



Financial Stability Report December, 2016

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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

Risks to financial stability remained contained during 2016, reflecting mainly strong capital levels in the various sectors, a mild overall improvement in asset quality indicators, and an incrementally firming macro-economic outlook.

Despite an improvement in commercial banks' asset quality indicators, the lending posture remained conservative. Stress-testing results, for the simulated possible deterioration in credit, deposit and other exposures meanwhile, continued to underscore healthy levels of capital and liquidity for banks, relative to international benchmarks. As it relates to credit conditions, the Central Bank eased its prudential stance in October 2016, to facilitate increased private sector access to financing for rebuilding activities following Hurricane Matthew. The temporary relaxation of lending guidelines included an increase in the total debt service ratio to 55% from the 40%-45% range, and the elimination of the 15% equity requirement for hurricane rebuilding financing facilities. The Bank signalled a broader easing in lending conditions in December, by reducing its policy rate by 50 basis points to 4.00% towards month-end, while the commercial banks' Prime rate was lowered by the same magnitude in the subsequent month to 4.25%. The improvement in credit quality indicators, meanwhile, reflected a combination of factors including: the sale of several delinquent mortgages, ongoing debt restructuring activity and, to a lesser extent, the Government's new Mortgage Relief Programme (MRP). Domestic banks' profitability also recovered, buoyed by the reduction in bad debt expenses and a rise in fee-based income.

Indicators for non-bank financial service providers also suggested a favourable performance during 2016. Specifically, credit unions noted a modest increase in profitability, supported by a reduction in operating expenses and a slight rise in other "miscellaneous" income. Their financial soundness indicators remained just above prudential standards, albeit signaling scope for increased buffers over the medium-term. Developments within the insurance sector were mixed, as the life insurance segment maintained its profitability and the soundness indicators remained at healthy levels. Conversely, the non-life insurance component was adversely affected by the passage of the hurricane in October, which led to a loss in net income, owing to a sharp rise in overall claims. Inflows from external reinsurance absorbed most of claims related costs.

Economic conditions in 2016, while subdued, still supported a more favourable context for the domestic financial institutions' operations. Following a 1.7% contraction in 2015, initial indications are that output declined marginally in the review period, as weather-related factors affected tourism sector output, while a number of varied-scale foreign investment projects supported construction sector activity. In addition, the hurricane-rebuilding component of construction helped stimulate employment gains. Inflation stayed subdued, benefiting from the pass-through effects of reductions in global oil prices in earlier periods and the stabilisation of domestic prices following the implementation of the value added tax (VAT) in January 2015. Meanwhile, an expansion in the deposit base, alongside constrained credit growth, resulted in a build-up in both liquidity and external reserves.

Over the medium-term, continued emphasis will be placed on strengthening the financial sector's resilience. This includes the sustained adoption of the best international standards for effective prudential oversight. Further enhancements to the effectiveness of anti-money laundering/countering the financing of terrorism systems are also being stressed, given the prominence of this issue for at-risk correspondent banking relationships. This also underscores the ongoing collaboration that must be sustained among domestic and regional regulators on such matters. The Central Bank is also improving macro-prudential oversight mechanisms, to ensure timely responses when heighten stability risks emerge.

CHAPTER 1: MACROECONOMIC ENVIRONMENT

Domestic economic conditions continued to be influenced by developments in the global environment. The performance of the United States' economy in particular, has the strongest importance for domestic tourism, which alongside foreign investment conditions, impact credit quality trends and net deposit growth. In the deposit space, these flows also have net consequences for liquidity conditions. Such influences also affect the fiscal revenue performance and, in the context of the Government's expenditure, the distribution of sustainable credit flows between the public and private sectors. In 2016, the global economic performance was incrementally slowed compared to the prior year, but sustained its positive trajectory. With employment conditions further improved in the major countries, a more positive outlook emerged for consumption and potential spending on travel.

1.1. The Global Environment

As it relates to the global economy, despite the rise in uncertainty in the financial markets following the United Kingdom's vote in June to exit the European Union, termed "BREXIT", world output grew by 3.1%, compared to a 3.4% rate in 2015. Advanced economies recorded an estimated 1.7% expansion, easing from 2.0% recorded in the prior year—due mainly to the lackluster performance of the euro area—while real output in emerging and developing markets combined, edged-down to 4.1% from 4.2% last year.

A breakdown of the advanced economies showed that the output growth tapering was evident in the United States, at 1.6% from 2.6% (see Table 1); the United Kingdom (1.8% from 2.2%); the euro area, (1.7% from 2.0%); Japan, (1.0% from 1.2%) and China, (6.7% from 6.9%). All regions experienced reductions in their respective jobless rates, and with the exception of the deflationary trend in Japan, the major economies experienced elevated inflation, mostly due to energy-related cost pressures. Given the uncertainty over the UK's "BREXIT" vote in late June, most of the major central banks either sustained or enhanced their accommodative monetary policy stance during the review year. The exception was the United States Federal Reserve, which commenced its programme of tightening in December 2015, after maintaining the target official rate rates at zero percent since 2008.

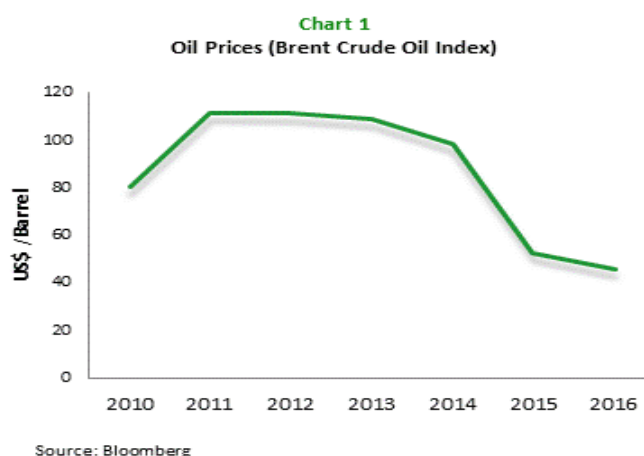
Economic activity in the Caribbean region remained lackluster, as evidenced by a contraction in 2016, vis-à-vis mild economic growth of 0.6% in the previous year (see Table 2). In particular, economic activity in Suriname and Trinidad & Tobago contracted further by 10.5% and 5.1% from 2.7% and 0.6%, respectively in the prior period, dragged down by lower commodity prices, while real output in the Eastern Caribbean

economies eased by 40 basis points to 2.2%. Providing some offset, Guyana's real output strengthened to by 20 basis points to 3.3%, while growth in Barbados and Jamaica firmed to 1.6% and 1.5%, from 0.9% and 1.0%, respectively, last year.

TABLE 1							
Selected Indicators for Developed Economies (%)							
	2010	2011	2012	2013	2014	2015	2016
GDP Growth Rates							
United States	2.5	1.6	2.2	1.7	2.4	2.6	1.6
Euro Area	2.1	1.5	(0.9)	(0.3)	1.2	2.0	1.7
United Kingdom	1.9	1.5	1.3	1.9	3.1	2.2	1.8
China	10.6	9.5	7.9	7.8	7.3	6.9	6.7
Japan	4.2	(0.1)	1.5	2.0	0.3	1.2	1.0
Unemployment Rates							
United States	9.6	9.0	8.1	7.4	6.2	5.3	4.9
Euro Area	10.1	10.2	11.4	12.0	11.4	10.9	10.0
United Kingdom	7.9	8.1	8.0	7.1	6.2	5.4	4.9
China	4.1	4.1	4.1	4.1	4.1	4.1	4.0
Japan	5.1	4.6	4.4	3.4	3.6	3.4	3.1
Inflation Rates							
United States	1.6	3.1	2.1	1.5	1.6	0.7	2.1
Euro Area	1.6	2.7	2.5	1.3	0.4	0.2	1.1
United Kingdom	3.3	4.5	2.8	2.6	1.5	0.2	1.6
China	3.3	5.4	2.6	2.6	2.0	1.6	2.1
Japan	(0.7)	(0.3)	(0.1)	0.3	2.8	0.0	(0.2)
Sources: IMF, International Statistical Bureaus							

TABLE 2							
Selected Caribbean Countries' GDP Growth Rates (%)							
	2010	2011	2012	2013	2014	2015	2016
Bahamas	1.5	0.6	3.1	0.0	(0.5)	(1.7)	0.0
Barbados	0.3	0.8	0.3	(0.1)	0.1	0.9	1.6
Belize	3.3	2.1	3.7	0.7	4.1	2.9	(1.0)
Eastern Caribbean	(3.5)	(0.2)	0.4	1.7	2.9	2.6	2.2
Guyana	4.4	5.4	4.8	5.2	3.8	3.1	3.3
Jamaica	(1.5)	1.4	(0.5)	0.2	0.5	1.0	1.5
Suriname	5.2	5.8	2.7	2.9	0.4	(2.7)	(10.5)
Trinidad & Tobago	3.3	(3.0)	1.3	2.7	(0.6)	(0.6)	(5.1)
Average	1.1	1.7	2.2	1.8	1.4	0.6	(8.0)

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



1.2. The Domestic Environment

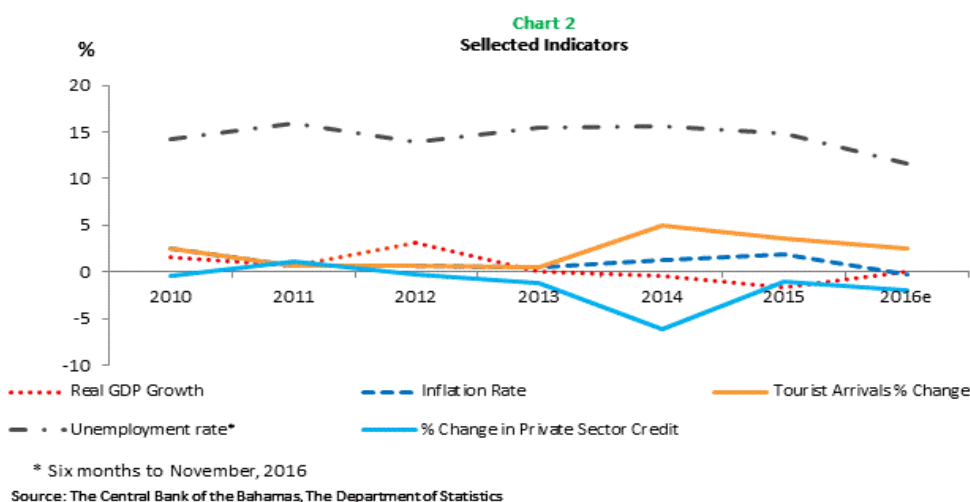
The domestic economy likely contracted marginally in 2016, after declines of 1.7% and 0.5%, respectively, in the prior two years. Disruptions to travel itineraries following the passage of Hurricane Matthew in October, and weaker performance in Grand Bahama, hindered the tourism sector's performance. For the year, total arrivals recovered by 2.5% to 6.3 million, but with the key air component up marginally by 0.1% to 1.4 million, while the dominant sea segment expanded by 3.2%.

The construction sector provided some positive stimulus, supported by several varied-scale foreign investment projects and rebuilding activity in the aftermath of the storm in the latter half of the year. However, the overall domestic market was soft, as total mortgage disbursements for new construction and building repairs, declined by 6.7% to \$112.7 million, in contrast to a 23.8% gain in the previous year. In terms of the segments, the value of the dominant residential component fell by 2.8% to \$107.8 million, vis-

à-vis a 34.7% expansion last year, while the commercial segment decreased by 51.0% to \$4.8 million, extending the 35.4% falloff in the prior period.

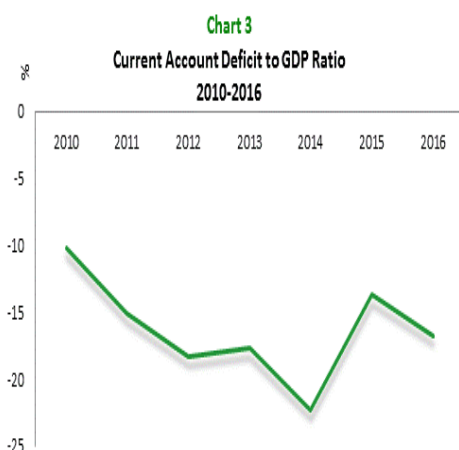
Supported by job gains in the tourism and construction sectors, employment conditions improved modestly in 2016. Specifically, the unemployment rate narrowed by 2.0 percentage points to 12.7% in May 2016, vis-à-vis November 2015, as an additional 7,540 persons were added to employers' payrolls, due in part to temporary hirings for several large-scale events. The jobless rate declined further by 1.1 percentage points at end-November 2016, owing to an increase in short-term construction-related jobs in the aftermath of Hurricane Matthew.

Domestic inflationary pressures remained subdued during the year, reflecting the relatively low international oil prices. Data for 2016 showed that average consumer prices—measured by changes in the Retail Price Index (RPI)—fell slightly by 0.35% in 2016, a turnaround from a 1.88% advance a year earlier, as average cost gains slowed sharply for the majority of the items in the index.

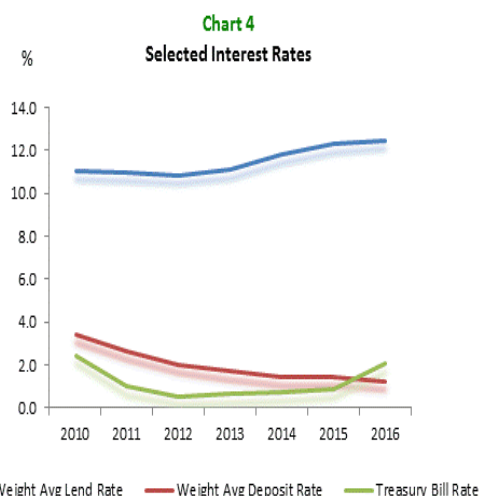


During FY2015/16, the Government's overall deficit decreased by \$71.6 million (18.7%) to \$310.4 million, benefitting from a widening of the tax base following the implementation of the value added tax (VAT), as well as the implementation of measures to improve revenue collection. Specifically, total revenue advanced by \$228.0 million (13.4%) to \$1,929.6 million, outpacing the \$156.4 million (7.5%) gain in aggregate expenditure, to \$2,240.0 million. However, on a calendar year basis, the deficit deteriorated by \$179.7 million (66.6%) to \$449.4 million, owing in part to unplanned expenditure related to the rebuilding of key infrastructure after the hurricane and the ensuing disruptions to the revenue intake.

Preliminary estimates for the external sector, showed that the current account deficit increased sharply by \$290.8 million (24.9%) to \$1,494.0 million, attributed largely to a reduction in the net services account surplus and a widening in the income account deficit. Moreover, reflecting in part a significant rise in net private investment inflows and public sector net inflows, related to the receipt of proceeds from the Government's US\$100.0 million equivalent loan, the capital and financial account surplus expanded by \$111.5 million (31.9%) to \$461.3 million in 2016.



Source: Central Bank of The Bahamas



Source: Central Bank of The Bahamas

Monetary developments were marked by expansions in both bank liquidity and external reserves in 2016, as the deposit base growth paced ahead of credit expansion. Deposit accumulation remained fueled by converted foreign currency inflows from real sector activities, with impetus also from the Government's external loan proceeds and re-insurance inflows for hurricane claims. Further, owing in large measure to the sale of delinquent mortgages, and sustained debt restructuring efforts, banks' credit quality indicators improved significantly in 2016. These reductions also justified a decline in bad debt provisioning, which helped improve the profitability of the sector in 2016. Moreover, reflecting the robust levels of liquidity in the banking system, the weighted average deposit rate declined, while the corresponding lending rate increased, leading to a widening in the average interest rate spread.

TABLE 3:**The Bahamas: Macroeconomic Indicators**

	2010	2011	2012	2013	2014	2015	2016*
B\$/US\$: Exchange Rate	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Nominal GDP Growth Rate (%)	1.1	(0.3)	6.5	1.5	1.1	2.7	1.0
Real GDP Growth Rate (%)	1.5	0.6	3.1	0.0	(0.5)	(1.7)	0.0
Inflation Rate (Average chg in RPI)	2.6	0.6	0.6	0.5	1.2	1.9	(0.3)
Unemployment Rate	n.a	15.9	14.0	15.4	15.7	14.8	11.6
Overall Fiscal Balance (B\$M)	(376.7)	(319.8)	(557.5)	(485.3)	(531.1)	(269.7)	(449.4)
% of GDP	(4.8)	(4.1)	(6.6)	(5.7)	(6.2)	(3.0)	(5.0)
Private Sector Credit (B\$000)	6,572.7	6,646.6	6,628.4	6,551.1	6,366.9	6,299.7	6,170.8
Weighted Average Lending Rate (%)	11.0	11.0	10.9	11.1	11.8	12.3	12.5
Weighted Average Deposit Rate (%)	3.4	2.6	2.0	1.7	1.4	1.4	1.2
Treasury Bill Rate (%)	2.4	1.0	0.6	0.7	0.7	0.9	2.0
Gross Int'l Reserves (B\$M)	860.4	884.9	810.2	741.6	787.7	811.9	904.0
Import Cover Ratio (Non-Oil (CIF) in weeks)	21.6	19.7	16.0	15.4	14.7	15.7	19.5
Current Balance (B\$M)	(796.0)	(1,101.2)	(1,394.5)	(1,365.4)	(1,885.3)	(1,203.2)	(1,494.0)
as % of GDP	(10.1)	(14.0)	(16.6)	(16.0)	(21.9)	(13.6)	(16.7)
Total Public Sector Debt (B\$M)	4,799.9	4,948.3	5,770.6	6,346.9	7,101.8	7,469.0	7,907.3
of which: External	916.2	1,044.9	1,464.7	1,616.1	2,100.5	2,184.8	2,382.0
Internal	3,883.8	3,903.5	4,305.9	4,730.7	5,001.3	5,284.2	5,525.3
Total Arrivals ('000s)	5,254.8	5,587.6	5,940.2	6,150.8	6,320.2	6,112.1	6,265.0
Tourist Expenditure (B\$M)**	2,164.0	2,142.6	2,312.7	2,287.5	2,316.4	2,537.3	2,590.5
Construction Number of Permits Issued	1,996.0	1,948.0	1,916.0	1,462.0	1,410.0	1,304.0	1,122.0
Value of Starts (B\$M)	154.2	147.5	116.6	140.2	129.2	117.1	96.2
Value of Completion's (B\$M)	337.6	500.6	317.1	216.6	250.5	228.9	193.2
Average Oil Prices (Brent Crude Oil Index)	80.3	111.8	111.4	109.1	98.5	52.6	45.7

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

n.a. - Not Available

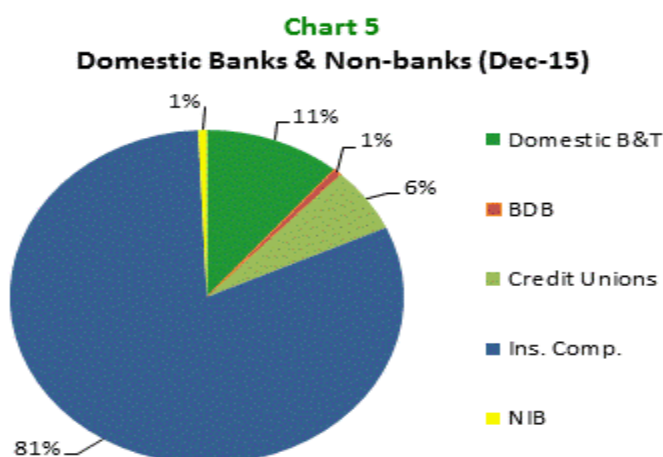
*2016 GDP obtained from the IMF's April 2017 WEO

**2016 Tourism Expenditure for 2016 is based on Central Bank estimates.

CHAPTER 2: FINANCIAL SYSTEM OVERVIEW

The Bahamian financial sector comprises both domestic and international operations; however, Exchange Control regulations maintain a separation between the two sectors, leaving only the latter relevant for financial stability assessments.

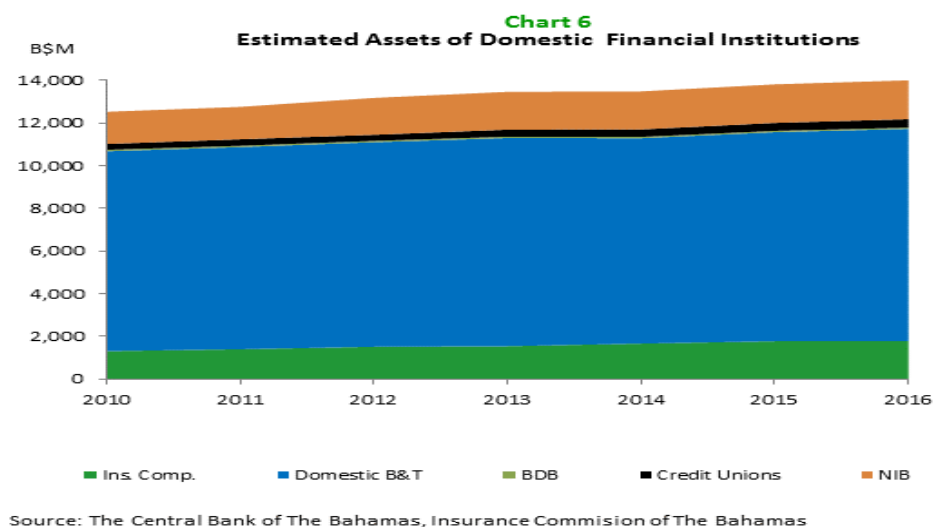
The activities in the overall sector contribute to an estimated 15% of the country's GDP. At end-December, there were 248 banks and trust companies, which employed in excess of 4,000 persons, with the largest single concentration in local domestic banks (3,163 persons). Additional entities within the sector include: 3 money transmission businesses (MTBs), 10 local credit unions (CUs), 50 insurance companies (Ins. Comp.), 19 financial & corporate service providers and 63 investment fund administrators. Notable Government sponsored entities include: the Bahamas Development Bank (BDB), the National Insurance Board (NIB) and the Bahamas Mortgage Corporation (BMC)¹. Within these operations, 8 of the banks and trust corporations operate either fully or in part within the domestic space, as well as 29 of the insurance companies. As a developing capital market, and the Bahamas International Securities Exchange (BISX) also characterizes the domestic financial sector's operating environment; although BISX trading volumes and market capitalization still do not pose systemic stability concerns.



As to balance sheet size, the banking industry recorded approximately US\$194.5 billion in assets at the end of December, of which international banks' asset holdings dominated, accounting for \$175.7 billion

¹ There have also been a few Special Purpose Vehicles (SPVs) established within the last three years to acquire a variety of financial assets.

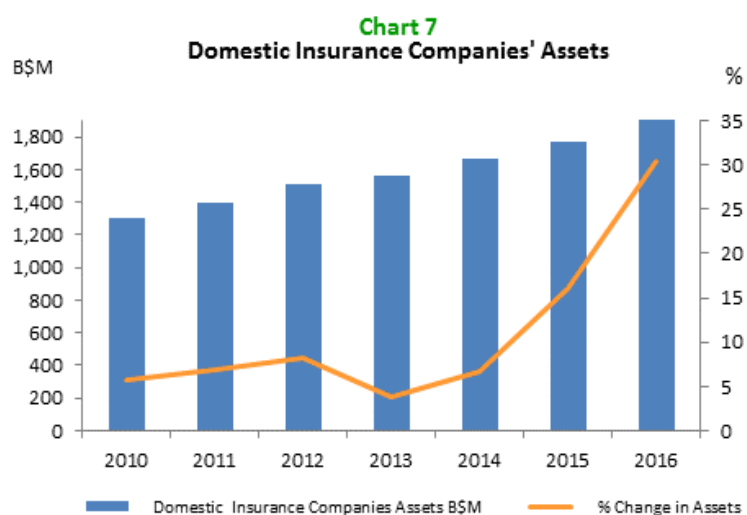
(90.3%) of the total, while domestic banks held the remaining \$18.8 billion (9.7%), split relatively evenly between domestic (\$10.0 billion) and foreign (\$8.8 billion) assets. Fiduciary assets under the care of trust companies are estimated near \$361.8 billion, almost exclusively “offshore”. Among the non-banks, investment administrators reported assets under management of \$136.8 billion within 890 investment funds, while the total assets of insurance companies and credit unions stood at an estimated \$2.3 billion and \$395.5 million, respectively. The National Insurance Board’s asset holdings of \$1.8 billion² were the third largest domestic assets concentration. During 2016, all sub-sectors experienced some balance sheet expansion. The Bahamas Development Bank (BDB), which provides financing for small and medium sized enterprises, recoded a contracted assets base of 6.9%, at \$57.3 million, partly corresponding to a reduction in outstanding credit.



² Data as at end-June, 2016.

TABLE 4							
Structure of the Financial System							
	2010	2011	2012	2013	2014	2015	2016p
Banks & Trusts							
International	256	260	249	249	237	233	232
Domestic	20	18	19	18	17	16	16
Total	276	278	268	267	254	249	248
Non-Bank Financial Institutions							
Mutual Funds	753	713	652	735	830	885	890
Credit Unions	13	13	13	7	7	7	10
Insurance companies	178	127	139	140	143	148	142
<i>Domestic Companies & Agents</i>	<i>157</i>	<i>114</i>	<i>124</i>	<i>121</i>	<i>122</i>	<i>125</i>	<i>121</i>
<i>External Insurers</i>	<i>21</i>	<i>13</i>	<i>15</i>	<i>19</i>	<i>21</i>	<i>23</i>	<i>21</i>

Source: Central Bank of The Bahamas



Source: Insurance Commission of The Bahamas

CHAPTER 3: BANKING SECTOR

The Bahamas' exchange control regime keeps the domestic economy insulated from the balance sheet operations of the international or offshore banks. Therefore, the focus of this chapter is on the stability issues in the domestic banking sector.

3.1 Domestic Banking Sector

The domestic banking sector is comprised of 8 onshore commercial banks, of which 4 are subsidiaries of Canadian banks, 3 are locally owned and 1 is a branch of a United States' based institution. The banks' funding sources are primarily from deposits, while assets are comprised mainly of credit to the private sector and investments in public sector debt securities. Although each institution tends to specialize in certain segments of the market, private exposures include commercial loans, residential mortgages and consumer loans. The majority of the sector's assets—in excess of two-thirds—are concentrated in the 3 largest institutions.

During the year, banks maintained high levels of liquidity, in light of the continued conservative posture towards private sector credit. The sector meanwhile, experienced recovered profitability, given slightly wider average effective interest spread, increased “fee-based” income and a reduction in bad debt expenses.

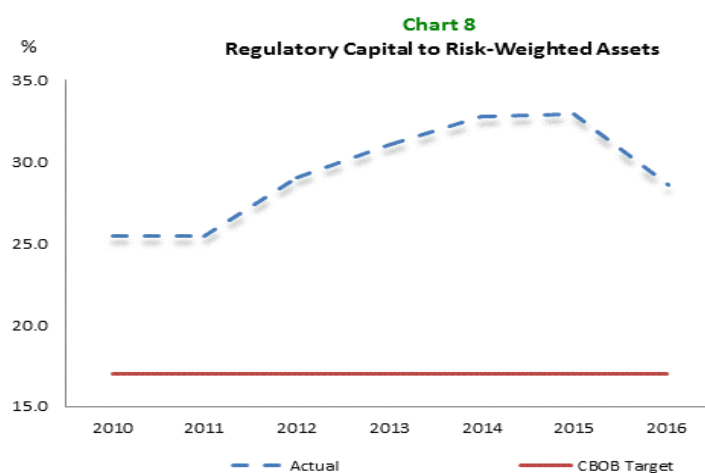
3.1.1. Asset Trends

In 2016, the total value of the banking system's domestic assets firmed by 1.6% to \$10.0 billion, following a 1.8% increase during the previous 12-month period. Contributing this outturn was a 47.6% expansion in banks' cash balances at the Central Bank, to \$867.3 million, a reversal from a 3.2% decline in the prior year. In addition, “other” miscellaneous assets rose by 4.6%, extending the 3.7% increase in 2015, while till cash firmed by 1.9%, after remaining unchanged a year earlier. Providing some offset, banks' holdings of securities fell by 5.6% to \$1,702.5 million, vis-à-vis a 12.9% build-up in 2015, owing to declines in investments in public corporations' securities (25.9%), private sector instruments (19.4%) and Government paper (2.5%), respectively. In addition, loans and advances decreased by 0.6% (\$43.3 million), after a 0.3% softening in 2015, as the dominant private sector credit component narrowed by 2.0% (\$124.2 million), extending the prior year's 1.2% contraction. In contrast, claims on the public sector increased by 12.3%, following an 8.6% gain in 2015.

At end-December, loans and advances held the largest share of total domestic assets (69.1%), followed by securities (17.1%), while balances with the Central Bank, “other” miscellaneous assets and till cash accounted for smaller shares of 8.7%, 3.7% and 1.4%, respectively.

3.1.2 Capital Adequacy

The domestic banks remained well capitalized in 2016. The ratio of total capital to risk weighted asset stood at 28.6% at end-December, which was 4.7 percentage points lower than in 2015, reflecting principally a change in the calculation to adhere to the new regulatory framework. However, the indicator stayed well above the international benchmark of 8.0% and the Central Bank's target of 17% of risk-weighted assets.³



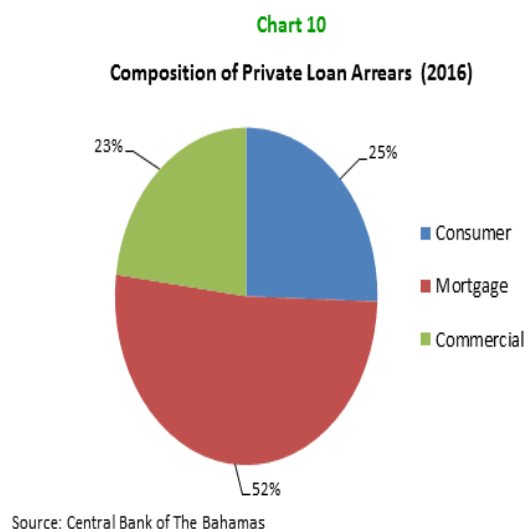
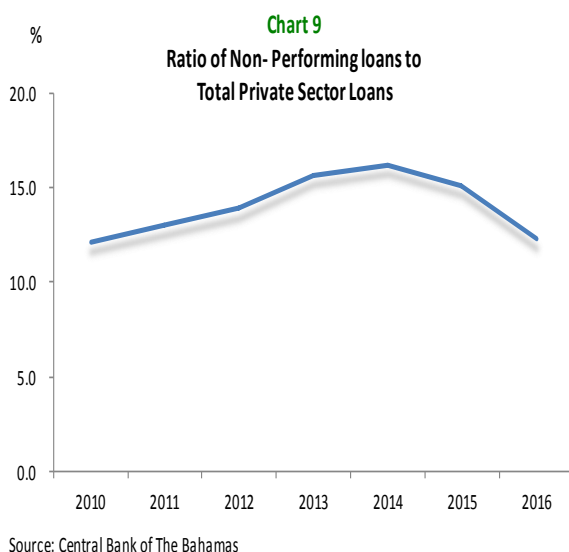
3.1.3 Asset Quality

Banks' credit quality indicators improved notably during 2016; although a significant gap remains before achieving normalization relative to the immediate years before 2008. Alongside ongoing restructuring of facilities, banks sold-off several tranches of their non-performing loans (NPLs) and made modest inroads under the Government's new Mortgage Relief Programme (MRP). As a result, total private sector loan arrears contracted by 17.1% to \$1,010.6 million, following a 5.7% reduction in the previous year. Similarly, the ratio of arrears to total private sector loans narrowed, by 3.3 percentage points to 17.1%, extending the prior year's 1.1 percentage point contraction. The decrease in total delinquencies was led by a 19.6% contraction in the NPL segment, to \$729.1 million, outpacing the 7.3% decrease in the prior year. In addition, short-term (31-90 day) arrears, declined by 10.1%, to \$281.5 million, exceeding the slight 0.7%

³ . 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.

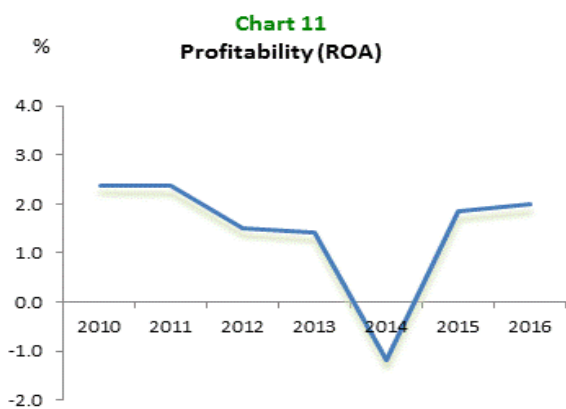
reduction during the previous year. At end-2016, NPLs accounted for 12.3% of total private sector loans, vis-à-vis 15.1% a year-earlier, while the short-term component represented 4.8% of the total, compared to 5.2% in 2015.

A breakdown by category, showed that the reduction in arrears was due mainly to declines in the mortgage component—51.6% of the total—which contracted by 25.3% to \$521.1 million, after a slight 0.2% decline in the preceding year. Similarly, consumer arrears decreased by 13.4% to \$257.7 million, following a 10.5% falloff in 2015. In contrast, commercial loan delinquencies firmed by 3.1%, to \$231.8 million, reversing the 14.4% reduction last year.

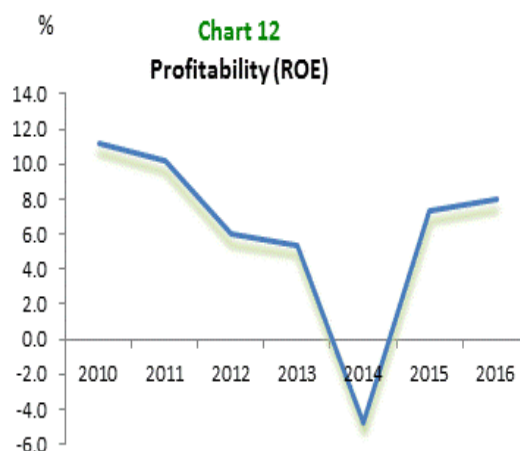


3.1.3. Profitability

Domestic banks' profitability strengthened by 10.1% to \$204.2 million during the year, benefitting primarily from a rise in fee-based income and decreased provisioning for bad debts. As a consequence, the respective ratios of net income to average monthly assets (ROA) and equity (ROE) grew to 2.0% and 8.0%, from 1.9% and 7.4% in 2015. Contributing to the improvement in these ratios was a falloff in bad debt provisioning and depreciation costs. However, the ratios of commission and foreign exchange income to average assets decreased to 0.25%, from 0.30% in 2015. In addition, the effective interest rate spread moved higher by 10 basis points to 7.23%, while the ratio of net interest income to average assets narrowed by 11 basis points to 5.33%, as an 8.3% reduction in interest expense, was offset by a 1.8% falloff in interest revenue.



Source: Central Bank of The Bahamas

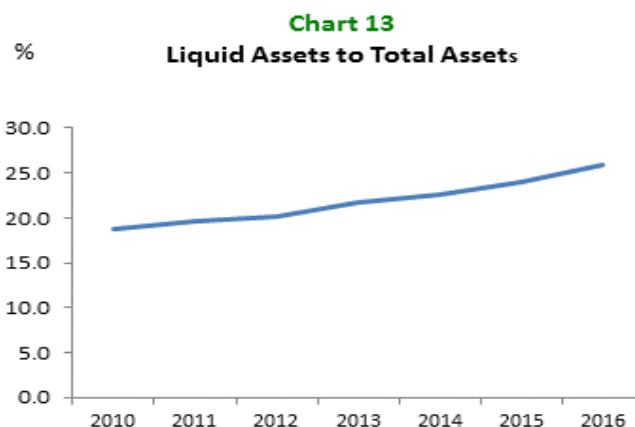


Source: Central Bank of The Bahamas

3.1.4. Liquidity

Liquidity measures continued to signal significant scope for credit expansion, provided banks' lending posture was more ameliorated. However, such a significant shift is not expected in the short-term, unless the conditions in economy improve in a more accelerated fashion to put more households and firms in a position to incur more debt. In those circumstances, the Central Bank is prepared to use other tools at its disposal to ensure that credit expansion does not outpace growth performance in the foreign exchange earning sectors and the related support for external reserves balances.

Liquidity was further bolstered in 2016, with the ratio of liquid assets to total assets increasing by 1.8 percentage points to 25.9%, after a 1.4 percentage point gain in 2015. In addition, the liquid assets to short-term liabilities ratio edged-up by 80 basis points to 37.8%; although lower than the 2.6 percentage point gain in the previous year. Meanwhile, the surplus resources accumulation was also evident in the 7.0 percentage points widening in the ratio of total deposits to total loans, to 99.1%, outpacing the 0.9 percentage point rise a year earlier. In addition, the ratio of demand deposits to total balances firmed by 4.6 percentage points to 37.2%, after a 0.9 percentage point increase in 2015, underscoring a more liquid posture for depositors as well.



Source: Central Bank of The Bahamas

TABLE 5

Key Domestic Banks Financial Stability Indicators (%)

	2010	2011	2012	2013	2014	2015	2016
Liquidity Indicators							
Loan to Deposit Ratio	115.9	114.1	114.5	114.0	109.6	108.6	100.9
Deposits to Loan Ratio	86.2	87.6	87.4	87.7	91.2	92.1	99.1
Demand Deposits to Total deposits	22.6	23.5	25.9	28.1	31.7	32.6	37.2
Liquid Assets to Total Assets	18.7	19.7	20.2	21.8	22.7	24.1	25.9
Liquid Assets to Short-Term Liabilities	28.8	30.0	31.2	34.0	34.4	37.0	37.8
Credit Risk Indicators							
Total Assets Growth rate	4.6	1.1	1.2	1.8	(1.4)	1.8	1.6
Loans & Advances Growth rate	1.8	0.4	0.0	0.2	(2.3)	(0.3)	(0.6)
Capital Adequacy							
Regulatory capital to risk-weighted assets (avg)	25.5	25.5	29.1	31.1	32.8	33.3	28.6
Trigger Ratio Capital Ratio	14.0	14.0	14.0	14.0	14.0	14.0	14.0
Target Ratio Capital Ratio	17.0	17.0	17.0	17.0	17.0	17.0	17.0
Profitability Indicators							
ROAA (annualized)	2.4	2.4	1.5	1.4	(1.2)	1.9	2.0
ROAE (annualized)	10.7	10.1	6.1	5.6	(4.7)	7.4	8.0
Net interest income to average earning assets (annualized)	5.6	5.5	5.4	5.4	5.3	5.4	5.3
Net interest income to gross income	58.9	62.8	67.1	68.8	69.8	70.5	69.4
Non interest expenses to gross income	34.7	37.9	40.8	47.1	66.3	47.4	48.5
Personnel expenses to non interest expenses	52.0	53.2	51.2	50.3	34.8	46.8	44.1
Trading and fee income to total income	2.6	2.8	3.0	3.0	3.0	3.9	3.2
Spread between reference loan and deposit rates	6.2	6.1	6.4	6.9	6.8	7.1	7.2

Source: Central Bank of The Bahamas

3.1.6. Stress Testing

The 2016 stress tests continued to incorporate plausible, yet extreme, shocks to the domestic banks, with a primary focus on credit risk, although liquidity and interest rate risk are also monitored. The tests assess

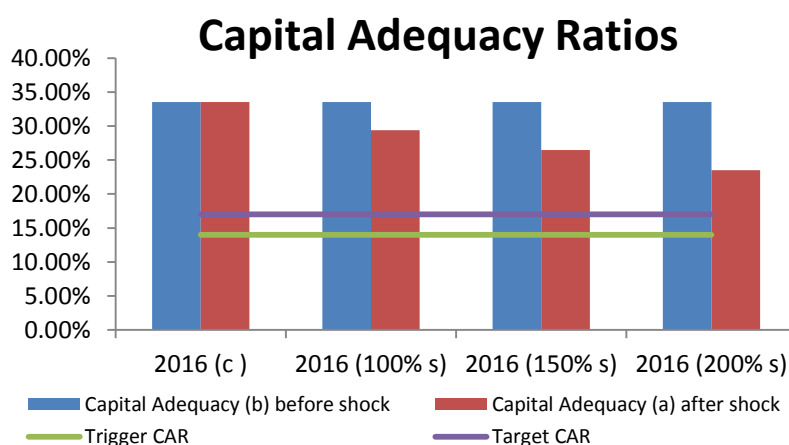
the capital adequacy or loss absorbing capacity of commercial banks, to shifts in the level of NPLs. This report does not examine liquidity or interest rate shocks, although these are not considered material vulnerabilities at present.

Credit Risk Stress Test

The scenarios used in 2016 to determine the capital shortfalls for credit risk shocks, if any, remained unchanged. The stressed scenarios included shocks of 100, 150 and 200 percent in the forecasted NPL rates for 2016 through 2018. In the baseline, it was assumed that macroeconomic trends and interventions at the operational level would have supported the continued gradual dissipation in the stock of NPLs, to a level closer to \$900 million over the forecast horizon.

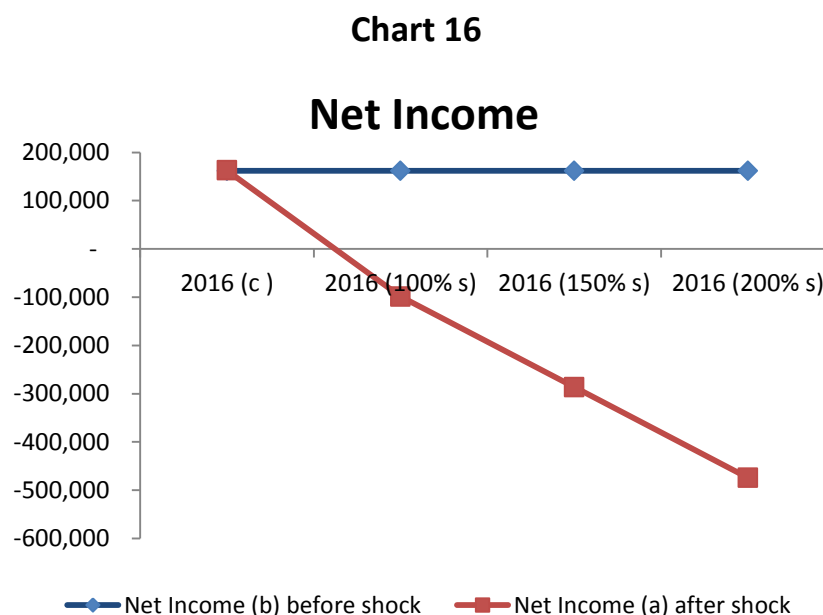
Adverse shocks therefore, would coincide with reversals in economic fortunes, and increasing stress on borrowers. In these cases, and with the posited shocks, NPLs would increase to within the \$1.8 billion to \$2.7 billion range. Capital would reduce under such outcomes, but still remain above the minimum adequacy level, given a starting weighted capital adequacy ratio (CAR) near 33.5% and average levels that would remain above 20% under the most extreme outcomes. On an aggregate basis, these stresses therefore do not suggest a need for any new injections.

Chart 15



At varying levels of shocks to the NPLs, the earnings of banks would be negatively impacted by anticipated hikes in provisioning levels and the loss in interest income. The banks would therefore be expected to seek

some stabilization from other non-interest income sources. Chart 16 depicts the projected net income before any shock, at a net gain of around \$161.8 million and declines in net income, due to applied shocks. Despite this, the impact on individual banks will vary.



Interest and Liquidity Shocks

On the whole, most institutions are not at risk from the near-term depletion of liquidity, given the significant excesses within the system. They underscore individual bank's ability to absorb sudden shifts in deposits without encountering liquidation difficulties.

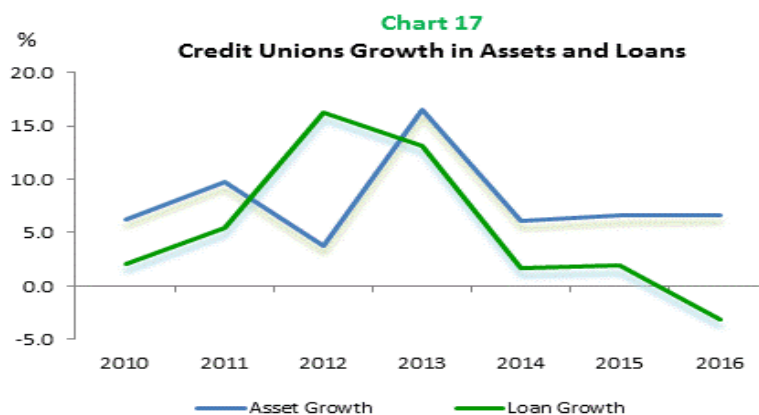
In isolation, banks' interest rate risks are predominantly tied to credit and deposit facilities, these would manifest largely in the impact of rate fluctuations on the incidence of credit distress. As the Government securities market modernizes, it is expected that balance sheets would also be subjected to securities valuation changes. In the meantime, the magnitude of shocks to NPL rates is deemed large enough to incorporate potential adverse interest rate movements.

CHAPTER 4: CREDIT UNIONS

After commercial banks, credit unions remained the second largest group of deposit taking and loan granting institutions. At end-2016, the number of active entities stood at 10, a gain of 1 over the prior year. The market continued to be dominated by one institution, which contained over one-half (50.2%) of total assets, while the remaining 9 entities accounted for smaller market shares, ranging from a low of 4.5% to a high of 15.2% of aggregate assets. Total membership in credit unions stood at an estimated 42,222 persons or 19.4% of the workforce at end-2016. During the year, these entities registered gains in deposit assets and liabilities, while the sector's capital levels continued to exceed the PEARLS⁴ benchmarks.

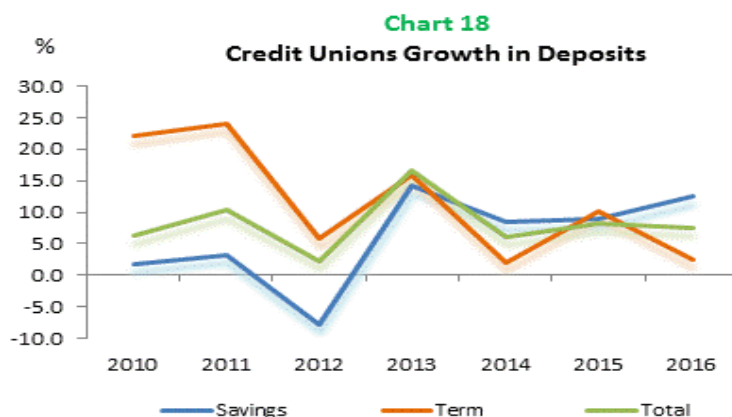
4.1. Assets and Liabilities

Credit unions' total assets advanced by 6.7% (\$24.9 million) to \$395.5 million at end-December 2016, slightly higher than the prior year's increase of 6.6%. The outturn was largely attributed to an expansion in the league's deposits, by 16.2% to \$72.0 million, while loans to members—which represented 57.6% of total assets—decreased by 3.1% at \$227.9 million. The bulk of credit was extended for small-scale consumer purchases (72.5%), followed by mortgages/land (23.2%), revolving lines of credit (2.2%), education (1.8%), and other “miscellaneous” loans (0.2%).



⁴ PEARLS is a financial performance monitoring system, which consists, *inter alia*, of a series of financial ratios which provide an assessment of an institution's performance in the areas of: protection, effective financial structure, asset quality, rate of return and cost, liquidity and signs of growth.

Total deposits advanced by 7.6% (\$24.0 million) to \$339.9 million, although a slowdown from the preceding year's growth of 8.3%. The expansion included an accelerated 12.6% boost in savings deposits—which accounted for 52.9% of the total—to \$179.7 million. Similarly, term deposits—at 40.7% of the aggregate—rose by 2.4% to \$138.5 million, after a 10.2% gain in 2015.



Source: Central Bank of The Bahamas

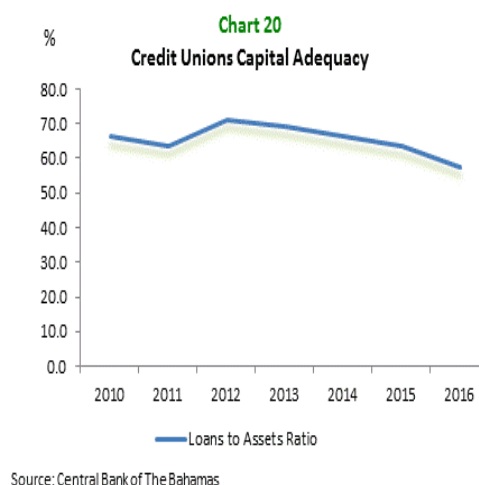
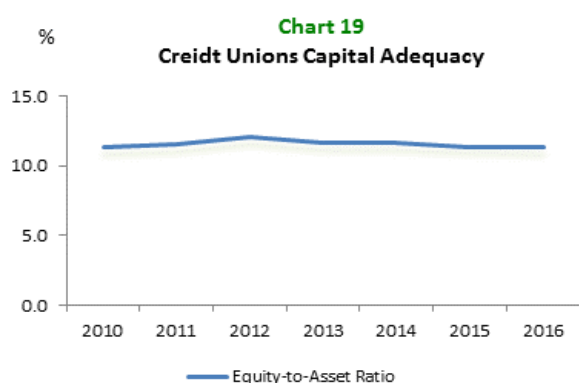
TABLE 9
Selected Financials for Credit Unions (B\$M)

	2010	2011	2012	2013	2014	2015	2016P
Assets	246.5	270.6	280.9	327.6	347.7	370.6	395.5
Loans	163.5	172.4	200.6	227.0	230.9	235.3	227.9
Deposits	208.2	229.7	235.3	274.7	291.6	315.9	339.9
Liquid Assets	69.8	86.2	74.7	98.6	113.8	128.4	156.0
Savings	123.4	127.6	117.8	134.8	146.4	159.6	179.7
Term Deposits	79.1	98.2	103.8	120.4	122.8	135.3	138.5
Total Deposits	208.2	229.7	235.3	274.7	291.6	315.9	339.9
Total Equity	2.8	3.6	34.1	38.4	40.7	42.4	45.1
Non-Earning Assets	15.8	12.7	11.6	17.2	25.2	25.0	34.8
Allowance	6.7	7.5	8.5	11.2	11.8	14.1	9.9
Short-Term (ST) Payables	6.5	6.4	0.7	1.2	1.4	1.0	1.1
Capital & Surplus	28.1	31.3	34.1	38.4	40.7	42.4	45.1
Provisions	1.3	1.7	2.7	1.6	1.1	2.3	2.4
Net Income	2.5	1.0	4.5	6.9	2.8	1.3	1.4
Institutional Capital	10.2	10.9	13.3	13.2	14.3	11.9	12.8
# of Credit Unions	13.0	13.0	13.0	7.0	7.0	9.0	10.0
							45.6
Financial Ratios (%)							
Equity-to-Asset Ratio	11.4	11.6	12.1	11.7	11.7	11.5	11.4
Return on Assets	1.0	0.4	1.6	2.1	0.8	0.3	0.3
Return on Equity	8.8	3.2	13.2	18.0	7.0	3.0	3.0
Provisions to Loans	0.8	1.0	0.3	1.6	0.5	1.0	1.0
Loans to Total Assets	66.3	63.7	71.4	69.3	66.4	63.5	57.6
Liquid Assets to Total Assets	28.3	31.9	26.6	30.1	32.7	34.7	39.5
Non-Earning Assets/Total Assets	6.4	4.7	4.1	5.2	7.2	6.7	8.8
(Liquid Assets-ST Payables)/Total Dep.	30.4	34.7	31.4	35.5	38.5	40.4	45.6

Source: Central Bank of The Bahamas

4.2. Capital Adequacy

During the year, credit unions' capital and liquidity indicators remained in line with international norms. The aggregate capital & surplus position of the sector—held to cover unexpected losses—increased by 6.4% (\$2.7 million) to \$45.1 million at end-2016, exceeding the previous year's 4.2% growth. As total assets rose faster, by 6.7%, the corresponding ratio of total equity⁵ to total assets (the gearing ratio) decreased by 10 basis points to 11.4%. This ratio stayed above the international PEARLS benchmark of 10%.



4.3. Asset Quality

In 2016, credit unions' impaired loans⁶ contracted further by 11.8% (\$3.6 million) to an estimated \$26.9 million, extending the 1.3% decrease in 2015. Correspondingly, the ratio of impaired to total loans narrowed to 12.3% from 13.8% in the prior year. By component, the short-term segment of arrears under 90 days (at 7.2% of the total) declined by 29.0% to \$1.9 million, following a 14.2% reduction in the previous year. Similarly, NPLs—arrears in excess of 90 days—decreased by 8.1% to \$22.0 million, a reversal from a 6.9% gain last year.

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

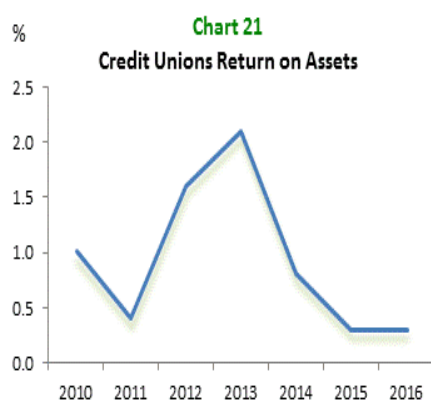
⁶ An impaired loan is defined as a one in which the full amount of principal or interest due is not collected on time, according to the contractual terms of the loan agreement.

In spite of the overall improvement in loan delinquencies, the value of collateral against impaired credit rose by 11.2% (\$1.1 million) to \$11.4 million, a turnaround from a 5.9% decline in the prior year. Meanwhile, credit unions' uncollateralized exposures fell by 23.4% (\$4.7 million) to \$15.5 million. In line with the reduction in delinquencies, total provisions for loan losses decreased by 29.6% (\$4.2 million) to \$9.9 million. As a consequence, the ratio of provisions-to-total loans steadied at 1.0%, while the coverage ratio to short-term arrears remained unchanged at 35.0% and for NPLs at 100%.

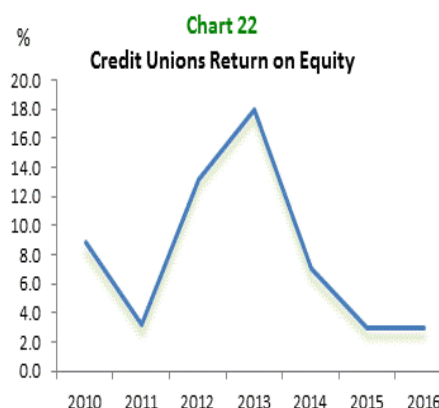
The value of non-earning assets—which included land, buildings, vehicles, furniture and cash—expanded by 39.4% (\$9.9 million) to \$34.8 million, vis-à-vis a decline of 0.7% in 2015. The balance share of these assets, firmed by 2.1 percentage points to 8.8%, remaining above the prudential ceiling norm of 5.0%.

4.4. Profitability

Reflecting a 10.4% reduction in operating expenses, combined with a 2.8% increase in other “miscellaneous” income, credit unions' overall profits rose by 4.6% (\$0.1 million) to an estimated \$1.4 million in 2016, a partial recovery from a sharp 54.7% decline in 2015. As a consequence, both the return on assets (ROA) and return on equity (ROE) ratios stabilized at 0.3% and 3.0%, respectively.



Source: The Central Bank of The Bahamas

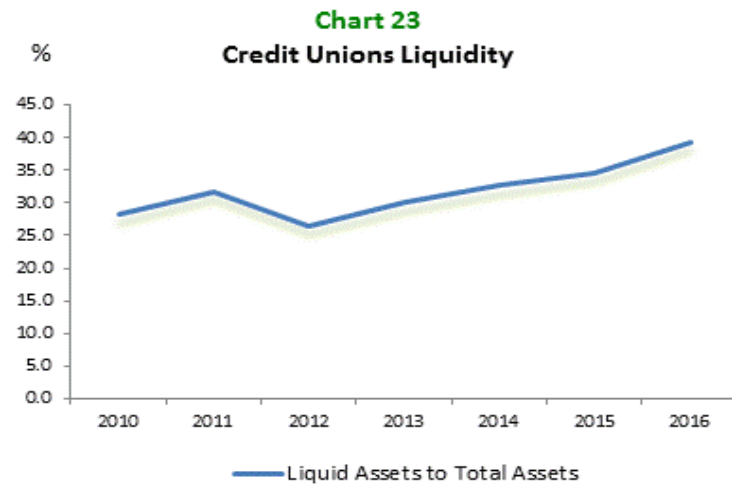


Source: Central Bank of The Bahamas

4.5. Liquidity

Credit unions maintained buoyant liquidity levels in 2016, as a 92.4% rise in cash holdings, along with a 13.3% increase in short-term financial investments, contributed to a 4.8 percentage point expansion in the ratio of liquid assets-to-total-assets to 39.5%. Similarly, the alternative indicator, the ratio of liquid assets

less short-term payables to total deposits, rose by 5.2 percentage points to 45.6%. Both ratios were in excess of the minimum prudential standard of 15.0%, indicating that credit unions collectively maintained robust levels of liquidity.



Source: Central Bank of The Bahamas

CHAPTER 5: THE INSURANCE SECTOR

Through their investment operations, domestic insurance companies have a modest impact on banking sector liquidity. This has less systemic importance however, than solvency considerations that expose holders of annuities and cash-value accumulation products to risks. Past failures in the domestic sector have imposed moderate fiscal costs for The Bahamas⁷ underscoring, at a minimum, the debt-associated incentives for maintaining stability in the insurance sector.

Information gathered from the Insurance Commission of The Bahamas (ICB), showed that the number of companies in the domestic insurance sector remained at 29 at end-2016—inclusive of 11 life and health insurers, offering whole life, term life and universal life, and 18 non-life insurers, providing, *inter alia*, insurance for automobiles, fire, liability and property. The composition of the sector remained unchanged from previous years, with a few large firms—4 life insurers and 6 non-life insurers—representing a combined market share of 80% of total gross premiums written and the majority of insurance coverage.

The external insurance sector, which is registered under the External Insurance Act⁸, primarily provides self-insurance coverage for non-resident entities in other countries. In 2016, it comprised 178 entities, of which 21 were insurance companies and 157 were captive cells. Despite the large number of external insurers in comparison to those on the domestic side, the former have a minimal impact on financial stability in the overall insurance sector by virtue of their core operations. Their impact on the domestic economy comes primarily from employment and fees charged by local service providers. As such, the following analysis will only focus on the domestic insurance sector.

With regard to the economy's size, the domestic insurance sector maintained its significance, as shown by a penetration ratio (total gross premiums to nominal gross domestic product) of an estimated 74.2% in 2016, although lower than the 86.8% recorded in the prior year. Reflecting in part the increase in claims following the passage of Hurricane Mathew in October, the non-life insurance sector showed an operating

⁷ Following the insolvency of the Colonial Life Insurance Company (CLICO) in 2009, the Government of The Bahamas at that time, agreed to absorb losses incurred by policy holders, at an estimated total cost of \$30.0 million (0.4% of GDP at end-2010). An IMF study in 2011, estimates that costs from affiliated entities of this operation elsewhere in the Caribbean ranged between 1.4% and 17.0% of GDP.

⁸ See website: <http://www.icb.gov.bs/home>

loss; however, the dominant life insurance segment recorded a profit. Nevertheless, on average, the stability indicators for the sector remained relatively unchanged.

5.1 Life Insurance

Life insurance companies—representing 59.2% of aggregate assets and 59.0% of gross premiums—continued to be the leading providers of insurance in the domestic sector. Based on provisional data, life insurers' total assets expanded by 4.2% (\$54.4 million) to \$1.4 billion, reflecting mainly a 3.4% increase in total investments to \$972.6 million—approximately 71.2% of total assets. The growth in the portfolio coincided with a rise in the holdings of Government securities and investments/claims on the private sector by 5.4% and 1.5%, to \$485.2 million and \$487.3 million, respectively. As to notable private sector exposures, policy loans rose by 2.5% to \$99.8 million, while investment property assets edged-up by 0.6% to \$89.3 million. In addition, the value of investments in mutual funds increased by 24.8% to \$20.5 million and other residual investments more than doubled to \$11.0 million. Providing some offset, mortgages declined by 3.0% to \$143.7 million, while both holdings of corporate securities and preference shares fell by 2.4% and 1.2% to \$41.7 million and \$33.4 million, respectively. Similarly, corporate equities listed decreased by 0.3% to \$27.4 million and corporate non-equities listed decreased by 0.7% to \$20.6 million. Meanwhile cash and deposits—the most liquid asset category—contracted by 11.5% to \$185.6 million.

Life insurance companies' liabilities grew by 3.6% (\$33.7 million) to \$958.5 million, explained mainly by a 5.3% growth in technical reserves—which were used to fund policyholders' claims and future benefits. Aggregate equity levels also increased by 3.5% to \$399.6 million, attributed to a rise in shareholders' investments and retained profits, which led to broad-based gains in retained earnings and share capital of 9.3% and 1.3%, to \$226.3 million and \$104.7 million, respectively. In contrast, other “miscellaneous” reserves fell by 9.6% to \$68.6 million.

On the earnings front, the estimated net income of domestic insurers contracted by 3.4% to \$43.2 million. This represented a 2.2% reduction in total income to \$451.8 million, as opposed to a 2.1% falloff in total expenses to \$408.7 million. The investment yield ratio narrowed by 70 basis points to 5.6%, as the decline in investment income, offset the growth in the value of investment assets. The expense ratio decreased by a muted 10 basis points to 29.5%. In addition, the return on equity (ROE) and return on assets (ROA) ratios softened by 0.8 and 0.2 percentage points to 10.8% and 3.2%, respectively.

Financial soundness indicators for the life insurance industry recorded mixed movements in 2016, but still remained in excess of international benchmarks. As a measure of the level of liquidity of insurance companies, the ratio of real estate plus unquoted equities and receivables to total assets, firmed by 2.6 percentage points to 17.4% (Table 6); however, the real estate-to-total assets ratio narrowed by 30 basis points to 6.5% and equities as a proportion of total assets—which are considered relatively higher risk—declined by 30 basis points to 6.0%. With regard to capital ratios, the net premium-to-capital ratio softened by 4.7 percentage points to 99.5% and the capital-to-total assets ratio decreased by 20 basis points to 29.3%. The capital-to-technical reserves ratio also moved lower by 90 basis points to 48.0%, although remaining above the international benchmark of 7.0%-10.0%.

Table 6:							
Life Insurance: Financial Soundness Indicators (%)							
	2010	2011	2012	2013	2014	2015	2016 ^p
Capital Adequacy							
Capital/Total Assets	25.0	26.2	26.2	29.1	29.8	29.5	29.3
Capital/Technical Reserves	37.4	40.1	41.2	46.5	48.3	48.9	48.0
Net Premium/Capital	126.4	128.5	119.0	106.7	104.5	104.2	99.5
Asset Quality							
(Real Estate + unquoted equities + receivables)/Total Assets	19.3	16.4	16.3	14.2	14.4	14.8	17.4
Equities/Total Assets	5.5	5.1	5.0	6.5	6.4	6.3	6.0
Real Estates/Total Assets	7.8	7.6	7.3	7.6	7.2	6.8	6.5
Earnings & Profitability							
Expense Ratio (expense/net premium)	41.6	31.4	31.0	30.0	29.3	29.6	29.5
Investment Yield (investment income/investment assets)	10.9	7.3	6.7	6.1	6.4	6.3	5.6
Return on Equity (ROE)	14.5	10.9	12.5	11.5	12.2	11.6	10.8
Return on Assets (ROA)	3.6	2.9	3.3	3.4	3.6	3.4	3.2
Source: Insurance Commission of The Bahamas & Central Bank of The Bahamas							
^k = revised							
^p = provisional							

5.2. Non-Life Insurance

Buoyed considerably by a one-off rise in re-insurance recoveries to \$396.7 million, as compensation for those policy holders affected by the hurricane, non-life insurers' assets more than doubled to an estimated \$940.0 million in 2016, compared to the previous year's \$461.6 million. Further, total investments grew by 3.7% to \$104.3 million, reflecting increased holdings of corporate securities and corporate equity listed securities. In contrast, holdings of non-listed corporate equity securities, preference shares and Government securities declined. The sector's total liabilities increase more than two-fold (\$486.8 million) to \$739.9 million, reflecting significant gains in both technical reserves and other "miscellaneous" liabilities to \$618.2 million and \$121.6 million, respectively, from \$210.7 million and \$42.4 million in 2015, owing to

claims emanating from the hurricane. Nevertheless, balance sheet equity declined by 4.0% to \$200.1 million, as the falloff in share capital and retained earnings, outpaced the gain in other reserves.

On the earnings side, a significant increase in hurricane-related claims led to non-life insurance companies experiencing an estimated net loss of \$7.6 million, vis-à-vis net income of \$18.6 million in the previous period. This outturn reflected the robust 30.7% growth in total expenses to \$122.0 million, which outpaced the 2.2% gain in total revenue to \$114.4 million.

As a result of these developments, the financial soundness indicators for the non-life insurance sector were mixed over the review period (see Table 7). As to asset composition, the equities to total assets ratio softened by 5.1 percentage points to 4.0%. Further, most earnings indicators weakened, with both the return on assets (ROA) and the return on equity (ROE) ratios recording loss equivalents of 0.8% and 3.8%, in contrast to positive net incomes of 4.0% and 8.9%, respectively, in the prior year. In addition, the loss ratio—which measures whether net claims paid out exceed net premiums collected—advanced to 56.3% from 30.3% in 2015, attributed to the passage of Hurricane Matthew. Further, the expense ratio firmed by 3.5 basis points to 66.3% in the review year, while the investment yield ratio rose by 2.6 percentage points to 9.6%.

Reinsurance ratios generally reflect the ability of the sector to minimize risk from adverse shocks, and in 2016, the risk retention ratio⁹ increased to 32.2% from 31.8% in the prior year, while the ratio of capital to technical reserves advanced to 309.0% from 101.1%, as the spike in technical reserves eclipsed that of net claims. Further, the technical reserves to net premiums ratio was significantly higher at 618.2%, vis-à-vis 210.0% in 2015. Overall, the increase in the ratios showed that the sector maintained adequate reserves to mitigate against the risk of significant negative events.

⁹ This ratio examines the relationship between net premium written and gross premium written.

Table 7:

Non-Life Insurance: Financial Soundness Indicators (%)

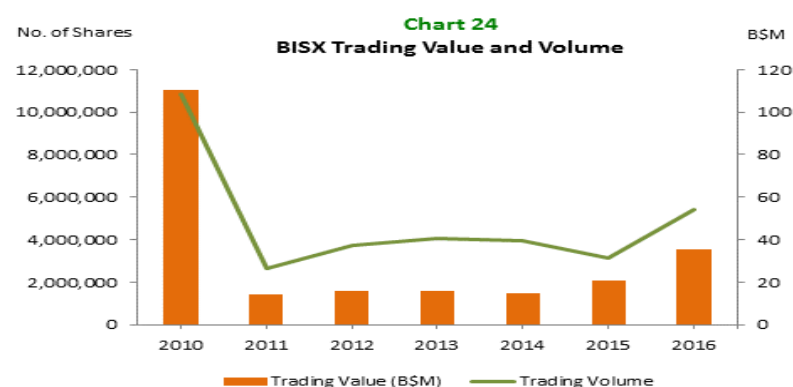
	2010	2011	2012	2013	2014	2015	2016 ^P
Asset Quality							
(Real Estate + unquoted equities + receivables)/Total Assets	40.6	56.9	58.4	51.2	51.2	52.5	72.7
Reinsurance and Technical Reserves							
Risk Retention Ratio (net premiums /total gross premiums)	35.4	29.2	33.9	34.2	33.2	31.8	32.2
Technical Reserves/Net Claims	380.6	554.1	500.0	471.6	720.1	693.6	1110.5
Technical Reserves/Net Premiums	153.3	207.3	188.9	166.7	191.1	210.0	618.2
Earnings & Profitability							
Expense Ratio (expense/net premium)	50.5	63.8	63.7	55.7	61.9	62.8	66.3
Loss Ratio (net claims/net premium)	40.3	37.4	37.8	35.4	26.5	30.3	55.7
Investment Yield (investment income/investment assets)	9.2	11.1	7.6	9.8	7.6	7.0	9.6
Investment income/net premium	5.5	8.4	4.7	6.2	6.1	7.0	10.0
Return on Equity (ROE)	10.9	4.5	6.4	12.9	12.9	8.9	-3.8
Return on Assets (ROA)	4.9	1.7	2.4	5.4	5.3	4.0	-0.8

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

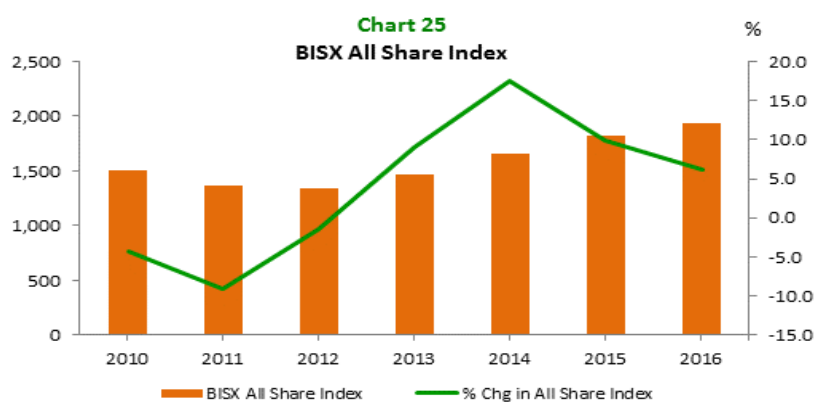
^R = revised^P = provisional

CHAPTER 6: CAPITAL MARKETS

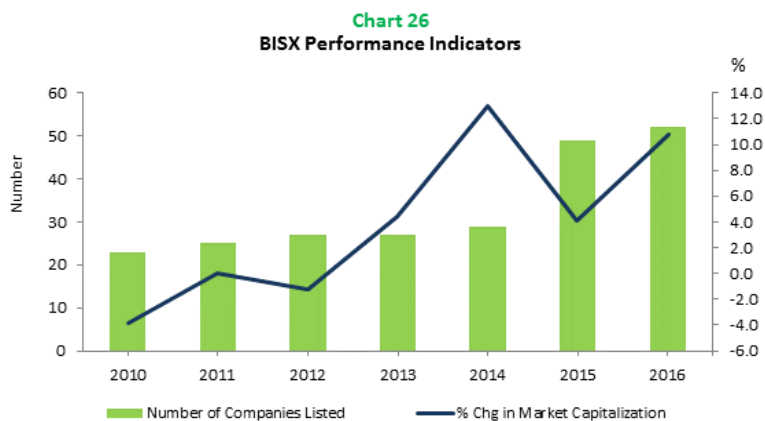
During the year, local equity market activity was relatively brisk on the Bahamas International Securities Exchange (BISX), owing in large measure to the listing of two new debt securities by a large telecommunications provider to fund its new business ventures. Specifically, the total volume of securities traded rose significantly by 86.0% to 5.4 million, a reversal from a 27.0% decline in the previous year, while the aggregate trading value expanded by 83.2% to \$35.5 million, outpacing the preceding year's gain of 29.0%. This represents an estimated 0.4% of GDP, and contrast with the net primary issuance of Government debt in the domestic market of \$544.3 million (6.1% of GDP).



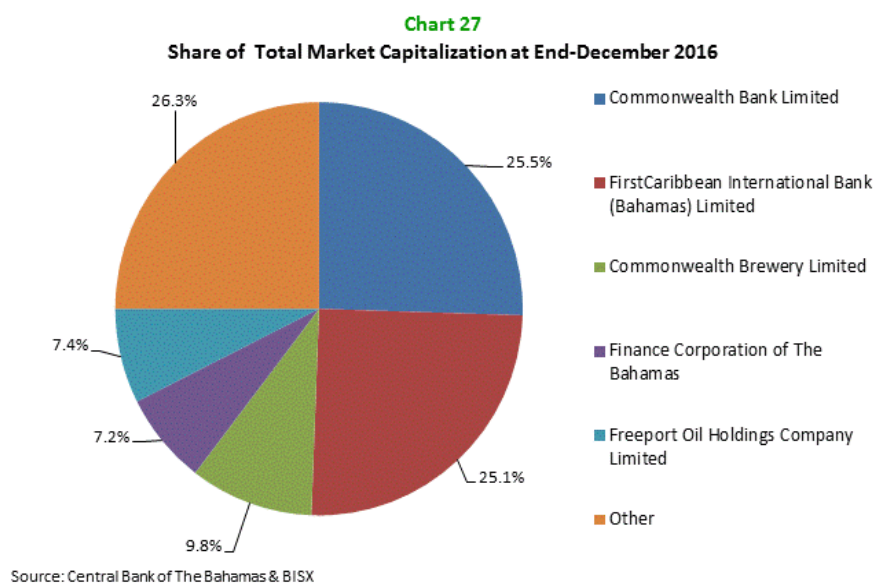
Other market indicators also improved during the review year. Specifically, supported by broad-based gains in share prices, the BISX All Share Index grew by 6.3% to 1,938.2 points, albeit lower than the 9.9% growth recorded in the preceding year.



During the year, market capitalization increased by 10.8% to \$4.0 billion, exceeding the year earlier expansion of 4.1%. The number of securities listed on the exchange firmed by 3 to 52, and comprised 20 common shares, 13 preference shares and 19 debt tranches at end-2016. The five largest companies, which are focused on providing financial, manufacturing and refining services, accounted for a dominant 68.4% of the index's total market capitalization, higher than the 73.3% recorded in the preceding year.



Source: Central Bank of The Bahamas & BISX



Source: Central Bank of The Bahamas & BISX

CHAPTER 7: PAYMENT SYSTEMS

Payments system developments continue to reflect a shift away from the use of cash and checks to more card and electronic based domestic transactions; both the automated systems for retail and gross payments settlements are helping to facilitate this transformation. While these developments align with greater efficiency in domestic payments transactions, they also underscore greater emphasis on sound liquidity management practices within the banking sector and with large firms that maintain deposit accounts for transaction purposes.

7.1. Real Time Gross Settlement (RTGS)

The RTGS system is owned and operated by the Central Bank and mainly processes large value transactions greater than \$150,000. During the year, the total volume of transactions facilitated via the RTGS increased by 13.0% to 85,504 items, following a 15.9% increase in the preceding period to 75,654 transactions. As a result, the associated value grew by 14.9% to \$25.5 billion, albeit a slowdown from a 23.4% expansion to \$22.2 billion in 2015.

7.2. Cash, Cheques and Electronic Payments

Although cash and cheques remain important modes of payment in the country, a marked shift towards electronic payments and debit & credit cards continued. Reducing cash reliance was underscored by the 6.3% reduction in the estimated volume of automated teller machine (ATM) withdrawals to 10.6 million during 2016, with a nearly one-third contraction in the value of transactions to an estimated \$2.0 billion. Similarly, the volume of cheques presented for clearing through the Automated Clearing House (ACH), fell further by 4.8% at 2,611,102 items in 2016, with the associated value of these instruments decreasing by 1.3% to \$7.0 billion, and reversing an uptick of 2.8% in 2015.

With regard to electronic payments, retail settlements processed through the Bahamas Automated Clearing House (BACH)—consisting principally of direct deposits of salaries and transfers—advanced by 14.3% to 2.3 million items in the review year, while the corresponding value expanded further by 32.9% to \$1,975.5 million. At the point of sale and other settings, the number of debit card transactions firmed by 9.6% at 9.1 million, while the associated value grew by 14.5% to \$1.4 billion. Credit card usage also rose, as the value of unpaid card balances increased by 2.8%; although aggregate growth was only concentrated among cardholders with higher spending limits (over \$10,000).

Box: De-Risking in the Caribbean

Correspondent banking relationships (CBRs) are critical for enabling key economic and financial transactions, such as remittances, foreign direct investments, international trade in goods and services, as well as the transfer of deposits from one location to another. Hence the potential loss of these CBRs will have serious consequences for financial stability and economic growth. Such threats are heightened in The Bahamas and the Caribbean, where domestic and offshore respondent banks rely on this access for international payments processing.

Correspondent banks rely on their respondent banks to put robust anti-money laundering and counter-financing of terrorism (AML/CFT) systems in place to guard against being used as channels for illicit activities. If there are any violations and based on the severity, corresponding banks may face sanctions of varying degrees, some civil in nature and others criminal, whereby some bank officers can even be imprisoned. There is also the possibility of damage to banks' reputations from having violations made public.

The Bahamas Correspondent Banking Survey Results

	Jul. 2015	Nov. 2016
Total Respondents	53	54
Licensees Impacted by De-Risking	6	14
Of which:		
Commercial Banks	2	3
Non-banks*	-	1
International Banks	4	10

Source: Central Bank of The Bahamas

* Non-banks were not included in the July 2015 Survey

In this environment, it is therefore the risk versus reward calculations that has fueled decisions to either sever or tighten CBRs—more commonly referred to as “de-risking¹⁰.” The de-risking strategy impact has decimated certain classes of business, clientele and jurisdictions throughout the Caribbean, as several banks have decided to exit countries and/or business lines, where the potential fines for which they might be subject, outweigh the likely profits. According to a report published by the World Bank in November, 2015¹¹, the Caribbean is one of the regions most affected by declining corresponding banking relationships. Several financial institutions in the region have lost important corresponding relationships, thereby shrinking the pool of institutions available to facilitate international transactions, and thus increasing the level of vulnerability of our financial institutions. Caribbean countries affected by de-risking include: Barbados, Belize, the Cayman Islands, The Bahamas, the Eastern Caribbean Currency Union (ECCU), Guyana, Haiti, Jamaica and Trinidad & Tobago.

Cognizant of the fact that The Bahamas, like its Caribbean counterparts, is vulnerable to the effects of de-risking, given its

reliance on tourism, trade, and foreign direct investments, the Central Bank conducted a survey in the first half of 2015, in an effort to assess the impact of the loss of CBRs on The Bahamas. The survey results revealed that at the time, the impact of the de-risking initiatives was relatively modest on domestic banks' operations. Specifically, the survey results showed that 2 of the 7 commercial banks were successful in finding replacements after the loss of the relationship, while others utilize their parent companies as their corresponding bank. Some banks also encountered greater levels of scrutiny as it relates to transactions, such as remittances and in some cases leading to processing delays. The Bank then conducted a second survey in August, 2016, and the results showed more widespread impacts from de-risking, with approximately one-fourth of the respondents encountering some challenges. The impacts were particularly concentrated among indigenous commercial banks and stand-alone international banks and trust companies. This pattern is likely replicated among other firms of a similar profile that did not participate in the survey.

Even where corresponding banking relationships were maintained, some respondents noted that additional AML/CFT requirements were imposed by their banker. However, licensees indicated that the enhanced AML/CFT requirements have not significantly impacted their operations. Nonetheless, the findings showed that banks within this jurisdiction generally rely on a small number of correspondent banking relationships and further losses in relationships could potentially pose a threat to the international financial sector's operations.

Although to-date, the effects of de-risking on The Bahamas have been less severe than in many other jurisdictions, the policy emphasis remains on reversing its severity, by further strengthening the effectiveness of the AML/CFT regime and countering perception biases concerning the risks within this jurisdiction. Pivotal to this development is the range of initiatives that will follow from the integrated national risk assessment (NRA) exercise, already underway, to assess and identify money laundering and terrorist financing risks faced by the country. The report will also serve to strategically inform enhancements to AML/CFT systems, including strengthened legal frameworks; enhanced and more targeted education and engagement with industry stakeholders; and capacity building within all of the regulators and law enforcement agencies. In addressing these issues, the Central Bank in particular, is placing greater emphasis on more AML certified personnel and collaborating with regulatory bodies for knowledge sharing and relationship building.

At the regional level, there has been increased cooperation, and the creation of a de-risking action plan, which seeks to, *inter alia*, strengthen data collection and analysis of de-risking, build regional capacity in the area of AML/CFT supervision and accelerating the migration to more electronic (non-cash) based payments.

¹⁰ De-risking is the purposeful termination of financial relationships with groups of customers or lines of business, considered high risk.

¹¹ See: “Withdrawal from Corresponding Banking, Where, Why and What To Do About It”, International Bank for Reconstruction and Development / The World Bank Group, Nov. 2015.

CHAPTER 8: ASSESSMENT OF RISKS

Financial stability risks within The Bahamas remain within manageable bounds, with no heightened medium-term concerns to be noted. Given the potential for an improvement in the economy over the near-term, there is the opportunity for the further mitigation in risks, although the very gradual growth prospects place an upper bound on the speed at which credit risks will dissipate. With this in view, the Central Bank anticipates that more aggressive direct intervention will still be necessary to speed up the reduction in NPLs. In addition, the credit bureau framework will provide the structural support for sounder lending practices over medium and longer-term horizons. Commercial banks remained well capitalized, relative to the regulatory prescribed target and trigger ratios of 17.0% and 14.0%, and well above the international minimum capital benchmark of 8.0%. However, important scope exists to enhance average buffers within credit unions, as the Central Bank further strengthens its oversight of these entities.

In a macroeconomic sense, the elevated levels of bank liquidity will also require continued close monitoring, as improving economic conditions favour an acceleration in consumer credit expansion. This reserve capacity for lending will still have to be unwound gradually, so as not to outpace the growth in the country's foreign earning exchange sectors. The Central Bank's medium term strategy in this area includes a gradual reduction in its holding of government debt, as this would absorb some of the surplus liquidity. The Bank's macro-prudential toolkit is also being developed with these and other high-level issues in view, and with technical assistance from the IMF's CARTAC.

The Bank, through its supervisory department, will continue to pursue policies geared towards mitigating the potential risks to supervised institutions and strengthening the regulatory environment. Focus will continue on the rollout of the Basel II and III framework for banks and trust companies, and strengthening risk and governance systems within credit unions. Progress has already been noted on the capital component of the Basel II regime, with specific importance placed on licensees' internal capital adequacy assessment process (ICAAP) and revisions to the Central Bank's guide on its Ladder of Supervisory Intervention. These reflect an emphasis on increased buffers, among other risks, over the course of the business cycle, domestically systemically important banks (D-SIBs) and maturity mismatches. The "evergreening" process to document a matured point-in-time risk view of financial institutions' risk profiles, is already underway. This will support further tailored supervisory engagement within individual licenses.

In line with its mission to ensure a sound financial system, the Central Bank, along with other regulators and domestic stakeholders, made further progress on proposals to finalize a National Financial Crisis Management Plan. As the core objective is to ensure strong alignment of The Bahamas' framework with recommended best international practices, the Bank has identified various amendments that are needed in the different legal frameworks, including resolution processes under the deposit insurance scheme. Appropriate deposit insurance mechanisms for credit unions will also be explored. These initiatives, combined with other measures being implemented by the Securities and Insurance Commissions, will serve to further enhance and strengthen the supervisory regime in place to ensure sustained stability of the financial sector.

