FSAP Financial Sector Assessment Program
A joint initiative of the World Bank and the IMF

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Barbados

FSA | Financial Sector Assessment

1. As part of the joint IMF-World Bank Financial Sector Assessment Program (FSAP), a mission visited Barbados during June 24 to July 12, 2002.[1] The principal objective of the mission was to assist the authorities in identifying potential vulnerabilities in the financial system that could have macroeconomic consequences and to identify measures to reduce these risks.[2] The mission also provided an assessment of the observance of international standards and codes in financial regulation and supervision as well as of the development needs of the financial system and its potential contribution to economic development. Preliminary results of the mission were discussed with the authorities during the IMF Article IV mission in October 2002.

A. OVERALL STABILITY AND DEVELOPMENT ASSESSMENT

2. **Systemic risks in the financial sector are generally contained but the sector faces considerable challenges both in the short- and medium-term**. Repercussions of the current economic slump, caused by the downturn in tourism, on the banking system are being felt, and profitability and asset quality are likely to remain depressed in the near-term. Aggregate financial soundness indicators, however, suggest that the system can withstand a moderate recession without major difficulties. Over the medium-term, financial integration under the Caribbean Single Market and Economy (CSME) framework will necessitate adaptations in domestic policies, prudential regulations, and monetary policy instruments, and the authorities would be well advised start preparing.

3. **Despite the small size of the economy and the domination of banks, the financial system in Barbados is quite sophisticated**. As in many other economies in the region, the system comprises both onshore and offshore activities. The onshore sector provides financial services for residents and has enjoyed stability and confidence in recent years. The offshore sector caters mostly to nonresidents outside the CARICOM area and has become an important contributor to economic activity. To preserve Barbados' reputation as a reputable financial center, the authorities have continued to adapt, modernize, and strengthen the supervision of the financial services industry. Off-shore banks are, to a large extent, insulated from the domestic banking system and their deposit-taking activities are highly circumscribed, thereby limiting their potential to destabilize the domestic financial system. Activities between onshore and offshore banks, for instance, require special permission by the Minister of Finance.

[1] The FSAP team was led by Messrs. S. Kal Wajid (IMF, Mission Chief) and Giovanni Majnoni (World Bank, Deputy Mission Chief) and was composed of Messrs. Robert Keppler, John McDowell, Craig Thorburn, Mss. Bikki Randhawa, Melinda A. Roth (all World Bank); Messrs. Tonny Lybek, Vassili Prokopenko, Mss. Ruby Randall, Massa Lansanah-Richardson (all IMF); and Messrs. Carlisle Procter (external expert, formerly with the Reserve Bank of Australia), Keith Bell (external expert, formerly with the Office of Superintendent of Financial Institutions, Canada), and Erik Huitfeldt (external legal expert).

[2] The FSAP team met with Dr. Marion Williams, Governor, Central Bank of Barbados (CBB); Mr. Grantley Smith, Director of Finance and Economic Affairs, Ministry of Finance; Sir Neville Nicholls, Chairman, Securities Commission; Mrs. Virginia Mapp, General Manager, Barbados Stock Exchange; Mr. Carlos A. Holder, Deputy Governor, CBB; Mr. Darcy Boyce, Deputy Governor, CBB; Mr. Harold Codrington, Adviser to the Governor, CBB; other staff of the CBB; Ms. Lynette Eastmond, Director of International Business, Ministry of Economic Development; Mr. Carlos Belgrave, Supervisor of Insurance, Ministry of Finance; Mr. Murray, Registrar of Cooperatives; Mr. Guyson Mayers, Financial Intelligence Unit; and representatives of commercial banks, external auditing firms, and other private sector institutions.

4. **Indicators of the health of the banking system and sensitivity analysis suggest that the system is resilient to external shocks**. Capital adequacy for the four locally incorporated banks is relatively high (18 percent of risk weighted assets) and all commercial banks reported profits in 2001. Although nonperforming loans increased in 2001, they accounted for 5 percent of total loans, with about half fully provisioned.

5. **However, the present regime of interest rate and exchange rate controls may weaken bank efficiency and may lead banks to underestimate their risk exposures.** It is important, therefore, to ensure the adequacy of prudential regulations regarding market risks as part of the process toward a gradual deregulation of interest rates. The present policy of stipulating a minimum savings rate introduces downward rigidity in interest rates. At the same time, the ceiling on the average lending rate, intended to reduce the intermediation spreads, may in effect restrain banks' lending and create an incentive for circumvention and compensation through increased level of fees and other charges. Policies to foster greater competition for loans under a liberalized regime of interest rates and capital flows could contribute to reducing the spreads and thereby increase financial intermediation.

6. **The rapid expansion of the credit union sector has introduced competitive pressures in the system and has widened households and small business' access to the credit market but at the cost of a deteriorating quality of credit unions' lending portfolio.** Credit unions represent now 10 percent of GDP in terms of assets and 7 percent in terms of loans. One fifth of outstanding loans, though, are classified as delinquent and their recovery may be affected by their concentration among lower income borrowers. In order to insure a close monitoring of the largest five credit unions, accounting for over 80 percent of total assets of the sector, the collaboration between the Registrar of Cooperatives and the CBB has been intensified with a program of joint inspections.

7. **The insurance sector is quite dynamic and has shown good profitability and a capacity to expand operations in other countries in the region, but the regulatory and supervisory framework continues to exhibit serious weaknesses**. Limited diversification opportunities in the saturated domestic market have induced insurance companies to seek business abroad, underscoring the need for vigilant supervision. The supervisory weaknesses are reflected in less than full observance of many of the Core Principles for Effective Supervision established by the International Association of Insurance Supervisors (IAIS). Areas of non-observance concern the organization and resources of the supervisor, implementation of prudential rules and onsite inspections.

8. **The outlook for Barbados' offshore financial sector is subject to some uncertainty.** Activity in this sector has been attracted by low tax rates and the advantageous provisions of bilateral tax treaties with some countries. The offshore sector which comprises offshore banks, exempt insurance companies, and subsidiaries of non-financial corporations (international business companies, foreign sales corporations), is now second only to tourism in terms of foreign exchange earnings and represents an important contributor to tax revenue. Doubts about the renewal of the bilateral tax treaties – with Canada (presently being renegotiated), the United States, the United Kingdom, and Switzerland – as well as competition from other countries offering similar advantages are beginning to deter new entrants.

9. **An ordered development of the financial system in Barbados is likely to have important implications for the spreading of sound financial standards in the region.** Barbados is, in fact, the base of two large financial institutions with important ramifications in the whole Caribbean area: the First Caribbean International Bank (FIBC), born from the merger of some of the Caribbean activities of Barclays and CIBC, and the insurance company, the Mutual of Barbados. In addition, Barbados has often provided a benchmark for regulatory developments to other lower income Caribbean countries, assuming an informal role as a standard setter. Therefore, a sound financial development strategy for Barbados is an important condition to improve financial standards in the region as a whole.

B. THE MACROECONOMIC SETTING AND RISKS

10. **The global economic slowdown poses near-term macroeconomic challenges for Barbados**. Following a prolonged period of robust growth, real GDP contracted 2.7 percent in 2001. The slump continued during the first half of 2002, reflecting the effects on the tourism industry of the global downturn and the September 11 terrorist attack. While aggregate financial soundness indicators suggest that the banking system can cope with the consequences of the slowdown, profitability of the sector is likely being squeezed and erosion in asset quality can be expected. Difficulties at individual institutions cannot be ruled out, although banks are making the required provisions for bad debts.

11. **Credit risk is the main systemic vulnerability of the onshore banking sector in the current environment**. The economy is particularly sensitive to business cycles in the United Kingdom, United States, and Canada through their effects on the tourism sector. Tourism is also vulnerable to changes in preferences and increased competition from other destinations. The construction sector expanded significantly during the boom ending in 1999, resulting in accelerating land and real estate prices which has now subsided. A decline in these prices due to lower economic growth, possibly through reduced demand from the offshore sector, could affect the value of banks' collateral. Finally, the manufacturing sector has been under pressure due to high costs and increased competition.

12. **Prospects for the development and deepening of the financial system over the medium-term are linked importantly to the liberalization and integration of financial activities envisaged under the Caribbean Single Market and Economy protocols**. The authorities plan to liberalize exchange controls gradually, first vis-à-vis the Organization of Eastern Caribbean States (OECS), and then more broadly among the CARICOM countries. The strategic considerations underpinning this initiative are compelling and will likely yield substantial efficiency gains and diversification opportunities in the financial sector. At the same time, the different degrees of exchange controls, types of exchange rate arrangements, and monetary policy and prudential frameworks – within CARICOM and vis-à-vis the rest of the world – necessitate careful preparation.

13. **Preparations for capital account liberalization entail adaptations in domestic policies, regulations, and instruments**. Prudent macroeconomic policies, especially restraint on wage increases and the fiscal deficit, are important for preserving external competitiveness and the credibility of the exchange rate regime. Strengthened supervision and regulation, particularly regarding foreign exchange exposures and market risks, will be crucial in limiting

the potential for financial instability from cross-border capital flows. A properly coordinated and sequenced liberalization will also necessitate a careful evaluation of the capacity of financial institutions to assess and manage risks associated with cross-border exposures and of the supervisory processes to contain their effects should the risks materialize.

14. **The substantial excess of bank liquidity during much of 2001 and 2002, in a context of low inflation, is symptomatic of an over-determined system.** The presence of a mandatory minimum savings deposit rate, a maximum average lending rate, and a pegged exchange rate regime supported by exchange controls have affected the balance between banks' resources and their productive use. The efforts to administer lower domestic interest rates have prevented lending rates from properly reflecting risk-return tradeoffs and caused banks to be overly cautious in extending credit.

15. **In view of a future capital account liberalization the Central Bank of Barbados' (CBB) liquidity management should increasingly rely on flexible market-based instruments.** At present, the main instruments are changes in cash reserve and securities requirements, regular tender sales of government securities, and adjustments in official interest rates. The CBB does not conduct active open-market operations and currently has only a small amount of government securities in its portfolio. It also maintains a discount facility which has not been used by banks for some time because of excess liquidity. The CBB should consider developing a framework for using market-based instruments for influencing monetary conditions in order to minimize distortionary costs on the banking system. Such a framework will be needed in an environment of liberalized capital flows and would require that rates of return on government securities are determined by the supply and demand of funds in a transparent auction process.

16. **The authorities have devoted considerable effort to developing an effective framework for anti-money laundering and combating financing of terrorism (AML/CFT).** The Anti-Money Laundering Authority is well organized and carries out its mandate through the Financial Intelligence Unit (FIU). The limited staff and resources of the FIU, however, necessitate heavy reliance on the supervisory bodies responsible for the oversight of various financial institutions. As a result, the degree of AML/CFT effectiveness is commensurate with that of the broader supervision of such institutions. In particular, effectiveness needs most attention in the insurance area and, to a lesser extent, given the limited activity, in the securities market.

C. The Banking Sector and Regulatory Structure

17. **The commercial banking system is largely foreign-owned.** About 74 percent of the assets of commercial banks belong to either branches of foreign banks or subsidiaries of foreign-owned entities from Canada, United Kingdom, and Trinidad and Tobago. Some of the Caribbean activities of Barclays PLC and CIBC have been merged with the formation of First Caribbean International Bank (FCIB), headquartered in Barbados, with operations in 15 countries and 8 jurisdictions. The bank is subject to supervision by the CBB as the home country supervisor. The merger has resulted in further concentration in the banking system, with FCIB accounting for about 33 percent of total assets and Royal Bank of Canada, the

second largest, for about 19 percent. The government continues to own a large share of Barbados National Bank (BNB) although it is expected to further reduce its ownership share.

18. **Aggregate information as of the end of last year suggests that commercial banks are on reasonably sound financial footing**. The average capital adequacy ratio of the four locally incorporated banks increased from 15 to 18 percent in the two years 2000-2001. At the end of 2001, the lowest reported capital adequacy ratio of a locally incorporated bank was 15 percent. Profits before tax have remained comfortably above 2 percent of total assets. They have been positive for all commercial banks and have been sustained by a stronger growth of the non-interest income, which now represents 33 percent of gross revenue.

19. **The economic slowdown has dampened the demand for credit and its effects are also beginning to be reflected in asset quality**. Nonperforming loans increased from just under 4 percent of total loans at end-2000 to 5 percent at end-2001. Discussions with bank representatives indicate that banks were starting to see an increase in delinquencies and requests for restructuring of loans in early 2002. At the same time, continuing deposit growth has resulted in a situation of excess liquidity that has contributed to the fall of interest rates on government securities. The reduction of government bond rates, though, has only partially been transmitted to deposit and lending rates.

20. **While credit risk and operational costs are the main threats to bank profitability, banks are subject to some interest rate risk, which is limited by the stipulated minimum deposit rate and the maximum average lending rate.** In the event that banks' interest expenditures were to increase from the reported average of 4 percent in 2001 to 6 percent, all other things equal, profits before tax would likely be reduced from just above 2 percent of total assets to less than 1 percent. Government securities, some of which have longer maturities, represent one-fifth of total banks' assets. Although these are typically held by banks to maturity and not for trading purposes, their value would be significantly reduced by an increase in interest rates in the event that these were marked-to-market.

21. **The largest group of deposit-taking institutions after commercial banks are credit unions, whose deposit base is now approximately equal to one-tenth that of the banking system**. Because of their orientation toward small savers and for social welfare considerations, credit unions have been exempted from compulsory reserve requirements and income taxes. Also as a result of the competitive edge provided by these exemptions, credit union lending has increased rapidly. Nonperforming loans, though, have increased faster so that they represent now 20 percent of total loans.

22. **Supervision has improved during the 1990s, as better legislation and prudential regulations have been adopted, but additional challenges remain**. Under the Financial Institutions Act of 1996, the Minister of Finance is responsible for supervision, regulation, and licensing of onshore financial institutions and delegates to the CBB certain supervisory and regulatory powers. Off-shore banks are instead regulated by the new International Financial Services Act that came into force in June 2002. In practice supervisory and licensing actions with respect to the commercial banks are taken based on recommendations by the CBB. Among other things, the Act establishes ownership limits of Barbadian incorporated banks, minimum capital requirements, lending limits to one borrower or group, propriety investment

limits, and restrictions on connected lending. Shortfalls remain in the domain of capital requirements for market risks, in that of corporate governance as well as in the CBB responsibilities in bank restructuring and liquidation. The operational independence of the CBB from the Ministry of Finance should also be explicitly stated in law.

23. **The assurances of support implied by the significant share of foreign ownership of the banking system should not be overvalued.** The majority of commercial banks are foreign owned and are therefore expected to rely on parent resources for emergency assistance. Recent examples of parents walking away from their subsidiaries, however, suggest that the CBB should not fully rely on parent support. The CBB should revisit the need for contingency plans in light of the experience gained during the takeover of BCCI's activities in Barbados (which became the Mutual Bank).

The government guarantee on the deposits of the state-owned bank (BNB) will be phased out over a two- to three- year period, while a new deposit insurance scheme will be introduced. It is contemplated that the level of coverage will be related to GDP per capita, similar to that in other countries in the region. Given the size of the financial sector, it may be desirable to consider a simple "pay box" scheme, carefully tailored to minimize moral hazard and the political temptation to expand its scope.

D. Insurance Sector

24. **Insurance companies account for the bulk of non-bank onshore financial activities and offer a wide range of insurance products**. The ratio of premiums to GDP (insurance penetration index) was equal to almost 8 percent in 2000, a value that puts Barbados nearer to the level of 9 percent observed in industrial countries than to the 2 percent of Latin American and Caribbean countries. Insurance companies have been profitable in recent years, although general insurance performance has been more volatile.

25. **Increasing concentration in the domestic industry and expansion abroad are natural consequences of the small market size and limited opportunities for organic growth in the domestic market**. The Barbados Mutual Life Assurance Society (The Mutual) has reached, after a process of acquisition, a local market share of about 65 percent and is now expanding abroad to diversify its risks and protect its growth opportunities. In fact, the reform of the National Insurance Scheme, necessary in the face of expected demographic changes, is not widely perceived as contributing to a material boost to the level of private retirement saving. Similarly, the proposed changes to occupational schemes are not expected to lead to a material increase in the local market size and growth.

26. **Notwithstanding the relevance of the insurance sector, a limited availability of official data make profitability and capital adequacy difficult to assess**. Discussions with the industry participants suggest that insurance companies have been profitable in recent years, although general insurance performance has been more volatile. Provisioning principles and capital for life insurers is self-regulated, and provisioning techniques reportedly are based, for most companies, on the Canadian system. For general insurance, the mission's discussions with the industry and analysis of unpublished data suggest that provisioning methods may be less reliable across all companies. A proposal is under consideration by the Ministry of Finance to

amend the insurance legislation to enhance, among other things, capital adequacy and solvency requirements.

27. **The exposure to natural hazards in the Caribbean is an important feature of the insurance sector**. Recent developments in risk management products may provide for some resiliency in the event of natural catastrophes. The dependence on external reinsurance for property insurance is expected to reduce gradually as companies take advantage of the recent fiscal changes making catastrophe provisions more attractive for companies to establish.

The offshore insurance sector is driven primarily by the various taxation treaties between Barbados and, in particular, the United States and Canada. This segment of the insurance industry has offered both a source of employment opportunities and revenue for the government through license fees. The presence of bilateral tax treaties allows insurance companies, after complying with the Barbadian fiscal rules, to repatriate profits net of taxes to their home country without incurring any further tax liability. In the event that these treaties were to be withdrawn altogether, the offshore market would have to rely on limited alternative advantages and, in all probability, would not be viable.

E. Capital Markets and Payment Systems

28. **Given its limited level of activity, the securities markets appears to present little systemic risk to the financial sector and little funding opportunity for the corporate sector**. Notwithstanding a relatively large size, as measured by a ratio of market capitalization to GDP equal to 71 percent, the Barbados stock exchange generates an exceedingly low level of activity. The value of yearly trades on the market floor accounts for less than one percent of the total capitalization, implying that an hypothetical full turnover of listed stocks would require more than a century. Securities settlement risk will be reduced further when the Barbados Central Securities Depository Inc. (BCSDI) joins, as planned by the authorities, the RTGS system and moves to a Delivery-Versus-Payment (DVP) scheme.

29. **The low level of activity and the size of the Barbadian market underscore the need to consider the development of stock market activities in a regional context**. Notwithstanding fairly well drafted legislation (as reflected in a positive assessment of the IOSCO Principles), the market is practically inactive. The limited volume of activity is a common feature of all the stock exchanges of the region. The limited diversification opportunities offered by each individual market in the region constrains the demand for investments and the volume of trades, restricting the revenues of market intermediaries and the amount of resources directed toward the stock market. A reduction of fixed costs and an increase in the number of listings can result from the adoption of a common listing, trading and settlement rules within the region, and from a removal of the restrictions on investments in the stock exchanges of the region.

30. **The risks embedded in the working of the payment system have been greatly reduced with the institution of the real-time gross settlement system (RTGS) and the automated clearing system (ACH)**. Until recently, the primary payment system processed paper checks and other paper instruments and presented the systemic weaknesses of all deferred net settlement systems. The authorities deserve credit for undertaking the modernization of the payment systems through the introduction of an RTGS and an ACH

system. The RTGS system is systemically important and has been designed to be in accordance with the CPSS Core Principles. The ACH serves retail transactions, accounting for no more than 30 percent of the total daily value of all transactions, and is, therefore, judged not to be systemically important.

F. POLICY PRIORITIES

31. **In the short term, the key priority is the consolidation of the ongoing process of modernization and rationalization of the financial and regulatory structure, with a view to strengthening some important areas of weakness in the supervision of onshore financial institutions and to increasing the effectiveness of supervision of the offshore sector**:

- **Supervisory resources of the CBB should be boosted to enable it to conduct regular onsite examinations of all onshore and offshore banks on an 18–24 month cycle**. Regulations should be adopted to provide for market and country risks for both onshore and offshore banks. The Financial Institutions Act should be amended to strengthen the independence of CBB, impose aggregate limits on large exposure and connected lending, facilitate license revocation and distressed bank resolution, and require CBB's prior approval of the external auditor for licensees.
- **Effective supervision and regulation of the insurance sector should be instituted**. A substantial strengthening of the existing supervisory structure should be considered together with adequate funding allocations. A timely and comprehensive reporting system needs to be put in place and a regular publication of industry statistics should be considered. It is also necessary to define an onsite inspection program, extended to the offshore sector, supported by a more analytical offsite review of sufficiently detailed returns from companies. A substantial strengthening of the regulatory framework should include provisions concerning corporate governance, internal control and, most importantly, solvency requirements.
- **The supervision of the large credit unions should be brought in line with that in place for commercial banks**. The capacity of the Registrar of Cooperatives to effectively supervise credit unions should be strengthened and a collaboration with the CBB should be considered. High priority should be assigned to completing regular, CBB-assisted, onsite examinations of the five large credit unions. Consideration should also be given to introducing a separate credit union law after gaining experience with these examinations.

32. **In the medium term, the key policy priority is to set the conditions for a more competitive provision of banking products and services. This will require a coordinated set of actions in the domain of bank regulation and supervision and in the conduct of monetary policy**:

- **A plan for gradual financial liberalization needs to be defined**. The effort to reduce bank lending spreads through administrative controls is likely to generate further distortions such as the recent increase of bank liquidity. A gradual removal of current controls on interest rates and capital flows should be considered as a more effective way to improve bank efficiency. It should also provide banks with more remunerative use of their liquidity and help to reduce the cost of bank credit.

- **Bank regulation should include appropriate tools for controlling market risk exposures**. Financial liberalization should be preceded by a suitable adaptation of supervisory and regulatory frameworks to properly measure, monitor, and control banks' exposures to market risk. Appropriate limits on net currency exposures or on portfolio composition need not be excluded as a part of a process of gradual liberalization.
- **Monetary policy should rely more on market-based instruments**. A progressive shift in the conduct of monetary policy from direct interest rate controls to market-based instruments of liquidity management is required to create the necessary infrastructures and develop the necessary skills the banking system will require for operating in a less protected environment.
- **Increased lending on the part of credit unions should not come at the expense of the quality of their loan portfolio.** Poor lending practices are likely to have played a significant role in the deterioration of credit unions loan portfolio and the perception of an implicit public guarantee may have generated phenomena of moral hazard. In addition to a more rigorous prudential supervision, it is therefore important to avoid indirect subsidies that may arise from the establishment of a deposit insurance structure for commercial banks.

ACRONYMS

ACH	Automated Clearing System
AML/CFT	Anti-Money Laundering and Combating Financing of Terrorism
BCCI	Bank of Credit and Commerce International
SDI	Barbados Central Securities Depository Inc
BNB	Barbados National Bank
BSE	Barbados Stock Exchange
BSD	Banking Supervision Department
CARICOM	Caribbean Community and Common Market
CARTAC	Caribbean Regional Technical Assistance Center
CBB	Central Bank of Barbados
CBRTGS	Central Bank of Barbados RTGS System
CIBC	Canadian Imperial Bank of Commerce
CSME	Caribbean Single Market and Economy
FCIB	First Caribbean International Bank
FIA	Financial Institutions Act
FIU	Financial Intelligence Unit
IAIS	International Association of Insurance Supervisors
NPSC	National Payments System Council
OECS	Organization of Eastern Caribbean States
PEARLS	Protection, Effective financial structure, Asset quality, Rates of return and costs, Liquidity and Signs of growth
RTGS	Real Time Gross Settlement System
SC	Securities Commission