Financial Stability Report December, 2012

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EXECUTIVE SUMMARY

The Central Bank of The Bahamas (the Bank), as part of its mandate to promote the stability of the financial sector, along with its associated regulators, the Securities Commission, Insurance Commission and the Department of Cooperatives, developed this report which seeks to provide an overview of key developments within the financial sector and an assessment of the underlying risks to financial stability. This report, which is to be produced semi-annually, builds on the earlier work undertaken by the International Monetary Fund (IMF) in its Financial Sector Assessment Programme (FSAP)[1] exercise for The Bahamas, conducted in July 2012.

During the year, the three (3) main regulatory agencies continued to assess the health of the financial sector, via a regime of onsite and offsite monitoring, information gathering and, in the case of the domestic banking sector, stress tests to ensure its resilience to unexpected shocks. Overall, the regulators concluded that the risks to financial stability were low, given the high levels of capital and liquidity in the domestic financial sector. In the few instances where issues have arisen, enhanced monitoring was implemented, and some firms were required to take measures to ensure that they continued to comply with domestic and international regulations.

The IMF, in the April 2013 edition of its "Global Financial Stability Report", noted that financial conditions worldwide had improved significantly over the six-month period, as central banks continued to provide significant stimulus to their economies. However, challenges to this outlook persisted, as the slow pace of the global recovery hindered efforts to improve public sector and households' balance sheets. Further, concerns lingered over the extent of balance sheet restructuring of the commercial banks, particularly those within the euro area which hold a large proportion of peripheral economies' debt. In this regard, the IMF advocated additional enhancements to countries' supervisory regimes and, in the case of Europe, the implementation of the Single Supervisory Mechanism (SSM).

During 2012, positive, but mild growth momentum was sustained in The Bahamas, as the economy expanded by a modest 1.8%, in line with the 1.7% gain a year earlier. Growth in the tourism sector—the largest in the economy—benefited from a rebound in the high value-added air segment and continued gains in the dominant sea visitors. Construction output registered further strengthening, supported by several foreign investment projects in the tourism sector and, to a lesser extent, public sector infrastructure investments. However, the absence of a broad-based recovery meant that overall business conditions remained weak and unemployment levels stayed elevated. This development was reflected in the banking sector, where credit was anaemic, due to both demand and supply constraints, while arrears and non-performing loans continued their upward trajectory—although the pace of growth slowed in comparison to the 2008-2009 recessionary period.

In this environment, banks increased their provisions for bad debt, constraining profitability levels; however, widening spreads helped to offset the impact on income, while buoyant levels of liquidity, combined with high capital ratios, ensured that financial conditions in the banking sector remained robust.

The insurance sector remained stable in 2012 as efforts continued to resolve the outstanding issues related to the insolvency of the local subsidiary of CL Financial Limited, called Clico (Bahamas) Limited[2]. Assets of the sector were maintained at a strong level, although some

1 The FSAP is an in-depth assessment of a country's compliance with international standards for the banking, securities and insurance sectors, its resilience to shocks and the corresponding effectiveness of financial safety nets.

2 Clico (Bahamas) Limited is a life and non-life insurance company incorporated in The Bahamas under Section 5(1) of the Insurance Act, Chapter 347. It is considered to be a small company with assets equivalent to less than 7.0% of the insurance sector in 2009.

softening in the industry's totals were recorded—mainly in the non-life insurance segments, while the contraction in profitability was due to a broad-based decline in revenues. From a financial stability perspective, the sector remained stable, as institutions sustained their conservative investment posture and the majority of firms, particularly those in the non-life sector, reinsured a substantial component of their portfolios with highly rated external firms.

During 2012, the credit union sector continued to be an important provider of financial services to its members, reinforced by steady expansion in its asset base. Progress was also made in bringing these institutions under the regulatory ambit of the Bank[3], inclusive of the preparation of a draft Bahamas Cooperative Credit Unions Bill, 2013.

3 See Central Bank of The Bahamas 2012 Annual Report, page 28.

Chapter 1:

MACROECONOMIC ENVIRONMENT

1.1. The Global Environment

Global economic conditions were subdued in 2012, marked by the protracted debt crisis in the euro-area and weak economic expansion within most of the leading economies. Accordingly, world output growth softened, from 4.0% in 2011 to 3.2% in 2012[4], reflecting decelerated growth momentum within developed and emerging market economies. As shown in Table 1, real GDP growth in the United States firmed, relative to 2011, to 2.2% from 1.8%; however, developments in Europe featured a slowdown in the United Kingdom's expansion and the euro area contracted by 0.6%, following a modest gain of 1.4% in 2011. Within Asia, China sustained strong growth of 7.8%, although decelerated from 2011's 9.3%, owing to reduced global demand; while real output firmed in Japan by 2.0%, after a mild contraction of 0.8% in the prior year. In the Caribbean region, real GDP growth averaged 1.9% in 2012, led by Suriname and Guyana, which firmed by 4.0% and 3.7%, respectively. The momentum was comparatively slower for Barbados, the Eastern Caribbean and Trinidad & Tobago, which registered gains of 0.7% each in 2012 (see Table 2).

In this environment, jobless rates for 2012 decreased in most of the major economies, although with further deterioration in the euro zone. Amid lethargic consumer demand and some stabilization in energy prices (see Chart 1), the rate of inflation tapered across most economies.

Against this backdrop, central banks continued to employ a suite of unconventional, accommodative monetary policies, designed to reinforce economic growth. In particular, the

TABLE 1

Selected Indicators for Developed Economies (%)

	2008	2009	2010	2011	2012
GDP Growth Rates					
United States	-0.3	-3.1	2.4	1.8	2.2
Euro Area	0.4	-4.4	2.0	1.4	-0.6
United Kingdom	-1.0	-4.0	1.8	0.7	0.3
China	9.6	9.2	10.4	9.3	7.8
Japan	-1.0	-5.5	4.5	-0.8	2.0
Unemployment Rates					
United States	5.8	9.3	9.6	9.0	8.1
Euro Area	7.7	9.6	10.1	10.2	11.4
United Kingdom	5.7	7.6	7.9	8.1	8.0
China	4.1	4.3	4.1	4.1	4.1
Japan	4.0	5.1	5.1	4.6	4.4
Inflation Rates					
United States	3.8	-0.3	1.6	3.1	2.1
Euro Area	3.3	0.3	1.6	2.7	2.5
United Kingdom	3.6	2.1	3.3	4.5	2.8
China	5.9	-0.7	3.3	5.4	2.6
Japan	1.4	-1.3	-0.7	-0.3	0.0

Sources: IMF, International Statistic Bureaus

4 International Monetary Fund's (IMF) World Economic Outlook (WEO) Update, April, 2013.

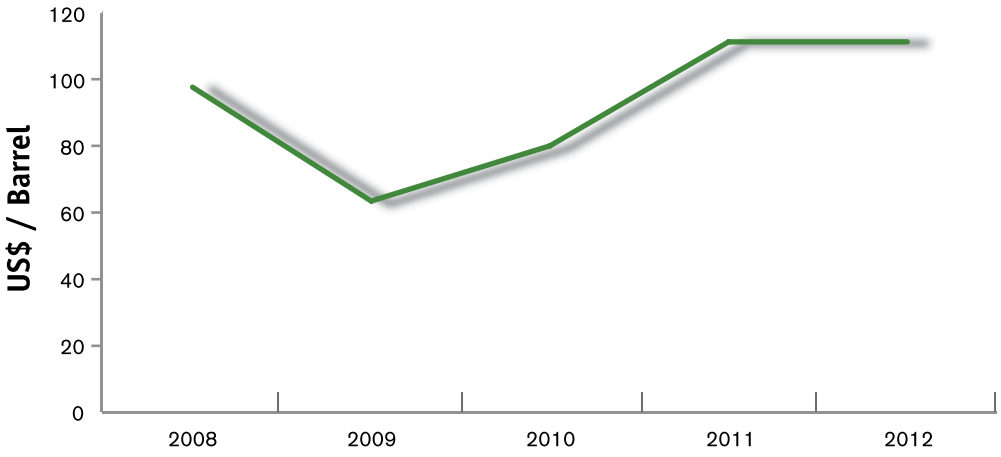
TABLE 2
Selected Caribbean Countries GDP Growth Rates (%)

	2008	2009	2010	2011	2012
Bahamas	-2.3	-4.9	0.2	1.7	1.8
Barbados	0.3	-4.1	0.2	0.6	0.7
Belize	3.6	0.0	2.7	2.0	2.3
Eastern Caribbean	2.9	-5.7	-2.2	-1.1	0.7
Guyana	2.0	3.3	4.4	5.4	3.7
Jamaica	-0.8	-3.5	-1.5	1.3	0.9
Suriname	4.1	3.0	4.1	4.2	4.0
Trinidad & Tobago	2.7	-3.3	0.0	-1.5	0.7

Sources: IMF, International Statistic Bureaus, Regional Central Banks

United States executed its third round of "quantitative easing", the European Central Bank (ECB) supplied additional long-term loans to banks and utilized its "Outright Monetary Transactions" programme to assist member states experiencing sharp fiscal imbalances, and the Bank of England increased the size of its asset-purchase programme. In Asia, the People's Bank of China reduced its reserve requirements and injected liquidity into the financial system via repurchase agreements, and the Bank of Japan augmented its asset purchase programme on several occasions during the year.

Chart 1
Oil Prices (Brent Crude Oil Index)



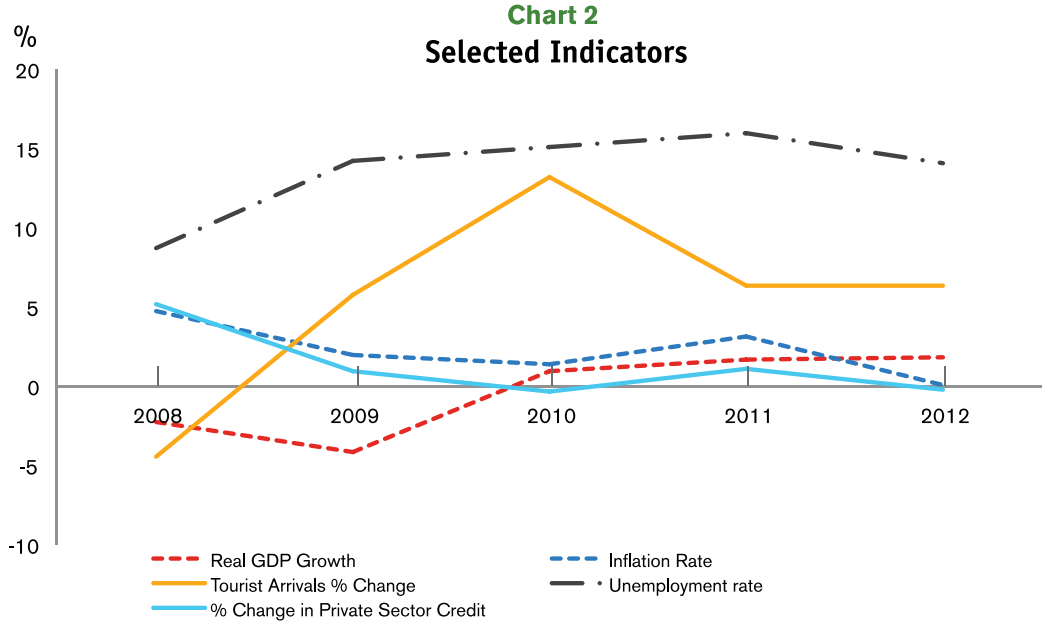
Source: Bloomberg

1.2. The Domestic Environment

During 2012, the domestic recovery maintained its weak but steady positive pace, as real GDP growth firmed by 10 basis points to 1.8%, explained by positive contributions from the tourism and construction sectors. As shown in Chart 2, tourist arrivals grew by 6.0%, as the high-value added stopover segment benefited from aggressive joint private and public sectors advertising campaigns; however, growth in revenue was less robust, due to discounting and other incentive programmes. For the construction sector, gains in output were buoyed by ongoing foreign

investment-led projects, as well as public sector infrastructural development programmes. These developments underpinned a modest improvement in unemployment; although the latter also contributed to a deterioration in the Government's FY2011/12 deficit, which was financed mainly from domestic sources. Price developments registered a marginal hike in domestic inflation, occasioned by higher prices for food and other related products (see Table 3).

Chart 2
Selected Indicators

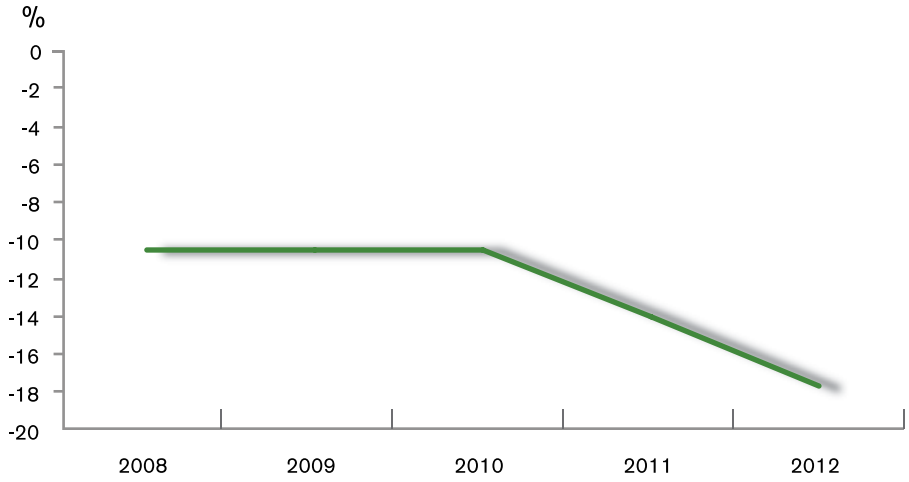


Source: The Central Bank of The Bahamas, The Department of Statistics
Note: 2012 Inflation -Annualized through October

Buoyed by increased imports relating to foreign investment activities, the current account deficit widened, as the expanded merchandise trade deficit outpaced the tourism-driven gain in the services account surplus (see Chart 3). The surplus on the capital and financial account narrowed relative to 2011, when direct investments benefited from the Government's one-off divestment of its controlling interest in a telecommunications company.

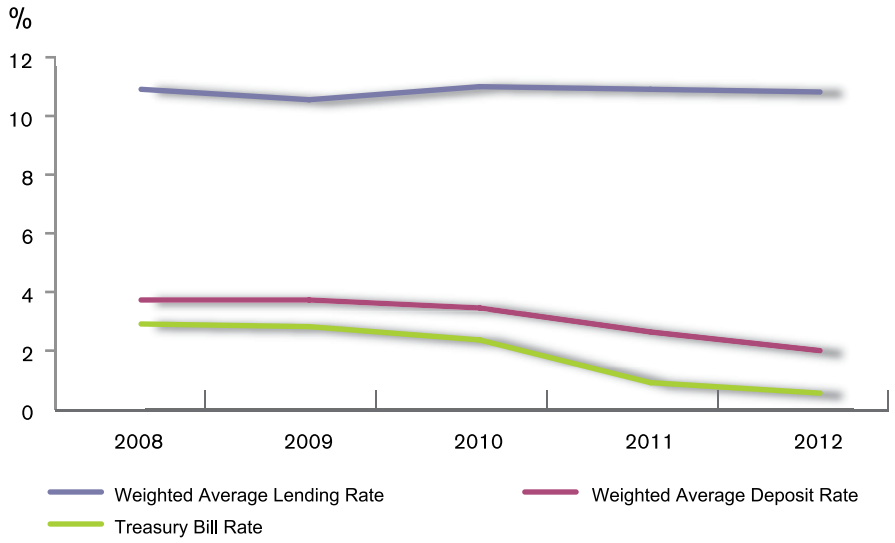
In the banking sector, liquidity remained buoyant, fuelled by Government's borrowing; however, private sector credit narrowed, amid high unemployment levels and challenging business conditions. Banks' profitability contracted, as provisions were boosted to deal with loan losses arising from elevated arrears and non-performing loans. Further, the high level of banking system liquidity contributed to a widening in the average interest rate spread, as the reduction in the weighted-average deposit rate was in excess of the narrowing in the corresponding loan rate (see Chart 4).

Chart 3
External Current Account Deficit to GDP Ratio



Source: Central Bank of The Bahamas

Chart 4
Selected Interest Rates



Source: Central Bank of The Bahamas

TABLE 3

The Bahamas: Macroeconomic Indicators

	2004	2005	2006	2007	2008	2009	2010	2011	2012
B$/US$: Exchange Rate	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Nominal GDP Growth Rate (%)	2.1	8.6	3.4	4.4	-0.9	-5.2	0.7	-0.2	3.5
Real GDP Growth Rate (%)	0.9	3.4	2.5	1.5	-2.3	-4.2	1.0	1.7	1.8
Inflation Rate (Average chg in RPI)	1.4	2.1	2.1	2.5	4.7	1.9	1.3	3.2	2.0
Unemployment Rate (%)	10.2	10.2	7.6	7.9	8.7	14.2	N/A	15.9	14.0
Overall Fiscal Balance (B$M)	(197.1)	(162.5)	(95.3)	(222.1)	(186.6)	(403.1)	(376.7)	(319.8)	(551.0)
as % of GDP	(2.8)	(2.1)	(1.2)	(2.7)	(2.3)	(5.2)	(4.8)	(4.1)	(6.9)
Private Sector Credit (B$000)	4,339.4	4,953.7	5,668.7	6,218.4	6,536.8	6,595.9	6,572.7	6,647.5	6,629.3
Weighted Average Lending Rate (%)	11.3	10.3	10.0	10.6	11.0	10.6	11.0	11.0	10.9
Weighted Average Deposit Rate (%)	3.8	3.2	3.4	3.7	3.8	3.8	3.4	2.6	2.0
Treasury Bill Rate (%)	0.32	0.35	3.00	3.04	2.92	2.81	2.44	0.97	0.58
Gross Int'l Reserves (B$M)	667.8	578.8	499.8	454.2	562.9	815.9	860.4	884.8	810.2
Import Cover Ratio (weeks)	17.6	12.1	8.9	7.4	8.6	15.6	16.1	14.5	11.8
Current Balance (B$M)	145.5	(304.7)	(1,031.1)	(954.3)	(871.7)	(808.5)	(813.1)	(1,089.8)	(1,421.6)
as % of GDP	2.1	(4.0)	(12.9)	(11.5)	(10.6)	(10.5)	(10.5)	(14.0)	(17.7)
Total Public Sector Debt (B$ M)	4,783.4	5,073.7	5,487.4	5,999.2	6,400.6	7,565.6	8,492.0	8,729.0	10,089.9
of which: External	236.5	215.9	297.2	294.5	413.2	371.1	372.5	411.4	414.7
Internal	4,153.6	4,449.7	4,864.2	5,389.4	5,573.9	6,095.8	6,849.0	6,888.8	7,604.4
Total Arrivals ('000s)	5,004.0	4,779.4	4,730.6	4,601.3	4,393.6	4,645.1	5,254.8	5,587.6	5,940.2
Tourist Expenditure (B$M)	2,226.7	2,449.5	2,437.5	2,600.1	2,501.0	2,014.2	2,146.8	2,254.1	2,366.8
Construction Number of Permits Issued	3,359.0	3,297.0	3,230.0	3,070.0	3,184.0	2,416.0	1,996.0	1,966.0	N/A
Value of Starts (B$ M)	174.6	208.9	249.2	223.4	399.6	360.9	154.2	131.1	N/A
Value of Completion's (B$ M)	269.9	313.5	273.8	323.6	427.1	297.0	337.6	482.7	N/A
Oil Prices (Brent Crude Oil Index)	38.2	55.6	66.5	74.2	97.9	63.5	80.3	111.8	111.4

"Source: Central Bank of The Bahamas, Department of Statistics, Bloomberg
N/A - Not Available

Chapter 2:

THE FINANCIAL SYSTEM

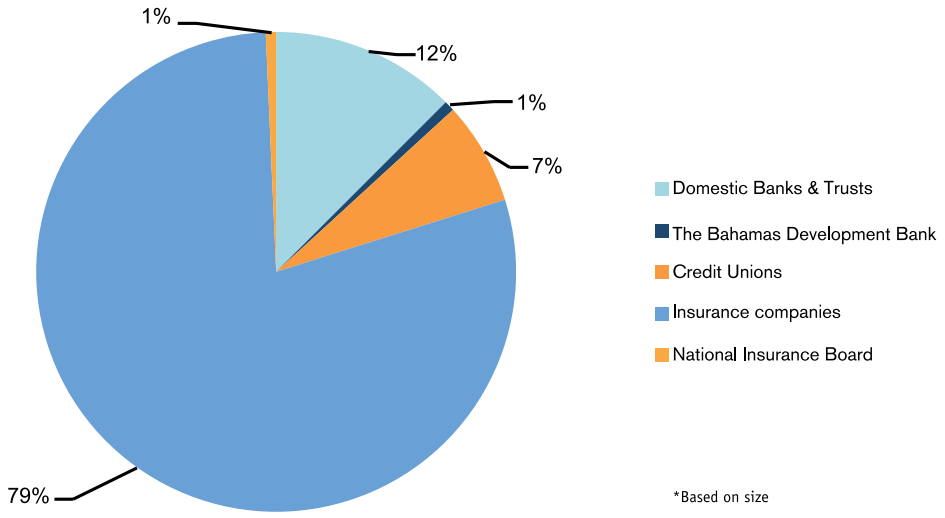
2.1. Overview

Since its early beginnings in the 1930's, the Bahamian financial sector has increased in significance, to between 15% and 20%[5] of the economy. In particular, the sector comprises over 400 banks and non-banks, employing over 6,500 individuals. In terms of composition, the domestic financial sector consists of domestic banks & trusts, The Bahamas Development Bank, money transmission businesses (MTBs), financial cooperatives, insurance companies, financial and corporate service providers, capital market entities, and the National Insurance Board (see Chart 5). International financial market participants include offshore banks, mutual/investment funds, International Business Companies (IBCs)[6], and private trust companies (PTCs). Specifically, offshore banks numbered 249 at end-2012, with domestic banks at 19 (see Table 4).

Collectively, the industry holds in excess of US$315.0 billion[7] in assets, the bulk of which are held by offshore banks, followed by domestic banks, and with The Bahamas Development Bank comprising the smallest portion. Among non-banks, mutual funds hold the majority of the assets, followed by insurance companies.

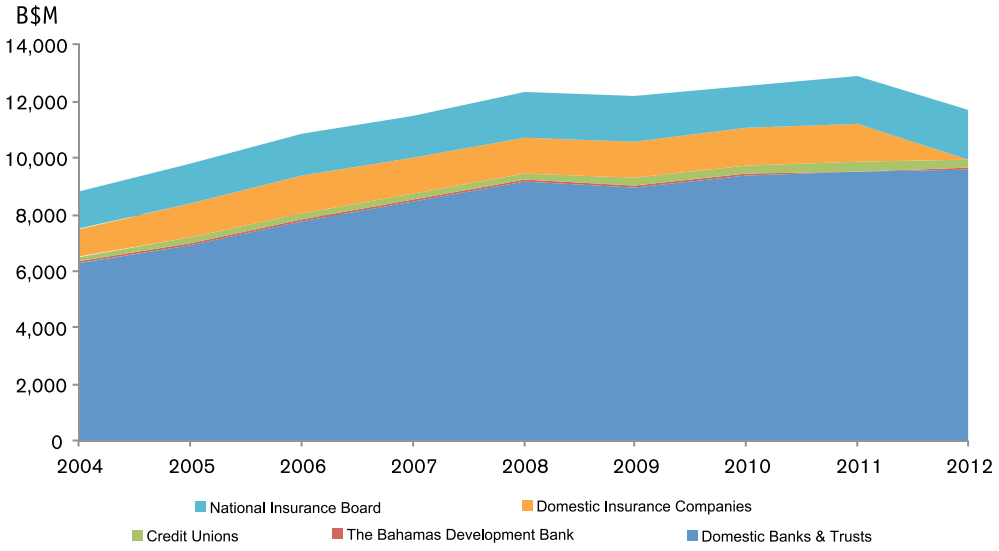
Within the domestic sector, most of the assets are held by domestic banks and trusts, followed by the National Insurance Board, and domestic insurers (see Chart 6).

Chart 5
Domestic Banks & Non-Banks (2012)*



5 Based on the Central Bank's Annual Banking Sector Survey 2011.
6 IBCs numbered approximately 166,344 at end-2012.
7 The Bahamian Dollar is equivalent to the U.S. Dollar.

Chart 6
Estimated Assets of Domestic Financial Institutions



Source: Central Bank of The Bahmas, Insurance Commission, National Insurance Board
Note: 2012 Data for Insurance Companies not available and is provisional for Credit Unions

2.2. Domestic Banks & Trusts

Banks and trust companies, comprising commercial banks, other local financial institutions and offshore banks, are regulated by the Central Bank under the principal legislation, the Banks and Trust Companies Regulations Act, 2000. Over the past five (5) years, the number of these entities averaged 273 each year; however, as of 2012, the total number of banks and trust companies stood at 268, 10 fewer than in 2011. Underlying this decline, the number of offshore banks fell by 11 to 249, while the number of domestic banks rose by 1 to 19 (see Table 4). In terms of asset value, domestic banks and trust companies held, on average, $9.3 billion in assets over the 2008 – 2012 period. As at end-2012, assets totalled an estimated $9.6 billion, an increase of $113 million (1.2%) over 2011. In contrast, the assets of offshore banks, which are substantially larger, contracted by $192.6 billion (48.7%)—from $588.3 billion in 2011 to $395.7 billion, partly reflecting the shifting of assets by a single offshore entity.

TABLE 4
Structure of the Financial System

	2008	2009	2010	2011	2012
Banks & Trusts					
Offshore Banks	251	252	256	260	249
Domestic Banks	20	20	20	18	19
Total	271	272	276	278	268
The Bahamas Development Bank	1	1	1	1	1
Non-Bank Financial Institutions					
Mutual Funds	867	788	753	713	n/a
International Business Companies	157,703	160,383	160,793	163,231	166,344
Credit Unions	17	15	10	10	10
Insurance Companies	166	174	178	127	139
Domestic Companies & Agents	*143*	*154*	*157*	*114*	*124*
External Insurers	*23*	*20*	*21*	*13*	*15*
National Insurance Board	1	1	1	1	1

Source: Central Bank of The Bahamas

2.2.1. The Bahamas Development Bank

The Bahamas Development Bank, the only state-owned lending institution[8], is governed by the Bahamas Development Bank Act, 1974; it facilitates financing for ventures relating to agriculture, fisheries, tourism, manufacturing and transportation services, which have the potential to contribute to economic growth and development. During the five year period 2008 to 2012, total assets averaged some $67.2 million, slightly below the 2012 average of $65.4 million—although representing a $4.4 million (2.8%) gain relative to 2011.

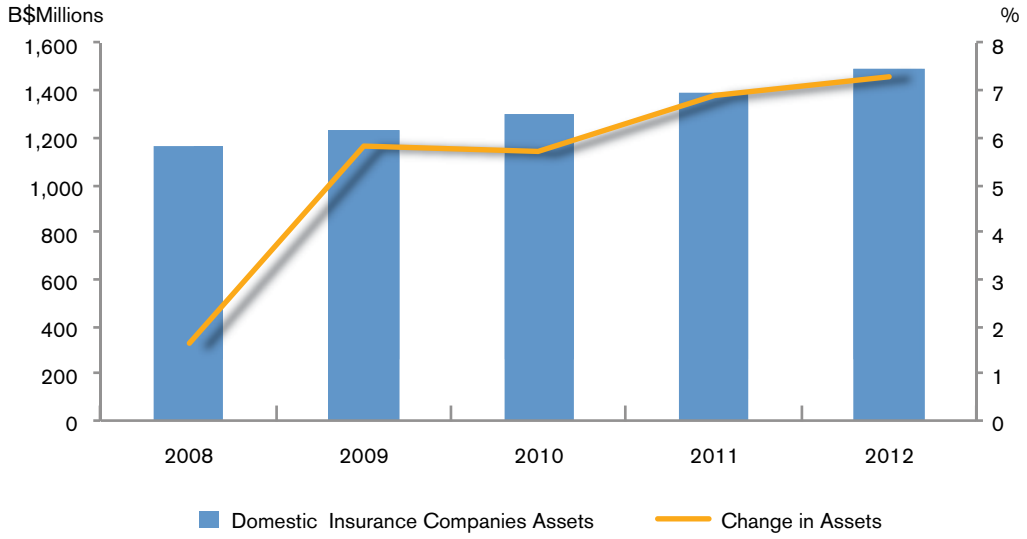
2.3. Non-Bank Financial Institutions

2.3.1. Insurance Companies

Among non-banks, the number of insurance companies and insurance intermediaries averaged 162 each year, over the period 2008 to 2012. These institutions are regulated by the Insurance Commission of The Bahamas and guided by the Insurance Act of 2005 and the External Insurance Act, 2010. At end-2011, insurance companies and intermediaries numbered 128, a decline of 50 relative to the prior year, largely due to the re-registration process which was required under the new Insurance Act. As a result, insurers and intermediaries who were inactive or only conducted ad hoc business were de-registered along with those who were unable or unwilling to meet the requirements of the new Act. In particular, the number of domestic and external insurers fell by 31 to 22 and by 11 to 13, respectively. Despite these trends, the asset value of domestic insurance companies remained relatively stable over the period—increasing moderately by 6.4% in 2011 to $1.39 billion relative to the prior year, and averaging $1.30 billion annually between 2008 and 2011 (see Chart 7). Gross premiums were also relatively stable, with a modest increase of 3.0% in 2011 to $686 million, relative to the prior year.

Chart 7

Domestic Insurance Companies' Assets



Source: Bahamas Insurance Commission

2.3.2. The National Insurance Board

The National Insurance Board registered positive asset growth throughout most of the five year review period, the exception being 2010, and averaged $1.63 billion. In 2012, the value of assets improved by $19.1 million (1.1%) to $1.73 billion.

8 The Central Government also holds shares in the Bank of The Bahamas International (BOB); however, it does not possess a controlling interest.

2.3.3. Credit Unions

Credit unions, which are governed by the Cooperatives Societies Act, 2005, continue to gain in profile, as an alternative to traditional commercial banks, offering savings and loan services to more than 38,000 members. Although currently overseen by the Department of Cooperative Development in the Ministry of Agriculture & Marine Resources, these entities are in the process of being brought under the regulatory and supervisory remit of the Central Bank. Over the past five (5) years, the number of registered credit unions averaged 14 and, as of 2012, there were 10 in operation—one less than during 2011. Provisional data for 2012 indicates that the assets of these institutions stood at $303.1 million at year-end, up $29.9 million (10.9%) relative to 2011, and averaged $256.9 million per year over the five (5) year period.

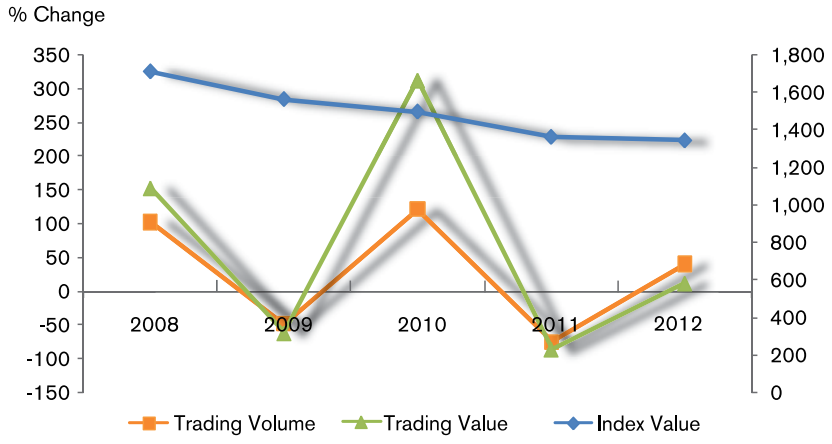
2.3.4. Other Non-Bank Institutions

Oversight of mutual funds, the domestic capital market, and financial and corporate service providers rests with the Securities Commission of The Bahamas, while International Business Companies (IBCs) are regulated by the Registrar General Department. The former are governed by the Securities Industry Act, 2011, which replaced the Securities Board Act, 1995, while the latter are governed by the International Business Companies Act, 2000.

Although still a major contributor to the overall financial services, in terms of the number of entities registered in The Bahamas and total assets, available data for the mutual funds industry signal a softening in activity over the five-year period. Specifically, the number of active mutual funds, which averaged 781, had fallen by 40 (5.3%) to 713 by end-2011 (the latest available data) from the previous year. Asset values averaged approximately $216.7 billion during the years 2004-2009, with a downward trend observed since 2008, to $189.6 billion at end-2009. Nonetheless, mutual funds rank second largest by assets, after offshore banks, among all sub-sectors of the domestic financial sector.

While data on assets is not available for IBCs, these institutions have exhibited steady growth in the number of registrants over the review period. The number of IBCs has grown on average by 2.8% each year from 2004-2011, and stood at 166,346 registrants at end-2012.

Chart 8
BISX Indicators



Source: Bahamas International Securities Exchange

With regard to the domestic capital market, the Bahamas International Securities Exchange (BISX), which was incorporated in September 1999, is relatively new in comparison to the other securities exchanges in the region. Nonetheless, it boasts a market capitalization averaging $2.9 billion over the 2008-2012 period. During the same five years, the number of listings, which is typically comprised of common and preference shares and debt tranches, averaged 25 annually. Market performance, as measured by the BISX All Share Index—a market-capitalization weighted index that consists of all primary market listings excluding debt securities—showed that the Index fell by 8.1% per annum. Between 2008 and 2012, the Index slumped by 21.4% to 1,346 at end-2012. Metrics on trading volume and value showed that an average of 6.4 million shares were traded, each year, over the five-year review period, with a mean annual value of $47.7 million. The largest gain was noted for 2010 (see Chart 8), when two significant block trades boosted the volume of securities more than two-fold.

During 2012, BISX's All Share Index fell by 1.4% to 1,345, while the number of listed securities rose by 2 to 27. When compared to 2011, trading volume moved higher by 39.8% (1.1 million) to 3.7 million shares, and the corresponding value increased by a lesser 11.3% ($1.6 billion) to $15.9 million. In contrast, the market capitalization decreased by 0.5% ($15.4 million) to $2.87 billion, due to a decline in the prices of several listings.

Chapter 3:

THE BANKING SECTOR

The banking sector in The Bahamas consists of ninety-one (91) public licences, of which eight (8) are onshore commercial banks and eighty-three (83) are offshore banks—reflecting the country's longstanding status as a major international financial centre. The assets of the offshore banks totalled $588.3 billion at end-2011, compared with $9.5 billion for the onshore banks.

As offshore banks are prohibited from holding balances in Bahamian dollars (except for local expenses) and cannot invest in domestic securities and Government debt, the focus in this report is on the onshore banks.

3.1. Onshore Banking Sector

Three (3) of the eight (8) onshore banks are domestically owned; the remaining five (5) are foreign owned, four (4) as subsidiaries and one (1) as a branch. The onshore sector is highly concentrated, with the three (3) largest banks controlling two-thirds of the assets. These banks are funded primarily by deposits and invest in traditional banking assets, such as residential mortgages and consumer loans.

3.1.1. Capital Adequacy

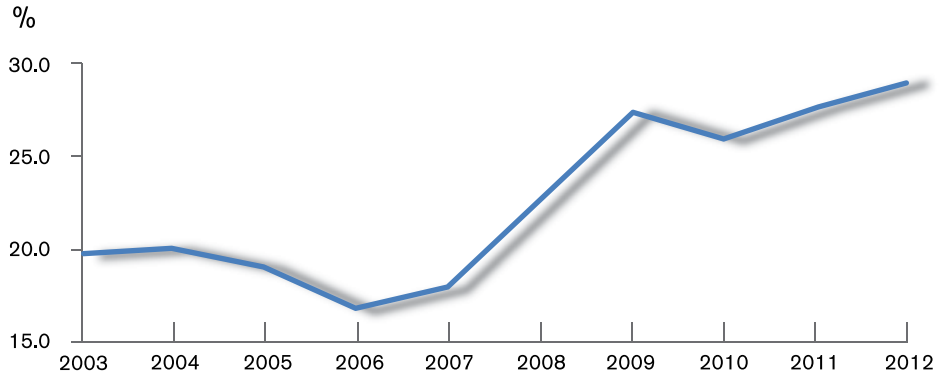
As shown in Chart 9, the banks are well-capitalized, with an aggregate Tier 1 capital adequacy ratio of 26.9 percent at end-2012, which is well above the Bank's target (17%) and minimum (14%) ratios. These ratios, in turn, are far higher than international norms and regional averages. Moreover, the industry's capital adequacy ratio (CAR) has risen by more than ten percentage points since the beginning of the financial crisis in 2007.

3.1.2. Asset Quality

The adverse economic climate and attendant challenges in business and labour market conditions have contributed to a sustained worsening in banks' credit quality indicators in the years following the recession. In the four years preceding the economic downturn (2004 to 2007), total private sector delinquencies averaged $418.3 million per annum. However, in the subsequent five years (2008 to 2012), average loan arrears expanded to an annual $1,090.7 million—attributed to a more than three-fold rise in non-performing loans (NPLs)[9], to an annual average of $674.8

Chart 9

Regulatory Capital to Risk Weighted Assets



Source: Central Bank of The Bahamas

9 NPLs are arrears in excess of 90 days and on which banks have stopped accruing interest.

10 Short term arrears are defined as those past due between 31-90 days.

million, and a more than doubling in short-term arrears[10] to an annual average of $416.0 million. The most precipitous deterioration in total arrears coincided with the height of the recession (2008 - 2009), when the domestic economy registered a 4.2% contraction in real output. Total arrears advanced by 43.1% in 2008 and by 42.4% in 2009, led by gains in the non-performing segment (46.1% in 2008 and 56.7% in 2009). In the subsequent years, the pace of expansion bottomed out, reflecting the mild domestic economic recovery.

As shown in Chart 10, asset quality deteriorated significantly following the onset of the financial crisis in 2007, as the ratio of NPLs to total loans ballooned from less than 5 percent in 2007 to almost 10 percent by 2009, and then firmed at a slower rate over the next three years, to 13.9% at end-2012.

Chart 10
Asset Quality

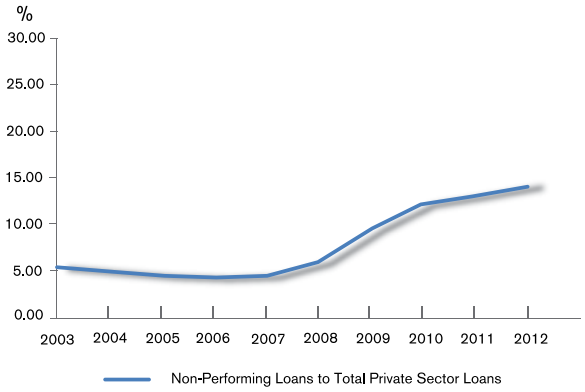
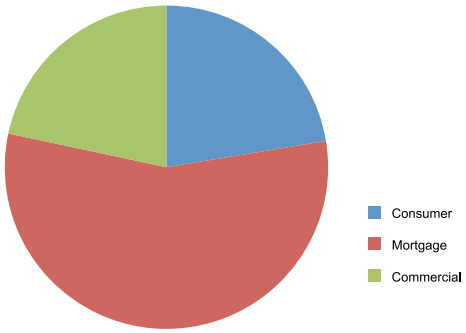


Chart 11
Composition of Private Sector Loan Arrears (2012)



Source: Central Bank of The Bahamas

The increase in NPLs has been driven by the residential mortgage component, which accounted for more than half of NPLs in 2012 (Chart 11), with the remainder split between consumer and commercial loans. The value of mortgage NPLs surged more than four-fold over the review period, rising from $116.8 million at end-2007 to $497.5 million at end-2012, while the consumer and commercial NPLs increased at much slower rates.

3.1.3. Profitability

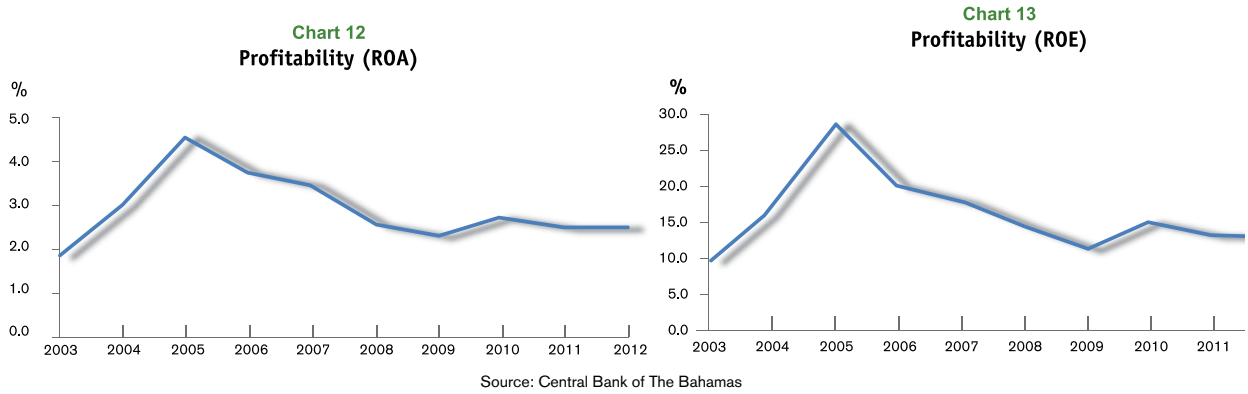
As shown in Charts 12 and 13, bank profitability spiked upwards during the 2004-2007 period, before returning to the levels obtained in 2003. Over the 2008 - 2011 period, commercial banks' total income averaged $857.0 million per year, an improvement from $699.9 million per annum over 2003-2007. Comprising the bulk of banks' income, average annual interest revenue was some $166.7 million higher at $733.4 million. Similarly, income earned from non-core operations averaged $106.5 million per year between 2008 and 2011, a gain from the $87.1 million averaged over the 2003 to 2007 period. In comparison, the average commission & foreign exchange income earned each year moderated over 2008-2011, to $25.1 million from $28.0 million during 2003 to 2007.

As measured by return on assets (ROA), profitability rose from less than 200 basis points in 2003 to a peak of 450 basis points in 2005, then receded to 250 basis points in 2008. Since 2008, ROA has fluctuated in the range of 230 – 270 basis points. Based on return on equity (ROE), profitability rose from some 10 percent in 2003, to a peak of almost 29 percent in 2005, before falling to 14 percent in 2008. Since this period, ROE has fluctuated between 12 and 15 percent. Profitability continued to be driven by the large differences between lending and deposit rates,

that have averaged about 750 basis points in each year since 2006. In recent years (2008-2012), the average lending rate has hovered around 11.0%, while the corresponding deposit rate has declined from 3.8% in 2008 and 2009, to 2.0% in 2012.

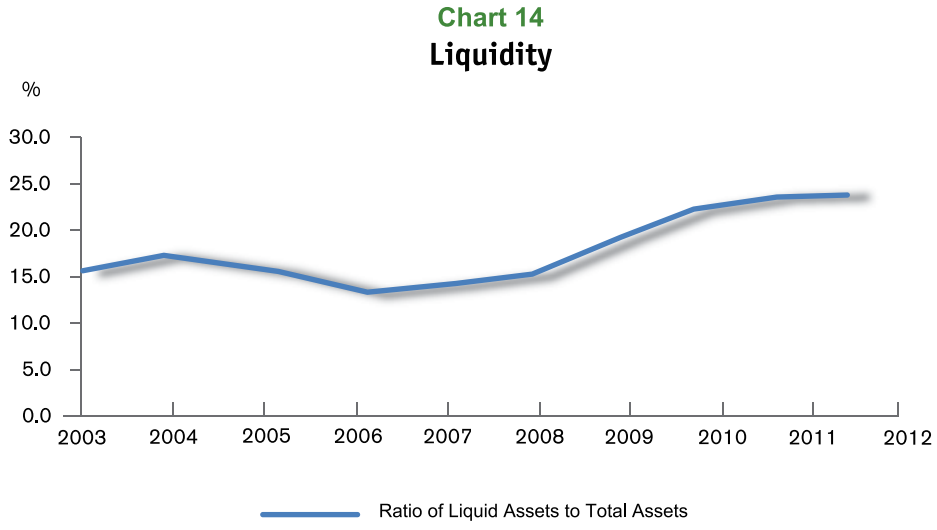
3.1.4. Liquidity

As shown in Chart 14, liquidity—as measured by the ratio of liquid assets to total assets—has risen significantly since the onset of the financial crisis in 2007. During that year, this ratio



stood at only 13 percent, but has grown in each subsequent year to a record 21 percent in 2012. This movement reflects the impact of the incidence of strong extraordinary foreign currency inflows, amid very anaemic private sector growth, with banks instead investing excess resources into short and long term Government securities, which roughly doubled over this period to $1.2 billion.

Banks' free cash balances firmed to 6.0% of total resident deposits in 2012 from 5.2% in 2011. This ratio has consistently been between a band of 2.3% and 6.5%, averaging 3.9% per year



over the 2003 – 2007 period and 4.6% per annum in the most recent five years. Similarly, the broader average monthly surplus liquid assets expanded to $931.8 million during 2012, up 1.3% over the prior year, and reached a high of over $1.0 billion during the month of July. Over the 2008 - 2012 period, surplus liquid assets averaged an annual $684.8 million, more than $500.0 million higher than in the preceding five-year period, and closed the year at $967.1 million—exceeding

the previous year by 7.9%. As a result, surplus liquid assets were 99.6% above the statutory requirement at end-December 2012, an improvement of 7.1 percentage points when compared to 2011, and 27.8 percentage points relative to the 71.8% annual average over the past five (5) years.

3.1.5. Growth in Assets

After double-digit growth in 2005 and 2006, the gains in assets slowed during 2007 and 2008 to around 8.6%, before contracting by 1.9% in 2009. During the 2010–2012 period, the expansion in assets was tepid, as loan growth was relatively flat (see Chart 15).

Specifically, in the five years prior to the recession (2003-2007), growth in total domestic assets of the banking sector averaged 8.6% per annum, capped by a high of 12.1% in 2006 after a low of 5.4% in 2003. Growth in total banking sector assets was occasioned by a rise in private sector

Chart 15

Growth in Assets

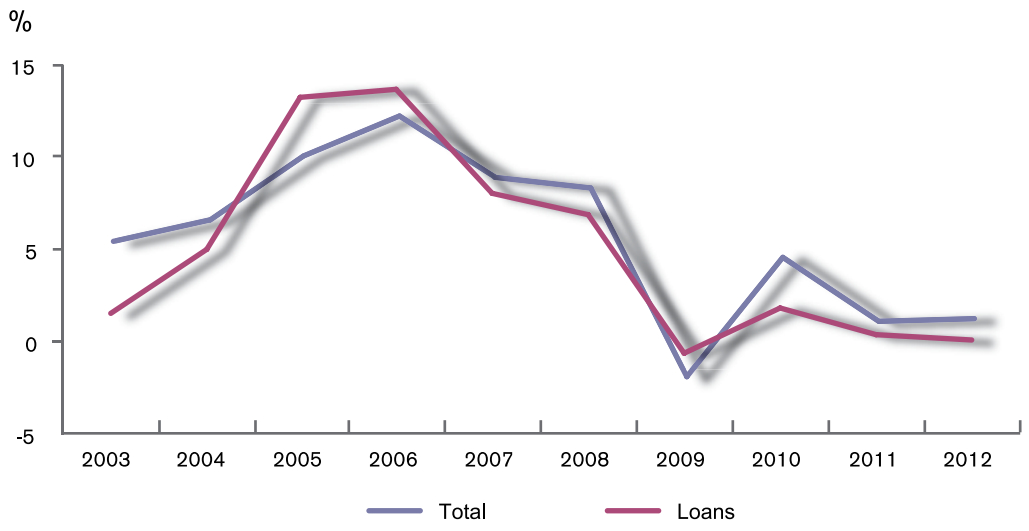


TABLE 5

Summary of Total Domestic Assets of the Banking System (B$M)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total Domestic Assets	5,899.4	6,288.4	6,917.6	7,757.1	8,449.9	9,147.3	8,970.8	9,382.6	9,489.0	9,602.1
Loans and Advances	4,495.7	4,716.4	5,342.1	6,071.3	6,553.0	6,997.3	6,951.1	7,075.5	7,103.7	7,106.0
Government	74.5	78.2	150.7	156.3	120.3	145.8	76.5	180.3	145.7	152.4
Public Corp.	347.0	313.5	265.8	268.1	243.9	343.5	305.9	339.8	326.8	338.5
Other	4,074.2	4,324.7	4,925.5	5,647.0	6,188.8	6,508.0	6,568.7	6,555.3	6,631.1	6,615.2
Other Assets	624.4	656.5	669.7	728.6	799.0	870.1	479.4	449.0	441.6	491.6
Till Cash	79.6	78.5	105.8	116.2	110.1	117.6	111.8	113.2	126.9	127.4
Balance with Central Bank	243.5	383.7	284.7	251.1	341.2	322.3	375.6	518.7	560.1	563.3
Securities	456.2	453.4	515.4	589.9	646.5	840.0	1,052.9	1,226.3	1,256.7	1,313.9
Central Government	417.1	420.0	466.6	447.1	519.2	713.6	918.6	1,093.3	1,123.0	1,180.4
Rest of Public Sector	18.6	18.6	20.6	121.1	97.7	97.5	107.0	115.6	117.4	119.4
Private Sector	20.4	14.8	28.3	21.7	29.6	28.8	27.2	17.4	16.4	14.1

Source: Central Bank of The Bahamas

claims, as loans and advances grew at a mean rate of 8.9% and securities rose by 35.4%. In terms of claims on the central Government, loans and advances and securities expanded at an average rate of 4.4% and 6.7%, respectively, during the five-year period. Loans and advances to public corporations grew by an annual average of 7.7%, and holdings of their securities increased more than two-fold.

By contrast, adverse economic conditions during the 2008-2012 period contributed to a reduction in the average growth in domestic assets of the banking system, to 2.6% per annum, including a 1.9% contraction in 2009. The rise in private sector loans and advances slowed to an annual average of 1.4%—contrasting with gains in both loans and advances to the Government (18.9% per annum) and public corporations (8.1% per annum), and corresponding hikes in banks' holdings of their securities, at average annual increases of 18.6% and 4.2%, respectively.

At end-2012, the composition of the domestic banking system's assets comprised loans and advances, (74.0%), followed by securities (14.0%), balances with the Central Bank (6.0%), "other" assets (5.0%) and till cash (1.0%) (see Table 5).

3.1.6. Loan Rates

Banks weighted average loan rate softened by 10 basis points to 10.9% at end-2012 (see Table 6). Underpinning this outturn was a slight decline in the average interest rate for commercial mortgages, to 8.3% from 8.4% in 2011, while the average rate for the residential component fell by 0.3 of a percentage point to 7.5% and consumer loan rates stabilized at 13.4%.

For the five-year review period, the weighted average lending rate was relatively stable, increasing slightly to an annual average of 10.9% in the 2008 - 2012 period, from 10.8% in previous five years, attaining a peak in 2003 of 12.0%. Consumer loans posted the highest average annual rate of 13.1% over the years 2008 - 2012, up from 12.7% in the preceding five years. In contrast, average residential and commercial mortgage rates, at 8.4% and 8.8% per annum over 2003 - 2007, fell marginally to 8.0% and 8.6% respectively, in the subsequently five years. The modest reduction in these rates partly reflected the 75 basis points lowering of the Central Bank's Discount rate, to 4.50% in June 2011, which engendered a corresponding decline in the commercial banks' Prime rate to 4.75%.

TABLE 6

Banking System Loan Rates (%)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Weighted Average Rate	12.0	11.3	10.3	10.0	10.6	11.0	10.6	11.0	11.0	10.9
Consumer Loans	13.8	13.0	12.2	12.0	12.7	13.0	12.7	13.2	13.4	13.4
Residential Mortgages	9.0	8.8	8.1	7.8	8.2	8.4	8.3	8.1	7.8	7.5
Commercial Mortgages	9.6	9.2	8.1	8.4	8.7	8.7	8.6	8.8	8.4	8.3

Source: Central Bank of The Bahamas

3.1.7. Deposit Rates

An analysis of deposit rates reveals a gradual downward trajectory, especially following the most recent global recession, and corresponding to the excessive build-up in banking sector excess liquidity. The weighted average deposit rate averaged 3.6% per annum over the 2003 - 2007 period, peaking in 2003 at 3.9%, before dropping to 3.2% in 2005. Deposit rates staged a gradual recovery in the next four (4) years and stabilised at approximately 3.8% from 2008 to 2009. However, rates receded over the following three (3) years, as deposits rose rapidly, to average 2.0% at end-2012 (see Table 7).

Among the main categories, the savings rate was relatively stable, averaging 2.2% per annum over the 2003 - 2007 period, before flattening out to an annual average of 1.9% in the last five years. The average range of interest rates on fixed maturities was reduced to 2.9% - 3.7% over the 2008 - 2012 period, from 3.8% - 4.2% in the prior five years.

TABLE 7
Banking System Deposit Rates (%)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Weighted Average Rate	3.9	3.8	3.2	3.4	3.7	3.8	3.8	3.4	2.6	2.0
Savings Deposits	2.2	2.6	2.3	2.2	2.1	2.2	2.1	1.9	1.7	1.6
Fixed Deposits										
Up to 3 Months	4.0	3.7	3.1	3.2	3.5	3.7	3.6	3.2	2.3	1.6
Up to 6 Months	4.1	4.2	3.4	3.6	3.9	4.1	3.9	3.6	2.7	1.9
Up to 12 Months	4.4	4.3	3.6	3.9	4.3	4.6	4.3	4.0	3.2	2.5
Over 12 Months	4.6	4.3	3.6	4.2	4.5	4.4	4.4	4.0	3.2	2.7

Source: Central Bank of The Bahamas

3.1.8. Stress Testing Analysis

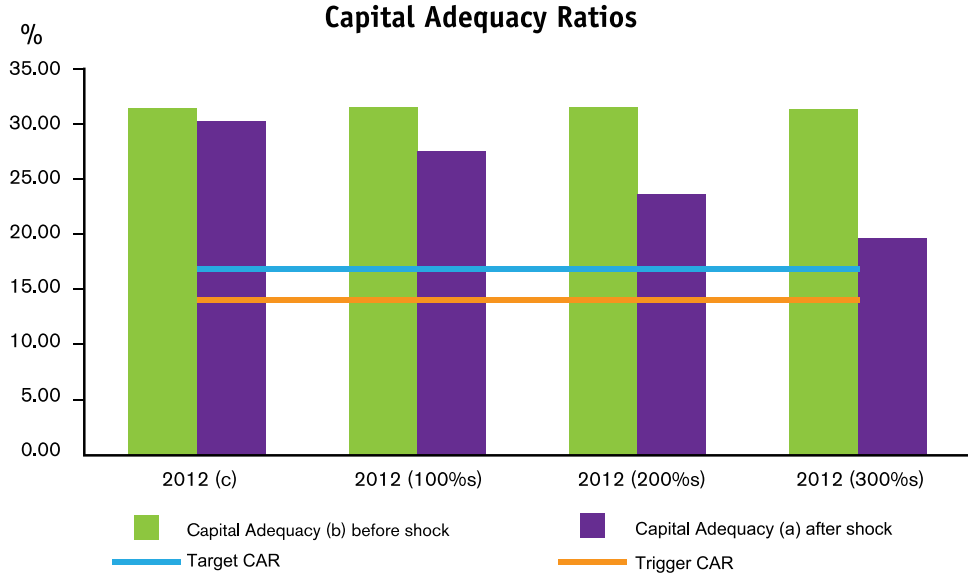
In 2009, stress testing became an integral part of the Bank's supervisory regime for the seven (7) locally incorporated domestic commercial banking entities, which have assets of around $11.0 billion. The Bank views stress testing as an essential risk management tool, especially in unstable economic cycles. Stress testing facilitates an anticipatory, rather than reactionary, risk management approach; it allows organizations to anticipate the impact of macroeconomic shocks on their business, as well as the impact of micro (specific industry, or firm-specific) shocks to their business.

The stress-testing framework has provided the Bank with a new and important tool for macro-prudential monitoring, supporting assessments of credit, liquidity, and interest-rate risks, and the impact of projected macro-economic trends on the domestic banking sector as a whole, inclusive of individual bank resilience tolerance levels.

In 2012, the Bank measured the financial soundness of banks using its stress-testing framework models. These models provide projections for three (3) years into the future. The credit-risk stress-testing model assessed the factors of credit quality, payout ratios and haircuts on collateral, with the underlying impact on the capital risk-adjusted ratio levels, based on the 14% and 17% trigger and target ratios set for the banks, both from a system wide and bank specific basis. A comparative analysis was conducted across banks, using ownership structure (domestic or foreign) to determine, as a group, the average levels of capital, along with the corresponding capital ratios—based on specific shocks being applied to the level of NPLs, at increases of 100%, 200% and 300%. Chart 16 indicates that, at the current (c) levels, the CAR remains above 30% and, despite the decreasing levels of net income over the period using various shocks, CAR remains well above the trigger/target ratios levels of 14%/17%, reaching a low of only about 20.0%.

Chart 17 shows that, while projected net income before any shocks should remain within the area of $200.0 million, net income steadily declines when shocks of 100%, 200% and 300% are applied to the level of NPLs, given the possibly of a shortfall in provisions and loss in interest income. The contraction in net income, to approximately $130.0 million from the initial forecast of $200.0 million in current times, registers continuous net losses of around $58.0 million, $330.0 million and $600.0 million when stressed at 100%, 200% and 300%, respectively. However, due

Chart 16
Capital Adequacy Ratios

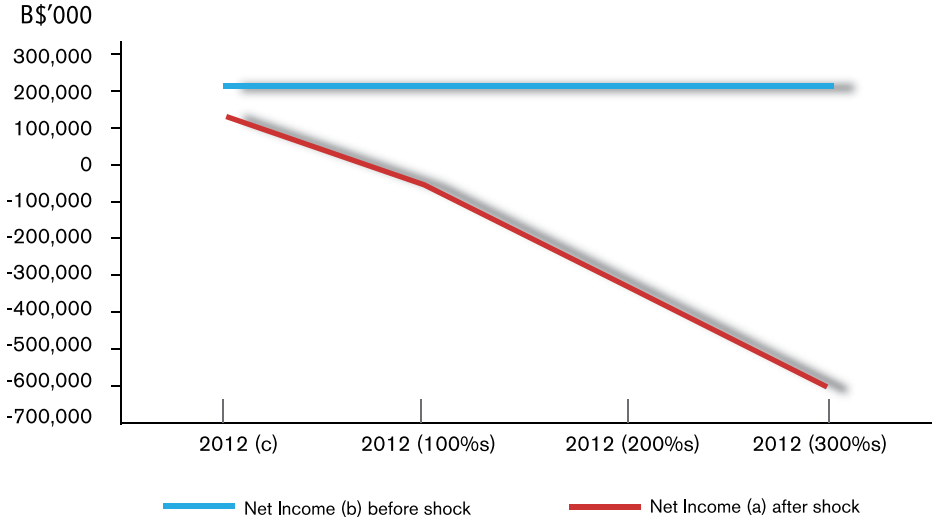


to the high level of consolidated capital, the system's capital ratios remain high, although the impact on individual firms will differ.

The interest-rate risk stress-testing model assessed the impact of interest rate movements on the bank's capital and profitability, using an upward and downward shift in interest rates, despite there being no active yield curve in The Bahamas. The same comparative analysis used for the capital-risk stress testing was used for the interest-rate-risk stress test.

Unlike the Bank's liquidity model, which focused on cash-flow analysis—using maturity wise analysis of assets and liabilities—the model used by banks for the most part, analyzed liquidity using 5-day and 30-day outflow stress horizons. The purpose of the test was to determine the overall risks of the banks, under plausible scenarios, to sporadic movements in liquidity, using liquid asset ratios of 20% as the benchmark.

Chart 17
Net Income



In 2013, the Bank plans to continue to work on enhancing the stress testing framework, and examining other plausible scenarios to be used in the various models. More specifically, the focus will be on developing the models in line with new international standards and policies that would further enhance the oversight of systemically important financial institutions in The Bahamas, that is, the domestic commercial banks, in the broader context of financial stability.

Chapter 4:

THE INSURANCE SECTOR

4.1. Overview

The Insurance Commission of The Bahamas (ICB) was established in 2009, following the enactment of the new Insurance Act (2005) in July of that year. The Commission is the regulator of the insurance sector of The Bahamas, comprising approximately forty (40) insurance companies and ninety-nine (99) insurance intermediaries, which conduct life & health, general and captive insurance business. There are presently twenty-four (24) companies operating in the domestic insurance sector—of which six (6) non-life insurers and four (4) life insurers account for a combined 80%-90% of the total insurance business by gross premiums written. Despite the failure of CLICO Bahamas Ltd, in 2009, the sector has registered broad-based improvement in total assets, equity and net income over the past four (4) years.

4.2. Life Insurance

Life-insurance companies account for over 70% of the $1.4 billion in total industry assets. During 2012, total life-insurance assets increased by 6.5% to $1.1 billion, with buoyant levels of liquidity, as cash & deposits firmed by 15.5%, while "other" assets and receivables advanced by 13.7% and 6.7%, respectively. Life insurance gross premiums expanded by 2.4% to $386.4 million, while their total investment portfolio increased by 3.3%, as holdings of preference shares, Government bonds and non-listed corporate equities rose by 24.4%, 17.4% and 5.0%, respectively. In contrast, mutual fund investments decreased slightly by 1.6%, owing primarily to a 5.8% falloff in mortgage loans, which eclipsed the three-fold hike in the smaller "other" miscellaneous investments component; a 2.7% gain in policy loans, and a 2.1% uptick in property investments. In addition, when compared with 2011, intangibles and fixed investments fell by 8.2% and 4.0%, respectively. Total liabilities for life insurance companies advanced by 6.2% to $795.4 million in 2012, as technical reserves grew modestly by 3.9%, while other liabilities surged by 24.2%. Equity levels moved higher by 7.1%, with retained earnings, share capital and other reserves firming by 12.7%, 2.4% and 0.6%, respectively.

Financial soundness indicators for the life-insurance industry in 2012 showed slight gains, in both the ratio of capital to total assets and the ratio of capital to technical reserves, which firmed to 26.4% and 41.4%, respectively, from 26.2% and 40.1%, in the prior year. However, the ratio of net premiums to capital fell to 118.8% from 128.5% in 2011 (see Table 8). Most of the selected asset quality indicators registered an improvement. The ratio of real estate plus unquoted equities and receivables to total assets declined, year-on-year, by 0.6 of a percentage point to 15.8% in 2012, reflecting a decrease in outstanding amounts owed. Similarly, the ratio of real estate to total assets narrowed to 7.3% from 7.6% a year earlier. However, there was a marginal deterioration in the ratio of equities to total assets, of 20 basis points to 26.4% in 2012. Over the past few years, with operating expenses on the decline and net premiums increasing, the expense ratio narrowed slightly. This trend resulted in the expense-to-premium ratio falling over the five-year period, from 44.3% in 2007 to 31.0% by end-2012. The return on investment in the sector fell, to 4.7% at end-2012 from 4.9% in the prior period, but was significantly below the 11.3% posted in 2007. Return on equity rose marginally, to 26.4% in 2012 from 26.2% a year earlier, benefitting from growth in share capital, retained earnings and other reserves.

TABLE 8

Life Insurance: Financial Soundness Indicators (%)

	2007	2008	2009	2010	2011	2012
Capital Adequacy						
Capital/Total Assets	19.4	22.4	24.0	25.0	26.2	26.4
Capital/Technical Reserves	27.6	32.2	36.0	37.4	40.1	41.4
Net Premium/Capital	187.2	180.3	148.6	126.4	128.5	118.8
Asset Quality						
Real Estate + unquoted equities + receivables)/Total Assets	12.3	15.0	23.2	19.3	16.4	15.8
Equities/Total Assets	19.4	22.4	24.0	25.0	26.2	26.4
Real Estates/Total Assets	n/a	n/a	8.0	7.8	7.6	7.3
Earnings & Profitability						
Expense Ratio (expense/net premium)	44.3	39.8	35.6	41.6	31.4	31.0
Investment Yield (investment income/investment assets)	11.3	10.4	7.0	7.2	4.9	4.7
Return on Equity (ROE)	19.4	22.4	24.0	25.0	26.2	26.4

Source: Insurance Commission of The Bahamas & Central Bank of The Bahamas

4.3. Non-Life Insurance

Indications are that non-life insurers continued to expand their operations, as gross premiums rose by 5.2% to $324.9 million in 2012, vis-à-vis the prior year, and aggregate assets were higher by 9.5% at $414.6 million. In terms of the components, the total cash balance advanced by 5.2%, fixed assets, by 55.0% and receivables, by 25.4%—eclipsing declines in the smaller categories other assets, intangibles and re-insurance recoveries, of 74.1%, 24.2% and 20.8%, respectively. On the liabilities side, there was an increase of 8.3% to $253.7 million in 2012 vis-à-vis the prior period, as the 14.1% rise in technical reserves overshadowed the 14.3% reduction in other liabilities. Total equity firmed by 11.5%; retained earnings, by 2.7%, share capital, by 2.8% and other reserves advanced almost three-fold, to $20.3 million from $7.6 million in 2011.

Financial soundness indicators for the non-life insurance sector (see Table 9) were mixed over the review period, as the risk retention ratio increased to 31.3% in 2012 from 29.2% a year earlier, signalling a rise in the sector's overall direct risk exposure, although it remained lower

TABLE 9

Non-Life Insurance: Financial Soundness Indicators (%)

	2007	2008	2009	2010	2011	2012
Asset Quality						
Real Estate + unquoted equities + receivables)/Total Assets	48.0	51.8	44.9	40.6	56.9	58.7
Reinsurance and Actuarial Issues						
Risk Retention Ratio (net premiums /total gross premiums)	40.3	40.7	37.2	35.4	29.2	31.3
Technical Reserves/Net Claims	346.1	360.6	302.2	380.6	554.1	682.7
Technical Reserves/Net Premiums	125.9	125.5	135.1	153.3	207.3	209.7
Earnings & Profitability						
Expense Ratio (expense/net premium)	44.4	48.3	45.7	50.5	63.8	72.1
Loss Ratio (net claims/net premium)	36.4	34.8	44.7	40.3	37.4	30.7
Investment income/net premium	4.3	4.0	5.0	5.5	8.4	5.3
Return on Equity (ROE)	54.4	53.2	39.6	37.3	39.8	45.6
Return on Assets (ROA)	13.3	11.1	5.5	4.9	1.7	2.2

Source: Insurance Commission of The Bahamas & Central Bank of The Bahamas

than the 40.3% for 2007. The net technical reserves ratio (net technical reserves held relative to net claims paid out) remained healthy over the year, rising to almost seven times net claims (682.7%), compared to an over 5 to 1 ratio in 2011 and 3 to 1 in the year prior to the recession. Similarly, the technical reserves to net premium ratio rose marginally to 209.7% from 207.3%, and remained considerably higher than the 125.9% recorded in 2007. The ratio of investment income to net premiums decreased to 5.3% from 8.4% in 2011, partly reflecting the low interest rate environment, while the profitability ratios, return on equity and assets, both rose, year-on-year, by 5.8 and 0.5 percentage points, to 45.6% and 2.2%, respectively. However, they are still significantly below the respective 54.4% and 13.3% attained in 2007.

Box 1: Financial Stability Report CLICO

Colonial Life Insurance Company (CLICO), which was founded in 1936, had operations which spanned the region and included 65 branches in 32 countries, by the time of its liquidation. After the acquisition of several large firms and the diversification of its range of products, the insurance company became CL Financial group, emerging from being the largest privately held conglomerate in Trinidad and Tobago to one of the largest local conglomerates in the region, with assets of over US$100 billion.

During the global recession in 2008-2009, CLICO came under financial pressure, and in 2009 "excessive related-party transactions", elevated interest rates and high leveraging of the Group's assets, combined with an extraordinary number of withdrawal requests, lead to an intensification of liquidity challenges. Accordingly, during early 2009, the Government of Trinidad and Tobago revealed that it would bail out CL Financial and assured depositors and policy holders that their funds would be safe. Specifically, in a bid to address the liquidity problem, the Central Bank of Trinidad and Tobago made the decision to take control of Clico Investment Bank Limited (CIB), transfer all the third-party assets and liabilities on the books of CIB and Caribbean Money Market Brokers Limited (CMMB) to First Citizens Bank, provide short term liquidity as needed and revoked CIB's banking license.

Further, CL Financial agreed to divest additional assets to assist with funding CLICO's existing Statutory Fund deficit. Trinidad and Tobago's Government agreed to provide any additional funding needed to eliminate this deficit in exchange for collateral and an equity interest in CLICO, with the intent to restore its profitability at some point in the future. As a result, CLICO Bahamas went into liquidation, as well as the branch in Guyana, while CLICO (Belize) Ltd was placed under the management of Belize's Supervisor of Insurance.

In The Bahamas, the winding-up process involving the life insurance company CLICO (Bahamas) Limited (CBL) and an unlicensed holding company CLICO Enterprises Limited (CEL) continued in 2012. While the relationship between CBL and CEL continues to be unclear, over 60% of CBL assets had been invested in CBL's wholly owned US subsidiary, Western Preserve Corporation and Wellington Preserve property located in Palm Beach County, Florida. As of June 30, 2012, CLICO Bahamas Limited company's total liabilities were $67.0 million and exceeded assets of $44.8 million, yielding an estimated deficiency of $22.2 million[1]. However, the final deficiency would be a function of recoveries from the liquidation of CEL. While the liquidation of CEL consisting primarily of the sale of Wellington Preserve property has progressed, no accounting of estimated recoveries is available at this time. The Government of The Bahamas has committed to provide a guarantee up to $30.0 million to finance the anticipated shortfall in the liquidation process. The terms of the guarantee included for policy holders, death coverage of up to $300,000 per person, coverage of up to $100,000 per person for Executive Flexible Premium Annuity (EFPA), and fixed deposit and pension annuity holders. Further, full coverage was proposed for accident and sickness.

1. See "Twelfth Report of the Official Liquidator of CLICO (Bahamas) Limited," for the period April 1, 2012 - June 30, 2012

CHAPTER 5:

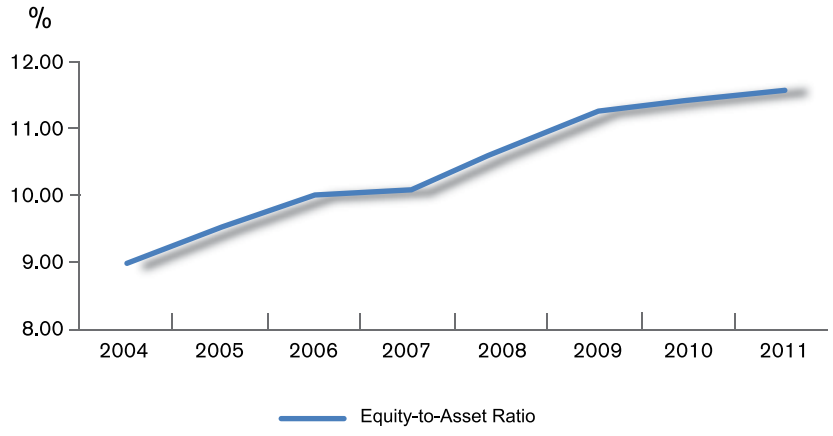
CREDIT UNIONS

Credit unions play a pivotal role in the Bahamian economy, as they provide an increasingly broader range of financial products and services to assist members in achieving their financial goals. During the 2007 - 2012 period, the number of active credit unions decreased from 17 to 10, as a result of four (4) consolidations and three (3) liquidations. Nonetheless, total credit union assets grew by almost 39.2%, from $216.2 million to $301.0 million, over the same period. Still, the credit union sector remains small when compared to the almost $10 billion in assets held by the banks conducting domestic business. The sector is highly concentrated, with one (1) institution accounting for just over half of total sector assets. Supervision of credit unions, from the inception of the movement, has been the responsibility of the Department of Cooperative Development within the Ministry of Agriculture and Marine Resources, but a project is underway to migrate them to the supervisory responsibility of the Central Bank in the near-term. Credit unions are not covered by the Deposit Insurance Corporation (DIC), which currently only insures Bahamian dollar deposits in banks conducting domestic business. However, the Credit Union League administers a stabilization fund for the purpose of protecting credit union depositors[11].

5.1. Capital Adequacy

Basel capital ratios, based upon Tier 1 and Tier 2 capital requirements are not available for the credit unions, so their capital adequacy must be assessed by a simple ratio of total equity to total assets, i.e., the gearing ratio. As shown in Chart 18, the simple leverage ratio has steadily increased, from 9.0% as of end-2004 to 11.6% at end-2011—exceeding the required 10%, as per the PEARLS[12] standard for credit unions. The riskiness of credit union assets is limited by restrictions on permissible investments such as commercial real estate.

Chart 18
Capital Adequacy



5.2. Asset Quality

Loans to credit unions are the largest asset category, and, as such, the portfolio poses a significant risk to their viability if they are not prudently managed. As shown in Chart 19, the

11 Each credit union contributes to this fund on an annual basis. In addition, the Credit Union League has retained earnings that can be used to cover deposits in the event of a crisis.

12 PEARLS is a financial performance monitoring system, which consists, *inter alia*, of a series of financial ratios which provide an assessment of an institution's performance in the areas of, protection, effective financial structure, asset quality, rate of return and costs, liquidity and size of growth.

loan-to-asset ratio for credit unions rose, from 65% as at end-2005 to 70% as at end-2007, but then dropped by 6 percentage point to 64% as of end-2011. This movement reflects a shift in portfolio risk, following the onset of the financial crisis.

Chart 19
Capital Adequacy

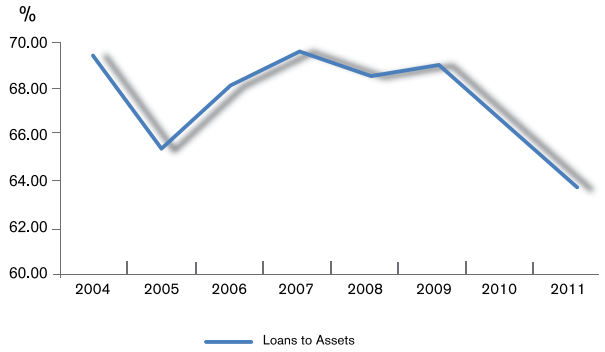
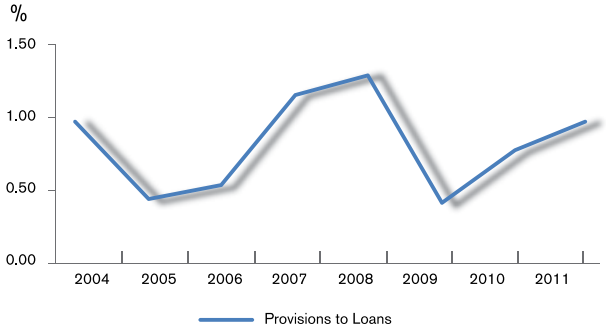


Chart 20
Asset Quality



Source: Department of Cooperatives

Credit union asset quality can be gauged by the ratio of provisions to total loans. As shown in Chart 20, provisions rose steadily from 2005 through the 2008 start of the financial crisis, but then fell sharply in 2009, before rising again during 2010 and 2011.

5.3. Profitability

As shown in Charts 21 and 22, credit union profitability, as measured by return on assets (ROA) and return on equity (ROE), has been declining steadily since peaking in 2006. Between 2006 and 2011, both ROA and ROE were slashed from 1.55% and 15.45%, to 0.37% and 3.22%, respectively. This decline has been largely attributable to a combination of rising provisioning expense amid a deterioration in asset quality and higher deposit interest expense, as credit unions competed with banks for customer deposits.

Chart 21
Return on Assets

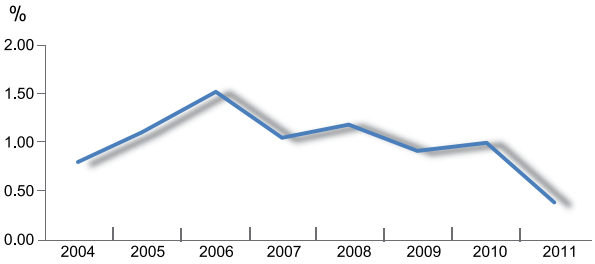
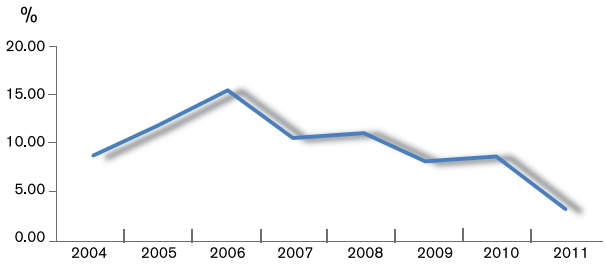


Chart 22
Return on Equity



Source: Department of Cooperatives

5.4. Liquidity

Credit union liquidity (as measured by the ratio of liquid assets to total asset) declined from 26% at end-2005 to 23% at end-2007, but then rebounded each year since, to 32% at end-2011.[13] This recovery was largely driven by an increase in fixed deposits, which grew from only $19 million at end-2005 to $46 million by end-2011.

13 Liquid assets are defined as cash plus investments.

Chart 23
Liquidity

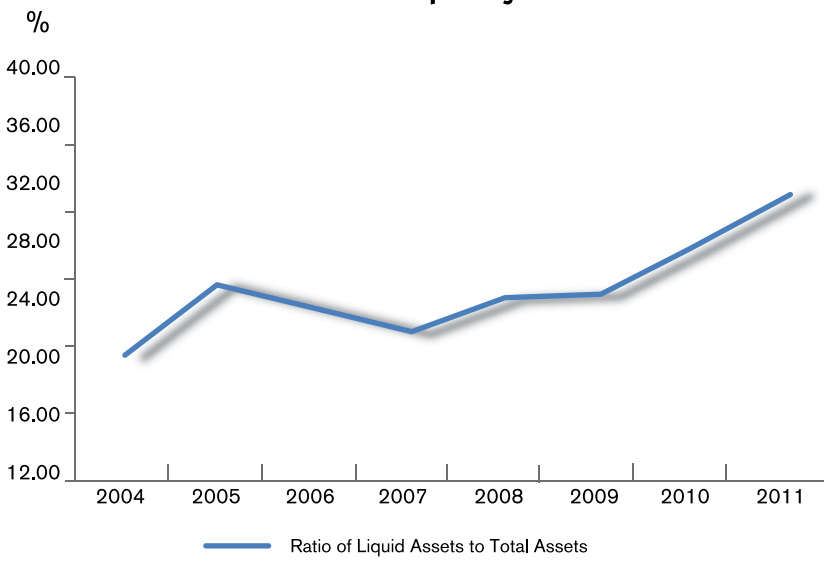


TABLE 10
Selected Financials for Credit Unions (B$M)

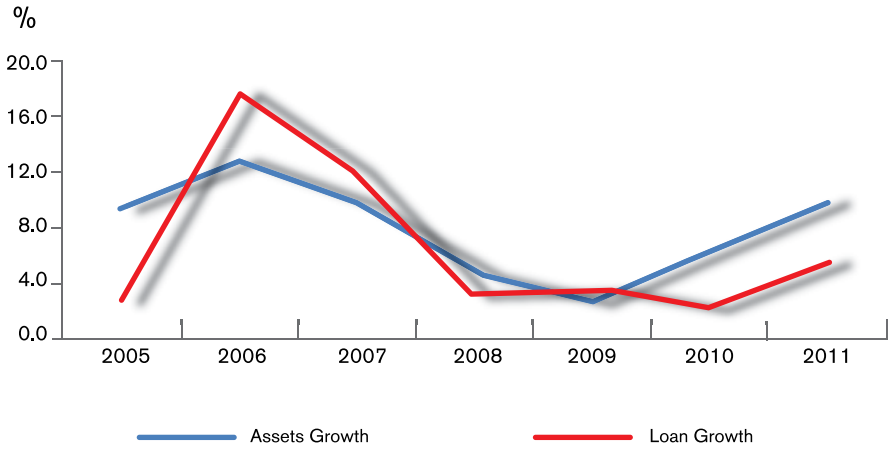
	2004	2005	2006	2007	2008	2009	2010	2011
Assets	159.7	174.5	196.8	215.9	226.0	231.9	246.5	270.6
Loans	110.9	114.0	134.1	150.2	154.8	160.1	163.5	172.4
Deposits	133.8	147.1	165.8	181.5	188.8	195.9	208.2	229.7
Liquid Assets	33.7	45.1	47.7	49.2	56.4	58.6	69.8	86.2
Savings	97.8	101.8	111.2	119.6	122.5	121.1	123.4	127.6
Term Deposits	10.4	23.2	29.7	33.3	53.8	64.8	79.1	98.2
Capital & Surplus	14.4	16.6	19.7	21.7	24.1	26.0	28.1	31.3
Provisions	-1.1	-0.5	-0.7	-1.7	-2.0	-0.6	-1.3	-1.7
Net Income	1.3	2.0	3.0	2.3	2.7	2.1	2.5	1.0
# of Credit Unions	17	17	17	17	17	15	10	10
Financial Ratios (%)								
Equity-to-Asset Ratio	9.0	9.5	10.0	10.0	10.7	11.2	11.4	11.6
Return on Assets	0.8	1.1	1.6	1.1	1.2	0.9	1.0	0.4
Return on Equity	8.8	12.0	15.5	10.6	11.2	8.2	8.8	3.2
Provisions to Loans	1.0	0.4	0.5	1.2	1.3	0.4	0.8	1.0
Loans to Assets	69.4	65.4	68.1	69.6	68.5	69.0	66.3	63.7
Liquid Assets to Assets	21.1	25.9	24.2	22.8	25.0	25.3	28.3	31.9

Source: Department of Cooperative Development

5.5. Growth in Assets and Loans

Chart 24 shows the annual percentage growth rates for credit union assets and loans. While highly correlated with asset growth, loan growth has been more volatile, rising from 3% in 2005 to 18% in 2006, before declining to below 4% in 2008, where it remained before firming to 6% in 2011. Asset growth at 9% in 2005, rose to 13% in 2006, declining thereafter during the three years to 2009 for an average 3%. Subsequently, asset growth picked up during 2010 and 2011 to 6% and 10%, respectively; this was largely attributable to a hike in fixed deposits.

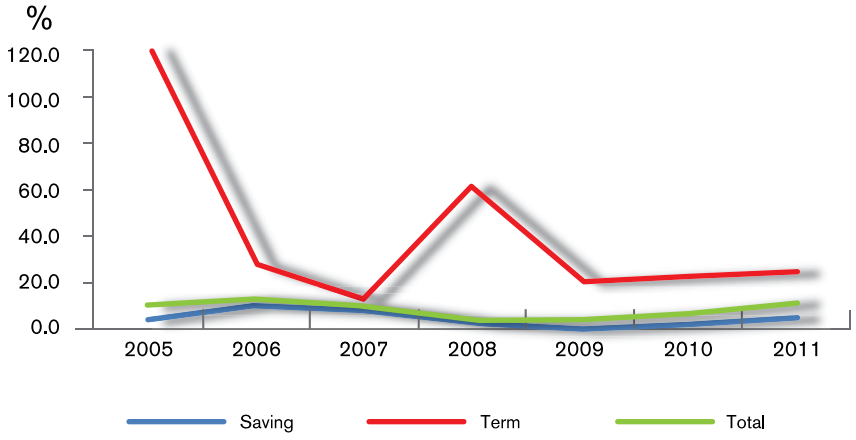
Chart 24
Growth in Assets and Loans



5.6. Growth in Deposit Liabilities

Chart 25 shows the annual percentage growth rate for total deposits, and separately for its two (2) major components—savings and term balances. During 2005, term deposits more than doubled—from $10 million to $23 million as of end-2005. Growth slowed markedly during 2006-2011, but still averaged almost 30% per annum. In contrast, savings deposits grew by an average 4% over the entire period, inclusive of a 1% decline in 2009. Consequently, the growth rate for total deposits, averaged only 8% of the entire period (see Table 10).

Chart 25
Growth in Deposits

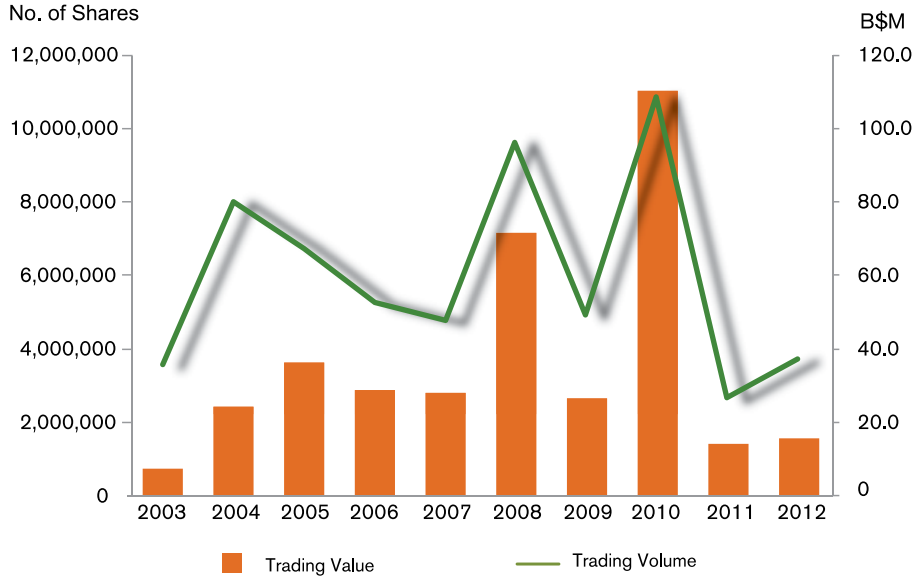


Chapter 6:

CAPITAL MARKETS

Developments in the local equity market were relatively robust in 2012, attributed mainly to two (2) significant share issues by a port development company and an insurer during the second quarter. As a result, the total volume of securities traded on the Bahamas International Securities Exchange (BISX) grew by 38.9% to 3.7 million. As shown in Chart 26, 2011 trading volume contracted by 75.5%, representing a return to more subdued levels, after spiking from 2009 to 2010 as a result of two (2) large block trades during that year. Similarly, the aggregate trading value rose by 11.3% to $15.9 million, in contrast to the preceding year's 87.1% contraction. On average, the daily trading volume advanced by 24.0% in 2012 to 0.2 million compared to 2011's 73.9% contraction. In the pre-recessionary years, the total trading volume grew by an annual average of 19.3%, and increased, on average, by 27.7% per annum in the subsequent five-year period, boosted by the more than doubling in trading volume for 2010 and an even stronger surge in the corresponding value.

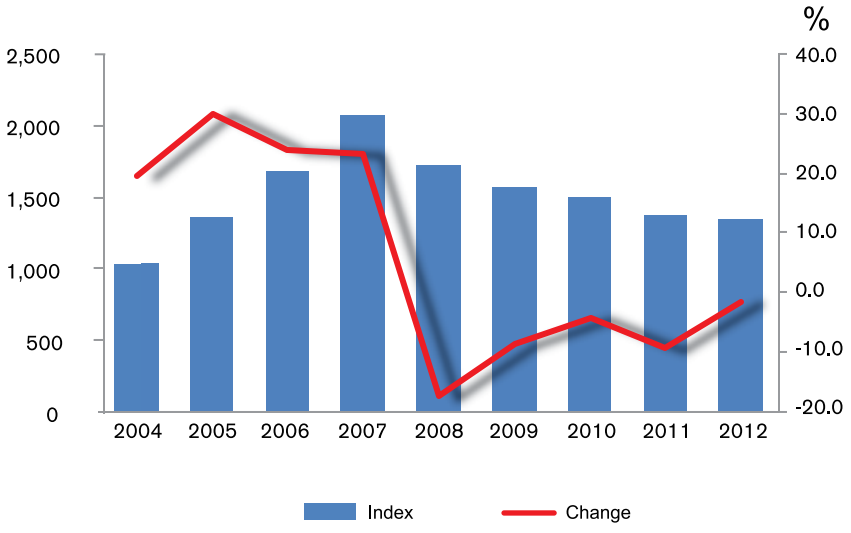
Chart 26
Trading Value and Volume



Source: Central Bank of The Bahamas & BISX

Other market indicators worsened over the period, as a general decline in share prices resulted in a 1.4% softening in the BISX All Share Index, to 1,346.3 points in 2012, following a 9.0% contraction in the previous year (see Chart 27). An analysis over the last decade showed that the local capital market performance is highly correlated with domestic economic developments. In the five years preceding the 2008-2009 recession, the BISX All Share Index advanced by an average of 24.3% per annum, but in the subsequent five-year period, it declined by an annualized average of 8.1%.

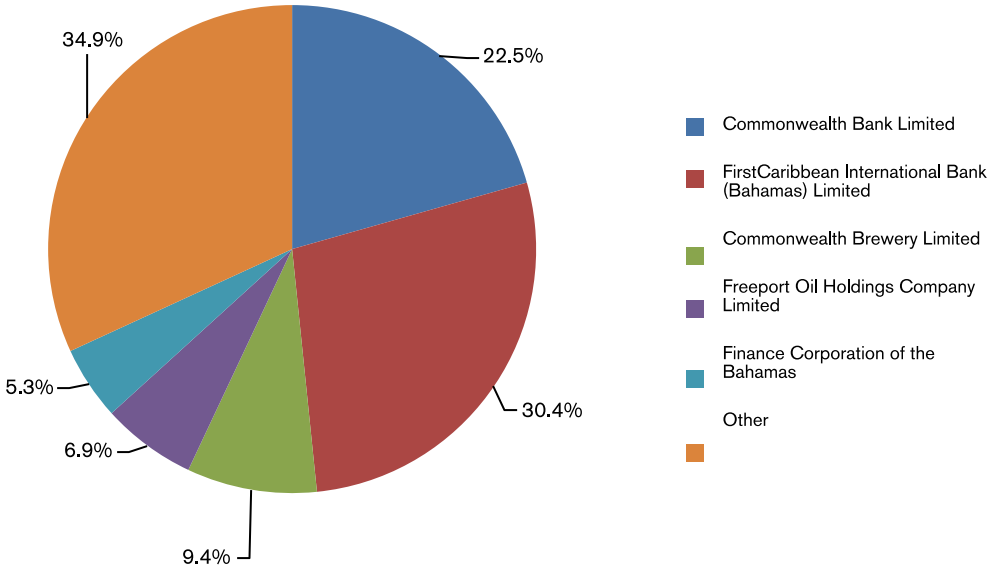
Chart 27
BISX All Share Index



Source: Central Bank of The Bahamas & BISX

In 2012, market capitalisation narrowed by 0.5% to $2,869.6 million, following a 0.7% reduction in 2011, while the number of companies listed on the Exchange rose by 2 to 27. The five (5) largest companies accounted for a dominant 74.6% of total market capitalization, a decline of 4.7% over the prior year (see Chart 28). During the 2003 - 2007 period, market capitalization grew, on average, by 24.3% per year, before declining by a yearly average of 4.9% in the next five years.

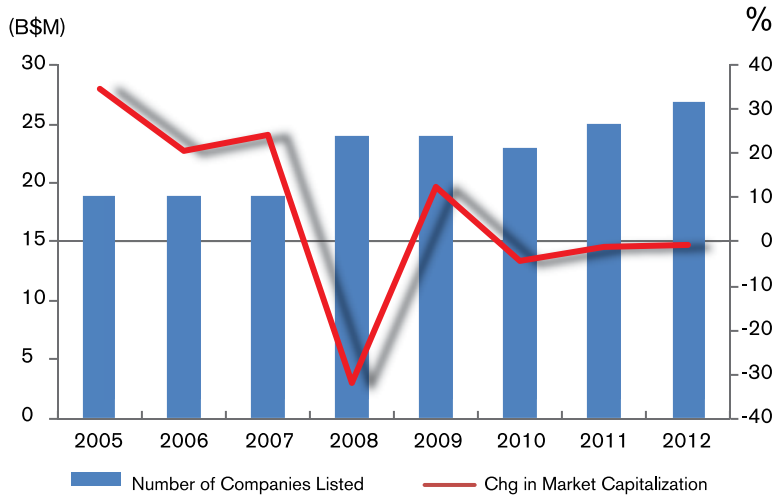
Chart 28
Share of Total Market Capitalization, at end-December 2012



A longer term trend analysis showed that the number of listed companies grew from 19 at end-2005 to 27 in 2012 (see Chart 29). The five (5) largest companies in the Index accounted for the bulk (82.2%) of the total market capitalization between 2003 and 2007. They grew at a mean rate of 33.0% per annum, but declined at an average yearly rate of 7.2% in the subsequent five-year period, while accounting for a lower 79.4% of total market capitalization.

Chart 29

BISX Performance Indicators



Source: Central Bank of The Bahamas & BISX

Chapter 7:

PAYMENT SYSTEMS

The national payment system represents a critical foundational element in the financial services infrastructure of The Bahamas, allowing for stable, efficient and secure payments and settlement of capital and money markets transactions, as well as routine private and public sector transactions across all sectors of the economy.

Recognising the critical need for a modern and efficient payments system, the Central Bank, in 2004, commenced the Payment System Modernization Initiative, aimed at improving the efficiency of domestic payment and settlement operations and allowing for the implementation of new and innovative payment instruments. This resulted in the creation of the Real Time Gross Settlement (RTGS) and Automated Clearing House (ACH) systems, as well as the drafting and subsequent enactment of the Payment System Act 2012 and associated Bye-laws, which allow the Bank to regulate, monitor and oversee "systemically important" and small payments systems, based on the Basel Committee's Core Principles.[14]

7.1. Real Time Gross Settlement (RTGS)

The RTGS system is owned and operated by the Bank, and processes large value transactions (greater than B$250,000). Transactions processed through the RTGS during 2012 firmed by 6.4% in volume to 55,223, a reversal from a 13.4% fall-off to 51,920 transactions in the prior year. In addition, the value of transactions advanced further by 7.1% to $13.0 billion, after gaining 5.1% to $12.2 billion in 2011.

7.2. Payment Instruments

7.2.1 Cash

Although cash remains the dominant method of making payments, other types of electronic transactions have been increasing in popularity in recent years. Nevertheless, at end-2012, the value of currency in active circulation grew by 10.0% to $216.5 million, surpassing the prior-year's gain of 1.2%, and firmed slightly to 13.75% of the broad money supply (M2).

7.2.2. Automated Teller Machines (ATMs)

Consistent with economic development trends and banks' efforts to facilitate the delivery of services to customers, the number of ATM machines and associated transactions has grown significantly—by 15.0% and 10.2%, respectively, during the year. At end-December 2012, the number of machines installed throughout The Bahamas remained stable at 2,017. Of this number, approximately 90% (192) were configured to dispense only Bahamian currency, while the remaining 10% (25) provide both local currency and US Dollars.

7.2.3. Cheques and Nacha[15] Payments

Although decreasing in relative importance in recent years, cheques remain the dominant form of non-cash payment for goods and services. Data recorded for the volume and value of cheques presented for clearing through the ACH[16] during 2012, showed that the total number, net of

14 See Central Bank of The Bahamas Annual Report 2012 for an overview of legislative developments in 2012.
15 National Automated Clearing House Association (Nacha) Payments.
16 In July, 2013 the Government eliminated the $0.40 Stamp Tax on debit card transactions.

returns processed, declined by 1.9% to 2,968,908, following a slight fall-off of 0.2% in 2011. Similarly, the value of cheques cleared through the ACH increased by 1.0% to $6.2 billion, after a 5.1% advance a year earlier. In addition, the number of Nacha direct debit transactions—such as payroll payments—processed by BACH, was higher by 23.0% at 1.49 million, and the value rose by 56.0% to $947.60 million.

7.2.4. Debit Cards

Prepaid cards, such as debit cards, have been increasing in their popularity over the last few years; however, widespread usage is limited by the relatively high fees and charges[17] that are incurred and the small number of point-of-sale terminals which are available. Nevertheless, as more commercial banks offer their customers these cards, the volume of transactions grew by 22.2% to 4.6 million and the estimated value by 16.1% to $3.3 million.

17 The ACH System is operated by the Bahamas Automated Clearing House (BACH).

CHAPTER 8:

ASSESSMENT OF RISK

Promoting the stability of the financial sector is a key part of the Bank's mandate, which is achieved via the monitoring of commercial banks' main risks, mainly credit risk, and making certain that banks adhere to all regulatory initiatives. In 2009, during the height of the global recession, the Bank set higher minimum risk-weighted target and trigger ratios, of 17% and 14% of risk weighted assets, respectively, for all commercial banks—in a bid to ensure that banks maintained sufficient levels of capital to act as a buffer against systemic risk and to guarantee the continued soundness of the financial system. These ratios remain well above the international minimum capital benchmark of 8%. In addition, in 2012 the Bank measured the financial soundness of the banks using its stress testing framework model, which targets credit, interest rate and liquidity risks.

Given the various strategic initiatives adopted by the Bank, there is no near-term risk to financial stability. This was confirmed when the IMF conducted its assessment of regulatory and supervisory practices in the country during its Financial Sector Assessment Programme (FSAP) exercise in 2012. The process entailed, *inter alia*, assessing compliance with the Basel Core Principles for Effective Banking Supervision (BCP) and an in-depth review of interbank connectivity and the transmission of global economic shocks, as well as stress testing of the domestic banking system to extreme, but plausible shocks.

The findings of the IMF's FSAP Mission affirmed that The Bahamas has in place a very strong legal and regulatory framework for banking supervision. The FSAP report also stated that there is no obvious near-term threat to bank stability in The Bahamas, since its licensees are very well capitalized, both in terms of quantity and quality of capital, they experience high levels of profitability and are not reliant on wholesale funding. Further, contagion risks were characterized as contained, due to extremely limited inter-linkages among onshore commercial banks. The FSAP assessors also noted that The Bahamas has made clear and material progress in the main area of financial oversight, since the IMF's 2004 Offshore Financial Center (OFC) assessment of the jurisdiction.

However, the key challenge in the on-shore financial sector pertains to elevated NPL ratios, especially on mortgages, which account for in excess of 50% of the total. Nevertheless, the Bank remains vigilant with regard to the potential impact on banks' capital, and has substantially improved credit risk monitoring. Therefore, requirements and practices on provisioning and asset impairments are in compliance with international standards.

With regard to the offshore financial sector, risks are mitigated by the fact that the bulk of the assets are held by branches of foreign institutions, for which solvency risk does not apply at the level of the jurisdiction. Further, since the main business models do not entail third party funding, liquidity risks are mitigated.

Notwithstanding the positive assessment, the FSAP assessors cited some areas requiring improvement in the Bank's supervisory and regulatory oversight arrangements. Since the FSAP, all domestic regulators have made significant progress in incorporating the recommendations, covering specific initiatives aimed at strengthening crisis management and financial safety nets, including improvements to the legal structure and operations of the DIC. In addition, the Bank has continued with a number of initiatives geared towards the enhancement of its bank supervision legislative regime and policy framework.