Financial Stability Update
August 2012

CENTRAL BANK OF BARBADOS

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Abbreviations

Abbreviation	Meaning
GDP	Gross Domestic Product
NPL	Non-performing Loan
MLFT	Money Laundering and Financing of Terrorism
AML/CFT	Anti-Money Laundering/Combating Terrorist Financing

Preface

This is the first update of the Central Bank of Barbados' Financial Stability Report, produced in collaboration with the Financial Services Commission (FSC). The Central Bank and the FSC are jointly responsible for the continuous oversight of the financial system, to assess vulnerabilities and to initiate policies to increase the resilience of the system in the face of possible adverse events. The Central Bank's Financial Stability Unit works with the FSC's staff to ensure that the assessment of risk exposures covers the activities of banks, international banks, insurance companies, international insurance and reinsurance companies, nonbank deposit taking financial institutions, credit unions, the activities of the Barbados Securities Exchange and issues and redemptions of government securities. This update analyses a range of financial stability indicators for banks and other financial institutions, as well as balance sheet and income and expenditure trends. For the banking system, financial forecasts are used to project a baseline of expectations for capital adequacy and the quality of credit. Stress tests are applied to the baseline, progressively increasing the pressure until capital adequacy falls below the eight percent minimum which the Central Bank stipulates. Progressive stress tests are also used to test for possible contagion among banks, and from banks' exposures to financial institutions abroad.

This FSR will appear in December each year, and will, like most of the Central Bank's publications, be published exclusively online. In June of each year the Central Bank will publish an update on the December FSR.

Financial Stability Update August 2012

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Financial Stability Update

(September 2011 to March 2012)

1. Overview

The principal impact of the weak economic environment on the Barbadian financial sector continues to be anaemic loan growth across the sector. Commercial banks and other deposit taking institutions remained profitable and well capitalised, although there continues to be some deterioration in credit quality. In response to the increase in credit risk since the onset of the crisis, banks have increased the level of provisioning, enhancing their capital buffer as a result. The major insurance companies were generally profitable although there was only modest growth in their Barbadian-based business.

The regulatory and supervisory framework was enhanced by the passage of the Anti-Money Laundering and Financing of Terrorism (Prevention and Control) Act 2011-23 in November 2011, while the Central Bank issued new policy guidelines on its intervention policy and on the management of credit risk. (See Box 1.)

Box 1: Updated Guidelines on Intervention and Credit Risk Management

On March 30, 2012 the Central Bank of Barbados published new policy guidelines for intervention and credit risk management, as well as revisions to the previously issued Anti-Money laundering Guidelines pursuant to the recently passed Money Laundering and Financing of Terrorism (Prevention and Control) (MLFT) Act 2011-23.

Intervention Policy Guideline

This guideline provides the broad framework for intervention by the Bank, when there are concerns about the operations of licensees or the non-compliance by licensees with applicable legislation, regulations, guidelines or any other directive issued by the Bank.

Credit Risk Management Guideline

This guideline applies to those entities licensed under the Financial Institutions Act 1996-16 and the International Financial Services Act 2002-5 that are undertaking business activities resulting in credit risk. It provides licensees with guidance on the obligations arising from managing exposure to credit risk, emphasising adherence to minimum standards as they relate to lending and other sources of credit risk, including those involved in investment management.

Revised Anti-Money Laundering/Combating Terrorist Financing (AML/CFT) Guideline

The revisions were issued as a collaborative effort of the Bank and the Anti-Money Laundering Authority to reflect the changes in the Money Laundering and Financing of Terrorism (MLFT) (Prevention and Control) Act 2010, replacing the previous 2006 Know Your Customer Guidelines. The guideline contains both advisory and obligatory requirements and sets out the minimum standards for best practice by licensees. Furthermore, it represents, together with the new MLFT Act 2011, an integral part of the framework used by the Bank in the assessment of the manner in which licensees implement AML/CFT policies. Section 22 of the MLFT Act 2011 mandates licensees to comply with this guideline.

See http://www.centralbank.org.bb

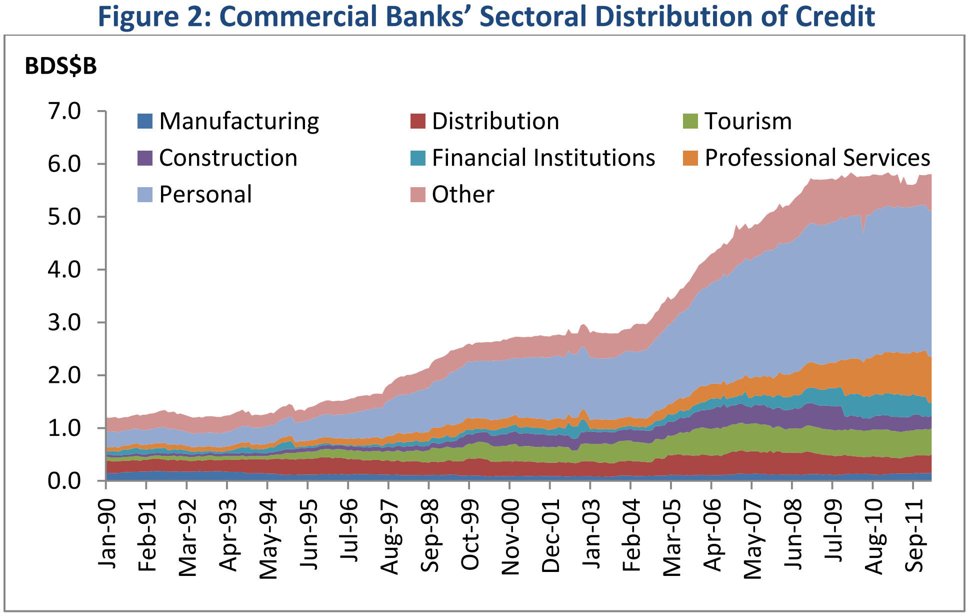
2. Commercial Banks

There has been no overall growth in commercial bank lending to the non-financial private sector since September 2011. Residential mortgages, which comprise about half of all personal loans, grew by 6.5 percent over the past year, but loans and advances to firms in Tourism and Construction fell by 2.4 percent and 8.7 percent, respectively (Figure 1). Credit card debt fell by about one percent since September 2011. The majority of commercial banks' credit continues to be concentrated in the Personal sector, which accounts for almost half of total loans outstanding (Figure 2). Loans to the Professional services are the second largest component of total credit.

Figure 1: Credit Growth to Selected Economic Sectors

Source: Central Bank of Barbados

Figure 2: Commercial Banks' Sectoral Distribution of Credit

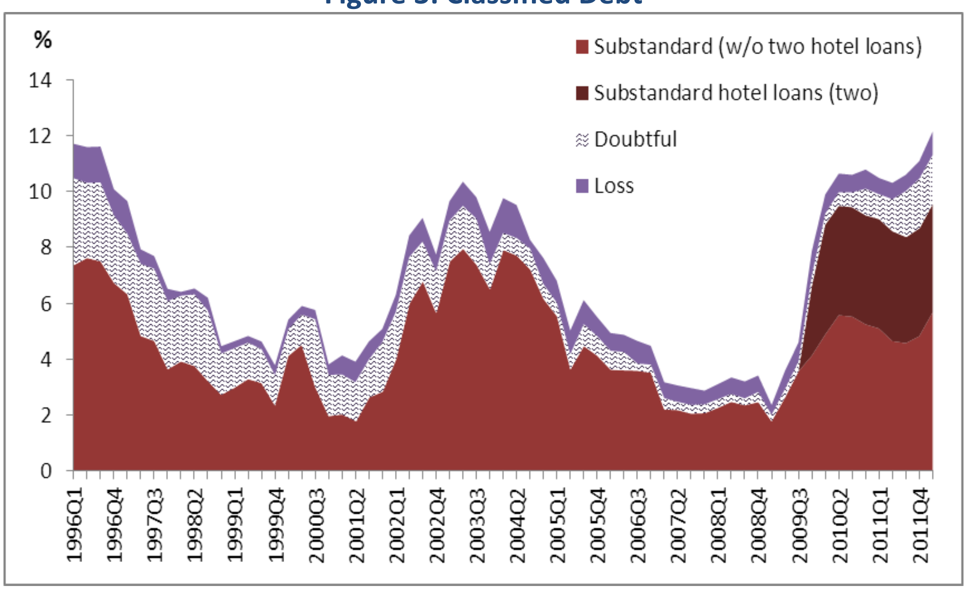


Source: Central Bank of Barbados

The amount outstanding on two large impaired tourism loans increased by about $4 million since the third quarter of 2011. Apart from these loans, the ratio of nonperforming loans (NPLs) to total loans of commercial banks moved from 6.8 percent to 8.3 percent between September 2011 and March 2012. Hotels, restaurants, construction firms and households together accounted for 86 percent of the increase in non-performing loans.

Most of the classified debt remains in the substandard category (an amount equivalent to 9.5 percent of total loans), but there have been increases in the doubtful and loss categories, which account for 1.8 percent and 0.8 percent of total loans, respectively (Figure 3). At the end of September 2011, the distribution of NPLs stood at 79.0 percent, 15.5 percent and 5.5 percent for substandard, doubtful and loss debt respectively. However, while the share of substandard debt has remained constant, doubtful and loss loans now account for 14.6 percent and 6.9 percent of all non-performing loans as at March 2012.

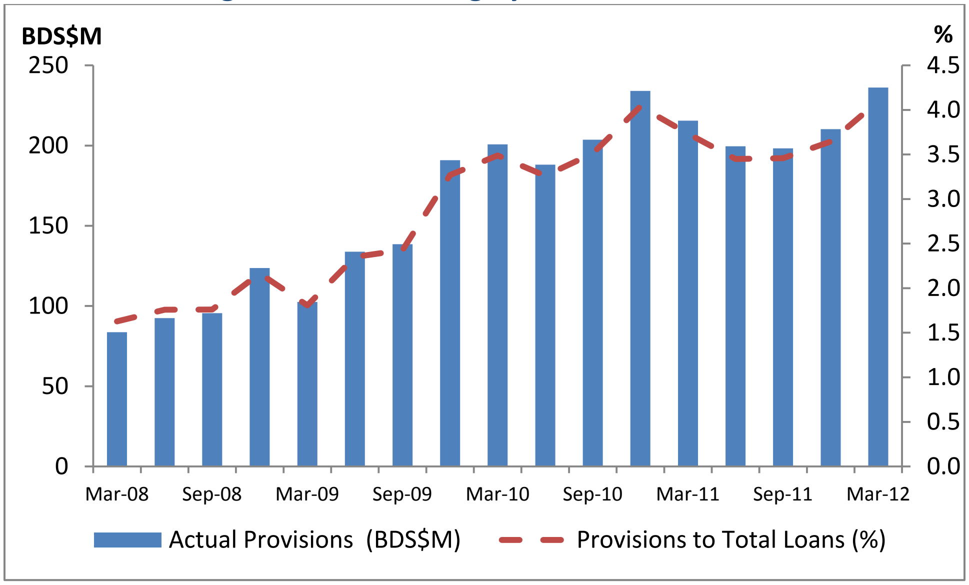
Figure 3: Classified Debt



Source: Central Bank of Barbados

Commercial banks made significant allocations to reserves held against delinquent loans (Figure 4). As a result, total capital adequacy ratio rose by 20 basis points to 19.5 percent.

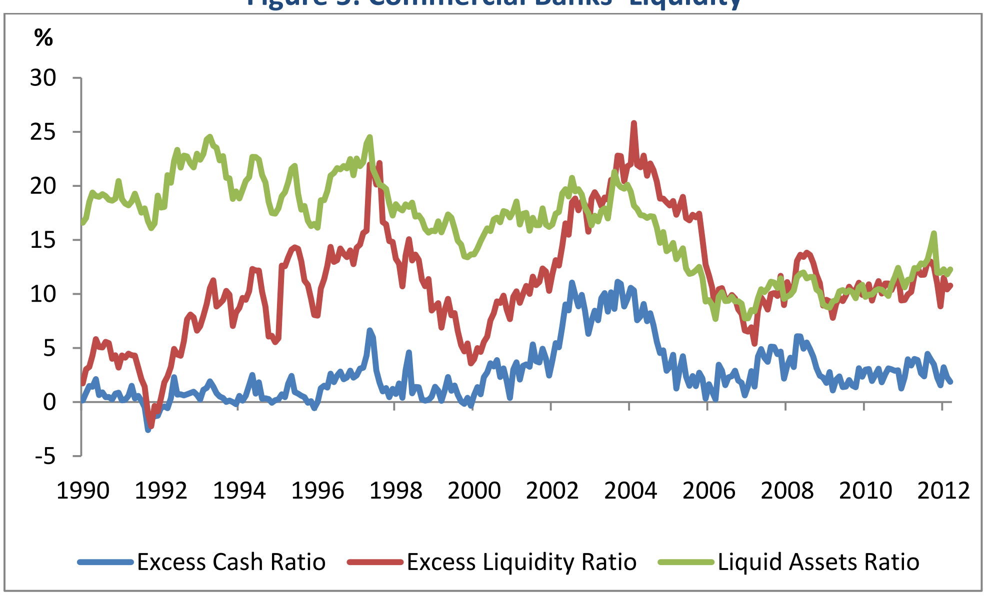
Figure 4: Provisioning by Commercial Banks



Source: Central Bank of Barbados

Commercial banks continued to be liquid, with holdings equivalent to 26 percent of domestic deposits, compared to the required minimum level of 15 percent (Figure 5). The bulk of the excess liquidity was held in the form of liquid Government securities.

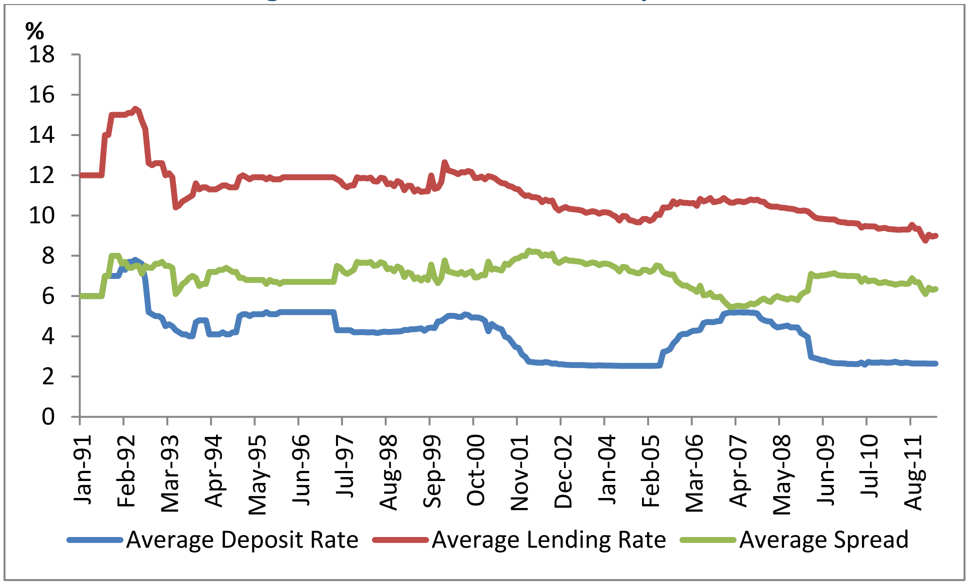
Figure 5: Commercial Banks' Liquidity



Source: Central Bank of Barbados

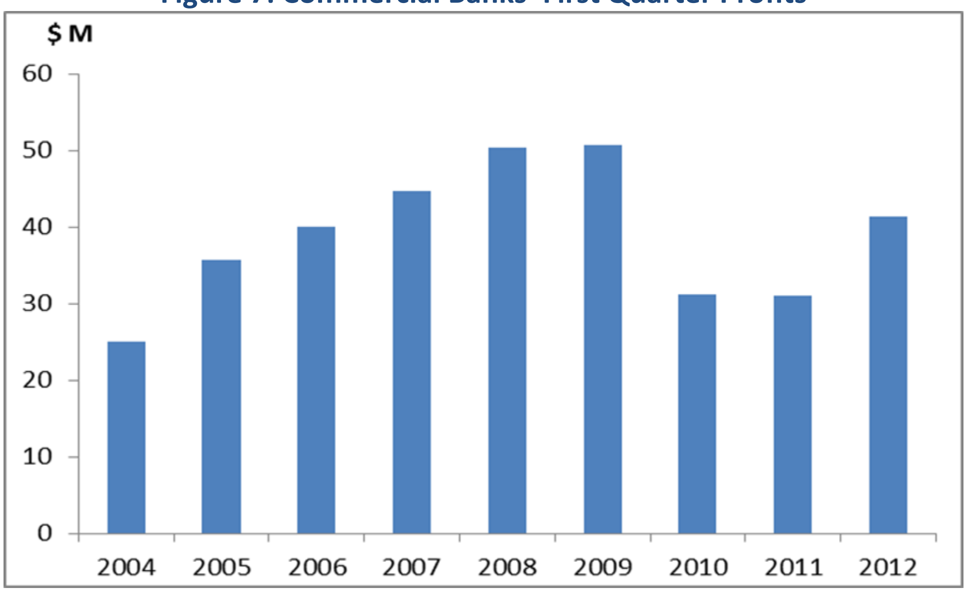
The spread between the average lending and deposit rate has drifted downward by 34 basis points since September 2011 (Figure 6), primarily due to a reduction in the average lending rate. The average spread was 6.35 percent, compared with a range of 8.26 percent to 5.44 percent over the past two decades.

Figure 6: Commercial Banks' Spreads



Source: Central Bank of Barbados

Figure 7: Commercial Banks' First Quarter Profits

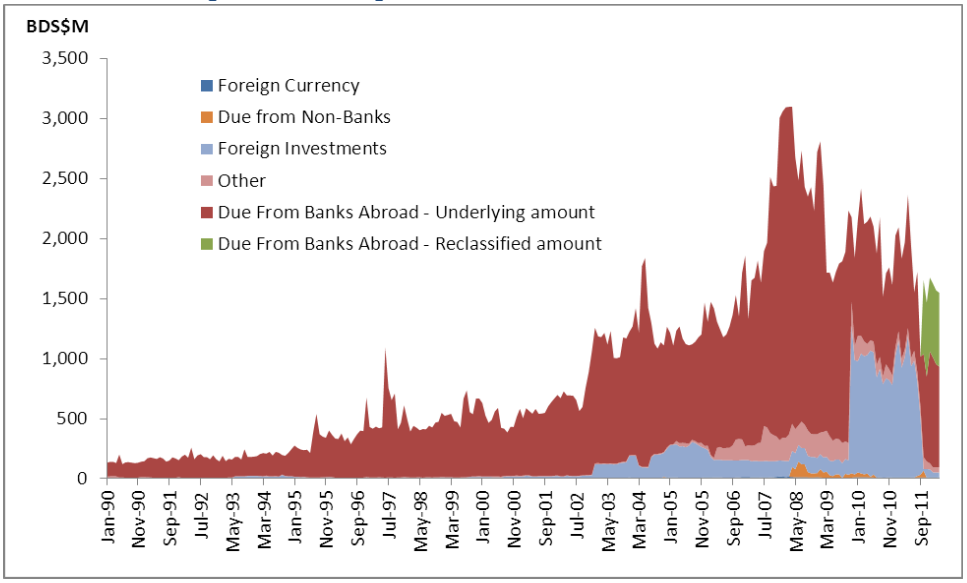


Source: Central Bank of Barbados

The banking industry remained profitable over the first quarter of 2012 (Figure 7). The annualized rate of return on assets and rate of return on equity were 1.6 percent and 7.6 percent, respectively, compared with an average return on equity of 9.5 percent and on assets of 1.1 percent, over the past 2 years. This was due to a 13 percent increase in interest income.

Outside of loans, banks' asset portfolios consist largely of Treasury bills. There has been no significant change in banks' foreign assets since September 2011 (Figure 8).

Figure 8: Foreign Assets of Commercial Banks



Source: Central Bank of Barbados

The parent companies of most banks remained well capitalised, and the country ratings of these parent companies remained within the investment grade category.

Table 1: Capital Adequacy and Rating of Parent

Domestic Bank	Majority Shareholder	Majority Shareholder Capital Adequacy (Tier 1-2011)	Majority Shareholder's Rating (Moody's)	Country Rating (Majority Shareholder) (Standards & Poor's)
Barbados National Bank	Republic Bank Ltd	30.6*	BBB+	A/Trinidad and Tobago
CIBC FirstCaribbean International Bank	CIBC	14.1	Aa2	AAA/Canada
Bank of Nova Scotia	Bank of Nova Scotia	12.2	Aa1	AAA/Canada
Royal Bank of Canada	Royal Bank of Canada	13.1	Aa1	AAA/Canada
Bank of Butterfield	Bank of Butterfield	17.7	Aa2	AA-/Bermuda
RBTT Ltd	Royal Bank of Canada	12.2	Aa1	AAA/Canada
Citibank Ltd	Citigroup Inc.	13.5**	A3	AA+/USA

* *Tier I & II capital adequacy; rating from Moody's*
** *2012 US Quarterly Financial Report*

Source: 2011 Annual Reports

Stress Testing (Credit & Liquidity)

Stress test simulations were done to examine the extent to which the existing capital buffers are able to withstand potential losses. The results suggest that banks are able to survive significant credit and liquidity shocks. Table 2 traces the impact of GDP shocks to NPLs taking account of feedback effects. In the case of only one bank, the capital adequacy ratio might fall below 8 percent if the economy contracted by 5 percent in 2012 and again in 2013. Capital adequacy in the banking system as a whole would remain above 8 percent unless the economy contracted by as much as 16 percent of GDP.

Table 2: Results of Macroeconomic Shocks to Non-performing Loans

Scenario	NPL 2012 (%)	NPL 2013 (%)	After Shock CAR Range (%)	Banks with CAR<8%
Baseline (GDP 0.5% 2012)	9.2% - 12.6%	7.2% - 10.6%	8.3% - 19.1%	0
Scenario 1 (GDP -5.0% 2012)	10.1% - 13.6%	10.5% - 13.9%	5.4% - 16.2%	1
Scenario 2 (GDP -8.0% 2012)	10.6% - 14.0%	12.0% - 15.5%	3.1% - 15.7%	1
Scenario 3 (GDP -10.7% 2012)	11.0% - 14.5%	13.6% - 17.0%	1.0% - 15.2%	1
Scenario 4 (GDP -16.0% 2012)	11.9% - 15.4%	16.6% - 20.1%	0.0% - 14.2%	1

Note: Based on simulations

Table 3 presents partial results based on cross-border exposures. The table shows the range of the capital adequacy ratios on the assumption that the foreign assets outstanding were lost in their entirety, and that this loss triggered deposit runs on domestic bank branches and subsidiaries. The impact on each domestic bank was examined to determine vulnerabilities that may arise from second and third round effects. In the first instance, "limited liquidity", the assumption is that runs on domestic deposits occur but banks have access to their parents' resources. The second assumption, "severely limited liquidity", is that bank runs are further complicated by the parent banks not intervening. The results show that banks are most exposed to the US and Canada. Furthermore, only under severe conditions, where banks experience extreme runs on their deposits and have no access to support from their respective head offices, is the domestic system compromised.

Table 3: Results of Default of Individual Banking Sectors and Groups

Shocks	After Shock CAR Range (%)	Banks with CAR<8%
Limited Liquidity*		
Europe	11.0% - 21.8%	-
Canada	6.4% - 21.1%	1
USA	0.0% - 17.3%	1
Caribbean Affiliates	9.7% - 21.8%	-
Global Affiliates	0.0% - 21.8%	2
Severely Limited Liquidity**		
Europe	11.0% - 21.8%	-
Canada	2.0% - 7.7%	6
USA	0.0% - 6.2%	6
Caribbean Affiliates	9.7% - 21.8%	-
Global Affiliates	0.0% - 21.8%	2

Notes: Based on simulations:

* *The Limited Liquidity scenario comprises an immediate run on banks as soon as one of its local counterparts fails;*

** *The Severely Limited Liquidity scenario assumes no access to funds held at head offices overseas when there is a run on local operations.*

3. Non-Bank Financial Institutions and Insurance Companies

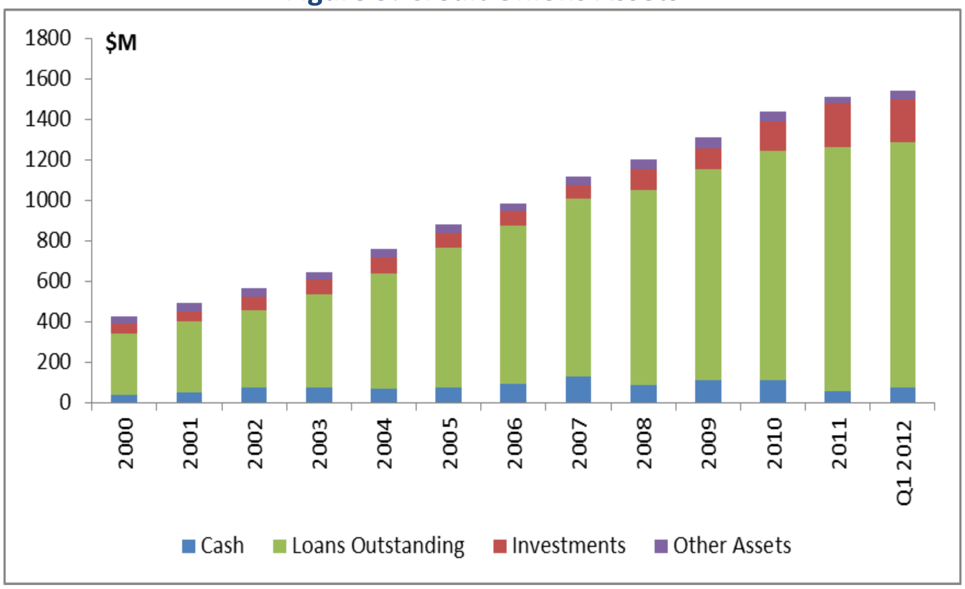
The NPL ratio for non-banks fell from 7.8 percent at September last year to 6.8 percent at March. The ratio of provisions to gross classified debt declined from 28.1 percent to 23.6 percent. The sub-sector recorded a 2.3 percent growth in average assets, and returns on assets and equity were 2.1 percent and 9.1 percent, respectively, in spite of declines in net interest income (1 percent) and non-interest income (22.8 percent). Liquidity remains very high at 56.5 percent of assets, and the capital adequacy ratio is above 14 percent.

The major publicly listed insurance companies in the Caribbean were all profitable over the first quarter of 2012. Sagicor Financial Corporation, the largest provider of insurance, recorded an increase in earnings to US 2.8 cents per share at the end of March 2012, compared to a loss of US 6.4 cents per share in the first quarter of 2011. The improved performance was as a result of the absence of extraordinary claims impacting the company's European business, which drove the 2011 outturn. Guardian Holdings Limited, the parent company of Guardian General Limited, reported a 16.7 percent increase in basic earnings to US 7 cents per share in the first quarter of 2012, with increased profitability across all segments of its business. However, the Insurance Corporation of Barbados reported a decline in the earnings per share to BDS 30 cents per share at the end of 2011, compared to BDS 37 cents per share at the end of 2010. The company noted the weak demand for insurance stemming from difficult economic conditions in 2011 as the primary cause of the reduction in its profitability.

4. Credit Unions

The rate of asset growth at credit unions has slowed to 5 percent, compared with an average of 7 percent for the five year period ending in 2008 (Figure 9).

Figure 9: Credit Unions Assets



Source: Financial Services Commission

Loan growth of only 0.5 percent lags the growth of deposits (2.3 percent), resulting in a build-up of liquidity, now at 5 percent of assets.

Non-performing loans at credit unions were 7.4 percent of all loans, a 0.4 percentage point reduction since September 2011. The provisions against loan loss stand at 77 percent, compared to the regulatory minimum of 100 percent[2]. However, both the net loans to total asset ratio (79 percent) and the member share capital to total asset ratio (13 percent), are in line with the international standards (70-80 percent and 10-20 percent, respectively).

[2]The regulatory guidelines for credit unions are to be found on http://www.woccu.org/financialinclusion/bestpractices/pearls/aboutpearls, the website of the World Council of Credit Unions. These prudential tests are commonly summarized by the acronym PEARLS, referring to Protection, Effective financial structure, Asset quality, Rates of return and cost, Liquidity and Signs of growth.

Appendix Tables

Appendix 1: Commercial Bank Key Financial Soundness Indicators

	2007	2008	2009	2010	2011	2011Q1	2012Q1
Solvency indicator							
Capital adequacy ratio (CAR)	16.4	16.1	17.5	17.1	19.3	18.1	19.5
Liquidity indicators							
Loan to deposit ratio (%)	56.0	64.0	66.0	67.0	70.4	63.8	71.3
Demand deposits to total deposits (%)	36.6	34.9	36.6	35.2	32.0	34.4	30.0
Liquid assets, % of total assets	9.5	9.0	10.8	11.5	12.0	11.4	12.3
Credit risk indicators							
Total assets (growth rate, %)	25.2	3.9	(5.4)	(1.5)	(4.7)	1.2	(8.0)
Loans and advances (growth rate, %)	8.1	11.9	2.7	0.6	(0.4)	0.8	0.5
Non-performing loans ratio (%)	2.9	3.5	7.9	10.8	11.1	10.5	12.1
Substandard loans/Total loans (%)	2.1	2.5	6.7	9.1	8.7	9.0	9.5
Doubtful loans/Total loans (%)	0.3	0.4	0.4	1.0	1.8	0.9	1.8
Loss loans/Total loans (%)	0.5	0.6	0.9	0.7	0.6	0.6	0.8
Provisions to non-performing loans (%)	52.4	60.1	43.6	37.4	32.9	35.6	33.7
Foreign exchange risk indicators							
Deposits in Foreign Exchange (% of total deposits)	18.9	14.8	13.3	13.6	6.6	14.2	4.5
Profitability indicators							
Return on Equity (ROE)*	19.3	17.3	15.8	12.3	6.7	11.5	7.6
Return on Assets (ROA)	1.8	1.4	1.6	1.2	1.0	1.1	1.6

*Source: Central Bank of Barbados; * Excludes branch operations*

Appendix 2: Non-bank Financial Institutions Selected Indicators

	2007	2008	2009	2010	2011	2011Q1	2012Q1
Solvency indicator							
Capital / Assets (%)	18.1	21.2	22.6	23.5	23.8	22.2	23.9
Liquidity indicators							
Loan to deposit ratio (%)	165.0	180.0	168.3	167.6	152.3	161.7	156.6
Demand deposits to total deposits (%)	34.5	25.0	22.4	29.0	23.0	28.1	27.7
Liquid assets/Short Term Liabilities (%)	67.4	54.7	46.7	52.8	77.4	56.7	56.5
Credit risk indicators							
Nonperforming loans ratio (%)	2.9	3.3	5.2	5.7	8.7	6.1	6.8
Substandard loans/Total loans (%)	2.6	3.0	4.8	5.2	7.4	5.5	5.9
Doubtful loans/Total loans (%)	0.2	0.1	0.1	0.1	0.7	0.1	0.2
Loss loans/Total loans (%)	0.2	0.2	0.3	0.3	0.6	0.4	0.6
Reserves to nonperforming loans (%)	18.3	21.2	16.2	14.5	17.0	16.0	23.6
Profitability indicators							
Net Income/Capital (%)	10.7	10.4	11.1	10.9	8.3	11.7	9.1
Return on Assets (ROA)	2	2.1	2.4	2.5	1.9	2.5	2.1

Source: Central Bank of Barbados

Appendix 3: Credit Unions Selected Indicators

	2007	2008	2009	2010	2011	2011Q1	2012Q1
Solvency Indicator							
Reserves to Total Liabilities (%)	9	9	9	8	8	8	8
Liquidity Indicators							
Loan to deposit ratio (%)	93	96	103	115	113	114	111
Liquid assets/Short Term Liabilities (%)	14	9	11	11	5	11	6
Credit risk Indicators							
Total assets, annual growth rate (%)	14	7	9	9.8	5	8.3	5
Loans, annual growth rate (%)	11	10	8	8.6	7	8.5	6
Nonperforming loans ratio (%)	6.4	5.2	6.5	7.2	7.0	7.0	7.4
Arrears 3 – 6 months/Total Loans (%)	2.1	1.6	2.1	2.1	1.9	1.9	2.0
Arrears 6 – 12 months/Total Loans (%)	1.8	1.3	1.8	1.9	1.7	1.8	1.7
Arrears 12 months & over/Total Loans (%)	2.5	2.3	2.7	3.2	3.4	3.3	3.7
Provisions to Total loans (%)	2.2	1.8	1.9	2.2	2.8	2.3	2.9
Profitability Indicator							
Return on Assets (ROA)	7	4	4	4	3	5	5

Source: Financial Services Commission