Financial Stability and the Importance of the Financial Services Sector

Remarks By
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Introduction

It is always a pleasure to bring remarks on the state of affairs in the financial services industry from the perspective of the regulator. I would like to recognise all of our industry stakeholders participating in this strategy summit, the Minister and other senior representatives from the Ministry of Financial Services, and representatives from the Bahamas Financial Services Board.

Today my remarks are on the subject of financial stability and the importance of the financial services sector. Each of these themes can be dealt with separately. However, I will connect both by underscoring the importance of the second element of stability in how we should view international financial services exports. Stability, however, in the mainstream is systemically important for the operations of the domestic sector. I will take up this topic before speaking to the overall importance of the financial sector.

What are the main takeaways?

As far as domestic financial stability is concerned, the current risk is heightened because of the necessary adjustments that arise from the COVID-19 pandemic. However, the sector remains on a firm footing. Our supervisory and regulatory focus continues to be to strengthen our capacity to effectively manage stability risks. As a regard, the economic importance of financial services has been a significant source of stability amid the pandemic. Now, policies and strategic interventions must converge to bolster the medium and longer-term growth potential of international services. We must create space for private innovations to thrive within operations that measure up to robust global standards for financial integrity and tax transparency. Today, the international sector is still adjusting to powerful headwinds, with continued incremental losses in employment and economic benefits.

Financial Stability

At the micro-level level, financial stability policies are designed to avoid economic and financial losses that cannot be covered from the capital or retained earnings that institutions maintain; and ensure that institutions have comfortable surpluses to absorb unexpected losses from the risks they assume. Polices are also crafted to sustain public confidence in supervised institutions and to discourage destructive panic flights to safety. From a regulatory perspective, stability assessments help to ensure that costly disruptions are prevented or minimised. These would be outcomes that undermine savings and investments; generate losses of economic output; disrupt payments and commerce; impose losses on depositors, or impose losses on the taxpayers from government interventions to resolve crises.

For The Bahamas, these are matters of domestic financial stability. Disruptions in the international sector do not transmit to the local economy in such a fashion because of the Exchange Control barrier.

The next term to consider is whether in moving from the disruption at the sector or institution level, stability becomes systemically important. This reduces to a question of whether we can tolerate the economic and other costs of allowing any crisis to resolve itself. Being of systemic importance means it would not be in the interest of either the sector or the economy to let a crisis resolve itself. In the Bahamian case, losses that would occur would start with depositors or incur to commerce.

In this context, local banking sector crises would pose the greatest systemic risks, particularly given the speed at which such events could unfold. For the number of losses that could be generated, the securities and insurance sectors are also of systemic importance to The Bahamas; but the crisis management response would look less urgent than would be the immediate case for a disrupted bank. These sectors are yet not as complex or integrated in real-time with the banking sector; although over time, more financial stability attention has to be given to them, ahead of the complexities which could develop.

Financial stability also matters for credit unions, but the issues which need sharp focus concern the confidence that must be maintained in the cooperative sector. The economy, deposit insurance and even the taxpayers could absorb instability losses without such impacts being systemic.

Let me also highlight that safety and soundness issues apply to all regulated financial institutions, even in the international sector. Ongoing surveillance and regulatory reporting allow the Central Bank to intervene when necessary to uphold orderly resolution of challenges. All banks are exposed to stress testing to gauge confidence in whether their balance sheets are strong enough to absorb negative calls on their liquidity or capital.

In our lending institutions funded by deposits, important emphasis is placed on governance and risk management practices around lending. As such, the emphasis is on ensuring that lenders make informed and sound judgements about the creditworthiness of borrowers; and that they manage within prudentially sound ranges the amount that is lent. Also, the standards dictate that collateral valuations, especially for mortgages, be reliably estimated; and that lenders provision for credit losses based on the levels of non-performing loans which they encounter. The capital adequacy assessments done for lenders, essentially weigh whether the institutions can absorb simulated losses on a risk-adjusted basis, without exhausting their surpluses.

Some Domestic Stability Highlight

In the Bahamian domestic banking sector, where all of the operations are considered systemically important, institutions have maintained significant excess capital. These are more than adequate to even to absorb potential loan losses that the pandemic could produce. In addition, the Central Bank maintains that the medium-term posture should be one of encouraging banks to reduce their capital levels. This is so that pressures are not exerted to take on risker lending to generate returns on the surpluses.

In the meantime, domestic banks have already considerably positioned themselves for losses out of the pandemic. Approximately $145 million of such expected losses were charged to profits in 2020. This reversed trends of gradually reducing provisioning levels since 2015. In addition, as a fraction of the NPLs, the provisioning coverage levels gradually increased to more than 100 per cent in 2020, from a low of 40% of the NPLs a decade ago. This adds confidence to our assessment of the level of preparedness that institutions have already made for losses.

Two other risks which are worth highlighting for deposit-taking institutions are liquidity risks, arising from the ability to accommodate sudden, large withdrawal of deposits without hardship or distress; and market risk sensitivity arising out of changes in interest rates that could threaten income and asset valuation losses. Neither of these is acute for the Central Bank supervised sector.
In fact, simulated shifts in the prime interest rate do not cause either immediate or significant changes in income or the asset values of domestic banks.

Further, the domestic banks remain highly liquid, being able on average to withstand simulated large deposit withdrawals without difficulties. Indeed, the Central Bank also has a medium-term objective of extracting liquidity from the system. The risks are more amplified that in the medium-term, such liquidity could generate faster credit expansion than would be desirable for financial stability.

Beyond these extracts, the Central Bank also tracks a banking stability index that amalgamates various individual financial stability indicators. It is projected that this indicator softened in 2020 and possibly in 2021 because of the pandemic. Nevertheless, the starting levels of capital and liquidity give confidence to the overall shock absorption capacity of the system.

Setting Policy Priorities

At the policy and regulatory level, the current emphasis is on strengthening the Bahamian financial stability mechanisms. This is entrenched in the strategic work plan of the Central Bank, and is intended to exploit the legislative progress achieved in 2020 to bolster the crisis management and deposit safety net systems.[1] In the case of deposit insurance, in 2020 protection was extended to all credit unions. Also, the Deposit Insurance Corporation was given a stronger mandate to build up the adequacy of its funding, relative to the insurable base

[1] The Bahamas has addressed the expediency of intervention in times of crisis by empowering the Central Bank to take an administrative approach to bank resolution that would bypass the courts; but confer avenues for judicial appeal where such resolutions are assessed to have made shareholders of banks worse off than other feasible approaches to resolution. The law now also requires that banks each prepare their own resolution plans. In this regard, the Central Bank is targeting the middle of 2022, as the timeline for the filing of these plans; and will develop regulatory guidance to assist this process.

of deposits. Crisis management also covers prevention, which relies on the supervisory tools that the Central Bank employs; our ability to monitor the system for signs of trouble; and to intervene in coordinated fashion, if necessary, across separately regulated spaces.

Our strategic work aims to build better data sets at either the institution (or micro) and macro levels. For example, our work plan includes the intention to improve the quality of real estate sector indicators that feed into mortgage lending risk assessments. We will also develop more tools that can be used efficiently to influence credit standards and risks taking behaviour across all regulated parts of the financial sector. This highlights the value of coordination on standards at the national levels because intermediation also occurs under the SCB and ICB supervision. Connected with this point, our crisis management framework will prioritise improvements to estimates of the interconnectedness within the domestic sector.

The Central Bank also assesses financial stability conditions in the context of access to international correspondent banking relationships. Operations are not viable if they lack access to international payments settlement. While such risks continue to be manageable for The Bahamas, they join the interests of the domestic and international sectors and underline the value of the international peer assessments of our AML/CFT frameworks.

Our tax transparency assessments have also had a significant influence on outcomes in this environment. In this regard, our continued national efforts bear fruits in easing access. The Central Bank's goal is to contribute to help to reduce the weight of reputational and jurisdiction considerations from among an already complex set of global factors that have motivated the consolidation of the corresponding banking landscape. For this, the continued inroads on AML supervision and constructive engagement with industry and international stakeholders are important.

Exploiting the economic value added from financial Services

Transitioning to the economic contribution of the financial services sector beyond its intermediation role widens the lenses to international services, which alongside the domestic activities provide employment, government revenues and general expenditures in the economy. In particular, during the pandemic, the foreign exchange earnings of the financial services sector have held up compared to the sharp losses within tourism. The very short-term resilience of financial services exports reinforces the importance of increasing the sector's contribution, starting with stabilising what has otherwise been a gradual decline, particularly in international banking activities.

In the domestic sector, efficiency improvements are expected to slow and even reduce employment levels, albeit the comprehensive assessment of the domestic contribution ought to remain based on the net value-added from its financial intermediation role. Intermediation has other benefits attached beyond the employment within the operations. In particular, there are medium-to-long-term returns in how the domestic activities finance growth in the rest of the domestic private sector. Nevertheless, supplies of domestic financial services also easily generate more than two-thirds of the financial services sector's direct contribution, in what is estimated to be a 15 to 20 per cent share of GDP.

The indications are that the international sector's employment and contribution share have fallen gradually, for a least the last half-decade, driven both by efficiency adjustments and a decrease in the banking sector's physical footprint. Other global pressures have also been important in the international sector, such as the re-domiciling of clients and operations to regularise tax their compliance with OECD home country requirements. In addition, The Bahamas has had to absorb the global political fallout from threats of sanctions in the context of EU and OECD initiatives on anti-money laundering and tax transparency. As a result, The Bahamas has experienced steady business declines from European markets that are still occurring faster than the emerging growth opportunities in Latin America. How both of these trends evolve will determine the medium-term outcome for the sector.

To strengthen the export potential of the financial services, our interventions will have to be effective in reducing growth suppression and shrinkage from financial integrity and international tax policy risks. That is, addressing how the Bahamian jurisdiction maintains proactive engagement with multilateral bodies in the standards-setting arena on anti-money laundering and other issues. Indeed, with good reason, fiscal recovery and consolidation are already a global priority in repairing the economic damage from the pandemic. It will shape new international tax policy offensives, such as which characterised the recovery efforts from the 2008 global recession. The experience has shown that tax initiatives do not easily disentangle from financial integrity matters.

Regarding financial integrity, the Central Bank's focus, as with other Bahamian regulators, is to improve the quality of supervision continuously.

In addition, it remains important to provide internationally compliant, enabling frameworks for growth and innovation. The Bahamas starts with the advantage of having a functional, highly skilled infrastructure. It has the human resources capacity to accommodate substance-based operations, with the upside of creating jobs and generating second-round effects in the economy. We can leave innovation to the private sector while fostering the internationally compliant regulatory space in which they do so.

Conclusion

In conclusion, even with the challenges posed by the COVID-19 pandemic, financial stability assessments for The Bahamas, which are more of a concern for domestic intermediation, are not cause for alarm. The banking system is expected to emerge from the pandemic with levels of liquidity and capital that would still require moderation in the medium term.
At the Central Bank, the regulatory focus will remain on strengthening the financial stability mechanisms, developing tools for more effective oversight, improving the range of indicators used to measure interconnectedness, and strengthening the collaborative crisis management arrangements across all financial sector regulators. Although systemic interconnection is absent between the domestic and international financial services, both sectors benefit from safety and soundness oversight. In the meantime, our international financial services exports provide the opportunity for increased economic resilience. Indeed, the relative stability of value-added provided during the pandemic contrasts sharply with the disruption still being experienced in tourism. However, policy interventions are still necessary to stimulate a medium-term recovery of the sector.

This is an area in which the Central Bank will continue to take a progressive posture.

Appendix of Tables and Charts

Table
Bahamas: Selected Financial Sector Indicators

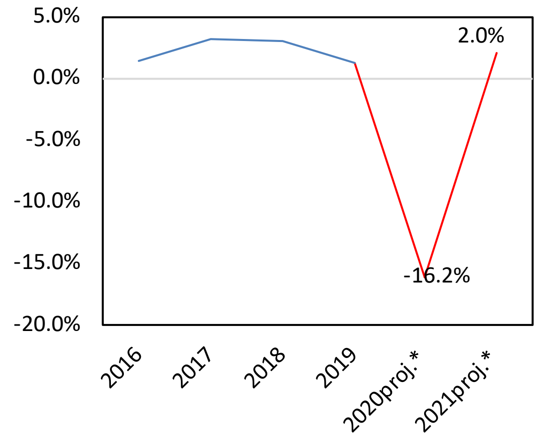
	Unit	2015	2016	2017	2018	2019p	2020p
Banks and Trust Companies							
Number of Institutions	Number	249	248	242	231	221	217
of which: Public Banks and Trust Cos	*Number*	95	97	90	89	85	84
Total Assets	*B$ Billions*	262.0	183.8	187.8	183.8	186.6	173.2
(of which Domestic Banks)	B$ Billions	29.3	18.8	19.4	17.8	18.8	19.6
Employment	*Number*	4,366	4,256	4,129	4,049	4,001	3,843
(of which Domestic Banks)	Number	3,253	3,163	3,133	3,182	3,195	3,124
Average Annual Salaries	*B$*	61,995	65,445	65,784	68,032	67,132	71,351
Total Expenditure	*B$ Millions*	724.2	729.7	710.4	760.2	770.8	779.8
(of which Domestic Banks)	*B$ Millions*	453.2	458.7	464.6	511.0	524.5	545.1
(of which Int'l Banks)	*B$ Millions*	271.0	271.0	245.8	249.2	246.3	234.6
Investment Funds							
Licensed Investment Funds	Number	885	859	783	748	725	713
Licensed Administrators	Number	66	64	62	62	57	48
Net Asset Value	*B$ Billions*	*200.2*	*136.8*	*86.3*	*n/a*	*192.6*	*n/a*
Insurance Companies and Agents							
Companies and Agents	Number	148	142	144	151	160	160
of which: Domestic	*Number*	*116*	*112*	*115*	*118*	*127*	*127*
Total Domestic Assets	*B$ Millions*	1,768.1	2,305.0	2,185.3	2,055.5	3,107.0	2,197.8
Average Annual Salaries*	*B$*	44,250	44,390	44,746	45,331	47,939	*n/a*
External Insurers & Intermediaries	Number	32	30	29	33	33	33
Credit Unions (Active)							
Number of Unions	Number	9	10	10	10	10	10
Total Assets	*B$ Millions*	370.6	395.5	420.8	450.9	476.0	482.3
Employment	*Number*	156	162	165	182	183	190
Average Annual Salaries	*B$*	29,091	37,383	33,352	30,473	31,525	29,816
Total Expenditures	*B$ Millions*	28.63	28.26	29.25	31.04	31.58	29.00

Sources: Central Bank of The Bahamas, the Securities Commission of The Bahamas and the Insurance Commission of The Bahamas.

Note:*2015-2018 data is based on Central Bank estimates and surveys. 2019 based on survey and includes bonus & commissions.

Chart 1
Bahamas: Selected Macro Indicators & the Banking Sector

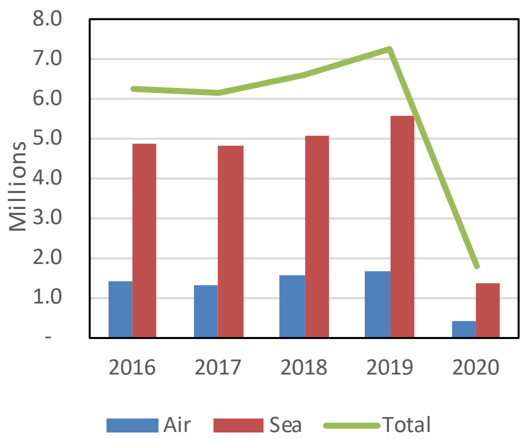
Bahamas: Real GDP Growth



Source: Bahamas Department of Statistics & *IMF projections

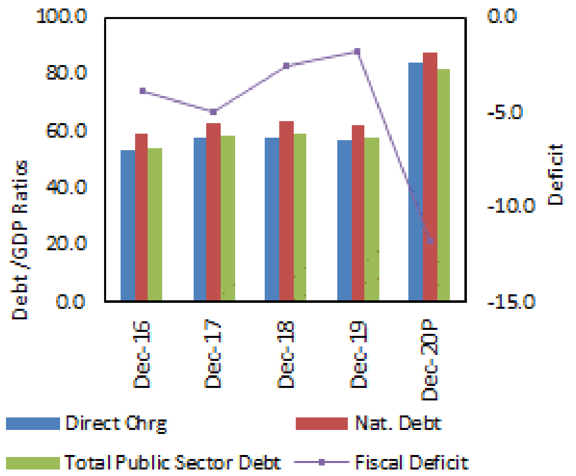
The Bahamas was negatively impacted by the COVID19 pandemic, most through the tourism channels. Public finance indicators also deteriorated. However, contributions from the banking and international financial services activities were more resilient.

Tourists Arrivals



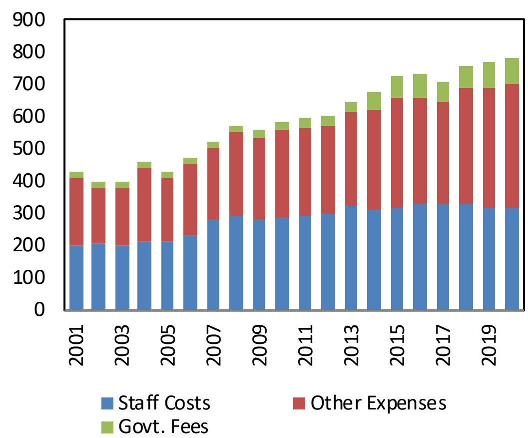
Source: Bahamas Ministry of Tourism

Fiscal Deficit & Debt/GDP Ratios (%)



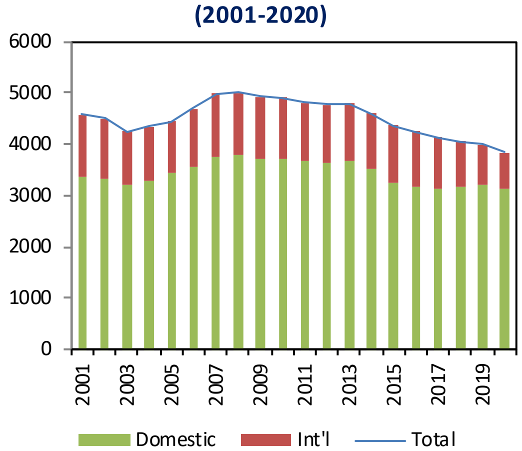
Source: Bahamas Ministry of Finance

Expenditures of the Banking Sector (B$M)



Source: Central Bank of The Bahamas

Employment in the Banking Sector (2001-2020)

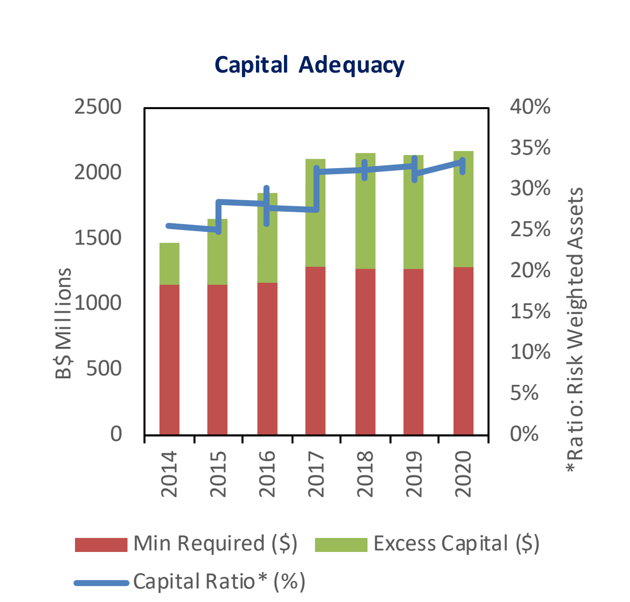


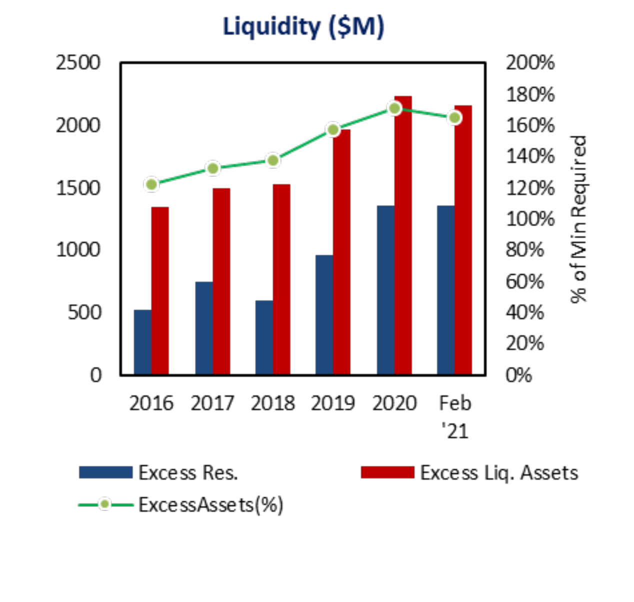
Source: Central Bank of The Bahamas

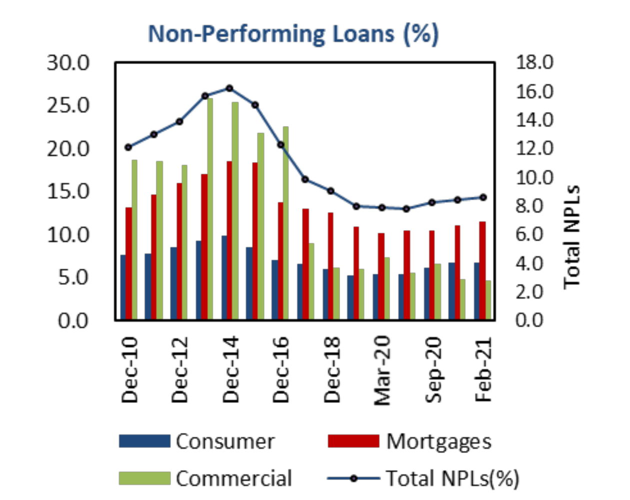
Chart 2 - Domestic Banks: Selected Indicators

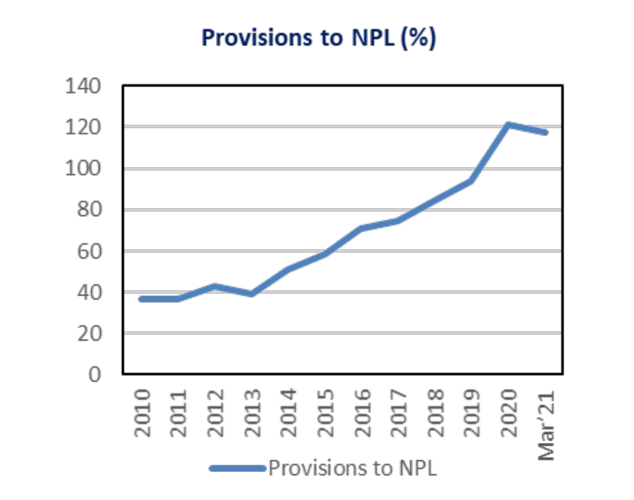
The capital and liquidity position of domestic banks remains resilient, in spite of expected losses from the pandemic. Provisions for losses has already increased, but the response of NPLs is still delayed, likely to be more pronounced over the course of 2021.

Data Sources: Central Bank estimates.









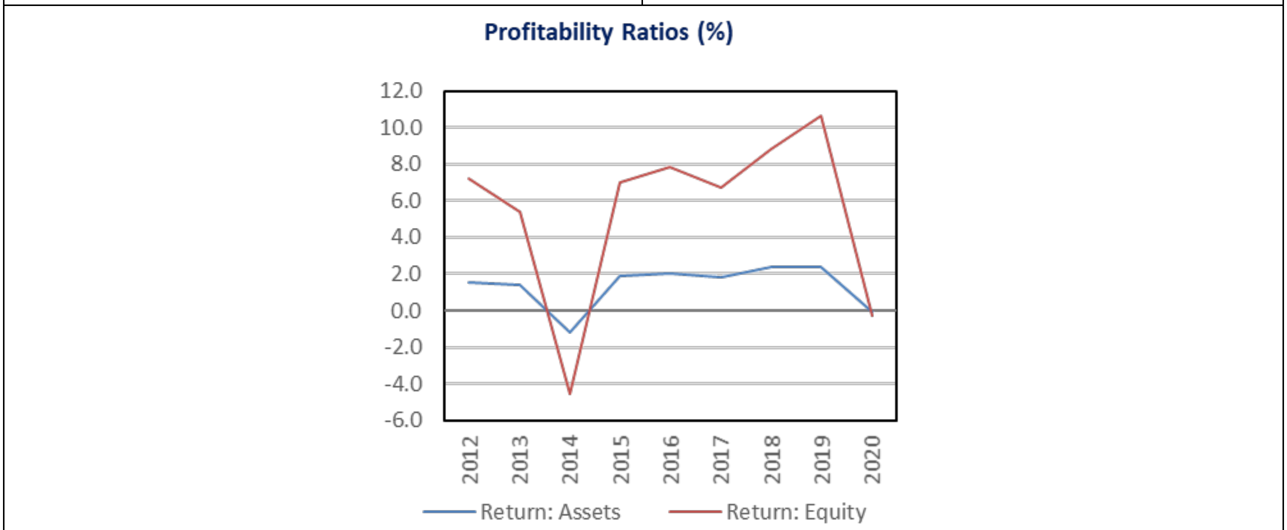


Chart 3 - International Banks" Selected Indicators

Since 2000, the Bahamas international banking sector has reduced in size in response to changes in the global regulatory landscape. In the early period of adjustment, the shift was heavily in terms of loss of operations without physical presence. Subsequently, changes in the tax compliance landscape resulted in a reduction in the size of the aggregate balance sheet, as predominantly business of European origin retreated.

Data Sources: Central Bank of the Bahamas