Financial Stability Report December, 2017

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PREFACE

As a key part of its statutory mandate, the Central Bank of The Bahamas is required, *"to ensure the stability of the financial system." In this report, financial stability focuses on the continued proper and efficient functioning of the financial sector, with the ultimate goal of ensuring that the system remains sound and resilient in the face of crises.* In this context, the report analyses key financial sector developments and assesses the underlying risks to financial stability in the domestic economy. It considers the financial system's ability to withstand shocks and function well enough to contribute to the healthy performance of the economy.

This Financial Stability Report (FSR) relies on data from the key regulators of the domestic financial system, which include the Central Bank, as the supervisor of banks and credit unions; the Securities Commission, the regulator for the securities industry; and the Insurance Commission, which is responsible for the insurance industry. It summarises the macroeconomic environment, provides an overview of key developments within the financial sector and assesses potential risks to the health of the system.

The first FSR was published in 2013, and the report is currently an annual publication.

EXECUTIVE SUMMARY

During the review year, the Central Bank remained steadfast in its efforts to improve its supervision of the financial sector, in order to ensure that the system remained stable. A series of initiatives were implemented, to strengthen the current AML/CFT[1] regime, while further steps were taken towards the development of a credit bureau. Programmes, which focussed on promoting financial inclusion, were also launched.

Against the backdrop of improving domestic macroeconomic conditions, the financial sector remained relatively stable in 2017. Domestic banks continued to reduce their loan arrears through a combination of non-performing loan (NPL) sales, debt restructuring programmes and loan write-offs. Further, bank liquidity remained at elevated levels, largely associated with banks' conservative lending posture and clients' efforts to deleverage. Stress testing—inclusive of shocks to credit risks, liquidity and interest—indicated that the banking system was resilient to sudden shocks, due to its healthy capital and liquidity buffers, relative to international benchmarks. However, given the softness in the economy and the high level of unemployment, private sector credit growth remained sluggish.

The majority of the non-banking sector's financial stability indicators were positive in 2017. Specifically, credit union profitability rose modestly, which resulted in gains in both the return on assets (ROA) and return on equity (ROE) ratios, while asset growth was robust, led by an expansion in members' deposit balances. In addition, tests showed that the sector had sufficient capital and surplus resources to cover any unexpected losses. Further, prudential indicators in both the life and non-life insurance sectors remained above international benchmarks; however, the overall profitability of the life insurance sector decreased, related mainly to the growth in total expenses. In contrast, the non-life sector returned to profitability in 2017, as expenses fell sharply back to trend levels, following a significant hurricane-related increase in the prior period.

The modernisation of the payments system remains an integral part of ensuring the stability of the financial sector. In this regard, the Bank released the Payments Instruments (Oversight) Regulations, 2017, and corresponding General Information and Application Guidelines for Providers of Electronic Retail Payments and Instruments and Electronic Money Products.

Going forward, the Central Bank will continue to place emphasis on closing gaps identified in the risk and compliance systems of its supervised financial institutions (SFIs), while strengthening the financial sector's resilience. As such, enhanced focus is being placed on risk management practices regarding AML/CFT. The Bank is also concentrating on enhancing its macro-prudential oversight mechanisms, in an effort to adequately address any stability risk that might emerge. The Bank is also taking a more guarded posture towards the monitoring of bank liquidity, as credit risks subside over the medium-term, this represents capacity for more elevated demands on foreign exchange outflows than tourism and foreign investment receipts would sustain.

[1] Anti-Money Laundering and Counter Financing of Terrorism.

CHAPTER 1: MACROECONOMIC ENVIRONMENT

1.1. The Global Environment and Near-Term Risks

Impacts on the domestic economy through developments in the international market remain as the most significant exposure for the financial sector, especially as it relates to the performance of the United States economy. In April 2018, the International Monetary Fund (IMF) projected that the global economy rose by 3.7%, which is expected to accelerate by 20 basis points to 3.9% in 2018, buoyed in part by the impact of the recently approved US tax policy changes.

In the United States, the expansion in real GDP quickened by 80 basis points to 2.3% in 2017, (see Table 1), attributed to positive contributions from personal consumption expenditure, non-residential fixed investment and exports. This outturn was particularly strong along the East Coast, which is the largest market for The Bahamas' main tourism sector. As a consequence of these developments, the jobless rate decreased by 50 basis points to 4.4% by end-December, while the annual inflation rate steadied at 2.1%, as gains in energy and food prices, were offset by declines in medical care and housing costs.

Given the improving economic conditions, the Federal Reserve sustained its efforts to normalize interest rates, by increasing its target range for the federal funds rate three times in 2017, by 25 basis points each to 1.25%-1.50%. In addition, the central bank reduced the size of its asset purchase programme by an additional $10 billion per month. These programmes have not had a measurable effect on US economic growth to-date; however, concerns remain over the potential long-term effect of US rate hikes on economic activity, and the resulting spillover effects on the Bahamian economy.

1.1.1. Other External Sector Risks

With the Bahamian Dollar being pegged to the US Dollar, the decline in the latter's value against other major currencies during the year had little impact on the country's terms of trade, due to the fact that the US is The Bahamas' largest trading partner—accounting for an estimated 84% of total imports in 2017.

Other external sector issues, such as the ongoing production cuts by OPEC and other major oil producers, which led to a sizable average 20.1% gain in global oil prices, had a moderate impact on The Bahamas' fuel import bill, while inflation rates remained subdued; although global oil price gains tend to have a lagged effect on domestic inflation rates.

External reserve balances were buttressed by the Government's successful US$750 million international bond issue in November[2]. Specifically, external reserves rose by $513.4 million (56.8%) to $1,417.4 million at the end of the year, while the internationally tracked import reserve cover, firmed by 6.0 weeks to 22.5 weeks of the current year's total merchandise imports at year-end—well above the 12-week international benchmark.

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[2] This bond has a fixed interest rate of 6.0% and will be repaid over a period of 11 years, with the first of three equal installments beginning in 2026.

1.1.2. International Sector

Perhaps the most sustained significant risk to the financial sector, has been the potential loss of correspondent banking relationships (CBRs), which are critical to facilitating international banking transactions, including credit card payments, import transactions and remittances. For The Bahamas, surveys conducted during 2016 and 2017 indicate that losses or adverse shifts in CBRs most adversely impacted standalone domestic and international banks and money transmission businesses (MTBs). Where relationships were withdrawn, supervised financial institutions (SFIs) were always able to find replacement arrangements. Although the landscape is outwardly calmer now, risks remain elevated, with SFIs generally maintaining costlier due diligence systems to satisfy heightened information requirements of correspondent banks. Another noteworthy constraint on domestic banks has been the restriction on inter-bank sales of foreign currency cash. However, it is worth noting that as the level of scrutiny placed on the sector by the CBs intensifies, there is a risk for further curtailing of relationships with potential spillover effects for the ease of conducting international trade transactions.

In response to these potential challenges on the domestic front, there has been a concerted effort to strengthen the Central Bank's AML/CFT supervisory regime, through the creation of an Analytics Unit within the Bank Supervision Department, which focuses on AML/CFT data compilation and analysis, and it has also established frameworks for the continuous oversight of AML/CFT systems within SFIs. As a policy, SFIs are required to maintain at least two CBRs to avoid disruptions in their operations. In the domestic market, the central bank is also engaging more actively to smooth out the availability of US dollar banknotes. Over the medium-term, the focus will be on financial literacy and other interventions, in order to increase the public's comfort in the use of electronic payment instruments for international travel.

Another risk to the financial sector emanates from the increased scrutiny placed on the country's international financial sector, from global bodies such as the Organisation for Economic Cooperation and Development (OECD). Although the international financial sector accounts for only a small segment of the overall financial system, in terms of key metrics such as jobs, local expenditures and Government revenues, the main benefit from international firms relates to their linkages with other segments of the economy, including high-end real estate and construction ventures. Risk mitigation efforts for the international firms are contained in the collaborative efforts of the public and private sectors to strengthen The Bahamas' capacity to deliver in the areas of international tax cooperation and transparency, and in the national AML/CFT initiatives, which are benchmarked to global standards.

1.2. The Regional Environment

The regional environment imposes linkages on the domestic commercial banking sector where, among other factors, capital allocation, credit risk management and operating cost structures are optimized across multiple jurisdictions. Low growth prospects still constrain the recovery pace for reducing NPLs and creating avenues for profit growth. As such, the incentives remain for international banks to redeploy capital from the domestic markets in the region, and to become more efficient in their operation through cost savings and the regional consolidation of operational units.

For the Caribbean in general, the economic performance improved modestly over the review period, as the region recorded modest growth of 1.2% in 2017, after a 1.0% contraction in the prior year (see Table 2). In particular, following a 0.8% reduction in real GDP in 2016, Belize's economy expanded by 2.5% during the review period. Further, economic growth in the Eastern Caribbean Currency Union (ECCU), Jamaica and Guyana strengthened by 60, 40 and 20 basis points to 3.2% 1.7% and 3.5%, respectively. In addition, the contractions in real output for Suriname and Trinidad & Tobago slowed to 1.2% and 3.2%, from 10.5% and 5.4%, respectively, in the prior period. In contrast, the growth in Barbados' economy narrowed by 70 basis points to 0.9%, as the country continued to face significant fiscal challenges.

TABLE 1

Selected Indicators for Developed Economies (%)

	2011	2012	2013	2014	2015	2016	2017
GDP Growth Rates							
United States	1.6	2.2	1.7	2.4	2.6	1.5	2.3
Euro Area	1.5	(0.9)	(0.3)	1.2	2.0	1.8	2.4
United Kingdom	1.5	1.3	1.9	3.1	2.2	0.9	1.7
China	9.5	7.9	7.8	7.3	6.9	6.7	6.9
Japan	(0.1)	1.5	2.0	0.3	1.2	0.9	1.8
Unemployment Rates							
United States	9.0	8.1	7.4	6.2	5.3	4.9	4.4
Euro Area	10.2	11.4	12.0	11.4	10.9	10.0	8.7
United Kingdom	8.1	8.0	7.1	6.2	5.4	4.9	4.4
China	4.1	4.1	4.1	4.1	4.1	4.0	3.9
Japan	4.6	4.4	3.4	3.6	3.4	3.6	2.8
Inflation Rates							
United States	3.1	2.1	1.5	1.6	0.7	1.3	2.1
Euro Area	2.7	2.5	1.3	0.4	0.2	1.1	1.4
United Kingdom	4.5	2.8	2.6	1.5	0.2	0.7	2.7
China	5.4	2.6	2.6	2.0	1.6	2.0	1.8
Japan	(0.3)	(0.1)	0.3	2.8	0.0	(0.1)	0.5

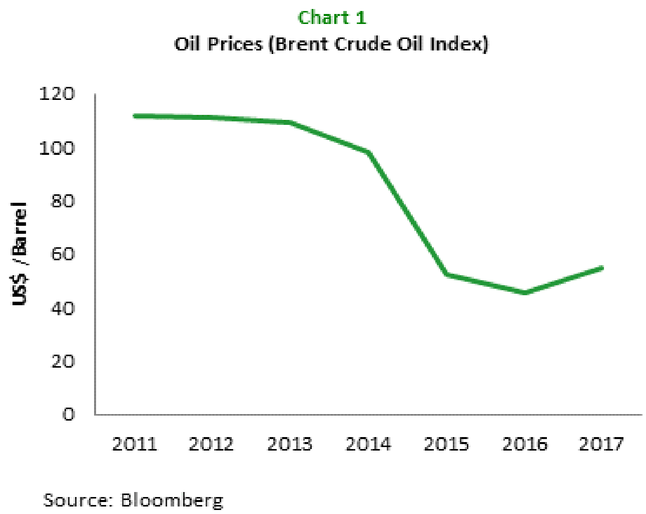
Sources: IMF, International Statistical Bureaus

TABLE 2

Selected Caribbean Countries' GDP Growth Rates (%)

	2011	2012	2013	2014	2015	2016	2017
Bahamas	0.6	3.1	(0.4)	(0.1)	1.0	(1.7)	1.4
Barbados	0.8	0.3	(0.1)	0.1	0.9	1.6	0.9
Belize	2.1	3.7	0.7	4.1	2.9	(0.8)	2.5
Eastern Caribbean	(0.2)	0.4	1.7	2.9	2.6	2.6	3.2
Guyana	5.4	4.8	5.2	3.8	3.1	3.3	3.5
Jamaica	1.4	(0.5)	0.2	0.5	1.0	1.3	1.7
Suriname	5.8	2.7	2.9	0.4	(2.7)	(10.5)	(1.2)
Trinidad & Tobago	(3.0)	1.3	2.7	(0.6)	(0.6)	(5.4)	(3.2)
Average	**1.7**	**2.2**	**1.6**	**1.3**	**0.5**	**(1.0)**	**1.2**

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



1.3. The Domestic Environment

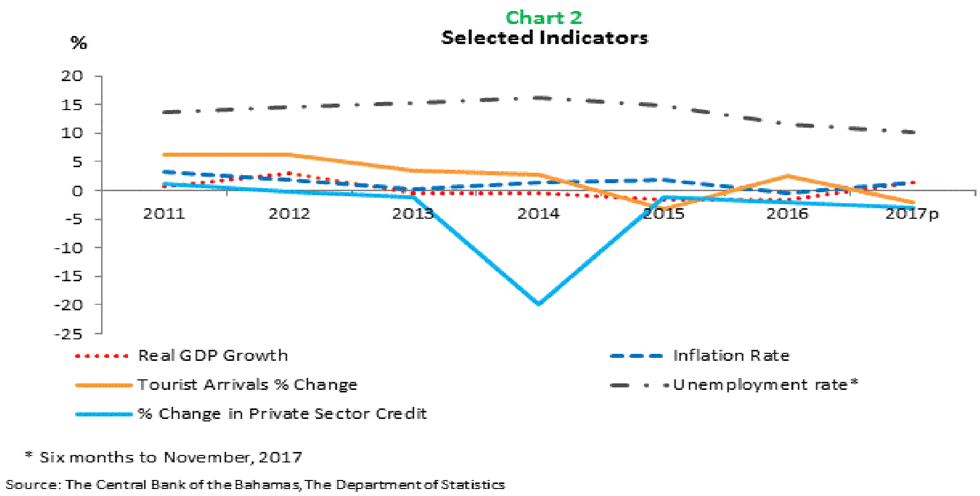
The health of the domestic environment continues to affect the speed of NPL reduction and the overall strengthening of commercial banks' balance sheets. The appetite to provide new lending is also tied to this environment, alongside the ability to manage new credit risk, which is only expected to be significantly enhanced after the credit bureau starts operations. Medium-term fiscal prospects also matter, as a sustained consolidation would also support some gradual reduction in bank liquidity, by taking pressure off central bank financing to Government.

The economy grew at a modest rate in 2017 of 1.4%, compared to a 1.7% contraction in the prior period. This outturn reflected steady gains in the construction sector, which received stimulus from several varied-scale foreign investment-related projects in both New Providence and the Family Islands and post-hurricane rebuilding work. However, softness persisted in the overall domestic market, with total mortgage disbursements for new construction and repairs decreasing by 3.4% to $108.8 million, albeit a slowdown from the year earlier 6.7% reduction. A breakdown by segment, showed that the value of the dominant residential component declined by 5.0% to $102.4 million, extending 2016's 2.8% contraction. In contrast, the commercial segment expanded by 32.7% to $6.4 million, a turnaround from a 51.0% decrease in the previous year.

The tourism sector continued to face headwinds in 2017, as the weather-related loss of significant room capacity in one major market a year earlier, combined with the disruption to flight and cruise ship itineraries caused by the passage of several hurricanes within the vicinity of The Bahamas in September, led to a falloff in tourism output during the year. Specifically, total visitor arrivals decreased by 2.1% to 6.1 million, a reversal from a 2.5% gain in 2016. Underlying this outcome was a 4.0% contraction in the high value-added air segment to 1.3 million, along with a 1.5% reduction in sea arrivals to 4.8 million.

In this environment, employment conditions improved during the year, buoyed by the onboarding of employees for the phased opening of the multi-billion dollar Baha Mar resort, hurricane construction recovery and stimulus from the hosting of a number of international cultural events. Specifically, the jobless rate declined by 1.5 percentage points to 10.1% in November 2017, over the prior year, as approximately 11,345 persons were added to employers' payrolls. By major job centers, the unemployment rate decreased for all markets. Specifically, the jobless rate in New Providence fell by 2.3 percentage points to 10.6% relative to the same period in 2016. Similarly, the rate narrowed for Grand Bahama and Abaco by 1.3 and 0.5 percentage points to 12.1% and 8.6%, respectively, vis-à-vis November 2016.

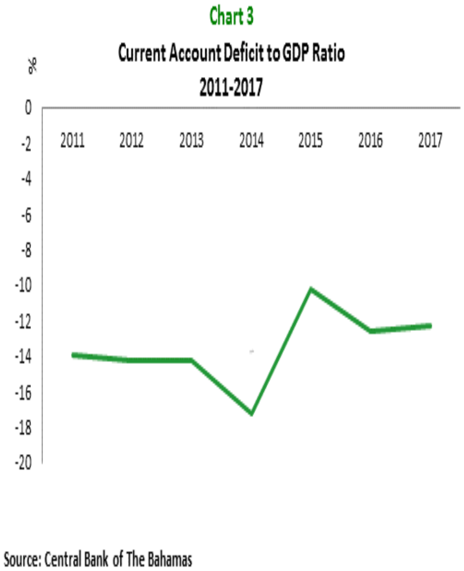
Domestic inflationary pressures remained relatively benign over the review year; although the sustained increase in global oil prices resulted in a firming in the rate in 2017. Data revealed that the Retail Price Index (RPI) for The Bahamas rose by 1.5%, following the prior year's 0.4% contraction, attributed to price gains for the major components of the index.



The overall fiscal deficit increased by more than two-fold to $669.3 million during FY2016/17, due in large measure to unplanned spending and disrupted revenue collections following the passage of Hurricane Matthew. Total outlays rose by $489.9 million (21.9%) to $2,729.9 million, outpacing the $131.0 million growth in aggregate revenue, to $2,060.5 million. On a calendar year basis, the deficit widened by $91.3 million (19.5%) to $559.3 million, as the rise in total expenditure—associated with hurricane and election-related spending—eclipsed revenue gains.

Preliminary estimates for the external sector revealed that the current account deficit widened markedly by $751.0 million (64.8%) to $1,909.3 million, as higher capital-related imports contributed to an increase in the merchandise trade deficit, while the services account surplus narrowed. In contrast, the capital and financial account surplus more than doubled to $1,602.3 million from $461.4 million, buoyed by the Government's external borrowing activities, combined with a rise in loan-based financing for foreign investment projects.

Domestic monetary trends featured robust expansions in both liquidity and external reserves in 2017, dominated by the Government's $750.0 million external bond issue. Further, banks' credit quality indicators improved during 2017, attributed primarily to the sale of a portion of one entity's non-performing loan portfolio to the Government-owned special purpose vehicle (SPV), Bahamas Resolve Corporation, as well as ongoing debt restructuring activities and loan write-offs. As a result, banks lowered their aggregate provisioning for loan losses. In addition, in the context of the persistent liquidity overhang, the weighted average deposit rate decreased, but was overshadowed by the fall in the weighted average loan rate, leading to a narrowing in the interest rate spread.



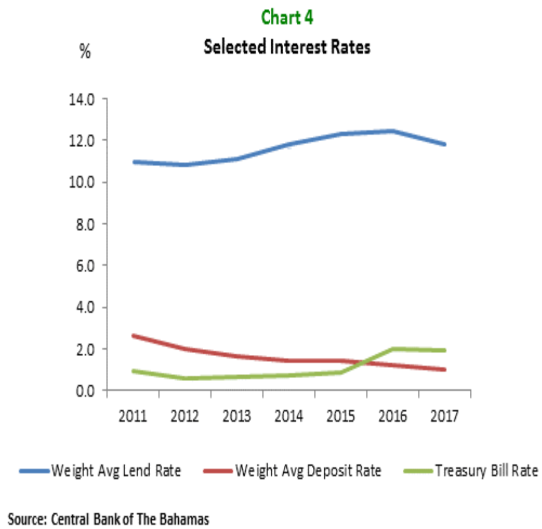


TABLE 3

The Bahamas: Macroeconomic Indicators

	2011	2012	2013	2014	2015	2016	2017
B$/US$: Exchange Rate	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Nominal GDP Growth Rate (%)	(0.3)	6.5	(0.9)	3.1	7.6	0.4	2.7
Real GDP Growth Rate (%)	0.6	3.1	(0.4)	(0.1)	1.0	(1.7)	1.4
Inflation Rate (Average chg in RPI)	3.3	1.8	0.2	1.3	1.9	(0.3)	1.5
Unemployment Rate	13.7	14.7	15.4	16.2	12.0	12.7	9.9
Overall Fiscal Balance (B$M)	(319.8)	(557.5)	(485.3)	(531.1)	(269.7)	(468.0)	(559.3)
% of GDP	(4.1)	(5.2)	(4.6)	(4.8)	(2.3)	(4.0)	(4.6)
Private Sector Credit (B$000)	6,646.6	6,628.4	6,551.1	6,366.9	6,299.7	6,170.8	5,982.9
Weighted Average Lending Rate (%)	11.0	10.9	11.1	11.8	12.3	12.5	11.8
Weighted Average Deposit Rate (%)	2.6	2.0	1.7	1.4	1.4	1.2	1.0
Treasury Bill Rate (%)	1.0	0.6	0.7	0.7	0.9	2.0	1.9
Gross Int'l Reserves (B$M)	884.9	810.2	741.6	787.7	811.9	904.0	1,414.1
Import Cover Ratio (Tot. Merch. (CIF) in week	14.5	11.6	11.4	11.4	13.3	16.5	23.0
Current Balance (B$M)	(1,101.2)	(1,531.8)	(1,516.2)	(2,192.6)	(1,610.2)	(1,158.3)	(1,909.3)
as % of GDP	(14.0)	(14.3)	(14.3)	(20.0)	(13.7)	(9.8)	(15.7)
Total Public Sector Debt (B$M)	4,948.3	5,770.6	6,346.9	7,101.8	7,460.0	7,898.3	8,811.0
of which: External	1,044.9	1,464.7	1,616.1	2,100.5	2,175.8	2,373.0	3,231.7
Internal	3,903.5	4,305.9	4,730.7	5,001.3	5,284.2	5,525.3	5,579.4
Total Arrivals ('000s)	5,587.6	5,940.2	6,150.8	6,320.2	6,112.1	6,265.0	6,136.2
Tourist Expenditure (B$M)**	2,142.6	2,312.7	2,287.5	2,316.4	2,537.3	2,316.0	N/A
Construction Number of Permits Issued	1,948.0	1,916.0	1,462.0	1,418.0	1,299.0	1,136.0	N/A
Value of Starts (B$M)	147.5	116.6	140.2	129.2	117.1	96.2	N/A
Value of Completion's (B$M)	500.6	317.1	216.6	250.5	228.9	193.2	N/A
Average Oil Prices (Brent Crude Oil Index)	111.8	111.4	109.1	98.5	52.6	45.8	55.0

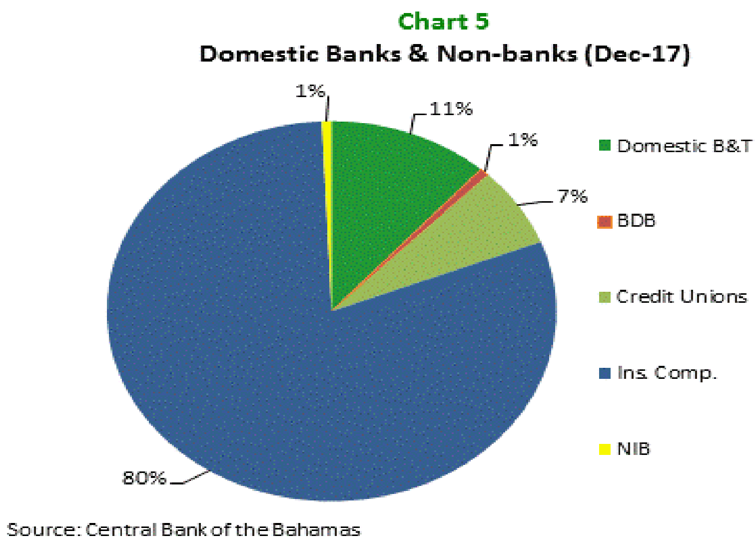
Source: Central Bank of The Bahamas, Department of Statistics, Bloomberg

N/A - Not Available

CHAPTER 2: FINANCIAL SYSTEM OVERVIEW

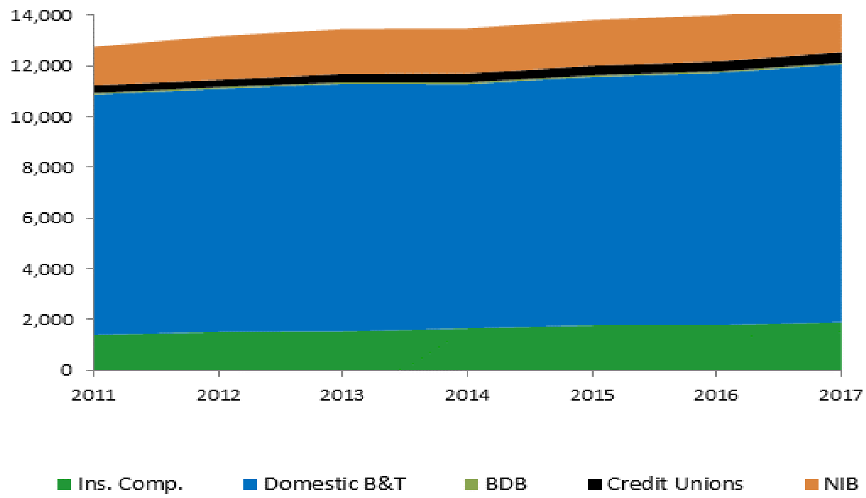
The Bahamian financial services sector, which is responsible for an estimated 10.0%-15.0% of the country's GDP, consists of both domestic and international operations; however, Exchange Control regulations provide for a distinct segregation of domestic and foreign currency operations.

At end-2017, the financial system comprised 242 banks and trust companies; of which 19 operated either fully or partially within the domestic space. The banking system employed more than 4,000 individuals, of which 3,133 resided within local domestic banks. Other entities operating within the sector included: 5 MTBs, 10 local credit unions (CUs), 50 insurance companies—of which 30 operated within the domestic sphere—as well as several financial & corporate service providers and investment fund administrators. The most significant public sector entities operating within the industry included: the Bahamas Development Bank (BDB), the National Insurance Board (NIB) and the Bahamas Mortgage Corporation (BMC). In addition, in recent years a few SPVs have been established to acquire a variety of financial assets. Further, the Bahamas International Securities Exchange (BISX) serves as the country's stock exchange, where shares in locally listed companies are traded.



An examination of the balance sheet of the banking sector, revealed total assets of US$189.8 billion at end-2017. International banks, which specialize in areas such as private banking, wealth management, lending and trading, accounted for a dominant $171.1 billion (90.1%) of the total. Domestic banks represented the remaining $18.7 billion, of which domestic and foreign assets amounted to $10.2 billion and $8.5 billion, respectively. Further, preliminary figures for fiduciary assets under the care of trust companies, decreased to $188.9 billion, from a revised $211.7 billion in 2016.

Chart 6
Estimated Assets of Domestic Financial Institutions



Source: The Central Bank of The Bahamas, Insurance Commision of The Bahamas

Non-bank entities, such as insurance companies and credit unions, recorded total assets of $1.9 billion and $420.3 million, compared to values of $2.3 billion and $395.5 million, respectively, a year earlier. Further, the Bahamas Development Bank, a Government-owned financial institution, which provides financing to small and medium-sized enterprises, reported a 6.6% contraction in its asset base to $53.5 million, attributed to reductions in demand deposits, “other” miscellaneous assets and outstanding credit.

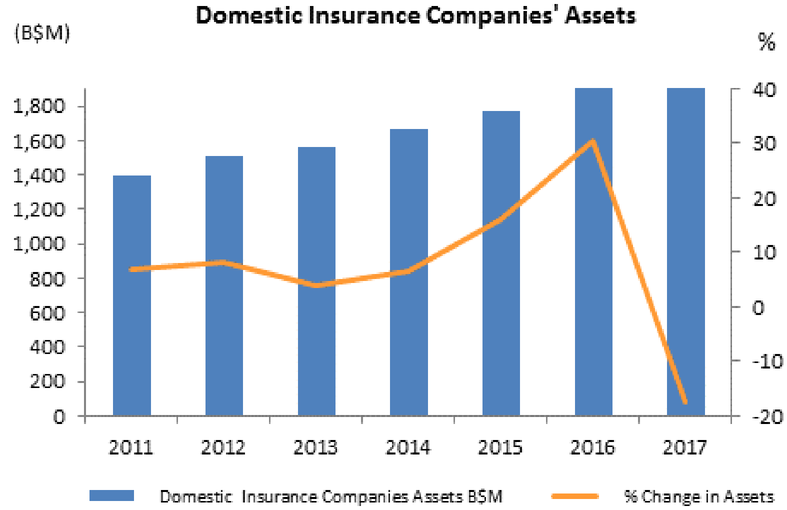
TABLE 4
Structure of the Financial System

	2011	2012	2013	2014	2015	2016p	2017p
Banks &Trusts							
International	260	249	249	237	233	232	225
Domestic	18	19	18	17	16	16	17
Total	**278**	**268**	**267**	**254**	**249**	**248**	**242**
Non-Bank Financial Institutions							
Mutual Funds	713	652	735	830	885	890	N/A
Credit Unions	13	13	7	7	7	10	10
Insurance companies	127	139	140	143	148	148	146
Domestic Companies & Agents	*114*	124	121	122	125	127	126
External Insurers	*13*	15	19	21	23	21	20

N/A - Not Available

Source: Central Bank of The Bahamas

Chart 7
Domestic Insurance Companies' Assets



Source: Insurance Commision of The Bahamas

CHAPTER 3: BANKING SECTOR

Under The Bahamas' exchange control regime, international banks are not permitted to undertake domestic business activities; therefore, the impact of these licensees' operations on domestic financial stability is not material. In this context, it is primarily the domestic sector that is pertinent to the assessment of financial stability.

3.1. Domestic Banking Sector

Over the year, the composition of firms in the local banking system increased by 1 to 17, comprising 8 onshore commercial banks; of which 4 are subsidiaries of Canadian banks, 3 are locally owned and 1 is a branch of a United States' based institution. The remaining 9 Other Local Financial Institutions include 3 Bahamian, 3 Canadian, 2 United States and 1 Bermuda owned entity. Funding sources for banks are predominantly from deposits, while assets consisted largely of credit to the private sector, which represented 58.5% of the total domestic assets, with holdings of Government and public sector debt securities, accounting for shares of 17.2% and 2.6%, respectively. Private exposures include commercial loans, residential mortgages and consumer loans, although each institution tends to specialize in different segments of the market. The majority of the sector's assets—in excess of two-thirds—remained concentrated in the 3 largest banks.

Banks' conservative lending practices supported sustained high levels of liquidity during the year. This liquidity does not pose a near-term risk to the financial sector, given that it reflects mainly the lack of viable credit opportunities in the market. However, over the medium to long-term, as economic conditions improve and more clients are able to qualify for loans, and the credit bureau improves borrower screening capabilities, there is the accelerated potential for the liquidity to be channeled towards credit, which could lead to a significant erosion of external reserves over time. That said, the Central Bank's increased focus on macro-prudential policies, which include the development of proactive tools to manage the pace of lending, should assist in mitigating the risk of a sharp and unsustainable increase in credit. While such measures are not warranted in the near-term, the Bank will seek to effect some gradual reduction in liquidity, in pace with the Government's fiscal consolidation, which will allow for additional sale and redemption of Government debt off of the Bank's balance sheet.

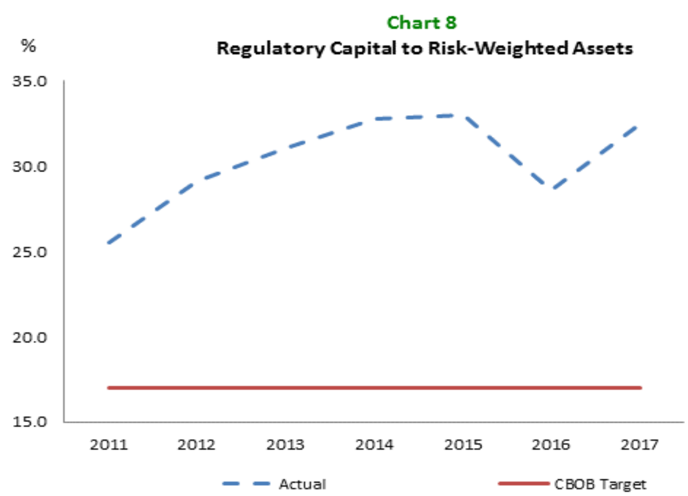
3.1.1. Asset Trends

During 2017, total domestic assets of the banking system grew by 2.3% to $10.2 billion, exceeding the 1.6% expansion recorded in the prior year. Underlying this development was a 19.3% gain in the holdings of securities to $2,030.8 million, a reversal from a 5.6% reduction in the preceding year. This was attributed to a sharp 60.2% increase in the stock of public sector instruments, related mainly to the Bahamas Resolve Corporation, and a 15.1% rise in investments in Government paper, which outstripped the 2.6% falloff in holdings of private sector instruments. Similarly, banks' cash balances at the Central Bank rose by 16.7%, to $1,012.2 million, albeit lower than the 47.6% growth registered in the prior year. In addition, "other" miscellaneous assets advanced by 8.9%, following a 4.6% increase recorded in the previous year, while till cash edged-up by 0.5%, after increasing by 1.9% in 2016. In contrast, owing to decreases in both the private and public sector segments, loans & advances fell by 4.1%, extending the 0.6% reduction in the previous year.

At end-December, loans & advances held the largest share of total domestic assets (64.8%), followed by securities (19.9%), balances with the Central Bank (9.9%), "other" miscellaneous assets (3.9%) and till cash (1.5%).

3.1.2. Capital Adequacy

Domestic banks remained well capitalized in 2017. The system's ratio of total capital to risk weighted assets stood at 32.5% at end-December—3.9 percentage points higher than 2016's level, with three institutions exceeding this ratio, while the other entities were within the 20%-30% range. As a consequence, the indicator remained well above the Central Bank's target of 17.0% of risk-weighted assets[3] as well as the international benchmark of 8.0%. Even with a more conservative stance that will begin to apply for the estimation of risk weighted assets and the definition of capital starting in 2019-2020, capital surplus will remain high. Over time, the Central Bank will encourage a gradual reduction in surplus capital, as a precaution against pressures being placed on banks to engage in riskier activities to generate higher returns on these buffers. The pace of capital adjustments would remain sensitive to the strength of net foreign currency inflows that would cushion any repatriation.



3.1.3. Asset Quality

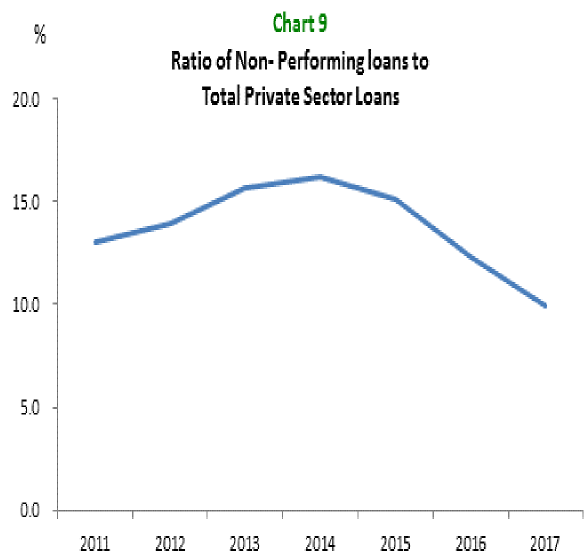
In addition to NPL sales and credit quality enhancements stimulated by the improving economic environment, the Central Bank has also directed commercial banks to take a more aggressive posture to resolve outstanding bad debts, where necessary, through foreclosures to liquidate their exposures. This stems the risk that elevated NPLs would pose if another economic downturn were to be encountered in the near-term.

Credit quality ratios improved in 2017, reflecting largely the sale of a portion of one institution's non-performing commercial loan portfolio to the Bahamas Resolve Corporation, along with ongoing debt restructuring activities and loan write-offs. As a consequence, total private sector loan arrears declined by 12.5% to $884.8 million, following the previous year's 17.1% reduction. Correspondingly, the ratio of

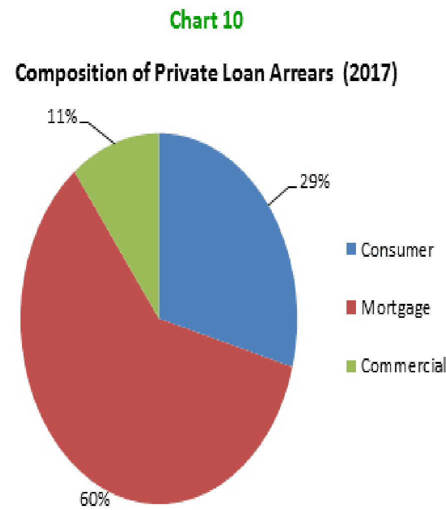
[3] The Central Bank also imposes a "trigger" ratio of 14.0%, below which licensees would be required to implement measures to either reduce risk exposures or supplement their capital.

arrears to total private sector loans narrowed by 1.7 percentage points to 15.4%, compared to a 3.3 percentage point falloff in the prior year. The contraction in total delinquencies was due solely to the NPL segment, which decreased by 22.2%, to $567.5 million, extending the 19.6% contraction in 2016. In contrast, the short-term (31-90 days past due) component increased by 12.7% to $317.4 million, a reversal from the preceding year's 10.1% falloff. At end-2017, NPLs comprised 9.9% of total private sector loans, compared to 12.3% in 2016; however, the share of short-term arrears increased by 70 basis points to 5.5%.

A sectoral breakdown showed that the decrease in the level of arrears reflected primarily a 60.2% reduction in the commercial component, to $92.4 million, after a 3.2% gain in 2016. Conversely, mortgage arrears—which accounted for 60.4% of the total—rose by 2.5% to $534.1 million, contrasting with a 25.3% falloff in the prior period. In addition, consumer arrears edged-up by 0.3%, to $258.3 million, a turnaround from a 13.4% contraction in the previous year.



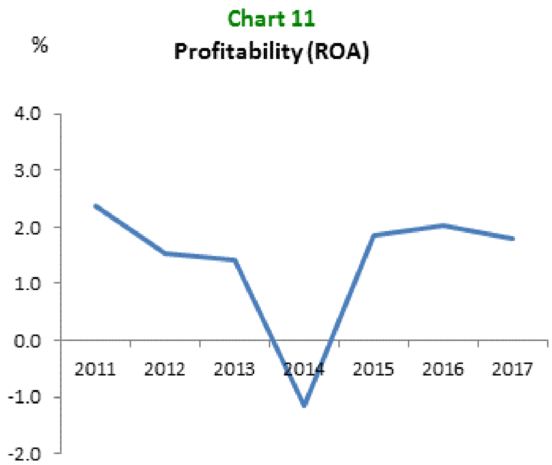
Source: Central Bank of The Bahamas



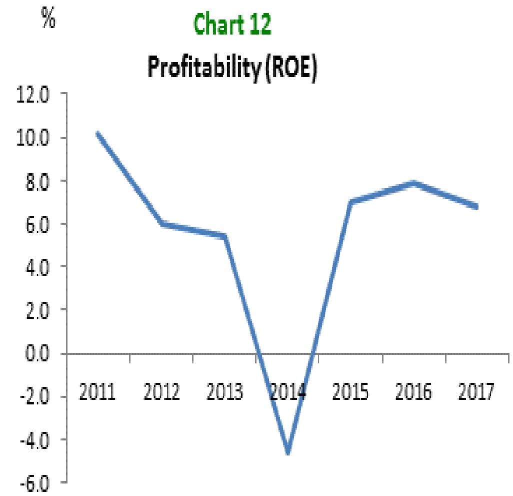
Source: Central Bank of The Bahamas

3.1.4. Profitability

Domestic banks' profitability contracted by 10.7% to $182.2 million in 2017, owing in large measure to a rise in other "miscellaneous" operating costs, which exclude outlays related to staffing and occupancy. As a result, the respective ratios of net income to average monthly assets (ROA) and equity (ROE), both moved lower, to 1.8% and 6.8%, from 2.0% and 7.9% in 2016. Contributing to these developments, other "miscellaneous" operating costs increased by 14.8%, raising the associated ratio to average assets by 13 basis points, to 3.7%. Further, the effective interest rate spread narrowed by 12 basis points to 7.11%, with the ratio of net interest income to average assets decreasing by 19 basis points to 5.14%, as a 15.4% contraction in interest expense, was offset by a 4.1% reduction in interest revenue. In contrast, the ratio of commission and foreign exchange income to average assets firmed marginally by 3 basis points to 0.28%.



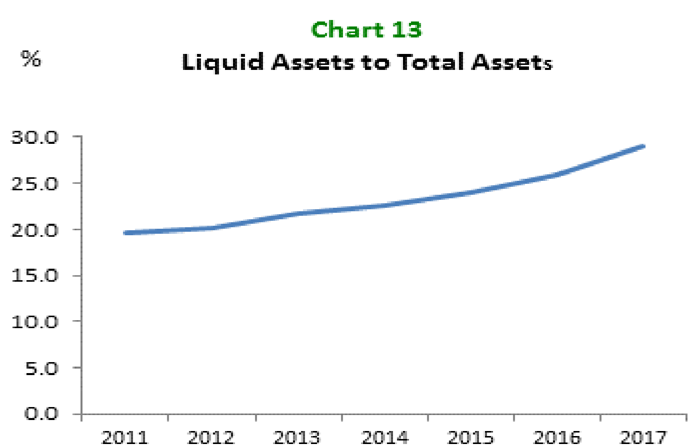
Source: Central Bank of The Bahamas



Source: Central Bank of The Bahamas

3.1.5. Liquidity

Bank liquidity levels remained elevated during 2017, as evidenced by a 3.1 percentage point increase in the ratio of liquid assets to total assets to 29.0%, outpacing the 1.8 percentage point gain in the prior year. Similarly, the liquid assets to short-term liabilities ratio expanded by 4.9 percentage points to 42.7%, after an 80 basis point firming in 2016. Banks' excess supply of available resources also contributed to a 5.7 percentage point gain in the ratio of deposits to loans to 104.8%, albeit lower than the 7.0% firming in the preceding year. Further, the ratio of demand deposits to total balances moved higher by 1.8 percentage points to 39.0%; although below the 4.6 percentage point strengthening in 2016.



Source: Central Bank of The Bahamas

TABLE 5

Key Domestic Banks Financial Stability Indicators (%)	2011	2012	2013	2014	2015	2016	2017
Liquidity Indicators							
Loan to Deposit Ratio	114.1	114.5	114.0	109.6	108.6	100.9	95.4
Deposits to Loan Ratio	87.6	87.4	87.7	91.2	92.1	99.1	104.8
Demand Deposits to Total deposits	23.5	25.9	28.1	31.7	32.6	37.2	39.0
Liquid Assets to Total Assets	19.7	20.2	21.8	22.7	24.1	25.9	29.0
Liquid Assets to Short-Term Liabilities	30.0	31.2	34.0	34.4	37.0	37.8	42.7
Credit Risk Indicators							
NPL to Total Private Sector Loans	13.0	13.9	15.7	16.2	15.1	12.3	9.9
Total Assets Growth rate	1.1	1.2	1.8	(1.4)	1.8	1.6	2.1
Loans & Advances Growth rate	0.4	0.0	0.2	(2.3)	(0.3)	(0.6)	(4.1)
Capital Adequacy							
Regulatory capital to risk-weighted assets (avg)	25.5	29.1	31.1	32.8	33.3	28.6	32.5
Trigger Ratio	14.0	14.0	14.0	14.0	14.0	14.0	14.0
Target Ratio	17.0	17.0	17.0	17.0	17.0	17.0	17.0
Profitability Indicators							
ROAA (annualized)	2.4	1.5	1.4	(1.2)	1.9	2.0	1.8
ROAE (annualized)	10.1	6.1	5.6	(4.6)	7.0	7.9	6.8
Net interest income to average earning assets (annualized)	5.5	5.4	5.4	5.3	5.4	5.3	5.1
Net interest income to gross income	62.8	67.1	68.8	69.8	70.5	69.4	69.4
Non interest expenses to gross income	37.9	40.8	47.1	66.3	47.4	48.4	52.1
Personnel expenses to non interest expenses	53.2	51.2	50.3	34.8	46.8	44.0	40.8
Trading and fee income to total income	2.8	3.0	3.0	3.0	3.9	3.2	3.8
Spread between reference loan and deposit rates	6.1	6.4	6.9	6.8	7.1	7.2	7.1

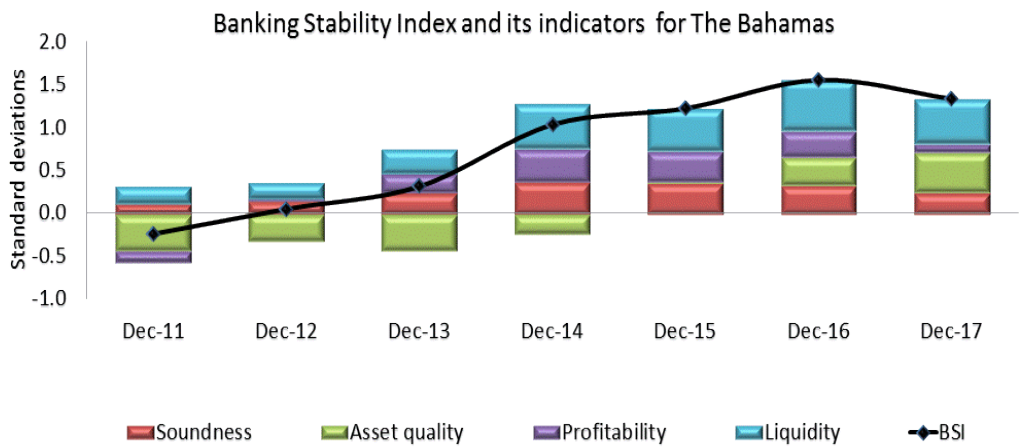
Source: Central Bank of The Bahamas

3.2 An Assessment of the Stability of the Banking Sector

3.2.1 The Banking Stability Index

In 2017, the Central Bank of The Bahamas—with the assistance of the IMF's Caribbean Technical Assistance Centre (CARTAC)—created a banking stability index (BSI) to measure the soundness of Deposit Taking Institutions (DTIs) in The Bahamas. The index was constructed as a weighted average of key performance indicators such as: capital adequacy, asset quality, profitability, and liquidity, with an increase in the index denoting an improvement in banking sector stability, while a decrease indicates a worsening in stability. An analysis of the movement in the BSI over the past eight years, showed that the sector remained relatively sound, reflecting gains in almost all of the subcomponents. A detailed analysis showed that the normalized asset quality indicator firmed to 0.46 from 0.33 in the previous year and registered a turnaround from a decrease of 0.56 in 2010, which indicated an ongoing improvement in stability in the credit quality of the sector. However, the normalized average capital adequacy indicator recorded a value of 0.24, which was lower than the prior year's 0.32 and 0.28 in 2010, respectively; nevertheless, since the value is closer to 1 it infers that there is no heightened risk to stability. Further, although the normalized average for the liquidity indicator declined to 0.53 in 2017 from 0.59 in the prior year, it far exceeded the 0.25 at end-2010. Its relatively high value is indicative of the elevated liquidity levels. Providing some offset, the normalized profitability indicator narrowed to 0.10 from 0.31 in 2016, and 0.11 in 2010, showing a deterioration in profitability, which was mainly due to a rise in operational costs, combined with a decline in interest income. The profitability dip, caused the banking stability index to decline to 1.33 in 2017 from 1.55 in 2016.

Chart 14



Note: The banking stability index is an aggregate indicator of the soundness of the Deposit-Taking Institution sector. It is constructed from normalized variables of indicators of which are capital adequacy, profitability, asset quality, and liquidity specified for our country. An increase in the index value shows greater stability. The BSI is measured in standard deviations from the 8-year average.

Source: Central Bank of The Bahamas

3.2.2. Stress Testing

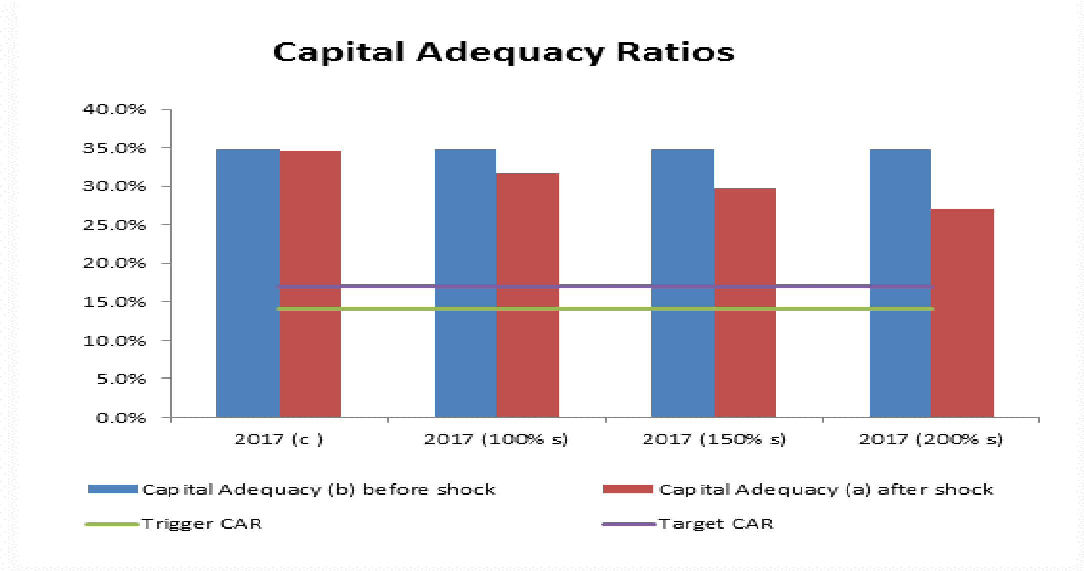
Credit risk stress tests remained the primary way to determine the resilience of the banking sector; although liquidity and interest rate risks are also monitored. The credit risk stress tests assess the capital adequacy or loss absorbing capacity of commercial banks, to shifts in the level of NPLs, resulting from extreme, yet plausible shocks to the domestic commercial banks' NPL rates. Further, the report provides general observations from liquidity and interest rate risk stress tests, since at present there are no material vulnerabilities.

3.2.2.1 Credit Risk Stress Tests

In 2017, the scenarios used to determine the capital shortfalls for credit risk shocks, if any, remained unchanged. The stressed scenarios included shocks of 100, 150 and 200 percent in the forecasted NPL rates for 2017 through 2019. It was assumed in the baseline, that macroeconomic trends and interventions, if any at the operational level, would have supported the continued gradual reduction in the stock of NPLs, to a level closer to $750 million over the forecast horizon.

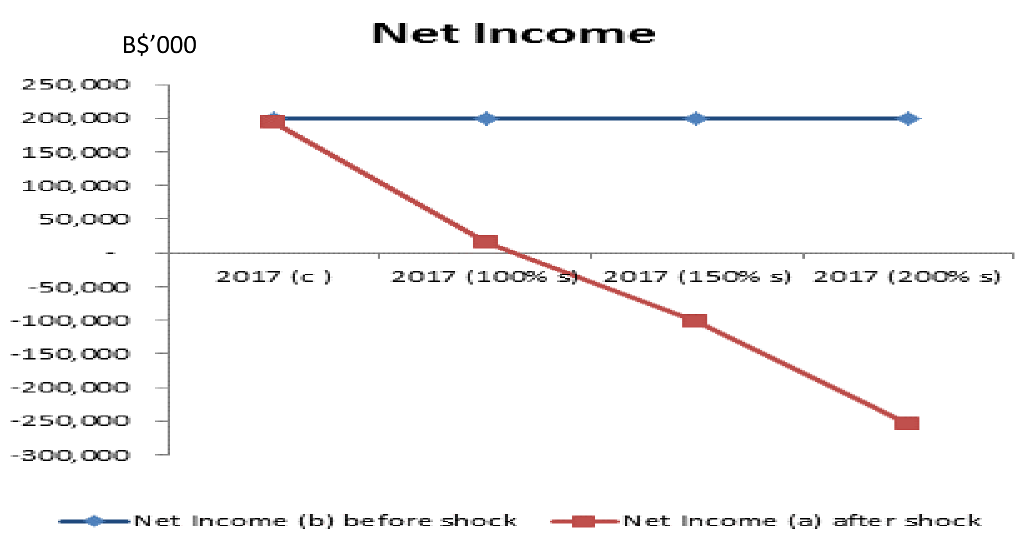
Therefore, adverse shocks would concur with reversals in economic fortunes, and increasing stress on borrowers. In these cases, and with the posited shocks, NPLs would increase within the range of $1.5 billion to $2.3 billion. Capital would be reduced under such outcomes, but still remain comfortably above the minimum regulatory adequacy level of 17%, given a starting weighted capital adequacy ratio (CAR) near 34.8% and average levels that would remain above 25.0% under the most extreme outcomes, as depicted in Chart 15. On an aggregate basis, these stresses therefore do no suggest a need for any new capital injections.

Chart 15



At varying levels of shocks to the NPLs, anticipated increases in provisioning levels and the possible loss in interest income would negatively impact banks' earnings. Hence the banks would be expected to seek to offset the loss in net income from other means, such as non-interest income sources. Chart 16 depicts the projected net income before any shock, at a net gain of around $200 million and declines in net income, due to applied shocks; although the impact on individual banks will vary.

Chart 16



3.2.2.2 Interest and Liquidity Shocks

Generally, most institutions are not at risk from the near-term depletion of liquidity, given the continued significant excesses within the banking system. The prevailing excesses underscore individual banks' ability to absorb sudden shifts in deposits without encountering liquidation challenges.

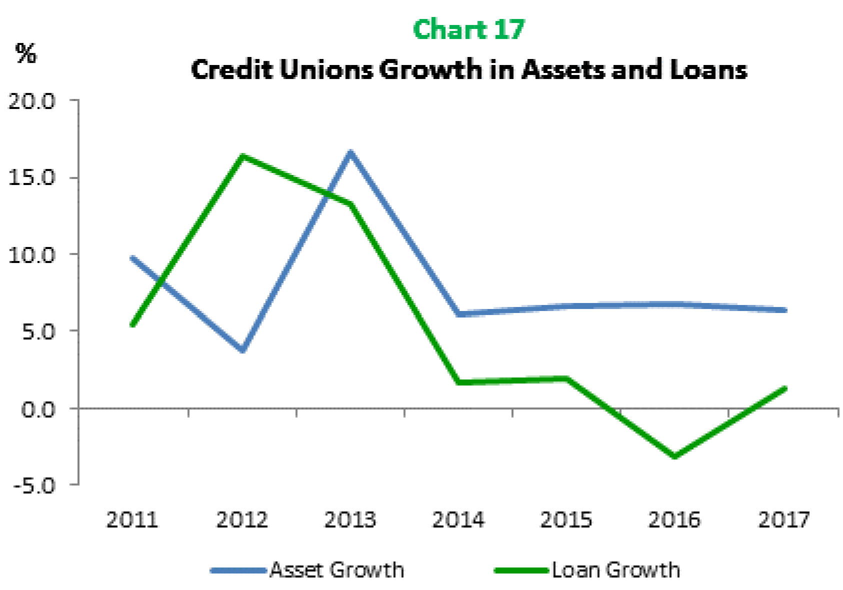
The banks' interest rate risks are predominantly tied to credit and deposit facilities, and are largely impacted due to rate fluctuations, especially during the incidence of credit distress. As the Government securities market modernizes, it is expected that balance sheets would also be subjected to securities valuation changes. In the interim, the level of shocks to NPL rates is deemed large enough to incorporate potential adverse interest rate movements.

CHAPTER 4: CREDIT UNIONS

Credit unions remained the second largest deposit taking institutions; however, the sector does not pose a significant risk to financial stability, given its conservative business model. At end-2017, the number of active credit unions—inclusive of the Credit Union League—remained at 10. The largest institution represented approximately 49.1% of the sector's total assets, while the remaining 9 entities accounted for smaller market shares ranging from 0.1% to 15.0% of the aggregate. These entities registered gains in deposit assets and liabilities, with the sector's capital levels exceeding the PEARLS[4] benchmarks. Nevertheless, the prudential buffers are not as strong as those for banks. The Central Bank is targeting a comparative improvement in these measures over the medium-term, particularly in the context of credit unions' expected enrollment in the Deposit Insurance Scheme. At end-2017, the credit unions' total membership stood at an estimated 42,186 persons, or 18.6% of the workforce.

4.1. Assets and Liabilities

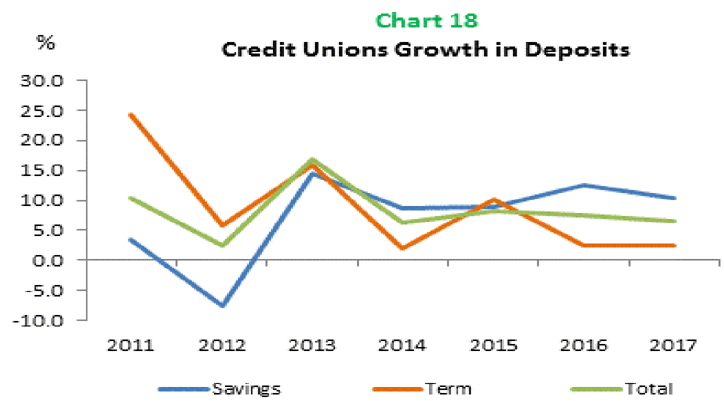
During the year, credit unions' total assets rose by 6.3% ($24.8 million) to $420.3 million at end-December 2017, after the previous period's 6.7% growth. The expansion in assets was led by a 7.4% ($5.3 million) rise in deposits held with the league to $77.3 million. In addition, loans to members, which comprised the dominant 54.9% of the total, grew by 1.3% ($2.9 million) to $230.8 million, a turnaround from a 3.1% reduction in the previous year. A disaggregation of the loan portfolio showed that the majority of the credit was extended for small-scale consumer purchases (73.6%), followed by mortgage/land (22.6%), education (1.8%), revolving lines of credit (1.7%) and other "miscellaneous" loans (0.3%).



Source: Central Bank of The Bahamas

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

Buoyed by the continued increase in the sector's membership, total deposits at credit unions rose by 6.6% ($22.3 million) to $362.2 million, following a 7.6% expansion in 2016. Underpinning this outturn, savings deposits—which accounted for 54.8% of the total—advanced by 10.5% to $198.4 million, following a 12.6% increase a year earlier. In addition, term deposits (at 39.2% of the aggregate) rose by 2.5% to $142.0 million, after a 2.4% expansion in the prior year.



Source: Central Bank of The Bahamas

TABLE 6

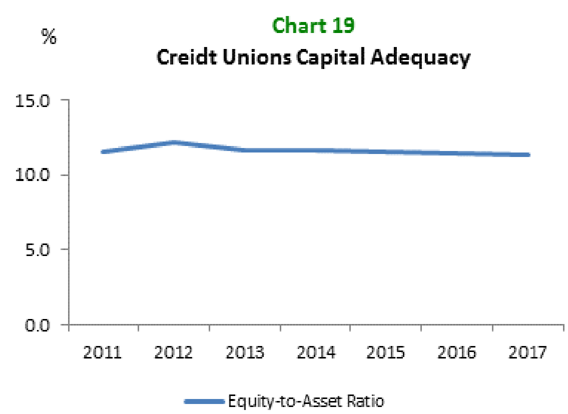
Selected Financials for Credit Unions (B$M)

	2011	2012	2013	2014	2015	2016	2017P
Assets	270.6	280.9	327.6	347.7	370.6	395.5	420.3
Loans	172.4	200.6	227.0	230.9	235.3	227.9	230.8
Deposits	229.7	235.3	274.7	291.6	315.9	339.9	362.2
Liquid Assets	86.2	74.7	98.6	113.8	128.4	156.0	171.6
Savings	127.6	117.8	134.8	146.4	159.6	179.7	198.4
Term Deposits	98.2	103.8	120.4	122.8	135.3	138.5	142.0
Total Deposits	229.7	235.3	274.7	291.6	315.9	339.9	362.2
Total Equity	3.6	34.1	38.4	40.7	42.4	45.1	47.4
Non-Earning Assets	12.7	11.6	17.2	25.2	25.0	34.8	33.4
Allowance	7.5	8.5	11.2	11.8	14.1	9.9	7.4
Short-Term (ST) Payables	6.4	0.7	1.2	1.4	1.0	1.1	0.5
Capital & Surplus	31.3	34.1	38.4	40.7	42.4	45.1	47.4
Provisions	1.7	2.7	1.6	1.1	2.3	2.4	3.9
Net Income	1.0	4.5	6.9	2.8	1.3	1.4	1.7
Institutional Capital	10.9	13.3	13.2	14.3	11.9	12.8	9.4
# of Credit Unions	13	13	7	7	9	10	10
Financial Ratios (%)							
Equity-to-Asset Ratio	11.6	12.1	11.7	11.7	11.5	11.4	11.3
Return on Assets	0.4	1.6	2.1	0.8	0.3	0.3	0.4
Return on Equity	3.2	13.2	18.0	7.0	3.0	3.0	3.6
Provisions to Loans	1.0	0.3	1.6	0.5	1.0	1.0	1.7
Loans to Total Assets	63.7	71.4	69.3	66.4	63.5	57.6	54.9
Liquid Assets to Total Assets	31.9	26.6	30.1	32.7	34.7	39.5	40.8
Non-Earning Assets/Total Assets	4.7	4.1	5.2	7.2	6.7	8.8	8.0
(Liquid Asses-ST Payables)/Total Dep.	34.7	31.4	35.5	38.5	40.4	45.6	47.2

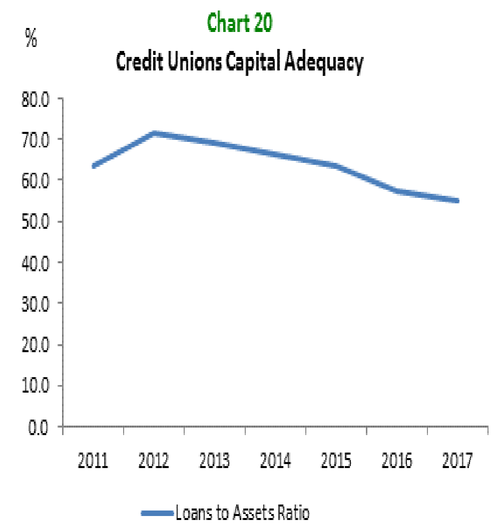
Source: Central Bank of The Bahamas

4.2. Capital Adequacy

During the review period, credit unions' capital ratio remained just above the 10.0% international PEARLS benchmark. The level of total capital & surplus resources—held to cover unexpected losses—rose by 5.0% to $47.4 million at end-2017. Further, the ratio of total equity[5] to total assets (the gearing ratio) was slightly lower at 11.3%, compared to 11.4% in 2016, as the 6.3% gain in total assets, outstripped the 5.1% expansion in the capital stock.



Source: Central Bank of The Bahamas



Source: Central Bank of The Bahamas

4.3. Asset Quality

Credit unions' total impaired loans[6] increased by 8.6% ($2.3 million) to an estimated $29.2 million in 2017, vis-à-vis an 11.8% reduction in the previous year. Correspondingly, the ratio of impaired to total loans firmed to 12.6% from 11.8% in the preceding year. In terms of the components, the short-term (90 days and under) segment—which comprised 10.8% of the total—grew sharply by 61.6% to $3.1 million, after a 29.0% decline in the prior year. In contrast, arrears in excess of 90 days fell by 5.9% to $20.8 million, albeit lower than the 8.1% reduction last year.

With the deterioration in loan delinquencies, the value of collateral against impaired credit rose by 29.4% ($3.3 million) to $14.7 million, exceeding the 11.2% growth in 2016. Meanwhile, credit unions' uncollateralized exposures declined by 6.6% ($1.0 million) to $14.5 million. In spite of the rise in delinquencies, total provisions for loan losses contracted by 25.0% ($2.5 million) to $7.4 million, reflecting a reduction in one entity's provisions. Nevertheless, the ratio of provisions-to-total loans firmed by 70 basis points to 1.7%, while the coverage ratio to short-term arrears and NPLs held steady at 35.0%, and 100.0%, respectively.

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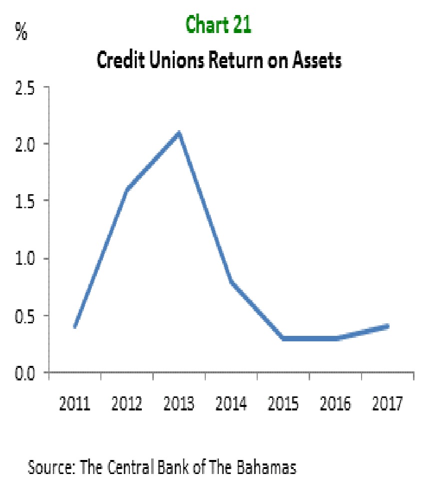
[5] Total equity is equivalent to capital & surplus resources and includes members' capital, institutional capital and the reserve fund.

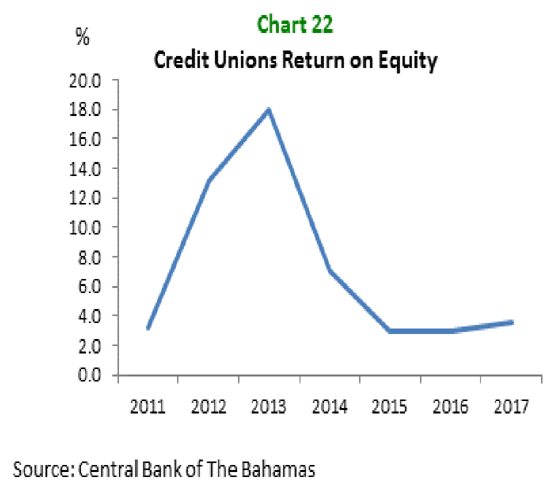
[6] An impaired loan is defined as one in which the full amount of principal or interest due is not collected on time, according to the contractual terms of the loan agreement.

The value of non-earning assets—which included land, buildings, vehicles, furniture and cash—decreased by 4.1% ($1.4 million) to $33.4 million, a turnaround from the prior year's expansion of 39.4%. As a result, the balance shares of these assets narrowed by 80 basis points to 8.0%, remaining above the prudential ceiling of 5.0%.

4.4. Profitability

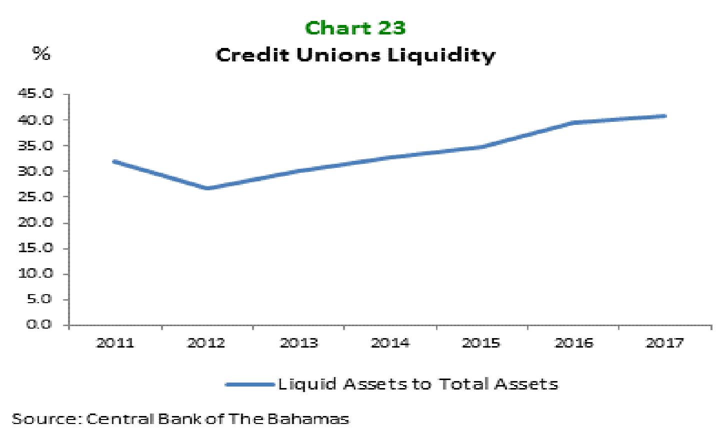
Buoyed by a rise in the gross earnings margin—after subtracting provisions for loan losses—combined with gains in other "miscellaneous" income, the sector's overall profits increased by 26.7% ($0.4 million) to an estimated $1.7 million in 2017, following a 4.6% gain in the prior year. As a consequence, both the return on assets ratio (ROA) and return on equity ratio (ROE), firmed by 10 and 60 basis points to 0.4% and 3.6%, respectively.





4.5. Liquidity

During 2017, credit unions' liquidity stayed relatively robust, owing in large measure to a sharp 73.7% growth in short-term financial investments, which outweighed the 16.4% reduction in cash balances. Consequently, the ratio of liquid assets-to-total assets firmed by 1.3 percentage points to 40.8%, year-on-year. Similarly, the alternative indicator, the ratio of short-term payables to total deposits, rose by 1.6 percentage points to 47.2% at end-2017. Both ratios exceeded the minimum prudential standard of 15.0%.



CHAPTER 5: THE INSURANCE SECTOR

The domestic insurance sector remained a small, but growing part of the financial landscape. From a financial stability perspective the industry is very important, given the vulnerability of The Bahamas to severe storms, which can cause significant devastation and disruption to the productive sectors of the economy. In this regard, the fact that the domestic non-life companies obtain reinsurance services from large overseas entities, helps to mitigate the country's weather-related financial risk exposure. Moreover, given the conservative nature of the insurance business domestically, with its focus on long-term stable investments, such as Government bonds, there have been no major concerns relating to the stability of the sector[7].

Data from the Insurance Commission of The Bahamas (ICB), revealed that the sector added one new company during the year, bringing the total to 30 at end-2017. The companies included 11 life and health insurers, offering whole life, term life and universal life, and 19 non-life insurers, providing, *inter alia*, insurance for automobiles, fire, liability and property. The sector continued to be dominated by a few large firms—4 life insurers and 6 non-life insurers—capturing a combined market share of approximately 80% of total gross premiums written and the majority of insurance coverage.

Registered under the External Insurance Act[8], the external insurance sector mainly provides self-insurance coverage for non-resident entities in other countries. In 2017, it consisted of 169 entities, of which 20 were insurance companies and 149 were captive cells. Importantly, by virtue of the external insurers' core overseas focused operations, they have a minimal impact on the stability of the domestic insurance sector; indeed their main impact on the domestic economy is via employment and fees charged by local service providers. Therefore, the domestic insurance sector will be the focal point of this analysis.

The domestic insurance sector sustained its significance in terms of the size of the economy, as shown by a penetration ratio (total gross premiums to GDP[9]), of an estimated 5.6% in 2017, albeit lower than the 6.4% registered in the preceding year. The non-life insurance sector recorded a profit, following an operating loss in 2016, which was related to the rise in claims from the passage of Hurricane Matthew. However, profits for the dominant life insurance segment declined, attributed to an increase in total expenses. Nevertheless, on average, the sector remained financially sound, as shown by the adequacy of its financial stability indicators.

5.1 Life Insurance

Life insurance companies comprise the dominant segment of the market, accounting for 72.1% of aggregate assets and 66.1% of gross premiums. According to provisional data, life insurers' total assets edged-up by 0.5% ($7.0 million) to $1.4 billion, owing in large measure to gains in cash & deposits—the most liquid asset category—of 27.9% to $237.4 million. Also noteworthy, total investments declined by 2.3% to $950.4 million—representing approximately 69.3% of the total—reflecting a 5.0% reduction in investments and claims on the private sector to $463.1 million, which outstripped the 0.4% uptick in the

[7] The last major bankruptcy of an insurance company occurred in 2008, when the local branch of the Trinidadian-based company Colonial Life Insurance Company Ltd. (CLICO), was placed in liquidation; however at the time, its assets amounted to a mere 7.0% of the total for the industry.
[8] See website: **http://www.icb.gov.bs/home**
[9] Based on the Department of Statistics' Estimates for GDP, April 2018.

holdings of Government securities to $487.3 million. On the funding side, liabilities rose by 1.0% ($9.6 million) to $968.1 million, comprising mainly of technical reserves to finance policyholders' claims and future benefits. In addition, aggregate equity levels expanded by 1.2% to $404.3 million, explained by gains in retained profits and shareholders' investments. In contrast, other "miscellaneous" reserves were reduced markedly by 62.1% to $26.0 million.

With regard to earnings, the estimated net income of domestic insurers decreased by 13.7% to $37.3 million. Underlying this outturn was a 4.2% expansion in total expenses to $425.8 million, which eclipsed the 2.5% growth in aggregate income to $463.1 million. Correspondingly, the expense ratio rose by 5.8 percentage points to 35.3%. Meanwhile, the investment yield ratio firmed by 1.2 percentage points to 6.8%, as the accumulation in investment income outpaced the decline in the value of investment assets. The return on equity (ROE) and return on assets (ROA) ratios narrowed by 1.6 and 0.5 percentage points to 9.2% and 2.7%, respectively.

The financial soundness indicators for the life insurance industry registered mixed performances in 2017; although they remained above international benchmarks. As a measure of the level of liquidity of insurance companies, the ratio of real estate plus unquoted equities and receivables to total assets, softened by 2.1 percentage points to 15.3% (Table 7). Similarly, the real estate-to-total assets ratio narrowed slightly by 10 basis points to 6.4% and equities as a proportion of total assets—which are considered relatively higher risk—declined by 80 basis points to 5.2%. With regard to capital ratios, the net premium-to-capital ratio moved lower by 1.0 percentage point to 98.5%, while the capital-to-total assets ratio increased by 20 basis points to 29.5%. The capital-to-technical reserves ratio also widened by 90 basis points to 48.9%, remaining above the international benchmark of 7.0%-10.0%.

Table 7

Life Insurance: Financial Soundness Indicators (%)

	2011	2012	2013	2014	2015	2016	2017p
Capital Adequacy							
Capital/Total Assets	26.2	26.2	29.1	29.8	29.5	29.3	29.5
Capital/Technical Reserves	40.1	41.2	46.5	48.3	48.9	48.0	48.9
Net Premium/Capital	128.5	119.0	106.7	104.5	104.2	99.5	98.5
Asset Quality							
(Real Estate + unquoted equities + receivables)/Total Assets	16.4	16.3	14.2	14.4	14.8	17.4	15.3
Equities/Total Assets	5.1	5.0	6.5	6.4	6.3	6.0	5.2
Real Estates/Total Assets	7.6	7.3	7.6	7.2	6.8	6.5	6.4
Earnings & Profitability							
Expense Ratio (expense/net premium)	31.4	31.0	30.0	29.3	29.6	29.5	35.3
Investment Yield (investment income/investment assets)	7.3	6.7	6.1	6.4	6.3	5.6	6.8
Return on Equity (ROE)	10.9	12.5	11.5	12.2	11.6	10.8	9.2
Return on Assets (ROA)	2.9	3.3	3.4	3.6	3.4	3.2	2.7

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

p = provisional

5.2. Non-Life Insurance

Non-life insurers' assets reverted back to trend in 2017, contracting by 43.6% ($409.6 million) to $530.4 million, as re-insurance recoveries decreased markedly, by 44.1% to $245.5 million, following a significant temporary increase in 2016, when outstanding claims were paid to policy holders who were affected by Hurricane Matthew. In addition, total investments fell by 15.5% to $88.1 million, as holdings of non-listed corporate entity securities were reduced to negligible levels and corporate securities contracted. Further, holdings of corporate equity-listed securities, investments in mutual funds and Government securities decreased during the review year. In contrast, investments in property, other "miscellaneous" investments and preference shares expanded. The sector's total liabilities contracted markedly by 52.2% ($386.3 million) to $353.6 million, explained by significant reductions in both technical reserves and other "miscellaneous" liabilities to $298.9 million and $54.7 million, from $618.2 million and $121.6 million, respectively, in prior period, related to hurricane claims. Moreover, balance sheet equity measures declined broadly by 11.6% to $176.8 million.

With regards to earnings, non-life insurance companies recorded an estimated net income of $9.8 million, versus a net loss of $7.6 million in 2016, which was due to a significant rise in hurricane-related claims. This outturn reflected a 44.7% reduction in total expenses to $67.5 million, combined with a 32.4% falloff in total revenue to $77.3 million.

As a result of these developments, the majority of the financial soundness indicators for the non-life insurance sector registered improvements over the review year. A breakdown by asset, showed that the equities to total assets ratio firmed by 1.0 percentage point to 4.1%. In addition, given the reversal in the sector's operations to a net profit from a net loss in the prior period, the majority of the earnings indicators improved. Specifically, both the ROA and the ROE ratios recorded positive values, of 1.9% and 5.6%, in contrast to negative 0.8% and 3.8%, respectively, in the previous year. Further, the loss ratio—which measures whether net claims paid-out exceed net premiums collected—narrowed to 28.9% from 55.7% in the prior period. However, the expense ratio edged-up by 60 basis points to 66.9%, while the investment yield ratio decreased by 5.2 percentage points to 4.4% (Table 8).

Table 8

Non-Life Insurance: Financial Soundness Indicators (%)

	2011	2012	2013	2014	2015	2016	2017p
Asset Quality							
(Real Estate + unquoted equities + receivables)/Total Assets	56.9	58.4	51.2	51.2	52.5	72.7	65.2
Reinsurance and Technical Reserves							
Risk Retention Ratio (net premiums /total gross premiums)	29.2	33.9	34.2	33.2	31.8	32.2	30.7
Technical Reserves/Net Claims	554.1	500.0	471.6	720.1	693.6	1110.5	1468.3
Technical Reserves/Net Premiums	207.3	188.9	166.7	191.1	210.0	618.2	424.0
Earnings & Profitability							
Expense Ratio (expense/net premium)	63.8	63.7	55.7	61.9	62.8	66.3	66.9
Loss Ratio (net claims/net premium)	37.4	37.8	35.4	26.5	30.3	55.7	28.9
Investment Yield (investment income/investment assets)	11.1	7.6	9.8	7.6	7.0	9.6	4.4
Investment income/net premium	8.4	4.7	6.2	6.1	7.0	10.0	5.6
Return on Equity (ROE)	4.5	6.4	12.9	12.9	8.9	-3.8	5.6
Return on Assets (ROA)	1.7	2.4	5.4	5.3	4.0	-0.8	1.9

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

p= provisional

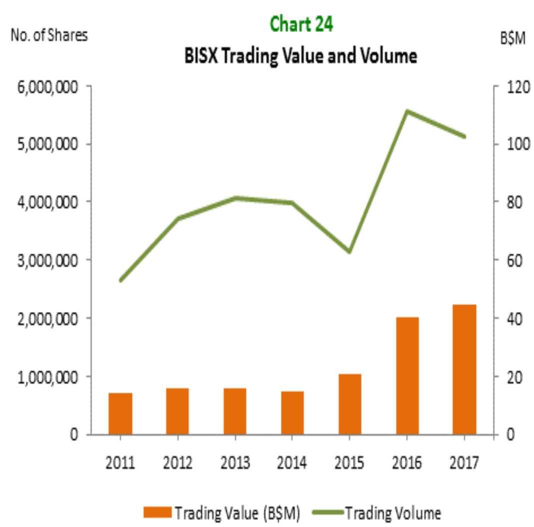
Reinsurance ratios generally reflect the appropriateness of risk-minimizing policies in relation to negative events. In 2017, the risk retention ratio[10] narrowed by 1.5 percentage points to 30.7%, while the ratio of capital to technical reserves returned to trend, falling to 169.0% after a sharp hurricane-related increase to 309.0% in 2016, as the decline in net claims outweighed the reduction in technical reserves. Further, the technical reserves to net premiums ratio lessened to 424.0% from 618.2% in the prior year. Notwithstanding, the sector continued to hold sufficient reserves to mitigate against the risk of adverse shocks.

[10] This ratio examines the relationship between net premiums written and gross premium written.

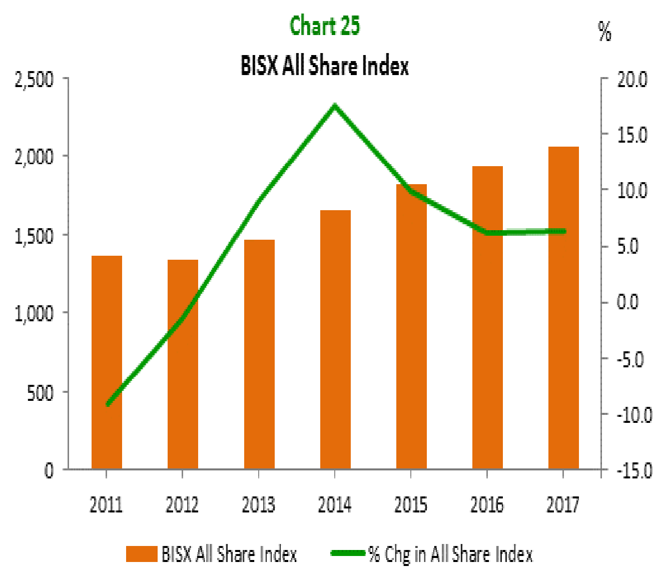
CHAPTER 6: CAPITAL MARKETS

At present, there are no financial stability concerns associated with the domestic capital market. The market forms a small but important part of the financial landscape of the country, representing mainly locally listed companies and the majority of the transactions are executed by resident entities. Minimal opportunities exist for investments using leverage, and non-resident flows are effectively prevented by exchange controls. As the market continues to develop, pricing volatility is also not a significant concern, as investors generally adopt a buy and hold strategy.

During the year, the performance indicators for the local equity market were positive, reflecting the improving economic environment. Specifically, the value of securities traded on BISX rose by 11.3% to $44.6 million; although the aggregate volume of shares traded fell by 7.6% to 5.1 million.



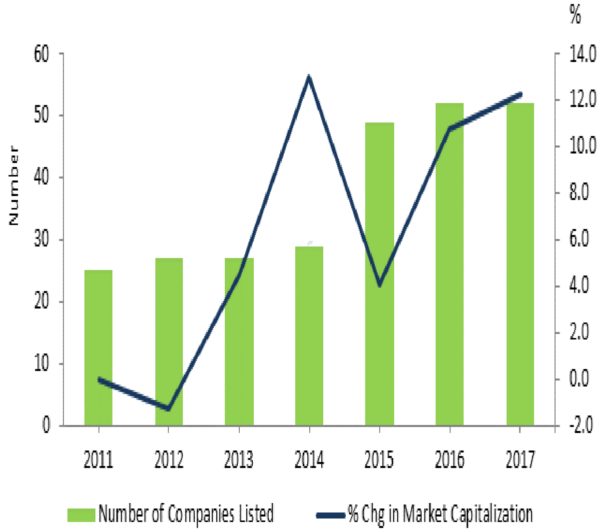
Source: Central Bank of The Bahamas & BISX



Source: Central Bank of The Bahamas & BISX

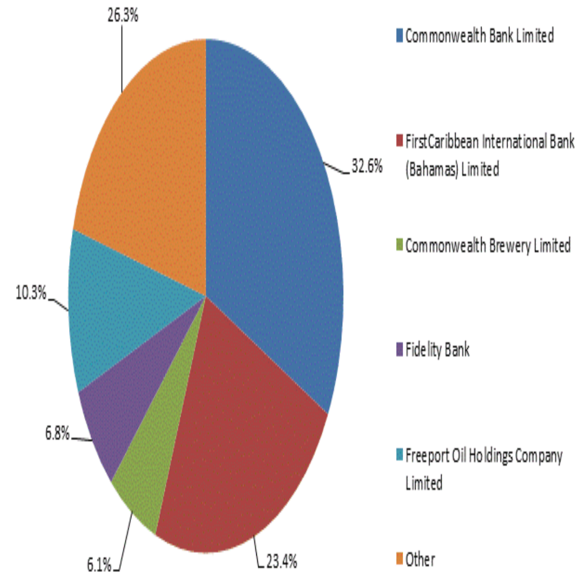
Similarly, in 2017, market capitalization rose by 12.3% to $4.4 billion, surpassing the previous year's 10.8% expansion. The number of securities listed on the Exchange remained at 52 and consisted of 20 ordinary shares, 13 preference shares and 19 debt tranches. The five largest companies listed on the exchange accounted for a dominant 79.2% of the index's total market capitalization, higher than the 68.4% recorded in the prior year.

Chart 26
BISX Performance Indicators



Source: Central Bank of The Bahamas & BISX

Chart 27
Share of Total Market Capitalization at End-December 2017



Source: Central Bank of The Bahamas & BISX

CHAPTER 7: PAYMENT SYSTEMS

The domestic payment system continued to evolve positively over the review period. Banks continued the process of replacing strip-based credit and debit cards with more secure chip-enabled cards, while other smaller payment providers sustained their efforts to implement new technologies to, *inter alia,* reduce transaction times and increase the level of convenience for their customers.

With the increased use of electronic-based transactions, cash and cheques have been on a declining trend. In this context, during the year the Payment Instruments (Oversight) Regulations, 2017, and corresponding General Information and Application Guidelines for Providers of Electronic Retail Payments Instruments and Electronic Money Products, were approved by the Government in July, 2017. It is anticipated that non-bank entities will avail themselves of the opportunity to offer these services, especially in the Family Islands, where several commercial banks have either reduced or eliminated their operations.

In terms of the structure of the payments environment in the country, the largest transactions (those greater than $150,000) are sent via the Central Bank-owned Real Time Gross Settlement System (RTGS), while smaller transactions utilize the Bahamas Automated Clearing House Association (BACH), which is owned by the clearing banks. Both of these systems have witnessed an increase in transaction volumes and values over the last six (6) years, and in 2017, RTGS and BACH payments totaled $29.3 billion and $2.8 billion, respectively. Other electronic-based payment instruments, namely debit cards, noted a significant increase in transaction value by 18.0% to $1.6 billion; however, the value of credit card transactions declined marginally by 0.5% to $254.9 million.

CHAPTER 8: REGULATORY AND SUPERVISORY DEVELOPMENTS

In the context of monitoring and mitigating the risks to the financial sector, the Central Bank, via its Supervision Department, remained focused on strengthening the regulatory environment by closing gaps identified in its risk and compliance systems. Consequently, the concept of "evergreening" was introduced to enhance its risk assessment process. This particular framework is expected to utilize the most essential supervisory tools, based on the scale and direction of emerging risks, while also rejuvenating the Bank's point in time risk assessment of financial institutions. In 2018, the Bank intends to adjust the evergreening cycle of its SFIs in undertaking a full/simplified risk assessment. Specifically, the Bank plans to move from its 18-month to 3-year cycle to a 3 to 5-year cycle. As a further degree of risk mitigation, newly licensed institutions will be required to complete a full/simplified risk assessment, following the first year of receiving their license.

In addition, as at January 1 2018, the Bank Supervision Department advanced from its intermittent examination of AML/CFT risks, to ongoing supervision of these risks, in order to address gaps identified in the Caribbean Financial Action Task Force's (CFATF) Mutual Evaluation Report for The Bahamas. Several major initiatives have commenced associated with the move to ongoing supervision. In particular, supervisory job descriptions and business practices have been updated, to ensure that SFIs are supervised both to reduce their risk of financial failure, and to decrease their risk of facilitating financial crime. In addition, all SFIs have been extensively surveyed on AML/CFT risks, and all 80 relevant SFIs have been explicitly risk-rated on AML/CFT risk, in addition to their extant ratings for financial failure risk. The Bank's new Analytics Unit also includes a team devoted exclusively to AML/CFT data compilation and Financial Data Analytics. Although prudential supervision will continue to be a key driver, the new Analytics Unit has been clearly mandated by the Bank to enhance its AML/CFT supervisory framework and provide continuous supervision of both financial stability and AML/CFT risks.

Moreover, the Government and the Central Bank are spearheading extensive reforms to legislation, regulation, and guidance material relevant to AML/CFT risk management. These reforms are expected to encourage stronger AML/CFT risk management practices by SFIs, and therefore provide better protection to the Bahamian financial system.

On correspondent banking, the AML/CFT supervisory reforms are supported by other initiatives to reduce near and long-term vulnerabilities. As mentioned earlier, as a precautionary measure all Central Bank SFIs are required maintain two relationships at all times. Addressing the national risk profile for illicit financial transactions also focuses on reducing the prevalence of the use of cash in the economy through increased use of digital payments, and as part of broader financial inclusion initiatives, less onerous requirements to open accounts for low-risk persons in the population. The Bank's digital currency project, will also promote these goals, with the targeted digital national identity system satisfying important KYC and other due diligence needs of the financial sector.

On the macro-prudential side, the Central Bank is also focused on reducing vulnerabilities. This includes the requirement for more aggressive resolutions of commercial bank's NPL exposure, before another recession is encountered. A gradual extinguishing of excess bank liquidity is also a medium term objective, to remove some of these resources to prevent unsustainable credit growth, and foreign exchange leakages. The capital levels of commercial banks also warrant some managed reduction over the medium-term, to keep the pressure off institutions to engage in risky lending behavior. For credit unions, sector confidence will be enhanced by their inclusion in the Deposit Insurance Scheme; however, corresponding emphasis is also being placed on strengthening balance sheet ratios.

Also of prudential significance, renewed progress is being made towards the establishment of a credit bureau[11], and in this regard, a new Request for Proposal (RFP) for a Credit Bureau operator was issued in 2018. It is expected that once the bureau becomes operational, it would provide significant assistance to banks in assessing customers' credit risk exposures, thereby mitigating future incidences of high non-performing loans.

Overall, the ultimate goal of the Bank is to ensure that the financial system remains sound by introducing policies geared towards fostering stability, by promoting best practices, while at the same time encouraging sustainable economic growth.

[11] The Credit Reporting Act was passed by Parliament in February, 2018.

CHAPTER 9: CONCLUSION

Overall, the domestic financial system remains stable, albeit with risks that must be managed and reduced. In addition to the Central Bank's initiatives, the insurance sector provides the next vital link to domestic financial stability. In particular, although the country is predisposed to hurricanes, the existence of re-insurance supports the favourable position. Again, the improving economic climate favours prospects for the insurance sector.

In the mix, maintaining credible levels of foreign reserves to support the fixed Bahamian dollar exchange rate, anchors financial stability. The external demand drivers include the pace of exchange control liberalization, the speed of drawdown in bank liquidity for credit expansion and the medium-term pace of fiscal consolidation, while the foreign exchange sources relate predominately to the tourism and foreign investment sectors. In this regard, the Bank will sustain its efforts to provide the balance between the growth in the sources of foreign exchange and the demand for such usage.

THE CENTRAL BANK OF THE BAHAMAS