FINANCIAL STABILITY REPORT

December 2015

Turks and Caicos Islands Financial Services Commission

FINANCIAL STABILITY REPORT

as at December 2015

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KEY OF ABBREVIATIONS

Abbreviations	Meaning
AML/CFT	Anti-money Laundering / Combating the Financing of Terrorism
BO	Banking Ordinance
CAR	Capital Adequacy Ratio
FATF	Financial Action Task Force
GDP	Gross Domestic Product
IMF	International Monetary Fund
IO	Insurance Ordinance
NPL(S)	Nonperforming loan(s)
ROA	Return on Assets
ROE	Return on Equity
TCI	Capital Adequacy Ratios: Pre and Post Increase in NPL Shocks

Preface

Global interconnectedness has, in large measure, increased both the speed and likelihood that adverse conditions in one financial system will spread to other areas. Because of the increasing incidence of crises and the enormous attendant costs both to private households and the public purse, authorities in the TCI have found it increasingly important to monitor financial stability with a view to preventing, or at least predicting, the next crisis.

Financial system stability – which has been defined as "the resilience of the financial system in the face of adverse shocks that enables the continued smooth functioning of the financial intermediation process" – is a critical pillar for sustained economic growth. Prolonged financial instability can be costly and vastly disruptive to the real economy, and can erode public confidence.

Small developing economies like the TCI's are especially sensitive to disruption. In the absence of a central bank to stand as Lender of Last Resort (LOLR), as well as other structural safeguards such as depositor protection, authorities in the TCI are especially committed to monitoring system stability and building resilience.

This report provides an overall assessment of the risks and threats to the financial system and the system's resilience to them. In publishing this assessment, the Commission endeavors to identify and provide appropriate context for those risks which it has assessed as having the potential to pose a threat to the TCI financial system, and highlight ongoing initiatives to strengthen financial sector resilience. This report is also intended to sensitize institutional stakeholders and the public at large, and promote informed discussion on the TCI financial system.

The report is presented in five main parts: Part I provides an overall financial stability outlook for the TCI; Parts II and III discuss the global and domestic environments and forecasts, respectively; Part IV assesses the structure of the system, highlighting significant exposures; and Part V highlights the performance of the system up to December 2015.The first edition of the Turks and Caicos Islands Financial Stability Report was published in December 2015, and incorporated data and findings up to June of that year. This edition presents an overview of the performance of the banking and insurance sectors from June to December 2015, and outlines legislative and prudential policy measures being undertaken to address risks in those sectors. Hereafter, the report will be published annually for the calendar year January to December.

Part I: Overview of Financial Stability in the TCI

The financial system and economic performance in the TCI have improved markedly since the height of domestic financial distress experienced in the wake of the 2007-08 financial crisis. After a period of recession which saw the exit of several entities (including one indigenous bank and a regionally active insurer) and the UK government stepping in to offer structured financial assistance, the economy now shows signs of modest growth and the outlook is encouraging.

This recovery in economic activity has had a positive impact on profitability across the financial system. Banks in particular continue to see higher profits and capital levels across the system are healthy.

Notwithstanding, the financial system remains fragile and faces challenges.

Concentration

Structurally, the financial system continues to be dominated by banks. The banking sector, as a subset of the wider financial system, is itself highly concentrated, with the top four banks (by asset size) being assessed as systemically important because of their role in promoting credit growth and financing large projects. While concentration of this nature can create greater sensitivity to volatility within an individual bank, the threat of contagion or "spillover effects", is limited by the fact that domestic inter-bank exposures are insignificant. As a further plus, the banking system remains well capitalized, despite moderate slippage in levels since 2013.

Owing to the proliferation of overseas-based entities operating in the system, the majority of the financial system's assets are foreign-owned. Three of the top four banks are either branches or subsidiaries of Canadian banks with strong regional presence, and almost all of the insurers active in the domestic market are foreign-owned. Consequently, there are significant cross-border exposures on the balance sheets of several banks and insurers. The Commission has therefore sought in recent years to step up surveillance of regional markets and improve its understanding of the risks and threats faced by parent and other related entities through greater reliance on colleges1 and other available regulatory structures. As at the end of December 2015, the parent companies of all foreign entities operating in the TCI domestic system were rated 'investment grade'.

[1] Regulators periodically convene colleges to discuss their responsibilities with respect to licensees which they supervise in common. Colleges play a vital role in advancing collaboration among regulators. They enhance routine information-sharing, facilitate development of a common understanding of risk in financial groups, promote a shared agenda for addressing risks and vulnerabilities, and provide a platform for communicating key supervisory messages among college members.

The Commission currently participates in colleges assembled with respect to 11 bank and insurance licensees domiciled outside of the Turks and Caicos Islands, and plans to engage peer regulators regarding establishment of two additional colleges in 2016.

Elevated NPLs

Nonperforming loans (NPLs), though on the decline, remain above pre-2008 levels. The fact that the lion's share of NPLs is real-estate backed has stymied some entities' efforts to clean up their balance sheets, due to a concurrent slump in real estate prices immediately following the crisis. Several banks and trust companies have already written off significant portions of irrecoverable balances. However, still elevated NPL levels evident in pockets of the system signal the need to pursue further and possibly more aggressive strategies to deal with legacy delinquent loans.

Declining investment options

Another lingering effect of the crisis has been a decline in investment options available to financial institutions within the TCI. Bank loan origination volumes have tapered off in recent years and several banks' loan books have shrunk, both in quantum and as a share of overall assets. This decline in lending and investment opportunities has pushed retail banks, which have excess liquidity from their access to relatively inexpensive deposits, to place funds increasingly outside of the TCI with regional affiliates, while some banks have opted to invest directly in the North American and European markets.

Strong dependence on North America

The positive outlook for the TCI financial system is also contingent on the continued strong performance and stability of regional and advanced economies. The strategic positioning of the TCI as a primarily service-based economy results in significant economic dependence on North America in particular, and susceptibility to slowdown in those markets. The TCI economy is especially dependent on tourist arrivals, particularly from the United States and Canada. A significant downturn in those economies, therefore, would have a direct impact on the TCI, the effects of which would be evident in debt repayment patterns. This dependence does not appear to present significant near-term challenge to the TCI, as official forecasts indicate stability and continued moderate expansion in the US and Canadian economies through 2016.

Reputational concerns and the threat of de-risking

The threat of de-risking has presented an increasing challenge to global financial stability in recent years. Incidence of de-risking – the term coined to describe the phenomenon of restricting or terminating banking relationships – has increased amid banks' rising concerns about low profits, transfer of reputational risks and the growing extent of regulatory scrutiny over AML/CFT matters.

Financial institutions in the Caribbean have traditionally relied on correspondent banking relationships with North American and, to a lesser extent European banks, to facilitate cross-border transactions, both for their own accounts and on behalf of clients. Access to these banking relationships is vital to the day to day operations of most financial institutions and by extension, to the functioning of the entire financial system. Severing of these relationships can threaten financial stability and undermine financial inclusion efforts, especially where the financial institutions across an entire region or country lose, or face restricted access to liquidity management, international wire transfer, cheque clearing, third party payments, foreign exchange and money transfer services.

According to a World Bank survey on correspondent banking published in November 2015, the Caribbean is among the regions most affected by alteration or outright termination of banking relationships[2]. The survey also found that small jurisdictions with significant international banking activities are also among those most likely to face the threat of de-risking. In 2015, operations of the global money transmitter, Western Union, were sufficiently impacted, forcing closure in several countries, including the TCI.

In response, Caribbean regulators, governments and other authorities have – at the national and regional level – sought to engage correspondent banks and their regulators to clarify, among other things, expectations on the application of standards handed down by the Financial Action Task Force (FATF), relating to due diligence responsibilities of respondent banks as well as on so-called "high risk" customer categories, such as money transmitters and non-profit organizations.

There is however a clear need for TCI authorities to pursue further discussion on this issue, while continuing to support efforts to strengthen due diligence and other AML/CFT mechanisms, and address deficiencies which would threaten the reputation and stability of the territory.

[2] Report to the G20 on actions taken to assess and address the decline in correspondent banking, Financial Stability Board; 6 November 2015; http://www.fsb.org/2015/11/report-to-the-g20-on-actions-taken-to-assess-and-address-the-decline-in-correspondent-banking/

Part II: The Global Environment

> "Global recovery continues, but at an-ever slowing and increasingly fragile pace."
>
> \- *World Economic Outlook, April 2016*

Overall, financial stability indicators reflect intensified risks to global financial stability since mid-2015, and this trend is expected to persist throughout 2016. Outlook has dampened slightly for the advanced economies throughout Europe, Asia and North America amidst increased uncertainty and setbacks to growth and confidence. Declines in oil and other commodity prices have also kept perceptions of risk high in emerging economies[3]. The stability outlook is further colored by concerns that economic rebalancing in China may spill over into other markets.

Global growth again fell short of expectation in 2015, slowing to 2.4 percent, down from 2.6 percent in 2014. This deceleration was due mainly to the combined effect of:

- gradual slowdown and rebalancing of economic activity in China away from investment and manufacturing towards consumption and services;
- declines in oil and other commodity prices; and
- gradual tightening of US monetary policy consequent on recovery in that market, even as central banks in several other advanced markets continue easing monetary policy to stimulate economic activity.
- Preliminary 2015 growth estimates for Latin America and the Caribbean region were also mainly positive, notwithstanding contraction in all but a few instances, relative to 2014.
- Going forward, global growth is projected to continue but at a slower pace, reaching 3.2 percent in 2016 and 3.5 percent in 2017. The North American economies, on which the TCI is especially dependent, are expected to contribute positively to this growth. The US, influenced by strengthening financial institutions' balance sheets and other factors, is expected see growth level off at 2.4 percent in 2016, with further increase likely in 2017. Similarly, recovery is expected for Canada during 2016, with growth projected at 1.5 percent for 2016 and increasing to 1.9 percent in 2017. Longer term forecasts for the US are less positive however, with estimated growth depressed at 2.0 percent by demographic and productivity factors.

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[3] Global financial stability report: Potent policies for a successful normalization, World Economic and Financial Surveys, International Monetary Fund, April 2016; https://www.imf.org/External/Pubs/FT/GFSR/2016/01/pdf/text.pdf

Table 1.1

Select Latin American and Caribbean Countries GDP Growth Rates (%)								
	2008	2009	2010	2011	2012	2013	2014	2015 (est)
Antigua and Barbuda	1.5	-10.7	-8.5	-1.9	3.6	1.5	4.2	1.8
The Bahamas	-2.3	-4.2	1.5	0.6	2.2	0.0	1.0	1.2
Barbados	0.4	-4.0	0.3	0.8	0.3	0.0	0.2	0.5
Belize	3.2	0.7	3.3	2.1	3.8	1.5	3.6	2.2
Dominican Republic	3.1	0.9	8.3	2.8	2.6	4.8	7.3	5.5
Guyana	2.0	3.3	4.4	5.4	4.8	5.2	3.8	2.4
Jamaica	-0.8	-3.4	-1.5	1.4	-0.5	0.2	0.4	1.4
Suriname	4.1	3.0	5.1	5.3	3.1	2.8	1.8	1.5
Trinidad and Tobago	3.4	-4.4	-0.1	0.0	1.4	1.7	0.8	-1.5
Eastern Caribbean	2.1	-5.3	-3.5	-0.2	0.4	1.7	2.9	2.2
Source: International Monetary Fund and country authorities								

Table 1.2

Select Indicators for Developed Economies (%)						
GDP Growth Rates						
	2010	2011	2012	2013	2014	2015
Canada	3.4	3.0	1.9	2.0	2.5	1.2
United States	2.5	1.6	2.2	1.5	2.4	2.5
Japan	4.7	-0.5	1.7	1.6	0.0	0.6
United Kingdom	1.5	2.0	1.2	2.2	2.9	2.2
Euro area	2.0	1.6	-0.8	-0.3	0.9	1.5
China (People's Republic of)	10.4	9.4	7.8	7.7	7.3	6.9
Employment Rates						
	2010	2011	2012	2013	2014	2015
Canada	8.0	7.5	7.3	7.1	6.9	7.1
United States	9.6	8.9	8.1	7.4	6.2	5.0
Japan	5.1	4.6	4.3	4.0	3.6	3.3
United Kingdom	7.9	8.1	8.0	7.6	6.2	5.1
Euro area	10.2	10.2	11.4	12.0	11.6	10.5
China (People's Republic of)	5.1	4.6	4.3	4.0	3.6	4.1
Inflation Rates						
	2010	2011	2012	2013	2014	2015
Canada	1.8	2.9	1.5	1.0	1.9	1.6
United States	1.6	3.1	2.1	1.5	1.6	0.7
Japan	-0.7	-0.3	0.0	0.4	2.7	0.2
United Kingdom	3.3	4.5	2.8	2.6	1.5	0.2
Euro area	1.6	2.7	2.2	0.8	-0.2	0.2
China (People's Republic of)	3.3	5.4	2.6	2.6	2.0	1.6
Source: www.tradingeconomics.com						

Part III: The Domestic Environment

The TCI real economic sector shows signs of strength based on available data. Economic growth in the TCI, while albeit slightly weaker, remained strong in 2015. Real GDP growth was projected at 5.9 percent in 2015, compared to 6.7 percent in 2014 and 1.3 percent in 2013.

Tourism continues to be the mainstay of the TCI economy, typically contributing more than 35 percent to annual GDP and just over 25 percent of the Government's annual recurrent revenue. Continental North America typically accounts for approximately 90 percent of the tourism source market, with the United States representing roughly 80 percent of that share.

Overall tourist arrivals have increased steadily since 2010 but at a significantly higher rate for cruise ship visitors than seen among stay-over guests. Visitor arrivals surpassed 1.3 million in 2014 and 2015, with cruise ship passengers accounting for over 70 percent of total in both years.

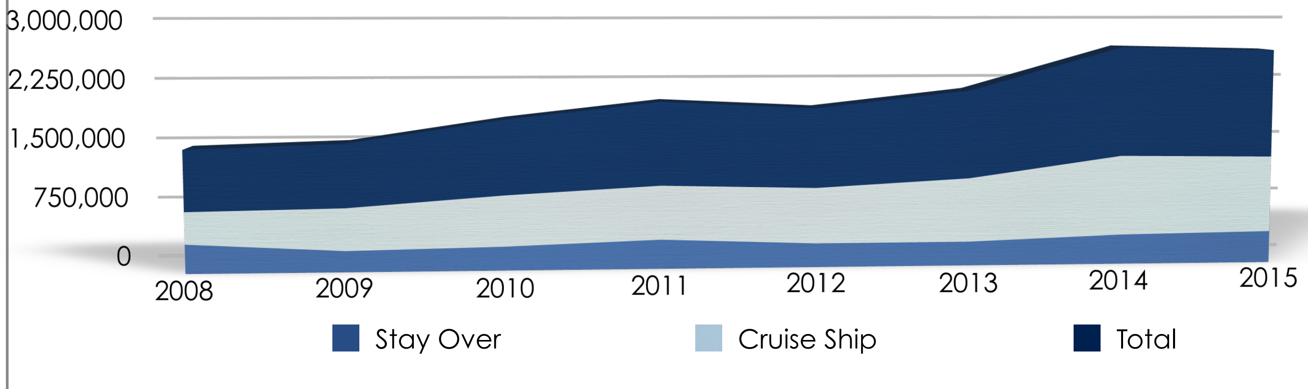
The Statistics Department projects that unemployment will continue to trend down in coming years. The unemployment rate, which is currently estimated at just fewer than 11 percent, is substantially lower than the 17 percent recorded during the 2012 census. It is further anticipated that the recent upsurge in development projects across the Islands will likely continue to boost employment and income levels going forward.

Table 1.3

TCI: Macroeconomic Indicators						
	2010	2011	2012	2013	2014	2015
Nominal GDP Growth Rate (%)	-2.3	6.1	-1.8	2.9	11.2	8.4
Real GDP Growth (%)	1.0	4.6	-2.5	1.3	6.7	0.9
Inflation Rate (%)	3.2	5.2	3.1	2.5	2.3	2.3
Unemployment Rate (%)	i.n.a.	i.n.a.	17.2	15.0	12.0	11.0
Imports ($ mns)	302.0	318.1	343.7	345.0	406.2	409.7
Exports ($ mns)	15.6	14.8	14.8	5.9	6.5	4.7
Merchandise Trade Balance ($ mns)	-286.4	-303.3	-328.9	-339.1	-399.7	-405.0
Tourist Arrivals	906,565	1,009,720	966,883	1,070,615	1,332,491	1,311,268
- Stay-over	288,702	354,223	290,236	291,695	360,653	385,531
- Cruise ship	617,863	655,497	676,647	778,920	971,838	925,737

Sources: TCI Financial Services Commission and the Statistical Department

Figure 1.1
TCI: Tourist Arrivals



Demand for tourism-related real estate[4] continues to increase based on sales at the end of December 2015. Sales volumes increased by 81 percent to 313 units during the period, up from 173 units just six months prior. That increase appears attributable in part to the 6.4 percent decline in median prices evidenced between June and December 2015.

[4] The analysis represents 56 percent of the real estate market in the Turks and Caicos Islands as reported by the Turks and Caicos Real Estate Association.

Part IV: Structure of the TCI Financial System

Structure of the Financial System

The financial system plays a pivotal role in the island's economy and is the second largest contributor to the economy, behind tourism. The domestic system, though smaller than some of the other British Overseas Territories' (BOTs), held assets valued at an estimated 217 percent of GDP as at December 2015; offshore financial services businesses held assets totaling a further 91 percent of GDP. There has been rapid growth in the number of financial services businesses in recent years, particularly among offshore businesses, as the TCI continues to establish itself as a popular domicile for niche U.S. manufacturer-owned offshore reinsurance companies called Producer Owned Reinsurance Companies (PORCs).

The structure of the domestic system, on which this report focuses, remained virtually unchanged during the second half of 2015; and at December 2015, comprised over 60 firms, including banks, trust companies, insurance licensees, money transmitters[5] and the National Insurance Board (NIB). As at the end of December 2015, domestic system assets were estimated at $1.9 bn[6] with banks sharing 85 percent of that total, followed by the National Insurance Board with 11 percent.

Domestic Banks

The financial system continues to be dominated by banks, owing both to their share of overall assets and by virtue of the critical intermediation and custodian services they provide to other system players. While there is very little interconnectedness among banks in the TCI, non-banks rely heavily on banks to hold operational and other balances, in satisfaction of solvency, restricted deposit and other prudential requirements.

The sector also has significant cross-border ties. Four of the six domestically active banks are either subsidiaries or branches of Canadian or Swiss banking groups. There is also clear evidence of concentration and segmentation within the sector as the three largest banks, which together account for more than 75 percent of gross sector assets, are all retail operations, while the three smaller banks, in contrast, are specialized outfits which cater mainly either to high net worth clients or focus on delivery of wholesale banking options.

Following assessment in 2012, four banks were designated as Domestic Systemically Important Banks (D-SIBs), critical not only to the financial sector but to the overall economy, due to their role in providing payment services, key public sector infrastructure support, and funding of recurrent expenditures for certain critical economic sectors.

Domestic banking operations have been primarily funded from deposits which are employed towards loan origination and to a lesser extent, placements with financial institutions outside of the TCI, many of which support liquidity up streaming to group affiliates.

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[5] Only three of the four licensed money transmitters were active during 2015.

6Based on unaudited prudential data for the banking, insurance, trust and money transmitter sectors as at December 2015, and latest available audited data for the NIB, as at March 2015.

Non-Bank Financial Institutions

Insurance Licensees

At the end of December 2015, there were 44 domestic insurers and insurance intermediaries licensed to provide insurance products and proffer advice to the residents in the TCI. As Table 2.1 reflects, the number of domestically active insurance entities in the TCI has remained relatively stable between 2010 and 2015[7].

Insurance licensees in the TCI are classified into broad categories of life and non-life (general) insurance providers: there is currently one composite insurer, which serves both segments roughly equally. Historically, there have been twice as many non-life as life insurers represented in the TCI and this disparity is reflected in the volumes of premium income generated by each segment. Among life insurers, the main lines of business are credit life – reflective of the requirement often placed on persons to obtain life insurance to qualify to borrow from banks – and group life. Insuring of property, health and motor vehicle chattel remain dominant among the non-life insurance segment.

The sector is comprised primarily of branches of insurers based throughout the Caribbean – only two of the 19 insurance companies are domiciled in the TCI. The domestic insurance sector is small when compared with the banking sector, sectors in other Caribbean jurisdictions and other British Overseas Territories. No group represented in the TCI generates more than 5 percent of total group premiums, or holds more than 3 percent of each group's total assets. Notwithstanding, the sector has seen considerable expansion, even in the wake of failure of the regional insurer, CLICO, and closure of one other insurer in 2015. Based on unaudited reporting to the Commission, domestic insurance sector assets as at 31 December 2015 amounted to $48.1mn, up 17.2 percent from the year prior8.

Since 2010, the most significant increases in total assets of 17 percent and 22 percent were recorded for 2012 and 2013 respectively, directly resultant on new market entrants and prudential requirements for firms to increase the level of assets held in the jurisdiction to at least match net liabilities. There is avid competition among the 12 active non-life insurers and as such, little concentration within that segment. The life sector is however dominated by two players, which together accounted for roughly 76 percent of gross premiums and 35 percent of assets, respectively, as at end December 2015.

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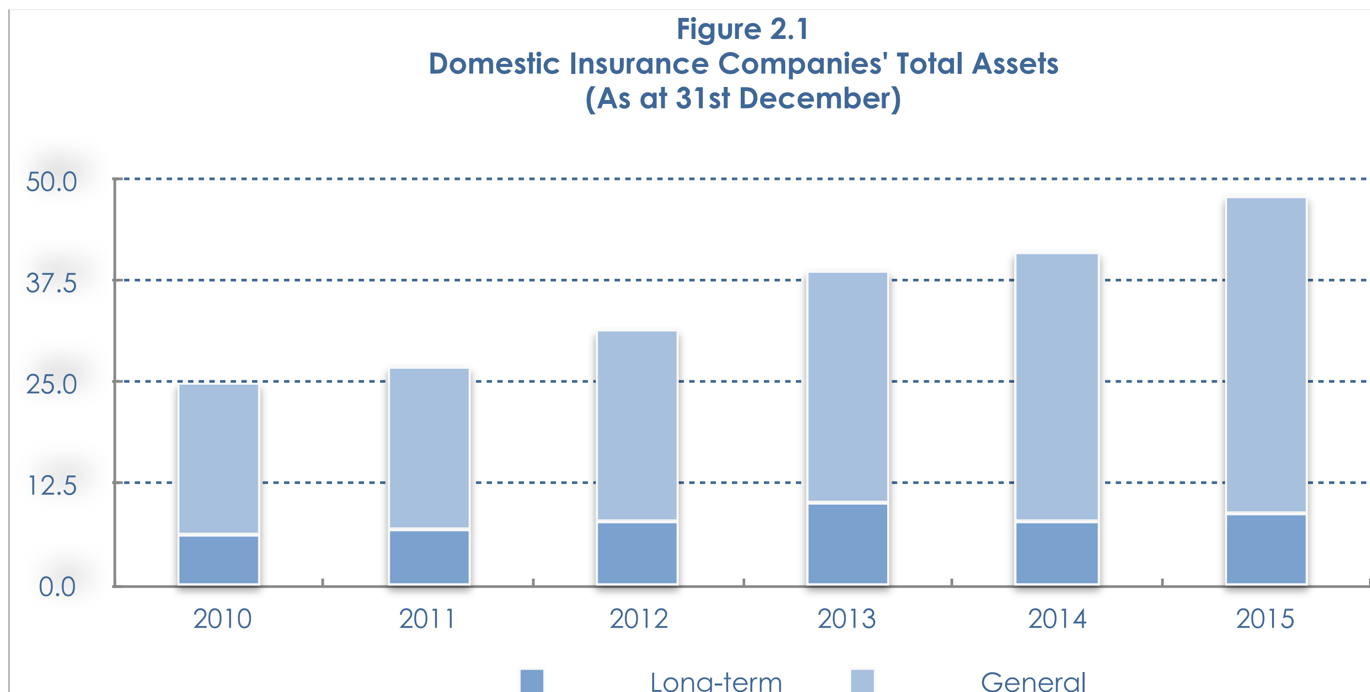
[7] Based on an application presented to the Supreme Court of the TCI by the Commission, one life insurer was placed in liquidation during January 2015. This resulted in the cancellation of the licence of the life insurer and its' six insurance agents. However, licences were issued for two non-life insurer, one insurance agent and five insurance sub-agents during the period under review.

8 The provisional figure for one company that was placed in liquidation in early 2015 was excluded from total sector assets as at 31 December 2014.

Table 2.1

Domestic Insurance Entities						
	As at 31 December …					
	2010	2011	2012	2013	2014	2015
INSURANCE LICENSEES	41	43	45	48	45	44
Insurance Companies	19	19	20	21	18	19
- Life	6	6	6	7	6	5
- Non-life	12	12	12	12	10	12
- Composite	1	1	2	2	2	2
Brokers	9	9	10	12	13	13
Agents	11	11	12	12	11	4
Sub-agents	2	4	3	3	3	8



Trust Companies

At the end of 2015, there were ten companies licensed to conduct unrestricted professional trust business in the TCI. The sector's total consolidated assets amounted to US$14mn, reflecting a 10 percent decline from the prior year. Total assets under management also declined by 3 percent to US$811mn, down from US$836mn in 31 December 2014.

Money Transmitters

The money transmitter or money services business (MSB) sector, though small, plays a vital role in the financial system and for the expatriate population in particular. The sector has been most adversely impacted by ongoing regional de-risking, which has resulted in alteration in some cases, and termination in others, of relationships with local banks.

Remittance outflows from the TCI nonetheless remain healthy and in 2015 increased by 6 percent to $87mn, from the $81.8mn recorded at the end of 2014. Haiti continues to receive the largest share of outflows from the TCI (31 percent) followed by the Dominican Republic (25 percent) and Jamaica (12 percent).

Inflows through MSBs over the same period fell roughly 13 percent to $6.3mn. Approximately 41 percent of these inflows were from the United States of America.
At end December 2015, aggregate MSB sector assets totaled $2.8mn, reflecting a 9 percent increase over December 2014.

National Insurance Board (NIB)

The National Insurance Board is the largest non-bank financial institution in the Turks and Caicos Islands, and was established to manage and administer the public National Insurance Fund. Among its sizable holdings, the NIB has significant assets in the TCI banking system. The NIB's asset base has reflected steady growth, increasing from $144.4mn in 2010 to $205.4mn in 2014. Most recent data available as at 31 March 2015 indicate total unaudited assets of $221.6mn, a roughly 8 percent improvement over one year prior.

Part V: Financial Sector Performance up to December 2015

The Banking Sector

Overview

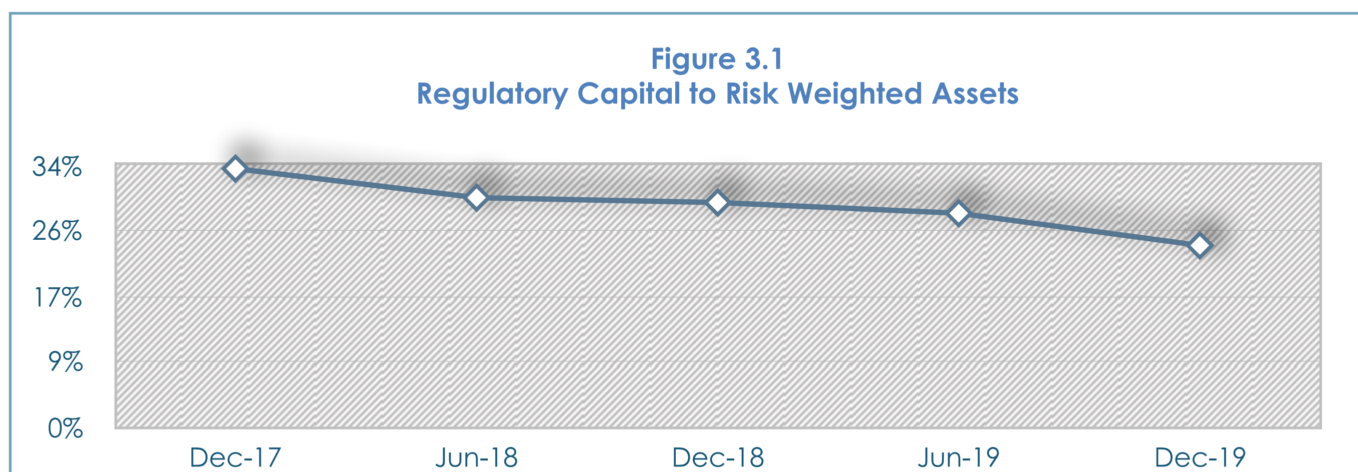
After weathering the lingering effects of the 2007-08 financial crises, the banking sector now appears poised for stable growth. Although the banking system's risk weighted capital adequacy ratio (CAR) has declined steadily since the end of 2013, the sector remains well capitalized with a CAR of 23.6 percent as at December 2015. Downward movement in capital over the period reflected one bank's decision to tap into capital buffers to fund a dividend in specie[9]. Notwithstanding this reduction in system CAR, all banks remained adequately capitalized with ratios ranging from 16 to 56 percent, well above the 11 percent statutory minimum. Almost all system capital available to absorb unanticipated losses was Tier 1 capital[10].

Asset Quality

During the second half of 2015, gross banking system assets contracted by 7percent or $134.5mn to $1,720mn, almost doubly eroding the 4.8 percent growth recorded in the first half of the year. This reduction, principally explained by reductions in other assets and gross loans, was partially tempered by minor increases in amounts due from financial institutions and cash.

Gross loans, the largest asset class, slipped a further 2 percent or $18.7mn to $925.4mn in the second half of 2015, reflecting a continuing decline in loan origination across the banking sector. This fall-off has resulted in a build-up of available funding at banks, which has been redeployed to fund deposit increases with affiliated financial institutions. Gross loans remained concentrated in the personal sector (52 percent), followed by construction & land development sector (20.2 percent).

Figure 3.1
Regulatory Capital to Risk Weighted Assets



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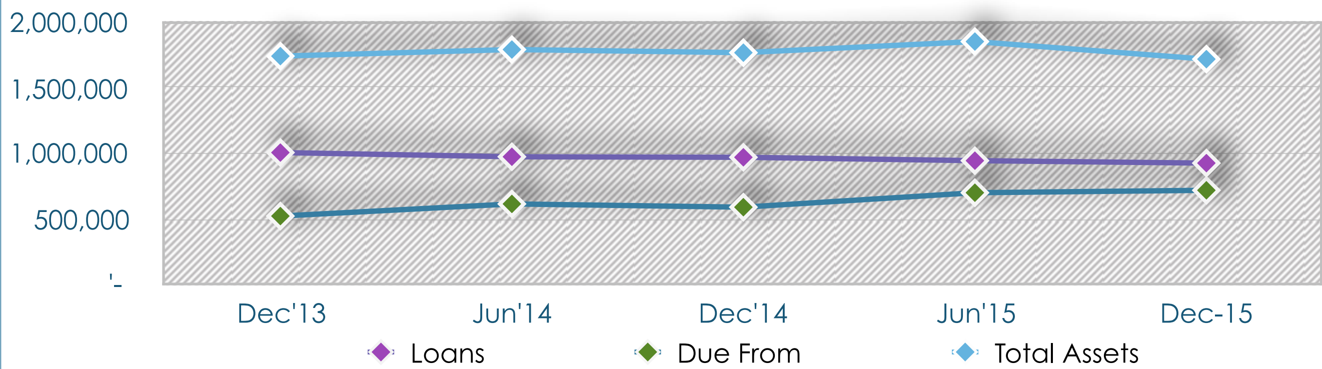
[9]A dividend in specie is one in which distribution to shareholders takes a form other than cash.

[10]Tier 1 capital is a core measure of a bank's financial strength. It is comprised of common stock, non-redeemable non-cumulative preferred stock, retained earnings and other disclosed reserves permitted by the regulator.



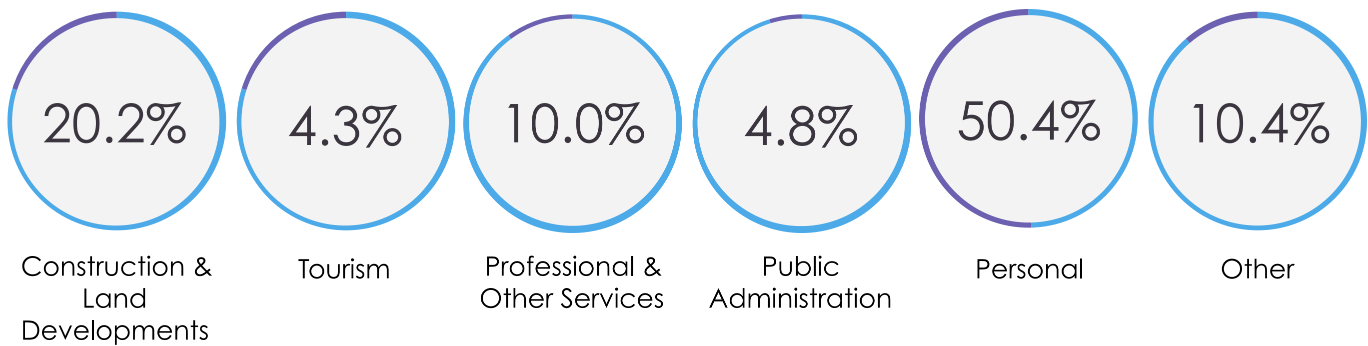
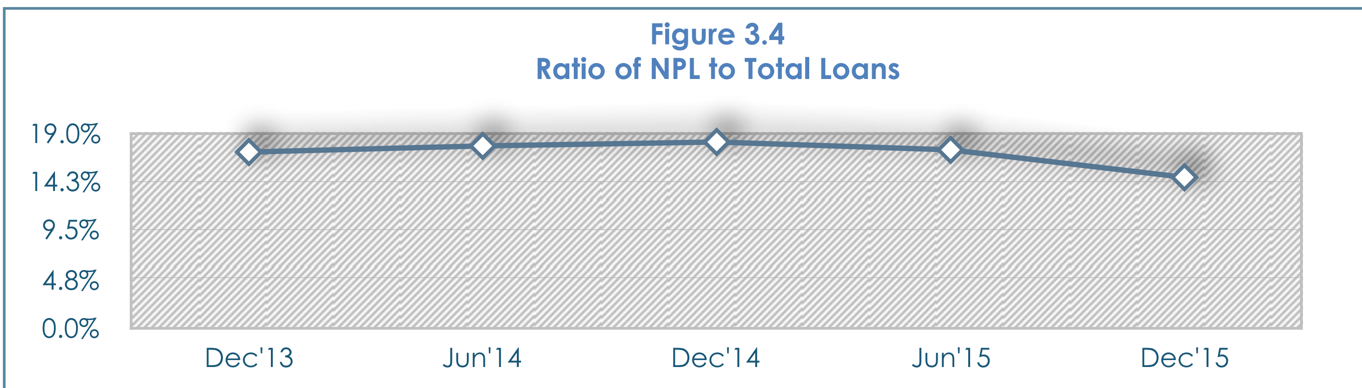


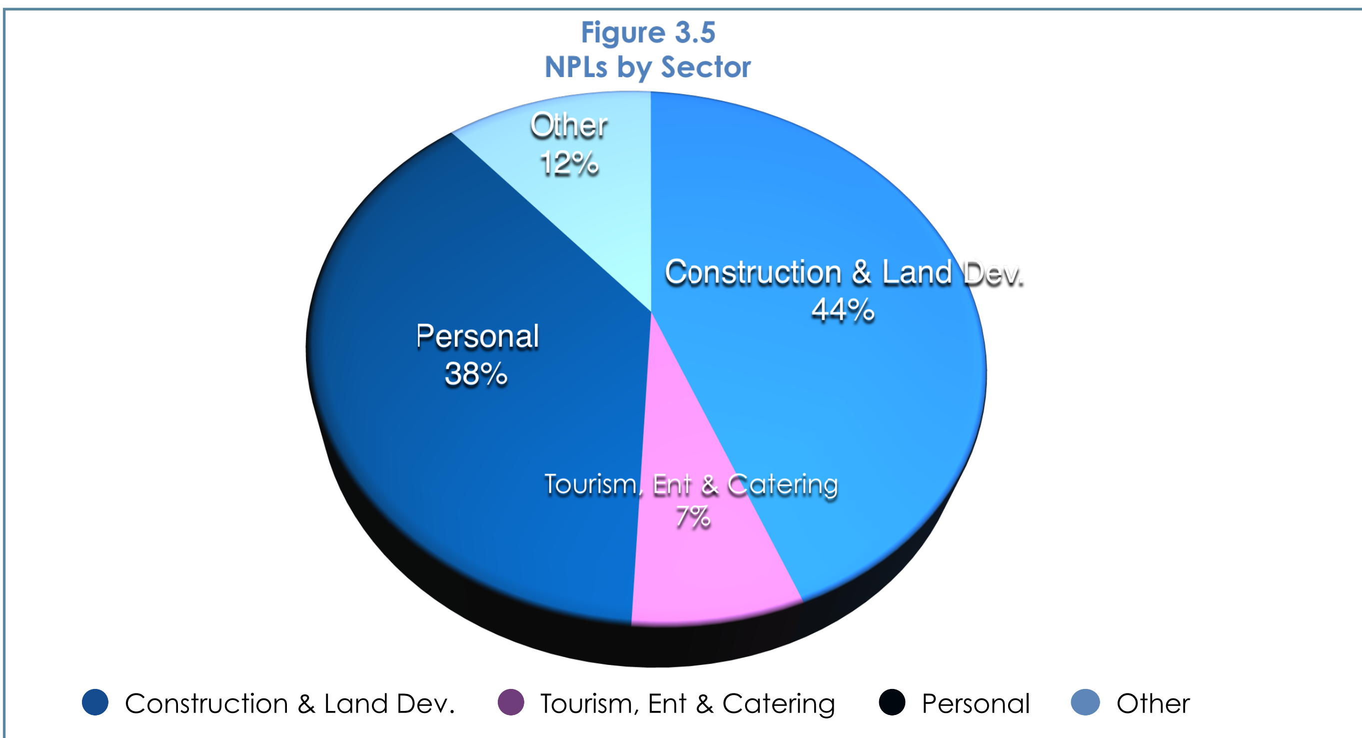
Table 3.1

Summary of Total Domestic Banking System Assets						
	Dec-13	Jun-14	Dec-14	Jun-15	Dec-15	% of assets
Cash	36,744	17,716	20,947	18,283	21,462	1.2
Loans and Advances	1,006,034	973,874	969,841	944,071	925,372	53.8
Investments	122,681	128,184	130,446	29,701	30,394	1.8
Due from	520,613	613,444	588,517	699,099	717,583	41.7
- Domestic financial institutions	1,916	7,581	6,005	12,362	2,702	0.2
- Overseas financial institutions	518,697	605,863	582,512	686,737	714,881	41.6
Other Assets	42,886	46,179	46,157	149,556	11,762	0.7
Fixed Assets	14,187	13,990	13,545	13,780	13,400	0.8
TOTAL ASSETS	1,743,145	1,793,387	1,769,453	1,854,490	1,719,973	100

Asset quality continues to improve, especially in the loan book. Credit quality, as measured by the ratio of non-performing loans (NPLs) to gross loans, declined by 2.7 percentage points to 14percent. Similarly, the NPL coverage ratio11for the sector increased to 48 percent compared with 47 percent in June 2015.These improvements were influenced by a 17 percent ($28mn) reduction in NPLs to $135.4mn through loan loss recoveries and write-offs. This improvement demonstrates the combined effect of banks' ongoing balance sheet clean-up efforts and overall more conservative lending postures, as well as more stringent lending limits put in place by the regulator.

The sectoral distribution of NPLs remained relatively unchanged over the second half of 2015, with the largest concentration in the construction & land development sector (44 percent), followed by personal sector (37 percent). This high concentration of NPLS among the construction and personal loan categories correlates strongly with the early 2000s boom and subsequent fall-off in economic activity following the global financial crisis.





[11]This ratio which measures a bank's stock of provisions in relation to its NPLs, describes its ability to absorb potential losses arising from its non-performing loans.

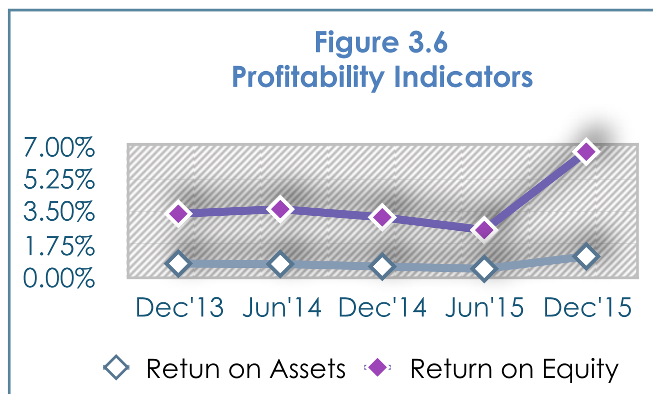
Earnings

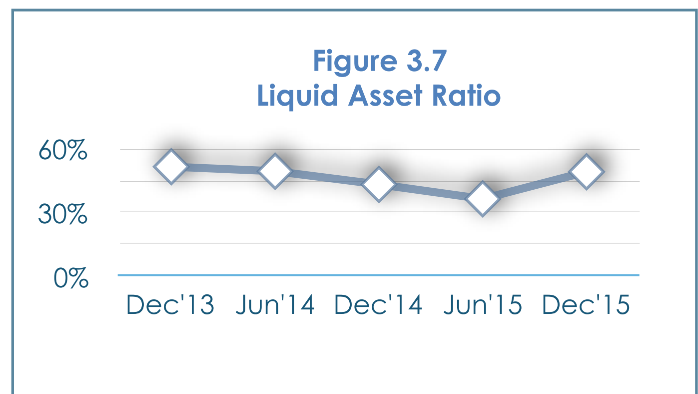
In 2015 the banking system posted net profits of $26.8mn. Of this figure, 70 percent ($18.8mn) was earned during the six-month period ended December 2015. The increased profit margin was largely influenced by reduced provisioning expense and loan write-offs, relative to the first six months of 2015.

The sector's return on assets (ROA) and return on equity (ROE) also improved during 2015, indicative of banks' more efficient allocation and use of assets and equity, compared with prior periods. ROA for the year ended December 2015 computed at 1.2 percent, 0.8 percentage points above the result for the half year ended June 2015 and a 0.1 percent improvement on the outcome for the year ended December 2014.

The twelve-month ROE to December 2015 computed at 9.5 percent, consequent on significantly increased profits (up 135.0 percent) and leaner equity (down 12 percent). When compared with the previous year, the sector's ROE improved by 2.7 percent.

Liquidity





Sector liquidity, as measured by the ratio of liquid assets to deposits liabilities[12] improved during the second half of 2015 by 13 percentage points to 49 percent, far exceeding the regulatory benchmark of 12 percent and surpassing the 36 percent reported in June 2015. Individual banks posted ratios between 23 and 108 percent. This 33 percent ($168.7mn) spike in liquid assets was driven by increased funds placed with foreign financial institutions, consequent on banks' strategic shifting away from loans towards placements and other asset classes.

The outlook for liquidity in the banking system remains positive, given the high levels of liquidity currently maintained across the system.

[12] This ratio is best described as high quality liquid assets approved by the Commission as a percentage of total customers' deposits plus balances from other financial institutions.

The Insurance Sector

▫ Life insurers

As at 31 December 2015, Life insurance business accounted for approximately 18.4 percent of total insurance sector assets in the jurisdiction. Unaudited data submitted to the Commission for the year ended 31 December 2015 showed an 11 percent increase in domestic life insurers' total assets, notwithstanding one insurer being placed in liquidation earlier in the year.

The largest reported asset category was cash and bank balances. Cash and bank balances grew by over 27 percent during 2015 as insurers put measures in place to ensure that there were sufficient realizable investments in the TCI to match insurance liabilities. To this effect, amounts held as cash and deposits of $7.0mn represented roughly 79 percent of total assets.

Retained earnings for the sector have shown significant accretion, consequent on positive returns for 2014 and 2015. Total equity grew by 17 percent consequent on insurers injecting capital into their TCI operations to ensure compliance with the restricted deposit requirement. In accordance with the Restricted Deposit Guidelines issued by the Commission, insurers are required to maintain a minimum sum in the form of term deposits in a local bank; these deposits are payable to the order of the Commission and cannot be reduced or released without the Commission's written permission. The main purpose of the restricted deposit is to offset costs in the event of liquidation.

During the year, total liabilities declined by 10 percent to $2.0mn, the lowest amount recorded by the life insurance industry during the five year period 2010 to 2015. The 28 percent reduction in technical reserves reported for the period was a direct result of the significant decline in Gross Premiums Written as policyholders' confidence in the credibility of the life sector was negatively impacted by the liquidation of the largest life insurer.

Gross premiums written by life insurers amounted to $2.4mn and of this amount 66 percent was ceded to reinsurers. Reinsurance is a risk management tool used by insurers to reduce their insurance risks, improve their ability to withstand financial shocks, lessen the volatility in period to period financial results and use available capital more efficiently. Creditor life insurance was the key driver of the life insurance market and represented 64 percent of gross premiums written. One insurer, accounting for 68 percent of gross premiums written, dominated the life insurance sector.

Despite the liquidation of an insurer which contributed significant losses, the sector's profitability improved with reported profit of $0.72mn for the year under review compared to $0.24mn for the year ended 31 December 2014.

The majority of aggregate financial indicators for the life sector reflected improvement for the period under review. The 17 percent increase in capital mentioned above resulted in significant improvements in the net premium to capital and capital to total assets ratios, respectively. The capital to technical reserves ratio also improved significantly resultant on the higher levels of capital in the sector coupled with a 28 percent decrease in technical reserves. The expense ratio increased by 2.7 percentage points

due to higher expenditure reported by the sector. The higher levels of capital reported signals that the sector's ability to withstand economic shock and contribute to the financial stability of the TCI has improved compared to prior year. The low ratios reported for investment income to net premiums and investment assets were influenced by the low interest rate environment in the TCI.

Non-life insurers

Preliminary data for the year ended December 2015 showed that total assets in the non-life domestic insurance sector increased by 15 Percent to $39.3mn. This balance sheet improvement signals steady growth in the non-life sector. In addition, the non-life insurance sector was responsible for a substantial share (82 percent) of domestic sector assets. The two largest items reported on the balance sheet were cash and bank balances and technical provisions. Amounts held in cash and bank balances represented over 37 percent of total assets. The significant increase in the sector's assets was directly owing to the growth in insurance activities during the period.

Table 4.1

Life Insurers Financial Soundness Indicators as at 31 December						
	2010	2011	2012	2013	2014	2015
Capital adequacy						
Net premium/capital	126.1%	594.1%	11,908.4%	479.2%	433.0%	40.5%
Capital/total assets	14.4%	17.0%	0.3%	6.6%	5.9%	13.0%
Capital /technical reserves	10.5%	13.2%	0.3%	6.4%	49.1%	154.9%
Asset quality						
(Unquoted equities+ receivables)/total assets	13.8%	5.0%	4.0%	6.4%	12.5%	8.8%
Receivables//(gross premium + reinsurance recoveries)	34.4%	6.5%	5.8%	12.0%	22.3%	28.5%
Equities/total assets	1.6%	4.3%	5.5%	5.2%	0.0%	0.00%
Earnings and profitability						
Expense ratio (expenses/net premium)	35.4%	14.6%	48.1%	47.0%	42.9%	45.6%
Investment income/net premium	1.7%	0.8%	2.6%	3.2%	0.7%	2.0%
Investment income/investment assets	0.7%	1.5%	2.0%	1.8%	30.0%	0.2%
ROE (return on equity)	20.9%	6.6%	-15.5%	13.9%	8.7%	1.1%

Total liabilities remained almost constant during 2015 at $25.9mn, compared to the prior year. There was however a 59 percent increase in accounts payable, which was partly offset by a 45 percent reduction in payables to related parties. As at December 2015, technical provisions of $19.5mn were the largest item on the balance sheet and included provisions for items such as unearned premiums, unexpired risks and outstanding claims.

Non-life insurance business has always contributed the lion's share of the domestic insurance sector's net income, generating 97 percent of net income for the period under review. Gross premiums written by the non-life insurance sector totalled $32.0mn, with 70 percent of this amount being ceded to reinsurers. Property and motor insurance were the major contributors to gross premiums written for the period, accounting for 74 percent and 14 percent, respectively. Property is however heavily reinsured and therefore contributed only 32 percent to the net premiums written whilst motor policies contributed 40 percent.

The non-life sector is relatively competitive with 21 percent of gross premiums written attributed to one insurer; four insurers had market share ranging from 10 percent to 21 percent, while the remaining insurers held market share ranging from 1 to 9 percent.

Overall, capital adequacy indicators for the non-life insurance sector have improved compared to December 2014. The non-life insurance sector recorded a 47 percent increase [$3.7mn] in capital compared to the previous year, resulting from an injection of cash to fulfill the restricted deposit requirement, coupled with the regularization of head office accounts to represent the capital investment in the TCI. The ratio of net premiums to capital declined by 94.4 percentage points, indicative of a lowering of risk arising from insurance operations, and was the lowest recorded during the five year period. Additionally, there was a 7 percent increase in the capital to total assets ratio, reflective of injection of capital into the sector. There was also improvement in the capital to technical reserves ratio, resultant on the noted increase in capital.

There was overall improvement in the earnings and profitability ratios for the non-life sector. The expense ratio showed the greatest improvement, reflecting a decrease of 10.5 percentage points as net premiums earned recorded for the period under review increased at a faster rate than expenditure. The loss ratio deteriorated marginally by less than 1.0 percentage point; however, it was considerably lower than the international maximum benchmark of 70 percent. Return on equity (measured as net income divided by capital) declined by 11.6 percentage points as a result of the improvement in capital base of the sector.

Table 4.2

Non-Life Insurers Financial Soundness Indicators as at 31 December…						
	2010	**2011**	**2012**	**2013**	**2014**	**2015**
Capital adequacy						
Net premium/capital	186.5%	254.0%	318.3%	413.5%	215.4%	121.0%
Capital/total assets	20.3%	14.0%	11.6%	9.3%	12.5%	20.1%
Capital (excluding unrealized gains)/technical reserves	39.4%	23.3%	20.7%	16.8%	22.1%	40.5%
Asset quality						
(Unquoted equities +receivables)/ total assets	26.4%	21.7%	20.1%	13.0%	14.4%	18.8%
Receivables/(gross premium +reinsurance recoveries)	21.1%	17.1%	14.3%	10.0%	12.5%	17.3%
Equities/total assets	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Earning and profitability						
Loss ratio (net claims/net premium)	29.9%	43.8%	29.9%	30.2%	32.8%	33.7%
Expense ratio (expenses/net premium)	30.7%	32.3%	55.9%	53.7%	50.3%	29.4%
Investment income/net premium	1.7%	23.8%	5.9%	2.4%	0.9%	1.2%
Investment income/investment assets	1.3%	21.3%	5.5%	2.3%	0.5%	0.7%
ROE (return on equity)	48.6%	16.6%	43.5%	25.0%	33.5%	21.9%

Banking Sector Stress Test Outcomes

The FSC conducted its second round of stress testing simulations on the TCI banking system, using prudential data as at end December 2015. Stress testing is one commonly used analytical tool to predict the potential effects of simulated shocks at varying severities on the financial stability of an institution or system. Stress testing is employed complementary to other regulatory approaches to determine appropriate prudential benchmarks and develop suitable resolution mechanisms to treat with potential severe occurrences.

Importantly, the stress scenarios which have been designed are not forecasts of macroeconomic or financial conditions. The scenarios have instead been developed, taking cognizance of banks' balance sheet profiles and global historical experience.

Overall the sector exhibited greater sensitivity to stress simulations than six months prior, due to the reduction in pre-shock CAR from 27.7 percent to 23.6 percent evidenced between June and December 2015. Notwithstanding a moderate decline in system capital, stress-test results suggest that the banking system is sufficiently capitalized to withstand adverse credit or liquidity stress scenarios which would likely affect the TCI.

The New Domestic Insurance Bill

In 2015 authorities in the TCI continued to upgrade the legal architecture governing insurance, culminating in approval by the House of Assembly of a new Domestic Insurance Bill, which is expected to take effect in the second half of 2016. The new Bill and its subsidiary Regulations will introduce a number of provisions which are expected to modernize the legislative and regulatory framework for domestic insurance and align these more closely with international standards. The Bill is also intended to strengthen existing, and secure additional protections for policyholders.

Among the enhancements the Bill will usher in are:

- A new requirement for creation of a Statutory Fund to facilitate transfer of amounts equivalent to an insurer's net liabilities in the TCI, into suitable trust arrangements earmarked solely for the protection of policyholders in the event of insolvencies or liquidations. Amounts held under these provisions must be reported on an annual basis.

- Formalization of the current requirement for the holding of restricted deposits, to ensure the availability of funds in the jurisdiction to offset costs in the event of liquidation.

- Expanded provisions to improve and strengthen reporting requirements and prudential standards in respect of, inter alia, capital adequacy and actuarial valuation of insurance liabilities, and underscore supervisory expectations regarding corporate governance, internal controls and risk management.

- enabling provisions for introduction of the 'Caribbean Policy Premium Method' which will be applied in the computation of policy benefit liabilities to ensure consistency between actuarial practice and the supervisory methodology used to determine the actuarial liabilities of a life insurer in the jurisdiction. The current Ordinance does not define a common approach for estimating the value of liabilities to policyholders.

Work is expected to commence in short order to develop new legislation for international insurers, at which point the current Insurance Ordinance will be repealed.

The Trust Ordinance and Trust (Licensing and Supervision) Bills

The TCI House of Assembly recently approved passage of two new Bills to modernize the operation and supervision of professional trustees in the jurisdiction. The soon to be enacted Trust Bill and Trust Companies (Licensing and Supervision) Bill were developed with significant input from the Association of Licensed Trustees (ALiT).

Once enacted, the Trust Ordinance should among other things:

- afford additional regulatory powers for licensing of professional trustees; and
- strengthen the legislative requirements for trustees by incorporating more common law provisions into the primary Ordinance, as the existing Ordinance has through successive amendments incorporated a few of these, but still only in a limited way.

The complementary Trust Companies (Licensing and Supervision) Ordinance is intended to, among other things:

- strengthen and more clearly delineate licensing requirements;
- enhance existing, as well as introduce new requirements for prudential reporting, as well as with respect to capital and governance; and
- Introduce an additional category of trust companies and provide opportunities for introduction of additional trust products.

In addition to buttressing prudential safeguards, enactment of these Bills is expected to reenergize trust business in the TCI by expanding the range of products and services. The Bills are also intended to remove certain features that have made the jurisdiction less competitive with regional and international peers. The added transparency in this new suite of legislation should also enable professional trustees to appropriately plan for the regulatory costs of doing business.

Banking Sector Stress Test Outcomes

The FSC conducted its second round of stress testing simulations on the TCI banking system, using prudential data as at end December 2015. Stress testing is one commonly used analytical tool to predict the potential effects of simulated shocks at varying severities on the financial stability of an institution or system. Stress testing is employed complementary to other regulatory approaches to determine appropriate prudential benchmarks and develop suitable resolution mechanisms to treat with potential severe occurrences.

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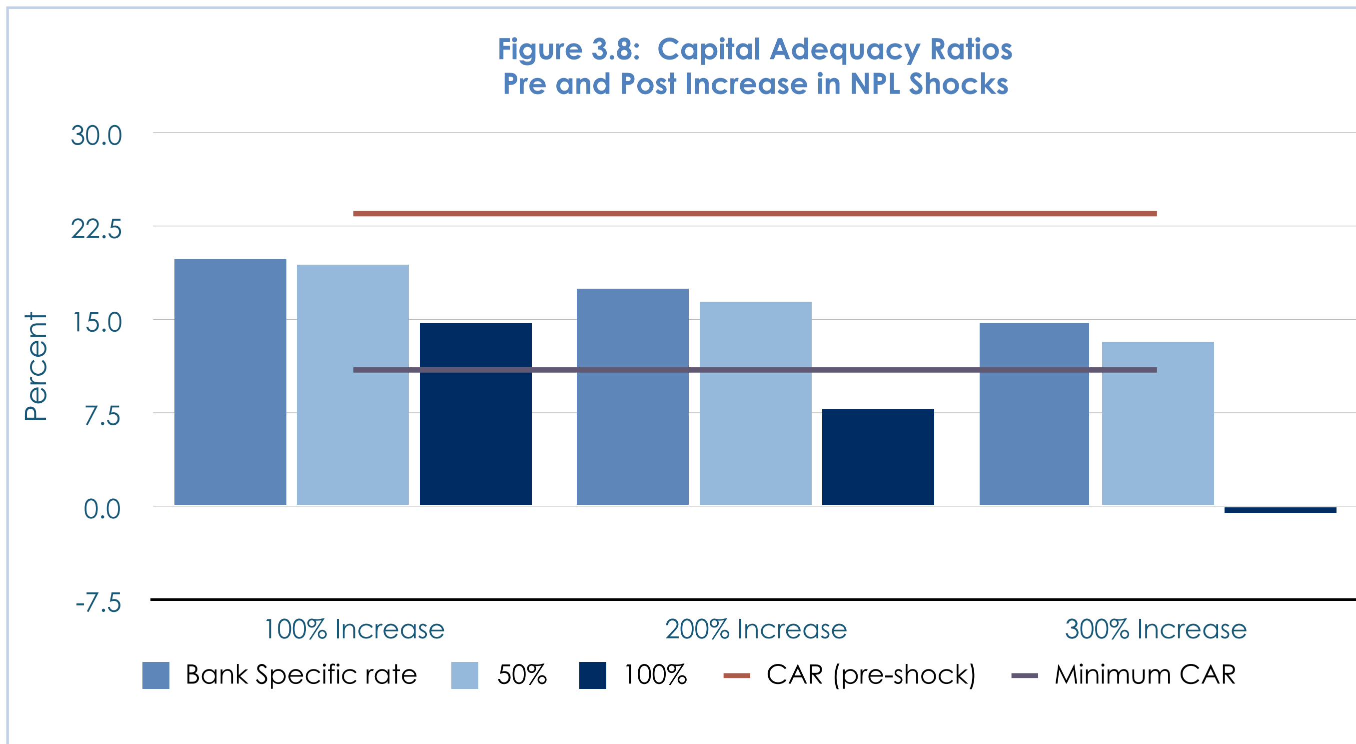
Overall the sector exhibited greater sensitivity to stress simulations than six months prior, due to the reduction in pre-shock CAR from 27.7 percent to 23.6 percent evidenced between June and December 2015. Notwithstanding a moderate decline in system capital, stress-test results suggest that the banking system is sufficiently capitalized to withstand adverse credit or liquidity stress scenarios which would likely affect the TCI.

Shock 1: Increase in NPLs shocks

This simulation evaluated the impact of increases in NPLs by100, 200 and 300 percent, under the requirement of each bank's specific provisioning rate[13], as well as based on a requirement of 50 per cent and 100 percent provisioning[14].



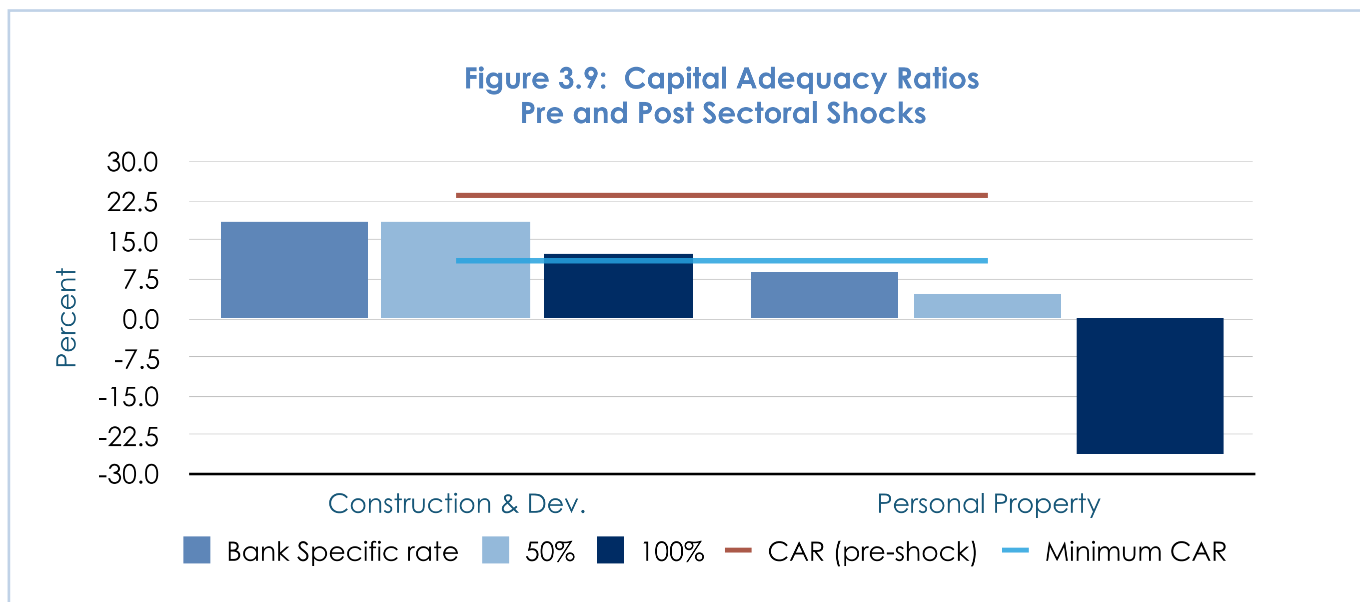
Applying100 percent shock to NPLs, the banking sector's CAR fell but remained above the 11percent requirement. At shock levels of 200 and 300 percent, with 100 percent provisioning required, sector CAR fell to 7.8 percent and negative 0.4 percent respectively. The sector would require additional capital of $26.7mn and $87.3mn respectively, to meet the 11 percent statutory limit.

[13] Bank specific provisioning rate refers to each bank's ratio of *total provisions to NPLs.*

[14] The 50 and 100 percent provisioning levels are consistent with levels required by the Commission for facilities classified as 'doubtful' and 'loss', respectively.

Shock 2: Sectoral shocks to NPLs

This simulation assumed a 100 percent migration to non-performing status of loans in the construction & development and personal property sectors. These assumptions were also applied under each of the following: (i) each bank applying its specific provisioning rates/requirements, (ii) requirement for 50 percent and (iii) requirement for 100 percent provisioning.



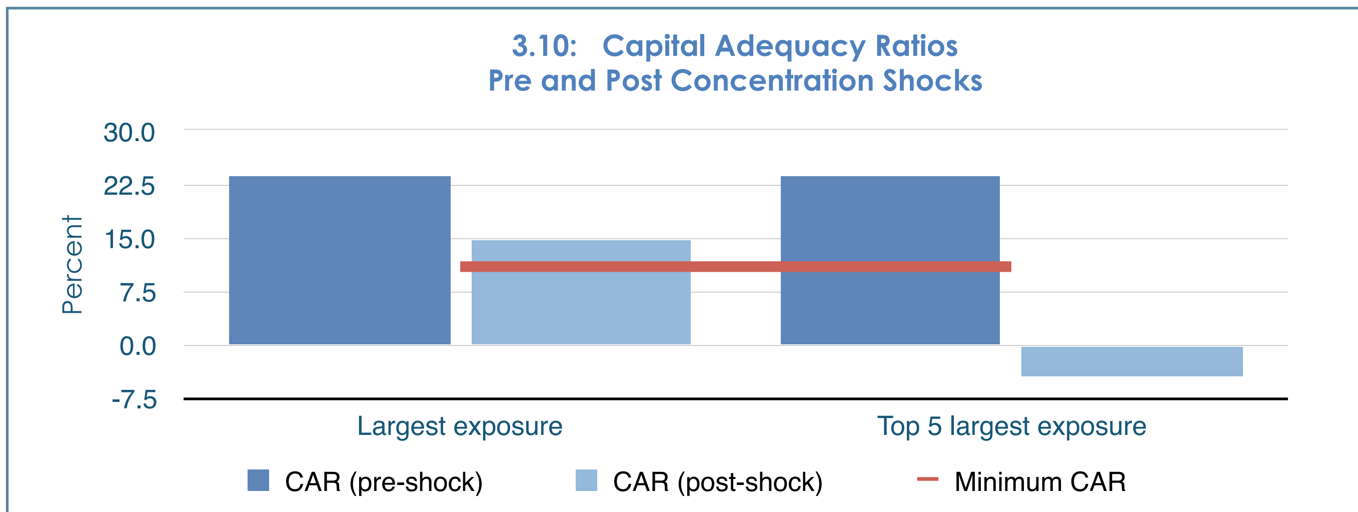
Shocks to the construction & development sector saw the banking sector's CAR displaying increased sensitivity relative to the results in June 2015, but sector CAR remained above the 11 percent requirement.

When these shocks were applied to the personal property category, the banking sector's CAR fell to 8.7 percent based on banks' specific provisioning rates and to 4.8 percent when 50 percent provisioning was required. The sector would require additional capital of $19.3mn and $50.2mn under these scenarios, to meet the 11 percent statutory requirement.

Increasing the provisioning requirement to100 percent would result in the complete erosion of capital, with the sector's CAR falling to negative 26.3 percent, requiring approximately $226.3mn in additional capital to meet the 11percent minimum requirement.

Shock 3: Credit concentration shocks

Simulated shocks were applied to large credit exposures under the assumption of default.



Assuming default by each individual bank's largest credit exposure to a single person or group of related persons, the sector's CAR would re-compute at 14.7 percent, down from 23.6 percent.

Assuming default by the top five (5) of each bank's credit exposures to a single person or group of related persons, there would be complete erosion of capital as the sector's CAR re-computed at negative 4.2 percent. Additional capital of $111.6mn would be required to restore the sector ratio to the 11 percent statutory minimum.

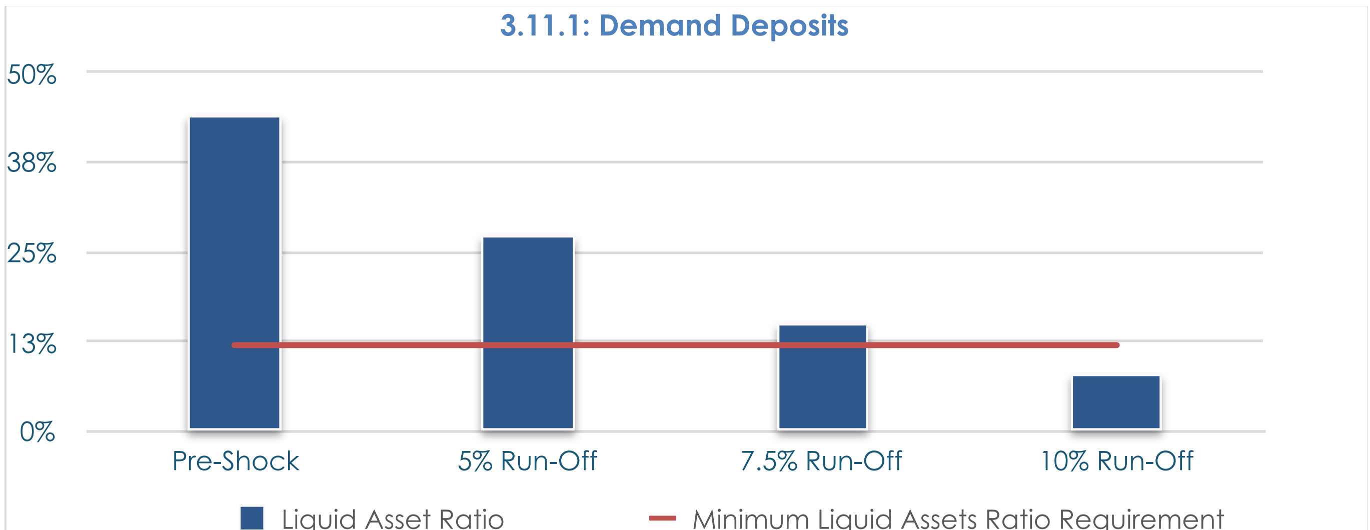
These results bear out the increase in credit risk concentration in the banking sector relative to June 2015.

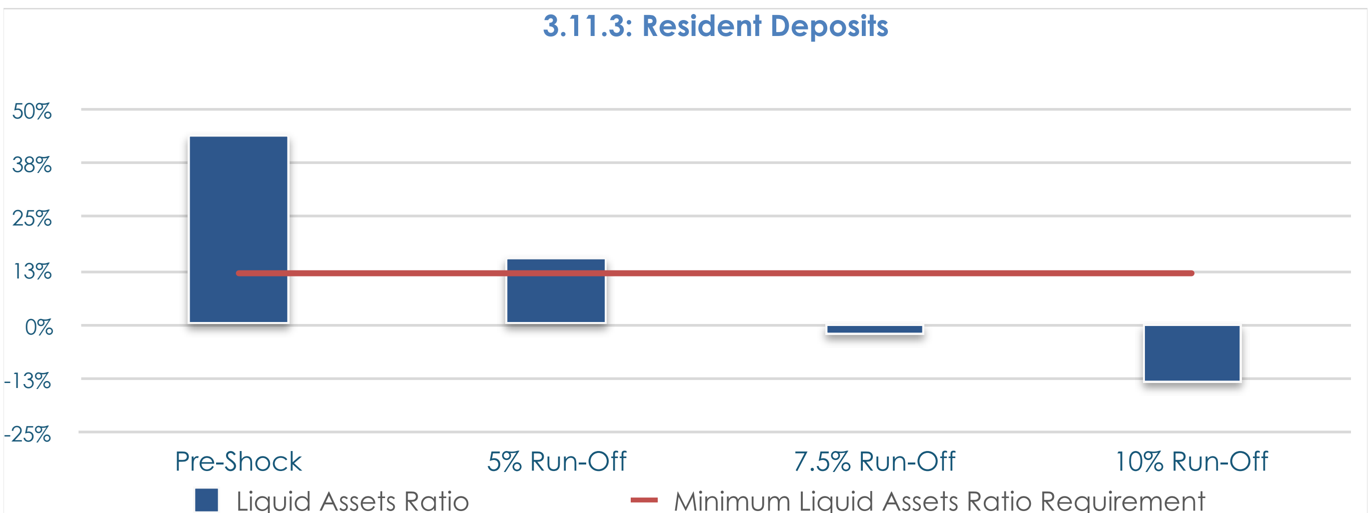
Liquidity Shocks

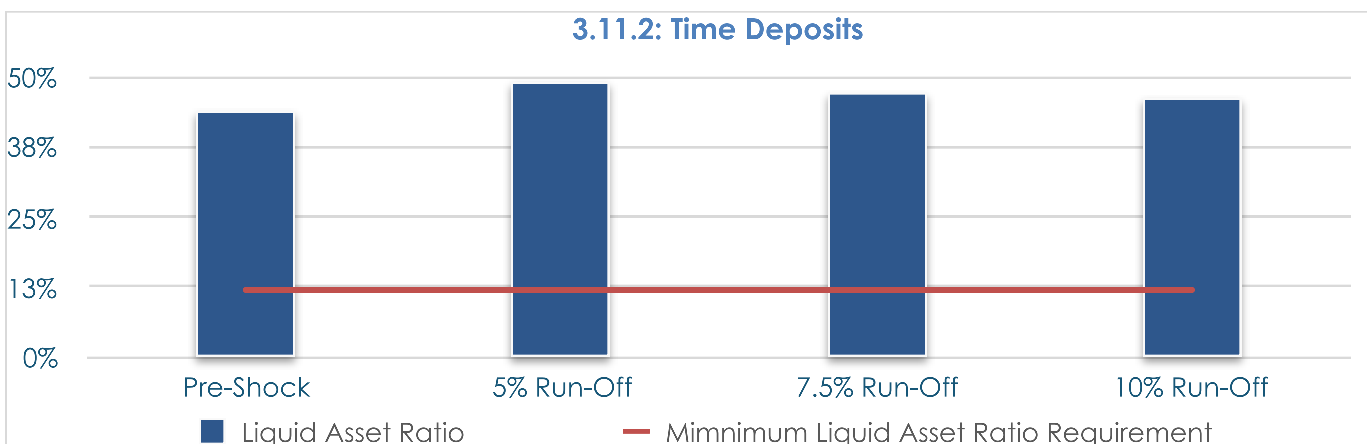
The liquidity stress test exercise was designed to evaluate the implications of simulated deposit runs on banks over a 30-day period. Deposits were analyzed by category, namely demand, time, resident, non-resident, and balances from affiliated and non-affiliated financial institutions. In each scenario, deposit run-off rates in the normal course of business were applied to each deposit category, except the category that was being stressed.

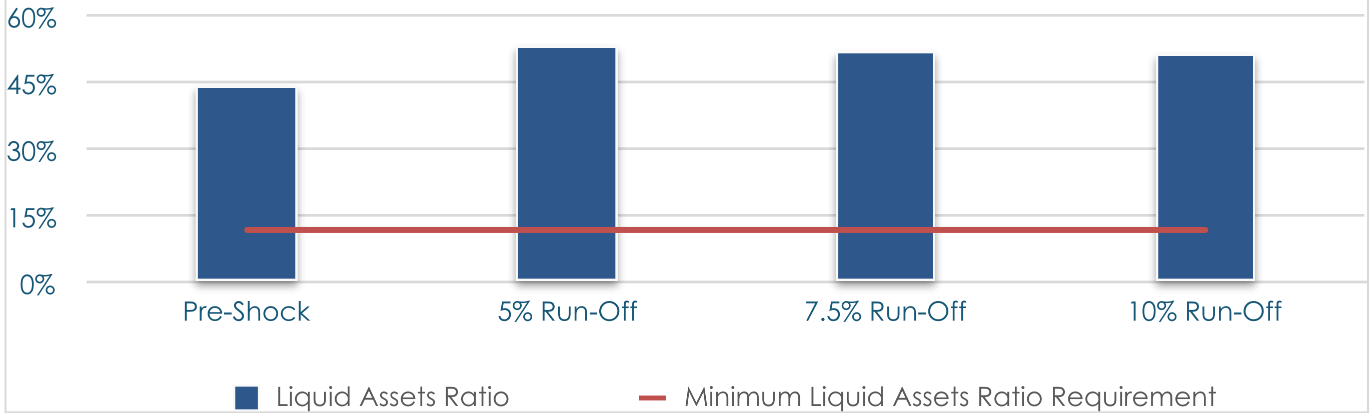
The stressed category was shocked with daily deposit run-off rates of 5 percent, 7.5 percent and 10 percent, respectively. In addition, it was assumed that banks were able to convert 95 percent of liquid assets and one percent of illiquid assets daily to offset deposit withdrawals over the 30-day period.

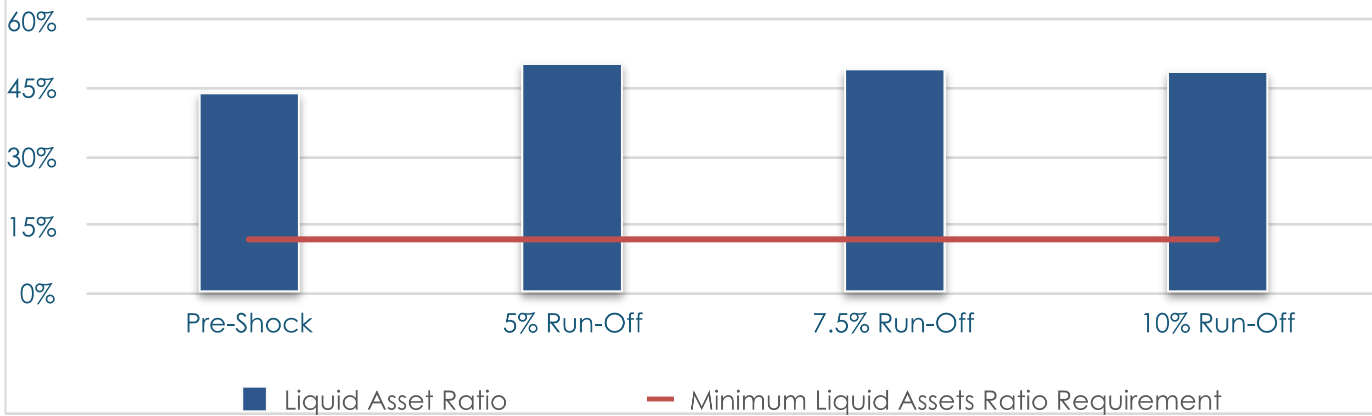
The Impact of Shocks to Deposit Categories on the Banking System's Liquid Asset Ratio

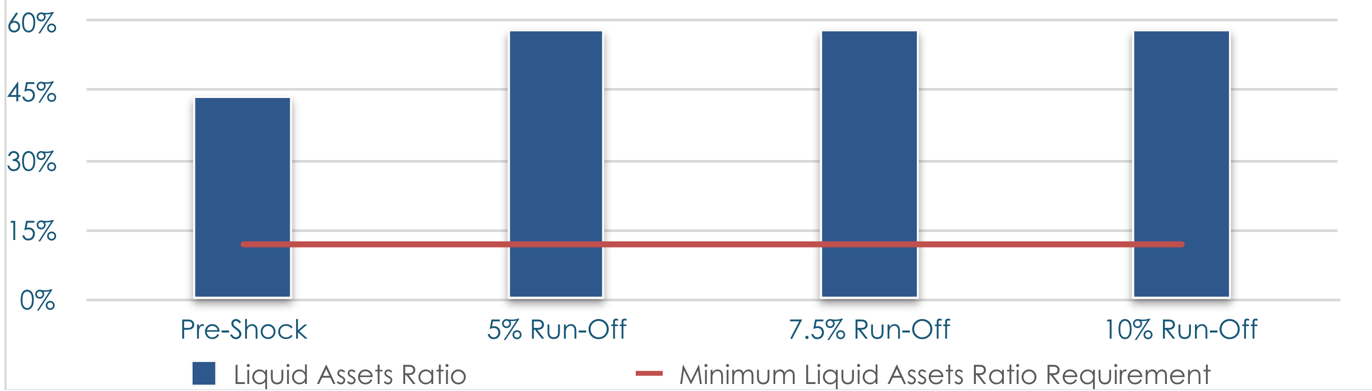







3.11.4: Non-Residents Deposits
60%
45%
30%
15%
0%
Pre-Shock
5% Run-Off
7.5% Run-Off
10% Run-Off
Liquid Assets Ratio
Minimum Liquid Assets Ratio Requirement


3.11.5: Balances from Affiliate Fin. Inst.
60%
45%
30%
15%
0%
Pre-Shock
5% Run-Off
7.5% Run-Off
10% Run-Off
Liquid Asset Ratio
Minimum Liquid Assets Ratio Requirement


3.11.6: Balances from Non-Affiliate Fin. Inst.
60%
45%
30%
15%
0%
Pre-Shock
5% Run-Off
7.5% Run-Off
10% Run-Off
Liquid Assets Ratio
Minimum Liquid Assets Ratio Requirement

Stress test results indicate that the banking sector is especially vulnerable to deposit runs in the demand and resident deposits categories, which each account for more than 70 percent of total deposits.

When stress was applied to demand deposits, the sector liquid asset ratio remained above the statutory minimum of 12 percent at the 5 percent and 7.5 percent daily deposit run-off rates, however on day 15 of the 10 percent daily deposit run-off rate stress scenario, the ratio would fall below the minimum 12 percent requirement.

Outcomes were more severe in the test on resident deposits, as the sector's liquid asset ratio would dip below the statutory minimum during both the 7.5 and 10 percent daily deposit run-off rates scenarios. The liquid asset ratio requirement would be breached on day 15 during the 7.5 percent daily deposit run-off rate scenario and on day 11, under the 10 percent daily run-off rate scenario.

Simulated runs on the other deposit categories – time, non-residents and balances from affiliated and non-affiliated financial institutions – revealed no threat to system liquidity or potential breach of statutory requirements at the test levels.