Financial Stability Report December, 2018

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The Manager
Research Department
Central Bank of The Bahamas
P.O. Box N-4868
Nassau, Bahamas

www.centralbankbahamas.com
email address: research@centralbankbahamas.com

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PREFACE

As part of its statutory mandate, the Central Bank of The Bahamas is required *"to ensure the stability of the financial system".* This report analyses key financial sector developments and assesses the underlying risks to financial stability in the domestic economy. It considers the financial system's ability to withstand shocks and function well enough to contribute to the healthy performance of the economy.

This Financial Stability Report (FSR) relies on data from the key regulators of the domestic financial system, which include the Central Bank, as the supervisor of banks and credit unions; the Securities Commission, the regulator for the securities industry; and the Insurance Commission, with responsibility for the insurance industry. It summarises the macroeconomic environment, provides an overview of key developments within the financial sector and assesses potential risks to the health of the system. The first FSR was published in 2013 and the report is currently an annual publication.

The Bahamian financial stability mandate examines the risks that emerge from two sources, the underlying sustainability of Balance of Payments (BOP) trends and the sustainability of supervised financial institutions (SFIs).

In the case of the BOP, the Central Bank works to ensure the sustainability of the Bahamian dollar peg, through maintaining adequate foreign reserves to absorb external shocks that could disrupt net foreign currency flows. The Bank also exercises oversight to prevent domestic shocks, such as from robust credit growth, which could result in the demand for foreign exchange outstripping the amount supplied through export sector activities. The lever used in this case is the ability to control both the actual and potential pace at which credit expands. Most current risks for The Bahamas relate to the potential pace for future private credit expansion from elevated liquidity in the banking system. However, the appetite for lending is still tempered and expected to undergo further retrenchment once the credit bureau enters its early stages of operation. In this interim, the Central Bank will continue to gradually reduce its holdings of Government debt, to absorb the liquidity overhang. In the case of BOP risks, the systemically important parts of the Bahamian financial system remain concentrated within the banking sector, which is under the Central Bank's direct supervision.

In terms of the financial soundness of SFIs, the stability concerns which they present relate to the risk of potential failure or disruption of one or several institutions, with significant economic and financial costs. Such could be the case from a loss of confidence or the insolvency/failure of an institution and the resulting loss to depositors, investors, the Government (through resolution costs); this would also disrupt the orderly functioning of the financial system. The Central Bank promotes stable outcomes, through the supervision of financial institutions to minimize the direct risk of financial failure, as well as the indirect risks, which could arise from failures of governance or other breaches that could trigger similar costly outcomes. Overall, domestic banking remains in a sound financial state, based on the capital and liquidity levels, and the system is not assessed as having material cross-border exposures. However, there is room to accelerate the improvement in credit quality. Banks hold significant excess capital relative to their regulatory requirement, which in the Central Bank's assessment, should be gradually reduced over the medium-term, in order to ease pressures to generate returns from either higher fees or riskier lending. The credit union sector meanwhile, would stand to benefit over the medium-term from improved balance sheet ratios, and strengthened governance arrangements, both of which the Central Bank is actively promoting. Supervisory standards will be enhanced in parallel with the sector's planned enrolment in the deposit insurance scheme.

The other systemic focus for stability is the preservation of The Bahamas' access to international payments through correspondent banking relationships (CBRs). Here, ongoing stability is juxtaposed against the continued tightening of standards by international financial firms, in order to ensure the maintenance of CBRs. The regulatory remedy for The Bahamas is to achieve sustained improvement in the jurisdiction's anti-money laundering (AML), counter-financing of terrorism (CFT) and anti-proliferation regimes.

EXECUTIVE SUMMARY

During 2018, the domestic financial sector remained stable, underpinned by improving economic fundamentals, as well as enhanced regulatory and supervision frameworks. Reflecting the growth in the economy, as well as institutions' aggressive debt collection measures, combined with on-going loan restructuring efforts, domestic banks continued to reduce their non-performing loans (NPLs). Moreover, despite relatively high approval rates for mainly consumer-based lending, overall credit conditions remained subdued, reflecting banks' sustained cautious stance as it relates to longer maturity loans. In the context of the contraction in private sector loan arrears, banks reduced their loan loss provisions during the year, which yielded profitability gains, while the stability of the sector was maintained, as determined by both the Bank Stability Index (BSI) and the Aggregate Financial Stability Index (AFSI). Further, the results of the stress tests—which comprised credit, liquidity and interest rate risks—showed sustained resilience to sudden shocks, as banks' capital ratios continued to exceed both the international and more rigorous domestic benchmarks.

Indications are that developments within non-bank financial institutions were largely positive in 2018. The credit union sector recorded a marginal increase in profitability, which contributed to relatively stable asset and equity ratios. Further, the sector's capital ratios firmed during the year and continued to surpass the targeted benchmark. Meanwhile, prudential indicators for both life and non-life insurance providers stayed in line with international benchmarks. However, the overall profitability in the insurance sector contracted during 2018.

Payments systems modernization and financial inclusion remained integral parts of the Central Bank's strategic objectives. To this end, in 2018 the "Project Sand Dollar" initiative was launched with the aim of implementing a digital version of the Bahamian dollar. It is part of an overall strategy to reduce dependence on cash usage, and to increase access to regulated financial services by all segments of the population. While payments system reforms targeting faster electronic funds movement will introduce channels through which financial shocks could be transmitted more swiftly across interconnected entities, opportunities also arise to strengthen the effectives of monetary policy and to improve AML/CFT risk management, particularly through direct inclusion of more participants in the formal financial system.

Over the medium-term, the Central Bank will maintain its active and diligent surveillance of financial institutions, in order to ensure the stability of the sector. The Bank will continue to improve its supervisory regime, especially as it relates to AML/CFT financing and payments systems oversight. Further, the Bank will sustain its efforts to embrace policies that promote effective liquidity management, within the context of an improving economy and increased employment, in order to mitigate the potential impact of the increased credit demand on external reserves.

CHAPTER 1: MACROECONOMIC ENVIRONMENT

1.1. The Global Environment

The domestic economy is heavily influenced by international developments, especially the performance of the United States economy. In its July 2019 World Economic Outlook report update, the International Monetary Fund (IMF) forecasted that the global economy expanded by 3.6% in 2018. However, this increase is projected to moderate by 40 basis points to 3.2% in 2019, underpinned by the expected growth slowdown in the Asian markets. Significant downside risks persist from elevated global trade policy tensions and the uncertainties over "Brexit".

The healthy US growth outcome in 2018, supported persistent labour market gains and continued monetary policy tightening to counter rising inflation concerns. Growth quickened by 70 basis points to 2.9% in 2018, owing mainly to increases in fixed non-residential and private investments, federal government spending and exports (see Table 1). Given this positive outturn, the jobless rate decreased by 50 basis points to 3.9% in 2018, while the annual inflation rate firmed slightly by 30 basis points to 2.4%, relative to the previous year, due mainly to increases in the costs of shelter and medical care. Amid the improving economic and labour market conditions, combined with a relatively low inflationary environment, the Federal Reserve continued to "normalize" its policy rate, by adjusting the target range for the federal funds rate upwards over the year, by an additional 100 basis points to 2.25%-2.50% by end-December.

With regard to the other major economies, their growth momentum slowed in 2018. Specifically, China's real GDP expansion narrowed by 20 basis points to 6.6%, reflecting the impact of the ongoing trade tensions with the United States. Similarly, Japan's real output growth moderated by 1.1 percentage points to 0.8%, due to the adverse effects of unexpected natural disasters. In the United Kingdom, economic growth decelerated by 40 basis points to 1.4%, as the "Brexit" negotiations impasse weighed on consumers and firms. Further, the euro area's output growth moderated by 30 basis points to 2.2%, in response to a reduction in car production, investment cutbacks and weakened consumer and business confidence.

1.2. Regional Environment

There is no material systemic exposure of the Bahamian financial system to regional spillovers, albeit progress on AML/CFT developments continued to benefit from regional cooperation, as opposed to exclusively national weighing in the CBR constructs.

At the Caribbean regional level in 2018, a common tread among economies was relatively low growth and elevated unemployment rates; although inflationary pressures remained well contained. Overall, the regional financial sector remained stable and highly capitalized, making it resilient to external shocks. However, risks remain due to the exposure of tourism-based economies to changing conditions in key source markets, while commodity-based economies were affected by the volatility in international prices. Overall, the economies showed some signs of improvement, with average real GDP growth strengthening by 1.2 percentage points to 1.8%, relative to the prior year (see Table 2). Of note, Guyana's growth strengthened to 3.4% from the prior period's 2.1%, while real output gains in both the Eastern Caribbean and Belize improved to 3.0% each, from 1.2% and 1.4%, respectively. More muted gains of 0.7 and 0.3 percentage points were recorded for Jamaica and Suriname, to 1.4% and 2.0%, respectively. Further, Trinidad and Tobago's economy recovered by 0.3%, from a 2.0% contraction a year earlier. In contrast, economic activity in Barbados remained constrained, as real output declined by a further 0.5%, extending the 0.2% contraction in the previous year, as the effects of the Government's IMF-supported structural adjustment programme took hold.

TABLE 1

Selected Indicators for Developed Economies (%)

	2011	2012	2013	2014	2015	2016	2017	2018
GDP Growth Rates								
United States	1.6	2.2	1.8	2.5	2.9	1.6	2.2	2.9
Euro Area	1.6	(0.9)	(0.2)	1.4	2.1	2.0	2.4	1.8
United Kingdom	1.6	1.4	2.0	2.9	2.3	1.8	1.8	1.4
China	9.5	7.9	7.8	7.3	6.9	6.7	6.8	6.6
Japan	(0.1)	1.5	2.0	0.4	1.2	0.6	1.9	0.8
Unemployment Rates								
United States	9.0	8.1	7.4	6.2	5.3	4.9	4.4	3.9
Euro Area	10.2	11.4	12.0	11.4	10.9	10.0	8.6	7.9
United Kingdom	8.1	8.0	7.1	6.2	5.4	4.9	4.4	4.1
China	4.1	4.1	4.1	4.1	4.1	4.0	3.9	4.0
Japan	4.6	4.4	3.4	3.6	3.4	3.6	2.8	2.4
Inflation Rates								
United States	3.1	2.1	1.5	1.6	0.1	1.3	2.1	2.4
Euro Area	2.7	2.5	1.3	0.4	0.2	0.2	1.5	1.8
United Kingdom	4.5	2.8	2.6	1.5	0.0	0.7	2.7	2.5
China	5.4	2.6	2.6	2.0	1.4	2.0	1.6	2.1
Japan	(0.3)	(0.1)	0.3	2.8	0.8	(0.1)	0.5	1.0

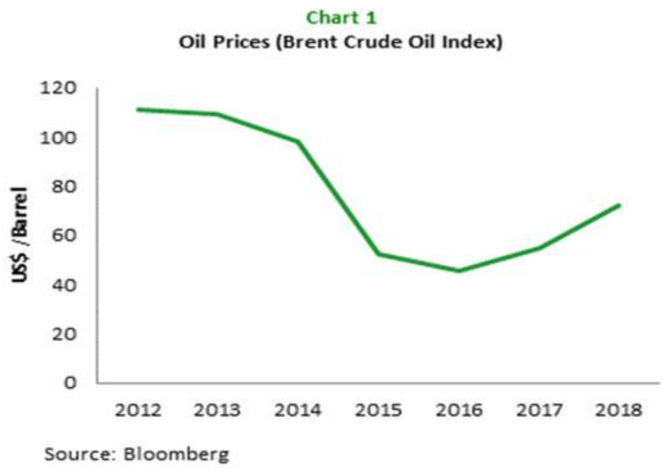
Sources: IMF, International Statistical Bureaus

TABLE 2

Selected Caribbean Countries' GDP Growth Rates (%)

	2011	2012	2013	2014	2015	2016	2017	2018
Bahamas	0.6	3.1	(0.4)	(0.1)	1.0	(1.7)	0.1	1.6
Barbados	(0.8)	(0.1)	(1.4)	(0.2)	2.2	2.3	(0.2)	(0.5)
Belize	2.2	2.9	0.9	3.7	3.4	(0.6)	1.4	3.0
Eastern Caribbean	(0.2)	0.4	1.7	2.9	2.6	2.7	1.2	3.0
Guyana	5.4	4.8	5.2	3.8	3.1	3.4	2.1	3.4
Jamaica	1.4	(0.5)	0.2	0.6	0.9	1.5	0.7	1.4
Suriname	5.8	2.7	2.9	0.3	(3.4)	(5.6)	1.7	2.0
Trinidad & Tobago	(0.2)	(0.7)	2.3	(1.3)	1.9	(6.5)	(2.0)	0.3
Average	**1.8**	**1.6**	**1.4**	**1.3**	**1.5**	**(0.6)**	**0.6**	**1.8**

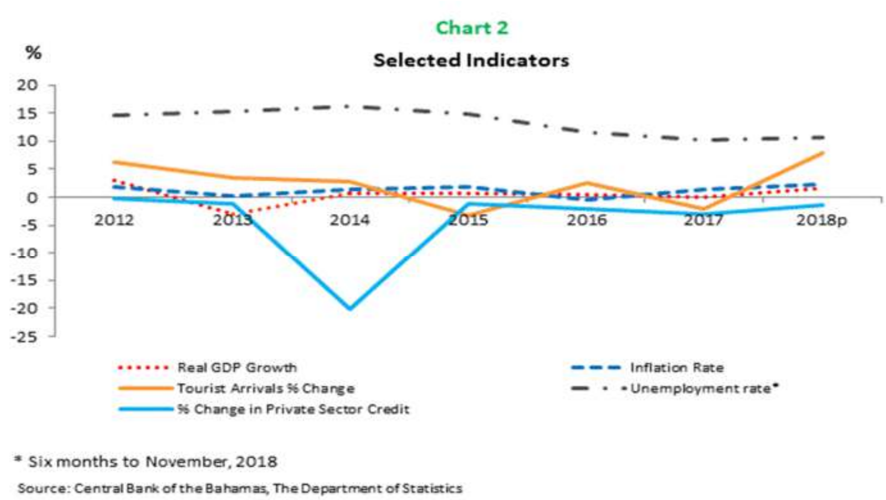
Sources: IMF, International Statistical Bureaus, Regional Central Banks, Bloomberg



1.2. The Domestic Environment

The pace of the recovery in the domestic economy continued to have a direct impact on the reduction in banks' non-performing loans (NPLs) and the improvement in their balance sheets. The economic environment is also affecting banks' desire to extend new credit to customers, alongside their ability to effectively manage credit risk.

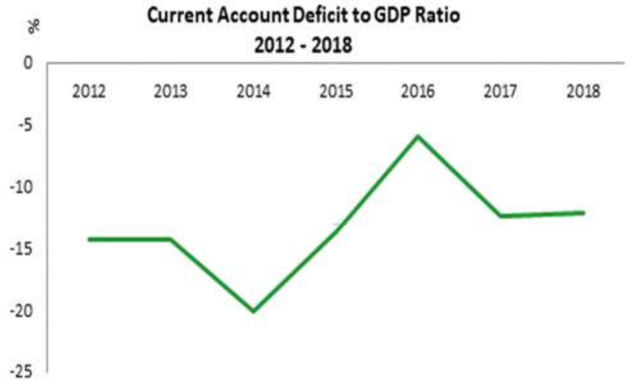
Improved growth and employment outcomes occurred alongside an energy and tax driven increase in inflation. Real GDP firmed by 1.6% in 2018, compared to a slight 0.1% uptick in the prior year (see Table 3), reflecting the momentum from increased tourism capacity (accommodation and food services). The tourism output strengthening, contributed to the growth in the real estate and wholesale & retail trade indicators. In light of the recovery in the economy, labour market conditions improved, bolstered by the on-boarding of new staff in the tourism and related sectors. However, as the rise in the labour force outpaced job gains, the unemployment rate firmed by 60 basis points, on an annual basis, to 10.7% at end-November 2018. While inflationary pressures were relatively subdued, the hike in the value added tax (VAT) rate by 4.5 percentage points to 12.0% on July 1st, along with higher fuel costs, led to modest firming in the inflation rate. As a consequence, the Retail Price Index (RPI) for The Bahamas increased to 2.3% in 2018, outpacing the 1.5% gain in the year prior, amid broad-based increases in the major components.



The overall fiscal deficit contracted by $254.4 million (38.0%) to $414.9 million during FY2017/18, as the falloff in total outlays outpaced the marginal decrease in revenue collections. Over the calendar year, the deficit decreased by $284.8 million (46.0%) to $334.1 million, due to a reduction in total spending, combined with growth in aggregate revenue. Despite the reduction in borrowing needs, greater reliance on domestic financing explained an overall upturn in domestic credit flows through the banking system.

Preliminary estimates for the external sector, showed that the current account deficit widened by $190.3 million (12.6%) to $1,699.0 million, explained by a rise in net income outflows and a widening of the merchandise trade deficit. However, the surplus on the capital and financial account was halved to $744.2 million, due to a sharp narrowing in both Government and private sector external financing-related inflows.

Chart 3
Current Account Deficit to GDP Ratio
2012 - 2018

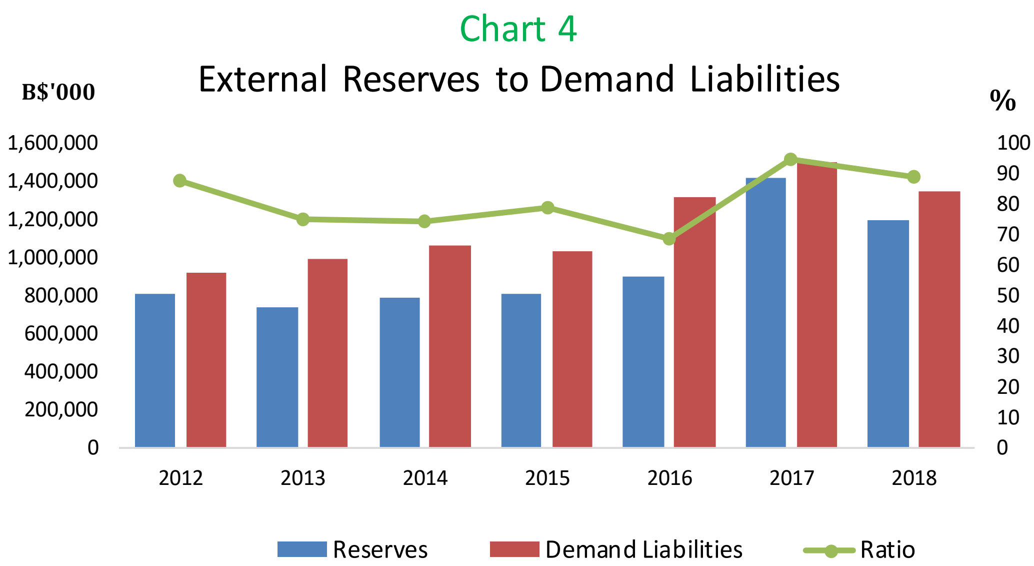


Source: Central Bank of The Bahamas

Domestic monetary trends featured a reduction in liquidity in 2018, reflecting the Government-led growth in domestic credit, alongside a contraction in the deposit base. Similarly, external reserves declined, reflecting the seasonal robust increase in foreign currency demand in the latter half of the year. However, claims on the private sector contracted for the seventh consecutive year, as banks maintained their conservative stance and households continued to deleverage. That said, banks' credit quality indicators improved further in 2018, attributed to entities' enhanced collection efforts, ongoing debt restructuring activities, and sales of NPLs.

Foreign reserve adequacy metrics continued to be strong in 2018, and are expected to be sustained over the medium-term, as a result of higher net inflows from tourism and other export activities; however, external balances declined during the year. This development reflected the fact that the public sector was a net purchaser of foreign exchange from the Central Bank, following significant refinancing transactions in 2017, which boosted reserves on a net basis. In a slight offset, the net private sector foreign currency inflows strengthened, even as domestic private sector credit contracted further. As a result, commercial banks recorded foreign exchange purchases from their customers and they sold a net amount to the Central Bank; this trend was further amplified through the first half of 2019.

At end-2018, external reserves of $1.2 billion equated to an estimated 22.3 weeks of non-oil merchandise imports, below the 26.5 weeks recorded a year earlier, but higher than the 19.2 weeks in 2016. The useable reserves—or balances remaining after statutory provisions for 50 percent of the Central Bank's demand liabilities—stood at $522.0 million, compared to year-end ebbs to below $300 million during each year of 2013-2016. In addition, efforts were sustained to strengthen the Central Bank's balance sheet, with the ratio of end-of year external reserves to demand liabilities estimated at 0.89, compared to 0.95 in the prior year and a recent low of 0.68 in 2016. Partly underlying this outcome has been the divestiture of the Central Bank's holdings of Government debt, which will continue over the medium-term. Since 2016, end of year holdings of Government debt (securities plus advances) have decreased by almost a third ($206.8 million), reverting back to the end-2015 levels. Subsequently, over the first quarter of 2019, the advances portion of these holdings decreased structurally by $50.5 million.[1]



Source: Central Bank of The Bahamas

[1] The total advances plus securities fell by $157 million during January – March 2019, however most of this was a reduction in Treasury bill holdings, which are more sensitive to commercial banks seasonal liquidity preferences.

TABLE 3

The Bahamas: Macroeconomic Indicators

	2011	2012	2013	2014	2015	2016	2017	2018
B$/US$: Exchange Rate	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Nominal GDP Growth Rate (%)	(0.3)	6.5	(1.5)	3.3	7.7	1.6	1.8	2.3
Real GDP Growth Rate (%)	0.6	3.1	(3.0)	0.7	0.6	0.4	0.1	1.6
Inflation Rate (Average chg in RPI)	3.3	1.8	0.2	1.3	1.9	(0.3)	1.5	2.3
Unemployment Rate	13.7	14.7	15.4	16.2	12.0	12.7	9.9	10.0
Overall Fiscal Balance (B$M)	(319.8)	(557.5)	(485.3)	(531.1)	(252.0)	(467.1)	(622.5)	(331.1)
% of GDP	(4.1)	(5.2)	(4.6)	(4.9)	(2.1)	(3.9)	(5.1)	(2.7)
Private Sector Credit (B$000)	6,646.6	6,628.4	6,551.1	6,366.9	6,299.7	6,170.8	5,982.9	5,893.4
Weighted Average Lending Rate (%)	11.0	10.9	11.1	11.8	12.3	12.5	11.8	11.3
Weighted Average Deposit Rate (%)	2.6	2.0	1.7	1.4	1.4	1.2	1.0	0.8
Treasury Bill Rate (%)	1.0	0.6	0.7	0.7	0.9	2.0	1.9	1.7
Gross Int'l Reserves (B$M)	884.9	810.2	741.6	787.7	811.9	904.0	1,417.4	1,196.3
Import Cover Ratio (Tot. Merch. (CIF) in week	14.5	11.6	11.4	11.4	13.3	16.5	21.9	17.4
Current Balance (B$M)	(1,101.2)	(1,531.8)	(1,516.2)	(2,192.6)	(1,610.2)	(710.8)	(1,508.6)	(1,505.2)
as % of GDP	(14.0)	(14.3)	(14.4)	(20.1)	(13.7)	(6.0)	(12.4)	(12.1)
Total Public Sector Debt (B$M)	4,948.3	5,770.6	6,346.9	7,101.8	7,460.0	7,899.0	8,832.2	9,213.2
of which: External	1,044.9	1,464.7	1,616.1	2,100.5	2,175.8	2,373.0	3,233.9	3,171.8
Internal	3,903.5	4,305.9	4,730.7	5,001.3	5,284.2	5,526.0	5,598.4	6,041.4
Total Arrivals ('000s)	5,587.6	5,940.2	6,150.8	6,320.2	6,112.1	6,265.0	6,135.8	6,622.0
Tourist Expenditure (B$M)**	2,141.6	2,311.6	2,287.5	2,314.4	2,537.5	2,610.1	N/A	N/A
Construction Number of Permits Issued	1,948.0	1,916.0	1,462.0	1,418.0	1,299.0	1,136.0	1,269.0	N/A
Value of Starts (B$M)	147.5	116.6	140.2	129.2	117.1	96.2	155.5	N/A
Value of Completion's (B$M)	500.6	317.1	216.6	250.5	228.9	193.2	1,493.6	N/A
Average Oil Prices (Brent Crude Oil Index)	111.8	111.4	109.1	98.5	52.6	45.8	55.0	56.0

Source: Central Bank of The Bahamas, Department of Statistics, Bloomberg

N/A - Not Available

CHAPTER 2: FINANCIAL SYSTEM OVERVIEW

The Bahamian financial sector, which comprises both domestic and international operations, is responsible for 15%-20% of the country's GDP; however, Exchange Control regulations maintain a separation between the two sectors' balance sheets. This leaves only the dominant domestic component relevant for financial stability assessments. The discussion below therefore focuses on banks, credit unions and the insurance sector. Features and developments concerning the capital markets are only discussed in Appendix 1, as the sector does not pose any systemic concerns for financial stability.

CHAPTER 3: BANKING SECTOR

The Bahamas' exchange control regime prohibits banks from undertaking domestic business activities other than through assets funded with domestic liabilities. This prevents any direct connection or balance sheet flows from direct international to domestic banking operations. As a consequence, this chapter focuses specifically on the stability of the domestic banking sector.

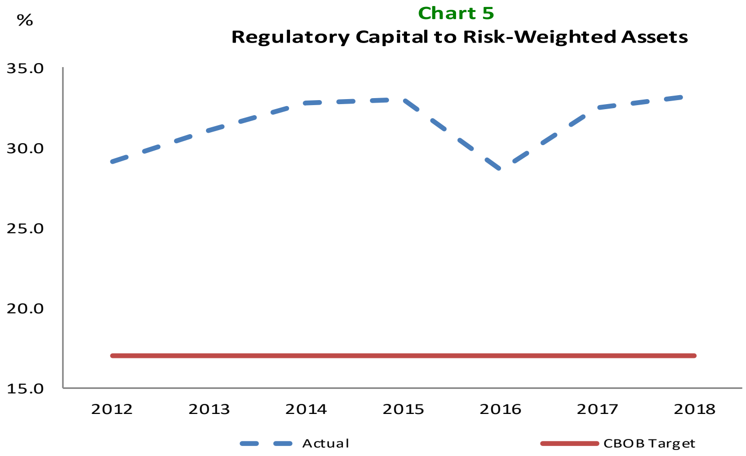
In the case of banking, the domestic sector is characterized by robust levels of liquidity, reflecting the accumulated conservative stance towards private sector lending, in light of the elevated—although declining—arrears and NPLs in the banking system. While this liquidity overhang does not present any near-term risk to the financial sector, it could place negative pressures on external reserves over the medium-term, if deployed to fuel excessive private credit demand. The establishment of the credit bureau will alleviate the current information asymmetry risks relative to the credit market, resulting in better lending quality over the medium-term. This critically, could limit a further run-up in risky lending and escalated credit losses in another economic downturn. Moreover, the Central Bank's ongoing quasi open market operations, focused on gradually reducing its holdings of Government securities, is targeted at directly removing liquidity from the system.

3.1 Asset Trends

In 2018, total domestic assets of the banking system contracted by 2.4% to $10.2 billion, reversing the 2.3% growth recorded a year earlier. Loans and advances represented the largest share of these assets (67.1%), followed by securities (19.3%), while balances with the Central Bank, "other" miscellaneous assets and till cash accounted for smaller shares of 8.0%, 4.2% and 1.5%, respectively. Of significance, loans and advances increased by 1.0%, vis-à-vis a 4.1% falloff in the previous year, as the growth in the public sector component outpaced the reduction in credit to the private sector. This was outweighed by trends in holdings of public sector debt securities, which declined by 5.3%, and the downturn in banks' cash balances at the Central Bank by 21.7%, after an external borrowing-led expansion in the prior year.

3.2 Capital Adequacy

Given the asset quality and suppressed returns environment for credit, a prudent posture for the industry would be to reduce surplus capital resources over the medium-term, to avert pressures to improve the profitability indicators through riskier credit activities. A majority of this reduction would represent outflows via the Canadian banks, which over the medium-term, should be accommodated from elevated levels of foreign exchange inflows from real sector activities, without adversely affecting the foreign reserves' indicators. In particular, domestic banks remained well capitalized during the year, as the system's ratio of average capital to risk weighted assets, rose by 70 basis points to 33.2% at end-December 2018; remaining well above the Central Bank's target of 17.0% of risk-weighted assets and the international benchmark of 8.0%.[2]



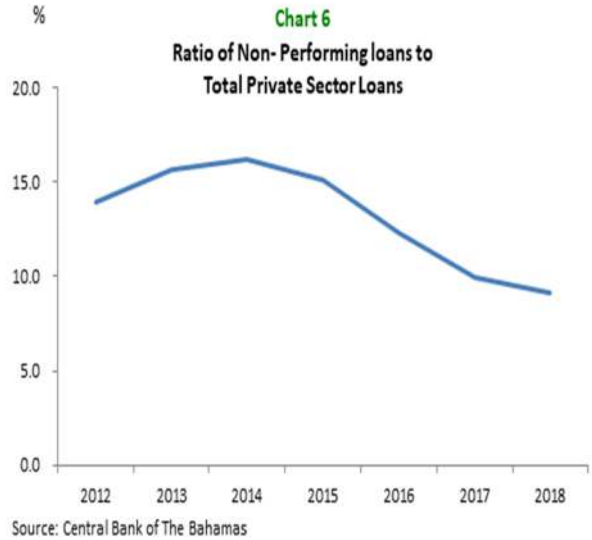
Source: Central Bank of The Bahamas

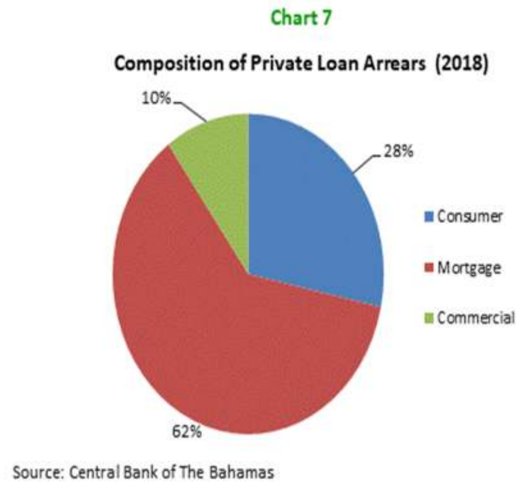
3.3 Asset Quality

Further, more accelerated reduction in the loan delinquency rate would reduce the average vulnerabilities faced by domestic banks. This underscores the more engaged posture of the Central Bank around credit resolution and credit risk management practices within lending institutions, which face heightened regulatory expectations, particularly for defaulted mortgages, foreclosures and the liquidation of collateral, valuation of collateral and provisioning for doubtful accounts.

Banks' credit quality indicators nevertheless continued on a positive trajectory for the fifth consecutive year, owing to broad-based contractions in arrears across loan categories, as entities sustained their efforts to restructure clients' outstanding debts and intensified collection measures. Total private sector loan arrears were reduced across all major lending categories by 8.5% to $809.8 million, after a 12.4% decline in 2017, when one institution sold a portion of its non-performing commercial loan portfolio to the Government-owned Bahamas Resolve Corporation. Consequently, the ratio of arrears to total private sector loans narrowed by 1.2 percentage points to 14.3%, following the prior year's reduction of 1.7 percentage points.

[2] The Central Bank imposes a "trigger" ratio of 14.0%, below which licensees would be required to implement measures to either reduce risk exposures or supplement their capital.



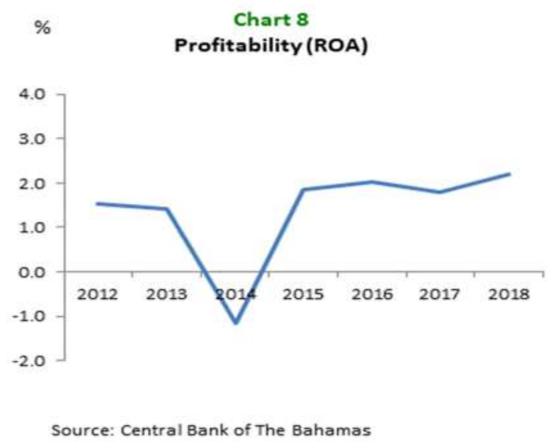


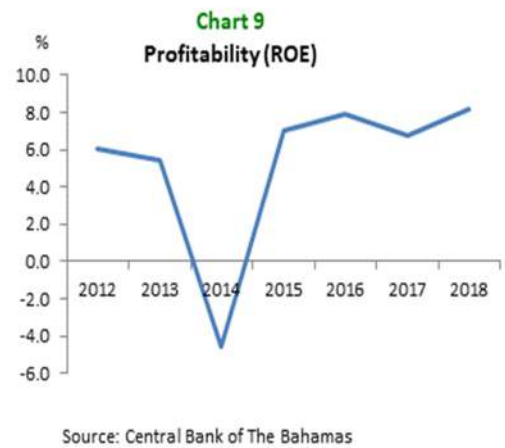
An analysis of the average age of delinquencies, showed that NPLs decreased further by 8.9% to $517.0 million, following a 22.2% decline in 2017, while the corresponding ratio to total private sector loans contracted by 80 basis points to 9.1%. This outturn reflected declines in commercial, consumer and mortgage long-term delinquencies, of 26.6%, 13.4% and 3.6%, respectively. In addition, short-term arrears (31-90 days), decreased by 7.7%, a reversal from a 12.7% gain in the prior year, resulting in the ratio to total private sector loans falling by 30 basis points to 5.2%. Specifically, mortgage and consumer delinquencies fell by 11.9% and 8.0%, respectively. In contrast, the relatively smaller commercial component expanded by 21.9%.

3.4 Profitability

During the year, domestic banks' profitability expanded by 18.2% to $215.3 million, attributed mainly to declines in depreciation costs, interest expense and provisioning for bad debts. Consequently, the ratios of net income to average monthly assets (ROA) and equity (ROE), rose to 2.2% and 8.1%, from 1.8% and 6.8% in 2017, respectively, (see Table 4).

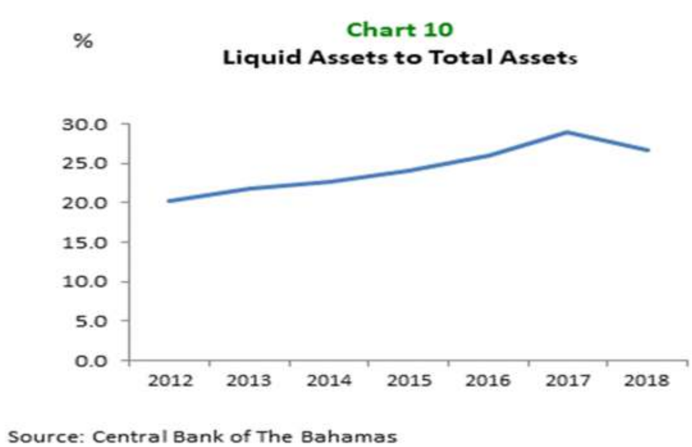
Underlying the improvement in these ratios, total provisions for bad debt fell by 14.5%, leading to a 16 basis point narrowing in the associated ratio to average assets to 0.9%. Similarly, depreciation costs fell by 19.6%, reducing the corresponding ratio by 3 basis points to a mere 0.1% of average assets. In addition, operating costs decreased by 2.3%, resulting in the relevant ratio to average assets easing by 9 basis points to 3.6%, as declines in staff and "other" miscellaneous operating costs, outpaced the rise in occupancy expenses. Further, the effective interest rate spread edged-down by 2 basis points to 7.09%, with the ratio of net interest income to average assets declining by 4 basis points to 5.10%, despite a 16.3% contraction in interest expense. In contrast, the ratio of commission and foreign exchange income to average assets firmed marginally by 1 basis point to 0.29%.





3.5 Liquidity

Bank liquidity declined modestly during the year; although remaining at elevated levels. As a share of total assets, holdings of liquid assets decreased by 2.4 percentage points to 26.6%, a reversal from the 3.1 percentage point growth recorded in 2017. Similarly, the ratio of liquid assets to short-term liabilities contracted by 3.7 percentage points to 39.0%, after advancing by 4.9 percentage points in the prior year. Banks' excess supply of available resources also declined, contributing to a 3.1 percentage point falloff in the ratio of deposits to total loans to 101.7%, which contrasted with an expansion of 5.7 percentage points in the previous year. Further, demand deposits as a share of total balances, moved higher by 0.9 percentage points to 39.8%; although a slowdown from a 1.8 percentage point increase a year earlier (see Table 4).



In this regard, the implementation of the credit bureau will assist significantly in the management of new credit risks. The significant liquidity overhang in the banking system is expected to be reduced gradually over the long-term, due to a series of measures including the Central Bank's ongoing sales of its holdings of Government securities to the public and the successful implementation of the Government's fiscal consolidation programme, which should limit Central Bank financing to the Government over time. In this regard, the passage of the Public Debt Management Bill will assist in both managing the existing stock of debt, while ensuring that new issues take into account the optimal mix of domestic and external financing sources, in order to minimize costs and support financial sector stability.

TABLE 4

Key Domestic Banks Financial Stability Indicators (%)

	2013	2014	2015	2016	2017	2018
Liquidity Indicators						
Loan to Deposit Ratio	114.0	109.6	108.6	100.9	95.4	98.4
Deposits to Loan Ratio	87.7	91.2	92.1	99.1	104.8	101.7
Demand Deposits to Total deposits	28.1	31.7	32.6	37.2	39.0	39.8
Liquid Assets to Total Assets	21.8	22.7	24.1	25.9	29.0	26.6
Liquid Assets to Short-Term Liabilities	34.0	34.4	37.0	37.8	42.7	39.0
Credit Risk Indicators						
NPL to Total Private Sector Loans	15.7	16.2	15.1	12.3	9.9	9.1
Total Assets Growth rate	1.8	(1.4)	1.8	1.6	2.3	(2.4)
Loans & Advances Growth rate	0.2	(2.3)	(0.3)	(0.6)	(4.1)	1.0
Capital Adequacy						
Regulatory capital to risk-weighted assets (avg)	31.1	32.8	33.3	28.6	32.5	33.2
Trigger Ratio	14.0	14.0	14.0	14.0	14.0	14.0
Target Ratio	17.0	17.0	17.0	17.0	17.0	17.0
Profitability Indicators						
ROAA (annualized)	1.4	(1.2)	1.9	2.0	1.8	2.2
ROAE (annualized)	5.6	(4.6)	7.0	7.9	6.8	8.2
Net interest income to average earning assets (annualized)	5.4	5.3	5.4	5.3	5.1	5.1
Net interest income to gross income	68.8	69.8	70.5	69.4	69.4	70.1
Non interest expenses to gross income	47.1	66.3	47.4	48.4	52.1	50.9
Personnel expenses to non interest expenses	50.3	34.8	46.8	44.0	40.8	41.2
Trading and fee income to total income	3.0	3.0	3.9	3.2	3.8	3.9
Effective Interest Rate Spread	6.9	6.8	7.1	7.2	7.1	7.1

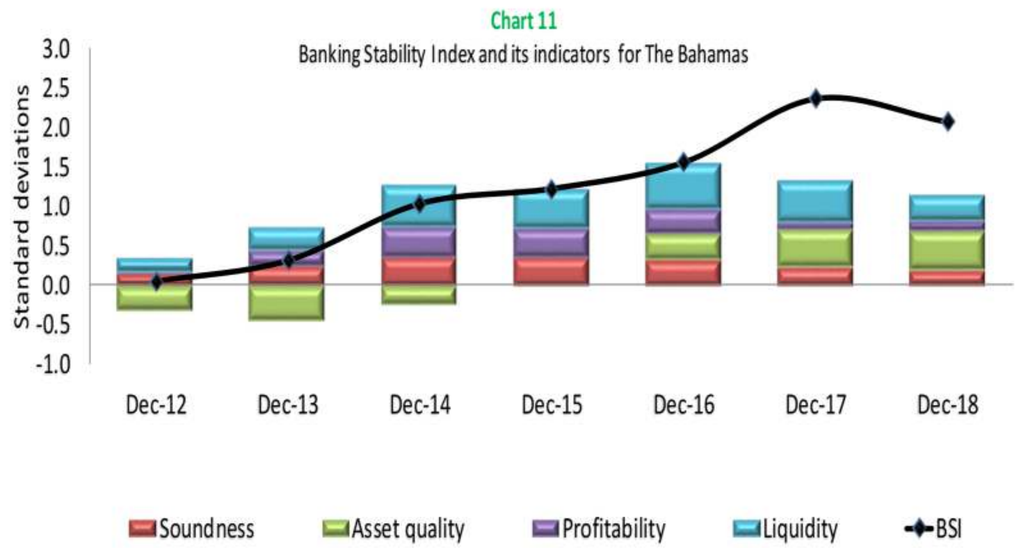
Source: Central Bank of The Bahamas

3.6 An Assessment of the Stability of the Banking Sector

3.6.1 The Banking Stability Index

In 2018, the Banking Stability Index (BSI)—which measures the soundness of deposit taking institutions (DTIs) in The Bahamas—indicated continued stability of the banking system, despite slight declines in some of its component indicators. Specifically, the normalized[3] asset quality indicator strengthened to 0.50 from 0.46 in the previous year. Similarly, the normalized profitability indicator firmed to 0.13 from 0.10 in 2017, as a decrease in operational costs and a significant rise in other "miscellaneous" income, led to an improvement in profitability. In contrast, the normalized average capital adequacy indicator fell by 0.05 points to 0.19 over the year. Further, the normalized average for the liquidity indicator narrowed to 0.34 from 0.53 in 2017; although still remaining elevated by international standards. As a result of these developments, the BSI decreased to 1.13 in 2018 from 1.30 in the prior year; nevertheless, the domestic financial conditions were relatively stable during the review year.

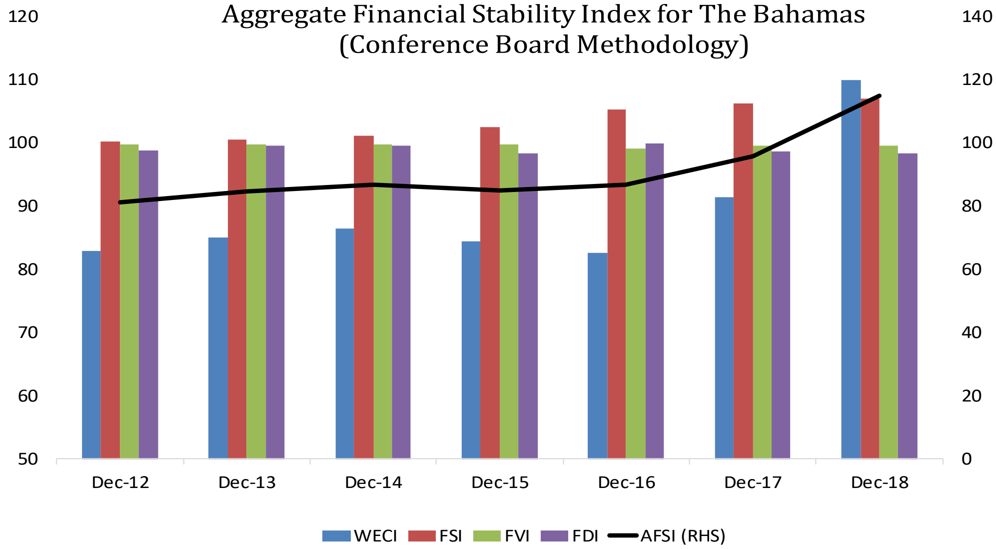
[3] See Appendix 2



3.6.2. Aggregate Financial Stability Index

The Aggregate Financial Stability Index (AFSI), forms a single measure of financial stability from microeconomic, macroeconomic and international factors. It is comprised of sub-components such as the financial development index, the financial soundness index, the financial vulnerability index and the world economic climate index. A higher AFSI value suggests increased financial sector stability, while a lower value signals a decline in stability. An anlaysis of the movements in the AFSI for DTIs in The Bahamas, showed that the sector remained stable in 2018, as the AFSI firmed to 107.4 in 2018 from 97.9 in the prior year, indicating a strengtheing in financial sector stability. An examination of the sub-components of the AFSI revealed that the financial soundness index firmed to 113.9 in the reivew year, compared to 112.0 in 2017, led by a rise in the liquid assets to total assets ratio. Further, the world economic climate index rose to 180.5 from 137.3 in 2017, while the financial vulnerability index held steady at 99.1. In contrast, the financial development index edged-down to 96.7 in 2018, from 97.3 in the previous year, as the total credit to GDP and the stock market capitalization to GDP ratios narrowed.

Chart 12
Aggregate Financial Stability Index for The Bahamas
(Conference Board Methodology)



3.6.3. Stress Testing

Credit risk stress tests remained the main tool used to assess the resilience of the banking sector; notwithstanding that liquidity and interest rate risks are also monitored. The credit risk stress test is designed to assess the capital adequacy or loss absorbing capacity of the domestic systemically important banks (D-SIBS), to significant shifts in the level of NPLs, due to extreme, but plausible shocks to the banks' NPL rates. In addition, general observations are provided relative to liquidity and interest rate risk stress tests; importantly, at present there are no material risk issues or vulnerabilities in these areas.

Credit Risk Stress Tests

During 2018, the stress scenarios used to assess whether there were any capital shortfalls for credit risk shocks remained unchanged. The forecasted NPLs are subject to shocks of 100%, 150% and 200% for 2018 through 2020, the impact of which flows through to the statement of income, with increases (or decreases) in expenses relative to loss interest income and provisions for impaired loans, ultimately impacting the level of capital.

Consolidated credit risk stress tests conducted in 2018 consistently showed that, at all levels of shocks, which reduced capital levels up to 10.1%, no new captial injection was required. Capital levels remained well above the target and trigger ratios of 17% and 14%, respectively, at an average capital to risk-weighted assets ratio of 31.3% to 35.6%, thus negating any financial stability concerns (see Chart 13).

Banks' earnings would be adversely impacted due to increases in provisioning levels and the loss in interest income at varying levels of shocks to the NPLs. Consequently, it is anticipated that banks would endeavour to partially counter the impact of the same by seeking other non-interest income sources. Chart 14 depicts the projected net income before any shock, at a net gain of around $190.0 million and declines in net income to net losses of $320.1 million, due to applied shocks. Notwithstanding the consolidated results, the impact on individual banks will vary.

Chart 13

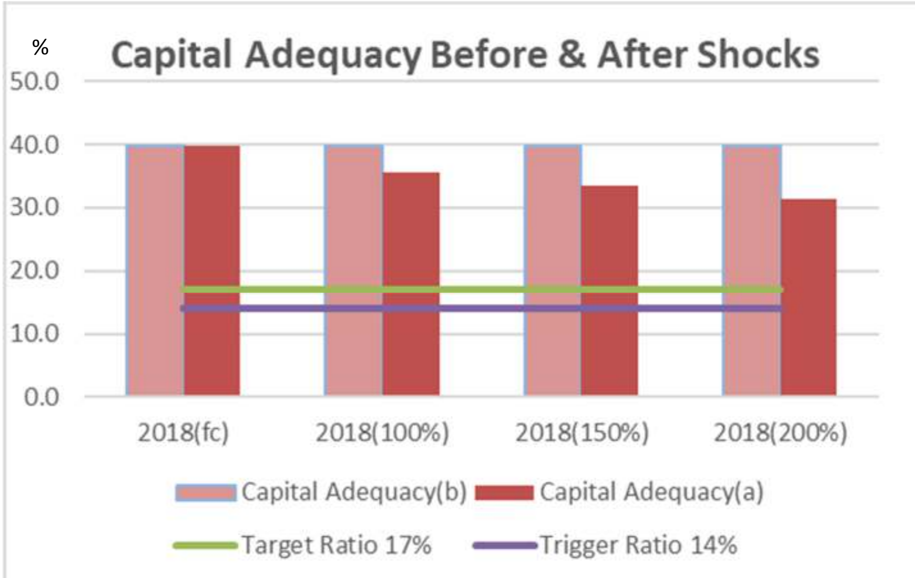
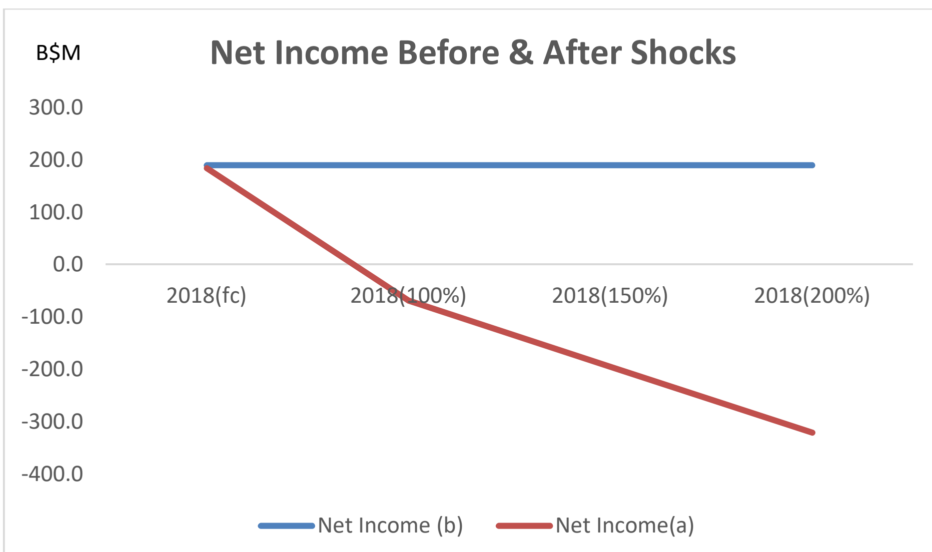


Chart 14



Interest and Liquidity Shocks

Stress test results continued to show that commercial banks are less susceptible to interest rate risk in their banking books, given the infrequent movement in the Bahamian dollar Prime lending rate and the continued robust levels of eligible capital, among other factors.

With regard to liquidity risk, stress test results continued to indicate that banks' risk to near-term depletion of liquidity is negligible, due to the high level of liquidity across the banking system, supported by banks' continued cautious stance to lending. In general, banks have the capacity to withstand sudden shifts in their deposit base, without encountering liquidity challenges.

CHAPTER 4: CREDIT UNIONS

Credit unions remained the second largest group of deposit taking and loan granting institutions. During the year, these entities registered gains in assets and deposit liabilities, while the sector's capital levels continued to exceed the PEARLS[4] benchmarks; however, the prudential buffers remained below that of the banks, with scope for further strengthening. Accordingly, the Central Bank decided to increase its target for the financial performance of credit unions, with heightened risk-based oversight. In a number of instances, institutions will require greater economies of scale in their operations to satisfy financial and governance standards that are becoming more demanding at the domestic and international levels. Strategically this will require some consolidation and mergers of smaller entities with other cooperatives. An important safety net for the sector is the proposed near to medium-term enrollment of credit unions in the deposit insurance fund.

4.1. Assets and Liabilities

Credit unions' total assets grew by 7.3% ($30.6 million) to $450.9 million at end-December 2018, extending the prior year's increase of 5.9%. This development was led by an expansion in the league's deposits, by 10.4% to $85.4 million, exceeding the 7.4% gain in 2017. Similarly, loans to members—which represented 51.9% of total assets—rose by 1.5% ($3.4 million) to $234.2 million, higher than the 1.3% growth recorded a year earlier. A breakdown of the loan portfolio, showed that the majority of credit was extended for small-scale consumer purchases (75.9%), followed by mortgages/land (21.7%), revolving lines of credit (1.4%), SME development (0.8%) and education (0.1%).

Reflecting the rise in the sector's membership, total deposits firmed by 6.6% ($24.0 million) to $386.2 million, following a gain of similar magnitude in the preceding year. This outturn included a 5.3% increase in savings deposits—which accounted for 54.1% of the total—to $208.9 million, although a slowdown from the prior year's expansion of 9.4%. Similarly, term deposits—at 37.4% of the aggregate—grew by 1.6% to $144.3 million, after a 2.5% advance in the previous year (see Table 5).

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[4] 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 cost, liquidity and signs of growth.

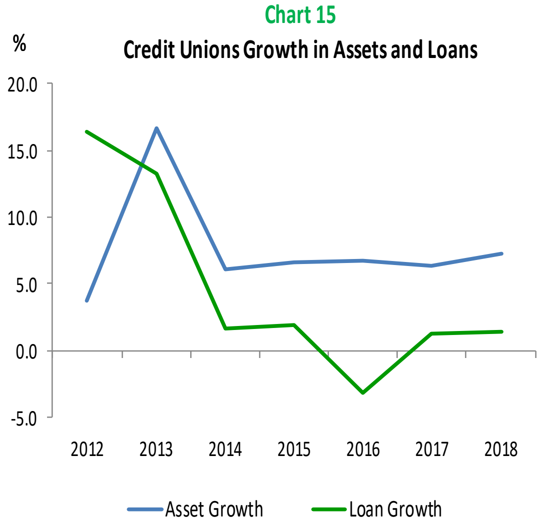
TABLE 5

Selected Financials for Credit Unions (B$M)	2010	2011	2012	2013	2014	2015	2016P	2017P	2018
Total Assets	246.5	270.6	280.9	327.6	347.7	370.6	395.5	420.3	450.9
Total Gross Loans	163.5	172.4	200.6	227.0	230.9	235.3	227.9	230.8	234.2
Total Deposits	208.2	229.7	235.3	274.7	291.6	315.9	339.9	362.2	386.2
Liquid Assets	69.8	86.2	74.7	98.6	86.8	101.6	129.7	146.0	172.3
Savings	123.4	127.6	117.8	134.8	146.4	159.6	179.7	198.4	208.9
Term Deposits	79.1	98.2	103.8	120.4	122.8	135.3	138.5	142.0	144.3
Total Members' Equity	28.1	31.3	34.1	38.4	40.7	42.4	45.1	47.4	51.3
Non-Earning Assets	15.8	12.7	11.6	17.2	25.2	25.0	34.8	33.4	37.1
Allowance	6.7	7.5	8.5	11.2	11.8	14.1	9.9	7.4	7.5
Short-Term (ST) Payables	6.5	6.4	0.7	1.2	1.4	1.0	1.1	0.5	0.7
Capital & Surplus	28.1	14.5	18.1	15.6	20.5	19.0	20.0	17.5	19.2
Provisions	1.3	1.7	2.7	1.6	1.1	2.3	2.4	3.9	3.5
Net Income	2.5	1.0	4.5	6.9	2.8	1.3	1.4	1.7	1.8
Institutional Capital	10.2	10.9	13.3	13.2	14.3	11.9	12.8	9.4	9.4
# of Credit Unions	13	13	13	7	7	9	10	10	10
Financial Ratios (%)									
Equity-to-Asset Ratio	11.4	11.6	12.1	11.7	11.7	11.5	11.4	11.3	11.4
Return on Assets	1.0	0.4	1.6	2.1	0.8	0.3	0.3	0.4	0.4
Return on Equity	8.8	3.2	13.2	18.0	7.0	3.0	3.0	3.6	3.5
Provisions to Loans	0.8	1.0	1.4	0.7	0.5	1.0	1.0	1.7	1.5
Total Gross Loans to Total Assets	66.3	63.7	71.4	69.3	66.4	63.5	57.6	54.9	51.9
Liquid Assets to Total Assets	28.3	31.9	26.6	30.1	25.0	27.4	32.8	34.7	38.2
Non-Earning Assets/Total Assets	6.4	4.7	4.1	5.2	7.2	6.7	8.8	8.0	8.2
(Liquid Assets-ST Payables)/Total Dep	30.4	34.8	31.4	35.5	29.3	31.9	37.8	40.2	44.4

Source: Department of Cooperative Development & Central Bank of The Bahamas

Chart 15

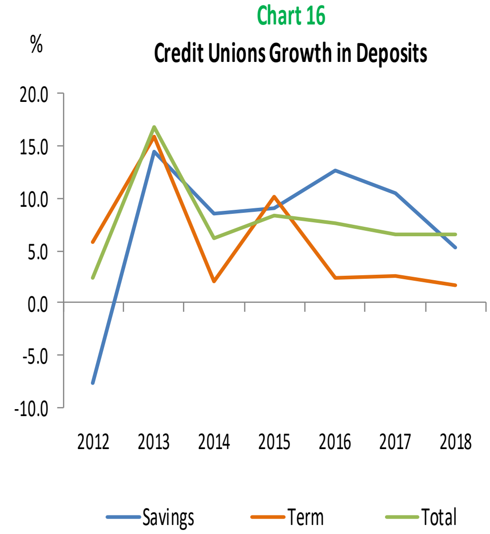
Credit Unions Growth in Assets and Loans



Source: Central Bank of The Bahamas

Chart 16

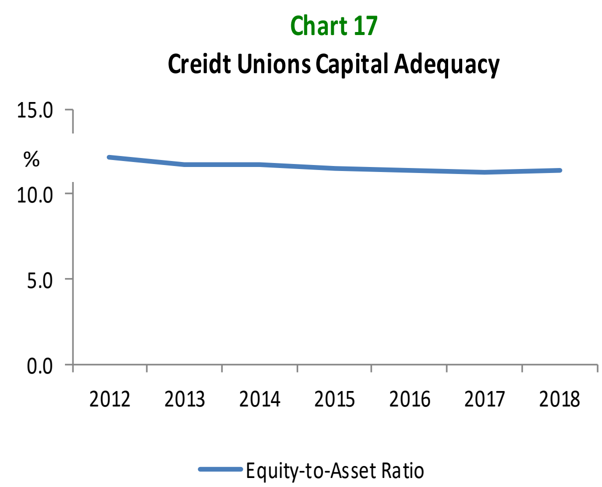
Credit Unions Growth in Deposits



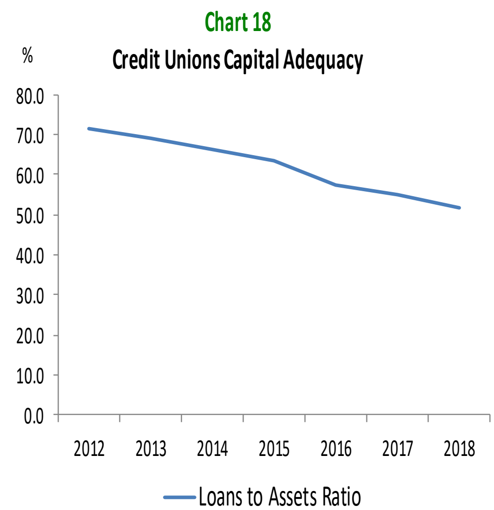
Source: Central Bank of The Bahamas

4.2. Capital Adequacy

Credit unions' capital ratio remained above the 10.0% international PEARLS benchmark in 2018. During the year, total capital & surplus resources—held to cover unexpected losses—increased by 9.4% ($1.7 million) to $19.2 million at end-2018, a reversal from a 14.4% contraction in the prior period. Further, on an aggregate basis, the corresponding ratio of total equity[5] to total assets (the gearing ratio), rose by 10 basis points to 11.4%, as the growth in the capital stock outpaced the rise in total assets.



Source: Central Bank of The Bahamas



Source: Central Bank of The Bahamas

4.3. Asset Quality

During 2018, credit unions' impaired loans[6] contracted by 2.7% ($0.8 million) to an estimated $28.4 million, vis-à-vis an 8.6% increase in the prior year. Correspondingly, the ratio of impaired to total loans declined marginally by 0.6 percentage points to 12.1%, year-on-year. A breakdown by component, showed that the short-term segment (90 days and under)—which constituted 28.3% of the total—fell by 4.5% to $8.0 million, following a sharp 75.0% expansion in the prior period. In addition, estimated NPLs decreased by 1.9% to $20.4 million; albeit a slowdown from the 5.9% reduction last year.

In line with the improvement in loan delinquencies, the value of collateral against impaired credit rose by 4.3% ($0.6 million) to $15.3 million, a slowdown from the 29.4% increase in the prior year. Further, credit unions' uncollateralized exposures decreased by 9.7% ($1.4 million) to $13.1 million. Despite the decline in delinquencies, the sector's total provisions for loan losses rose by 1.5% ($0.1 million) to $7.5 million. As a consequence, the ratio of provisions to total loans fell by 20 basis points to 1.5%, while the coverage ratio for short-term arrears remained unchanged at 35.0% and for NPLs, at 100%.

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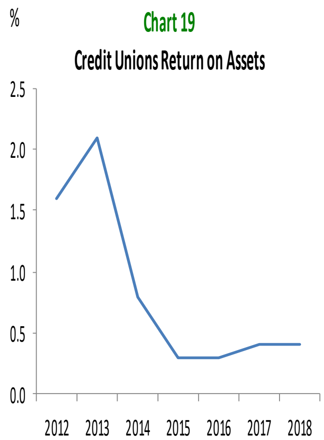
[5] Total equity is equivalent to capital & surplus resources and includes members' capital, institutional capital and the reserve fund.

[6] An impaired loan is defined as a one in which the full amount of principal or interest due is not collected on time, according to the contractual terms of the loan agreement.

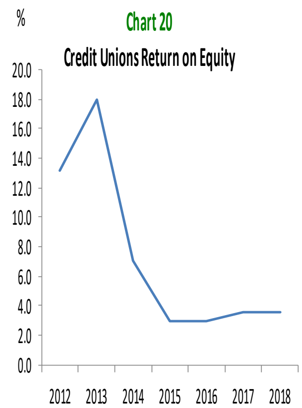
The value of non-earning assets—which includes land, buildings, vehicles, furniture and cash—grew by 11.1% ($3.7 million) to $37.1 million, vis-à-vis a decline of 4.3% in 2017. Consequently, the share of these assets firmed by 29 basis points to 8.2%, remaining above the prudential ceiling of 5.0%.

4.4. Profitability

Reflecting an increase in other "miscellaneous" income, which offset the rise in operating expenses, the sector's overall profitability grew by 4.8% ($0.1 million) to $1.8 million in 2018. As a result, the ROA remained unchanged at 0.4%, while the ROE narrowed, by 12 basis points to 3.5%.



Source: Central Bank of The Bahamas



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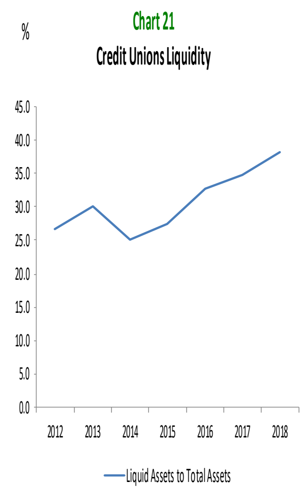

Source: Central Bank of The Bahamas

4.5. Liquidity

Credit unions maintained buoyant liquidity levels in 2018, as evidenced by a 27.9% expansion in short-term financial investments and a 16.2% increase in cash holdings. As a result, the ratio of liquid assets to total assets firmed by 3.5 percentage points to 38.2%. Similarly, the alternative indicator—the ratio of short-term payables to total deposits—advanced by 4.3 percentage points to 44.4%. Both ratios were in excess of the minimum prudential standard of 15.0%, indicating that credit unions continued to hold adequate levels of liquidity.

CHAPTER 5: THE INSURANCE SECTOR

The domestic insurance industry's total balance sheet is positioned ahead of that of the credit unions, but significantly less than the banking sector's. Given the country's exposure to natural disasters, such as hurricanes, insurance companies are very important to ensuring the stability of the financial sector. The sector's weather-related financial risk exposure is somewhat mitigated by the fact that the domestic non-life companies acquire reinsurance services from large overseas entities. Given the conservative nature of the insurance business domestically—with its focus on long-term stable investments, such as Government bonds—there have been minimal concerns regarding the sector's stability.

Notably, as external insurers' core focus is on overseas operations, their main impact on the domestic economy is through employment and the fees charged by local service providers; however, their operations do not affect the local financial sector. Therefore, going forward, the domestic insurance sector will be the focal point of this analysis.

In terms of the domestic insurance sector's key performance indicators, the penetration ratio (total gross premiums to GDP[7]), rose by 10 basis points to 3.6% over the prior year. Specifically, the non-life sector registered a profit, albeit lower than prior year's outturn, while the profits of the dominant life insurance segment contracted as a result of an increase in total expenses. On average, the sector remained financially sound, as revealed by the adequacy of its financial stability ratios.

5.1 Life Insurance

Life insurance companies—which constituted 71.9% of aggregate assets and 57.6% of gross premiums—continued to be the dominant segment of the market. According to provisional data, life insurers' total assets declined marginally by 1.1% ($0.2 million) to $1.4 billion, owing in large measure to a 25.0% contraction in cash & deposits to $176.2 million. In addition, notable decreases were recorded for intangibles ($7.7 million), fixed assets ($8.5 million) and other assets ($3.8 million). Providing some offset, total investments grew by 5.8% to $1.0 billion—representing 74.6% of the total—explained by an almost two-fold increase in other "miscellaneous" investments to $27.8 million, from $15.8 million in 2017 and a 45.4% gain in the value of investments in mutual funds to $32.4 million. In addition, holdings of Government securities rose by 14.4% to $571.7 million, while re-investment recoverables firmed by 35.5% to $41.5 million. In terms of funding, total liabilities decreased slightly by 0.4% ($3.7 million) to $985.0 million, comprising largely of technical reserves to finance policyholders' claims and future benefits. In addition, aggregate equity levels were reduced by 2.9% to $411.2 million, attributed mainly to a 52.8% contraction in shareholders' investments to $49.5 million. In contrast, retained earnings and other "miscellaneous" reserves grew by 14.8% and 9.8%, to $268.3 million and $93.5 million, respectively.

In terms of earnings, the net income of domestic insurers decreased by 19.2% to $31.8 million. Underpinning this development was a 10.5% gain in total expenses to $428.7 million, which outstripped the 7.7% increase in aggregate income to $460.5 million. As a result, the expense ratio firmed by 4.8 percentage points to 33.3%, while the investment yield ratio rose by 1.1 percentage points to 6.3%, as both

[7] Based on the Department of Statistics' revised GDP for 2017 and estimates for 2018.

investment income and the value of investment assets strengthened. However, the respective ROE and ROA ratios narrowed by 1.6 and 0.5 percentage points, to 7.7% and 2.3%.

During 2018, despite mixed performances of the financial soundness indicators for the life insurance industry, they remained above international benchmarks. As a measure of the liquidity of insurance companies, the ratio of real estate plus unquoted equities and receivables to total assets, moved lower by 60 basis points to 14.2%, while the value of equities as a proportion of total assets—which are considered relatively higher risk—declined by 1.7 percentage points to 4.1%. Conversely, the real estate-to-total assets ratio rose by 40 basis points to 6.1%. With regard to capital ratios, the net premium-to-capital ratio quickened by 7.4 percentage points to 96.1%, while the capital-to-technical reserves ratio increased by 30 basis points to 49.4%; however, the capital-to-total assets ratio narrowed by 50 basis points to 29.5% (see Table 6), albeit remaining above the international benchmark of 7.0%-10.0%.

Table 6

Life Insurance: Financial Soundness Indicators (%)

	2012	2013	2014	2015	2016	2017	2018p
Capital Adequacy							
Capital/Total Assets	26.2	29.1	29.8	29.5	29.3	30.0	29.5
Capital/Technical Reserves	41.2	46.5	48.3	48.9	48.0	49.1	49.4
Net Premium/Capital	119.0	106.7	104.5	104.2	99.5	88.7	96.1
Asset Quality							
(Real Estate + unquoted equities + receivables)/Total Assets	16.3	14.2	14.4	14.8	17.4	14.8	14.2
Equities/Total Assets	5.0	6.5	6.4	6.3	6.0	5.8	4.1
Real Estates/Total Assets	7.3	7.6	7.2	6.8	6.5	5.7	6.1
Earnings & Profitability							
Expense Ratio (expense/net premium)	31.0	30.0	29.3	29.6	29.5	28.5	33.3
Investment Yield (investment income/investment assets)	6.7	6.1	6.4	6.3	5.6	5.2	6.3
Return on Equity (ROE)	12.5	11.5	12.2	11.6	10.8	9.3	7.7
Return on Assets (ROA)	3.3	3.4	3.6	3.4	3.2	2.8	2.3

Source: Insurance Commission of The Bahamas & Central Bank of The Bahamas
p = provisional

5.2. Non-Life Insurance

Non-life insurers' assets declined sharply in 2018 by 29.5% ($227.9 million) to $545.1 million, as receivables and re-insurance recoveries—which represent 20.3% and 34.3% of total assets—decreased markedly by 50.6% and 35.6%, to $110.8 million and $187.2 million, respectively, reverting back to trend, following residual reinsurance inflows related to the 2016 hurricane. Further, cash and deposits—which constituted 20.2% of the total—contracted by 7.8% to $110.3 million, while fixed and other "miscellaneous" assets were reduced by 48.9% and 12.5%, to $14.2 million and $2.1 million, respectively. In contrast, total investments expanded by 11.7% ($12.3 million) to $117.5 million, as the significant growth in preference shares, investment property and other investments, eclipsed the falloff in corporate entity and Government securities. The sector's total liabilities decreased considerably by 41.1% ($228.6 million) to $327.8 million, underpinned by a significant reduction in technical reserves by almost half ($237.5 million) to $238.3 million—after a temporary increase in the prior period related to hurricane Matthew—which overturned the 11.3% rise in other "miscellaneous" liabilities to $89.5 million. In a slight offset, the total equity stake edged-up by 0.3% to $217.3 million, owing to increases in retained earnings and other reserves.

With regard to earnings, non-life insurance companies recorded a reduction in estimated net income of $4.1 million (23.1%) to $13.7 million. Underlying this outturn, total revenue fell by 11.2% to $110.9 million, outpacing the 9.2% decline in total expenses to $97.2 million, explained by sharp decreases in investment and other "miscellaneous" income.

The performance of the financial soundness indicators for the non-life insurance sector were mixed over the review year. As it relates to asset composition, the equities to total assets ratio firmed by 3.0 percentage points to 8.5%. Further, some of the earnings indicators recorded improvements, as the loss ratio—which measures whether net claims paid-out exceed net premiums collected—decreased to 24.6% from 33.3% in the prior year. In addition, the ROA ratio edged-up by 20 basis points to 2.5%. In contrast, the ROE narrowed by 1.9 percentage points to 6.3%, while the investment yield ratio fell by 6.9 percentage points to 2.5%. Finally, the expense ratio firmed by 1.3 percentage points to 67.7%.

Reinsurance ratios generally reflect the appropriateness of risk-minimizing policies in relation to negative events. In 2018, the risk retention ratio[8] moved higher by 40 basis points to 31.2%, while the ratio of capital to technical reserves fell to 109.7% from 219.7% in 2017, when the receipt of residual proceeds from the 2016 hurricane, resulted in a sharp increase in the ratio. Further, the technical reserves to net premiums ratio contracted to 226.3% from 443.3% in the previous year (see Table 7). Notwithstanding, the sector continued to hold sufficient reserves to mitigate against the risk of adverse shocks.

Table 7

Non-Life Insurance: Financial Soundness Indicators (%)

	2012	2013	2014	2015	2016	2017	2018p
Asset Quality							
(Real Estate + unquoted equities + receivables)/Total Assets	58.4	51.2	51.2	52.5	72.7	67.5	57.5
Reinsurance and Technical Reserves							
Risk Retention Ratio (net premiums /total gross premiums)	33.9	34.2	33.2	31.8	32.2	30.8	31.2
Technical Reserves/Net Claims	500.0	471.6	720.1	693.6	1110.5	1332.1	918.9
Technical Reserves/Net Premiums	188.9	166.7	191.1	210.0	618.2	443.3	226.3
Earnings & Profitability							
Expense Ratio (expense/net premium)	63.7	55.7	61.9	62.8	66.3	66.4	67.7
Loss Ratio (net claims/net premium)	37.8	35.4	26.5	30.3	55.7	33.3	24.6
Investment Yield (investment income/investment assets)	7.6	9.8	7.6	7.0	9.6	9.4	2.5
Investment income/net premium	4.7	6.2	6.1	7.0	10.0	9.2	2.8
Return on Equity (ROE)	6.4	12.9	12.9	8.9	-3.8	8.2	6.3
Return on Assets (ROA)	2.4	5.4	5.3	4.0	-0.8	2.3	2.5

Source: Insurance Commission of The Bahamas & Central Bank of The Bahamas
p= provisional

[8] This ratio examines the relationship between net premiums written and gross premiums written.

CHAPTER 6: PAYMENTS AND CENTRAL BANK DIGITAL CURRENCY

The systemic importance of the payment infrastructure continues to be highlighted by the increasing shift to electronic, mainly card-based transitions. In fact, as it relates to payments, the key objectives of the Central Bank are to reduce the reliance on the use of cash in the domestic market, accelerate financial inclusion initiatives and support the more efficient delivery of services by non-deposit taking institutions. In this context, the initiative to develop and introduce a digital version of the Bahamian dollar, branded "Project Sand Dollar" was officially launched in August, 2018. It will be piloted on the island of Exuma—a tourism-based microcosm of The Bahamas—which has a community of nearly 8,000 residents.

While strictly adopting AML/CFT and anti-proliferation safeguards, a retail Central Bank Issued Digital Currency (CBDC) system, will incorporate safeguards to preserve financial stability. One option would entail the creation of retail accounts, held with the Central Bank, which would be non-interest bearing, and which would be capped in terms of the amount of funds that individuals could deposit into them. This would avoid the perception that the Central Bank intends to accumulate domestic resources, which ought to best be intermediated by the private sector[9]. Above these defined thresholds, digital wallets would have to be linked to transactional deposit accounts with commercials banks or other regulated deposit-taking entities. Although commercial entities and the public sector would be able to act as the originating and terminating points for large volume currency payments, they would in all cases be required to house the material terminal flows in deposit taking institutions.

From a liquidity and crisis management perspective, the Central Bank will also propose circuit breaker mechanisms, to monitor and prevent destabilizing surges in fund flows between financial institutions. An identified financial stability concern relates to the fact that in a crisis of confidence scenario, and without safeguards, CBDCs could expose banks to a rapid loss of deposits, which could lead to the failure of weak entities[10]. It should be noted though that the speed at which funds shift in real time between financial intuitions would not be a feature uniquely enabled by a CBDC. Contingent safety mechanisms must also be devised in anticipation of private sector innovations for more rapid, real time settlement of payments.

The pilot phase of "Project Sand Dollar" will allow for some controlled enhancement of the real time payments mechanisms, and where necessary, a scaling of parameters and limits, which relate to transactions that apply for various categories of users. In all outcomes, a CBDC would not be proposed as a deposit substitute, but as an enabler for expanded access to the existing regulated financial services.

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[9] The Bank for International Settlements (BIS) discusses the potential for remunerated CDBC to incentivize the accumulation of resources outside of the banking system, which would leave the Central Bank in the suboptimal position of having to determine how to recycle funds back into financial intermediation activities. ***Central Bank Digital Currencies***, Committee on Payments and Market Infrastructures (CPMI), March 2018: https://www.bis.org/cpmi/publ/d174.pdf). It is worth noting however, that this is not an outcome that would be sought for The Bahamas, either in terms of remuneration of digital wallets or with regards to the amount of funds that can be housed in CBDC accounts.

[10] See also BIS reference above.

CHAPTER 7: ASSESSMENT OF RISKS

Financial risks remained well contained for The Bahamas in 2018, with no immediate threat to the stability of the system and with no heightened medium-term concerns to be noted. Given the potential for an improvement in the economy over the near-term, there is the opportunity for the further amelioration of conditions; although the very gradual growth prospects places an upper bound on the speed at which credit risks would dissipate. With this in mind, the Central Bank anticipates that more aggressive direct supervisory intervention is warranted to speed-up the reduction in NPLs, through loss recognition, the enforcement of collateral (via foreclosures and asset sales) and debt restructuring where still feasible. In addition, the credit bureau framework will provide the structural support for sounder lending practices over the medium-term, to prevent a significant buildup of new credit risks.

That said, important scope exists to enhance average buffers within credit unions, as the Bank seeks to further strengthen its oversight of these entities. This should transpire in tandem with reforms to enroll credit unions in the deposit insurance scheme and others aimed at boosting the operating efficiency of the sector.

In a macroeconomic sense, there is the continual need for the elevated levels of bank liquidity to be closely monitored, as improving economic conditions favour an expansion in consumer-related credit over the medium to long-term. The Bank is cognizant of the fact that the reserve capacity for lending needs to be unwound gradually, in order to not outpace the growth in the country's ability to generate foreign exchange from the productive sectors. Therefore, as noted earlier, the Central Bank's near to medium-term strategy in this area includes the measured reduction in its holdings of Government securities, through sales to the commercial banks, which would absorb a significant portion of the surplus liquidity. These efforts will be further enhanced with the passage of the revised Central Bank Act, which will place further limits on the Bank's financing to the Government, as well as the Public Debt Management Bill, which seeks to support the prudent management of the National Debt[11]. The Bank's macro-prudential toolkit is also being strengthened—with assistance from the IMF's regional technical assistance centre, known as CARTAC—in order to more effectively address this and other high-level issues.

Along with the liquidity overhang, the domestic banks' high capital levels also require some managed reduction over the medium-term. The alternative is the deployment of resources in ways that become unsustainable or which place escalated reliance on fee-based pricing structures. Since the majority of the capital repatriation will impact Canadian banking operations, outflows will use net foreign exchange, although not at a detriment to the country's net foreign reserves, as the economy is expected to experience continued elevated receipts from tourism and other export-facing activities.

In line with its mission to ensure a sound financial system, the Central Bank—along with other regulators and domestic stakeholders—are also advancing proposals to strengthen the National Financial Crisis

[11] Both of these acts are presently under review by the Government.

Management framework. This would reduce vulnerabilities around the speed and statutory precision at which responses to crises, if they arise, can be effected. As the core objective is to ensure strong alignment of The Bahamas' framework with recommended best international practices, the Bank has identified various amendments that are needed in the different legal frameworks, including resolution processes, under the deposit insurance scheme. Extending the deposit insurance mechanisms to credit unions dovetails into these proposals. These initiatives, combined with other measures being implemented by the Securities and Insurance Commissions, will serve to further enhance and strengthen the supervisory regime in place to ensure the stability of the financial sector.

With regard to CBRs, the Bank sustained its efforts to monitor such developments, to determine if the loss of CBRs had any destabilizing impact on either financial institutions or the system as whole. The results of the 2018 survey revealed stable conditions with respect to access to external counterparts, but with continued concentrated pressures among banks, and standalone Bahamian entities. All financial institutions remain impacted on some level by heightened monitoring and more stringent customer due diligence requirements now being imposed by correspondent banks, which has now become the "new normal".

At the international level, the Caribbean, as well as small country jurisdictions like The Bahamas, remains disproportionately impacted by the global "de-risking" trends, that showed continued overall reductions in the number of entities that provide correspondent banking services[12], which concentrated the region's dependence through such channels for larger volumes of global transactions. The risk of disruption to Bahamian international payments, which still persists, is expected to subside partly in concert with efforts to strengthen The Bahamas' risk rating profile in the areas of AML/CFT and anti-proliferation. Key to this initiative, is progress being made to remove the country from the FATF's heightened monitoring process, as the strategic national initiatives take hold (see: Box 1).

[12] See FSB Action Plan to Assess and Address the Decline in Correspondent Banking: Progress Report, May 2019: https://www.fsb.org/wp-content/uploads/P290519-1.pdf.

Box 1

Strengthening Supervision of Financial and AML/CFT Risks in the Banking Sector

The Central Bank—through its Supervision Department—continued to implement policies geared towards mitigating the risks to the financial sector. Specifically, the Bank updated its overall approach to supervision, which entailed an increase in its focus on proactive intervention, by utilizing its Ladder of Supervisory Intervention and it also issued a consultative paper on Basel III liquidity reforms. Further, the Bank adopted an Administrative Monetary Penalties (AMP) regime for the AML/CFT Framework in December 2018. The annual supervisory cycle was also streamlined, by consolidating inspections performed throughout the year into an annual in-depth financial and compliance review. In addition, the traditional approach to the risk assessment/ever-greening process was adjusted to ensure that the risk profiles of SFIs were updated throughout the year. It was also determined that going forward, in order to mitigate emerging risks within the industry, the annual in-depth reviews and the resulting risk profile updates will inform the supervisory communication letters issued to SFIs on an annual basis. In addition, Full Strategic Risk Assessments will continue to be performed on a 3 to 5-year cycle, with newly licensed institutions required to complete a full/simplified risk assessment, following the first year of receiving their license.

As it relates to AML/CFT, following the enactment of substantial legislation to enhance the regulatory, supervisory and enforcement regimes within the jurisdiction and to address gaps identified within the country's 2017 Mutual Evaluation Report (MER), the Bank updated its AML/CFT Supervisory Guidelines, and extended its risk-based supervisory approach to credit unions and Money Transmission Service Providers. As a result, risk rating assessments have been completed for all these SFIs and on-going AML/CFT supervision has been maintained in all sectors. Moreover, in an effort to encourage strong risk management practices and ensure that institutions demonstrate a sound understanding of their money laundering/terrorist financing (ML/TF) risks, the Bank required all SFIs to document and submit their own risk assessments on an annual basis. In the future, supervision of ML/TF risks will remain as robust as the Bank's prudential supervision, with its focus on maintaining financial stability.

CHAPTER 8: CONCLUSION

The domestic financial system remains sound, both in its current assessment and the outlook. For its part, the Central Bank will continue to pursue policies and reforms aimed at mitigating the potential risks to supervised institutions and strengthening the regulatory environment. Focus will be maintained on the rollout of the Basel II and III frameworks for banks and trust companies, while also strengthening the risk and governance systems within credit unions. Progress has already been noted on the capital component of the Basel II regime, with specific importance being placed on licensees' internal capital adequacy assessment process (ICAAP) and revisions to the Central Bank's guide on its Ladder of Supervisory Intervention. These measures entail an emphasis on increased buffers, among other risks, over the course of the business cycle for domestically systemically important banks (D-SIBs) and maturity mismatches. The "evergreening" process to document a matured point-in-time risk view of financial institutions' risk profiles is already underway. This will support further tailored supervisory engagement within individual licenses. Similarly, financial inclusion themed reforms to the payments system, are aimed at widening the formal reach of the system to enhance the macro effectiveness of policy tools and to reduce systemic risks from any threatened access to international correspondent banking arrangements. The Central Bank remains equally focused on the sustainability of the exchange rate arrangements, given the diverse channels through which this also impacts financial stability prospects.

The overall goal of the Bank is to maintain a financially sound and compliant financial sector, ensuring that prudent risk management practices are in place and economic growth is sustained.

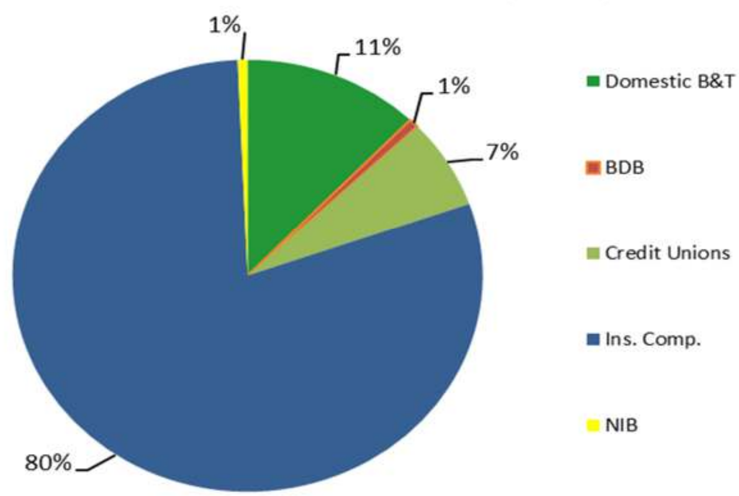
APPENDICES

Appendix 1

Structure of the Bahamian Financial System –Selected Highlights

From a financial stability perspective, the Bahamian financial system comprises operations under three key regulators. These are the Central Bank, for banks & trust companies, credit unions, money transmission businesses (MTBs) and payment services firms; the Securities Commission of The Bahamas for investment funds, non-deposit taking lenders, investment fund administrators and capital markets; and the Insurance Commission of The Bahamas for insurance companies. Only the domestic side of these supervised operations matter for financial stability, and current systemic operations are mostly confined to banks, credit unions and the payments system infrastructure.

Chart 1
Domestic Banks & Non-banks (Dec-18)



Source: Central Bank of the Bahamas

At end-2018, there were 231 banks and trust companies (see: Table 1, Appendix), which employed in excess of 4,000 persons, with the largest single concentration in the 20 local domestic banks and trust companies[13] (3,277 persons). Other entities within the sector include 5 money transmission businesses (MTBs), 10 local credit unions, 50 insurance companies, 19 financial & corporate service providers and 63 investment fund administrators. Within these operations, 8 of the banks and trust corporations operate either fully or in part within the domestic space, as well as 29 insurance companies. In addition, Government controlled public sector financial entities include: the Bahamas Development Bank (BDB), the National Insurance Board (NIB) and the Bahamas Mortgage Corporation (BMC)[14]. The Bahamas International Securities Exchange (BISX) is also an important component of the domestic financial sector;

[13] There were 8 commercial banks in this total, representing the majority of the domestic assets.

[14] There have also been a few Special Purpose Vehicles (SPVs) established within the last three years, to acquire a variety of financial assets, including: Bahamas Resolve Limited and Poinciana Limited.

but with relatively small trading volumes and the absence of complex derivatives or other sophisticated instruments.

TABLE 1 Structure of the Financial System	2011	2012	2013	2014	2015	2016r	2017r	2018p
Banks & Trusts								
International	260	249	249	237	233	232	225	211
Domestic	18	19	18	17	16	16	17	20
Total	**278**	**268**	**267**	**254**	**249**	**248**	**242**	**231**
Non-Bank Financial Institutions								
Investment Funds	713	652	735	830	885	859	783	748
Credit Unions	13	13	7	7	7	10	10	10
Insurance companies	127	139	140	143	148	148	149	172
Domestic Companies & Agents	*114*	124	121	122	125	127	129	151
External Insurers	*13*	15	19	21	23	21	20	21

r - revised
p - provisional

Source: Central Bank of The Bahamas

Banking sector

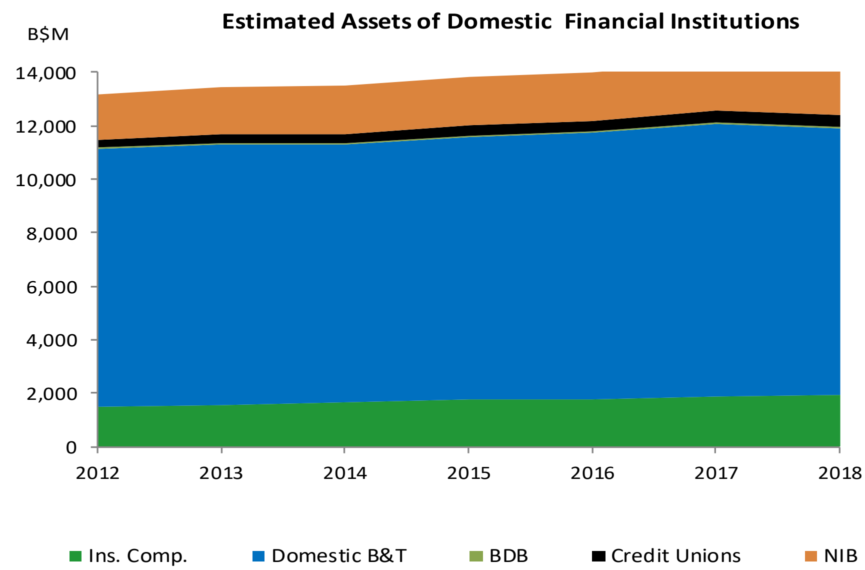
The banking sector's balance sheet approximated US$183.8 billion at end-2018, of which international exposures dominated, accounting for $166.0 billion (90.3%) of the total. Domestic licensees (8 commercial banks and 12 mostly trust entities) held the remaining $17.8 billion (9.7%) of assets—which contracted by 2.4% in 2018—divided between domestic ($10.2 billion) and foreign ($7.6 billion) assets. Deposits served as banks' most significant source of funds, while the majority share of domestic assets (58.9%) consisted of credit to the private sector in the form of commercial, consumer and residential mortgages. In addition, holdings of Government and public sector debt securities accounted for respective shares of 16.7% and 2.3%. The majority of the sector's assets—in excess of two-thirds—were concentrated in the 3 largest banks.

Fiduciary assets under the care of trust companies were estimated at $236.7 billion, and were almost exclusively held by international financial firms. Among the non-banks, the total assets of insurance companies and credit unions stood at an estimated $1.9 billion and $450.9 million, respectively.

State-Owned Enterprises

The major state-owned enterprises in the financial system include: the National Insurance Board (NIB), the Bahamas Mortgage Corporation (BMC) and the Bahamas Development Bank (BDB). The NIB would be systemically important for financial institutions' liquidity management practices, given its sizable deposit holdings. However, there are no financial stability concerns pertaining to the Board's operations. Neither BDB nor the BMC attract deposit funding for their lending operations and neither represent a systemically important source of credit expansion on an annual basis. The Bahamas Development Bank (BDB)—which provides financing for small and medium-sized enterprises—registered a 6.2% contraction in its assets base, to $50.2 million in 2018, partly corresponding to a reduction in outstanding credit. At BMC, mortgages outstanding stood at an estimated $189 million for year-ended June 2018, with relatively subdued overall lending in recent years.

Chart 2



Source: Central Bank of The Bahamas, Insurance Commision of The Bahamas

Credit Unions

After commercial banks, credit unions are the only other deposit taking and loan granting institutions. At the end of 2018, the total membership in these cooperatives stood at an estimated 44,559 persons or 18.6% of the workforce. The market continued to be dominated by one institution, which accounted for almost one-half (47.6%) of total assets, while the remaining entities were responsible for smaller market shares, ranging from a low of 0.1% to a high of 15.3% of aggregate assets.

Insurance Companies

Information from the Insurance Commission of The Bahamas (ICB), showed that operations consisted of 11 life and health insurers, offering whole life, term life, as well as universal life, and 18 non-life insurers, providing, *inter alia*, insurance for automobiles, fire, liability and property. The sector continued to be dominated by a few large firms—5 life insurers and 6 non-life insurers—which represent a combined market share of approximately 84.2% of total gross premiums written and the majority of insurance coverage. The external insurance sector, which is registered under the External Insurance Act[15], mainly

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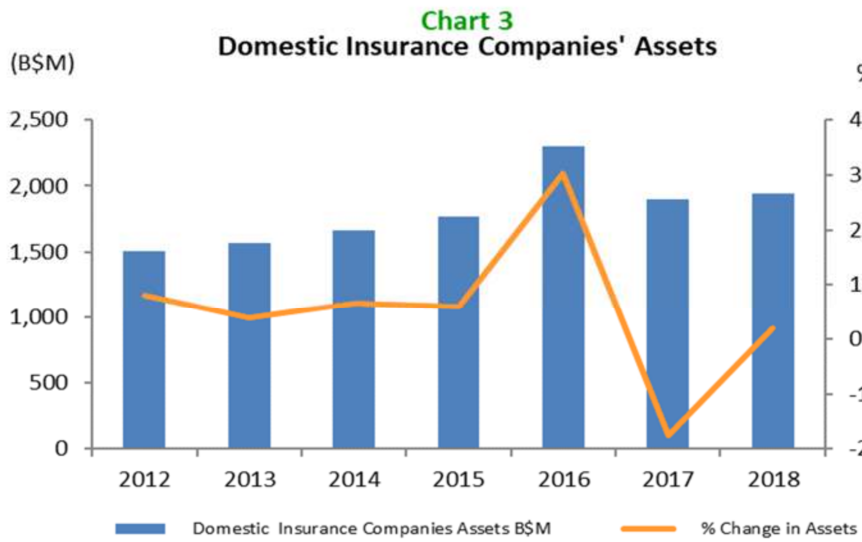
[15] See website: http://www.ibc.gov.bs/home

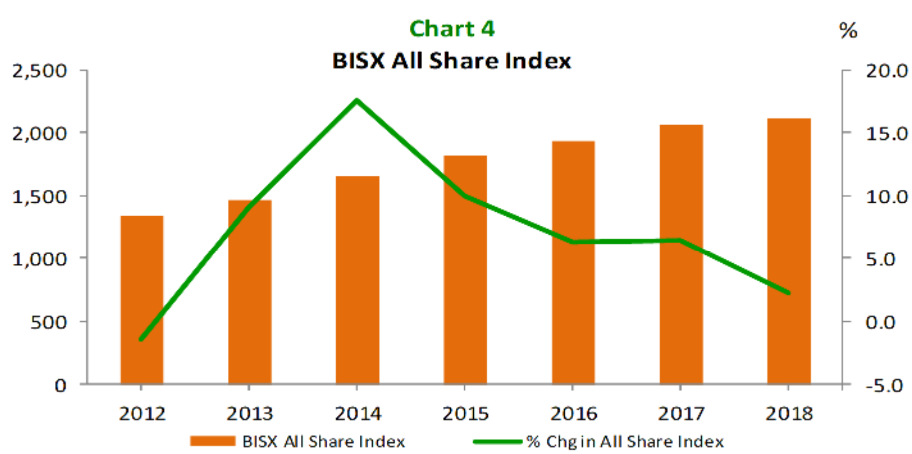
provides self-insurance coverage for non-resident entities in other countries. In 2018, it comprised 193 entities, of which 21 were insurance companies and 172 were captive cells.



Source: Insurance Commision of The Bahamas

Capital Markets

The operations of the Bahamas International Stock Exchange (BISX) captures virtually all of the private capital market activities, and should soon list the bulk of the Government's domestic bonds. There are minimal opportunities for investments using leverage, while Exchange Control-related policies effectively mitigate transactions which utilize external funding.



Source: Central Bank of The Bahamas & BISX

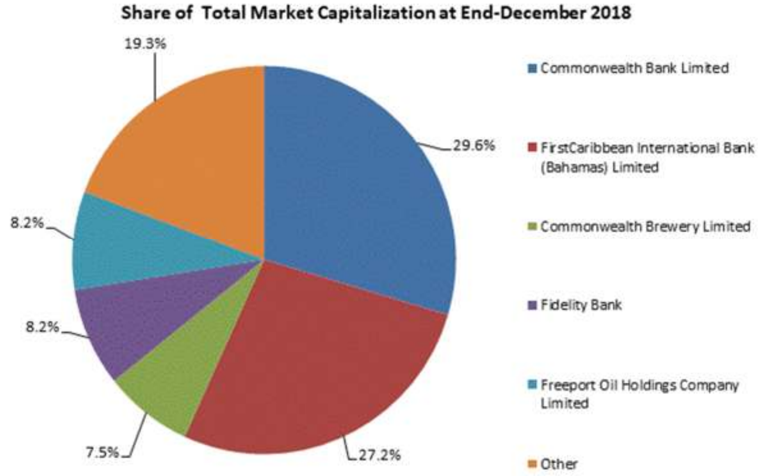
In this regard, local equity market conditions were relatively stable in 2018. The BISX All-Share Index firmed by 2.2% to 2,109.5 points at end-December 2018, after the prior year's 6.5% growth, attributed to broad-based valuation gains (see Chart 4). In terms of market activity, the aggregate volume of securities traded on the exchange increased sharply by almost two-thirds to 8.5 million; although the total value narrowed by 6.2% to $41.8 million.

In 2018, BISX's market capitalization rose by 1.0% to $4.5 billion, after a 7.2% expansion in the prior period, while the number of securities listed on the exchange decreased by 1 to 51 and comprised 19 common shares, 13 preference shares and 19 debt tranches. The five largest companies listed on the exchange accounted for a dominant 80.7% of the index's total market capitalization (see Chart 6), which was marginally higher than the 79.2% recorded in the previous year.

Chart 5
BISX Performance Indicators

Source: Central Bank of The Bahamas & BISX

Chart 6
Share of Total Market Capitalization at End-December 2018



Source: Central Bank of The Bahamas & BISX

Payments System

Following the release of the Payment Instruments (Oversight) Regulations, 2017, and corresponding General Information and Application Guidelines for Providers of Electronic Retail Payments Instruments and Electronic Money Products, in 2018, the Central Bank issued one license for the provision of electronic payment services, with an additional one pending approval in 2019. It is expected that more non-bank entities will make application to offer these services, as the shift towards electronic payments and debit & credit cards persists.

With regard to the settlements infrastructure, the Central Bank owns and operates the Real Time Gross Settlement System (RTGS), which processes large value transactions (greater than $150,000). Smaller transactions are channeled through The Bahamas Automated Clearing House Association (BACH), which is owned by the clearing banks. In 2018, the total value of transactions processed through the RTGS increased by 2.5% to $30.0 billion, while retail payments processed through the Bahamas Automated Clearing House (BACH), grew by 22.2% to $3.4 billion.

In terms of other electronic-based payment instruments, the value of debit card transactions rose at a tempered pace of 2.6% to $1.7 billion, while those executed using credit cards, increased by 2.3% to $249.1 million. Alongside these trends, the value of ATM transactions fell by 7.8%, with indications that customers made more frequent use of the electronic payments infrastructure for lower average value purchases.

Appendix 2

A Breakdown of the Banking Stability and Aggregate Financial Stability Indices

The Banking Stability Index

The Banking Stability Index (BSI) is an aggregate indicator of the soundness of the Deposit-Taking Institutions. It was calculated as a normalized weighted average of key performance indicators, namely capital adequacy, asset quality, profitability and liquidity. Each variable was normalized using statistical standardization, which allows for the different variables to be on the same scale. The normalized values range from 0.0 to 1.0. An increase in the index value shows greater stability. The BSI is measured in standard deviations from the 8-year average.

The Aggregate Financial Stability Index

The Aggregate Financial Stability Index (AFSI) is calculated using four indicators (sub-indices): the world climate index, the financial development index, the financial vulnerability index and the financial soundness index. The methodology consists of weighted averages used across the sub-indices, along with the normalization of each indicator for comparability among the variables. The AFSI is therefore the summation of the product of the normalized sub-indices and their associated weights.

CENTRAL BANK OF THE BAHAMAS