Financial Stability Report December, 2019

Issue No. 8

The Financial Stability Report is a publication of The Central Bank of The Bahamas, prepared by The Research Department for issue in June. All correspondence pertaining to the Report should be addressed to:

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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.

EXECUTIVE SUMMARY

The domestic financial sector remained stable during 2019, with the Bank heightening its overall approach to supervision, employing risk-based supervision and widening focus on non-bank entities. In terms of the credit unions, the Bank is in the process of extending the deposit insurance mechanisms to that body. With regard to the establishment of a credit bureau, the Bank officially licensed an operator in December 2019, marking a vital step toward the promotion of sounder lending practices and to the prevention of a significant buildup of new credit risks.

Through 2019, financial stability indicators remained sound. With the onset of the COVID-19 pandemic risk to the outlook have increased, with credit losses expected to become elevated. However, such setbacks are expected to pace below the major write-offs recorded after the 2008 Great Recession, and to be absorbed without having destabilising effects, in view of the healthy excess capital retained by banks. The loss absorbing capacity of credit unions is considerably constrained, although the risk do not rise to the level of systemic importance, in view of the size of the sector and the domestic financial safety net mechanism.

Amid the modest gains in the domestic economy, combined with ongoing debt restructuring activities, loan write-offs and hurricane relief measures, banks credit quality indicators improved during 2019. Further, the Bank Stability Index (BSI) showed that sector stability was maintained in 2019. However, owing in part to increased financial vulnerability and heightened tension in the world economic climate, the Aggregate Financial Stability Index (AFSI) revealed a moderation in overall financial stability. Meanwhile, the results of the stress tests—which comprised credit, liquidity and interest rate risks—showed that, at all levels of shocks, which surpressed banks' capital levels up to 22.0%, no capital injection was required and there are no near-to-medium term concerns of risk to financial stability.

With regard to the non-bank financial institutions, preliminary indications are that they sustained a positive outturn. In particular, the credit union sector remained profitable and highly liquid relative to the prior year, which contributed to relatively stable prudential ratios. Specifically, capital adequacy ratios firmed during the year and continued to surpass the targeted benchmark, while impaired loans and NPLs declined. Similarly, prudential indicators for both life and non-life insurance providers were in line with international benchmarks. The dominant life insurance sector registered a profit, albeit a moderation from the previous year. However, the non-life insurance segment recorded an operating loss during 2019, vis-à-vis a profit in 2018, reflective of a rise in claims associated with the passage of Hurricane Dorian in September. Nevertheless, on average, the sector remained financially sound, as revealed by the adequacy of its financial stability ratios.

Payments systems modernization and financial inclusion remained an integral part of the Central Bank's strategic objectives. Against this backdrop, in December 2019 the Bank launched, in Exuma, the pilot phase of its digital currency, Project Sand Dollar. In February 2020, following the passage of Hurricane Dorian, the pilot was extended to Abaco, so as to help mitigate financial and payments system recovery challenges. Further, in 2019, in an effort to control risk and facilitate stability of the financial sector, the Central Bank issued a moratorium on new license applications for the Payment Service Providers (PSPs) and Money Transmission Businesses (MTBs).

Moreover, from mid-March 2020, the effects of the Novel Coronavirus (COVID-19) began to take an accelerated toll on the economy negatively impacting tourism output, and by extension employment conditions and credit quality. As a result, in an effort to maintain financial stability, commercial banks implemented loan payment deferral programs for an initial 3 to 6 months period to assist customers whose debt servicing capacity has been adversely impacted by the COVID-19 pandemic. Further, the Central Bank commenced the preparation of tailored guidance notes for supervised financial institutions that would graduate the starting date at which loan loss provisioning would be required.

Going forward, the Central Bank remains committed to pursue active and diligent surveillance of financial institutions, in order to ensure the stability of the sector. Ongoing emphasis will be placed on risk management practices regarding AML/CFT, along with the closing of any gaps identified in the risk and compliance systems of supervised financial institutions (SFIs). Further, the Bank will sustain its efforts in the monitoring of bank liquidity, so as to mitigate the potential impact of any increase in credit demand on external reserves.

CHAPTER 1: MACROECONOMIC ENVIRONMENT

1.1. The Global Environment

The Bahamian economy remains heavily dependent on global economic developments, which impacts the tourism sector, which is a major contributor to economic growth in the local economy. In 2019, the International Monetary Fund (IMF) estimated that the global economy grew by 2.9%, following a 3.6% strengthening in 2018. However, the global economy is projected to contract by 4.9% in 2020, following a growth 2.8% in 2019, dominated by the Novel Coronavirus (COVID-19) pandemic and measures imposed globally to contain the spread.

The United States economy recorded an annualized growth rate of 2.3% in 2019, relative to 2.9% in 2018, amid declines in residential fixed investments, which surpassed increases in personal consumption and Federal Government spending. In labour developments, the unemployment rate contracted by 20 basis points to 3.7%, with an average gain of 175,000 jobs per month. Further, annual inflation rose by 40 basis points to 2.3%, owing mainly to a rise in food, healthcare, rent and fuel prices. Against this backdrop, the Federal Reserve lowered the target range for the federal funds by 75 basis points to 1.50%-1.75%, in an attempt to stimulate economic growth, amid global uncertainty.

Developments in other major economies reflected the moderation in global economic activity. Specifically, real GDP growth in China slowed by 50 basis points to 6.1%, as a result of the exacerbated trade conflict with United States. Similarly, Japan recorded a 0.7% growth, vis-à-vis 0.8% a year prior, amid reduced global demand. In Europe, economic output slowed for the euro area by 70 basis points to 1.2%, reflecting a decrease in household consumption and Government spending. Meanwhile, the United Kingdom's real GDP remained held steady at 1.4%, amid ongoing deliberations regarding BREXIT.

1.2. Regional Environment

In 2019, a common trend among economies in the Caribbean region was relatively low growth, coupled with high unemployment rates. Despite these developments, inflationary pressures remained stable over the review period. Further, the regional financial sector remained stable and highly capitalized, making it resilient to external shocks. Nonetheless, risks remain due to tourism-based economies exposure to volatile conditions within key source markets, while commodity-based economies were affected by the instability in international prices. Average real GDP growth for the region moderated to 1.6% in 2019 from 1.8% in 2018 (see Table 2). Specifically, Belize's growth declined by 2.7 percentage points to 0.3%, while real output in both Jamaica and the Eastern Caribbean decreased by 40 and 20 basis points, to 1.0% and 1.8%, respectively. Further, Trinidad and Tobago's economy recorded a flat outturn compared to a 0.3% gain a year earlier. In contrast, Guyana's real GDP growth strengthened by 1.3 percentage points to 4.7%, from the previous year and Suriname's economic output firmed by 0.3 percentage points to 2.3%, relative to the previous year. In addition, the contraction in real GDP in Barbados slowed to 0.1% from 0.5% in 2018.

TABLE 1

Selected Indicators for Developed Economies (%)

	2013	2014	2015	2016	2017	2018	2019
GDP Growth Rates							
United States	1.8	2.5	2.9	1.6	2.2	2.9	2.3
Euro Area	(0.2)	1.4	2.1	2.0	2.4	1.8	1.2
United Kingdom	2.0	2.9	2.3	1.8	1.8	1.4	1.4
China	7.8	7.3	6.9	6.7	6.8	6.6	6.1
Japan	2.0	0.4	1.2	0.6	1.9	0.8	0.7
Unemployment Rates							
United States	7.4	6.2	5.3	4.9	4.4	3.9	3.7
Euro Area	12.0	11.4	10.9	10.0	8.6	7.9	7.6
United Kingdom	7.1	6.2	5.4	4.9	4.4	4.1	3.8
China	4.1	4.1	4.1	4.0	3.9	4.0	3.6
Japan	3.4	3.6	3.4	3.6	2.8	2.4	2.4
Inflation Rates							
United States	1.5	1.6	0.1	1.3	2.1	2.4	1.8
Euro Area	1.3	0.4	0.2	0.2	1.5	1.8	1.2
United Kingdom	2.6	1.5	0.0	0.7	2.7	2.5	1.8
China	2.6	2.0	1.4	2.0	1.6	2.1	2.9
Japan	0.3	2.8	0.8	(0.1)	0.5	1.0	0.5

Sources: IMF, International Statistical Bureaus

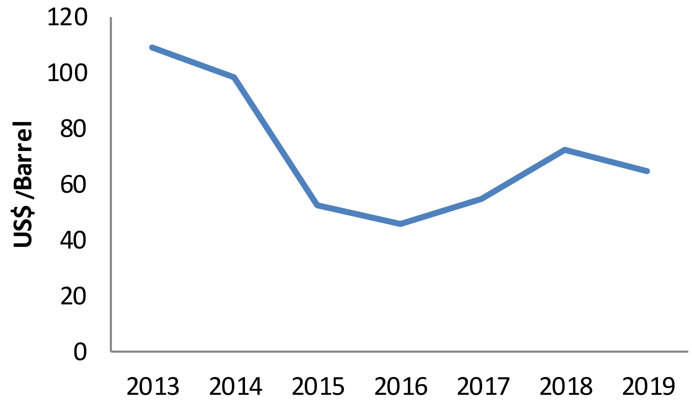
TABLE 2

Selected Caribbean Countries' GDP Growth Rates (%)

	2013	2014	2015	2016	2017	2018	2019
Bahamas	(3.0)	0.7	0.6	0.4	0.1	1.6	1.8
Barbados	(1.4)	(0.2)	2.2	2.3	(0.2)	(0.5)	(0.1)
Belize	0.9	3.7	3.4	(0.6)	1.4	3.0	0.3
Eastern Caribbean	1.7	2.9	2.6	2.7	1.2	3.0	2.8
Guyana	5.2	3.8	3.1	3.4	2.1	3.4	4.7
Jamaica	0.2	0.6	0.9	1.5	0.7	1.4	1.0
Suriname	2.9	0.3	(3.4)	(5.6)	1.7	2.0	2.3
Trinidad & Tobago	2.3	(1.3)	1.9	(6.5)	(2.0)	0.3	0.0
Average	**1.4**	**1.3**	**1.5**	**(0.6)**	**0.6**	**1.8**	**1.6**

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

Chart 1
Oil Prices (Brent Crude Oil Index)



Source: Bloomberg

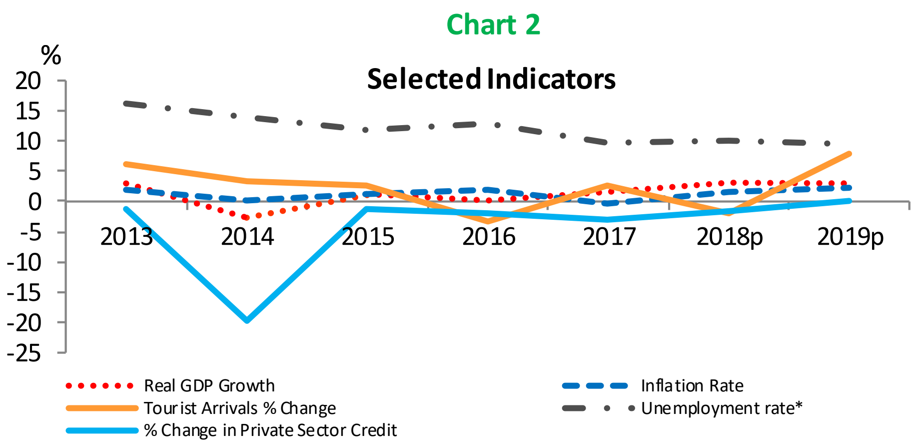
1.2. The Domestic Environment

The mild pace of growth in the domestic economy continued to affect the speed of the reduction in banks' non-performing loans (NPL) portfolio and by extension their desire to provide new lending. These developments continue to influence banks' ability to manage new credit risk, but this is expected to be addressed with the successful implementation of the credit bureau. The significant liquidity overhang in the banking system is projected to reduce gradually over the medium-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 ease the pressure on Central Bank financing to Government. In this regard, the passage of the Government's Debt Management Bill will assist in the management of the existing stock of debt, while ensuring that new issues consider the optimal mix of domestic and external financing sources, in order to minimize costs and encourage financial sector stability.

In terms of the economy's performance during 2019, real GDP grew by 1.2%, albeit a moderation from the 3.0% growth recorded in 2018. The outturn was supported by gains in the tourism sector, despite the passage of Hurricane Dorian in September, which left the Abaco market temporarily offline and Grand Bahama with weather-related loss of hotel capacity. Specifically, tourism sector output grew in 2019, underpinned by growth in the New Providence and the Family Islands markets, that were unaffected by the storm, and a rise in both hotel room capacity and vacation rental sales. In particular, total visitor arrivals increased by 9.5% to 7.2 million, outpacing the previous year's 7.9% strengthening. In the underlying developments, the dominant sea segment rose by 10.3% to 5.6 million, extending the 5.5% gain in 2018. Further, the high value added air segment grew by 6.7% to 1.6 million, although a slowdown from the 16.7% expansion last year.

In the labor market, preliminary data from the Department of Statistics' Labor Force Survey showed that conditions improved in New Providence. In particular, the unemployment rate fell to 10.7% over the 12 months to November 2019, from 11.0% in the previous year. Surveys were not conducted in Grand Bahama and Abaco due to the passage of the storm; however, estimates are that due to the cessation of business operations on the islands and workforce dislocation, the national average would be higher than the 10.7% rate that was recorded in November 2018.

Domestic inflationary pressures remained subdued during 2019. The Retail Price Index (RPI) for The Bahamas rose to 2.5% in 2019, from 2.3% in the previous year, as average cost gains rose for the majority of the items in the index, amid elevated global oil prices.

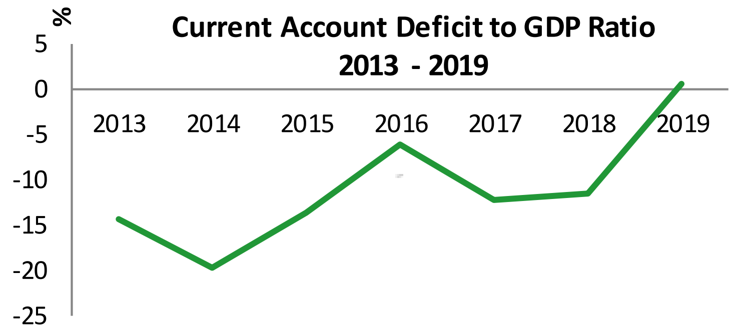


* Six months to May, 2019
Source: Central Bank of the Bahamas, The Department of Statistics

The overall fiscal deficit contracted by $195.6 million (47.2%) to $219.3 million during FY2018/2019 in comparison to FY2017/2018. In the underlying developments, total revenue expanded by $383.9 million (18.8%) to $2,426.3 million, supported by value added tax (VAT) proceeds, while aggregate expenditure rose by $188.3 million (7.7%) to $2,645.6 million. Over the calendar year, the deficit narrowed by $96.4 million (28.6%) to $241.0 million, as total revenue increased by $340.7 million (15.7%), outstripping the $244.3 million (9.7%) growth in aggregate spending.

In the external sector, the estimated current account position reversed to a surplus of $525.6 million in 2019, from a deficit of $1,115.3 million in 2018, owing primarily to a surge in current account transfers related to re-insurance inflows following the passage of Hurricane Dorian, combined with a decrease in the merchandise trade deficit. In contrast, the capital and financial account surplus reduced by $378.2 million (62.1%) to $230.9 million, reflective of a decrease in private sector loan based financing inflows and net direct investment receipts.

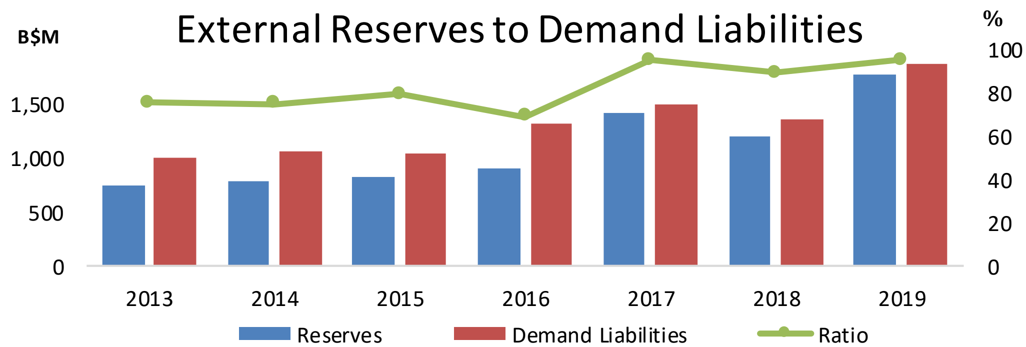
Chart 3
Current Account Deficit to GDP Ratio 2013 - 2019



Source: Central Bank of The Bahamas

Domestic monetary trends featured a buildup of liquidity in 2019, as the expansion in the deposit base outstripped the growth in domestic credit. Similarly, external reserves grew largely attributed to net foreign currency inflows from re-insurance claims and real sector activities. Bank's credit quality indicators improved in 2019, on account of ongoing debt restructuring activities, loan write-offs and hurricane relief measures. Further, the weighted average interest rate spread narrowed during the year, as the decline in the average loan rate, contrasted with the rise in the corresponding deposit rate.

Chart 4
External Reserves to Demand Liabilities



Source: Central Bank of The Bahamas

At end-2019 external reserves stood at $1.8 billion and was equivalent to an estimated 37.9 weeks of total merchandise imports, exceeding the 22.3 weeks at end-2018. The useable reserves, or balances remaining after statutory provisions for 50 percent of the Central Bank's demand labilities, amounted to $837.5 million, notably higher than the $522.4 million recorded in the previous year. Further, the Central Bank's balance sheet continued to improve, evident by the ratio of end-of year external reserves to demand liabilities strengthening to an estimated at 0.95 compared to 0.89 in 2018 and a low of 0.68 in 2016. The outcome was owing in part to the divestiture from Central Bank holdings of Government debt that will persist over the medium-term. Since 2016, end of year holdings of debt (securities plus advances) decreased by 37.1% ($271.5 million) to $460.4 million from last year's levels. Subsequently, over the first quarter of 2020, the advances portion of these holdings declined structurally by $59.7 million, which was $9.1 million more than the comparative period in 2019.

TABLE 3

The Bahamas: Macroeconomic Indicators

	2013	2014	2015	2016	2017	2018	2019
B$/US$: Exchange Rate	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Nominal GDP Growth Rate (%)	(1.4)	5.1	5.4	1.9	4.7	4.3	4.3
Real GDP Growth Rate (%)	(2.7)	1.1	0.2	1.4	3.1	3.0	1.2
Inflation Rate (Average chg in RPI)	0.2	1.3	1.9	(0.3)	1.5	2.3	2.5
Unemployment Rate (May)	16.2	13.8	12.0	12.7	9.9	10.0	9.5
Overall Fiscal Balance (B$M)	(485.3)	(531.1)	(252.0)	(467.1)	(622.5)	(337.4)	(238.9)
% of GDP	(4.6)	(4.8)	(2.2)	(3.9)	(5.0)	(2.6)	(1.8)
Private Sector Credit (B$000)	6,551.1	6,366.9	6,299.7	6,170.8	5,982.9	5,886.2	5,891.6
Weighted Average Lending Rate (%)	11.1	11.8	12.3	12.5	11.8	11.3	10.5
Weighted Average Deposit Rate (%)	1.7	1.4	1.4	1.2	1.0	0.8	0.6
Treasury Bill Rate (%)	0.7	0.7	0.9	2.0	1.9	1.7	1.8
Gross Int'l Reserves (B$M)	741.6	787.7	811.9	904.0	1,417.4	1,196.3	1,758.1
Import Cover Ratio (Tot. Merch. (CIF) in week	11.4	11.4	13.3	16.5	21.9	17.4	28.7
Current Balance (B$M)	(1,516.2)	(2,192.6)	(1,610.2)	(710.8)	(1,509.1)	(1,487.7)	83.7
as % of GDP	(14.3)	(19.7)	(13.7)	(6.0)	(12.1)	(11.4)	0.6
Total Public Sector Debt (B$M)	6,346.9	7,101.8	7,460.0	7,898.8	8,832.0	9,247.8	9,424.9
of which: External	1,616.1	2,100.5	2,175.8	2,373.0	3,233.9	3,171.8	3,123.1
Internal	4,730.7	5,001.3	5,284.2	5,525.9	5,598.1	6,076.0	6,301.9
Total Arrivals ('000s)	6,150.8	6,320.2	6,112.1	6,265.0	6,135.8	6,622.0	7,243.5
Tourist Expenditure (B$M)**	2,287.5	2,314.4	2,537.5	2,725.9	2,930.2	3,727.6	4,125.5
Construction Number of Permits Issued	1,462.0	1,418.0	1,299.0	1,136.0	1,269.0	1,503.0	1,399.0
Value of Starts (B$M)	140.2	129.2	119.8	96.2	155.5	118.2	96.6
Value of Completion's (B$M)	216.6	250.5	228.9	193.2	1,493.6	333.8	195.1
Average Oil Prices (Brent Crude Oil Index)	109.1	98.5	52.6	45.8	55.0	72.4	64.7

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

CHAPTER 2: FINANCIAL SYSTEM OVERVIEW

The Bahamian financial sector, which comprises both domestic and international operations, contributes between 15.0% and 20.0% to the country's GDP. Further, due to imposed exchange control regulations, there exists a distinct separation between the balance sheets of the two sectors. As such, financial stability assessments only focuses on the domestic component. In Appendix 1, the overall structure of the financial sector is discussed, with emphasis on banks, credit unions and the insurance sector. Further, while features of, and developments within, the capital markets do not pose any systemic concerns for financial stability, a brief summary of their performance was conducted.

CHAPTER 3: BANKING SECTOR

The Bahamas' exchange control regime disallows banks from undertaking domestic business activities other than through assets funded with domestic liabilities. Therefore, this averts 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.

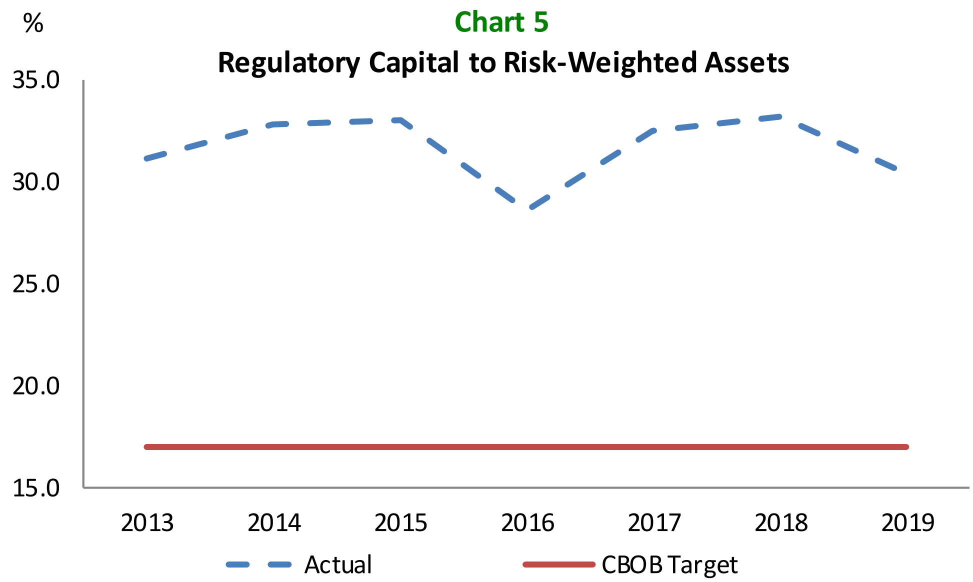
3.1 Asset Trends

Total domestic assets of the banking system rose by 7.4% to $10.7 billion in 2019, a reversal from the 2.4% reduction recorded in the previous year. Loans and advances represented the largest share of these assets (63.3%), followed by securities (18.9%), and claims on the Central Bank (13.1%). Comprising relatively modest shares were "other" miscellaneous assets (4.8%). Of significance, banks' claims on the Central Bank (cash and balances) expanded by 48.2%, following a decline of 18.7% in the prior year. Similarly, banks' holdings of securities grew by 17.0%, after decreasing by 5.3% in 2018, reflecting increases in both the public and private sector components. Further, growth in "other" miscellaneous domestic assets accelerated to 24.1% from 4.3%.

3.2 Capital Adequacy

Domestic banks remained well capitalized during the review year, although the ratio of average capital to risk weighted assets narrowed by 2.8 percentage point to 30.4% at end-December 2019, as the system's aggregate level remained well above the Central Bank's target ratio of 17.0% of risk-weighted assets and the international benchmark of 8.0%.[1]

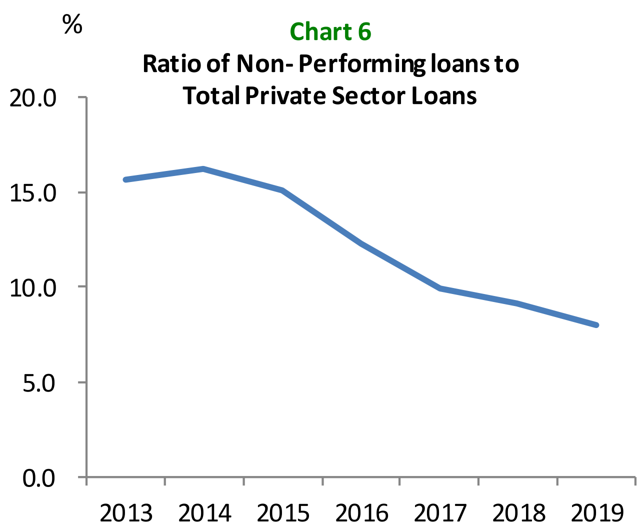
[1] The Central Bank imposes a "trigger" ratio of 14.0%, below which licensees would be required to implement measures to either reduce risk exposures or supplement their capital.



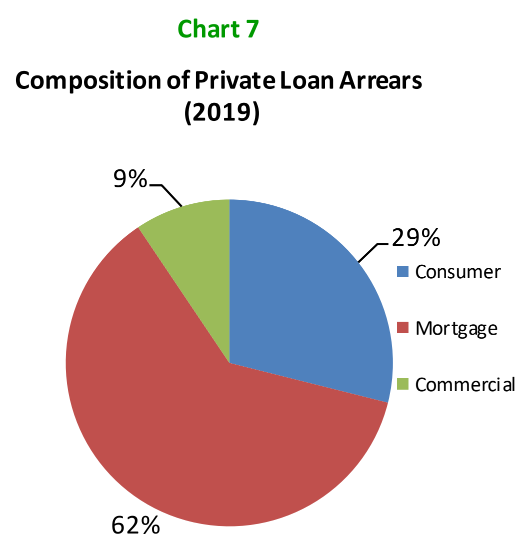
Source: Central Bank of The Bahamas

3.3 Asset Quality

Banks' credit quality indicators improved during the year, buoyed by modest gains in the economy, combined with sustained debt restructuring activities, loan write-offs and hurricane relief measures following the passage of the major storm. Total private sector loan arrears stood at their lowest level since 2008, declining by 15.3% to $686.3 million; accelerating from an 8.5% falloff in 2018. The outturn reflected broad-based improvements across all loan categories. Consequently, the ratio of arrears to total private sector loans moderated by 2.2 percentage points to 12.1%, extending the decrease of 1.2 percentage points a year earlier.



Source: Central Bank of The Bahamas



Source: Central Bank of The Bahamas

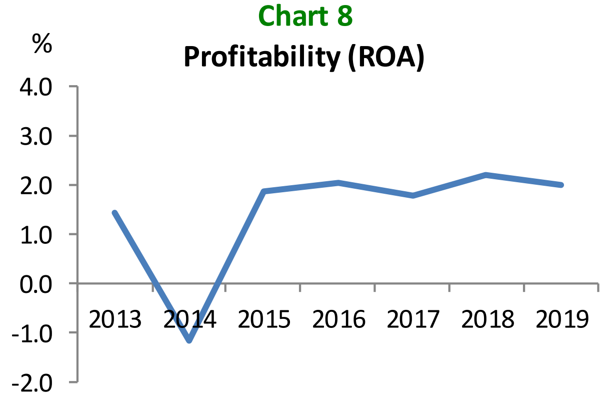
An analysis of delinquencies by average age revealed a 20.7% contraction in short-term arrears (31-90 days), following a 7.7% decline in 2018. Underlying this development were reductions in the commercial, mortgage and consumer components, of 56.3%, 17.5% and 13.7%, respectively. Meanwhile, non-performing loans contracted by 12.2% to $454.0 million, following an 8.9% decrease in 2018. In particular, long-term mortgage and consumer delinquencies reduced by 14.2% and 13.3%, respectively, overshadowing the 5.0% increase in the commercial category. Consequently, the ratios of short-term and long-term arrears to total private sector loans both declined by 1.1 percentage points each, to 4.1% and 8.0%, respectively.

3.4 Profitability

Domestic banks' profitability increased by 9.4% to $255.5 million in 2019, as the growth in income from interest and commission & foreign exchange, as well as profits from "non-core" activities, overshadowed a rise in operational costs. As a result, the ratios of net income to average monthly assets (ROA) and equity (ROE), firmed to 2.4% and 10.7%, respectively, compared to 2.3% and 8.8% in 2018 (see Table 4).

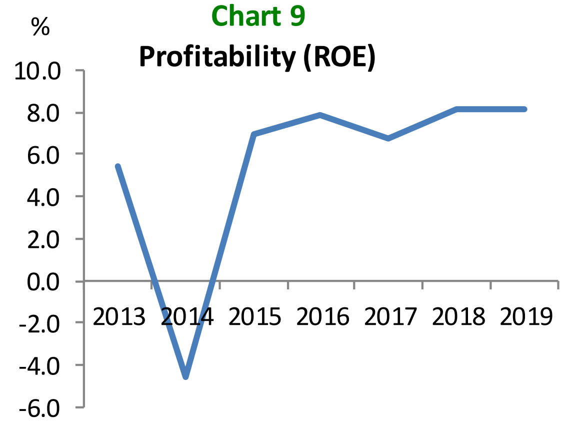
Contributing to the improvement in these ratios, total provisions for bad debt fell by 0.6%, resulting in a decrease of 2 basis points in the associated ratio of average assets to 0.92%. Similarly, depreciation costs tapered by 7.0%, reducing the corresponding ratio by 1 basis point to 0.12% of average assets. In addition, operating costs rose by 7.6%, with the relevant ratio to average assets increasing by 22 basis points, to 3.81%, reflecting broad-based growth in outlays for staff, occupancy and "other" miscellaneous operating costs. The effective interest rate spread decreased marginally by 2 basis points, to 7.08%. Specifically, the ratio of net interest income to average assets strengthened by 12 basis points to 5.23%, supported by a 9.2% contraction in interest expense. In addition, the ratio of commission and foreign exchange income to average assets moved higher by 8 basis points to 0.37%.

Chart 8
Profitability (ROA)



Source: Central Bank of The Bahamas

Chart 9
Profitability (ROE)



Source: Central Bank of The Bahamas

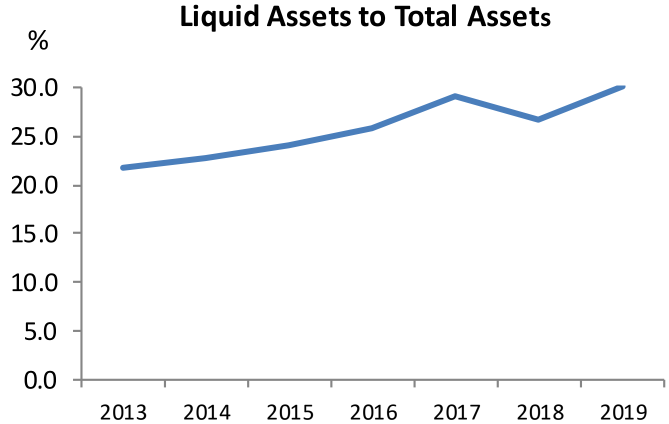
3.5 Liquidity

Bank liquidity levels rose and remained elevated in 2019, largely attributed to a sharp rise in banks' balances with the Central Bank. As a share, of total assets, holdings of liquid assets grew by 3.5 percentage points to

30.1%, contrasting with the 2.4% reduction reported in 2018. Similarly, the ratio of liquid assets to short-term liabilities increased by 3.3 percentage points to 41.6%, after contracting by 4.4 percentage points in the preceding period. As banks' excess supply of available resources expanded, the ratio of deposits to total loans moved higher by 10.6 percentage points to 114.3%, vis-à-vis a decrease of 1.1 percentage points in the prior year. In addition, the ratio of demand deposits to total deposits rose by 4.5 percentage points to 45.2%; accelerating from the 1.8 percentage points increase a year earlier (See Table 4).

Chart 10

Liquid Assets to Total Assets



Source: Central Bank of The Bahamas

TABLE 4

Key Domestic Banks Financial Stability Indicators (%)

	2013	2014	2015	2016	2017	2018	2019
Liquidity Indicators							
Loan to Deposit Ratio	114.0	109.6	108.6	100.9	95.4	96.4	87.5
Deposits to Loan Ratio	87.7	91.2	92.1	99.1	104.8	103.7	114.3
Demand Deposits to Total deposits	28.1	31.7	32.6	37.2	39.0	40.7	45.2
Liquid Assets to Total Assets	21.8	22.7	24.1	25.9	29.0	26.6	30.1
Liquid Assets to Short-Term Liabilities	34.0	34.4	37.0	37.8	42.7	38.3	41.6
Credit Risk Indicators							
NPL to Total Private Sector Loans	15.7	16.2	15.1	12.3	9.9	9.1	8.0
Total Assets Growth rate	1.8	(1.4)	1.8	1.6	2.3	(2.4)	7.4
Loans & Advances Growth rate	0.2	(2.3)	(0.3)	(0.6)	(4.1)	0.9	1.4
Capital Adequacy							
Regulatory capital to risk-weighted assets (avg)	31.1	32.8	33.3	28.6	32.5	32.3	28.6
Trigger Ratio	14.0	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	17.0
Profitability Indicators							
ROAA (annualized)	1.4	(1.2)	1.9	2.0	1.8	2.2	2.0
ROAE (annualized)	5.6	(4.6)	7.0	7.9	6.8	8.2	8.2
Net interest income to average earning assets (annualized)	5.4	5.3	5.4	5.3	5.1	5.1	5.2
Net interest income to gross income	68.8	69.8	70.5	69.4	69.4	68.5	67.4
Non interest expenses to gross income	47.1	66.3	47.4	48.4	52.1	49.7	50.5
Personnel expenses to non interest expenses	50.3	34.8	46.8	44.0	40.8	41.2	39.0
Trading and fee income to total income	3.0	3.0	3.9	3.2	3.8	3.8	4.7
Effective Interest Rate Spread	6.9	6.8	7.1	7.2	7.1	7.1	7.1

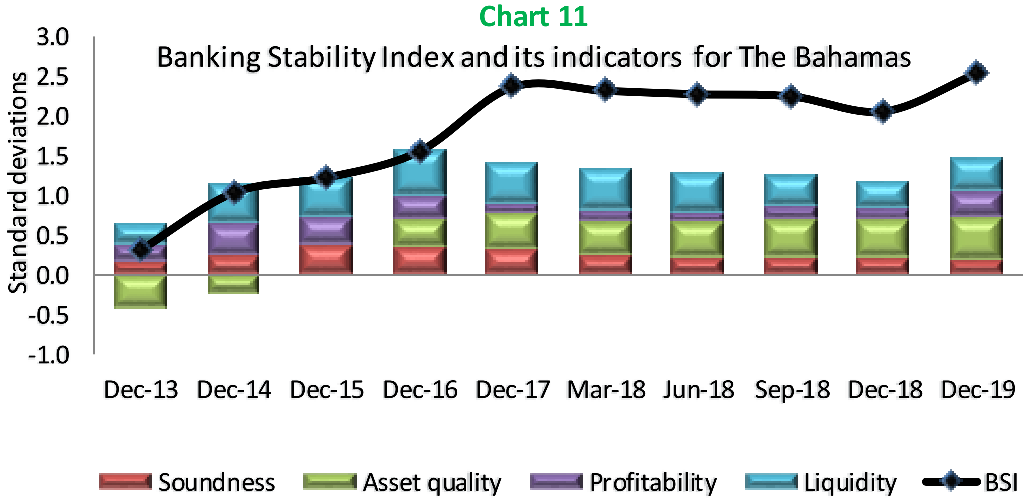
Source: Central Bank of The Bahamas

3.6 An Assessment of the Stability of the Banking Sector

3.6.1 The Banking Stability Index

In 2019, the Banking Stability Index (BSI)—which measures the soundness of deposit taking institutions (DTIs) in The Bahamas—registered its highest level since 2007. Relative to December 2018, the index increased to 1.32 from 1.12. Specifically, the normalized profitability indicator strengthened to 0.33, from 0.20, as return on equity increased slightly. In addition, the normalized asset quality and liquidity indicators both increased, to 0.53 and 0.43, from 0.50 and 0.34, respectively. Providing partial offset, indicators of respective capital adequacy and interest rate edged down to 0.11 and 0.02, relative to 0.19 and 0.03 in 2018. Further, the BSI increased on a standard deviation of 0.5 from December 2018, suggesting that liquidity levels within the sector remained robust, as the share of liquid assets to total assets grew.

Chart 11



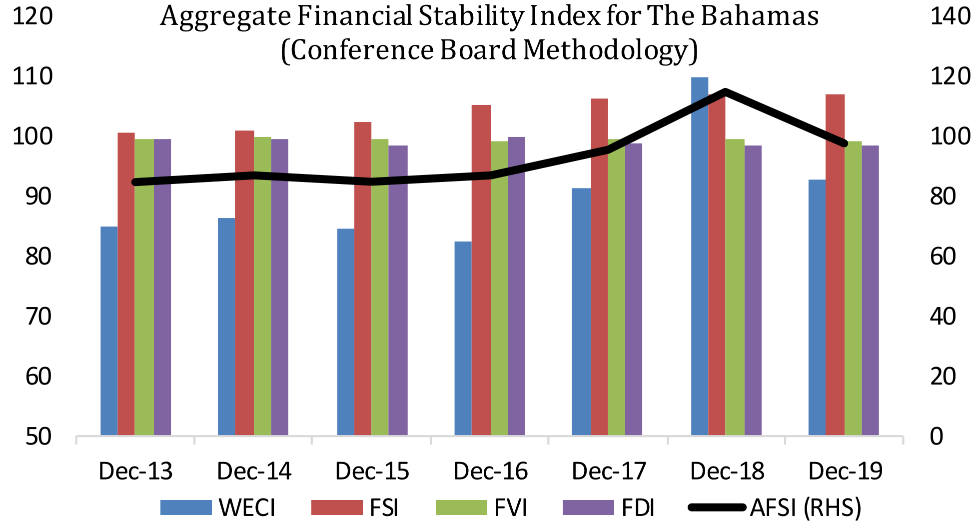
Source: Central Bank of The Bahamas

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. While domestic fiscal indicators and global foreign exchange market volatility influenced some reduction in the AFSI, this was not sufficient to casued heightened concerns about stability.

Chart 12

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



Source: Central Bank of The Bahamas

An analysis of the AFSI showed that the overall index decreased to 98.7 from 107.4 in 2018. A disaggregation of the index components revealed that the world economic climate sub-index narrowed to 85.7, vis-à-vis 119.8 a year earlier, owing partly to increased exchange market volatility. In addition, the financial vulnerability sub-index declined to 98.8 from 99.2, reflecting a sharp expansion in The Bahamas total fiscal balance to GDP ratio. In contrast, the financial soundness index strengthened to 114.2 from 113.9 in 2018, reflecting a notable growth in the ratio of liquid assets to total assets. Meanwhile, the financial development index stabilized at 96.5, as a rise in stock market capitalization outstripped the softening in total credit to GDP. Despite the mixed performance of these indicators, the domestic financial sector remained stable and there were no heightened stability concerns at end 2019.

3.6.3. Stress Testing

Credit stress tests continued to be conducted semi-annually and remained the primary tool to assess the resilience of the banking system. Liquidity and interest rate risks are also monitored on an ongoing basis, with the former being subject to more enhanced monitoring recently, given the elevated levels. The credit risk stress test uses extreme, but plausible, stress scenarios to assess the total loss absorbing capacity of the domestic systemically important banks (or DSIBs), via various levels of shocks to NPLs, with the attendant reduction in banks regulatory capital. Meanwhile, broad observations from consolidated results are provided relative to liquidity and interest rate risk stress tests. Notwithstanding the above, there are no near-to-medium term concerns of risk to financial stability.

Credit Risk Stress Tests

Using data for the year 2019, the stress scenarios were used to assess the level of capital deficiency, if any, for credit risk shocks that remained constant at 100%, 150% and 200% to NPLs for forecasted years 2020 through 2021. The overall impact of which affects the statement of income, through increases (or decreases) in expenses, driven mainly by foregone interest income and provision shortfalls for increases in impaired loans, ultimately impacting on the level of banks' total eligible capital.

The results of consolidated credit risk stress tests conducted, consistently showed that, at all levels of shocks, which surpressed banks' capital levels up to 22.0%, no capital injection was required when assessed against the regulatory trigger ratio of 14.0%. However, the results showed that capital injection was required at the 200% shock level, when assessed against the regulatory target ratio of 17.0%. The post shock results reflected an average capital to risk-weighted assets ratio of 14.4% and 33.4% (see Chart 13). While there is expected to be some expanison in NPLs into 2021, as COVID-19 related loan payments deferrals scheme conclude, banks' capital and provisioning levels are still projectd to be adequate, with losses for banks likely to peak below the magnitues that accrued after the 2008 recession. In particular, as banks have not regained the same levels of direct exposure to the tourism sector.

Banks' earning capacity invariably would be negatively impacted due to increases in loan loss provisioning levels and the loss in interest income, associated with varying levels of shocks to NPLs. Chart 14 illustrates projected net income impacts for 2020 before any shock, at a net gain of around $225.0 million and reductions in net income of $1.0 billion, due to applied shocks. Notwithstanding the consolidated results, the potential impact on individual banks will vary.

Chart 13

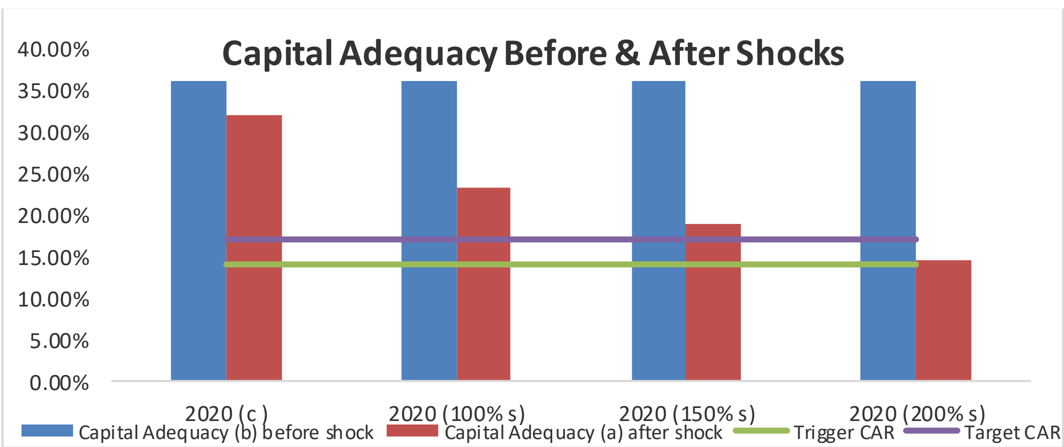
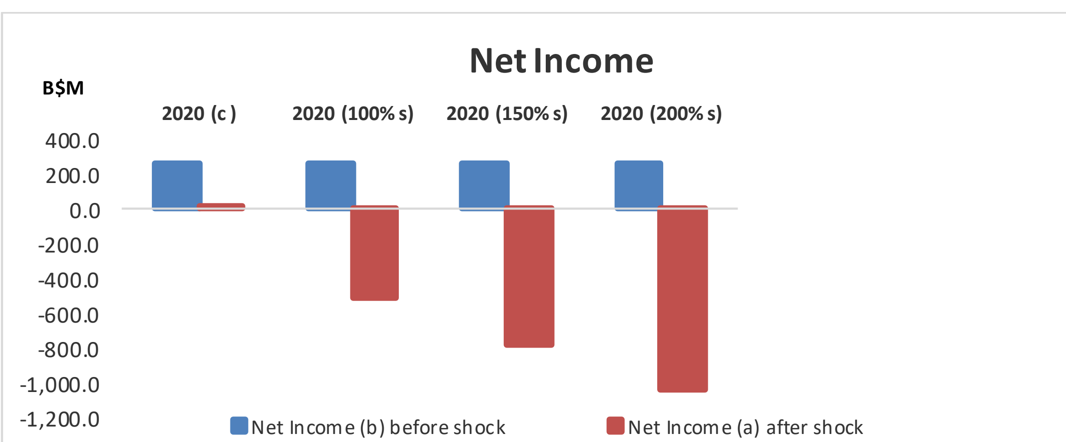


Chart 14



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 out other efficiencies. 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.

Interest and Liquidity Shocks

Stress test results continued to show that commercial banks are less vulnerable 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.

Relative 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 posture to lending, and the limited investment opportunities locally for banks to deploy their excess liquidity.

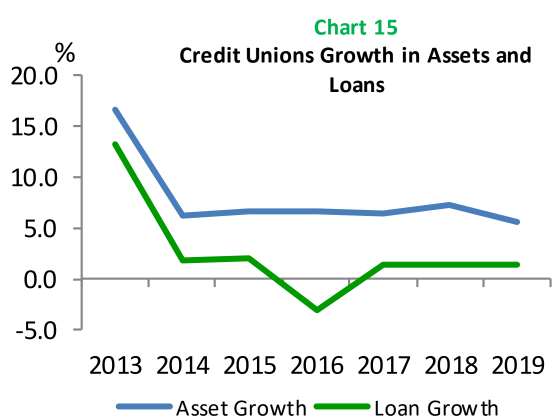
CHAPTER 4: CREDIT UNIONS

Credit unions remained the second largest deposit taking and loan granting institutions, following commercial banks. These entities reported increases in both assets and liabilities, while the sector's capital levels continued to exceed the PEARLS[2] benchmarks; although the prudential buffers remained below those of banks, with scope for further improvements. The Central Bank in its supervision and monitoring of credit unions financial performance has employed a risk-based approach, with heightened focus on anti-money laundering/know your customer (AML/KYC). The narrow excess capital base, however, leaves the sector more vulnerable to the effects of the COVID-19 pandemic. Losses are expected to deplete the sector's capital to a greater extent than for banks. Concerns however, are diminished by the enhanced safety net mechanisms in which these entities are being enrolled, and greater certainty around the access to vaccines for COVID-19 that will enable a strengthened performance for tourism over the course of the second half of 2021 and into 2022.

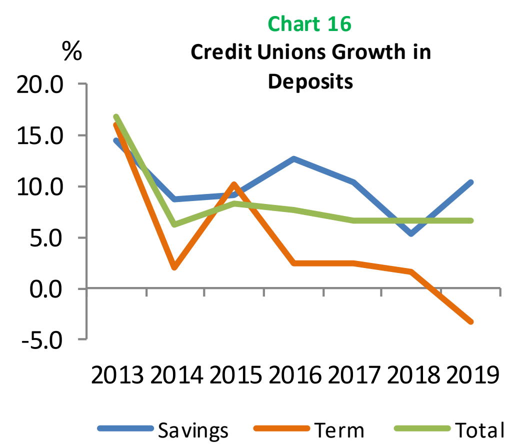
4.1. Assets and Liabilities

Credit unions' total assets expanded by 5.6% ($25.1 million) to $476.0 million at end-December 2019, albeit lower than the prior year's increase of 6.8%. The outturn was largely attributed to an expansion in the league's deposits, by 4.6% to $90.0 million. In addition, loans to members—which represented 49.9% of total assets—grew by 1.3% ($3.1 million) to $237.3 million, following a gain of 1.5% in the previous year. A disaggregation of the loan portfolio revealed that the majority of credit was for consumer purchases (78.8%), followed by mortgages (22.2%) and education (1.9%), with muted increases for revolving lines of credit small-scale (0.8%) and SME development (0.8%).

Total deposits rose by 6.5% ($25.1 million) to $411.3 million, vis-à-vis a 6.2% growth in 2018. The expansion included a 10.3% rise in savings deposits—which accounted for 48.4% of the total—to $230.4 million. In



Source: Central Bank of The Bahamas



Source: Central Bank of The Bahamas

[2] 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.

contrast, term deposits—at 29.3% of the aggregate—declined by 3.2% to $139.6 million, a turnaround from the a 1.6% gain in 2018.

TABLE 5

Selected Financials for Credit Unions (B$M)

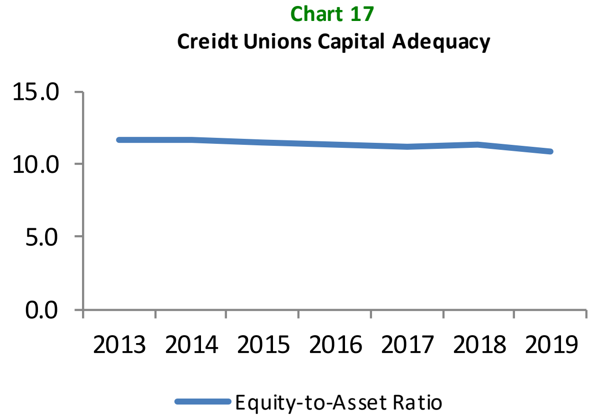
	2013	2014	2015	2016P	2017P	2018	2019
Total Assets	327.6	347.7	370.6	395.5	420.3	450.9	476.0
Total Gross Loans	227.0	230.9	235.3	227.9	230.8	234.2	237.3
Total Deposits	274.7	291.6	315.9	339.9	362.2	386.2	411.3
Liquid Assets	98.6	86.8	101.6	129.7	146.0	172.3	192.4
Savings	134.8	146.4	159.6	179.7	198.4	208.9	230.4
Term Deposits	120.4	122.8	135.3	138.5	142.0	144.3	139.6
Total Members' Equity	38.4	40.7	42.4	45.1	47.4	51.3	52.1
Non-Earning Assets	17.2	25.2	25.0	34.8	33.4	37.1	50.2
Allowance	11.2	11.8	14.1	9.9	7.4	7.5	8.0
Short-Term (ST) Payables	1.2	1.4	1.0	1.1	0.5	0.7	1.0
Capital & Surplus	15.6	20.5	19.0	20.0	17.5	19.7	16.4
Provisions	1.6	1.1	2.3	2.4	3.9	3.5	3.4
Net Income	6.9	2.8	1.3	1.4	1.7	1.8	1.9
Institutional Capital	13.2	14.3	11.9	12.8	9.4	9.4	7.8
# of Credit Unions	7	7	9	10	10	10	10
Financial Ratios (%)							
Equity-to-Asset Ratio	11.7	11.7	11.5	11.4	11.3	11.4	10.9
Return on Assets	2.1	0.8	0.3	0.3	0.4	0.4	0.4
Return on Equity	18.0	7.0	3.0	3.0	3.6	3.5	3.7
Provisions to Loans	0.7	0.5	1.0	1.0	1.7	1.5	1.4
Total Gross Loans to Total Assets	69.3	66.4	63.5	57.6	54.9	51.9	49.9
Liquid Assets to Total Assets	30.1	25.0	27.4	32.8	34.7	38.2	40.4
Non-Earning Assets/Total Assets	5.2	7.2	6.7	8.8	8.0	8.2	10.5
(Liquid Assets-ST Payables)/Total Dep	35.5	29.3	31.9	37.8	40.2	44.4	46.5

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

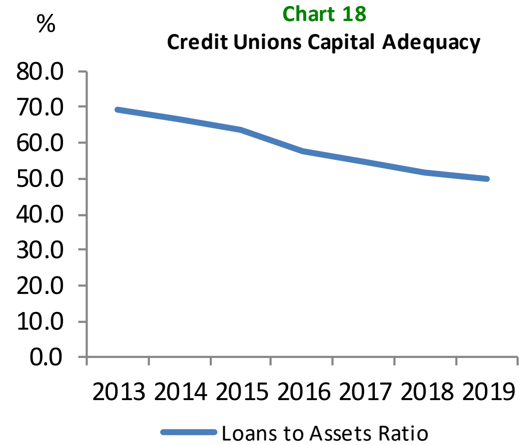
4.2. Capital Adequacy

During the review period, credit unions' capital ratio remained above the 10.0% international PEARLS benchmark. The aggregate capital & surplus resources—held to cover unexpected losses—reduced by 16.6% ($3.3 million) to $16.4 million at end-2019, a reversal from the 11.0% gain in the previous year. Similarly, the corresponding ratio of total equity[3] to total assets (the gearing ratio), narrowed to 10.9% from 11.4% in 2018, as the falloff in the capital stock offset the growth in total assets.

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



Source: Central Bank of The Bahamas



Source: Central Bank of The Bahamas

4.3. Asset Quality

During the review year, credit unions' impaired loans[4] declined marginally by 0.7% ($0.2 million) to an estimated $28.2 million, vis-à-vis a 2.7% reduction in the prior year. However, the ratio of impaired to total loans edged up to 12.3% from 12.1% in 2018. A disaggregation by component revealed that the short-term segment (90 days and under)—which represented 18.6% of the total—expanded by 31.6% to $5.3 million, following a 27.2% growth in the previous year. In addition, estimated NPLs rose by 12.7% to $23.0 million, a turnaround from a 1.9% falloff last year.

Despite the rise in loan delinquencies, the value of collateral against impaired credit fell by 3.9% ($0.6 million) to $14.7 million, a switch from a 4.3% increase in the previous year. However, credit unions' uncollateralized exposures rose by 3.4% ($0.5 million) to $13.5 million. Nevertheless, the sector's total provisions for loan losses declined by 3.4% ($0.1 million) to $3.5 million. As a consequence, the ratio of provisions to total loans narrowed by 10 basis points to 1.4%, while the coverage ratio for short-term arrears remained unchanged at 35.0% and for NPLs, at 100%.

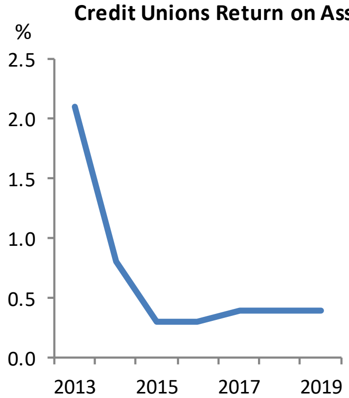
The value of non-earning assets—which includes land, buildings, vehicles, furniture and cash—rose by 35.1% ($13.1 million) to $50.2 million, following a $3.7 million (10.0%) growth in the previous year. Resultantly, the share of these assets firmed by 2.3 percentage points to 10.5%, remaining above the prudential ceiling of 5.0%.

[4] 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.

4.4. Profitability

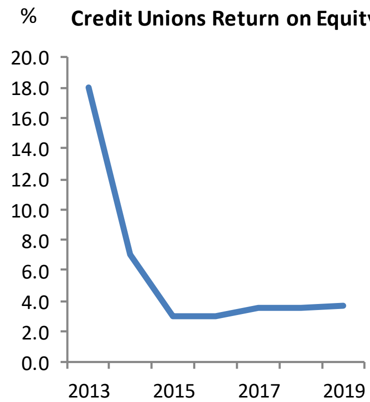
Reflecting an increase in other "miscellaneous" income, the credit unions' overall profits grew by 7.2% ($0.1 million) to an estimated $1.9 million in 2019. As a result, the ROA remained unchanged at 0.4%, while the ROE moved higher by 20 basis points to 3.7%.

Chart 19
Credit Unions Return on Assets



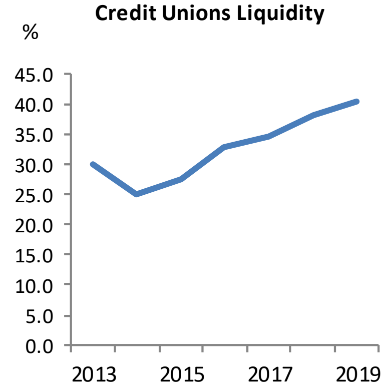
Source: Central Bank of The Bahamas

Chart 20
Credit Unions Return on Equity



Source: Central Bank of The Bahamas

Chart 21
Credit Unions Liquidity



Source: Central Bank of The Bahamas

4.5. Liquidity

During 2019, credit unions liquidity remained at a healthy level, owing in large measure to a 50.0% growth in cash holdings and a 43.0% rise in short-term financial investments. Consequently, the ratio of liquid assets to total assets rose by 2.2 percentage points to 40.4%, year-on-year. Similarly, the alternative indicator—the ratio of liquid assets less short-term payables to total deposits—firmed by 2.1 percentage points to 46.5%. Both ratios were in excess of the minimum prudential standard of 15.0%, signifying that credit unions sustained robust levels of liquidity.

CHAPTER 5: THE INSURANCE SECTOR

The domestic insurance business remains conservative, with its focus on long-term stable investments, such as Government bonds, there have been minimal concerns regarding the sector's stability. Moreover, property insurers acquire international reinsurance to mitigate weather-related financial risk exposures.

Information from the Insurance Commission of The Bahamas (ICB), showed that the number of companies rose by one to 30 at end-2019. The companies consisted of 12 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 represented a combined market share of approximately 93.6% of total gross premiums written and the majority of insurance coverage.

The external insurance sector, which is registered under the External Insurance Act[5], mainly provides self-insurance coverage for non-resident entities in other countries. In 2019, it comprised 39 entities, of which 22 were insurance companies and 17 were captive cells. External insurers' concentration is on overseas operations, as such 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, in this analysis, the domestic insurance sector will be of key focus.

In terms of the domestic insurance sector's key performance indicators, the penetration ratio (total gross premiums to GDP[6]), decreased by 20 basis points to 3.3% over the prior year. Specifically, reflective of a rise in claims associated with the passage of Hurricane Dorian in September, the non-life sector recorded an operating loss, following a profit in 2018. However, the dominant life insurance segment registered a profit, albeit a moderation from the previous year. Nevertheless, on average, the sector remained financially sound, as revealed by the adequacy of its financial stability ratios.

5.1 Life Insurance

Life insurance companies constituted 46.5% of aggregate assets and 54.4% of total gross premiums, remaining the dominant segment of the market. According to provisional data, life insurers' total assets increased by a muted 0.1% ($0.9 million) to $1.4 billion, owing in large measure to gains in receivables, which rose by 39.7% to $112.5 million, while fixed assets grew by $8.3 million (14.6%) to $65.4 million. However, notable declines were registered in cash & deposits—the most liquid asset category—by $14.9 million (8.3%) to $164.3 million, as well as intangibles ($7.7 million), other assets ($5.7 million) and re-insurance recoveries ($3.1 million). In addition, notable decreases were recorded for total investments—representing 73.1% of the total—by $8.1 million (0.8%) to $1.1 billion. An analysis of investments revealed a reduction in corporate equities non-listed (91.3%), corporate securities (54.8%), preference shares (18.8%) and mortgage loans (8.0%). In an offset, other "miscellaneous" investments surged to $33.6 million from $15.3 million in the prior

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

[6] Based on Department of Statistics GDP figures.

year, while mutual funds doubled to $36.8 million from $18.3 million last year. Moreover, corporate equities listed advanced by $5.4 million (19.6%), while Government securities grew by 1.3% to $590.6 million.

In terms of funding, total liabilities moved higher by 0.8% ($7.7 million) to $1.0 billion, due to a sharp increase in other liabilities to $313.1 million in 2019 from $123.1 million in 2018. On the other hand, technical reserves—which finance policyholders' claims and future benefits—fell by 20.6% to $704.3 million. In addition, aggregate equity levels reduced by 1.6% to $428.6 million, attributed mainly to a 49.6% contraction in shareholders' investments to $51.8 million. In contrast, retained earnings and other "miscellaneous" reserves grew by 15.5% and 7.5%, to $278.3 million and $98.4 million, respectively.

In terms of earnings, the net income of domestic insurers decreased by 7.0% to $29.7 million. Underpinning this development was a 9.5% rise in total expenses to $457.5 million, which outstripped the 8.4% increase in aggregate income to $487.2 million. As a result, the expense ratio firmed by 3.7 percentage points to 34.1%, while the investment yield ratio rose by 2.9 percentage points to 8.1%, as investment income strengthened. However, the respective return on equity (ROE) and return on assets (ROA) ratios narrowed by 40 and 10 basis points, to 6.9% and 2.1%, respectively.

During 2019, 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 real estate plus unquoted equities and receivables to total assets ratio, moved higher by 70 basis points to 16.1%, while the value of equities as a proportion of total assets—which are considered relatively higher risk—declined by 1.4 percentage points to 3.9%. Conversely, the real estate-to-total assets ratio rose by 20 basis points to 6.1%. With regard to capital ratios, the net premium-to-capital ratio firmed by 3.3 percentage points to 93.8%, while the capital-to-technical reserves ratio increased by 11.8 percentage points to 60.9%. However, the capital-to-total assets ratio narrowed by 50 basis points to 29.6% (see Table 6), albeit remaining above the international benchmark of 7.0%-10.0%.

Table 6

Life Insurance: Financial Soundness Indicators (%)

	2013	2014	2015	2016	2017	2018	2019p
Capital Adequacy							
Capital/Total Assets	29.1	29.8	29.5	29.3	30.0	30.1	29.6
Capital/Technical Reserves	46.5	48.3	48.9	48.0	49.1	49.1	60.9
Net Premium/Capital	106.7	104.5	104.2	99.5	88.7	90.5	93.8
Asset Quality							
(Real Estate + unquoted equities + receivables)/Total Assets	14.2	14.4	14.8	17.4	14.8	15.4	16.1
Equities/Total Assets	6.5	6.4	6.3	6.0	5.8	5.3	3.9
Real Estates/Total Assets	7.6	7.2	6.8	6.5	5.7	5.9	6.1
Earnings & Profitability							
Expense Ratio (expense/net premium)	30.0	29.3	29.6	29.5	28.5	30.4	34.1
Investment Yield (investment income/investment assets)	6.1	6.4	6.3	5.6	5.2	5.2	8.1
Return on Equity (ROE)	11.5	12.2	11.6	10.8	9.3	7.3	6.9
Return on Assets (ROA)	3.4	3.6	3.4	3.2	2.8	2.2	2.1

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

p = provisional

5.2. Non-Life Insurance

Underpinned largely by a one-off growth in re-insurance recoveries to $1.1 billion from just $100.0 million in the previous year, non-life insurers' assets more than double to an estimated $1.7 billion in 2019, compared to $610.5 million in 2018. This accumulation reflected provisions for compensation for those policyholders affected by Hurricane Dorian. Further, cash and deposits—which constituted 11.8% of the total—increased considerably by $83.9 million (74.8%) to $196.0 million, following a 6.3% decline in the prior year. In addition, investments grew by $43.2 million (39.3%) to $153.1 million, due to notably gains in other investments, property investments, preference shares and mutual funds, which overshadowed the decline in Government securities and corporate securities.

The sector's total liabilities increased more than three-fold to $1.5 billion from $387.3 million in 2018. This reflected a significant rise in both other liabilities and technical reserves to $925.8 million and $572.2 million, from $65.9 million and $321.3 million, respectively, associated with claims emanating from the hurricane. In this environment, balance sheet equity reduced by 26.8% to $163.3 million, as the falloff in retained earnings (53.4%) and share capital (23.4%), outstripped the 21.5% growth in other reserves.

With similar factor attributing, non-life insurance companies recorded an estimated net loss of $23.2 million in 2019, relative to a net income of $16.6 million in the preceding year. Underlying this outturn, total expenses expanded by 32.5% to $139.2 million, while total income fell by 4.7% to $116.0 million, explained by decreases in net premiums and other income.

Financial soundness indicators for the non-life insurance sector recorded mixed movements during 2019 (see Table 7). As it relates to asset composition, the equities to total assets ratio weakened by 3.8 percentage points to 2.5% in 2019. Further, some of the earnings indicators worsened, with the loss ratio—which measures whether net claims paid-out exceed net premiums collected—increased sharply to 60.1% from 23.2% in the prior year, attributed to Hurricane Dorian. In addition, the ROA and the ROE recorded loss equivalents of 1.4% and 14.2%, in contrast to positive net incomes of 1.6% and 7.5%, respectively, in 2018. The expense ratio also firmed by 0.9 percentage points to 71.9% in the review year, while the investment yield ratio rose by 1.9 percentage points to 3.6%.

Table 7

Non-Life Insurance: Financial Soundness Indicators (%)

	2013	2014	2015	2016	2017	2018p	2019p
Asset Quality							
(Real Estate + unquoted equities + receivables)/Total Assets	51.2	51.2	52.5	72.7	67.5	59.4	78.8
Reinsurance and Technical Reserves							
Risk Retention Ratio (net premiums /total gross premiums)	34.2	33.2	31.8	32.2	30.8	30.2	28.3
Technical Reserves/Net Claims	471.6	720.1	693.6	1110.5	1332.1	1241.3	903.3
Technical Reserves/Net Premiums	166.7	191.1	210.0	618.2	443.3	288.2	542.9
Earnings & Profitability							
Expense Ratio (expense/net premium)	55.7	61.9	62.8	66.3	66.4	71.0	71.9
Loss Ratio (net claims/net premium)	35.4	26.5	30.3	55.7	33.3	23.2	60.1
Investment Yield (investment income/investment assets)	9.8	7.6	7.0	9.6	9.4	1.7	3.6
Investment income/net premium	6.2	6.1	7.0	10.0	9.2	1.6	5.2
Return on Equity (ROE)	12.9	12.9	8.9	-3.8	8.2	7.5	-14.2
Return on Assets (ROA)	5.4	5.3	4.0	-0.8	2.3	2.7	-1.4

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

p= provisional

Reinsurance ratios generally reflect the appropriateness of risk-minimizing policies in relation to negative events. In 2019, the risk retention ratio[7] decreased by 1.9 percentage points to 28.3%. However, the ratio of capital to technical reserves accelerated to 350.3% from 143.9% in 2018, explained by the receipt of proceeds from the 2019 hurricane, which resulted in a notably rise in the ratio. Further, the technical reserves to net premiums ratio surged to 542.9% from 288.2% last year. Overall, the sector maintained adequate reserves to mitigate against the risk of significant negative shocks.

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

CHAPTER 6: ASSESSMENT OF RISKS

Financial stability within The Bahamas remained within manageable limits, with no immediate nor medium-term threat to the stability of the sector.

The International Monetary Fund (IMF) completed an independent, updated assessment of the Bahamian financial stability prospects and framework in January 2019, during its second Financial Sector Assessment Programme (FSAP) mission to The Bahamas. The assessment comprised of a series of reviews of the key segments of the financial sector, mainly systemic risk oversight, financial stability analysis and stress testing, banking supervision, and crisis management and to a lesser extent, the insurance and securities activities. The findings summarized that there were no threats to financial stability in The Bahamas and acknowledged the effective supervisory programme that the Bank has in place, as well as the many strategic initiatives undertaken since the 2012 FSAP Mission, that have helped to strengthen the overall regulatory and supervisory framework for the banking and trust sectors.

Since March 2020, the system has faced substantial operational and financial challenges arising from the COVID-19 pandemic and related restrictions on Bahamian business operations. This later episode has not materially altered the financial stability assessments. The exposed credit risks are estimated to be within manageable limits, either systemically or because of more than adequate loss absorbing buffers of lending institutions. In managing COVID-19 credit exposures, domestic banks and credit unions moved quickly to introduce loan payment deferral schemes to assist borrowers whose debt servicing capacity were adversely impacted. As deferments unwind, the impact on NPLs and capital are expected to become more pronounced, albeit with less negative effects than the accumulated impacts of the Great Recession, which started in 2008. However, banks will rely on higher average excess capital than credit unions. Greater oversight will be required in managing the credit union sector's adjustment; albeit the improving prospects around distribution of COVID-19 vaccines could shorten the duration of stress experienced by these cooperatives.

The near-term outlook is for continued gradual increased in financial sector liquidity as lending institutions maintain very conservative lending policies. The downside risk to the external reserves and riskier credit exposures are located more towards the medium to longer-term horizon, when lending policies are more likely to be relaxed. In the near-term, stress test results indicated that systemic risk of depletion of liquidity is negligible. Over the medium-term, it therefore remains important to sustain the strategy of measured reductions in the Central Bank's holdings of Government securities, through sales in the secondary market, to absorb significant portions of the surplus liquidity. Support for restrained holdings of Government debt has been enhanced, given the passage of the revised Central Bank Act, which places comprehensive limits on the Bank's financing to the Government, as well as the Public Debt Management Bill, which support the prudent management of the public debt[8].

[8] The Public Debt Management Bill, 2020, has been tabled in Parliament and is awaiting enactment.

Progress to operationalize the credit bureau also strengthens outlook for financial stability, as risk management practices around lending should further improve. In December 2019, the Bank issued the first credit bureau license to CRIF Information Services Bahamas Limited. This followed the passage of the Credit Reporting Act in 2018, and issuance of the accompanying regulations in the first quarter of 2019. With the introduction of the credit bureau, The Bahamas is now positioned to strengthen the information quality upon which lending decisions are executed. During 2020, the operator began testing of the reporting infrastructure with banks, with the intention of transitioning to live data during the first half of 2021.

In the meantime in 2020, the Central Bank and the Deposit Insurance Corporation (DIC) began the process of enrolling credit unions into the deposit protection scheme. This aligns with overall strengthening of prudential oversight of these financial cooperatives. In this regard, the Protection of Depositors (Amendment) Act, 2020, which came into force in September 2020, admits credit unions as members of the DIC.

The Central Bank, along with other regulators and domestic stakeholders, remained steadfast with regard to the ongoing strengthening of the National Financial Crisis Management framework. The proposals advanced would serve to 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 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 are part of these proposals. These initiatives, will serve to further enhance and strengthen the supervisory regime in place to ensure the continued stability of the financial sector.

CHAPTER 7: CONCLUSION

The domestic financial system remains stable and sound, in both the current assessment and the outlook. In this context, the Central Bank will continue to pursue policies and reforms aimed at mitigating any potential risks to supervised financial institutions and strengthening of the regulatory environment. Against this backdrop, the Bank will sustain efforts to upgrade the risk-based supervisory framework (Basel III) for banks and trust companies. 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. In addition, improve oversight frameworks for the assessment and suppression of risks related to money laundering, terrorism financing, proliferation and other financial crimes, ensuring internationally compliant systems within supervised financial institutions. Further, the Bank will continue to strengthen the prudential oversight for domestic credit unions, inclusive of transitioning to membership in the deposit insurance scheme.

APPENDICES

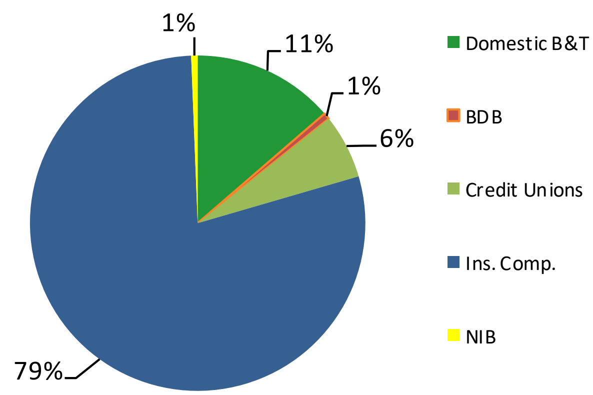
Appendix 1

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, which supervises the 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-19)



Source: Central Bank of The Bahamas

At end-2019, there were 221 banks and trust companies (see: Table 1, Appendix), which employed approximately 4,000 persons, with the largest single concentration in the 22 local domestic banks and trust companies[9] (3,369 persons). Other entities within the sector include 5 money transmission businesses (MTBs), 2 payment service providers, 10 local credit unions, 57 insurance companies, 353 financial & corporate service providers and 57 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 31 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)[10]. The Bahamas International Securities Exchange (BISX) is also an important component of the

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

[10] 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.

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

TABLE 1 Structure of the Financial System							
	2013	**2014**	**2015r**	**2016r**	**2017r**	**2018r**	**2019**
Banks & Trusts							
International	249	237	233	232	225	211	199
Domestic	18	17	16	16	17	20	22
Total	**267**	**254**	**249**	**248**	**242**	**231**	**221**
Non-Bank Financial Institutions							
Investment Funds	735	830	885	859	783	748	725
Credit Unions	7	7	9	10	10	10	10
Insurance companies	140	143	148	142	144	151	160
Domestic Companies & Agents	121	122	116	112	115	118	127
External Insurers	19	21	32	30	29	33	33

r - revised

Source: Central Bank of The Bahamas

Banking sector

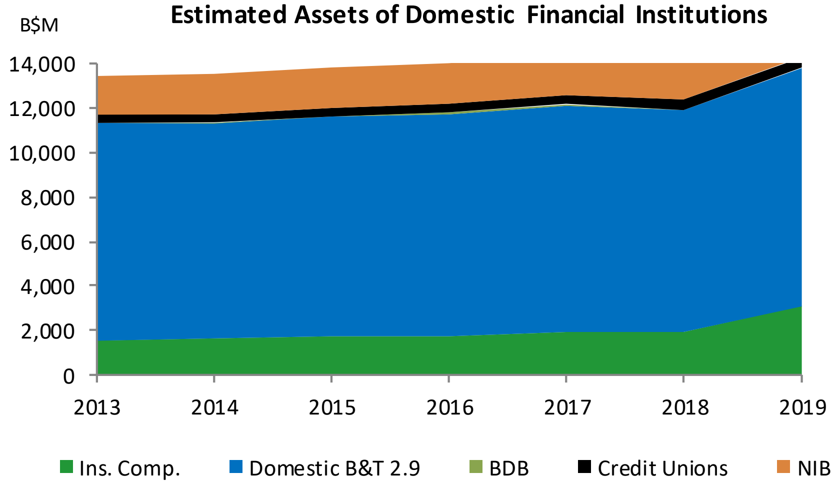
At end-2019, the banking sector's balance sheet approximated $186.3 billion, of which international exposures dominated, accounting for $167.9 billion (90.1%) of the total. Domestic licensees (8 commercial banks and 12 mostly trust entities) held the remaining $18.4 billion (9.9%) of assets—which grew by 7.4% in 2019—divided between domestic ($10.7 billion) and foreign ($7.7 billion) assets. Deposits served as banks' most significant source of funds, while the majority share of domestic assets (53.7%) 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 16.1% and 2.1%. 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 $254.9 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 $3.1 billion and $476.0 million, respectively.

State Owned Enterprises

Major state-owned enterprises in the financial system include: the National Insurance Board (NIB or The Board), the Bahamas Mortgage Corporation (BMC) and the Bahamas Development Bank (BDB). While NIB is considered systemically important for financial institutions' liquidity management practices—given its sizable deposit holdings—there were no financial stability concerns pertaining to the Board's operations over the course of the year. Due to the effects of the 2020 Covid-19 pandemic however, the resultant surge in claims on The Board has led to a drawdown in liquidity, which could have implications for financial stability over the next few years. Notwithstanding, 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. BDB—which provides financing for small and medium-sized enterprises—recorded a 30.3% reduction in its assets base, to $35.0 million in 2019, largely reflecting a tightening of its balance of outstanding credit. At BMC, mortgages outstanding remained at an estimated $167.2 million for the year.

Chart 2
Estimated Assets of Domestic Financial Institutions



Source: Central Bank of The Bahamas

Credit Unions

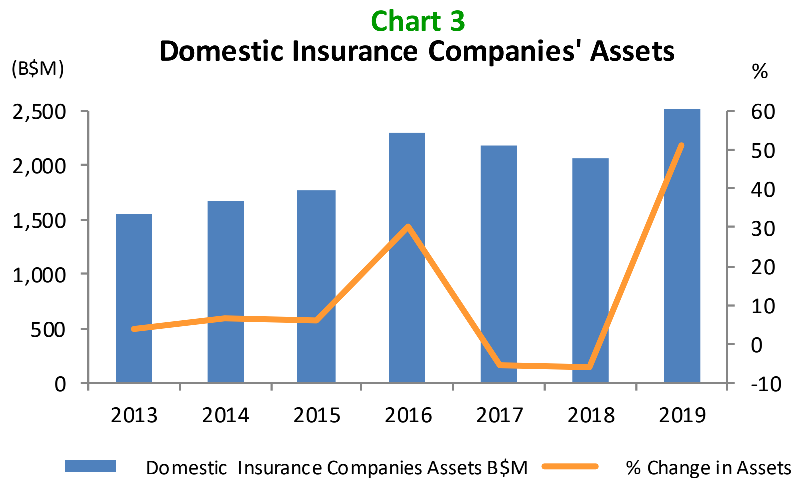
After commercial banks, credit unions are the only other deposit taking and loan granting institutions. At the end of 2019, the total membership of these cooperatives stood at an estimated 44,109 persons or 25.8% of the workforce. At end-2019, the number of active credit unions—inclusive of the Co-operative League—remained at 10. The market continued to be dominated by one institution, which represented approximately 46.4% of the sector's total asset, while the remaining 9 entities accounted for smaller market shares ranging from 0.3% to 15.1% of the aggregate.

Insurance Companies

Information from the Insurance Commission of The Bahamas (ICB), showed that operations consisted of 12 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 93.6% of total gross premiums written and the majority of insurance coverage as at December, 2019. The external insurance sector, which is registered under the External Insurance Act[11],

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

mainly provides self-insurance coverage for non-resident entities in other countries. In 2019, it comprised 39 entities, of which 24 were insurance companies and 17 were captive cells.

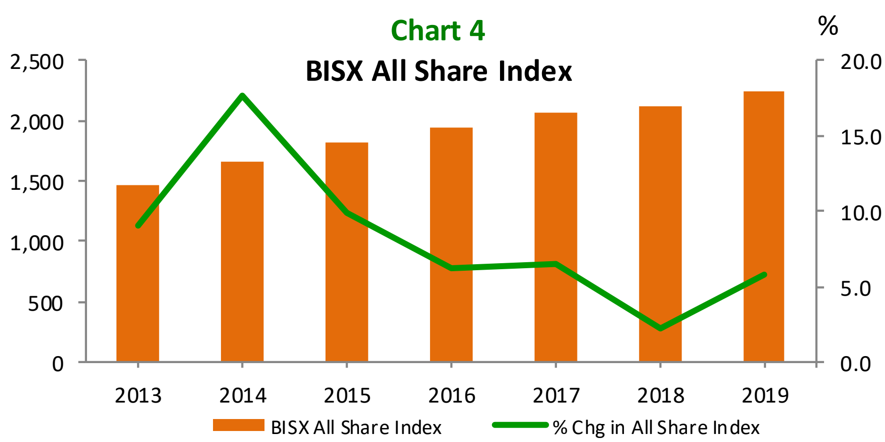


Source: Insurance Commision of The Bahamas

Capital Markets

The domestic capital market forms a small, but important part of the financial landscape of the country, representing mainly locally listed companies on The Bahamas International Securities Exchange (BISX), with Government's domestic bonds commenced listing in 2020. Currently, there are no financial stability concerns associated with the domestic capital market.

During the year, the performance of indicators for the local equity market were positive, reflecting the improvement in economic conditions. The BISX All-Share Price Index grew by 5.8% to 2,231.6 points, extending the 2.2% increase in the previous year (see Chart 4). In 2019, the volume of share traded on BISX rose by 3.9% to 8.9 million, following a 66.1% growth in 2018. Further, the corresponding value increased by 2.2% to $42.7 million, vis-à-vis a decline of 6.2% in the prior year.

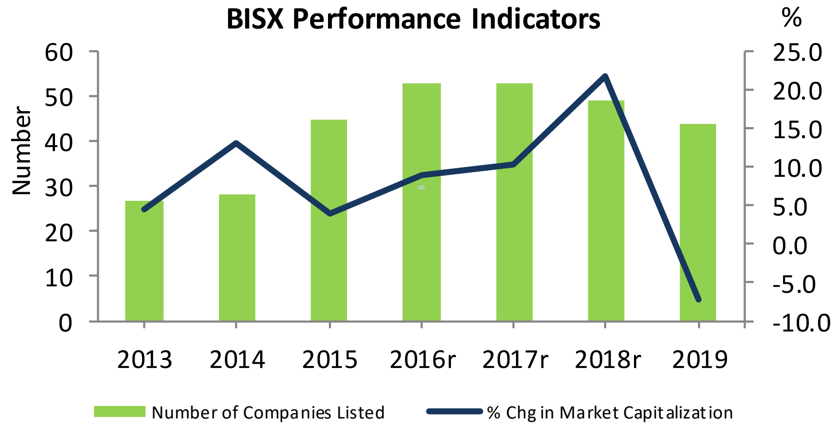


Source: Central Bank of The Bahamas

In 2019, BISX market capitalization firmed by 4.4% to $5.0 billion, exceeding the 1.0% uptick in the preceding year (see Chart 5). The number of securities listed on the Exchange declined by 13 to 38, and consisted 19 common shares, 7 preference shares and 12 debt tranches. The five largest companies listed on the Exchange accounted for a dominant 78.9% the index total market capitalization, lower than 80.7% in the previous year.

Chart 5

BISX Performance Indicators



Source: Central Bank of The Bahamas & BISX

Payments System

Regarding 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. During 2019, the total value of transactions processed through the RTGS rose by 7.2% to $32.0 billion. Similarly, retail payments processed through the Bahamas Automated Clearing House (BACH) increased by 8.2% to $3.7 billion.

In terms of other electronic-based payment instruments, the value of debit card transactions grew by 13.7% to $1.9 billion, while those performed using credit cards, increased by 9.6% to $273.0 million. Following a similar trajectory, the value of ATM transactions also expanded by 9.2%. The upward trend observed indicated that the prevalence in customers utilizing electronic payments for various purchase types, was rising. Expectations are that these trends will continue to be observed in the domestic payments environment in the near future, through electronic payments and increased debit/credit card usage.

Appendix 2

The Banking Stability Index

The Banking Stability Index (BSI) is an aggregate indicator of the soundness of the Deposit-Taking Institution sector. 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 range of values are 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) was calculated using four indicators (sub-indices): world climate index, financial development index, financial vulnerability index and financial soundness index. The methodology consists of weighted averages used across the subindices, 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.

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The Financial Stability Report is a publication of The Central Bank of The Bahamas, prepared by The Research Department for issue in June. All correspondence pertaining to the Report should be addressed to:

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