



FINANCIAL STABILITY REPORT 2018



EASTERN CARIBBEAN CENTRAL BANK

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The ECCB welcomes your questions and comments on this publication.



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The Financial Stability Report is a publication of the Eastern Caribbean Central Bank. It contributes to the Eastern Caribbean Central Bank's financial stability objective by identifying, monitoring and communicating on systemic risks. The view is to enhance the resilience of the ECCU financial system by taking action to reduce or remove any threat to financial system stability. This is a key strategic priority of the Eastern Caribbean Central Bank and supports the bank's objectives as it relates to growth, sustainability and employment.

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ABBREVIATIONS

AML/CFT	Anti-Money Laundering/Countering Financing of Terrorism
BSD	Bank Supervision Department
BSI	Banking Stability Index
CAR	Capital Adequacy Ratio
CARAMELS	Capital, Assets, Reinsurance, Actuarial provisions, Management, Earnings, Liquidity, and Subsidiaries and group issues
CBR	Correspondent Banking Relationship
CISS	Composite Index of Systemic Stress
ECACH	Eastern Caribbean Automated Clearing House
ECCB	Eastern Caribbean Central Bank
ECCSD	Eastern Caribbean Central Securities Depository
ECCU	Eastern Caribbean Currency Union
ECHMB	Eastern Caribbean Home Mortgage Bank
ECSE	Eastern Caribbean Securities Exchange
ECSM	Eastern Caribbean Securities Market
ECSRC	Eastern Caribbean Securities Regulatory Commission
HHI	Hirschman Herfindahl Index
IBM	Interbank Market
IMF	International Monetary Fund
LFI	Licensed Financial Institution
NBFI	Non-Bank Financial Institution
NFC	Non-Financial Corporation
NPL	Nonperforming Loan

PEARLS	Protection, Effective financial structure, Asset quality, Rates of return and Cost, Liquidity and Signs of growth
RBS	Risk Bases Supervision
RGSM	Regional Government Securities Market
ROA	Return on Assets
ROE	Return on Equity
RTGS	Real Time Gross Settlement
SRU	Single Regulatory Units
UK	United Kingdom
US/USA	United States of America
WEO	World Economic Outlook

The following symbols are used:

E	Estimate
F	Forecast
Q	Quarter
RHS	Right Hand Side
LHS	Left Hand Side

Preface – From the Governor

As the ECCB continues in its pursuit of the Strategic Objective of ensuring a strong, diversified and resilient financial sector, it is incumbent upon us, as the regulatory and monetary authority to remain accountable to you, the people of the Eastern Caribbean Currency Union (ECCU). This edition is the third instalment of our Financial Stability Report and represents even more so, the efforts of the ECCU’s regulatory authorities to mitigate and report on systemic risk in the region.

This regulatory partnership serves to both enhance the reporting framework and enrich the conversation surrounding risks emanating from within the ECCU. As with new beginnings, we continue to face challenges, especially as it pertains to data limitations within the credit union and insurance sectors. These limitations have served to restrict the scope and coverage in this Report. This edition of the financial stability report continues to provide readers with an assessment of the main developments and vulnerabilities in the ECCU’s financial system. The report is divided into five (5) chapters:

1. The Macro-Financial Environment and Key Risks Influencing the ECCU Region.
2. Financial Performance and Soundness of Deposit-Taking Institutions: Banking and Credit Union Sectors.
3. Financial Performance and Soundness of Non-Deposit-Taking Institutions: Insurance Companies.
4. Policy Initiatives for Enhancing Financial Stability in the ECCU.
5. Outlook

This issue of the FSR identifies four main vulnerabilities within the financial sector and as with previous reports, boxes are used to highlight key information for understanding. Consequently, in this report, we provide for you, an overview of the insurance sector and its role in financial stability in our region. Additionally, work continues on the development of the macroprudential framework as well as new supervisory arrangements by the ECCB. These policy initiatives reinforce our commitment to the people of the ECCU.

1. OVERVIEW OF THE FINANCIAL STABILITY IN THE ECCU

The financial sector in the ECCU remained broadly stable throughout 2018. The growth rate of global economic activity slowed during the period, under the influence of trade tensions between advanced economies. As a result, financial conditions in these countries were somewhat tighter, in comparison with emerging economies, where financial conditions showed greater volatility.

Global inflationary pressures remained subdued, reflecting the weaker economic expectations and the decrease in oil prices in international markets. Amid higher uncertainty surrounding economic growth, central banks in advanced economies lowered expectations for the monetary policy normalization. Across the financial sector, developments were largely favourable and positive. A favourable macroeconomic environment and strengthened supervision and regulations has contributed to this stability. Overall, companies and households' lending as a percentage of GDP increased moderately but remained below pre 2008/2009 levels.

In addition, their debt-servicing capacity improved on account of higher profits and incomes. The low interest rate also has a positive effect on debt servicing capacity and member countries currently benefit from low interest payments, but borrowers were also exposed to substantial interest rate risk.

Banks and credit unions maintained their positive performance. In the banking sector, profitability, capitalisation, liquidity and credit risk all recorded improvements. Notwithstanding, operational efficiency remains a feature of the structure of the banking system where overhead costs are high. Likewise, credit unions maintained their performance but were impacted by slightly higher levels of non-performing loans. Both banks and credit unions increased their lending during 2018.

The insurance sector is faced with sustained low yields attributable to the low interest rate environment, which is a particular challenge in the life insurance business. Nevertheless, the sector's aggregate profitability improved in 2018. Additionally,

the solvency capital ratio of the ECCU insurance sector is at a high level.

Despite this, a number of structural vulnerabilities remain in the financial sector. This publication of the FSR identifies four main vulnerabilities within the financial sector; **(i)** a high degree of concentration in the lending/loan portfolio, **(ii)** continued elevated levels of NPLs, **(iii)** a growing share of non-bank lending relative to total lending, **(iv)** exposure to cyber security risk. Due to credit institutions increased reliance on Information Technology (IT) in their operations, and the development of innovative financial technology products; IT security risk has the potential to become a systemic vulnerability to financial institutions.

The main risk factors to overall stability of the financial sector are, **(i)** a possible weakening in the economic environment in which financial institutions operate, **(ii)** the impact of natural disasters and **(iii)** further losses in correspondent banking relationships. The domestic macroeconomic environment remains stable, however, there is greater uncertainty in the international environment, but it is difficult to predict

adverse consequences to financial stability from the international environment. Additionally, risk factors stemming from the impact of hurricanes are large. Following natural disasters, households and businesses suffer both a loss of wealth and income. As such, they are unable to service their debt in the short term. Moreover, with natural disasters, insurance firms are at times unable to meet claim obligations due to several reasons and as such, may become insolvent. Along with these challenges, de-risking poses a challenge to the banking sector as the discontinuation of correspondent banking services can hamper the smooth and efficient delivery of payments globally, which can affect the real economy. Additionally, there are other risks that can affect the financial sector, which are cyclical and structural.

An additional area of concern is the financial cycle, which is now entering an expansionary phase as credit growth continues to recover. An expansionary financial cycle raises household debt levels and can cause an overvaluation of asset prices, both of which can have serious negative consequences during an economic downturn. Another area of concern is the movements in

international interest rates as Central Banks in advanced economies aim to normalize their balance sheets. This type of risk is most acute at institutions with large foreign bonds portfolio. A sudden repricing in fixed income

markets can lead to substantial capital losses for institutions with large bond holdings.

2. OVERVIEW OF THE FINANCIAL SECTOR IN THE ECCU

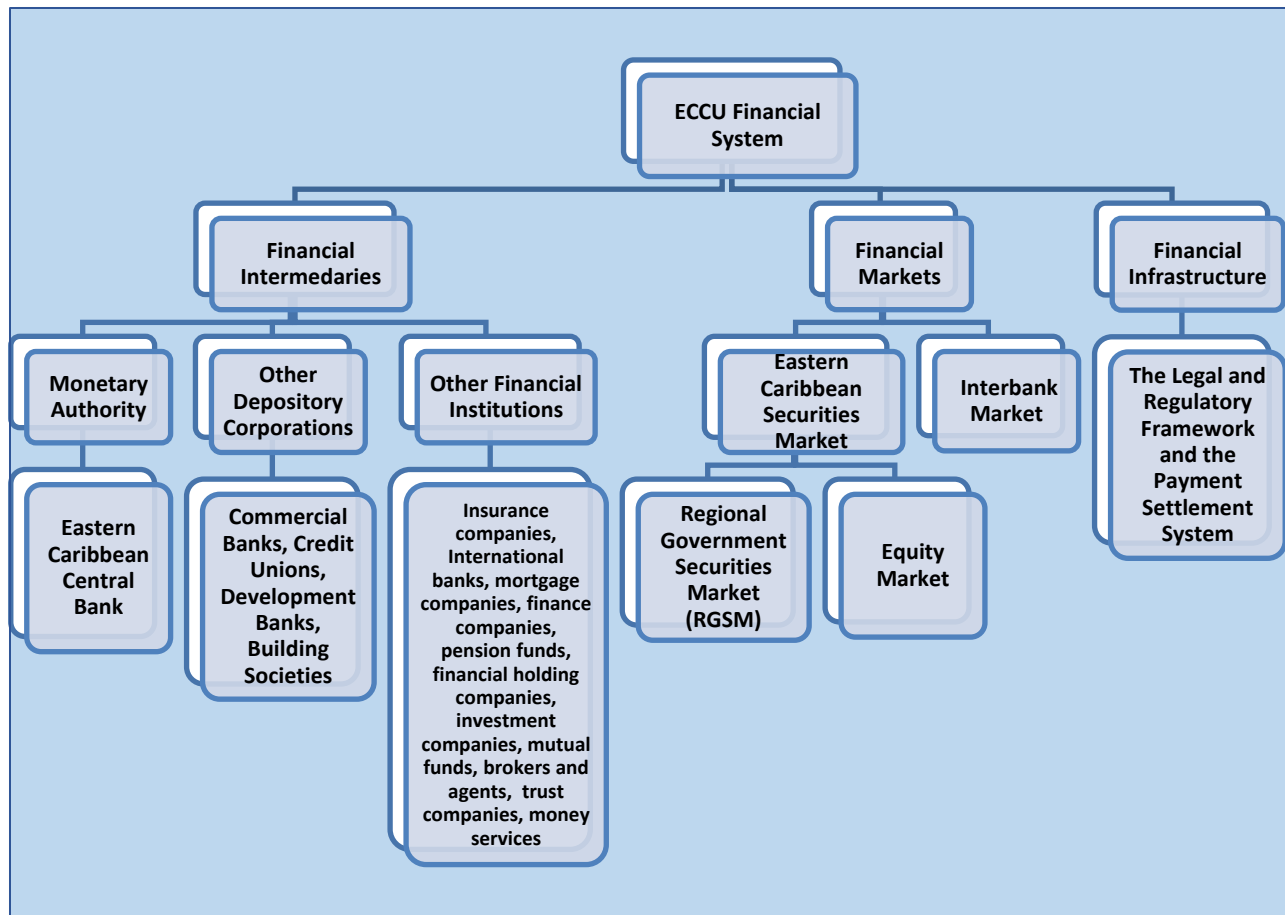
The Eastern Caribbean Currency Union (ECCU) comprises six (6) sovereign countries (Antigua and Barbuda, Dominica, Grenada, Saint Kitts and Nevis, Saint Lucia and Saint Vincent and the Grenadines) and two (2) UK overseas territories (Anguilla and Montserrat) with an overall population of approximately 620,000 persons. The financial sector in the currency union is organized around 20 licensed commercial banks, 12 of which are indigenous commercial banks owned by resident investors including governments, and eight (8) foreign owned groups (which in turn operate 23 subsidiaries or branches across the ECCU).

Besides commercial banks and other institutions licensed under the Banking Act, the financial system also comprises of approximately 160 insurance companies, 49 credit unions, 6 development banks/boards,

offshore banking entities and a range of other non-bank financial institutions comprising investments and securities firms, building societies and money services business.

For the immediate purposes of this report, focus is on institutions licensed under the Banking Act, Credit Unions and Insurance companies. The financial markets are the interbank market (IBM), the Regional Government Securities market (RGSM) and the Eastern Caribbean Securities Exchange (ECSE) which make up the money and capital markets; and the financial infrastructure which incorporates the payment settlement system and the legal and regulatory framework that facilitates the effective operation of financial intermediation (Figure 1).

FIGURE 1: STRUCTURE OF THE ECCU FINANCIAL SYSTEM



I. Financial Intermediaries

Financial intermediaries operating in the ECCU include institutions licensed under the Banking Act (commercial banks and NBFIs), credit unions and insurance companies. The ECCU financial system is dominated by the commercial banking sector. The dominance of the banking sector is evident in areas such as asset size, deposit base and credit to the private sector. In addition to commercial banks, there were 11 NBFIs licensed under

the Banking Act, which include finance companies. At the end of 2018, total assets of the sector accounted for about 81.0 per cent of total domestic assets of the financial sector.

The system also included 49 credit unions distributed among 7 member countries and approximately 160 insurance entities.

II. Financial Markets

The financial markets in the ECCU are primarily the interbank market and the Eastern Caribbean Securities Market (ECSM), which comprises of the Regional Government Securities Market (RGSM) and the Eastern Caribbean Stock Exchange (ECSE). An official Interbank Market was established in 1986 in an attempt to strengthen the infrastructure for liquidity management in the ECCU. The IBM was meant to provide a transparent platform for the lending and borrowing of funds between licensed commercial banks in the region.

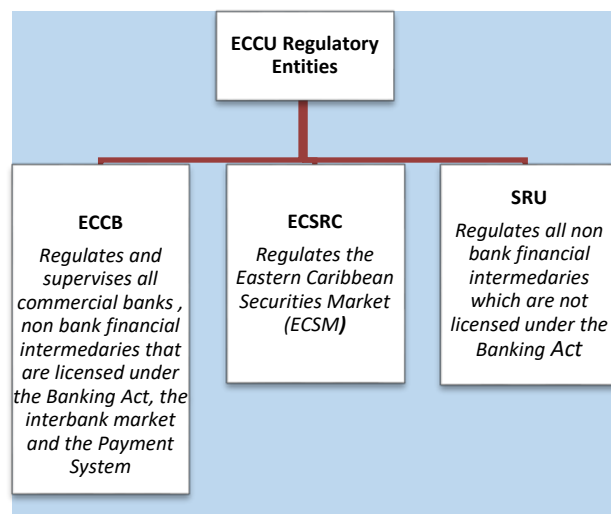
The ECSE was designed to provide an alternative mechanism for institutions to raise capital within the regional financial system. It facilitates primary and secondary market trading, thereby giving investors an opportunity to raise capital through new issues of securities as well as by trading in existing securities. The ECSM comprises the RGSM and the ECSE. The RGSM was established in November 2002 to facilitate and further the improvement of fiscal management in the ECCU. On the equity side, there are presently thirteen (13)

corporate securities listed on the market. As at December 2018, total market capitalisation was EC\$8.3 billion, an increase of EC\$31.3 million or 0.4 per cent compared to that of 2017. This increase in market capitalisation is attributed mainly to the listing of the Grenada Cooperative Bank Ltd in July, a rights issue and an additional public offering by The Bank of Nevis Ltd, as well as a marked appreciation in the share price of the St Kitts-Nevis-Anguilla National Bank Ltd, which contributes 5.0 per cent of total market capitalisation.

III. Regulations

The regulation and supervision of the financial system is conducted by three principal entities namely the Eastern Caribbean Central Bank (ECCB), the Eastern Caribbean Securities Regulatory Commission (ECSRC) and the Single Regulatory Units (SRU) in each member state (Figure 2).

Figure 2: ECCU Regulatory Framework



IV. THE EASTERN CARIBBEAN CENTRAL BANK

The Eastern Caribbean Central Bank (ECCB) is the monetary authority for the eight (8) participating member territories of the Eastern Caribbean Currency Union. The primary responsibility of the ECCB is to maintain the stability of the Eastern Caribbean currency and the integrity of the financial system. Article 3 of the Eastern Caribbean Central Bank Agreement Act (The Agreement) authorises the ECCB to regulate and supervise institutions engaging in banking business. The regulatory and supervisory functions of the ECCB is conducted through the Bank Supervision, and Banking and Monetary Operations Departments. The Banking Act governs the regulation and supervision of institutions

engaging in banking business in the ECCU. In 2015, a new uniform Banking Act was passed in the member states, mainly to address revealed legislative and regulatory gaps and to allow regulators to undertake a more risk focused approach to supervision. The ECCB regulates and supervises all institutions licensed under the Banking Act i.e. the 20 licensed commercial banks and 11 NBFIs.

V. THE EASTERN CARIBBEAN SECURITIES REGULATORY COMMISSION

The Eastern Caribbean Securities Regulatory Commission (ECSRC) is responsible for licensing all individuals and companies who wish to engage in the securities business in the Eastern Caribbean Securities Market (ECSM). This directive, contained in Article 4 of the ECSRC Agreement, requires the Commission to “license any person engaged in securities business and to monitor and supervise the conduct of such business by a licensee.” The primary functions of the ECSRC are:

- To maintain the integrity of the ECSM;
- To protect investors;
- To promote market efficiency; and

- To facilitate market development.

VI. THE SINGLE REGULATORY UNITS

The Single Regulatory Units (SRUs) in each territory regulate and supervise financial institutions, which are not licensed under the Banking Act. These include international (offshore) banks, insurance companies, credit unions, cooperative societies, building societies and money services businesses.

The main functions of the SRUs are to:

- Provide more effective protection for consumers;
- Assist with minimising systemic risk;
- Promote market confidence; and
- Contribute towards strengthening the performance of financial institutions.

VII. Role of ECHMB in the Financial Sector of the ECCU

The Eastern Caribbean Home Mortgage Bank (ECHMB) was founded on 09 August 1994. The primary purposes of the Bank as established by its charter are:

- 1) To develop and maintain a secondary market for residential mortgages in the member territories;

- 2) To contribute to the mobilisation and allocation of long-term savings for investment in housing;
- 3) To support the development of a system of housing finance and provide leadership in the housing and home finance industry;
- 4) To promote the growth and development of the money and capital market; and
- 5) To improve underwriting practices and efficiency in processing mortgages and to promote services and benefits related to such mortgages.

As at December 2018, total assets of the ECHMB was EC\$261.9m, of which, \$42.9m is comprised of mortgage loans (which refer to purposes 1-3) while investment assets comprised \$204.3m (relates to purpose four 4), which is approximately 78.0 per cent of ECHMB's assets. The Bank's investment securities are held in a diverse range of financial institutions, corporations and governments both locally, regionally and internationally. Equity instruments are held with the ECSE.

Given the prevailing high levels of liquidity in the banking system, the role of the ECHMB has shifted somewhat from the purchase of mortgages to more investment management and products. The Bank currently issues corporate bonds on the ESCE; the funds received are invested in regional and international investments. The spread between the rate of return on the investment and what is paid to the participating institutions is used to fund the operations of the ECHMB.

Hence, the ECHM currently offers institutional investors another safe investment asset to invest in beyond Government paper. However, these activities pose no material risk to financial stability given the nature of the investments, which ECHMB makes. The investments, which the Bank makes, are high quality top rated investments. Thus far, Bank of St. Lucia and First Citizens Investment Services Limited have dominated the uptake in the issuances. There has been limited to no participation by institutions in Anguilla, Antigua and Barbuda, Commonwealth of Dominica, Montserrat and St Kitts and Nevis.

VIII. FINANCIAL INFRASTRUCTURE - THE PAYMENT SYSTEM

The ECCB operates a Real Time Gross Settlement (RTGS) system, based on straight-through processing with the use of SWIFT messaging. The commercial banks, member governments, the Securities Registry and the Eastern Caribbean Automated Clearing House (ECACH) are participants in the Interbank Settlement System. Large value transactions (values above \$150,000 XCD) are settled on a RTGS basis through the Interbank Settlement System while retail payments (payments below \$150,000 XCD) are settled through the ECACH. The Automated Clearing House (ACH) provides clearance for cheque based transactions but settlement occurs through the Interbank Settlement System at the Central Bank. Securities, which include regional government and private sector securities are settled through the Securities Clearance and Settlement System; operated by the Eastern Caribbean Central Securities Depository (ECCSD).

CHAPTER 1: THE MACRO-FINANCIAL ENVIRONMENT AND KEY RISKS

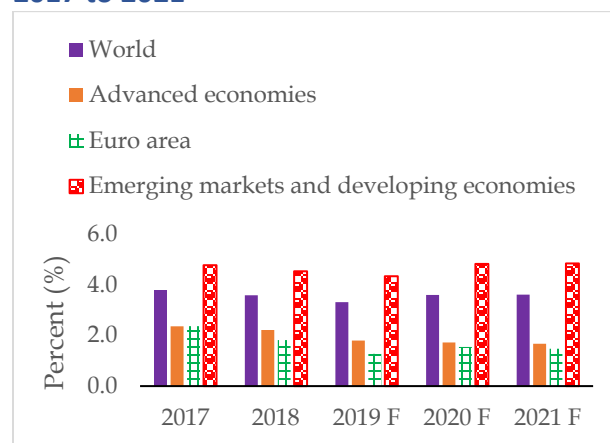
INFLUENCING THE ECCU REGION

1.0 International Economy

The ECCU financial stability report comes at a time when the global economy is slowing amid, (i) increasing trade tensions between the USA and China, (ii) geopolitical tensions and (iii) uncertainty regarding the United Kingdom's (UK) exit from the European Union (EU). In its latest WEO update (April 2019), the IMF is predicting a moderation in global economic growth. Global economic growth is forecasted to expand by 3.3 per cent in 2019 down from 3.6 per cent in 2018. Growth in advanced economies is projected at 1.8 per cent in 2019, compared with an expansion of 2.2 per cent in 2018 (Figure 3). As a result of the slowing global economy, Central Banks in advanced economies have delayed their decisions to raise benchmark interest rates. Financial conditions in these in advanced countries are also tightening, in comparison with emerging economies, where financial conditions showed greater variability.

In the USA, growth will decelerate to 2.2 per cent in 2019 per cent from 2.7 per cent. In the Euro Area and United Kingdom are also expected to weaken in 2019 due to heightened uncertainty from Brexit and slowing industrial production in Germany. Economic output from China is anticipated to ease to 6.3 per cent in 2019 following a 6.6 per cent expansion 2018. For emerging and developing economies, growth is expected to decelerate to 4.4 per cent in 2019 (from 4.5 per cent in 2018), 0.3 percentage points lower than in the October 2018 WEO.

Figure 3: Global Output, Selected Countries, 2017 to 2021



Source: IMF World Economic Outlook Database, April 2019

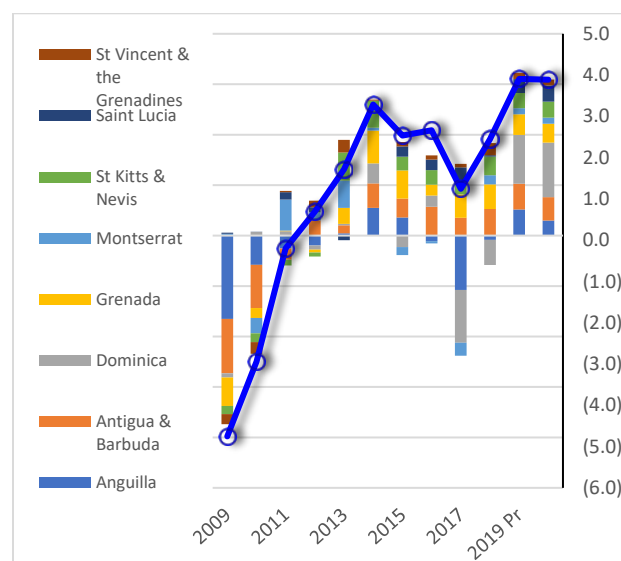
1.1 The Domestic Economy

The ECCU economies continue to perform well in 2018; economic growth improved and fiscal conditions remained positive. Initial estimates suggest that the pace of economic activity accelerated over 2017. Real economic growth for 2018 is estimated to have increased by 3.8 per cent versus 0.9 per cent in 2017 (Figure 4). Six of the ECCB member states recorded inflationary conditions during 2018, compared with the previous year, when all eight countries experienced inflationary pressures. The overall balance on the consolidated fiscal accounts of member governments reverted to a surplus position after recording a deficit last year. The turnaround resulted from developments on the current account, which more than offset the impact of higher capital outlays. Despite the improvement in the overall fiscal performance, the outstanding debt of the public sector rose, driven in part by increases in both external and domestic borrowing.

Economic output in the ECCU is forecasted to remain stable at 3.3 and 3.2 per cent respectively in 2019 and 2020. Growth is expected to be supported by reconstruction activity and an overall expansion in the

construction sector while tourism activity is expected to be buoyant. The risk to the outlook for the ECCU is largely balanced despite the slowing global economy. Domestic policy action has strengthened the domestic economies and bolstered their resilience to economic shocks.

Figure 4: ECCU Economic Growth Summary 2009-2019 (per cent change)



Source: Eastern Caribbean Central Bank (ECCB)

Buttressed by strengthening economic conditions, the ECCU financial sector remained stable throughout 2018, though there are points of weakness. This assessment is hinged on a strengthening macroeconomic environment, improving capital buffers, and ample liquidity in the financial system. Risks associated with the

financial cycle remain low. However, the changing paths of its components may be signalling the upward phase of the financial cycle (see section on cyclical risks).

Structural risks remain and are centred on the concentration of loan portfolios to households.

1.2 Key Vulnerabilities and Risks

A key aspect of the FSR is the assessment and monitoring of shocks/risks and vulnerabilities in the financial system. Shocks, such as sudden changes to financial or economic conditions, are typically surprises and are inherently difficult to predict. These shocks/risks are triggers, which can spark systemic stress if the financial system is sufficiently vulnerable.

Vulnerabilities are pre-existing conditions that can amplify and propagate shocks throughout the financial system. Vulnerabilities tend to build up over time and are the aspects of the financial system that are most expected to cause widespread problems in times of stress. Vulnerabilities can be classified into two categories: cyclical vulnerabilities that evolve with the financial

cycle and structural vulnerabilities that are inherent features of the financial system.

Vulnerabilities - The main vulnerabilities in the ECCU financial sector were:

- i. High levels of loan portfolio concentration;
- ii. Elevated levels of non-performing loans;
- iii. Migration of lending whereby non-bank credit suppliers continue to increase their share of total credit to households;
- iv. Large exposure household mortgages; and
- v. Exposure to cyber-security threats, operational risks and financial interconnections

Concentration - One of the main goals of macroprudential policy is to limit direct and indirect exposure concentration, close to 60.0 per cent of all lending by FI's was extended to households; a key vulnerability in the financial sector. Roughly, 55.0 per cent of lending to households is for house and land acquisition. With such large exposure to households, any large and abrupt negative shock to household income or shifts in interest rates are likely to have a

significant impact on the financial system through higher delinquencies and or loan defaults. The current macroeconomic conditions coupled with low interest rate are helping to support debt servicing capacity, however, this can change with a shift in economic conditions. While complete data is not available, increasing loans to households especially for mortgages suggest that debt burdens (debt to disposable income) are rising for households.

Elevated level of NPLs - Though the volume of non-performing loans has been declining (exceptions Dominica and St Kitts and Nevis); the NPL ratio remains very high. At 11.4 per cent, the ratio exceeds the regulatory minimum and may take some time to decrease to acceptable levels. In the interim, this means that institutions have to retain high levels of provisioning which affects their profitability and capital. Moreover, a deterioration in macroeconomic conditions can further exacerbate this vulnerability.

Risk Shifting-Growing Share of Non-Bank Lending – Credit Unions and payday lenders continue to increase their share of lending to the domestic economy. Credit union lending

has remained buoyant throughout the last few year and its share of overall lending has increased. While the expansion of credit from these institutions has assisted credit-constrained households, credit growth has potential systemic risk implications. These institutions may have weaker credit underwriting standards when compared with commercial banks and as such, they pose a risk to financial stability through amplifying and propagating negative effects when there is a shock to the domestic economy. This is especially true for very large credit unions.

Cyber threats remain a key structural vulnerability. As financial institutions shift their services online, this exposes them to the threat of a cyber-attack. A successful cyber-attack or other major cyber incident at a financial institution can spread across the interconnected financial system, interrupting the delivery of crucial financial services and damaging consumer and investor confidence.

Risks - Risks are those triggering factors that can amplify and transmit vulnerabilities in the financial system leading to financial

instability. The key risk factors that are identified in 2018 were:

(i) **Further slowdown or recession in major trading partners' economies.** The ECCU countries are small open economies and thus any changes in the external macroeconomic environment is likely to affect financial stability. Additionally, some commercial banks and insurance companies have exposures to advanced economies' bond and stock markets. The volatility of these markets in 2018, is likely to have impacted these institutions.

(ii) **Natural Disasters** - The increasing frequency and intensity of natural disasters are likely to have a negative impact on the financial sector and the real economy. For example, the passage of a hurricane can cause widespread damage to the real economy through the destruction of agriculture and infrastructure. Furthermore, borrower's financial positions may be affected through job and income losses as well as damage to physical collateral, which can significantly affect the financial sector. These effects can also lead to an increase in the cost of insurance and can place upward pressure on both the cost of construction

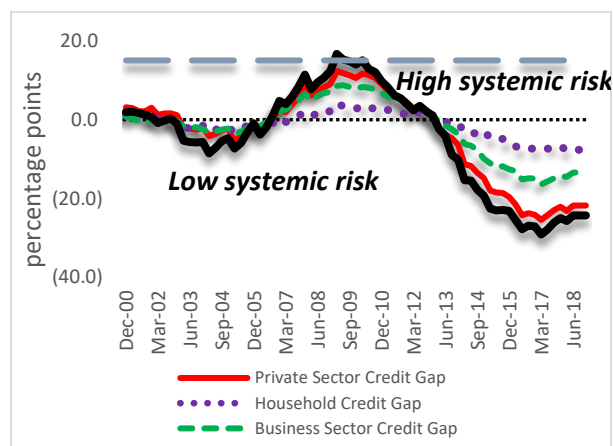
and home ownership. Thus, households may choose to underinsure their property.

(iii) **Further loss of CBRs** - Though the loss of CBRs for the region has been stabilised, there is still a risk that further loss of these relations can exacerbate the timely transmission of payments internationally thereby interrupting the smooth and efficient function of the financial system and the economy. Therefore, this risk needs to be assessed continually.

1.3 Cyclical Risk

At the end of 2018, cyclical risk, as measured by the credit to GDP gap was low (negative). **This negative gap indicates that excessive levels of debt are not accumulating in the financial sector (Figure 5).** The total credit to GDP gap stood at negative 24.4 per cent as at end December 2018 compared with negative 25.0 per cent recorded at the end of December 2017. Though negative, the credit to GDP gap is closing, indicative of an expansionary phase of the financial cycle.

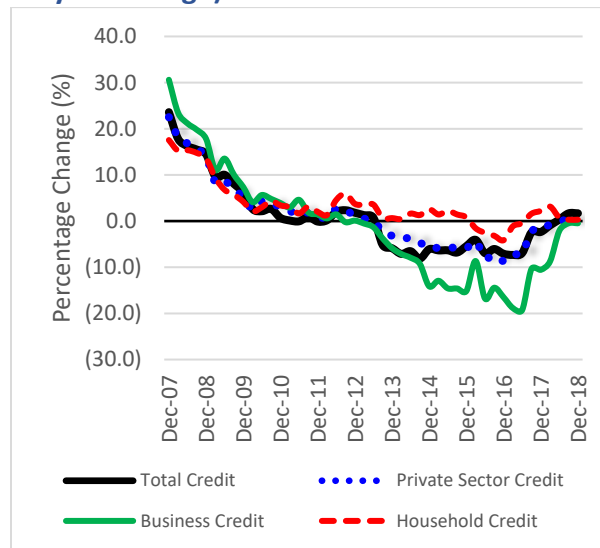
Figure 5: Credit to GDP Gap (Financial Cycle)



Source: Eastern Caribbean Central Bank (ECCB)

This analysis is also substantiated by the year on year growth rate of credit, (Figure 6). Overall, domestic lending is gradually recovering but asymmetric across segments of the financial sector. While credit growth in the banking sector slowly recovered, growth in credit remained buoyant in the credit union sector. Across lending categories, lending to non-financial corporations (NFCs) remained subdued, mortgage lending moderated, while spending on consumer durables accelerated.

Figure 6: Credit Growth by Segment (year on year change)

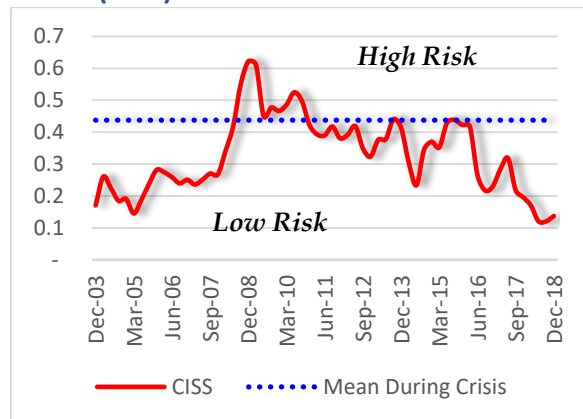


Source: Eastern Caribbean Central Bank (ECCB)

The Composite Index of Systemic Stress (CISS) shows a decline in the correlation of risk across different segments of the financial sector (money market, bond market (RGSM), and household credit). The CISS was recorded at 0.14 points as at end December 2018 when compared to a value of 0.20 points at the end of December 2017 (Figure 7).

The CISS remains below the levels observed during periods of high stress (average of 0.44 points). The lower risk across these sectors was reflective of cyclical effects, as risk aversion remained high across financial market segments.

Figure 7: Composite Index of Systemic Stress (CISS)



Source: Eastern Caribbean Central Bank (ECCB)

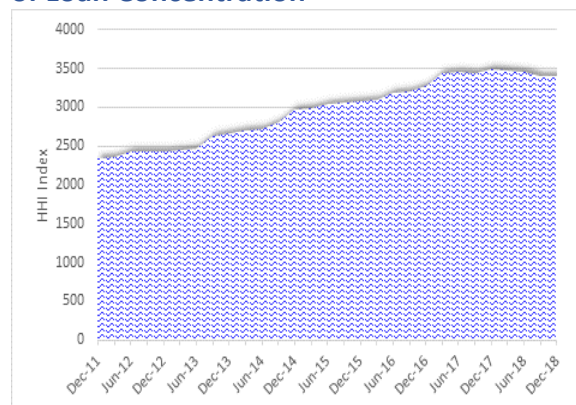
1.4 Structural Risk

There was an upward trend in structural risk, as measured by concentration and interconnections. The concentration of commercial bank credit is one of the most important factors contributing to systemic banking risk¹. As at December 2018, the concentration of banks loan portfolios was at 3,448 points, a 24-point reduction from the December 2017 index (Figure 8). Although a marginal reduction was recorded, the overall trend has been

¹ According to a 2004 Basel committee study, credit concentration of banks caused 9 of the 13 major banking crises around the world in the twentieth century (Westernhagen et al., 2004). It is fair to say that bank asset concentration also contributed significantly to the two major banking crises that the twenty-first century has witnessed so far. The simultaneous overexposure of several

upward, with most of the concentration being in the personal sector, in particular loans for land and home acquisition. Close to 60.0 per cent of commercial bank's lending was concentrated in the personal sector.

Figure 8: Hirschman Herfindahl Index (HHI) of Loan Concentration



Source: Eastern Caribbean Central Bank (ECCB)

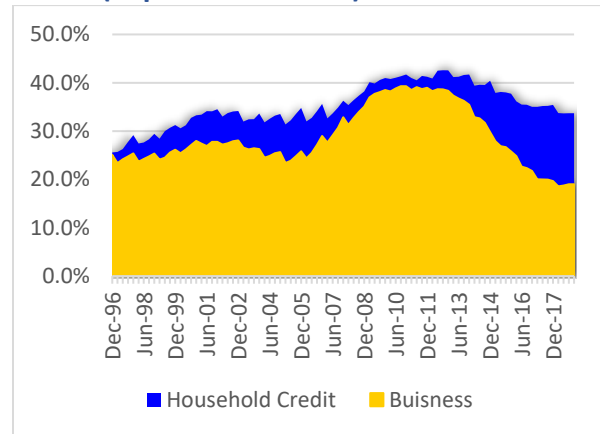
The financial health of households is important for the financial system. Households are vulnerable to cyclical downturns in the economy, which may cause income loss and possibly loan defaults.

banks to the U.S. mortgage market initiated the global financial crisis '07-'08 (Brunnermeier, 2009), and the overexposure of several banks to sovereign debt of distressed European countries severely deepened the European debt crisis of '11-'12 (Acharya et al., 2014).

A high level of debt can pose risks by increasing potential losses to lenders. It can also increase the likelihood of sharp cuts in consumption, especially by highly indebted households, which may amplify a downturn. This in turn increases the risk of losses to lenders on all forms of lending. Additionally, the efficiency of the financial system can be compromised if high levels of household debt inhibit the flow of credit to creditworthy borrowers.

Households continued to benefit from the economic recovery and the low interest rate environment in 2018. Although household debt levels have been declining since the global financial crisis, households remain vulnerable. Household debt to GDP was 34.0 per cent at the end of 2018, 8.9 percentage points below its maximum value of 42.6 per cent (Figure 9).

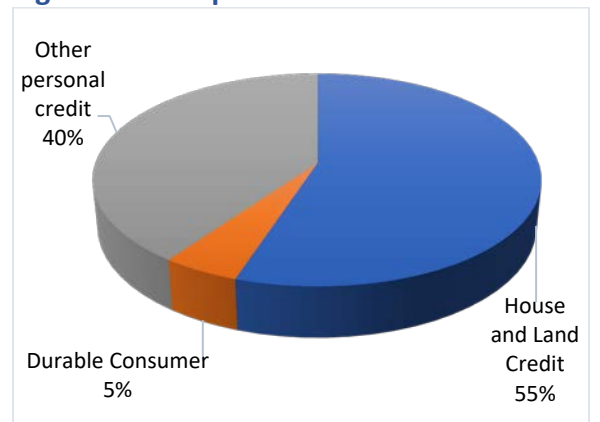
Figure 9: Household and Private Business Credit (in per cent of GDP)



Source: ECCB and Author calculation

Approximately 56.0 per cent of bank lending was to the household sector, which gave rise to a concentrated loan portfolio, with particularly large concentrations of debt for the acquisition of property, (mortgage related debt). Mortgages represented 30.0 per cent of all lending and 55.0 per cent of the total credit extended to households see (Figure 10).

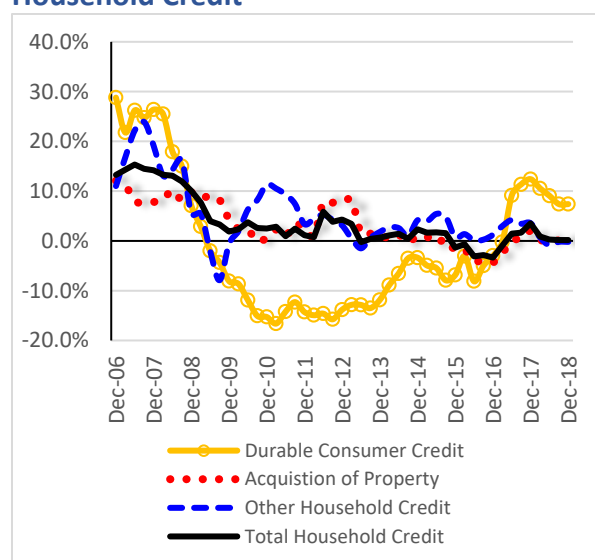
Figure 10: Composition of Household debt



Source: Eastern Caribbean Central Bank (ECCB)

Lending for consumer durables showed the greatest degree of acceleration in recent times (Figure 11). This type of credit is usually for the purchase of motor vehicles where demand has been the strongest due to a confluence of factors. First, increased competition has placed some downward pressures on these lending rates. Additionally, it has now become cheaper to purchase motor vehicles due to importation of Japanese used automobiles, which has led dealerships to lower prices on new vehicles. Given the short-term nature of this type of debt, i.e. household credit, it is considerably easier for households to acquire this type of credit, but also for them to default.

Figure 11: Growth Rate of Components of Household Credit



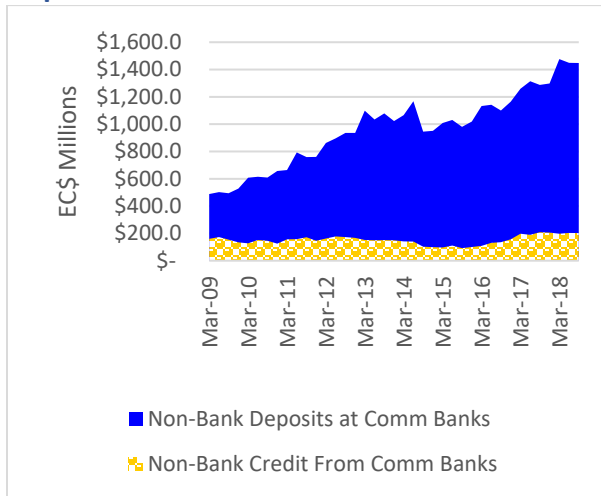
Source: Eastern Caribbean Central Bank (ECCB)

1.5 Interconnections

Interconnections in the financial sector are established through the evolution of assets and liabilities as well as common exposures and ownership. At the end of 2018, interconnections, as measured through lending and deposits between the banking sector and the NBFIs sector, continued to increase (Figure 12). Commercial banks' deposits held with NBFIs totalled EC\$1.95b. NBFIs deposits held at commercial banks reached EC\$1.45b at the close of 2018 from EC\$1.3b at the end of 2017. There was no concentration of NBFIs deposits at the country level (Figure 13).

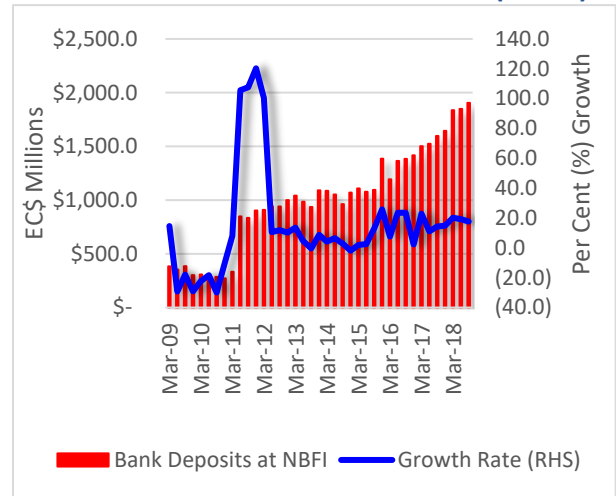
Other transmission channels for contagion risk may be established between banks and sovereigns. Risks emanating from the domestic banking sector can weaken a country's public finances, especially where troubled banks require intervention and government support. Furthermore, domestic sovereign risk can weaken banks' balance sheets through banks' holdings of government debt. However, given the progress in public finances and improvements in the banking sector, this risk is estimated to be low in 2018.

Figure 12: Interconnections as measured by Deposits and Loans



Source: Eastern Caribbean Central Bank (ECCB)

Figure 13: Bank Deposits at Non-Bank Financial Institutions (NBFIs)



Source: Eastern Caribbean Central Bank (ECCB)

CHAPTER 2: FINANCIAL PERFORMANCE AND SOUNDNESS OF DEPOSIT-TAKING INSTITUTIONS: BANKING AND CREDIT UNION SECTORS

2.0 Banking Sector

Overall, the 2018 performance of the ECCU banking sector was positive. There appeared to be some realignment of the positive long-run relationship between the banking sector and the level of economic activity.² Commercial banks continued their adoption of IFRS 9 Financial Instruments throughout the period.

The Bank Stability Index (BSI) remained in positive territory³ for the ninth consecutive quarter. The level obtained at the end of 2018 was slightly higher than that of 2017 (Figure 14). All performance metrics were positive as capital, profitability, liquidity and asset quality all improved. Credit from the sector was positive for the first time in five years, due to a slower deterioration in business credit.

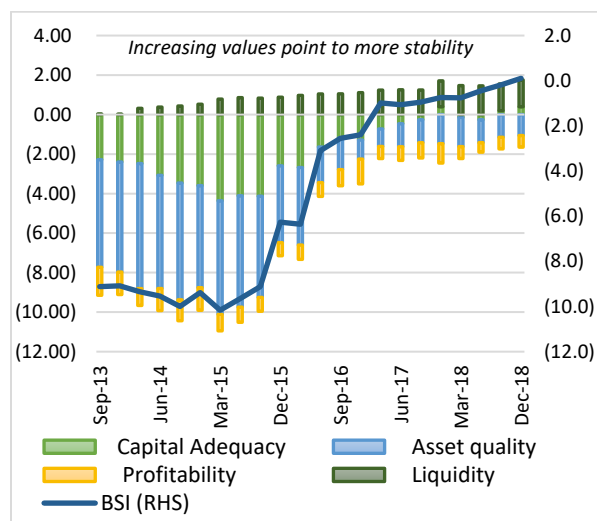
These developments underscore the current strength of the commercial banking sector. This will likely translate into greater support for the macro economy. Even so, there remained areas of concern. Firstly, non-performing loan levels (NPLs) remain elevated, contributing to higher credit risk vulnerability. Secondly, cyber threats remain a key concern for banks as these threats continue to elevate banks' operational risks. Data breaches and system failures can impede the proper functioning of the financial system. Thirdly, the increasing frequency and intensity of natural disasters in the region may negatively influence the asset and collateral quality of commercial banks. Lastly, the loss of correspondent banking relationships (CBRs), though stabilised, still pose potential risks.⁴ National banks are particularly affected by these CBR withdrawals.

² A thorough review, analysis, and appraisal of this long-run relationship resides in “*Finance and Growth: Theory and Evidence*,” by Ross Levine (2004).

³ A positive value of the BSI suggests stability. Increasing values indicate a greater improvement of the performance of the banking sector.

⁴ IMF. (2017). *Recent Trends in Correspondent Banking Relationships – Further Considerations*. International Monetary Fund.

Figure 14: Bank Stability Index (BSI) ECCU



Source: Eastern Caribbean Central Bank (ECCB)

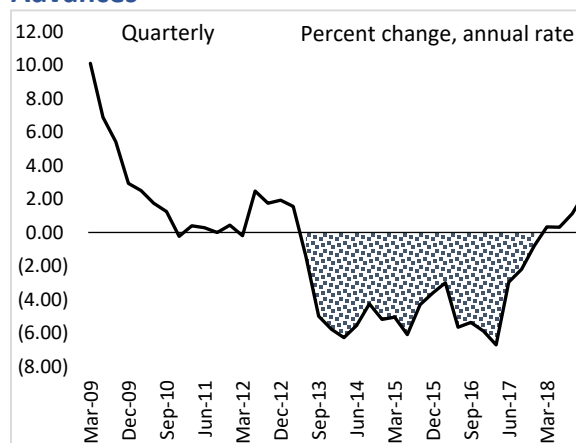
Overall, the ECCU banking sector expanded in 2018. Total banking sector assets increased by 3.9 per cent (EC\$1.1b) to EC\$30.8b. On the liabilities side, deposits in the banking system grew by 2.1 per cent in 2018 to EC\$21.3b. Both outcomes surpassed the performance observed in 2017, when annual growth was 3.0 per cent and 4.9 per cent for total deposits and total assets, respectively.

Growth in total assets were mostly a function of the commercial banks' investment activities along with contributions from growing loan portfolios.

At the end of 2018, commercial banks' outstanding loan balances increased by EC\$291.4m (2.4 per cent) to EC\$12.5b

(Figure 16). The evolution of credit growth over the past ten years (2009 -2018), is shown in figure 15. When credit portfolios are adjusted for non-performing loans, the total value in 2018 increased by EC\$346.5m to EC\$11.1b compared with the level at the end of December 2017. This point of inflection reflected the gradual recovery of bank credit, which will ultimately benefit the overall economy.

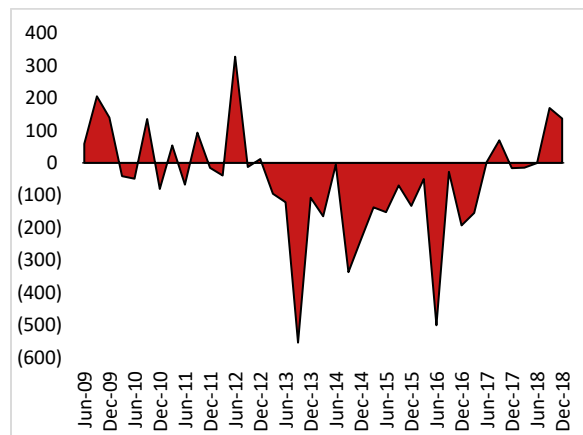
Figure 15: Banking Sector Loans and Advances



Notes: Shaded area represents the 19 consecutive quarters in negative territory.

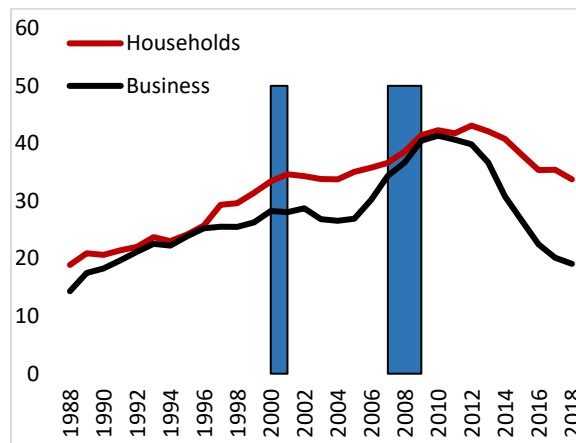
Source: Eastern Caribbean Central Bank (ECCB)

Figure 16: Commercial Banks Dollar Change in Loans and Advances (in millions)



Source: Eastern Caribbean Central Bank (ECCB)

Figure 17: Business and Household Credit as a per cent of GDP ⁵



Note: The shaded bars indicate periods of recession.

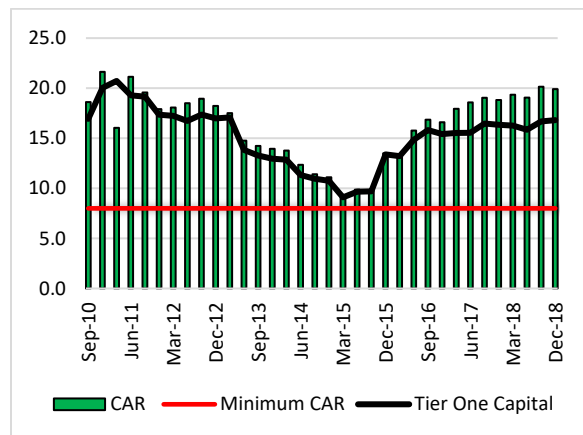
Source: Eastern Caribbean Central Bank and Staff calculations

Figure 17 shows loans disaggregated across two main categories: households and businesses. Both categories have grown relatively slower than GDP, particularly after the financial crisis. In recent periods (2017 and 2018), growth outcomes in both categories have been moderate. Business credit appears to have bottomed out, declined at a decreasing rate for 2018.

There was continued strengthening of the sector as indicated by the increasing CAR and the declining NPL ratios. The aggregate CAR of the banking sector was 19.1 per cent at the end of 2018, 0.4 percentage points above the ratio at the end of 2017, (Figure 18). The increase in the CAR was due to outpaced growth in total regulatory capital (6.0 per cent), relative to adjusted risk-weighted assets at 3.6 per cent. Simultaneously, the tier-one capital ratio increased to 16.8 per cent from 16.3 per cent at the end of December 2017.

⁵ Business credit tends to track the business cycle more closely compared to household credit.

Figure 18: Commercial Banks Capital Adequacy Ratios (in per cent)



Source: Eastern Caribbean Central Bank (ECCB)

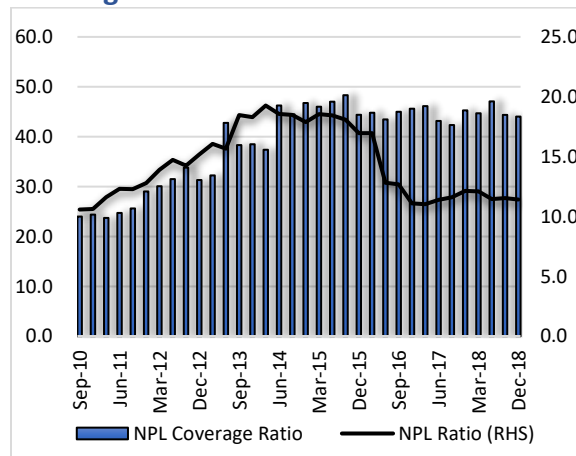
Credit risk, which is the principal source of potential losses in the domestic banking sector, has trended further downwards. The structure of NPLs has improved. The provisions created by banks at the aggregate level seem to be sufficient to cover the current expected loss given a default. The ratio of non-performing loans to total loans (NPLs) decreased by 0.7 percentage points to 11.4 per cent from December 2017 (Figure 19). The decrease in the ratio was achieved as total loans and total NPLs continued along diverging paths.

The NPL ratio was 6.4 percentage points above the regulatory minimum of 5.0 per cent. Convergence to the regulatory minimum would require a further decline of NPLs to the tune of \$803.0m, all things being

equal. The same can be achieved through an expansion of performing loans at a similar magnitude.

As at December 2018, the overall coverage of NPLs by provisions stood at 44.0 per cent, down 1.2 percentage points from levels at the end of 2017 (Figure 19). The ratio seems sufficient for the current NPL loss rate. The NPL coverage ratio is expected to remain elevated in 2019 as banks adjust to the new reporting standard IFRS 9.

Figure 19: Commercial Banks NPL and NPL Coverage Ratio

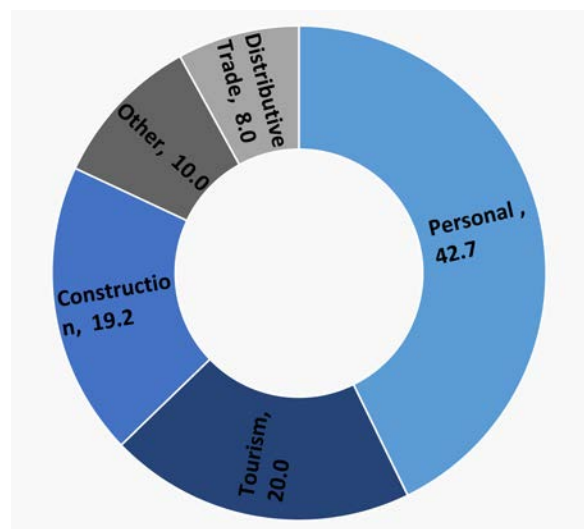


Source: Eastern Caribbean Central Bank (ECCB)

Turning to the sectoral breakdown, NPLs in the personal sector continued to account for the bulk - a little over 40.0 per cent - of total NPLs (Figure 20). While the overall trend has been downward, NPLs from the tourism and construction sectors have been increasing.

The increase in tourism and construction NPLs was primarily attributable to developments in St Kitts and Nevis.

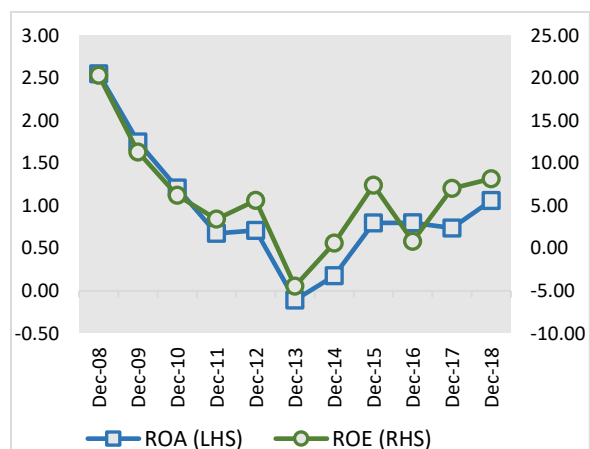
Figure 20: Breakdown of NPLs by Sector (per cent)



Source: Eastern Caribbean Central Bank (ECCB)

Banking sector profitability gradually increased over the years. Cumulative profits before taxes surpassed EC\$300.0m in 2018. The pace of growth in the bottom line of banks' is reflected in improved profitability indicators (Figure 21). The enhanced profitability will help to preserve capital levels through retained earnings. Nonetheless, large differences persist across banking groups. Foreign branch banks are observed to generate returns that are more consistent.

Figure 21: Commercial Banks Return on Assets (ROA) and Return on Equity (ROE)



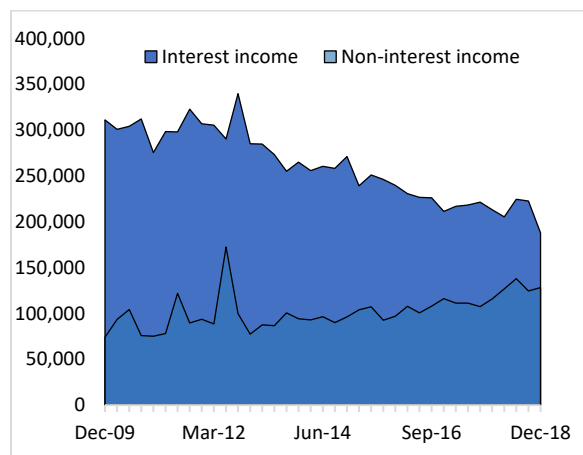
Source: Eastern Caribbean Central Bank (ECCB)

The primary revenue streams (interest and non-interest income), increased relative to 2017. Total income improved by 3.2 per cent in 2018 when compared to the corresponding period of 2017. Non-interest income rose by 16.1 per cent in 2018, while growth in interest income declined by 3.2 per cent in 2018 (Figure 22). Non-interest income continued to be a major source of income for the commercial banks.

Profitability was further supported by declining impairment losses, which are linked to the business cycle and the decreasing share of NPLs and provisions. Thus, asset impairment losses are at very low levels, which may not correspond to the real long-term risks. An adverse turn in the

business and financial cycle can lead to asset impairment losses increasing, although not expected at the same rates as those observed during the financial crisis.

Figure 22: Commercial Banks Profits Decomposition (in 000' EC\$)



Source: Eastern Caribbean Central Bank (ECCB)

2.1 Credit Union Sector

For 2018, the credit union sector continued to exhibit expansions in membership, assets, loans and deposits, albeit at slower rates than reported in 2017.

Credit union membership for 2018 rose by 3.5 per cent to 385,207, up from 372,232 members at the end of 2017. However, the growth in membership for 2018 is 6.0 percentage points lower than the rate reported in 2017; likely signalling that credit union penetration is nearing capacity

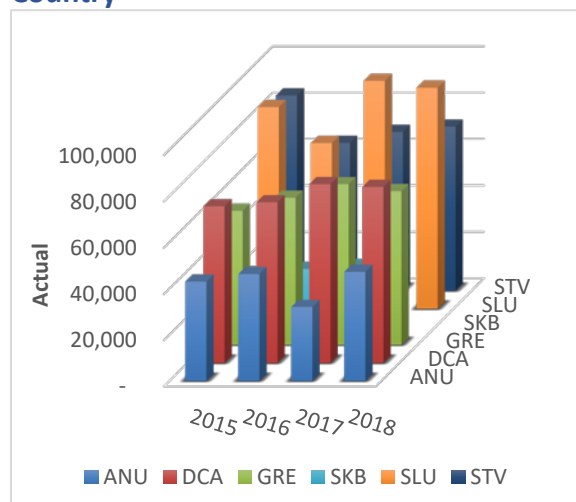
(Figure 23). Antigua and Barbuda and St Kitts and Nevis reported the largest increases in membership for 2018 (Figure 24).

Figure 23: Credit Unions Total Membership



Source: Single Regulatory Units and ECCB

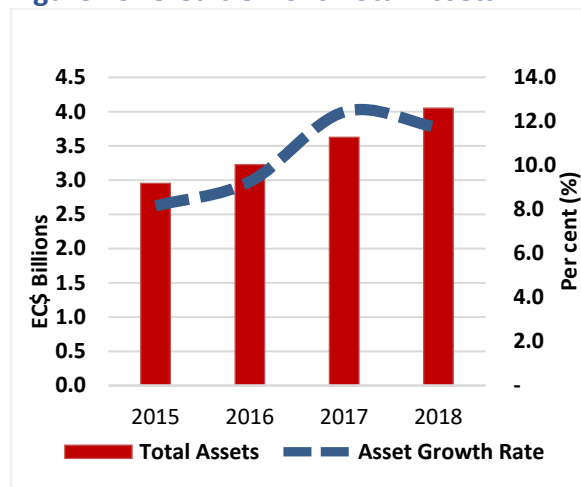
Figure 24: Credit Union Membership by Country



*Source: Single Regulatory Units in the ECCU

Total assets for the sector increased by 11.7 per cent to EC\$4.1b in 2018, up from EC\$3.6b in 2017. However, for 2018, the growth in assets is 0.7 percentage points lower than the growth rate (12.4 per cent) reported for 2017 (Figure 25).

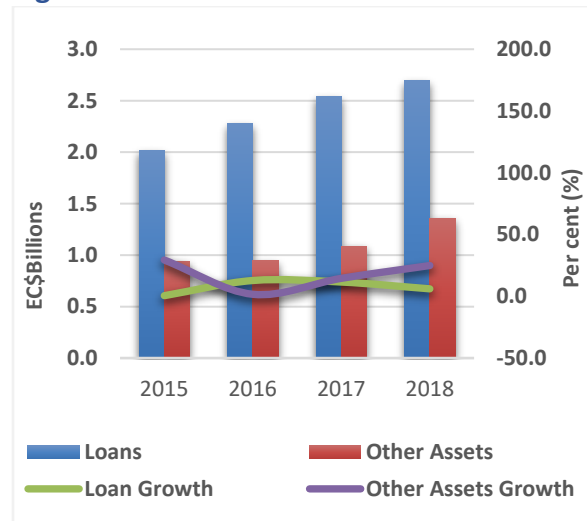
Figure 25: Credit Unions Total Assets



**Source: Single Regulatory Units in the ECCU*

Loans, which occupied 66.7 per cent of the total assets of the sector for 2018, increased by 6.1 per cent to EC\$2.7b while non-loan assets rose by 24.9 per cent to EC\$1.4b (Figure 26).

Figure 26: Credit Unions Loans

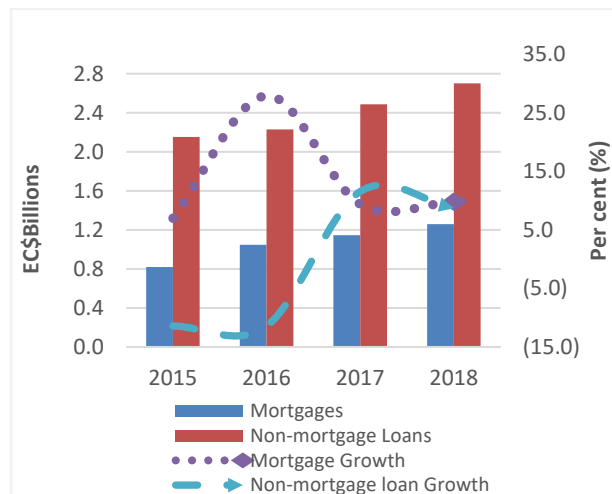


**Source: Single Regulatory Units in the ECCU*

The increase in loans was due to growth in mortgage and non-mortgage loans. Mortgages rose by 6.3 per cent (EC\$72.2m) in 2018 to EC\$1.2b in 2018, decelerating from a 9.4 per cent or EC\$98.2m increase in 2017. Conversely, non-mortgage loans, increased by 5.9 per cent (EC\$81.5m) to EC\$1.5b in 2018; down from a 13.1 per cent or EC\$164.5m increase at the end of 2017 (Figure 27).

For 2018, mortgages accounted for 45.2 per cent of the total consolidated loan portfolio of the credit union sector. This was slightly higher than the 45.1 per cent reported at the end of 2017.

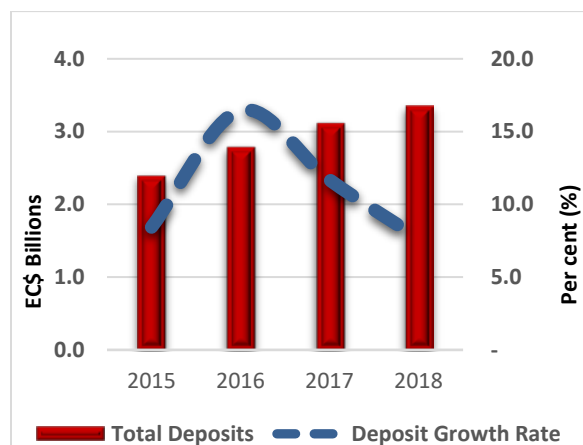
Figure 27: Credit Union Loan Growth by Type



**Source: Single Regulatory Units in the ECCU*

Total deposits for the sector stood at EC\$3.3b for 2018 up from EC\$3.1b at the end of 2017 (Figure 28). The rate of growth in deposits reported for 2018, however, is 4.0 percentage points lower than the pace (11.7 per cent) recorded at the end of 2017.

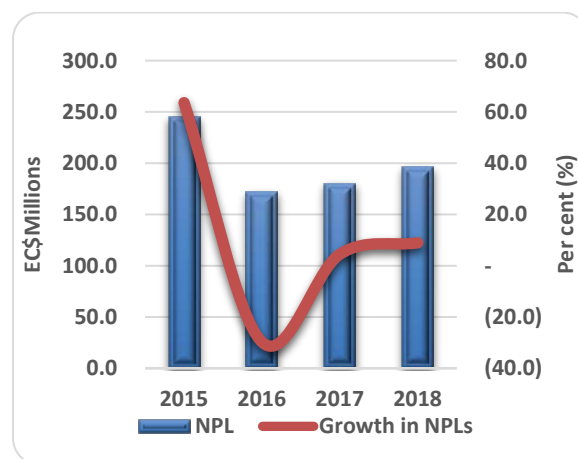
Figure 28: Credit Unions Total Deposits



Source: Single Regulatory Units and Eastern Caribbean Central Bank (ECCB)

Despite the evidence of continued growth in the sector, credit risk remains elevated as non-performing loans increased by 8.9 per cent to EC\$195.9m in 2018, from EC\$179.9m reported at the end of 2017 (Figure 29).

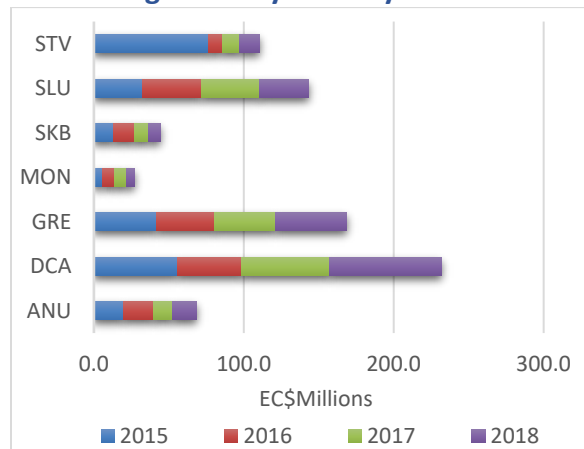
Figure 29: Credit Unions Non-performing Loans (NPLs)



Source: Single Regulatory Units and Eastern Caribbean Central Bank (ECCB)

Non-performing loans rose in four of the seven reporting territories; namely Antigua and Barbuda, Dominica, Grenada and St Vincent and the Grenadines. Dominica recorded the greatest increase (EC\$15.6m) in non-performing loans, followed by Grenada, with an increase of EC\$7.1m (Figure 30). The passage of Hurricane Maria in Dominica in September 2017 and closure of Ross University are likely to have contributed to the rise in NPLs.

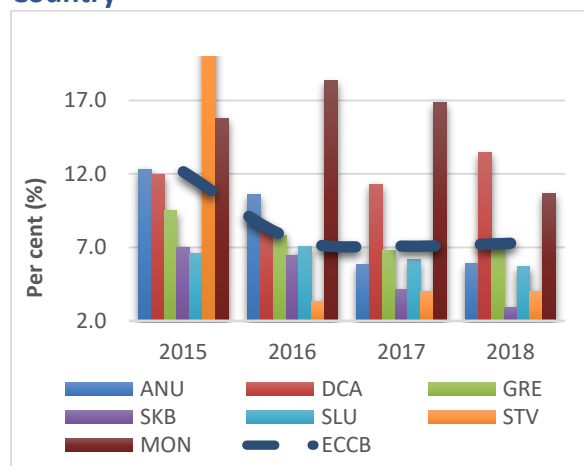
Figure 30: Credit Unions Total Non-Performing Loans by Country



Source: Single Regulatory Units and ECCB

Consequently, the percentage of non-performing loans to total loans (NPL ratio) also grew, albeit marginally, to 7.3 per cent at the end of 2018; up from 7.1 per cent for 2017. In Dominica, where the rise in value of NPLs for 2018 was highest, the NPL ratio, stood at 13.5 per cent, up from 11.3 per cent in 2017 (Figure 31).

Figure 31: Credit Unions NPL Ratio by Country



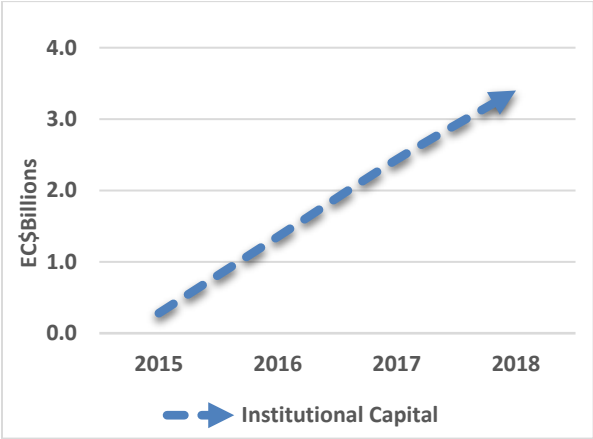
Source: Single Regulatory Units and ECCB

Provision for loan loss expanded by 10.6 per cent to EC\$82.9m at the end of 2018 compared to an increase of 0.2 per cent or \$74.9m for 2017.

Meanwhile, the NPL coverage ratio, measured as the percentage of loan loss provision to NPL, rose by 0.6 percentage points to 42.3 per cent above the level of 41.7 per cent at end of 2017. Nevertheless, the coverage ratio remained below the 100.0 per cent benchmark set out by the PEARLS standards indicating that provisioning did not increase sufficiently to cover the rise in non-performing loans. Consequently, capital would be required to cover any shortfall. The NPL coverage ratios for all reporting countries were below the PEARLS benchmark, with the exception of St Kitts and Nevis.

Institutional capital for the sector continued to grow at a slower pace. At end of 2018, institutional capital for the aggregate credit union sector rose by 39.6 per cent to \$3.4b compared with EC\$2.4b reported at the end of 2017. The continued expansion in capital suggests that credit unions are building a buffer to enhance the likelihood of withstanding negative shocks (Figure 32).

Figure 32: Credit Unions Institutional Capital



Source: Single Regulatory Units and ECCB

The data indicated that levels of capital are sufficient to meet any shortfall of loan loss provisioning. However, credit risk, which pose the greatest threat to the sector, requires continued monitoring particularly in countries with increasing NPL levels. Additionally, as credit unions continue to expand their operations and are becoming more significant players in the financial system, several risks are becoming apparent. Risks associated with cybersecurity and fraud are likely to be of greater concern. It is therefore important that credit unions adopt strategies that will strengthen their technological infrastructure and thereby enhance their risk management framework.

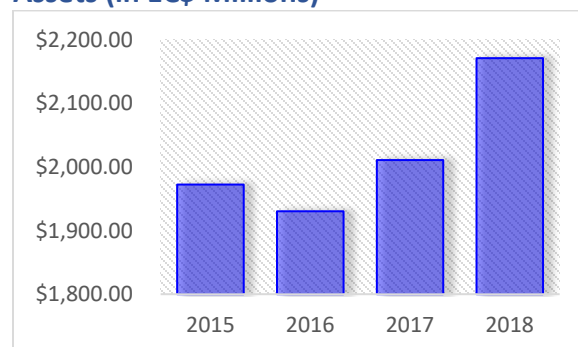
CHAPTER 3: FINANCIAL PERFORMANCE AND SOUNDNESS OF NON-DEPOSIT-TAKING INSTITUTIONS: INSURANCE COMPANIES

3.0 Overview

The insurance sector is a cornerstone of the ECCU financial system, especially as it pertains to the transfer of risk. Following the passage of hurricanes Irma and Maria in 2017, the insurance sector rebounded in 2018.

Overall, the insurance sector in the ECCU was stable in 2018, as solvency metrics exceeded regulatory minimums, premiums increased and there was a small marginal increase in profitability. Performance across the ECCU countries was asymmetric but broadly positive. The total assets of the ECCU insurance sector was estimated at EC\$2.2b at the end of 2018⁶, slightly above when compared with EC\$2.01b recorded at the end of 2017 (Figure 33).

Figure 33: ECCU Insurance Sector Total Assets (in EC\$ Millions)



Source: SRUs and Eastern Caribbean Central Bank (ECCB)

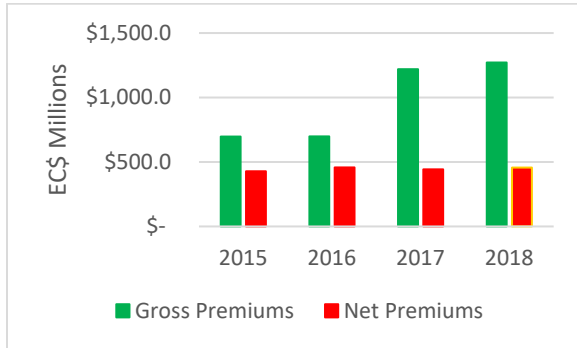
Gross premiums rose to EC\$1.3b, up from EC\$1.2b at the end of 2017 (Figure 34). Both non-life and life insurance companies contributed to the growth in gross premiums.

Notwithstanding, insurance companies do not retain all the premiums that they write. There are reinsurance allocations, giving rise to the net premiums written. Net premiums totalled EC\$456.6m at the end of 2018. This gave rise to a 35.9 per cent risk retention ratio for the insurance companies. The general increase in premiums reflects two factors; (1) an increase in premium rates

⁶ Complete data for Antigua and Barbuda was not available at the time of writing this report

following the catastrophic events hurricanes of 2017 as well as, (2) an increase in the customer base.

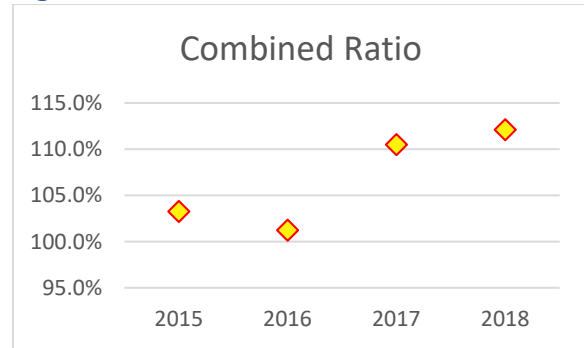
Figure 34: Gross Premiums and Net Premiums



Source: SRUs and Eastern Caribbean Central Bank (ECCB)

There was a slight deterioration in profitability for 2018. The combined ratio increased to 112.1 per cent at the end 2018 from 110.5 per cent (Figure 35). The increase in the combined ratio reflected an increase in the expense ratio while the loss ratio fell.

Figure 35: Combined Ratio Insurers



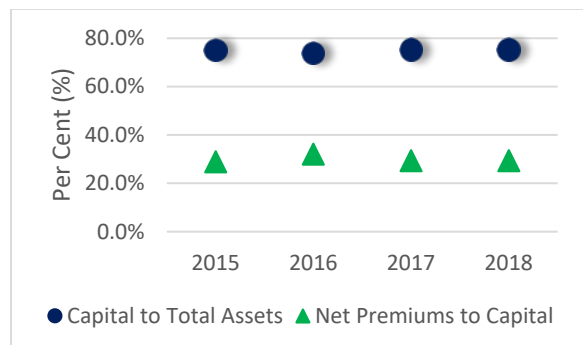
Source: SRUs and Eastern Caribbean Central Bank (ECCB)

The sector remained solvent. As at the end of 2018, the capital to assets ratio stood at 78.8 per cent, while the net premiums to capital ratio was estimated at 29.3 per cent (Figure 36). The solvency margin⁷, another solvency metric, exceeded regulatory limits for all ECCU countries. As at the end of 2018, the average solvency margin was well over 100.0 per cent. Capital to technical reserves stood at 153.0 per cent compared with 150.0 per cent at the end of 2017. Capital strength, however, varies across insurers, and some insurers have relatively small buffers over the minimum capital requirements.

⁷ The solvency margin is the amount of capital insurance companies are required to hold in relation to the premiums they write (on average 20.0% of

premiums). These are the assets eligible to cover technical provisions

Figure 36: Solvency Metrics - Insurers



Source: SRUs and Eastern Caribbean Central Bank (ECCB)

Liquidity across the sector was high with composite and non-life insurance companies retaining higher levels of liquidity due to the nature of their business. Life insurance companies retained lower levels of liquidity as their liabilities are mostly long term.

3.1 Risk Assessment

Systemic risk in the ECCU insurance sector is the occurrence of large catastrophic hurricanes as was witnessed with hurricanes Maria and Irma. These events can quickly diminish an insurance company's capital base due to large claims, especially if the hurricanes cover more than one country in which the insurance company operates.

Secondly, the current low interest rate environment poses significant challenges for insurers, especially life insurance companies. At the same time, rising interest rates come

with additional challenges, given the negative relationship between interest rates and the value of investment instruments. The risk here is that the value of assets can potentially fall below what is required for solvency margins.

Thirdly, the sovereign debt exposures of insurance companies always require close monitoring. Insurance companies hold a large stock of government debt on their balance sheets. Therefore, whenever concerns over fiscal sustainability are brought to the fore, it can negatively affect insurance companies, especially if the instruments are marked to market. These effects can lead to solvency issues as the value of assets held for solvency purposes decreases.

The introduction of IFRS 17 is likely to present significant costs and implementation challenges for firms. IFRS 17 is a new accounting standard for insurance contracts, and is expected to come into force in 2022. This standard will change the basis for profit recognition on insurance contracts. Conversion to the standard is likely to have the effect of reducing retained earnings, with a knock-on effect through firms' ability to pay dividends.

BOX 1: INSURANCE AND FINANCIAL STABILITY IN THE ECCU

A stable and efficient functioning insurance sector is an important prerequisite for the functioning of the financial sector. Insurance companies allow for the transfer of risk. To conduct risk transfer, insurers must be sufficiently capitalised to withstand a range of possible loss events. The pooling of risk and the pricing of differences in risk are fundamental features of an efficient insurance sector. Supervisors and regulators need to understand the potential implications of the insurance sector for financial and systemic stability, as well as the tools available for the surveillance of insurers. Systemic concerns differ not only between banks and insurers but also between life and non-life insurance companies.

The ECCU insurance sector is comprised of life, non-life and composite insurance companies. However, the structure of the sector is such that composite insurance companies tend to dominate the market. Composite insurance companies are those which offer both life and non-life insurance products. The insurance sector is dominated by insurance companies, that are not headquartered in the ECCU, but in other CARICOM countries. Hence, risk in the insurance sector has to be analysed in a holistic sense, i.e. understanding developments not only in the ECCU but also regionally.

There risks confronting the insurance sector can be categorised into; (i) technical risks; (ii) investment (asset) risks; and (iii) other risks. These risks may also be contingent on the business mix of the firm. For example, the risk profile of non-life (general) insurance surrounds catastrophic risk. Failures of non-life insurance companies may lead to the failure of certain services, which can be interrupted, due to a lack of insurance protection. On the other hand, life insurance offers a variety of products, with different degrees of protection and investment components, including; pensions, savings, permanent health and term assurance policies. Therefore, the insurer's commitment may be based on death, the occurrence of a specific event (e.g., diagnosis of a specified illness), survival or inability to work due to health problems. Policies can offer guaranteed nominal or real yields or may be unit-linked and may include profit-sharing provisions.

Technical risks stem from the very nature of the insurance business; indeed, the major risk to which an insurer is exposed is due to policy underwriting. Not all risks will crystallize into liabilities; the future risk and their costs are usually estimated by actuarial techniques.

There are several examples of technical risks. Under-pricing risk occurs when premiums are too low to cover claims and insurer's expenses. Another risk is that of unforeseen or inadequately understood events, including

deviation risk, or the risk that actual development of claim frequencies such as mortality, morbidity, and interest rates will deviate from actuarial assumptions, in addition to the risk of error. Reinsurance risk occurs when there is insufficient reinsurance coverage, for example, if a reinsurance company fails or there are other risks connected with reinsurance), or catastrophes (major earthquakes, floods or hurricanes affecting the financial and economic stability of countries).

Asset risks affect the value, performance, returns, liquidity and structure of insurer's investment portfolio and debtors. It includes; the market risk (changes in interest rates, equity and real estate prices and exchange rates fluctuations), credit risk (non-payment by counterparties) and liquidity risk. An insurer's exposure to credit risk arises from the creditworthiness of the debtors with respect to both premium income and reinsurance recoveries, as well as the concentration of debtors.

When analysing market risk, both sides of the balance sheet need to be considered. In particular, it is necessary to identify the market risk that is a part of "risk pass through" products under which the company bears the investment risks and rewards. Risk pass through products do not affect the risk profile of the company (except for reputation risk). These products include unit-linked products where the assets are held in the general assets of the company, group experience refund products, administration services only products and some participating life insurance products.

Mismatch in the duration of assets and liabilities can expose an insurer to interest rate risk. The rate of interest is, however, often an integral part of premium rate calculation and reserve estimation, as such, interest rate risk may manifest itself in many ways, and thus total interest rate risk ought to be evaluated carefully.

Although insurance companies typically face less liquidity risk than commercial banks, they still face liquidity risk; this is especially true of non-life insurance companies. The frequency, severity, and timing of claims or benefits are uncertain, so this give rise to liquidity risk.

It is through this lens that risks confronting the insurance sector of ECCU is analysed. However, paucity of data precludes an extensive analysis of the sector. More needs to be done in terms of closing data gaps in the insurance sector to fully understand how it can transmit risk to the real economy and the rest of the financial sector.

CHAPTER 4: POLICY INITIATIVES FOR ENHANCING FINANCIAL STABILITY IN THE ECCU

4.0 Overview

In the ECCU, several initiatives are expected to assist in enhancing financial stability. These include; (1) new regulatory and supervisory arrangements, (2) the establishment of the ECCU Credit Bureau, (3) establishment of a regional deposit Insurance Corporation, (4) development of a macroprudential policy framework.

4.1 New Supervisory Arrangements

Within the ECCB, the Bank Supervision Department (BSD) works to provide the highest level of financial stability assurance and supports monetary policy of a strong and stable Eastern Caribbean Dollar. The Bank Supervision Department has recently instituted a risk-based supervisory (RBS) framework. The RBS is a comprehensive, formally structured system that assesses risks within the financial system, giving priority to the resolution of those risks. Work on the implementation of Basel II/III remains ongoing. Simultaneously, the BSD continues to work on the development of an

AML/CFT framework for licenced financial institutions (LFIs) under the Banking Act.

During 2018, the ECCB is in the process of establishing regulations for the Caribbean Credit Card Corporation (4Cs). Though discussions are ongoing, it is expected that this will increase the number of LFIs within the region. Additionally, discussions are ongoing for the regulation of systemically important credit unions in the ECCU. Presently, the ECCB is working towards the development of a framework for identifying systemically important financial institutions. It is anticipated that upon completion and adoption, the framework will be used for both commercial banks and credit unions.

4.2 The Establishment of the ECCU Credit Bureau

The Harmonised Credit Reporting Bill (HCRB) was developed to provide for the proper administration and licensing of credit bureaus. Additionally, the Bill provides for

the compilation and maintenance of databases, evaluation, update and dissemination of the data to subscribers and other data related adjustments. Enactment of the Bill, however, remains outstanding in four (4) member countries having been passed in the parliaments of Antigua and Barbuda, St Vincent and the Grenadines, Grenada and St Kitts and Nevis. Supervision and oversight of this new credit reporting system will be conducted by the ECCB. It is expected that upon passage in all ECCB member countries, that the establishment of the Credit Bureau will address the issue of asymmetric information. This can accelerate the speed at which credit applications are processed. Thus, providing credit-granting firms with greater means to assess risk and facilitate the extension of credit to the populous.

4.3 The Establishment of the Eastern Caribbean Deposit Insurance Corporation

Work continues on the establishment of a deposit insurance scheme for the ECCU region. The ECCB is expected to receive technical assistance in 2019 to implement the technical aspects of the scheme.

4.4 Macroprudential Policy Framework

The ECCB continued to work toward the development of a macroprudential policy framework for the ECCU region. The goal of this framework is to assess risks across the entire financial sector. The framework would then make recommendations on an appropriate course of action to stymie any activity that threatens the stability of the financial sector. Several initiatives have already been achieved toward this goal, including the development of a suite of indicators to assess stability and the publication of two Financial Stability Reports (2016 and 2017). The establishment of a Regional Financial Stability Committee and the enactment of legislation to give the ECCB powers to undertake macroprudential policy are outstanding and important steps to achieve the goal. The timely sharing of information by the SRUs is another important element towards the realisation of this goal.

Chapter 5: OUTLOOK

The outlook for the ECCU financial sector is largely positive and is expected to remain stable in 2019. Despite increasing signs of a slowing global economy, the ECCU economies are forecasted to record positive economic growth. The growth outlook is central to all the main risks to financial stability as it can impair the balance sheet of economic agents in the economy. Against the backdrop of positive economic growth, the financial sector is anticipated to record stronger performance in profits, increasing credit growth, and lower default risk for 2019. The non-performing loans (NPL) ratio is predicted to continue to moderate due to a combination of higher loan growth and lower default risk on account of a favourable macroeconomic environment. However, the introduction of IFRS 9 is expected to keep provisioning levels elevated. The resilience of the financial sector (as measured by capitalisation) is likely to remain in place except for major tail risks.

Nonetheless, key vulnerabilities such as an overly concentrated loan portfolio are expected to remain. Both commercial

banks and credit unions have portfolios that are heavily concentrated on household loans. Any weakening of economic conditions can have an adverse impact on the financial position of households, which can then affect credit intermediaries. Legacy NPLs held by these institutions, continue to affect the financial system due to the high provisioning cost. Mechanisms to reduce these legacy NPLs are important to improving the efficiency of the financial sector.

The key risks to the outlook are related to the increasing probability of a slowing global economy in 2019 and hurricanes. Materialisation of downside risks to global economic growth can be transmitted to the ECCU economies and to the financial sector. Persistent downside risks to growth reinforce the need to strengthen balance sheets of highly indebted households, firms and governments. Natural disasters, particularly hurricanes, remain an ever-looming threat to the stability of the financial sector.

The implementation of a number of legislative reforms are also likely to add to the resilience of the financial sector. The introduction of the Credit Bureau will add to an understanding of the credit worthiness of borrower's which contributes to better underwriting standards for commercial banks, which can help to lower default risk on loans. Completing the deposit insurance scheme is important to the development of an effective resolution framework for the financial sector. Finally, the development and implementation of the macroprudential framework is an integral component for the assessment of systemic risk in the financial sector.



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