



THE EASTERN CARIBBEAN CENTRAL  
BANK

# THE ANNUAL FINANCIAL STABILITY REPORT 2020

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2020 | ISSUE NO.5



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The ECCB welcomes your questions and comments on this publication.





## FINANCIAL STABILITY REPORT

2020 | Issue No. 5

The Financial Stability Report is a publication of the Eastern Caribbean Central Bank. It aligns with 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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## Table of Contents

Preface from the Governor.....	1
1.0 Overview of Financial Stability in the ECCU .....	3
1.1 The Macro-Financial Environment .....	3
1.2 Key Vulnerabilities and Risks.....	4
2.0 Financial Performance and Soundness of Deposit-Taking Institutions: Banking and Credit Union Sectors .....	11
2.1 Banking Sector .....	11
2.2 Credit Union Sector .....	14
3.0 Financial Performance and Soundness of Non-Deposit-Taking Institutions: Insurance Companies .....	17
3.1 Insurance Sector .....	17
4.0 Policy Initiatives for Enhancing Financial Stability in the ECCU .....	21
5.0 Outlook .....	25

## **List of Figures**

Figure 1: ECCU Real GDP Growth .....	3
Figure 2: Primary Vulnerabilities in the ECCU Financial System .....	4
Figure 3: NPL Ratios in the Credit Union Sector .....	5
Figure 4: Commercial Banks' NPLs and Coverage Ratios.....	6
Figure 5: Provisions in the Banking Sector.....	7
Figure 6: Commercial Banks' Trend in Liquid Assets and Liabilities .....	8
Figure 7: Selected Liquid Balance Sheet Items for Commercial Banks .....	8
Figure 8: Balance Sheet Composition of the Domestic Banking Sector .....	11
Figure 9: Changes in Selected Balance Sheet Items of the Banking Sector .....	12
Figure 10: Changes in Commercial Bank Credit.....	12
Figure 11: Commercial Bank Credit to Households and Businesses (as a % of GDP) .....	12
Figure 12: Capital Structure of the Banking Sector .....	13
Figure 13: Loans in the Credit Union Sector .....	15
Figure 14: Deposits in the Credit Union Sector .....	15
Figure 15: Capital Adequacy in the Credit Union Sector.....	15
Figure 16: Gross Premiums Collected by Aggregate Insurance Sector .....	17
Figure 17: Total Claims Paid Out by Aggregate Insurance Sector.....	17
Figure 18: Capital to Asset Ratios for Life Insurers.....	18
Figure 19: Net Premiums to Capital Ratios for General Insurers .....	18
Figure 20: Combined Ratios of Life Insurers .....	19
Figure 21: Combined Ratios of General Insurers .....	19
Figure 22: Key Initiatives by the ECCB in 2020.....	21
Figure 23: Key Financial Stability Actions Proposed in the PARRT for 2020-2021 .....	22

## Abbreviations

AML/CFT	Anti-Money Laundering (AML) & Countering Financing of Terrorism
CAR	Capital Adequacy Ratio
ECAMC	Deposit Taking Institution
ECCU	Eastern Caribbean Currency Union
ECPGC	Eastern Caribbean Partial Credit Guarantee Scheme
FST	Financial Stability Team
GDP	Gross Domestic Product
IDA	International Development Association (IDA)
IFRS	International Financial Reporting Standards
LFI	Licensed Financial Institution
NBFI	Non-Bank Financial Institution
NPL	Nonperforming Loan
NSFR	Net Stable Funding Ratio
PARRT	Programme of Action for Recovery, Resilience and Transformation
RBC	Royal Bank of Canada
RBS	Risk-Based Supervisory Framework
SRU	Single Regulatory Units

The following symbols were used in this Report:

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B	Billion
M	Million
L/A	As a Proportion of Total Assets
L/L	As a Proportion of Total Liabilities

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## Preface from the Governor

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The synchronised impact of the Covid-19 pandemic across the world called for collective, coordinated and continuous actions in order to save lives and to maintain socio-economic and financial stability. We at the Eastern Caribbean Central Bank (ECCB) remained true to our purpose of serving the region well, through enhanced partnerships and engagements. Among other areas, we relentlessly pursued our strategic objective of developing a strong, diversified and resilient financial sector, as the regulatory and monetary authority of the Eastern Caribbean Currency Union (ECCU).

After intense assessments and consultations with relevant stakeholders, the ECCB endorsed one of the most significant financial sector initiatives in the ECCU in 2020 - a loan moratoria programme was granted by Licensed Financial Institutions and Credit Unions for individuals and businesses. This initiative was in keeping with our stance of providing targeted support to the people of our region while maintaining financial stability. Despite the large and adverse shock of the unprecedented health pandemic, we worked towards ensuring our financial system continued to meet the needs of individuals, households, businesses, and the economy in general.

This fifth edition of the ECCB's Financial Stability Report was therefore written under the theme "*The Covid-19 Pandemic and Financial Sector Resilience*". The Report seeks to highlight the key vulnerabilities and financial stability risks in the ECCU in 2020. It presents the implications of the ongoing pandemic on financial performance and soundness of ECCU commercial banks, credit unions, and insurers in 2020. The Report also shares key financial stability initiatives undertaken and planned. Based on in-house assessments of the resilience of the financial sector to future risks, a medium-term outlook for the region's financial system is given at the end of this Report.

We thank all contributors to this Publication, in particular, the Single Regulatory Units. May this Report update you on financial stability issues in our region, and ultimately inspire you to start or continue to be a part of the call for collective action towards further development of our region!



*Photo Credit: Bing Image*

# SECTION ONE

## Overview of Financial Stability in the ECCU

### KEY INSIGHTS

1. International and regional macro-economic conditions deteriorated in 2020 due to the Covid-19 pandemic and related restrictions.
2. The ECCU financial system remained stable and resilient in 2020, backed by adequate capital and liquidity buffers that pre-date the pandemic.
3. Credit risk was most pronounced, liquidity and market risks were not as significant, and concentration risk rose modestly in 2020.
4. Risks to financial stability in 2020 were mitigated, in part, by unprecedented policies and responses.



## 1.0 Overview of Financial Stability in the ECCU

### 1.1 The Macro-Financial Environment

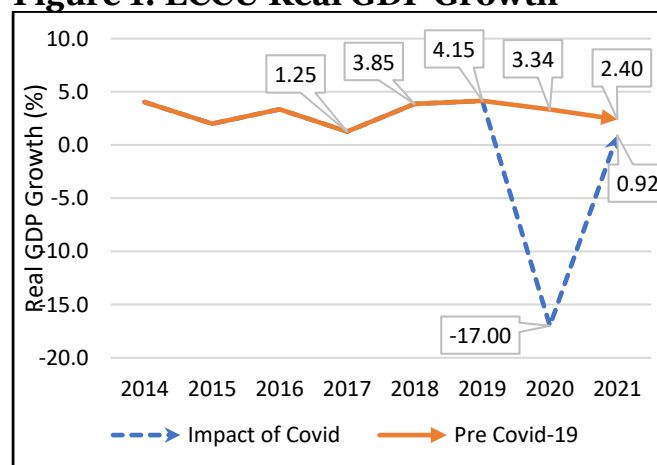
**Developments in the global environment in 2020 were largely shaped by the COVID-19 pandemic.** Global economic output contracted by 3.3 per cent in 2020<sup>1</sup>, the first global recession since 2009.

**The ECCU was significantly impacted by the pandemic.** The major drivers of growth, including tourism and foreign direct investment, plummeted. Consequently, total output of the Currency Union fell by 17.0 per cent in 2020 (**Figure 1**). Member governments undertook extensive policies and measures to stabilise their countries and save lives and livelihoods.

**The overall fiscal position of the region worsened and the total disbursed outstanding debt of the public sector of the ECCU rose during 2020.**

During the year under review, no defaults were recorded on sovereign debt.

**Figure 1: ECCU Real GDP Growth**



Source: ECCB

Debt relief was received from bilateral creditors for member countries who were part of the International Development Association (IDA). The largest economy of the ECCU, Saint Lucia, received a downgrade in its sovereign credit rating (CariBBB-), but maintained its stable outlook by the rating agency CariCRIS in 2020.

**Amid these developments, the ECCU financial sector remained stable.** Policy and regulatory responses coupled with stable balance sheets of financial institutions, helped the system to weather the effects of the pandemic.

<sup>1</sup><https://www.imf.org/en/Publications/WEO/Issues/2021/03/23/world-economic-outlook-april-2021>

No financial institution failure was recorded. The payment system functioned effectively despite national lockdowns, deposits in the financial sector remained stable and, in some cases, increased. In addition, the government's stabilisation and support programmes provided liquidity to the real economy and prevented a precipitous wave of credit defaults across businesses and households.

**The banking sector, which constitutes roughly 80.0 per cent of the ECCU's total financial sector assets, continued to display resilience due to adequate capital and liquidity.** Profitability of banks, albeit at a lower level year-on-year, enhanced the sector's capitalisation. However, credit defaults are expected once the period of moratoria ends and capital levels will be negatively impacted as a consequence. During the year under review, the ECCB issued guidelines for restraint in profit distribution to safeguard capital buffers in the event of credit and unexpected losses.

**The credit union sector remained broadly stable in 2020 despite the rise in vulnerabilities and risks emanating from the pandemic.**

Continued supervision and regulatory responses helped maintained overall stability of Credit Unions.

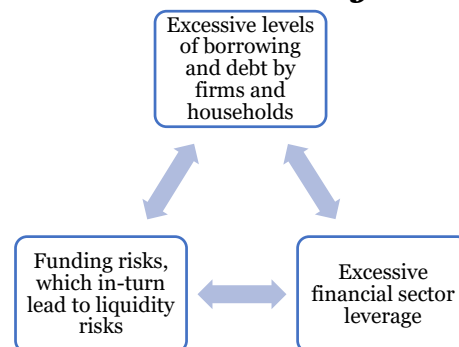
**Insurers based across the ECCU weathered the economic impact of the pandemic.** This outcome underscored adequate capital buffers across our region's heterogeneous insurance sector which covers both domestically and regionally focused life and non-life insurance and reinsurance companies.

## 1.2 Key Vulnerabilities and Risks

### *Vulnerabilities*

In the Eastern Caribbean financial space, there are three primary vulnerabilities that require enhanced monitoring and focus **(Figure 2)**. In the event that Covid-19 shocks amplify within the medium term, these vulnerabilities could increase and lead to widespread issues in the financial system.

**Figure 2: Primary Vulnerabilities in the ECCU Financial System**



**Our financial sector faced risks, at varying levels, during 2020.** Credit risk was the most pronounced during the year, although it was eased somewhat by policy and regulatory responses. The risk to capital was reduced as a consequence of the moratoria initiative. Liquidity and market risks remained low, while concentration risk emerged. The level of all risks could rise if existing vulnerabilities become elevated.

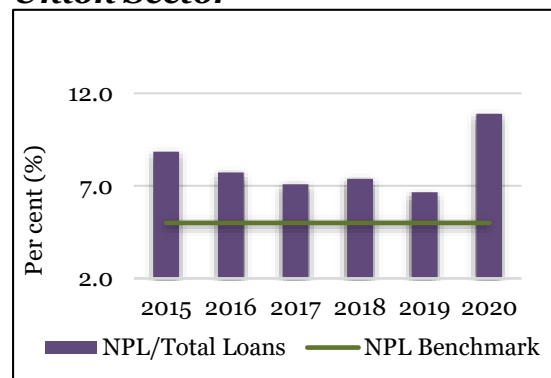
### *Credit Risk*

**The deterioration in the ECCB-area economies in 2020, resulted in higher probabilities of credit default and, by extension, credit risk. Of note, a high incidence of credit defaults, in the near to medium term, can pose significant stress on the financial system.**

**In the credit union sector, asset quality worsened.** The non-performing loan (NPL) ratio moved from 6.6 per cent in 2019 to 10.9 per cent in 2020 (**Figure 3**). The higher NPL ratio was likely a consequence of the negative impact of the pandemic on income flow of households and businesses, and signifies higher exposure of the credit unions to borrowers in

sectors that were hardest hit. Credit unions in all member countries experienced elevated NPL ratios with a rise of more than 8.0 percentage points in two of the countries.

**Figure 3: NPL Ratios in the Credit Union Sector**



*Sources: Single Regulatory Units in the ECCU and ECCB staff*

**The elevated vulnerabilities and risks in the private sector, emanating from the severe contraction in income, prompted credit unions in the ECCU to grant borrowers in distress the option to restructure loan contracts or request loan moratoria.**

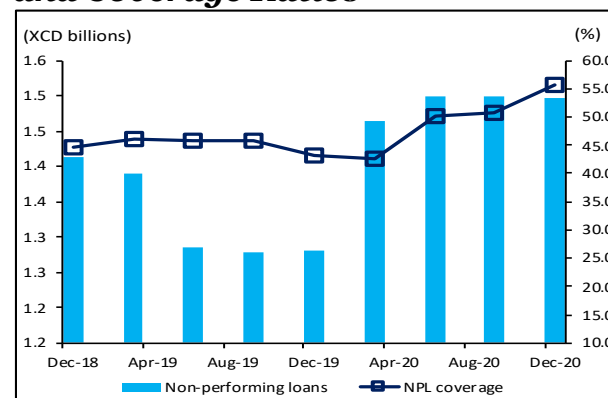
**Meanwhile, in the commercial bank sector some exposures migrated to higher risk stages.** Some materialization of credit risk occurred during 2020, with exposures migrating to Stage 3. For the first time in a 4-year period, the level of non-performing exposures increased in 2020.

NPLs rose by 16.7 per cent or \$214m. As a result, the ratio of NPLs to gross loans increased by 1.3 percentage points to 11.3 per cent.

**The banking sector's coverage of NPLs increased substantially.** The NPL coverage ratio rose by 12.3 percentage points in 2020 relative to the prior year. Banks are currently in the position to cover more than 50.0 per cent of NPLs in their loan books (**Figure 4**). Findings show that banking sector coverage ratios tend to lag behind deteriorations in asset quality on average.<sup>2</sup> During 2020, the adjustment was swift and appears sufficient at this present interval.

**The banks also reacted to increasing credit risk by increasing provisioning in 2020.**

**Figure 4: Commercial Banks' NPLs and Coverage Ratios**



Source: ECCB

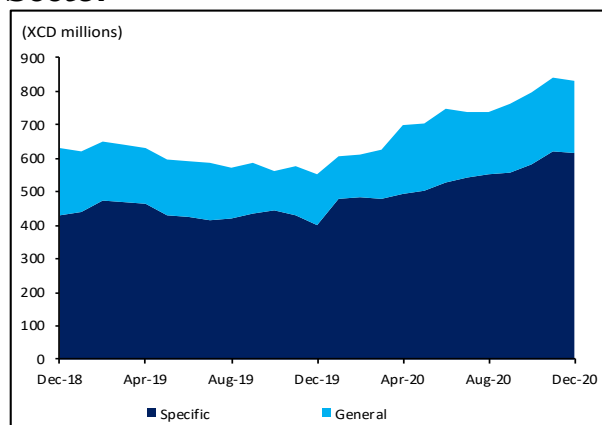
Contrasting 2019, where provisioning declined, the banking sector increased provisioning by over 50.0 per cent year-on-year to \$830m (**Figure 5**). This was expected since the banks were exposed to increased credit risk and sought to reserve coverage, given the uncertainty surrounding the pandemic.

**Overall, policy measures and regulatory responses helped to contain the extent of credit risk in 2020.**

<sup>2</sup> Alessi et al (2020) find that coverage ratios do not adjust timely or sufficiently when there is a deterioration in asset quality. Their findings

emphasize the importance of macroprudential levers and micro prudential oversight for enhancing banks' coverage policies.

**Figure 5: Provisions in the Banking Sector**



Source: ECCB

Policies and responses by member governments and the ECCB limited the impact of the pandemic on the real economy. Some of the implemented measures included income support or tax cuts for the most affected segments. Such initiatives helped to support domestic consumption when tourism and other sectors halted. The measures helped to shield the financial system from the adverse effects of the pandemic. Additionally, the loan moratoria offered by lending institutions, and endorsed by regional regulators (ECCB and Single Regulatory Units), contained the increase in credit risk. The moratoria allowed financial institutions and borrowers a chance to restructure lending facilities without default.

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*Approved moratorium applications surpassed 10,000 going into 2021 and amounted to \$3.1b. This represents close to 20.0 per cent of the total loans in the banking sector and was skewed towards the national banks.*

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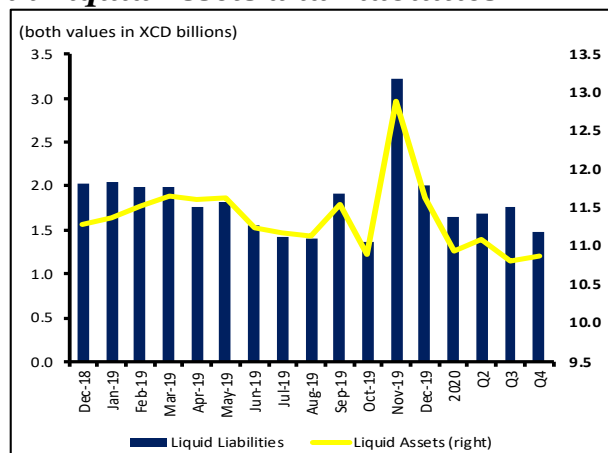
### *Liquidity Risk*

**Liquidity risk was generally low in 2020.** High liquidity levels prior to the health pandemic provided adequate buffers. Also, some business models, e.g. those in the insurance sector, are predisposed to low levels of liquidity risk. Notably, though, uncertainty in the operating environment post-2020, and the potential for a confluence of events including natural disasters in 2021 could heighten liquidity risk in individual firms.

**The banking sector maintained high liquidity levels throughout 2020.** The sector held liquid assets amounting to \$10.9b at the end of 2020 (**Figure 6**). Though the trend in banks' liquid assets holdings displayed sideways dynamics, the level of short-term liquid liabilities declined more assiduously over the past eight quarters. This resulted in a higher average net liquidity position for the sector.



**Figure 6: Commercial Banks' Trend in Liquid Assets and Liabilities**

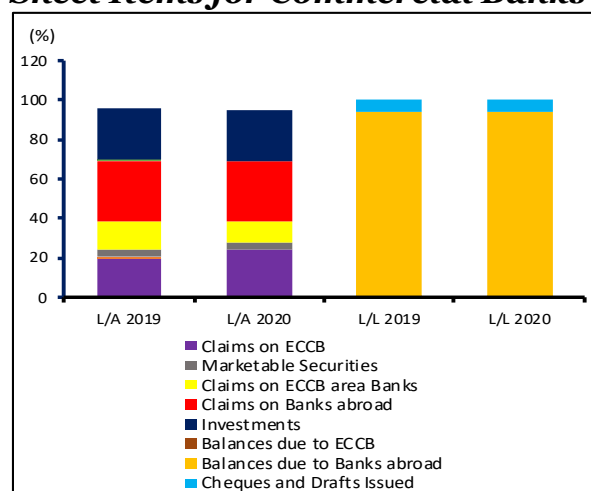


Source: ECCB

**Liquidity positions of commercial banks appear to be firm.** Banks maintained a 60.0 per cent share of loans relative to system deposits on their balance sheets, marginally higher (1.5 percentage points) than the average observed in 2019. Nonetheless, this should afford the banking system some resilience against unexpected liquidity shocks. In addition, 27.0 per cent of the banking sector's liquid assets were considered as high-quality, that is, its claims on ECCB balances (**Figure 7**). There was a relatively unchanged position in the level of short-term liabilities, specifically those due to non-ECCB area banking institutions. Those balances declined to \$1.3b from \$1.8b in 2019.

The ECCB, lender of last resort, provided timely monetary easing in the financial sector through the lowering of its discount rate in 2020. The lower cost available financing from the Central Bank, which could have been utilised for liquidity purposes, was not utilised by any LFI during the year under review.

**Figure 7: Selected Liquid Balance Sheet Items for Commercial Banks**



Sources: ECCB and FST's calculations

### Market Risk

**Exposure to market risk remained varied across the financial system, depending on a number of institutional factors.** Those include the firm's asset mix; duration, nature, and currency profile of their liabilities; plus, their risk appetite. Overall, the level of this risk in the financial sector was low in 2020.

### *Concentration Risk*

**Prior to 2020, the ECCU underwent changes in the ownership structure of banking sector, which led to greater concentration.** The exit of some Canadian banks tilted ownership to local banks which increased their asset base. The most recent change was the sale of Royal Bank of Canada (RBC) assets to a consortium of local banks. Though not currently a cause for concern, a more concentrated banking sector can potentially reduce the scope for competition and raise the cost of resolution in the case of failures. Hence, ensuring optimal regulation of the banking sector is of utmost significance.

### *Other risks*

With fast-tracked digital transformation of financial institutions, in response to the pandemic, operational risks such as cyber security are likely to have increased in 2020. It is estimated that threats relating to cyber-attacks and fraud are likely to have increased during the reporting period.



*Photo Credit: Bing Image*

## SECTION TWO

### Financial Performance and Soundness of Deposit-Taking Institutions: Banking and Credit Union Sectors

#### KEY INSIGHTS

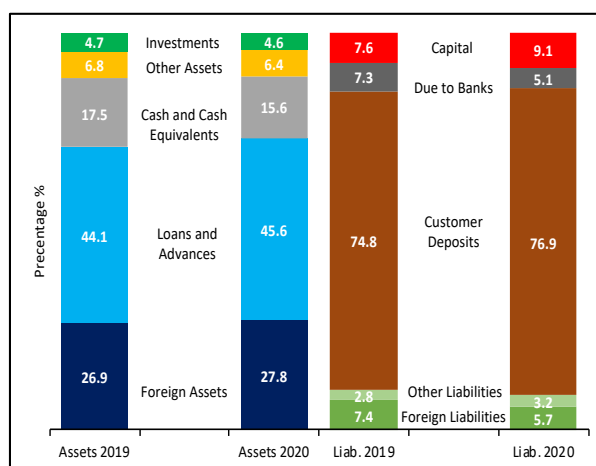
1. Even amidst the coronavirus pandemic the banking sector remained stable, with the composition and size of the sector's aggregate balance sheet remaining relatively unchanged.
2. In the banking sector, total assets declined slightly, capital levels grew, total deposits rose marginally, the total loan stock increased modestly, and foreign assets grew below its annual average growth rate. Profitability of the sector was lower in 2020. Funding risks remained low for the sector.
3. The credit union sector experienced deceleration in balance sheet activity during 2020.
4. Despite the challenges of the pandemic, the credit union sector remained adequately capitalised during the year under review.

## 2.0 Financial Performance and Soundness of Deposit-Taking Institutions: Banking and Credit Union Sectors

### 2.1 Banking Sector

The composition and size of the banking sector's aggregate balance sheet remained relatively unchanged from 2019 (Figure 8). The aggregate Net Stable Funding Ratio (NSFR) was estimated at 124.0 per cent.

**Figure 8: Balance Sheet Composition of the Domestic Banking Sector**



Sources: ECCB and FST's calculations<sup>3</sup>

On aggregate, total assets of the banking sector amounted to \$28.3b (162.0 per cent of GDP), slightly lower than the level in 2019.

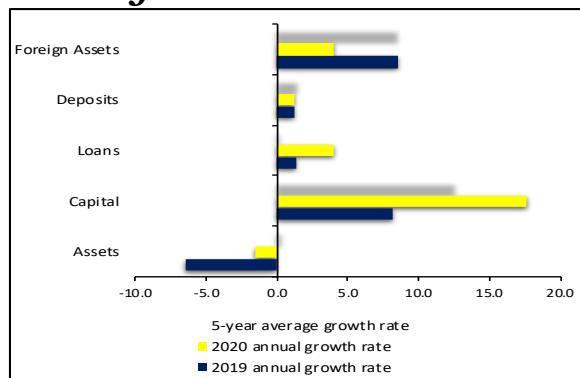
<sup>3</sup> Notes: Cash and cash equivalents contain claims on other banks along with currency holdings. The investments category reflects

The NSFR is a tool developed by the Basel Committee on Banking Supervision with the objective of reducing the funding risk associated with banks. Banks should have a minimum of 100% of their available stable funding relative to the amount of required stable funding.

The reduction was not as large as in 2019, due to strong growth in the loan portfolio in 2020 (Figure 9). Meanwhile, foreign assets grew at a pace slower than its average growth rate. Foreign assets have grown persistently over the last five years, with year-on-year growth averaging 8.5 per cent.

local/ECCB-area securities only, while foreign investments are captured in foreign assets.

**Figure 9: Changes in Selected Balance Sheet Items of the Banking Sector**



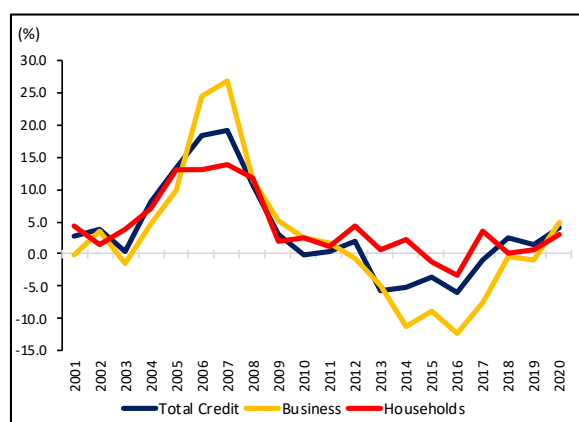
Sources: ECCB and FST's calculations

**Commercial banks' exposures to households and businesses increased in 2020.** Despite the slump in economic activity in 2020, the total stock of loans in the banking sector increased by 4.0 per cent (**Figure 10**). This credit growth outturn is the largest single period movement since the global financial crisis of 2008. Credit to households and businesses rose by 5.0 per cent and 3.1 per cent respectively.

**Year-on-year, both debt owed by households and businesses rose as percentages of GDP (Figure 11).** The combined effect of increases in credit extended to both segments and a simultaneous decline in GDP, contributed to growth in the credit to GDP ratios. Household indebtedness was equivalent to the levels observed

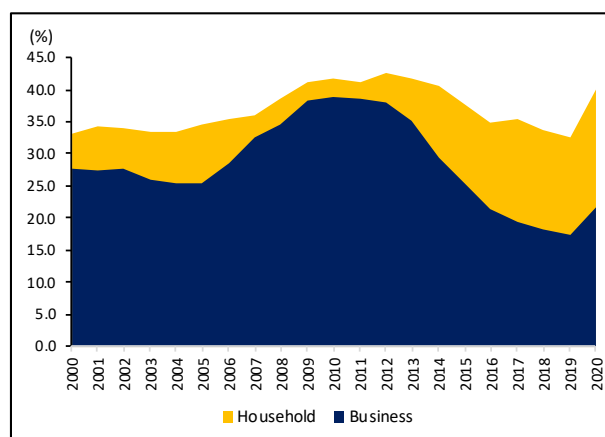
during the global financial crisis. For firms, their total indebtedness relative to GDP in 2020 was below the highs recorded ten years prior. In a scenario where economic recovery is protracted, borrowers could face difficulties servicing their debts.

**Figure 10: Changes in Commercial Bank Credit**



Sources: ECCB

**Figure 11: Commercial Bank Credit to Households and Businesses (as a % of GDP)**



Source: ECCB



**The banking sector continued to build resilience with growth in capital levels.** Banks have steadily built capital buffers over the last ten years, a behavioral shift associated with the global financial crisis. The capital surpluses in the sector are important.

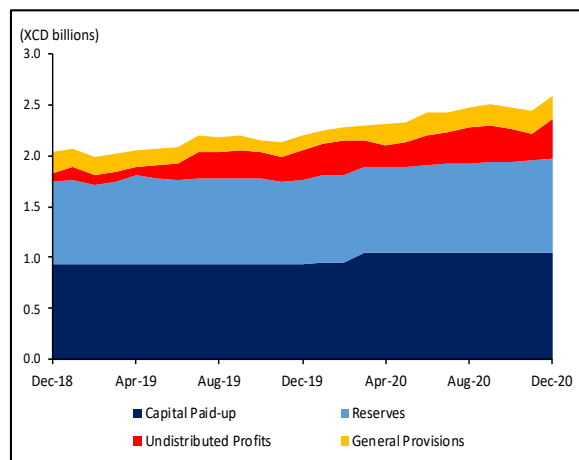
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*Capital surpluses are those extra resources maintained by banking institutions in excess of the actual regulatory requirements. Most banks maintained capital positions above the minimum regulatory capital requirement of 8.0 per cent.*

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In fact, over the past six years, capital and reserves more than doubled. The capital adequacy ratio (CAR) of the banking sector was 20.9 per cent in 2020. Capital rose to \$2.5b in 2020, a change of \$386.6m over the previous year. The capital level rose primarily on account of increases in undistributed profits and general provisions, however, all eligible capital components exhibited growth (**Figure 12**).

**Figure 12: Capital Structure of the Banking Sector**



Source: ECCB

Even with rising capital, the CAR declined marginally by 0.2 percentage point. The Tier 1 capital ratio fell by 0.3 percentage points to 17.2 per cent. Increased loan exposures and the accompanying growth in risk-weighted assets drove the CAR downward.

**The leverage ratio for the sector grew by 1.3 percentage points to an estimated 8.4 per cent in 2020.** This increase is consistent with the upward trend observed in past periods. This is another indication of the strengthened capital position of the sector necessary for ensuring resiliency during uncertain times or stressed periods. Stress testing exercises conducted by the ECCB Staff, the results of which are discussed briefly in the Outlook Section, also support this

stance. Banks have reduced certain balance sheet exposures over the last three years and as such the reduced degree of leverage to its core capital.

**Profitability of the banking sector was lower in 2020.** The annualized return on assets for the sector fell by 0.3 percentage point to just over 1.0 per cent. Similarly, after consistent improvements over the past few years, return on equity declined by 7.6 percentage points to 12.2 per cent. The sharp decline in return on equity reflected a fall in profits and increase in capital. Profits in the sector are at least 25.0 per cent lower than in 2019. Banks increased their holdings of earning assets (e.g. loans) and this positively affected their revenue performance in 2020. The higher credit risk environment, however, prompted an increase in provisioning, which would have affected bottom lines adversely.

**Funding risks remained low in the banking sector in 2020.** The main source of funding for the sector continued to be deposits. Total deposits in the sector were marginally higher in

2020. They accounted for 77.0 per cent of banks' liabilities on average. Hence, funding risks are deemed lower given that deposits are considered a more stable source of funding for core assets. The sector placed less reliance on short-term wholesale funding, which is less stable and prone to disruption. Any instability in the sector's funding structure could weaken liquidity positions in stressed periods.

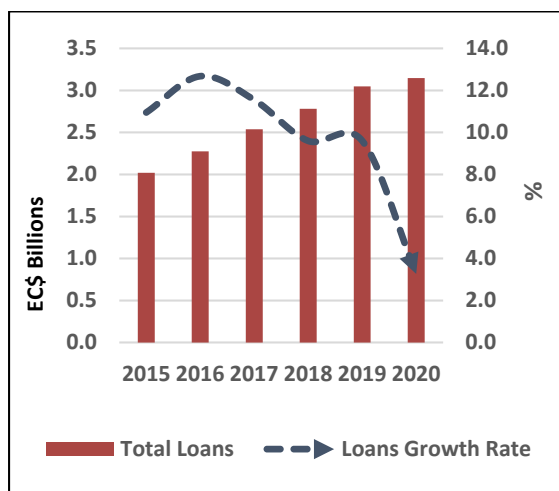
## 2.2 Credit Union Sector

**This sector experienced a deceleration in balance sheet activity during 2020.** At the end of 2020<sup>4</sup>, total assets of the credit union sector grew by 6.0 per cent compared to 10.3 per cent in 2019; representing a slowdown in growth by 4.3 percentage points. A similar trend was recorded for total loans which grew by 3.1 per cent or 6.3 percentage points slower compared to 2019 (**Figure 13**).

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<sup>4</sup> The figures reported for December 2020 include estimates for two (2) of the seven (7) reporting countries.

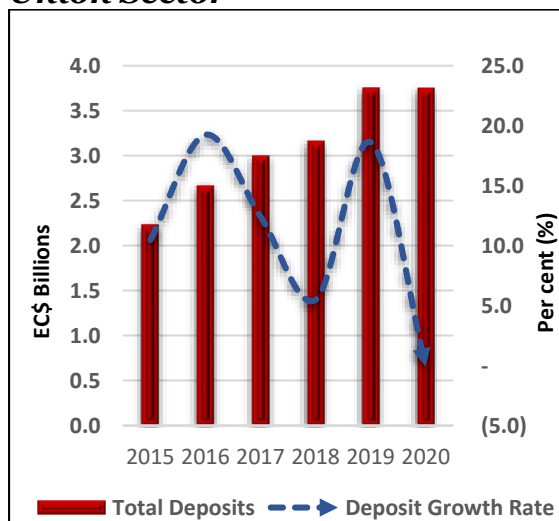
**Figure 13: Loans in the Credit Union Sector**



Source: Single Regulatory Units in the ECCU and ECCB staff

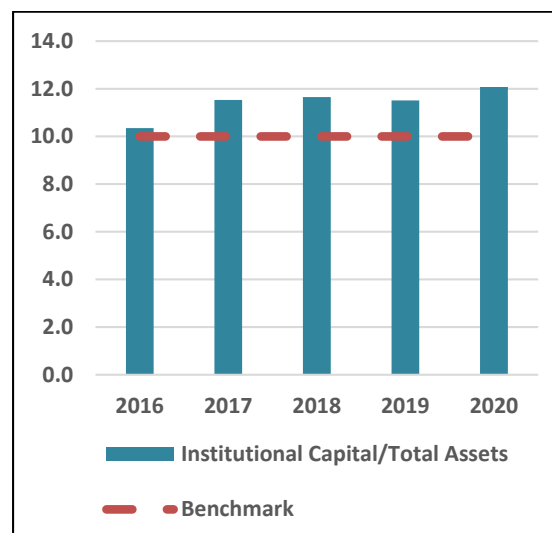
Conversely, total deposits fell to \$3.7b from \$3.8b in 2020 (Figure 14).

**Figure 14: Deposits in the Credit Union Sector**



Despite the challenges posed by the pandemic, the sector remained adequately capitalised in 2020. A performance measure of capital adequacy, namely institutional capital to total assets, was above the benchmark (Figure 15). The ratio was 12.1 per cent in 2020, slightly above 11.5 per cent recorded in 2019.

**Figure 15: Capital Adequacy in the Credit Union Sector**



Source: Single Regulatory Units in the ECCU and ECCB staff



*Photo Credit: Bing Image*

## SECTION THREE

### Financial Performance and Soundness of Non- Deposit-Taking Institutions: Insurance Companies

#### KEY INSIGHTS

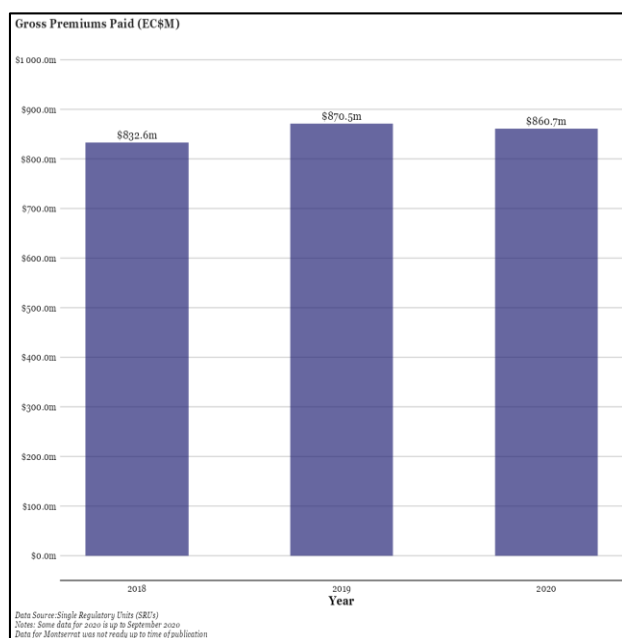
1. In the insurance sector, gross premiums collected fell marginally, while total claim payments rose in 2020.
2. Insurers maintained strong capital buffers.
3. Profitability across the insurance sector was mixed.

## 3.0 Financial Performance and Soundness of Non-Deposit-Taking Institutions: Insurance Companies

### 3.1 Insurance Sector

**Aggregate premiums collected by the insurance sector decreased to \$860.0m during 2020 from \$870.5m during the previous year (Figure 16).**

**Figure 16: Gross Premiums Collected by Aggregate Insurance Sector**

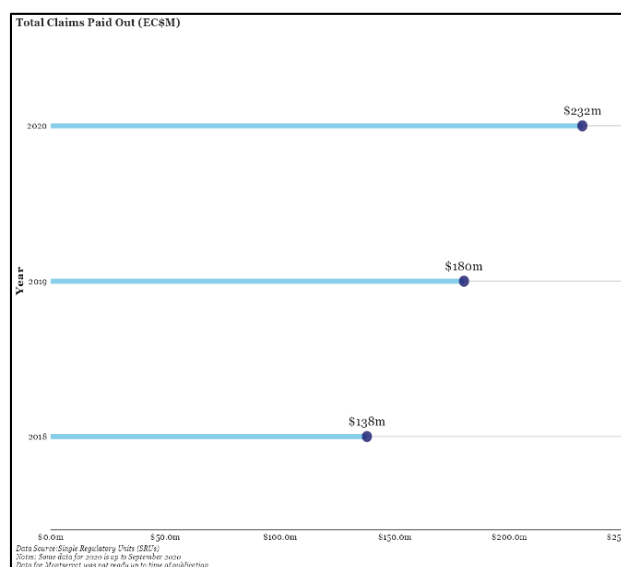


*Sources: Single Regulatory Units in the ECCU and ECCB staff*

The rise in unemployment, due to the pandemic related restrictions, ultimately led to reductions in premiums collected.

**Meanwhile, claim payments for the aggregate insurance sector increased in 2020 (Figure 17).** This outcome was partly influenced by Covid-19 related claims. There was a reduction in the total claims related to natural disasters due to the relatively benign Hurricane season in 2020.

**Figure 17: Total Claims Paid Out by Aggregate Insurance Sector**



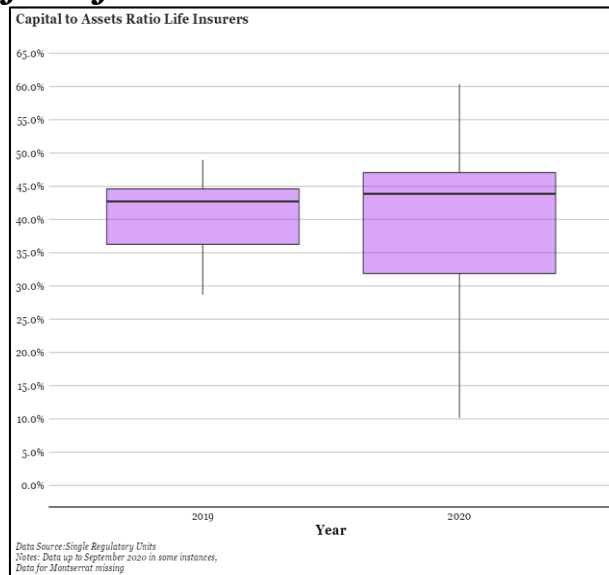
*Sources: Single Regulatory Units in the ECCU and ECCB staff*

**Insurers maintained strong capital buffers during 2020.** For long term insurers, capital adequacy is measured using the capital to asset ratio. Based on



this metric, long term insurers have remained within an estimated range of 30 to 40 per cent across the region (**Figure 18**). The median value for the capital to assets ratio was 43.0 per cent in 2020, an improvement over the 2019 value. However, the dispersion among insurers was wider, indicating that some companies recorded a decline in their capital positions.

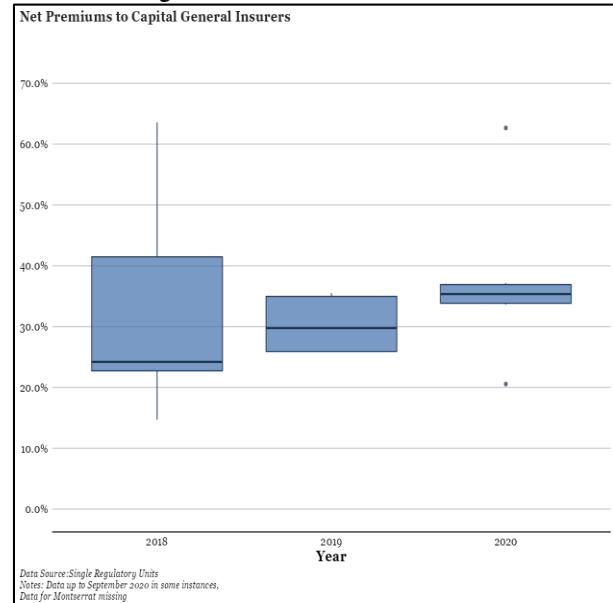
**Figure 18: Capital to Asset Ratios for Life Insurers**



Sources: Single Regulatory Units in the ECCU and ECCB staff

The median value for the net premium to capital ratio for general insurers was estimated to be 35.0 per cent in 2020, higher than the level of 30.0 per cent recorded in 2019 (**Figure 19**).

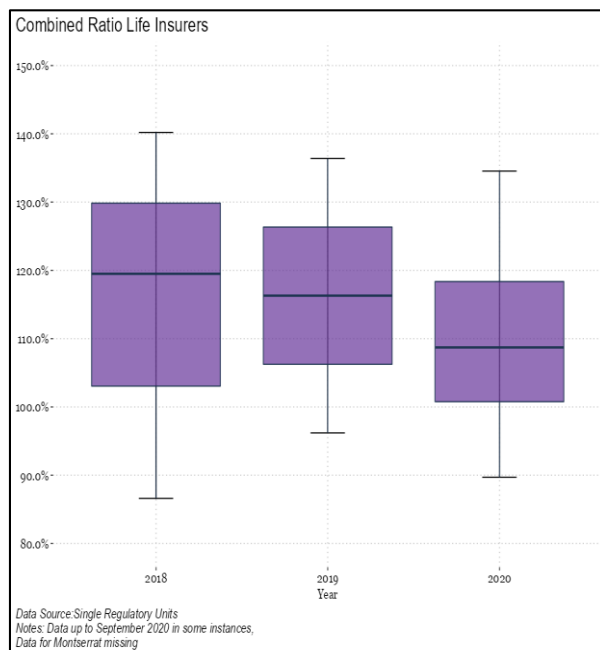
**Figure 19: Net Premiums to Capital Ratios for General Insurers**



Sources: Single Regulatory Units in the ECCU and ECCB staff

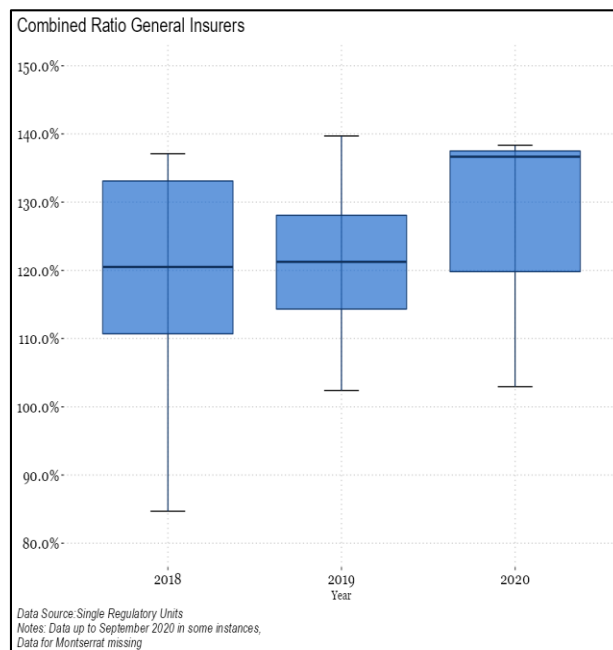
**Profitability across the insurance sector was mixed.** Life insurers fared relatively better than general insurers. The combined ratio for life insurers increased marginally during 2020 (**Figure 20**). The combined ratio for life insurers rose by an average of 3.0 per cent to 95.9 per cent.

**Figure 20: Combined Ratios of Life Insurers**



Sources: Single Regulatory Units in the ECCU and ECCB staff

**Figure 21: Combined Ratios of General Insurers**



Sources: Single Regulatory Units in the ECCU and ECCB staff

Non-life insurers were most affected by COVID-19 related claims, but these were not at a level to threaten firms' solvency positions. Meanwhile, general insurers recorded a deterioration in their performance during 2020. This was despite claims declining, especially across the motor vehicular sector due to restrictions on movement in 2020. For general insurers, the median value of the combined ratio was higher in 2020 at 134.8 per cent relative to the level registered in the prior year of 124.2 (Figure 21).



*Photo Credit: Bing Image*

## SECTION FOUR

# Policy Initiatives for Enhancing Financial Stability in the ECCU

### KEY INSIGHTS

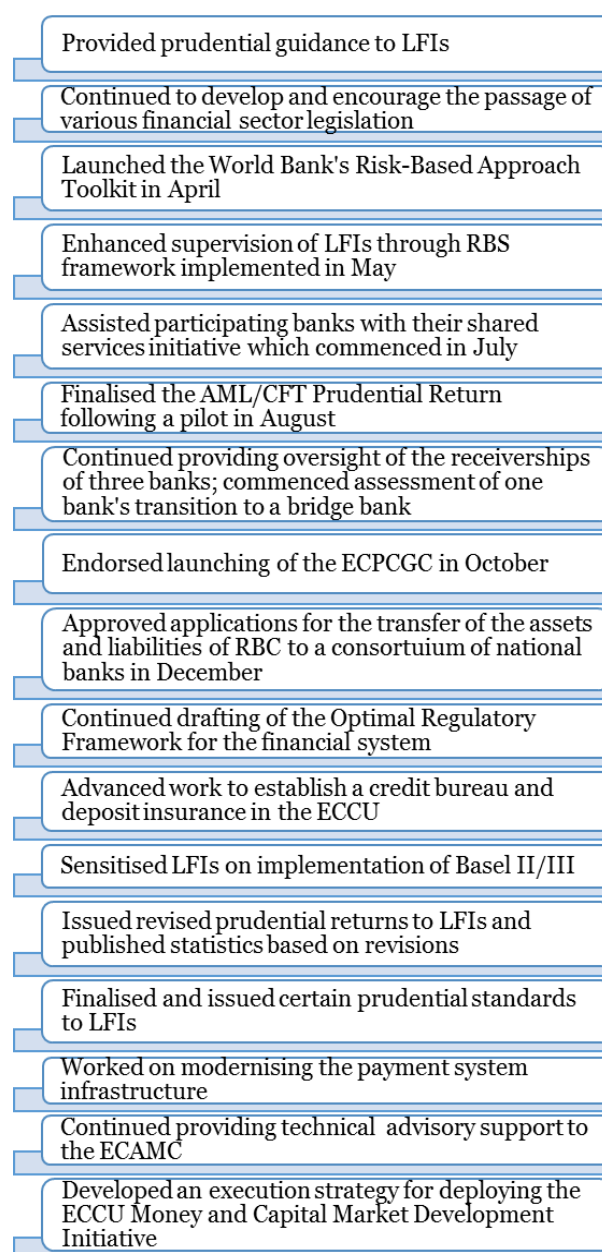
1. Unprecedented policies and responses including the loan moratoria helped to contain the impact of the COVID-19 pandemic on the ECCU's financial system.
2. Enhanced monitoring, supervision and collaboration all supported the stable financial environment.
3. A number of macroprudential policies are planned for the medium term to help maintain financial stability in the ECCU.

## 4.0 Policy Initiatives for Enhancing Financial Stability in the ECCU

The Bank maintained a strong dollar policy as the backbone of the financial system. The stable exchange rate policy continued to foster confidence and other positive sentiments in financial markets.

Several other initiatives were undertaken within our regional space in 2020 to ensure a strong, diversified and resilient financial system (Figure 22). Some were spearheaded by the Bank, in collaboration with member governments, national regulators or SRUs and other stakeholders. The ECCB provided regulatory guidance to Licensed Financial Institutions (LFIs) on areas including the application of IFRS 9 requirements for the treatment of initiatives such as the loan moratoria.

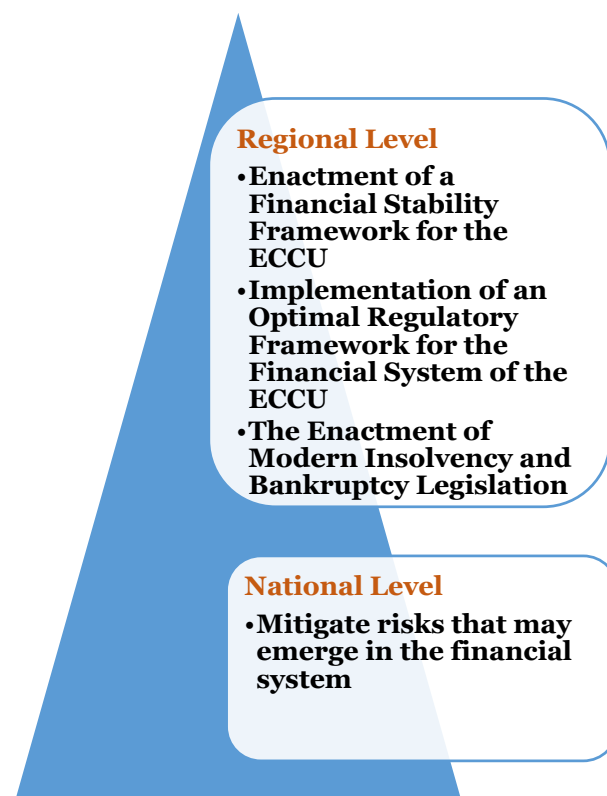
**Figure 22: Key Policy Initiatives and Regulatory Responses by the ECCB in 2020**



The loan moratoria programme given for six months from March 2020 in the first instance, with a 12-month extension from October 2020, was endorsed by the ECCB. The Central Bank also continuously engaged with national regulators on the moratoria and other matters.

**Additionally, a Programme of Action for Recovery, Resilience and Transformation (PARRT) for the ECCU was approved by the Monetary Council of the ECCB approved<sup>5</sup> in October 2020.** The PARRT focuses on medium-term (2021-2023) actions, at both the national and regional levels, which are fundamental for the recovery, resilience and transformation of the ECCU. It is based on four pillars, the first pillar being financial stability<sup>6</sup>. Before the PARRT's approval, work had already started on some of its proposed actions for financial stability (**Figure 23**).

**Figure 23: Key Financial Stability Actions Proposed in the PARRT for 2020-2021**



**At the regional level, efforts continued apace to ultimately enact legislation, develop infrastructure, and implement regulations for financial stability.** The aim is to establish a Macroprudential Framework for Financial Sector Stability. The ECCB also finalized research on the Optimal Regulatory Framework in the ECCU. Further, the Bank, in

<sup>5</sup> The approval was subject to a further discussion on an extension of the targeted year (2030) of the fiscal anchor, that is the Debt to GDP Ratio target of 60.0 per cent.

<sup>6</sup> The remaining pillars of the PART are Fiscal and Debt Sustainability, Resilient and Inclusive Growth, and Payments Modernisation and Digital Transformation.



collaboration with member governments and the IFC, advanced work on a modern harmonized insolvency and bankruptcy legislation.

**At the national level, the SRUs enhanced their supervision; conducted periodic meetings with financial stakeholders; and continued targeted assessments and, in some cases, stress tests.** Notably, member governments continued to encourage and support the timely sharing of data from the SRUs to the ECCB. They consistently pledged support for the timely resolution of any issues in the financial system which pose high systemic risk. Also, member governments continued to collaborate with the ECCB on the establishment a regulatory arrangement that seeks to improve regulatory coverage and reduce gaps and opportunities for regulatory arbitrage.

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*These Frameworks will guide towards implementing a regulatory arrangement that seeks to improve regulatory coverage and reduce gaps and opportunities for regulatory arbitrage.*

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The financial stability initiatives which the Bank will pursue in the medium term, in collaboration with member

governments and national regulators are summarised as follows:

- ✚ Enhance Risk-Based Supervisory and Management Framework;
- ✚ Implementation of a Macro-Prudential Framework;
- ✚ Delivery of a new risk management infrastructure to support the ECCU financial sector; and
- ✚ Support consolidation within the banking sector;

Alongside these, financial development initiatives will be pursued by the ECCB as follows:

- ✚ Improve payment infrastructure to adapt to market expectations;
- ✚ Deepen money and capital markets;
- ✚ Increase citizen access to credit and other financial services; and
- ✚ Develop a renewable energy infrastructure fund facility.



*Photo Credit: Bing Image*

## SECTION FIVE

# Outlook

### KEY INSIGHTS

1. A protracted economic recovery can worsen risks to financial stability, in particular credit risk, in the medium term. Efficient and effective implementation of financial stability initiatives should mitigate risks.
2. High capital positions of commercial banks are likely to support future stability and growth in the commercial banking sector. There are no strong indications of weakening capital positions going forward. Capital levels are right for absorption of any further credit losses and for smooth lending to the real economy.
3. A weak recovery for the ECCU in 2021 can cause credit unions to face further deterioration in their credit portfolio when loan forbearance measures are discontinued.
4. The ongoing fallout from the COVID-19 pandemic could lead to unanticipated negative net cash flows for the insurance sector.

## 5.0 Outlook

### *General Outlook*

**The ECCU entered 2021 with prospects of an economic recovery 0.9 per cent and 6.9 per cent real GDP growth in 2021 and 2022 respectively. Several factors, though, can stall this anticipated recovery.** They include the strength and pace of the global rebound, developments related to Covid-19 and vaccines both domestically and abroad, resumption of world and regional tourism, as well as the effectiveness of local and regional policies to stimulate the regional economy. Other uncertainties relate to the frequency and scale of future volcanic eruptions in Saint Vincent and the Grenadines, and the intensity of the hurricane season in 2021.

**A protracted recovery could worsen risks to financial stability. Credit risk can increase in the medium term (especially with the expiration of the loan moratoria).** Ongoing engagement between the ECCB,

LFIs and national regulators will help to ensure a proper exit from the moratoria.

**Another issue that can confront the financial sector is weakening of profitability.** This issue could be exacerbated by a weaker economic recovery. Other factors such as lower credit growth, reduced premiums (insurance), and additional credit provisioning can reduce profitability. Further, institutions in the financial system exposed to overseas financial markets face the risk of a significant market correction, which can negatively impact investment income. In particular, the buoyancy of some equity markets in 2020 led to concern about disconnect between underlying fundamentals of the global economy and global financial markets. IMF (2021)<sup>7</sup> indicated that equities are trading at levels higher than those suggested by models based on fundamentals, and deviations from fair value per unit of risk have reached levels last seen before the bursting of the dot-com bubble in 2001.

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<sup>7</sup> See IMF Global Financial Stability Report, April 2021.

**Additionally, sovereign risk could intensify if the regional debt to GDP level continues to rise over the next few years.** The level could rise for several reasons including the absent of an economic recovery, lack of fiscal consolidation, and increases in contingent liabilities for the public sector. An adverse debt scenario can call for sovereign debt restructuring accompanied by fiscal tightening. The holdings by financial institutions of government debt instruments on the Regional Government Securities Market, are intricately linked to discussions on sovereign risk, balance sheets and potential solvency. On the upside, credibility of the regional debt to GDP target and commitment by member governments to reach the 60.0 per cent target by 2035, should help to mitigate sovereign risks.

**Risks can be mitigated by the efficient and effective implementation of planned medium-term financial stability and development initiatives.**

#### *Outlook for the Banking Sector*

**Banks are likely to experienced increased credit risk in 2021.** When the moratorium period expires, there could be further materialization of credit risk in banks' loan portfolios. Further, in the absence of a solid economic recovery, credit risk could heighten.

**The commercial banking sector's capital levels are adequately positioned to absorb credit losses that may result from the ongoing pandemic.** Maintaining strong capital positions are paramount given that the pandemic could be prolonged and the long-term implications on the real economy are not fully known.

The observed capital surpluses end-December 2020 mean that the banking sector had conditional lending capacity entering 2021, a factor that will help to support activity in the real economy. However, considering heightened credit risk and uncertainty surrounding the economy, banks may be reluctant to substantially expand lending.

**There are no expectations for significant declines in banking sector capital positions.** This is the short to medium term assumption, hence, banks should be able to maintain adequate capital levels going into 2021 and 2022. However, there is still the risk that a prolonged period of muted economic activity and restrictions could result in increased credit losses for the sector. There will be marginal declines in capital ratios as the banking sector increases its loan exposures from moderate to high-risk weights. If the 2020 dividend policy is maintained in the short term, then this will help to bolster and support capital positions.

**Future profitability in the sector will depend on banks' ability to maintain interest income and limit credit losses, which are partly**

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*The ECCB Staff macro stress test exercises indicated that the banking sector remains resilient to an adverse economic scenario in 2021. Under the Adverse Scenario, over the stress test horizon 2021-2023, aggregate banks can maintain capital above the 8.0 per cent regulatory minimum, because of the high capital position end-December 2020. The results also show that the capital surplus level can be key in maintaining banking sector stability under adverse economic conditions. Hence, banks need to continue to act very prudently in managing capital and their dividend policies given the current economic environment.*

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**hinged on the pace and strength of economic recovery.**

*Outlook for the Credit Union Sector*

**Credit unions will likely face further deterioration in their loan portfolios especially with a weak economic recovery in 2021.**

Additionally, as many businesses adapt to the new technological environment, it is likely that some workers may face difficulties re-entering the job market. Unemployment and lack of income among the low skilled could persist in the medium term, thereby increasing the potential for further credit defaults,

drawdown of deposits and discontinuance of premium payments. Credit conditions are expected to tighten (i.e. reduced extension of new credit) as the sector manages credit risk. Meanwhile, the growth rate in deposits are likely to slow further in 2021 as households and businesses continue to recover from the lingering effects of the pandemic on income. Policy action may therefore be necessary to ensure the continued resilience of the sector.

#### *Outlook for the Insurance Sector*

**The ongoing fallout from the COVID-19 pandemic could lead to unanticipated negative net cash flows.** This outcome could arise from a combination of a considerable increase in claims, reduced premium income, a deterioration in the market liquidity of some asset types.

The insurance sector can be exposed to higher sovereign risk with any sovereign debt distress, due to the nature of the sector's investments. Fixed interest securities (government debt instruments) represent an average of one third of insurers' assets across the ECCU. Long term insurers particularly have large holdings of government debt to

match their long-term liabilities. On the upside, the continued absence of default by sovereigns, and the credibility of the regional debt to GDP target can help temper sovereign risk.

**The profitability and capital generating capacity of the sector can be affected in multiple ways in the medium term.** First, structural and regulatory changes such as IFRS 17 can impact the industry. Second, elevated health and economic risks, as well as rising uncertainty can impact future insurance demand, premium income, customer retention rates, competitiveness of operations, investment income and consequent profitability levels. On the upside, a more stable claims environment could contribute over time to an increase in the availability of insurance in some sectors and a reduction in premiums.

For the insurance sector, the increased regulatory focus on liquidity monitoring, should be maintained to mitigate against this risk.



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