." Of course, a supervisory approach has a core of rules, and we introduced several in our report. However, it must be based on the recognition that financial firms/banks differ. Each has its own particular style; its regional or local bias and, periodically, each may want to change its priorities and the way it conducts business. Provided it sticks to the core rules, no supervisor should stop it. This is what a free market means, after all.

Regulations, on the other hand, start from the premise that a bank is a bank is a bank, and that all cases are similar. This may be acceptable when dealing with fire extinguisher in factories, i.e., so many extinguisher every so many square feet. However, this approach to banking is not reasonable and, in the case of developing nations, it may also be dangerous.

Future Cuban officials must be careful not to embrace the U.S. model, or any other model, too readily. The Cuban model must be based on the economic realities and expectations of the Cubans themselves.

The question of what constitutes a "Cuban-owned" bank, or those owned by Cuban nationals, deserves some thought. Technically speaking, a subsidiary of a foreign bank incorporated in Cuba under Cuban laws is a "Cuban bank," but not a Cuban-owned institution. On the other hand, if such Cuban bank is owned by Cuban nationals, then it is clearly a Cuban bank as long as we can agree on the definition of a "Cuban national." The issue is not merely academic because one has to assume that Cuban-Americans currently residing outside Cuba will want to invest in the banking industry. In fact, we can assume there are no local investors left in Cuba.

In this regard, Article 32 of the 1976 constitution clearly states that persons born in Cuba lose their Cuban citizenship when they adopt the citizenship of another country. Interestingly, Article 15 of the 1940 constitution reads exactly alike, although it provides different mechanisms for reacquiring the Cuban citizenship which are more ambiguous in the 1976 version. While we can argue that the Constitution will have to be revised, this could present an obstacle to many potential investors until such changes are made.

As indicated throughout the report, this study is not meant to be all-encompassing nor an answer to all of the problems that Cuba will face as it struggles to rejoin the community of free nations. We do hope, however, that it can serve as the basis for further discussion and inquiry into the subject. Our role is not to criticize others for their past actions nor to draft legislation from afar. Instead, we have tried to outline the boundaries within which a modern financial system could evolve. By raising questions now, future leaders will be able to focus on those issues that we, as professionals in our field, think are important to Cuba and to our industry. It doesn't matter if 8 percent is better than 6 percent in defining capital standards, as long as we all agree that the new legislation must address the issue, and as long as we agree that new norms have to be established and enforced.