# FINANCIAL STABILITY REPORT

December 2018

Turks & Caicos Islands Financial Services Commission

## Disclaimer



Financial Stability Report 2018
Turks and Caicos Islands Financial Services Commission

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# Preface

The Turks and Caicos Islands Financial Stability Report describes the overall risks and threats to financial stability in the Turks and Caicos Islands ('TCI') and the resilience of the financial system in the context of those assessed threats. The report is produced by the Turks and Caicos Islands Financial Services Commission ('the Commission'), pursuant to its mandate to monitor financial services business conducted in and from within the TCI.

This 2018 edition seeks, among other things, to:

1. describe the overall risks and threats to financial stability in the TCI and discuss the resilience of the system in the context of those assessed threats;
2. review trend movement of specific risk indicators and stress test exercise outcomes;
3. discuss emerging risks to system stability and their likely implications; and
4. outline the ongoing and planned policy responses to some of these developments.

This report addresses only the domestic financial system, with primary focus on the domestic banking sector which is the main engine of intermediation and most vulnerable to unexpected shocks through exposure to the rest of the economy. The report therefore does not focus in detail on less systemically important sectors. It also does not include financial institutions licensed to conduct business solely outside of the TCI. At publication date, the offshore sector was dominated by over 7,000 small international insurers, the overwhelming number of which were Producer Owned Reinsurance Companies (PORCs) which reinsure low-value risks generated by related entities. The TCI is also home to a small number of other captive insurers, as well as one investment dealer, which operate solely outside of the TCI.

This document, unless otherwise stated, references data available as at 31 December 2018.

The report is published to promote public understanding and transparency around this subject and is available to the public for download at http://www.tcifsc.tc.

## Acknowledgments

The Commission wishes to acknowledge the contribution of a number of statutory bodies including the Statistics Department to this report.

# Abbreviations

| | |
|---|---|
| AML | Anti-money laundering |
| CAR | Capital adequacy ratio |
| CARICOM | Caribbean Community |
| CFT | Counter financing of terrorism |
| D-SIB | Domestic systemically important bank |
| EU | European Union |
| GDP | Gross domestic product |
| GFC | Global financial crisis |
| HHI | Herfindahl-Hirschman Index |
| IMF | International Monetary Fund |
| NPL | Non-performing loan |
| ROAA | Return on average assets |
| ROAE | Return on average equity |
| TCI | Turks and Caicos Islands |
| US | United States |
| UK | United Kingdom |

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## Executive summary

The TCI financial system remained stable through 2018 and risk levels remained low to moderate, despite slowing global growth. The domestic economy returned to growth in the aftermath of Hurricanes Irma and Maria in 2017, buoyed by tourism revenues. This growth benefited the banking sector which remained highly liquid and well-capitalized. The sector ended the year with a liquid assets to total assets ratio of 53.9 per cent and CAR of 29.2 per cent, up from 45.9 and 26.8 per cent respectively, in 2017. Asset quality also improved with the significant reduction in legacy non-performing assets. As a result, the sector performed better in the 2018 credit stress tests compared to previous years.

Against that backdrop of growing resilience in the banking sector, risk levels are expected to remain stable over the next 12 to 18 months. Tourism revenues, the key driver of GDP, are anticipated to support domestic expansion and boost asset quality. Nonetheless, uncertainty brewing in global markets could pose challenges. 2019 growth forecasts have been revised downwards as global activity slows especially in advanced economies. In the US – the TCI's largest tourism source market – waning effects of government stimulus and rising protectionism are expected to cool growth by at least half a percent, which could have knock-on effects for the TCI economy.

The Commission intends to support system resilience by improving the quality of supervision. In addition to continuing its current focus on improving capital and liquidity, this will also include strengthening the quality of oversight through better and more risk-based supervision. A special priority within that programme is strengthening of AML/CFT oversight. To the extent that de-risking represents, in part, a response to actual or perceived AML/CFT weaknesses, the Commission is working to ensure that regulatory policies and methodologies not only comply with international requirements and expectations, but as much as possible, do not unwittingly or unnecessarily prevent access to financial services.

The GFC and other crises have affirmed the need for robust ex-post responses, where the onset of crisis cannot be prevented. In the coming years, the Commission will work to enhance its crisis management arrangements, including formalizing relationships with other stakeholder agencies which support financial stability. The imminent establishment of a credit union movement and current legal requirement for a deposit insurance scheme to be implemented for that sector has also reopened dialogue on the issue of protection for all depositors.

# 2. Financial system developments

## 2.1. Composition and size

The domestic financial system remains the second largest contributor to the TCI economy, behind tourism. At the end of 2018, the system comprised the following types of institutions:

- 6 banks
- 19 insurance companies
- 9 trust companies[1]
- 5 investment dealers[2]
- 3 mutual funds

The system grew by 3.8 per cent in 2018 to $3,745.3mn. As a result, system size relative to estimated GDP grew from 550.8 per cent to 571.8 per cent. Expansion was mainly driven by the banking and investment dealer sectors. The banking sector's consolidated balance sheet grew by $303.2mn or 16.0 per cent, while significant increases in activity by two investment dealers boosted that sector's share by $93.3mn or 21.5 per cent. All other segments declined. Attenuation was greatest in the trust and general insurance sectors, owing to the voluntary winding up of one trust business, and reduction of general insurers' cash, investments and insurance reserves to settle hurricane-related claims. The system remained dominated by banks whose market share expanded to 58.8 per cent of system assets, up from 52.6 per cent the previous year. Despite declining by 13.1 per cent, trust companies accounted for the second-highest share, 18.8 per cent of the system, while the expansion among investment dealers propelled that sector to a 14.0 per cent share of the system.

**Table 1: Size and composition of the domestic financial system ($mn)**

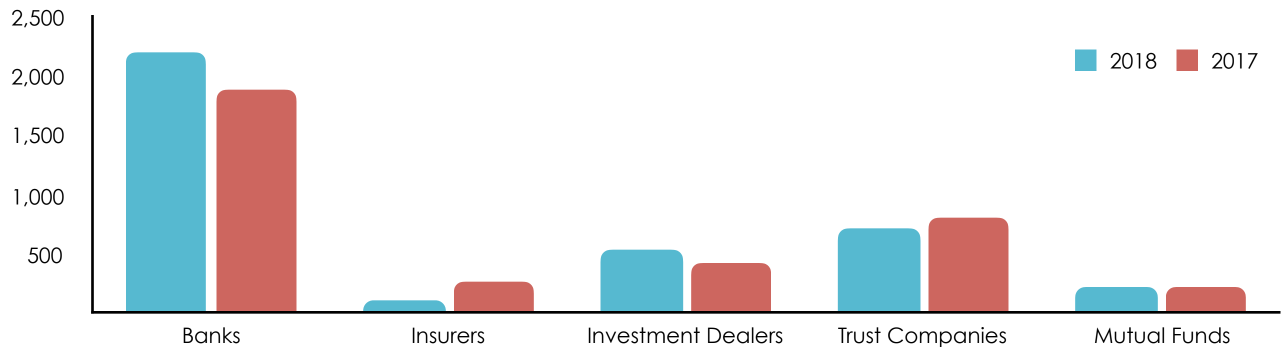
| | 2018 | 2017 | Change | |
|---|---|---|---|---|
| | | | $ | % |
| Total Financial System | **3,745.3** | **3,607.6** | **137.7** | **3.8** |
| Banks | 2,201.1 | 1,897.9 | 303.2 | 16.0 |
| Insurance companies | 104.9 | 253.7 | (148.8) | (58.7) |
| Investment dealers | 525.8 | 432.6 | 93.2 | 21.5 |
| Mutual funds | 210.9 | 214.7 | (3.8) | (1.8) |
| Trust companies | 702.6 | 808.7 | (106.1) | (13.1) |

*Source: Financial Services Commission*

[1] This includes one entity which, at publish date, was voluntarily winding up its operations and another for which data was carried forward from June 2018.

[2] This total does not include assets under management by one international wealth management company which is registered as a foreign company to provide institutional investment services to the national pension scheme.

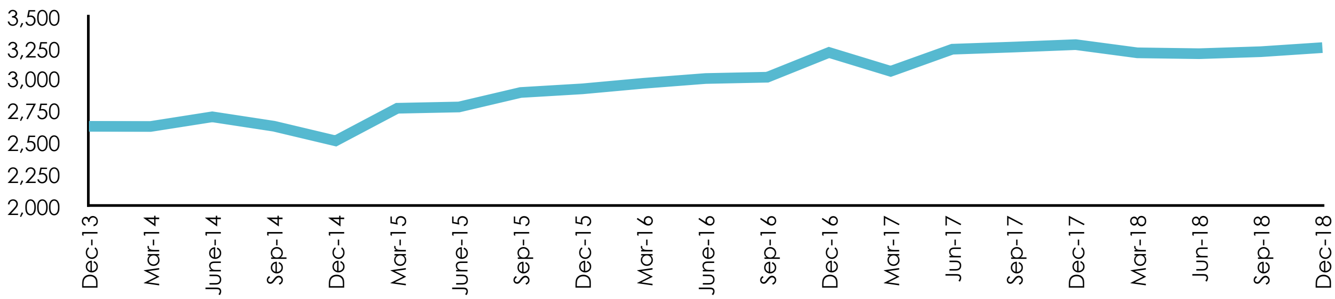
Chart 1: Distribution of financial system assets ($mn)




## 2.2. Systemic importance and concentration

Concentration remains a feature of the TCI financial system, particularly within the banking sector. At the end of 2018, over 87 per cent of banking assets were held among three retail banks, all of which have been designated as systemically important.

Chart 2: Banking sector concentration
[measured by the Herfindahl-Hirschman Index (HHI)]




*Source: Financial Services Commission*

## 3. Financial stability trends

The TCI financial system remained stable during 2018, supported by the domestic economy's strong performance. GDP growth returned to positive after the 2017 hurricanes, following strong rebound in tourism and other key sectors. Declining unemployment and low inflation also positively contributed to domestic stability.

The banking sector – which handles the largest share of financial intermediation in the TCI – benefited from this growth. Liquidity, asset quality and capital indicators continued to improve, and the sector's profitability increased. On the downside, trending deceleration in lending activity continued and interconnectedness between banks with other domestic non-bank financial institutions deepened, although domestic contagion risk remained limited. The dashboard below reflects the combination of financial and real sector factors which influence financial stability in the TCI, the level of associated risks and the Commission's expectations for the direction of those risks over the near to medium term.

**Table 2: Financial stability dashboard**

| Risk emanating… | Factor | Indicator | 2018 | [3]Risk level | Risk forecast |
|---|---|---|---|---|---|
| …from the International environment | global economic growth | GDP growth rate | 3.7% | | ↗ |
| | US economic growth | US GDP growth rate | 2.9% | | ↗ |
| | Caribbean economic growth | Caribbean (average) GDP growth rate | 1.9% | | ↘ |
| …from the domestic environment | economic growth | real GDP growth | 2.5% | | → |
| | unemployment | unemployment rate (actual) | 7.0% | | → |
| | [4]real estate sales | rate of growth in sales | 9.8% | | → |
| …from the banking sector | profitability and earnings | ROAE (actual) | 15.5% | | → |
| | | ROAA (actual) | 2.2% | | → |
| | credit | rate of loan growth | (0.6%) | | → |
| | | ratio of loans to deposits | 66.7% | | → |
| | liquidity and funding | ratio of liquid assets to loan deposits | 161.3% | | → |
| | | ratio of liquid assets to total assets | 53.9% | | → |
| | asset quality | ratio of NPLs (before provisions) to total loans | 5.4% | | → |
| | | ratio of NPLs (net of provisions) to regulatory capital | 11.2% | | → |
| | lending / deposit concentrations | total of each bank's largest group loan exposure as a % of total deposits | 14.0% | | → |
| | | total of each bank's largest group loan as a % of total sector regulatory capital | 38.1% | | → |
| | | total of each bank's largest deposits as a % of total deposits | 7.8% | | → |
| | | total of each bank's largest group deposit exposure as a % of regulatory capital | 32.1% | | → |
| | capital adequacy | Caribbean (average) GDP growth rate | 29.2% | | → |
| | degree of connectedness with other entities | change in domestic non-bank FI holdings in banks | 7.8% | | → |
| | | change in net assets held by domestic banks in overseas FIs | 3.7% | | → |

Sources: IMF World Economic Outlook Database / Caribbean Development Bank Annual Report 2018 / Department of Statistics, Ministry of Finance, Investment and Trade / Financial Services Commission

[3]The risk levels represent the overall current assessment of the Commission and have been determined and incorporate relevant prudential and other available data, including assessment of qualitative factors. Colours and position on the gauge indicate the current risk intensity for each indicator: green = low potential risk; yellow = moderate potential risk; red = high potential risk. Direction of the arrows indicate the anticipated trend over the near to medium term for each indicator: ↘ = expected reduction in risk; ↖ = expected increase in risk; → = risk level expected to remain constant.

[4] These are sales reported by members of the Turks and Caicos Real Estate Association (TCREA) and do not include sales recorded by non-TRCEA members and agents. As at 31 December 2018, there were 90 listed agents in TCREA assembled from the largest firms (by volume of sales).

# 4. Macroeconomic environment

## 4.1. The global economy

The global economy grew by 3.6 per cent in 2018. Expansion was upbeat at the start of the year on the heels of pickup in global manufacturing and trade in late 2017. However, momentum slowed in the second half of 2018 and growth estimates were revised downwards, as investors lost confidence, financial conditions tightened in some markets, and trade tensions and retaliatory tariffs between the US and China fueled uncertainty. Global growth was also uneven, as the UK, Canada, China and euro area all experienced slower growth than projected. Notably, the US economy maintained robust growth, buoyed by tax cuts and spending increases, particularly in the second quarter, and the strength of the dollar.

**Table 3: Select economic growth trends and forecasts (%)**

| | Five-year trend | | | | | | Forecast | |
|---|---|---|---|---|---|---|---|---|
| Real GDP growth (annual % change) | 2014 | 2015 | 2016 | 2017 | 2018 | Trend | 2019 | 2020 |
| Canada | 2.9 | 0.7 | 1.1 | 3.0 | 1.8 | | 1.5 | 1.9 |
| United Kingdom | 2.9 | 2.3 | 1.8 | 1.8 | 1.4 | | 1.2 | 1.4 |
| United States | 2.5 | 2.9 | 1.6 | 2.2 | 2.9 | | 2.3 | 1.9 |
| Caribbean (entire region)* | 4.3 | 4.6 | 3.1 | 2.7 | 4.7 | | 3.6 | 3.7 |
| Major advanced economies (G7) | 1.9 | 2.1 | 1.4 | 2.2 | 2.1 | | 1.6 | 1.5 |
| World | 3.6 | 3.4 | 3.4 | 3.8 | 3.6 | | 3.3 | 3.6 |

Source: IMF World Economic Outlook Database

The nearly two-year upswing in global growth is expected to slow to 3.3 per cent in 2019 – 0.4 percentage points lower than previously forecast – reflecting expectations for the 2018 year-end deceleration to continue. That is the weakest growth forecast since the global economy exited the GFC. Expectations are for stabilization in the first half of the year and growth thereafter. Emerging and developing economies are projected to expand by 4.4 per cent, offsetting further slowing in advanced economies to 1.8 per cent in 2019. The spike in growth in the US economy is expected to wane as the effects of stimulus measures diminish. Meanwhile, growth estimates for the UK remain shrouded in uncertainty especially regarding the BREXIT outcome.

Risks are firmly on the downside. Potential triggers include a no-deal withdrawal of the UK from the EU, lingering trade tensions between the US and China, and other geopolitical uncertainties, any of which could affect market sentiment and further dampen growth.

### 4.1.1. The United States

In 2018, the US economy expanded by 2.9 per cent, surpassing the previous year's 2.2 per cent and representing the strongest growth since 2015. This was due largely to the effects of government spending and corporate tax cuts. During the year, inflation hovered slightly below 2 per cent and unemployment reached a near five-decade low of 3.7 per cent in both September and November. Exports to Europe and Asia however lagged due to the effects of tariffs.

Growth is expected to slow to 2.5 per cent in 2019, as the effects of stimulus measures taper. While retaliatory tariff increases in other countries are expected to cool demand for US goods and tamp down activity, these may be offset by a combination of accommodative monetary policy and increased productivity and labour force participation.

#### 4.1.2. The United Kingdom

Economic growth in the UK was feeble against the backdrop of rumblings over BREXIT. The country recorded its lowest growth since 2012 of 1.4 per cent, down from 1.8 per cent in 2017. Exports suffered and business investment figures fell as the global economy contracted and as concerns mounted over whether the country will be able to exit the EU without severely disrupting trade. Nonetheless, household spending remained buoyed by wage growth and was the main driver of growth. The job market remained strong and unemployment was the lowest since 1975.

Even under an orderly BREXIT, growth is projected to dip to 1.1 per cent in 2019 and strengthen only moderately thereafter. Consensus among analysts is for household spending to wane by 0.5 percentage points to 1.4 per cent in response to increasing interest rates and subdued growth in house prices. The balance of risks in this forecast is strongly weighted to the downside as the possibility of a less than orderly exit grows.

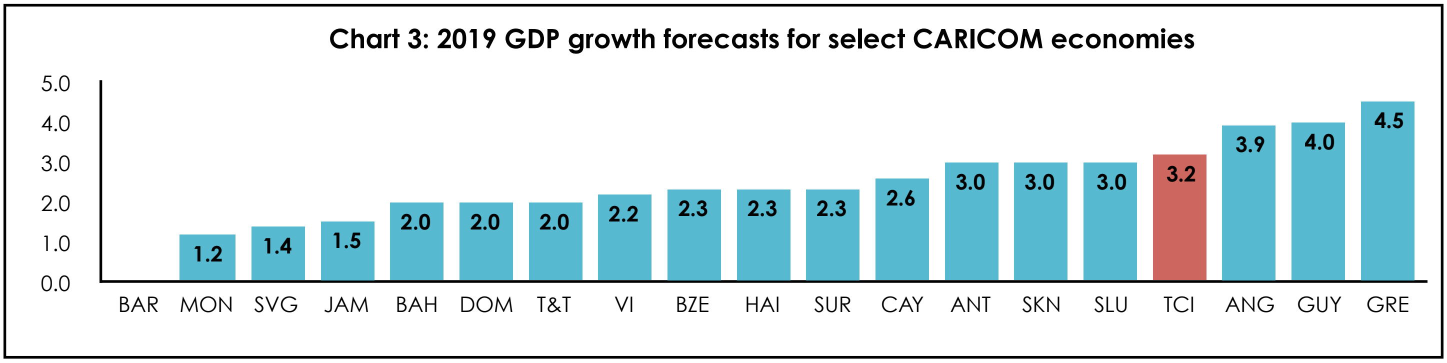
#### 4.1.3. The CARICOM region

Many of the CARICOM member states were hard-hit by the 2017 hurricane season, so 2018 was a year of recovery. Still, regional GDP grew by almost 2 per cent, up from 0.5 per cent in 2017. Activity was dominated by infrastructure projects as rebuilding continued, however several countries also reaped the benefits of improving fiscal management and debt restructuring.

Several countries in the region experienced improved economic outturn from increased tourism demand, supported by growth in the region's main source market, the US. Overnight visitor arrivals were up in most of the tourism-dependent countries. Rising oil and gold prices also spurred growth and stoked investment linked to future exploration for the commodities-based economies. In Guyana for example, expansion was mainly driven by construction activity ahead of a new commercial oil production venture set to commence in 2020.

Regional growth is expected to remain positive in 2019, even as deceleration continues in global markets. Forecasts point to improved performance for almost all countries in the region except Barbados, where the ongoing effects of recent structural reforms are expected to neutralize growth in tourism.

Strengthening prices should augur well for performance of commodities-dependent economies such as Guyana, Trinidad and Tobago and Suriname.




*Source: Caribbean Development Bank Annual Report 2018*

Predictions for the region could be threatened by several factors. Of note, derailment of the fiscal restructuring programmes now ongoing in several countries could lead to weaker growth. The region's location and susceptibility to hurricanes and other natural disasters; crime; and other negative publicity can all affect outturn, particularly in the tourism centres.

Domestic GDP growth was estimated at roughly 2.5 per cent in 2018, rebounding strongly from the 1.5 per cent slide in 2017 on the heels of two hurricanes. Inflation was estimated at 2.1 per cent, unchanged from 2017. Strong performance was also signaled by relatively low unemployment, which was estimated at 7 per cent in 2018.

**Table 4: Domestic macroeconomic indicators**

| | Actual | | | Estimated | | Projection |
|---|---|---|---|---|---|---|
| | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
| Real GDP (%) | 6.7 | 5.9 | 4.4 | (1.5) | 2.5 | 3.0 |
| Inflation (CPI) (%) | 2.3 | 2.2 | 2.0 | 2.1 | 2.1 | 2.1 |
| Unemployment (%) | 12 | 11 | 7 | 6 | 7 | 7 |

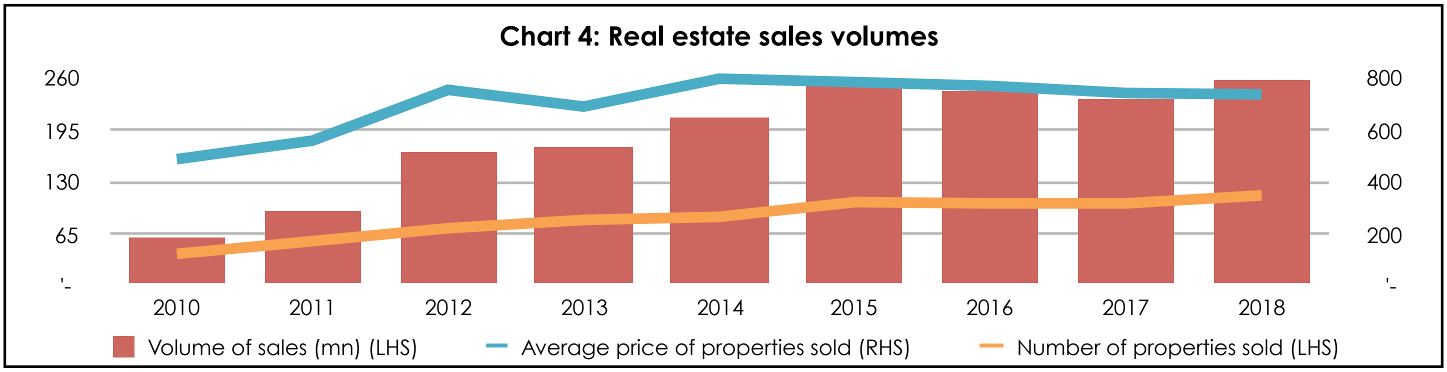
*Source: Strategic Planning & Policy Department, Ministry of Finance, Investment and Trade*

In recent years, real estate sales[5] have also been strong indicators of economic performance. This trend continued in 2018, as real estate sale volumes in 2018 reached an eight-year high and topped $255mn.

## 4.2. The domestic economy

The outlook for 2019 is for the domestic economy to grow by 3.2 per cent, buoyed by increasing tourism-related revenues and investment. Income from tourism is especially expected to improve, as booking and arrivals estimates remain high and room inventory expands. As with the forecast for the wider Caribbean region however, vulnerability to global changes, natural disasters or an upsurge in local crime, could dampen projections.

[5] These are sales reported by members of the Turks and Caicos Real Estate Association (TCREA) and do not include sales recorded by non-TCREA members and agents. As at 31 December 2018, there were 90 listed agents in TCREA assembled from the largest firms (by volume of sales).

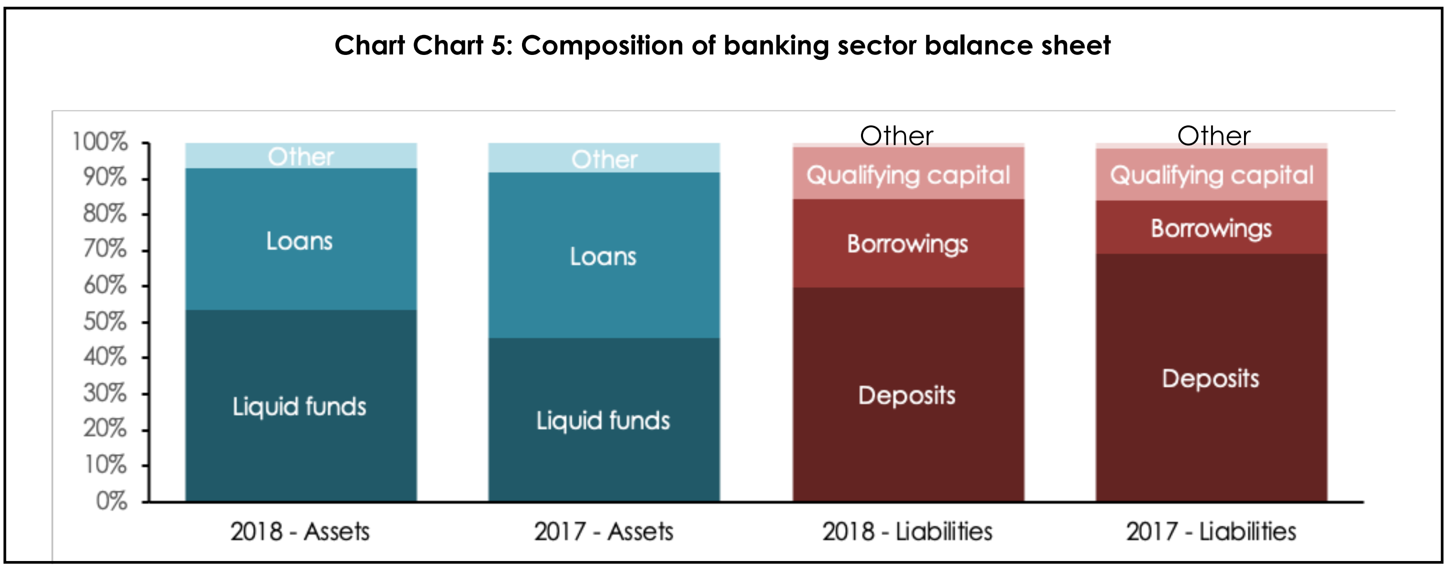



*Source: Turks and Caicos Real Estate Market Report 2018 / Sotheby's*

# 5. Banking sector resilience

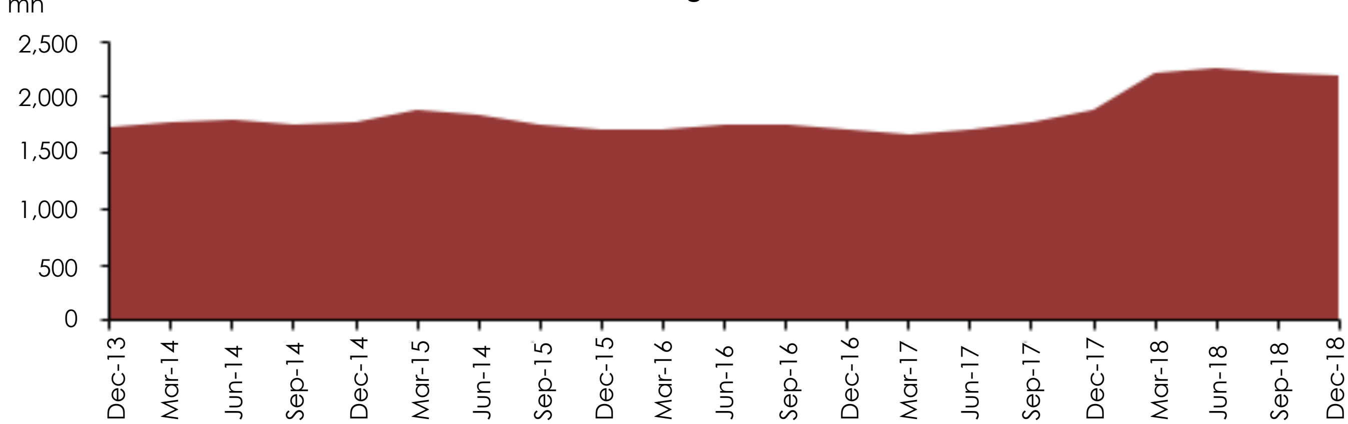
## 5.1. Balance sheet composition

Sector assets grew by 16.0 per cent in 2018, to $2,201.0mn. Growth was dominated by expansion in placements held with other financial institutions, which increased 38.4 per cent to just under $1,196.4mn. Loan levels remained near even with 2017, declining slightly by $5.4mn or 0.6 per cent while most other major assets categories, including investments, declined more steeply. Balance sheet growth was funded mainly from borrowings and increases in retained earnings.



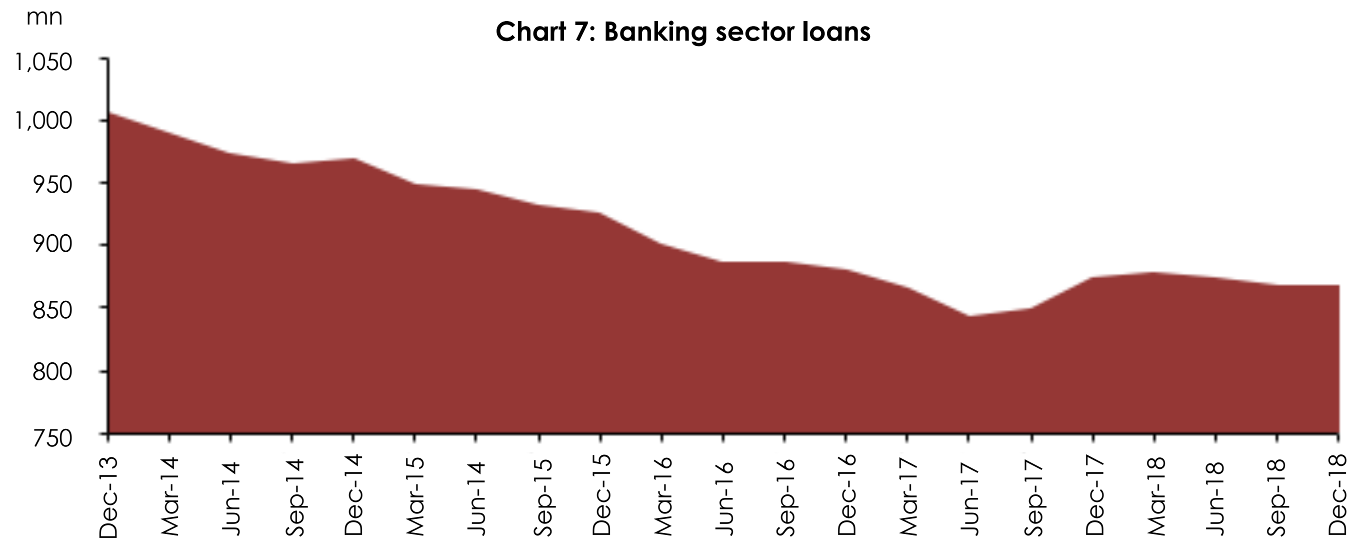

Of note, the overall pace of loan origination within the sector has slowed, with total loans fluctuating around the $850mn mark throughout the year. The distribution of credit by economic sector also remained relatively unchanged over the year. Personal loans (including mortgages) continued to account for the largest share, 50.2 per cent.

Chart 6: Banking sector assets




*Source: Financial Services Commission*

Chart 7: Banking sector loans



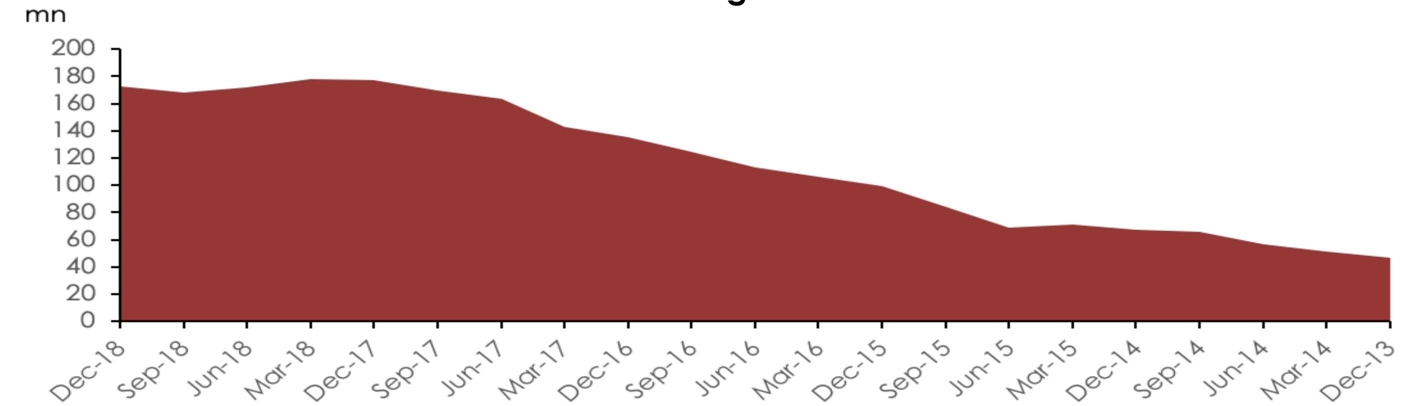

*Source: Financial Services Commission*

## 5.2. Asset Quality

Asset quality – as measured by the ratio of NPLs to total loans – continues to improve across the sector due to write-offs and rehabilitation of legacy NPLs. NPLs have returned to pre-GFC levels after falling 30.5 per cent to $46.9mn. Following from this reduction, the ratio of NPLs to total loans declined to 5.4 per cent, down from 7.7 per cent a year prior. Declines of 35.4 and 30.0 per cent respectively within personal and construction NPL categories contributed most to this improvement.

Despite the reduction in NPL volumes, the NPL coverage ratio, which measures provisions as a share of NPLs, weakened by over 11 percentage points to 53.3 per cent. This was driven by banks' scaling back on provisions which were increased immediately following the 2017 hurricanes. Consequently, reduced coverage for remaining NPLs. In 2018, loss provisions fell to $25.0mn or 2.9 per cent of total loans.

**Chart 8: Banking sector NPLs**




*Source: Financial Services Commission*

**Chart 9: Banking sector NPL coverage ratio and provisioning trends**

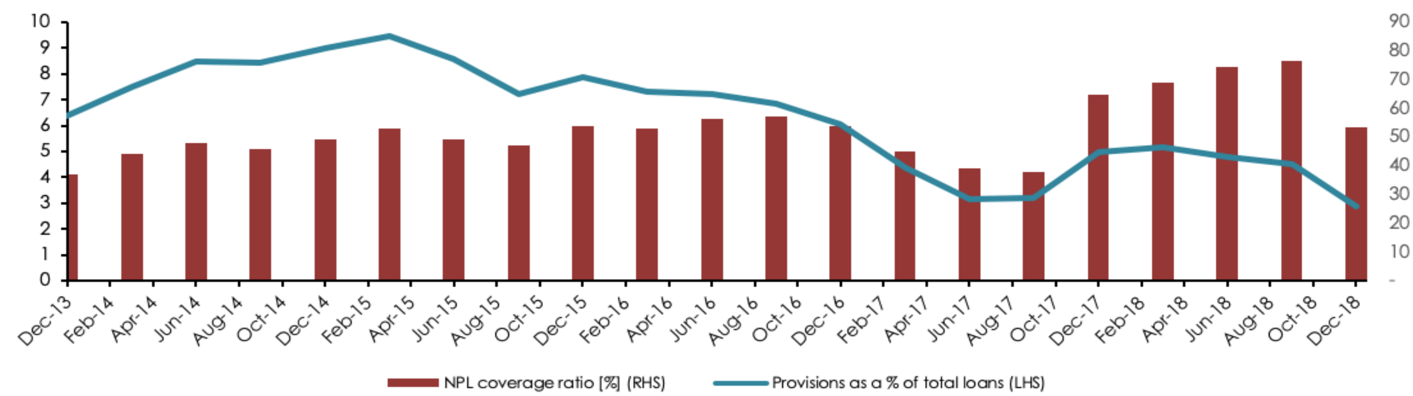


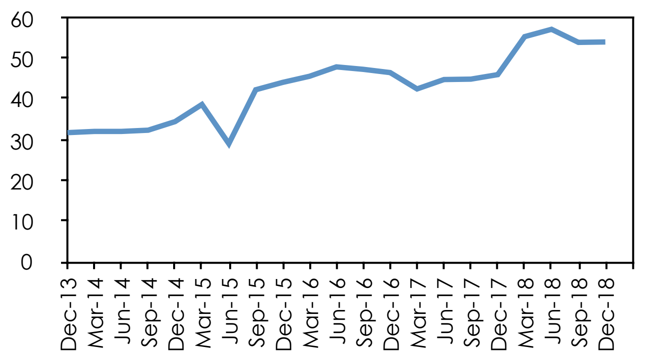

*Chart 9: Banking sector NPL coverage ratio and provisioning trends*

## 5.3. Liquidity

Owing in part to a shortage of domestic instruments, the majority of the sector's liquid assets are held overseas with foreign head offices. At the end 2018, the value of external liquid assets was more than twice external funding. Resilience against systemic liquidity shocks therefore hinges on the timely return of the liquidity buffer kept at head offices. To date – even at the height of the GFC – access to this liquidity from head offices has been assured.

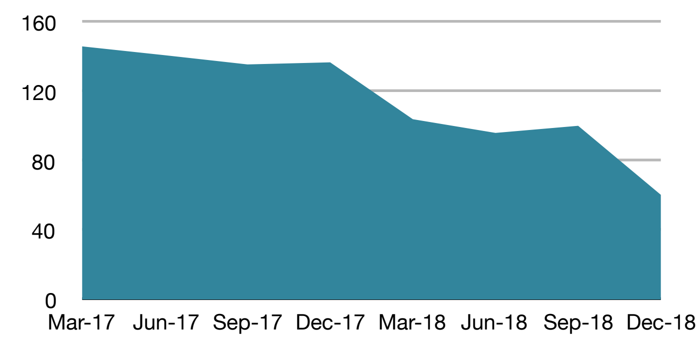
In 2017, the Commission adjusted prudential requirements to require the holding of more and better quality liquidity. In the two years following, sector liquid assets increased by 34.8 per cent, to total $1,173.4mn, and the ratio of liquid assets to total assets rose to 53.3 per cent. The increased liquidity in the sector positively impacted the liquidity transformation measure – which compares short-term liabilities against liquid assets – as this ratio declined by more than half to 60.4 per cent at the end of 2018.

Chart 10: Banking sector liquid assets to total assets (%)



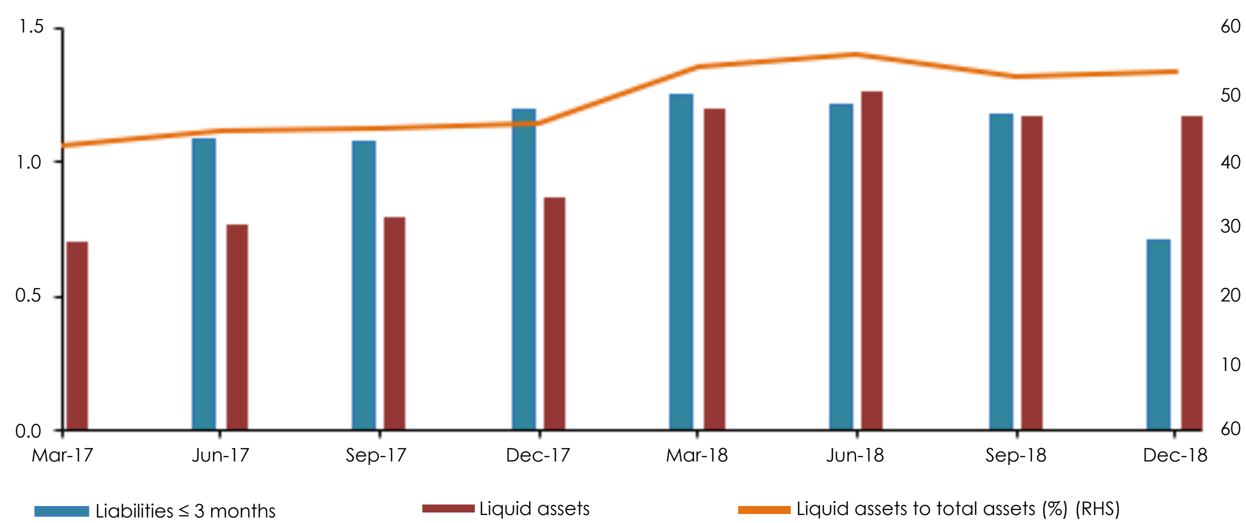

*Source: Financial Services Commission*

Chart 11: Banking sector two-year liquidity transformation trend (%)




*Source: Financial Services Commission*

Chart 12: Banking sector two-year liquidity profile trend



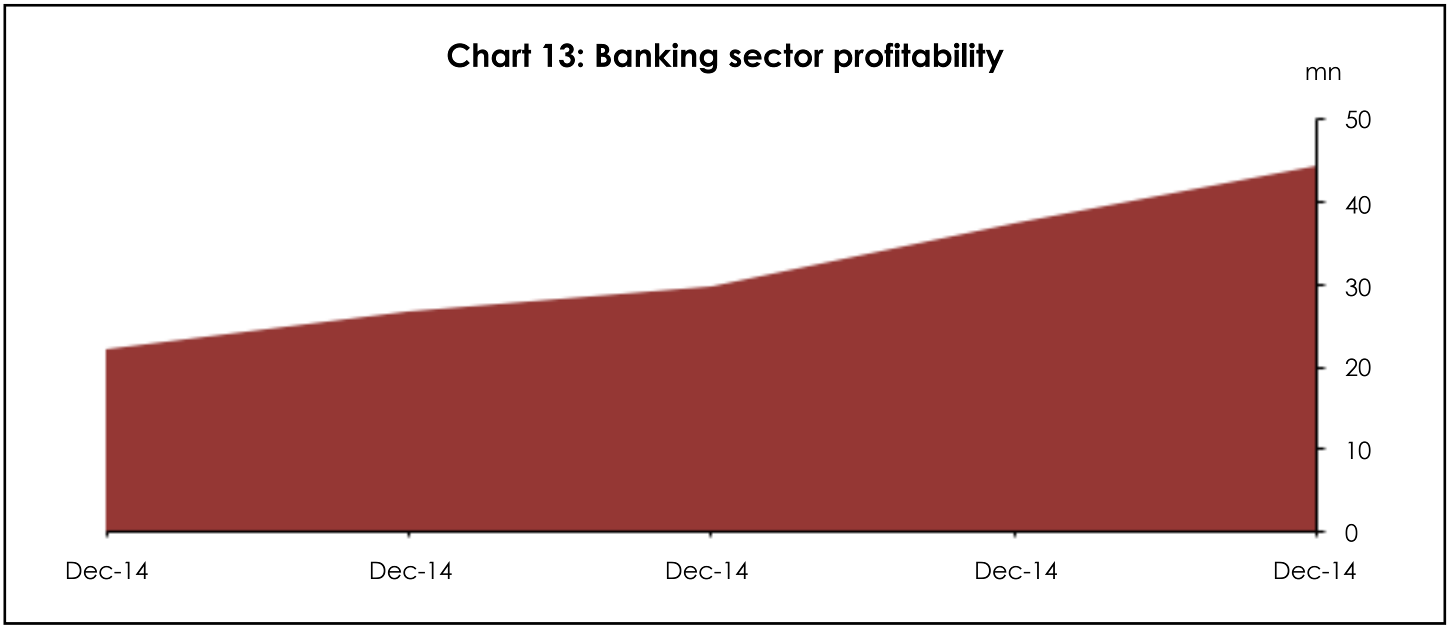

*Source: Financial Services Commission*

## 5.4. Funding

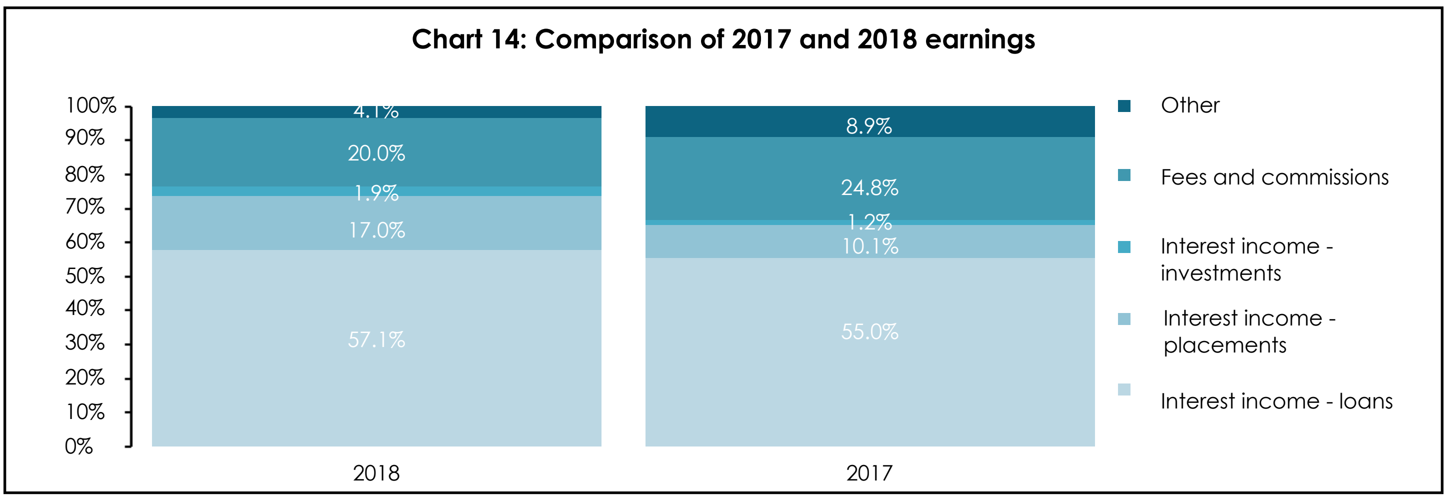
Banks' activities continue to be funded primarily from customer deposits, which grew by 1.4 percent to $1,303.0mn or 70.0 per cent of liabilities. Deposit growth outpaced that of loans, resulting in a 1.4 percentage point contraction to 66.6 per cent in the ratio of total loans to deposits. Deposits also accounted for a reduced share of overall funding, as retail banks increased head office and intra-group borrowings, resulting in a 91.1 per cent uptick in those liabilities.

## 5.5. Earnings and profitability

The trend of strong earnings and profitability continued into 2018, as net profits grew by 18.8 per cent to $44.6mn, boosted by 33.8 per cent higher interest income than in 2017.




Total revenue grew by 16.7 per cent to $104.6mn. Combined interest income from loans, placements and investments accou nted for an increased 76.0 per cent of overall earnings, fueled by the near doubling of income earned on placements, to $17.8mn. Of note, there was a 6.1 per cent reduction in income from fees and commissions and a 46.8 per cent reduction in other non-interest income, relative to 2017.




Expenses also grew by 15.3 per cent to $60.0mn. This increase was spread across most expense categories but was primarily evident in interest expense paid on deposits and borrowings, and on write-offs, which increased by 227.7 and 311.2 per cent respectively. Write-off activity was especially high during the fourth quarter, fueled by NPL clean up within one retail bank.

Increased profitability spawned higher ROAE of 15.5 per cent for 2018, up from 14.6 per cent from the previous year. Decomposition of that indicator confirmed a near steady increase in net profit margin in the context of marginal increase in the equity multiplier and little change in asset turnover. These results reflect the sector's growing efficiency and relatively low reliance on leverage to drive profits. Expanding profits also nudged growth in ROAA to 2.2 per cent, up from 2.1 in 2017.

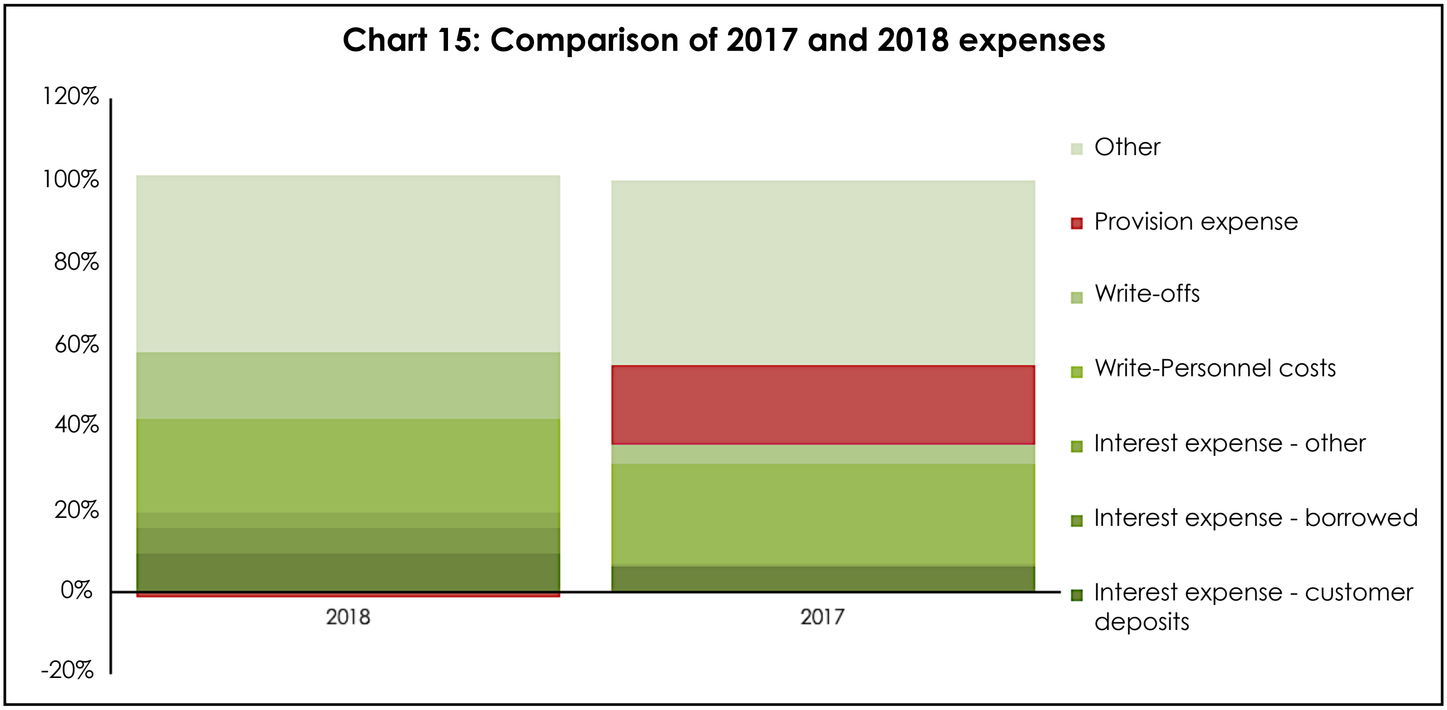


Chart 15: Comparison of 2017 and 2018 expenses
120%
100%
80%
60%
40%
20%
0%
-20%
2018
2017
Other
Provision expense
Write-offs
Write-Personnel costs
Interest expense - other
Interest expense - borrowed
Interest expense - customer deposits

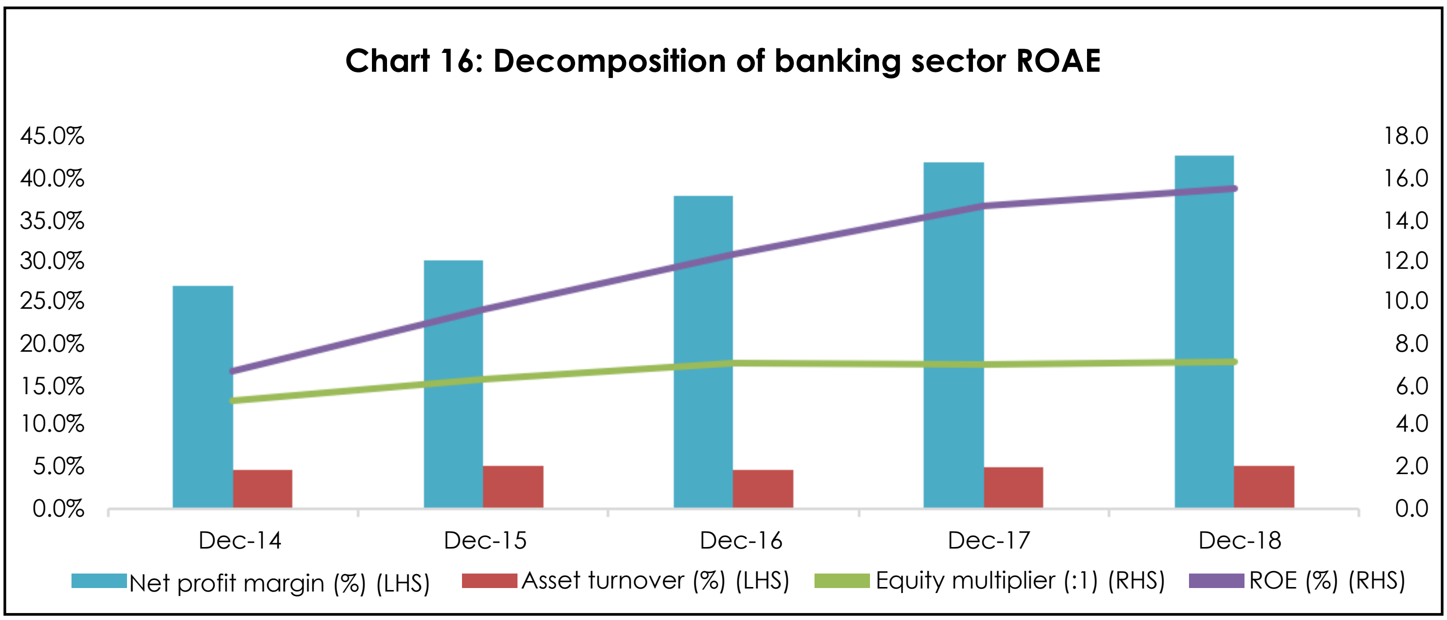
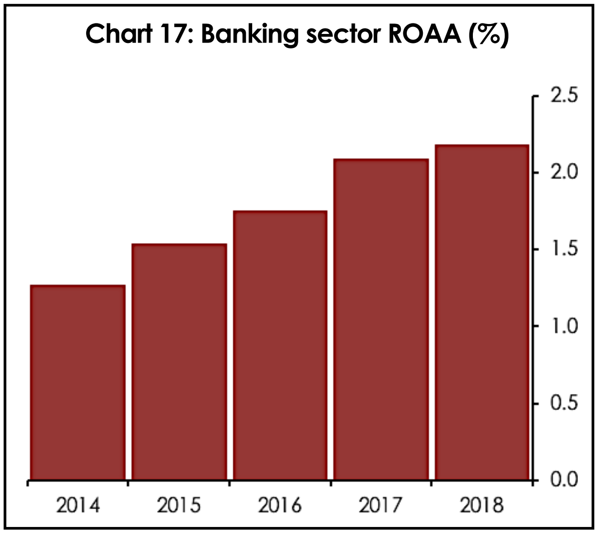
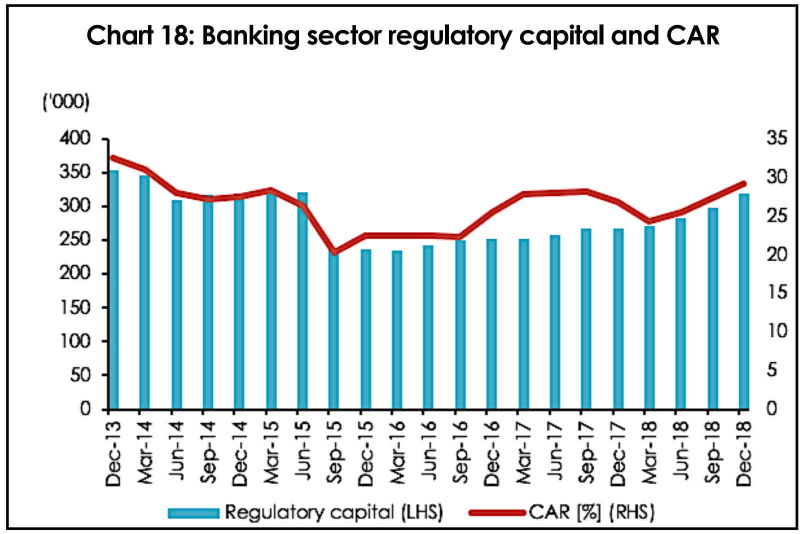


Chart 16: Decomposition of banking sector ROAE
45.0%
40.0%
35.0%
30.0%
25.0%
20.0%
15.0%
10.0%
5.0%
0.0%
18.0
16.0
14.0
12.0
10.0
8.0
6.0
4.0
2.0
0.0
Dec-14
Dec-15
Dec-16
Dec-17
Dec-18
Net profit margin (%) (LHS)
Asset turnover (%) (LHS)
Equity multiplier (:1) (RHS)
ROE (%) (RHS)




*Source: Financial Services Commission*

## 5.6. Capital

Bank capital levels are increasing, driven by strong earnings rebounds from GFC lows. At the end December 2018, banks collectively held regulatory capital of $318.2mn, up from $267.6mn a year prior. Consequent on this strengthening, sector CAR improved to 29.2 per cent, up from 26.2 per cent in 2017. Capital levels were highest within the wealth management segment however all banks reported capital ratios well above regulatory limits.

### 5.6.1. Stress test outcomes

The 2018 test assessed the banking sector's resilience to specific credit and liquidity shocks under similar parameters applied in the 2016 test. The results were generally either consistent or reflected slight improvement compared with 2016 outcomes.

#### (i) The credit test

The 2018 credit test considered following scenarios:

- Scenario 1a: Generalized Increase in NPLs
- Scenario 1b: Correction for 'under provisioning'
- Scenario 1c: Migration Across NPL Categories
- Scenario 1d: Sectoral Shock (Mortgages)
- Scenario 1e: Credit Concentration

As outlined in the section on Bank Capital above, bank capital levels are increasing. Consequently, sector CAR has grown almost steadily since December 2016. Credit test outcomes revealed that the banking sector was well capitalized and resilient to a range of scenarios. One of the tests however revealed an instance of potential capital inadequacy where one bank's CAR would have fallen below the statutory 11 per cent minimum, and additional capital would be required to restore the ratio.

**Table 5: Credit stress test outcomes**

| | 2018 test results | 2016 test results | Scenario |
|---|---|---|---|
| Baseline: | 29.2 per cent | 25.2 per cent | |
| Post credit shocks: | | | |
| 1a: Generalized increase in NPLs | 25.8 per cent | 21.5 per cent | If the value of NPLs in each category doubled, sector CAR would have fallen to 25.8 per cent. Post-shock CAR for all banks remained above the statutory benchmark. |
| 1b: Correction for 'underprovisioning' | 25.0 per cent | 18.0 per cent | This test involved fully providing for, and writing off, all NPLs in arrears for longer than 365 days. After this simulated correction, sector CAR fell to 25.0 per cent. Post-shock CAR for all banks remained above the statutory benchmark. |
| 1c: Migration across NPL categories | 24.6 per cent | 17.1 per cent | Under this scenario. which assumes that full migration of each category of NPLs to the next worse bucket and write-off of loss loans, post-shock sector CAR was 24.6 per cent. Post-shock CAR for all banks remained above the statutory benchmark. |
| 1d: Mortgage portfolio shock | 25.6 per cent | 20.7 per cent | This scenario assumed a 100 per cent increase in delinquent mortgages. Under this test, the sector recorded a post-shock CAR of 25.6 per cent, and all banks' CAR remained above the statutory benchmark |
| 1e: Credit concentration | 18.5 per cent | 18.2 per cent | This simulation sought to test the sector's resilience to default by the largest borrower groups in each bank. The sector as a whole withstood this test, with a post-shock CAR of 18.5 per cent. Following this shock, one bank's ratio would have fallen below the statutory benchmark. |

It is important to note the following regarding these outcomes:

- While all banks in the TCI held capital in excess of minimum statutory requirements, capital levels vary significantly across the sector. At the end December 2018, CARs for the six banks included in the test ranged between 25.1 and 77.5 per cent. It bears emphasis that the wealth management category contributes a large portion of system capital relative to the level of lending undertaken by that segment.
- Notwithstanding these and other test outcomes, bank capital should be determined based on current and future economic needs, taking into account all relevant statutory and prudential requirements. It bears further emphasis that it is nearly impossible to predict the nature and origins of future financial

crises. Beyond striving merely for capital accretion, banks should also work to ensure that their risk management and control systems remain robust to increase their resilience to shocks.

### (ii) The liquidity test

The liquidity stress test examined the number of days that the overall system, as well as individual banks could withstand a simultaneous run on demand and time deposits before liquid assets were depleted and contingent lines or other external sources of liquidity would be required.

Under this scenario (assuming a daily run rate of 20 per cent on demand and 5 per cent on time deposits) the sector as a whole had in excess of 30 days' liquidity; however at the entity level, three banks would have exhausted their liquidity and require additional liquidity before the 30-day mark.

## 6. Risk outlook

Financial system risk exposures are low to moderate and should remain relatively stable over the next 12 – 18 months. Domestic economic outturn should benefit from the anticipated increase in tourism revenues and investment in tourism related infrastructure projects. Downward trending unemployment and low steady inflation are also positive signals of stability over the coming months. The forecast of continued strong performance in the domestic financial sector should also positively contribute to system stability. As outlined earlier in this report, despite some retrenchment in that sector, banks remain well capitalized, asset quality has improved and risks to stability emanating from that sector are expected to remain moderate over the period.

However, there are widening vulnerabilities in the global environment which may threaten stability beyond then. As the IMF's 2018 Global Financial Stability Report (GFSR) has identified, slowing growth, possible escalation of trade tensions and tightening financial conditions could all threaten stability going forward.

From the vantage point of the TCI, any outcome which curtails US consumers' spending and demand for travel for a prolonged period, could slow growth and ultimately threaten stability. Going forward, it will therefore be important to closely monitor how macroeconomic, regulatory and other policy shifts across the world will impact this prediction.

## 7. Key policy initiatives

Based on its assessment of vulnerabilities in the financial system, the Commission is rolling out a slate of regulatory and supervisory actions to promote greater resilience. As such, the Commission has targeted the following:

### 7.1. Enhancement of financial crisis management arrangements

The Commission has an array of tools and powers under the FSCO and other legislation to respond to weaknesses within individual financial institutions. Over the next three years, the Commission will work to formalize and strengthen the framework for deployment of these various tools and powers during financial crises. These measures will include strengthening the Commission's existing protocols to guide communication during a crisis; formalizing interagency relationships and interactions during crises; and developing strategies for timely resolution of non-viable entities.

## 7.2. Proposed implementation of deposit insurance

In 2016, the House of Assembly passed a Credit Union Ordinance to promote development and provide for regulation of that sector. Since then, subsidiary Regulations and Prudential Standards have been drafted and are expected to come into effect in 2019. This suite of legislation required establishment of a deposit insurance scheme for the benefit of that sector's depositors. It has been proposed that that part of the Ordinance be temporarily withheld to allow more time for planning and engagement with stakeholders around the issue and development of an appropriate scheme.

## 7.3. Strengthening of AML/CFT Supervision

An additional priority for financial sector resilience is continued strengthening of AML/CFT oversight. Although not as acute as in recent years, financial institutions continue to face the threat of de-risking. The financial stability impact of de-risking is potentially far reaching, however very few concrete solutions have been reached to date. To the extent that de-risking represents, in part, a response to actual or perceived AML/CFT weaknesses, the Commission is working to ensure that regulatory policies and methodologies fully meet international requirements and expectations and to promote compliance among its licensees.

In September 2018, the Caribbean Financial Action Task Force (CFATF) conducted an in-country assessment of the adequacy of AML/CFT measures put in place by the TCI. The findings of this evaluation, which was conducted against the Financial Action Task Force (FATF) recommendations are now being finalized and will inform ongoing work within the Commission, to strengthen supervision of this area.

# 8. Annex I: Methodology and key assumptions of the banking sector stress test

## The credit stress test

The credit component has been expanded in recent years to include two additional shocks – one to correct for "underprovisioning" and another to test the impact of portfolio deterioration and migration across NPL categories – largely in response to post-crisis observations in the domestic and regional markets.

## The liquidity stress test

**Table 6: Credit stress test assumptions**

| Risk Type | Scenario | Assumptions |
|---|---|---|
| General Credit Risk | 1a: Generalized Increase in NPLs | • Each category of NPLs increases by 100 per cent.<br>• Each bank's new NPLs provided for at its current average/effective rate of provisioning. |
| | 1b: Correction for 'Underprovisioning" | • NPLs in arrears for longer than 1 year fully provided for and written off. |
| | 1c: Migration Across NPL Categories | • All loans in each NPL category migrate 'down' to the next worst category, and the prudential provisioning rates applied.<br>• Loss category is fully written off. |
| Sector Credit Risk | 1d: Mortgage Portfolio Shock | • Sector wide deterioration of mortgage loans leads to 100 per cent increase in mortgage NPLs. |
| Credit Concentration Risk | 1e: Credit Concentration | • Default by each bank's largest borrower (or borrower group, as applicable). |

The liquidity test evaluates the implications of simulated deposit runs on the banking sector.

**Assumptions**

The tests assumed:

- Steady attrition of time and demand deposits at differing daily rates
- 75 per cent of (remaining) liquid assets would be available on any given day to offset deposit withdrawals.
- No non-liquid assets were considered available for use under this scenario.

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