Central Bank of Trinidad & Tobago

# Financial Stability Report 2008

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# Financial
STABILITY REPORT
2008

## Central Bank of Trinidad and Tobago
September 2008

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# FINANCIAL STABILITY REPORT

## EXECUTIVE SUMMARY

- Driven by a vibrant energy sector and a favorable macro-economic environment, the Trinidad and Tobago financial system expanded rapidly in the period 2001 - 2008. In 2008, the sector's overall contribution to GDP amounted to 9.5 per cent.

- During the period, the financial sector became increasingly diversified and underwent a process of reform characterized by (i) an increase in linkages among banking, insurance and other parts of the system, in some cases within conglomerate structures; (ii) considerable product innovation in line with developments in more mature financial markets; and (iii) offshore expansion into the Caribbean and Central America.

- While most of the major financial indicators strengthened markedly, the evolution of the financial system in this period laid bare a range of structural and institutional vulnerabilities that were held in check by the favourable global and domestic economic environment. Some of these vulnerabilities were:

  - the dominance of mixed conglomerates with sizable intra-group exposures, reduced transparency and increased risks for the financial institutions;

  - a high level of concentration in banking and insurance;

  - an illiquid domestic capital market;

  - an evolving legal and regulatory framework that was not yet equipped to deal with complex conglomerate structures;

  - in addition, several important financial institutions, most notably some statutory corporations, lay beyond the purview of regular statutory oversight.

- Most of the bank soundness indicators showed solid improvement during the period 2001 - 2008. Banks' (risk-weighted) capital adequacy ratios were significantly above statutory levels; the level of non-performing loans remained extremely low compared with regional and international standards; and banks' profitability levels have been very high by international standards. In general, most of the indicators pointed to a robust banking system that is well positioned to withstand exogenous shocks.

- The non-banking sector, while for the most part profitable and stable with sound prudential indicators, faced a range of difficulties over the past few years. In order to take advantage of economies of scale and improve efficiency, the commercial banks moved to absorb the deposit and lending operations of their trust and mortgage affiliates. The other segment of the non-bank sector – the finance companies and merchant banks —faced high operating expenses, in part, because of the need to offer higher interest rates, lower investment income and higher delinquency rates. These factors, which have served to squeeze profitability, as well as considerations specific to its conglomerate structure, were largely responsible for the collapse of CLICO Investment Bank. The assets of this institution accounted for a sizeable proportion of the non-bank sub-sector.

- The insurance sector also benefited from the economic buoyancy as reflected in a steady rise in insurance premiums. With occasional exceptions, the industry has adhered to statutory fund obligations which require that assets be placed in trust to support policyholders' obligations. However, even if companies complied fully with meeting their statutory fund obligations, the inconsistent applications of actuarial valuation standards and inappropriate loss reserving methodologies have resulted, in some cases, in an understatement of reported policyholders' liabilities. Capital requirements for insurance companies are extremely low by international standards and, as such, most insurers have exceeded the minimum level.

- In the period 2001-2008, the life insurance sector saw a marked shift towards short term deposit-like products, which, in some cases, gave rise to asset/liability maturity mismatches. This trend also prompted a search for higher investment returns. As investment yields have declined in the last two to three years, profitability in the life insurance sector has also waned. Two insurance companies, CLICO and British American, which focused disproportionately on short-term, high interest rate deposits got into serious financial difficulties and had to be intervened by the Regulator.

- The non-life insurance sector has also seen an expansion in activity reflecting the housing boom and the explosion in motor vehicle sales. In general, the industry carried adequate levels of re-insurance although there have been concerns that a few companies have insufficient reserves for outstanding claims. Over the past few years, net claims and expenses in the sector have exceeded net premium income. This results in excessive reliance on investment income to meet obligations. Some companies have sought to address this by underpaying claims. This represents an area of serious vulnerability in the sector.

- The international financial crisis did not have a major contagion effect on the domestic financial system. However, the economic decline, which has been influenced by the global recession, has had some negative repercussions on the system.

- In the first six months of 2009, banks have experienced a decline in loans, a small increase in non-performing loans, and an increase in loan provisioning. Because of its strong capital base, conservative operating policies and robust overall health, the banking system is well-positioned to cope with the change in economic conditions.

- Concerted attempts are being made to mitigate risks and vulnerabilities in the financial system. These include on- going initiatives to upgrade the legal and regulatory framework as well as to enhance supervisory practices, which, as noted, are major areas of financial sector vulnerability. The Financial Institutions Act (FIA) 2008, which was approved in December 2008:

  - formalizes consolidated supervision in order to identify and evaluate group risk and the risk of contagion;

  - seeks to address related party lending and upgrades governance structures for licensed institutions, and

  - gives more authority to the Bank to take early corrective action to protect depositors.

- In February 2009, the amended Insurance Act gave the Central Bank the authority to (i) issue compliance directions in cases of urgency; (ii) suspend operations of troubled institutions; (iii) seek injunctive relief; and (iv) strengthen the statutory fund.

- The new Insurance Act is expected to include provisions to:

  - increase the minimum capital requirements for insurance and introduce risk-based capital requirements,

  - introduce limits on related-party transactions, and

  - standardise valuation of liabilities and introduce prompt sanctions for non-compliance with statutory requirements.

# INTRODUCTION

For several years, staff at the Central Bank prepared bi-monthly assessments of the licensees for discussion at the Bank's Senior Management and Executive Board levels. This is the first Financial Stability Report (FSR) to be published and made available to the general public. The intention is to produce an annual FSR in March of each year which is to be supplemented by a shorter mid-year Financial Stability Review to be published in September.

In this inaugural report, we have tried to set the stage by using **Chapter One** to discuss the meaning and importance of financial stability and by introducing our readers to a list of generally - accepted financial soundness indicators recommended by the International Monetary Fund. **Chapter Two** contains a summary description of the structure of the financial system of Trinidad and Tobago, highlighting how this structure has changed over the past decade. **Chapter Three**, which focuses on the banking system, traces the evolution of the financial stability indicators against the background of the rapid rate of growth enjoyed by the Trinidad and Tobago economy since 2001. **Chapter Four** presents similar analyses for the non-bank financial institutions and the insurance sector.

The discussion in the two previous chapters covers the period up to 2008. **Chapter Five** analyses the impact of the international financial crisis on the domestic financial system and the risks that the ongoing economic slowdown carries for financial stability. The evolution of the financial soundness indicators for the first half of 2009 is also discussed. The final chapter, **Chapter Six**, summarises the main risks and vulnerabilities of the financial system and discusses initiatives geared to addressing these risks, including the upgrading of financial regulation and supervision.

The Financial Stability Report is addressed to financial market participants as well as others interested in economic management and policy. The aim is to give a comprehensive assessment of the financial system and of the system's ability to withstand potential disturbances. It is envisaged that provision of this information will condition market behaviour and in so doing help to promote financial stability.

The preparation of the Financial Stability Report will be the responsibility of the Central Bank's Financial Stability Committee (FSC) which comprises:

- The Governor (Chairman)
- The Deputy Governors (Research and Policy and Operations)
- The Inspector of Financial Institutions
- Deputy Inspector of Financial Institutions
- The Chief Economist
- Senior Manager, Banking Operations
- Advisor, Office of the Governor

The Financial Stability Support Committee (FSSC), which is chaired by the Inspector of Financial Institutions and includes senior staff members of the Financial Institutions Supervision, Research, Payments and Domestic Markets Departments, will provide the necessary documentation and analysis to inform the deliberations of the FSC. The Advisor in the Governor's Office will coordinate the Support Committee.

# CHAPTER 1

## DEFINING FINANCIAL STABILITY

In the 1990s, the number and frequency of financial crises worldwide brought into sharp focus the importance of financial sector stability. A study conducted by the International Monetary Fund (IMF) found that, between 1980 and 1995, 133 of the 181 Fund members had experienced significant banking crises at some stage over the sixteen year period. The countries ranged from emerging market to industrialized economies and in some countries there were repeated crises. [1] The growing complexity of financial instruments, the increased interdependence among economies and the ease with which shocks are transmitted between them, have increased the potential for contagion and financial sector turbulence. Consequently, achieving and maintaining financial stability have now become important public policy goals.

Financial crises are costly for several reasons: first, they result in lost output; second, they usually carry heavy fiscal costs associated with public bailouts; third, they tend to complicate monetary management; and fourth, they invariably result in a loss of confidence in the financial system, which is extremely difficult to rebuild.

There are several definitions of financial stability. A comprehensive definition proffered by Andrew Crockett argues that:-

> "Financial stability requires that (i) the key institutions in the financial system are stable, in that there is a high degree of confidence that they can continue to meet their contractual obligations without interruption or outside assistance, and (ii) the key markets are stable, in that participants can confidently transact in them at prices that reflect fundamental forces and that do not vary substantially over short periods when there have been no changes in fundamentals." [2]

Financial stability is threatened when key institutions and key markets are subject to different types of vulnerabilities. Financial systems are vulnerable to macroeconomic shocks such as asset price bubbles or changes in the terms of trade. Financial systems can be vulnerable because of weak balance sheets, poor asset quality or overexposure to loans in a particular sector. In addition, weaknesses in the capital markets and payment systems can make financial systems vulnerable to systemic risk. *(See Box 1.1).*

In the wake of the Asian crisis, several studies showed that macroeconomic shocks to output, sharp deterioration in the terms of trade and asset price bubbles were some of the factors which contributed to crises in different financial systems. Moreover, because of close linkages between the real and financial sectors in the region, it was at times difficult to prevent the crisis from spreading.

The recent international financial crisis had its roots in the sub-prime mortgage crisis in the United States. Given the close linkages among the financial systems in the advanced countries, the contagion quickly spread first to the United Kingdom, the Eurozone and to other industrialized economies. In short order, several emerging market economies, which depended heavily on foreign capital flows found that they were also seriously affected by the crisis which had spread from advanced economies.

In Trinidad and Tobago, past episodes of financial crises demonstrated that the financial system was vulnerable to macroeconomic shocks (e.g. the collapse of oil prices in 1986) as well as weak balance sheets (e.g. the NFI crisis of the late 1980s). More recently, additional sources of vulnerability have been identified as emanating from the following:- (i) the financial conglomerate model and especially the mixed conglomerate structure where banks, insurance companies and commercial activities exist within the same group; (ii) equity and property booms; and (iii) international diversification of the financial system's lending.

[1] C. Lindgren et al, **Bank Soundness and Macroeconomic Policy**, International Monetary Fund, 1996.
[2] Andrew Crockett, "Why is Financial Stability a Goal of Public Policy", Federal Reserve Bank of Kansas City, **Economic Review** Fourth Quarter 1997, **pp. 5-22**.

## BOX 1.1
## PAYMENT SYSTEMS IN TRINIDAD AND TOBAGO

An essential element of any modern financial system is a set of arrangements in which payments are cleared and settled. It is important that payment systems are well-designed, well-managed and sound as they provide linkages among financial institutions. The malfunctioning of a payments system could result in risks being transmitted to the wider financial system. A failure in any payment system creates the potential for systemic risk; for example, the inability of one participant to meet its obligations could cause other participants in the system not to meet their obligations, with serious consequences for the overall financial system.

Under the Financial Institutions Act, 2008, the Central Bank has the authority to license payment systems operators and oversee their operations, paying particular attention to those deemed systemically important. There are certain features which a payment system may possess which could make it systemically important e.g. large value payments or large volume payments. At present in Trinidad and Tobago, there are four systems so characterized:- the cheque system which is operated by the Central Bank; the debit card (LINX system) which is operated by Infolink Services Limited; the Automated Clearing House (ACH) system which is operated by Trinidad and Tobago Interbank Payments System (TTIPS) and the Real Time Gross Settlement System (RTGS) which is operated by the Central Bank. The RTGS is used for large value (TT$500,000 and over) transactions while cheques and debit cards are examples of large volume payments.

The next issue of the Financial Stability Report will contain a fuller discussion of the payment systems of Trinidad and Tobago.

While the linkages with the international financial system are not as close as in the case of the larger emerging market countries, the financial system in Trinidad and Tobago has become increasingly integrated with that of the CARICOM region because of ownership structure as well as through lending exposures. This has meant that regional developments could also affect the stability of the domestic financial system.

Empirical evidence has shown that strong macro-economic performance, specifically steady economic growth with low inflation, strong fiscal and external accounts, low personal and public indebtedness all contribute to strengthening a country's ability to deal with contagion. The robustness of a country's regulatory and supervisory regime also impacts on its ability to prevent and/or deal with financial crises. The financial legislative framework is an important aspect of this regime. So too, is the scope and quality of financial sector supervision.

Some international financial institutions, most notably the IMF, have compiled a range of macro-prudential indicators to serve as barometers of the health and stability of the financial system and to provide early warning signals of potential problems for the banking system. The list of financial soundness indicators (FSIs) includes measures of capital adequacy, asset quality, earnings and profitability, liquidity and market risk.

A similar set of indicators can also be assembled for the insurance industry, pension funds, credit unions and other financial institutions.

Table 1.1 below contains a full list of these indicators categorized as "core" and "encouraged".

## Table 1.1: Financial Soundness Indicators

| **Core Indicators:** | |
|---|---|
| Deposit-Taking Institutions (Commercial Banks, etc) | |
| Capital Adequacy | Regulatory capital to risk weighted assets<br>Regulatory tier 1 capital to risk weighted assets |
| Asset quality | Nonperforming loans to total gross loans<br>Nonperforming loans net of provision to capital<br>Sectoral distribution of loans to total loans |
| Earnings and Profitability | Return on Assets<br>Return on Equity<br>Net interest margin to gross income<br>Noninterest expenses to gross income |
| Liquidity | Liquid assets to total assets<br>Liquid assets to short-term liabilities |
| Sensitivity to market risk | Net open position in foreign exchange to capital |
| **Encouraged Indicators** | |
| Deposit-Taking Institutions | Capital to assets<br>Large Exposures to capital<br>Geographical distributions of loans to total loans<br>Gross asset position in financial derivatives to capital<br>Gross liability position in financial derivatives to capital<br>Trading income to total income<br>Personnel expenses to noninterest expenses<br>Spread between reference lending and deposit rates<br>Spread between highest and lowest interbank rate<br>Customer deposits to total loans<br>Foreign currency-denominated loans to total loans<br>Foreign currency-denominated liabilities to total liabilities<br>Net open position in equities to capital |
| Other Financial Corporations | Assets to total financial system assets<br>Assets to GDP |
| Nonfinancial Corporations | Total debt to equity<br>Return on equity<br>Earnings to interest and principal expenses<br>Corporate net foreign exchange exposure to equity<br>Number of applications for protection from creditors |
| Households | Household debt to GDP<br>Household debt service and principal payments to income |
| Market Liquidity | Average bid-ask spread in the securities market<br>Average daily turnover ratio in the securities market |
| Real Estate Markets | Real estate prices<br>Residential real estate loans to total loans<br>Commercial real estate loans to total loans |

# CHAPTER 2

## THE STRUCTURE OF THE FINANCIAL SYSTEM IN TRINIDAD AND TOBAGO

By developing country standards, the Trinidad and Tobago financial sector is relatively large, diversified and advanced. Accounting for approximately 9.5 per cent of GDP, the sector is organized around eight commercial banks and seventeen non-bank financial institutions (NFIs) made up of finance houses, merchant banks and trust and mortgage companies. The finance houses are involved principally in trade confirming and leasing and the financing of consumer durables, while the merchant banks focus more on loan syndication, bond underwriting and corporate credit. The trust and mortgage institutions provide trustee services and engage in mortgage lending funded by long-term funds mobilized largely from institutional depositors.

In addition to these "banking" enterprises, there are thirty one active insurance companies (nine life companies, seventeen general companies and five composite companies); one hundred and thirty active credit unions with twenty-one large and thirteen medium size unions accounting for 93 per cent of the assets of the sector and over two hundred private pension funds.

### Table 2.1: Number of Existing Financial Institutions, 2001 – 2008

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|---|---|
| Commercial Banks | 6 | 6 | 6 | 6 | 6 | 6 | 8 | 8 |
| Finance Companies and Merchant Banks | 9 | 10 | 10 | 12 | 12 | 11 | 10 | 10 |
| Trust and Mortgage Finance Companies | 5 | 5 | 5 | 6 | 6 | 7 | 7 | 7 |
| Development Banks | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 |
| Credit Unions1 | 122 | 122 | 125 | 126 | 129 | 129 | 131 | 130 |
| Insurance Companies[2] | 57 | 56 | 56 | 51 | 51 | 51 | 51 | 51 |
| Thrift Institutions | 3 | 3 | 3 | 3 | 3 | 3 | 3 | 3 |
| National Insurance Board | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 |
| Stock Exchange | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 |
| Unit Trust Corporation | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 |
| Home Mortgage Bank | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 |
| Private Registered Pension Plans[3] | 212 | 215 | 248 | 256 | 256 | 256 | 256 | 256 |

1. Data from 2002 onwards represent active credit unions only.
2. This represents the number of insurance companies registered to do business in Trinidad and Tobago. In 2008, only thirty-one insurance companies were actually conducting business.
3. These refer to self-administered pension plans which are supervised by the Central Bank. This is exclusive of insured pension plans, pension plans to be wound-up and those under judicial management.

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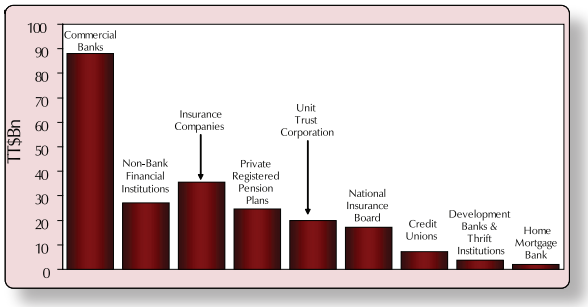
## Table 2.2: Financial System Assets by Institutions, 2001 - 2008 /$Mn/

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|---|---|
| Commercial Banks | 38,137 | 40,104 | 43,226 | 48,426 | 58,847 | 67,906 | 75,745 | 88,074 |
| Finance Companies and Merchant Banks | 6,251 | 6,885 | 8,303 | 12,422 | 13,970 | 17,284 | 17,817 | 18,225 |
| Trust and Mortgage Finance Companies | 8,907 | 9,451 | 11,228 | 10,324 | 10,083 | 7,723 | 10,307 | 8,894 |
| Development Banks | 1,327 | 1,406 | 1,880 | 2,140 | 2,262 | 2,544 | 2,630 | 3,649 |
| Credit Unions | 3,479 | 3,864 | 5,991 | 5,500 | 6,396 | 7,032 | 7,228 | 7,200 |
| Insurance Companies | 12,589 | 14,913 | 17,968 | 24,211 | 26,944 | 29,264 | 33,478 | 35,687 |
| Thrift Institutions | 62 | 66 | 68 | 67 | 65 | 74 | 77 | 80 |
| National Insurance Board | 7,185 | 8,310 | 9,679 | 11,829 | 13,651 | 14,363 | 15,296 | 17,060 |
| Stock Exchange | 22 | 23 | 30 | 33 | 50 | 50 | 59 | 59 |
| Unit Trust Corporation | 5,579 | 8,456 | 11,340 | 14,278 | 16,828 | 17,477 | 18,975 | 19,908 |
| Deposit Insurance Corporation | 515 | 575 | 652 | 743 | 842 | 957 | 1,126 | 1,286 |
| Home Mortgage Bank | 885 | 1,141 | 1,631 | 1,749 | 1,944 | 1,924 | 2,078 | 2,035 |
| Private Registered Pension Plans | 14,432 | 16,375 | 20,321 | 27,775 | 24,307 | 23,858 | 25,517 | 24,719 |

Source: Central Bank of Trinidad and Tobago and Annual Reports

## Chart 2.1
## Financial System: Total Assets, 2008




The sector also boasts of specialized mortgage institutions (the Home Mortgage Bank (HMB) and the Trinidad and Tobago Mortgage Finance Company (TTMF)), one development bank (the Agricultural Development Bank (ADB)) and three thrift institutions.

The HMB, which is a joint venture between private and public sector shareholders, was originally conceived as a secondary mortgage institution but has increasingly become involved in underwriting mortgages in the primary market. TTMF is a major provider of mortgage financing for government – constructed housing and also provides financing for private housing. The ADB is a state-owned institution that focuses on the development of the agricultural sector.

The country's **capital market** is centered on the Trinidad and Tobago Stock Exchange where equities and fixed income securities are traded. The market also includes a rapidly growing vibrant mutual fund industry. The latter includes the state-sponsored Trinidad and Tobago Unit Trust Corporation (UTC). In most developing countries, the local

capital market is very narrow and illiquid when measured in terms of the array of instruments and the number of firms and investors that participate in market activity. While activity in respect of public sector bonds has increased significantly in the equity market has languished. The number of listed companies has increased only moderately over the decade from 30 - 34. Market capitalization increased sharply in the first half of the decade based on the surge in equity values. However, since 2005, there has been a steady decline in market capitalization, the number of shares traded and in the Composite Stock Price Index. The stock market has therefore not succeeded in being a source of new capital for listed businesses.

One aspect of the capital markets - the mutual fund industry - has expanded significantly over the past several years and now competes with the commercial banks as a vehicle for private investment.

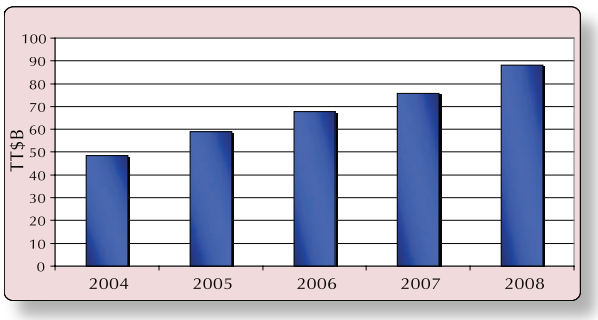
Commercial banks dominate the financial sector accounting for more that half the total assets of the licensed deposit taking institutions and over a quarter of the assets of the financial system. (Table 2.2). Of the eight commercial banks, six are foreign-owned and two are locally owned, one by the government.

## Table 2.3: Selected Capital Market Indicators, 2001 - 2008

| | 2001 | 2003 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|
| No. of Listed Companies | 30 | 32 | 34 | 34 | 33 | 34 |
| Market Value ($M) | 1,044.9 | 2,303.2 | 3,918.1 | 2,463.2 | 2,138.1 | 2,191.1 |
| Composite Price Index(January 1983=100 | 434.2 | 694.1 | 1,067.4 | 969.2 | 982.0 | 842.9 |
| Number of Transactions ('000) | 6,609 | 16,690 | 32,316 | 20,772 | 17,733 | 22,053 |
| Volume of Shares Traded (M) | 122.1 | 409.6 | 193.5 | 218.9 | 119.4 | 134.9 |

Source: Central Bank of Trinidad and Tobago and the Trinidad and Tobago Stock Exchange.

## Chart 2.2
## Commercial Banks: Total Assets, 2004 - 2008

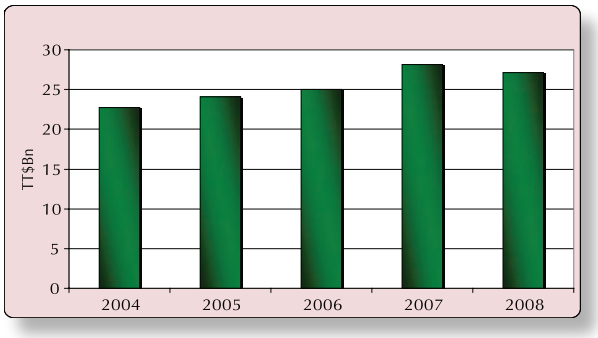



Over the past decade or so, strong ownership and transaction links have developed in the financial sector and there has been some blurring of the boundaries between the various institutions. Nearly all the commercial banks have become universal banks, offering banking products as well as pension and mutual fund management, individual annuity plans, trust services, leasing, brokerage and merchant bank services. Some of these services were previously the preserve of the non-banks. In order to compete, insurance companies have been issuing deposit-like products and mutual funds.

Commercial banks dominate the financial sector accounting for more that half the total assets of the licensed deposit taking institutions and over a quarter of the assets of the financial system. (Table 2.2). Of the eight commercial banks, six are foreign-owned and two are locally owned, one by the government.

Consolidation in the sector has given rise to four conglomerate structures. Two are financial conglomerates and two are mixed conglomerates comprising both financial and non-financial commercial operations. As at end 2008, two banking conglomerates controlled 47.4 per cent of total bank assets and two insurance conglomerates 71.0 per cent of the assets of the insurance sector.

**Chart 2.3**
**Non-bank Financial Institutions:**
**Total Assets, 2004 - 2008**




Most of the major players in the financial system have expanded their operations into CARICOM and extra-CARICOM markets. This has taken the form of off-shore loans and investments bonds, issues and cross-listing on regional stock exchanges and the existence of regional subsidiaries.

The Central Bank is the regulator of the deposit-taking institutions, the insurance industry and private pension funds. There is a Deposit Insurance Corporation (a subsidiary of the Central Bank), which provides insurance for deposit-taking institutions (the banks and non-banks). The Securities and Exchange Commission is the regulator of the securities firms and the Stock Exchange, and the Office of the Commissioner of Cooperatives of the Ministry of Labour and Small and Micro Enterprise Development is the regulator of the credit unions. Three financial institutions created by statute are currently outside the scope of regulatory supervision. These include the Trinidad and Tobago Unit Trust Corporation, the Trinidad and Tobago Mortgage Finance Company and the Agricultural Development Bank. The Home Mortgage Bank was brought under the regulatory ambit of the Central Bank in 2007.

**Chart 2.4**
**Life Insurance Companies:**
**Total Assets, 2004 - 2008**

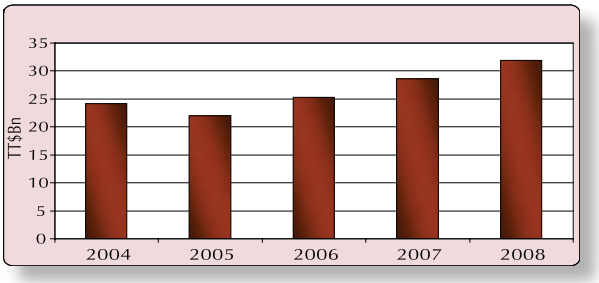



**Chart 2.5**
**Pension Funds:**
**Total Assets, 2004 - 2008**

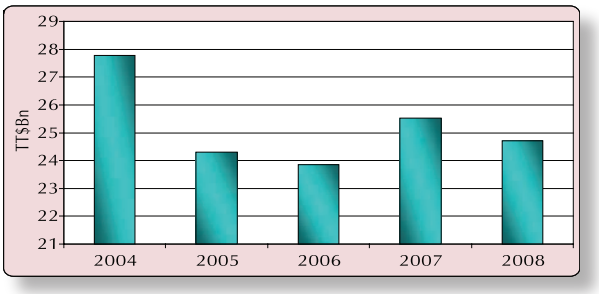
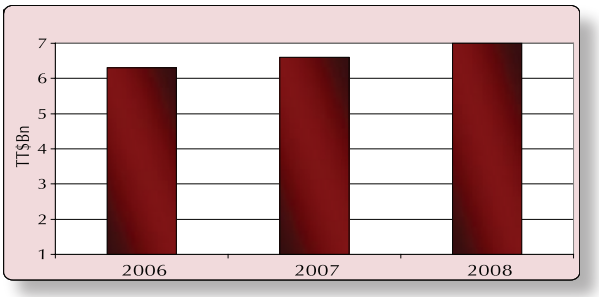



**Chart 2.6**
**Credit Unions:**
**Total Assets, 2006 – 2008**



# CHAPTER 3

# THE EVOLUTION OF THE FINANCIAL STABILITY INDICATORS: THE BANKING SYSTEM (2001-2008)

## Macro-Economic Developments

Over the eight-year period from 2001 - 2008, real GDP growth averaged 7.6 per cent a year. While the main driver was the expansion of the energy sector, whose growth averaged 11.2 per cent a year, the non-energy sector also grew at a very healthy 5.4 per cent per year. In the period, the energy sector benefitted from the steady rise in oil, gas and petrochemical prices as well as a significant increase in direct investment in liquefied natural gas and methanol facilities. The rapid growth of the non-energy sector was fuelled by the increase in government spending financed by buoyant energy revenues. The leading non-energy growth sectors were Construction, Banking and Finance and Distribution.

Rapid economic growth translated into a significant increase in job creation with the unemployment rate declining from an average of 10.8 per cent in 2001 to an average of 4.6 per cent in 2008. From around the middle of the decade there was tangible evidence of serious labour shortages in several sectors, most notably in Construction. These gaps were partly filled by an increase in labour migration from other CARICOM territories The buoyant economic conditions also had some negative side effects. The most significant of these was the sharp rise in inflation from a low of 2.9 per cent in 2003 to 14.5 per cent at the end of 2008. There was also a significant increase in real estate values with median residential house prices estimated to have doubled over the decade. Equity prices showed marked volatility, rising sharply in 2001 – 2005 then undergoing a sharp 18-month retreat before stabilizing somewhat. Since the last quarter of 2008 equity prices have generally been on the decline mirroring the slower pace of economic activity.

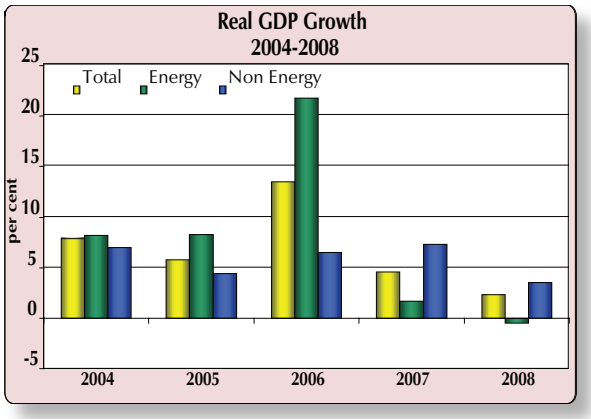
Several other indicators reflect the favourable macro-economic performance over the period under review. Boosted by buoyant energy revenues, the central government operations registered overall fiscal surpluses averaging 3.1 per cent of GDP. These surpluses facilitated an accumulation of savings in the Heritage and Stabilization Fund, which amounted to US$2.9 billion, as at the end of 2008. There was also a steady reduction in the public debt, from the equivalent of 54.1 per cent of GDP in 2001 to 25.1 per cent of GDP at end-2008.

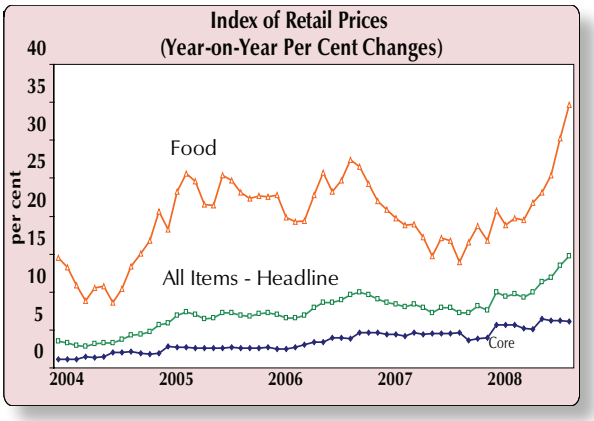
## Table 3.1: Selected Macro-Economic Indicators, 2001 – 2008

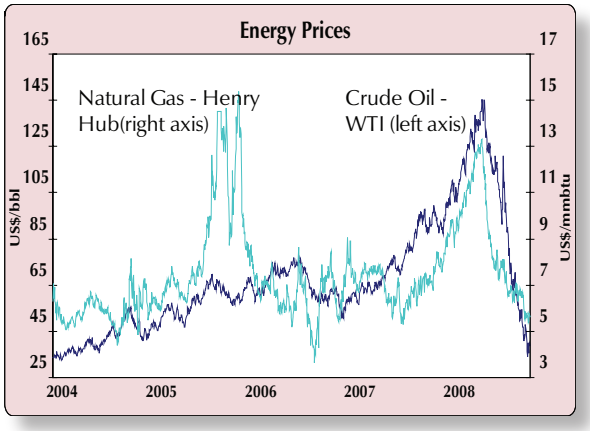
| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|---|---|
| Real GDP Growth (%) | 4.2 | 7.9 | 14.4 | 7.9 | 5.8 | 13.5 | 4.6 | 2.3 |
| Energy | 5.6 | 13.5 | 31.1 | 8.2 | 8.3 | 21.8 | 1.7 | -0.5 |
| Non-Energy | 2.8 | 4.8 | 6.7 | 7.0 | 4.4 | 6.5 | 7.3 | 3.5 |
| Construction | 10.3 | -5.1 | 23.4 | 8.1 | 16.1 | 6.2 | 8.9 | 3.1 |
| Distribution | -2.8 | 1.3 | 2.0 | 3.2 | 4.5 | 15.1 | 3.3 | 9.8 |
| Finance, Insurance and Real Estate | 0.8 | 11.5 | 7.3 | 21.7 | -2.4 | 1.0 | 10.4 | 3.9 |
| Headline Inflation (%) | | | | | | | | |
| End of Period | 3.22 | 4.28 | 2.96 | 5.63 | 7.16 | 9.08 | 7.62 | 14.45 |
| Period Average | 5.53 | 4.15 | 3.81 | 3.72 | 6.89 | 8.33 | 7.89 | 12.05 |
| Core Inflation (%) | | | | | | | | |
| End of Period | 2.39 | 2.9 | 0.91 | 1.96 | 2.69 | 4.61 | 3.93 | 7.12 |
| Period Average | 4.01 | 2.96 | 1.69 | 1.57 | 2.66 | 3.63 | 4.31 | 6.19 |
| Food Inflation (%) | | | | | | | | |
| End of Period | 7.51 | 11.04 | 12.28 | 20.57 | 22.57 | 22.02 | 16.77 | 30.61 |
| Period Average | 13.94 | 10.2 | 13.79 | 12.8 | 22.95 | 23.23 | 17.42 | 25.92 |
| Unemployment Rate (%) | 10.8 | 10.4 | 10.5 | 8.4 | 8.0 | 6.2 | 5.5 | 4.6 |
| Equity Prices | | | | | | | | |
| Composite Stock Price Index (1000=1983) | 434.2 | 545.6 | 694.1 | 1074.6 | 1067.4 | 969.2 | 982.0 | 842.9 |
| Real Estate Prices | | | | | | | | |
| Median House Price (TT$) | 577,750 | 627,375 | 721,481 | 835,475 | 951,250 | 1,065,000 | 1,076,994 | 950,000 |
| Fiscal Balance/GDP (%) | 1.6 | -0.6 | 1.4 | 1.9 | 5.2 | 6.9 | 1.8 | 6.3 |
| Total Public Sector Debt/GDP (%) | 54.1 | 58.3 | 49.9 | 44.1 | 35.6 | 31.7 | 29.4 | 25.1 |
| External Current Account/GDP (%) | 5.0 | 0.8 | 8.7 | 12.3 | 22.4 | 39.4 | 25.6 | 33.7 |
| Overall Balance/GDP (%) | 4.2 | 0.5 | 2.2 | 4.0 | 9.2 | 6.1 | 7.3 | 10.4 |
| Net Official Reserves (US$Mn) | 1,694.7 | 1,743.9 | 1,991.3 | 2,522.9 | 3,998.8 | 5,117.6 | 6,658.7 | 9,364.2 |
| Import Cover (months) | 5.6 | 5.5 | 5.4 | 6.9 | 8.9 | 9.9 | 9.4 | 11.5 |
| Heritage & Stabilization Fund (US$Mn) | 162.6 | 161.5 | 250.2 | 452.5 | 866.7 | 1,396.3 | 1,788.3 | 2,895.8 |
| Energy Prices | | | | | | | | |
| Petroleum (WTI - US$/bbl) | 26.06 | 25.88 | 31.73 | 41.50 | 56.61 | 66.01 | 72.31 | 99.64 |
| Natuarl Gas (Henry Hub - US$/mmbtu) | 3.95 | 3.37 | 5.44 | 5.96 | 8.88 | 6.76 | 6.97 | 8.86 |
| Methanol (US$/tonne) | 197.80 | 163.88 | 256.84 | 264.63 | 284.02 | 376.82 | 433.79 | 504.02 |

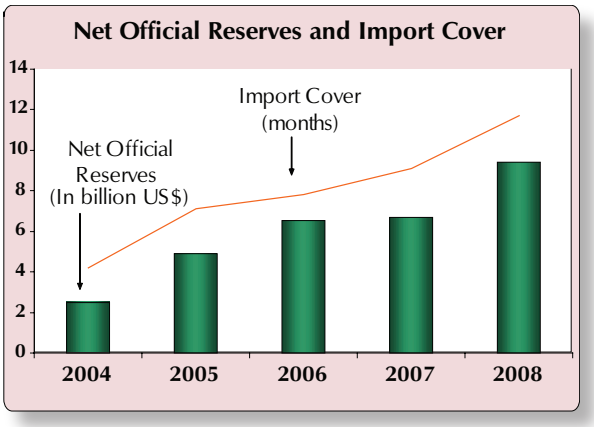
Source: Central Bank of Trinidad and Tobago.

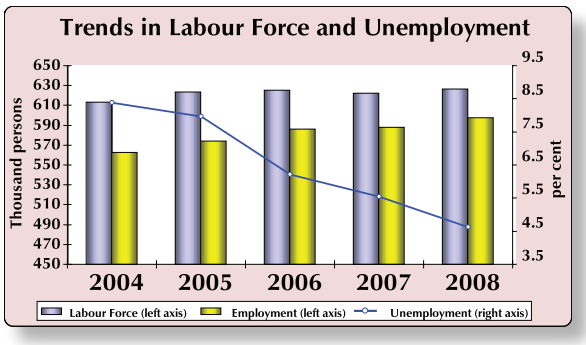
## Chart 3.1 Selected Macro-Economic Indicators, 2001 - 2008

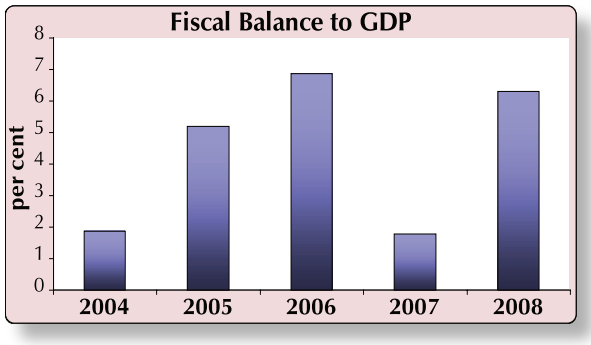


## Banking System Developments

The banking system both benefited from and contributed to the impressive economic developments noted above. In the period under review, bank deposits increased at an annual rate of 23 per cent, outstripping the growth of nominal GDP. The bulk of the growth came from time and savings deposits. Bank deposits, which are the most stable and least volatile sources of funding, constituted an average of 73 per cent of total commercial bank resources at the end of 2008. As regards other funding instruments, foreign liabilities constituted approximately less than 1 per cent of commercial bank funding while other borrowings accounted for 9.6 per cent. Inter-bank borrowing has not been an important source of bank funding.

The easy availability of funding facilitated a significant expansion in the growth in bank loans and advances which increased at an average annual rate of 17.6 per cent from 2001 to 2005 and by close to 20 per cent per year in the last three years to 2008. While loans and advances rose as a share of total bank assets from around 40 per cent to 52 per cent, the share of investments in banks' balance sheets has declined from 17.7 per cent to 14.8 per cent over the five years to 2008. These investments are comprised primarily of government securities, with equity holdings accounting for less than 10 per cent of the total.

It is interesting that the rapid expansion of the operations of the banking system was accompanied by an improvement in the major prudential indicators. This development was, in part, the result of the banks' deliberate efforts to upgrade risk management and governance policies in the wake of the bank crisis in neighbouring Jamaica. The upgrading of the FIA and the tightening of prudential supervision also played a contributory role.

In terms of the specific indicators, this period of unprecedented bank expansion also saw a reduction in banks' non-performing loans, an increase in banks' statutory capital, excess bank liquidity and rising bank profitability. Banks' foreign exposures remained contained as were the risks deriving from sectoral concentration.

A summary of the evolution of the main indicators is given below:

### *Loans and Advances*

In the five years to 2008, consumer loans accounted for an average of 30.4 per cent of total bank loans while loans to business firms averaged around 40 per cent. Between 2004 and 2008 credit cards loans grew on average by 16 per cent, however at the end of 2008 credit card loans comprised about 4 per cent of total loans and advances.

In the period 2003-2005, the share of real estate mortgage loans more than doubled from 13 per cent to 27 per cent of total loans. Part of the recorded increase in mortgage loans outstanding represented a transfer of portfolios from affiliated trust and mortgage institutions to their parent commercial banks. The transfer which took place in 2003-2004, was undertaken to secure operating efficiencies and to take advantage of the reduction in statutory reserve requirements applicable to the commercial banks and non-banks.[1]

The banking system does not face a problem of sectoral loan concentration. What stands out is that the petroleum sector, which contributes around 45 per cent of GDP, accounts for a mere 2 per cent of bank loans outstanding. This reflects the fact that most of the large energy firms are foreign-owned multinationals which obtain most of their funding from abroad. The data also show very limited bank credit expansion to the agricultural sector. While the formal classifications do not illustrate the point, bank credit to small and micro enterprises also forms a small part of total bank credit expansion. Much of the credit to the small business sector is mobilized through personal loans.

[1] In 2004, the cash reserve requirement applicable to commercial banks was reduced to 11 per cent of prescribed liabilities with effect from 15 September, 2004. In October 2003 the Bank had signaled its intention to lower the reserve requirements on a phased basis over a period of eighteen months from 18 per cent to 9 per cent. With effect from 15 October, 2003, the ratio was reduced from 18 per cent to 14 per cent of prescribed liabilities.

## Table 3.2 Commercial Banks: Financial Soundness Indicators, 2001 - 2008

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|---|---|
| | | | | (In percent, unless indicated otherwise) | | | | |
| *Capital adequacy* | | | | | | | | |
| Regulatory capital to risk-weighted assets | 19.5 | 20.6 | 20.3 | 19.3 | 18.2 | 18.0 | 19.1 | 18.8 |
| Regulatory Tier I capital to risk-weighted assets | 17.6 | 17.3 | 18.2 | 17.4 | 16.4 | 16.2 | 17.0 | 15.5 |
| Regulatory Tier II capital-to-risk-weighted assets | 1.9 | 3.3 | 2.2 | 1.9 | 1.7 | 1.9 | 2.1 | 4.4 |
| Regulatory capital-to-total assets | 11.1 | 11.7 | 12.4 | 13.2 | 11.6 | 11.3 | 12.4 | 12.1 |
| *Banking sector asset composition* | | | | | | | | |
| Sectoral distribution of loans-to-total loans | | | | | | | | |
| Households | 42.8 | 41.3 | 40.4 | 38.9 | 41.0 | 41.3 | 41.4 | 39.9 |
| *of which:* | | | | | | | | |
| Proportion secured as mortgage loans | 10.2 | 11.4 | 11.3 | 18.3 | 27.2 | 26.5 | 26.1 | 28.4 |
| Financial sector | 12.5 | 12.1 | 17.6 | 17.8 | 17.2 | 18.7 | 22.5 | 19.8 |
| Oil and gas sector | 5.5 | 4.2 | 4.6 | 2.9 | 2.8 | 3.8 | 2.8 | 3.3 |
| Construction | 3.8 | 4.6 | 7.4 | 6.4 | 5.9 | 6.5 | 6.1 | 6.8 |
| Transport and communication | 4.9 | 3.7 | 3.7 | 3.6 | 2.7 | 2.9 | 2.8 | 1.8 |
| Non-residents | 2.2 | 3.2 | 2.3 | 4.6 | 5.6 | 6.3 | 7.1 | 6.6 |
| Geographic distribution of loans-to-total loans | | | | | | | | |
| Domestic | 97.8 | 96.8 | 97.7 | 96.3 | 93.8 | 93.9 | 93.3 | 93.6 |
| Foreign | 2.2 | 3.2 | 2.3 | 3.7 | 6.2 | 6.1 | 6.7 | 6.4 |
| Foreign currency loans-to-total loans | 30.1 | 31.2 | 17.2 | 26.8 | 23.9 | 23.2 | 21.4 | 23.0 |
| *Banking sector asset quality* | | | | | | | | |
| Nonperforming loans-to-gross loans | 3.2 | 3.6 | 2.0 | 3.9 | 1.7 | 1.4 | 0.7 | 1.0 |
| Nonperforming loans (net of provisions)-to-capital | 4.7 | 3.4 | -1.1 | 7.9 | 2.3 | 2.3 | -0.3 | -0.1 |
| Specific provisions-to-impaired assets | 57.7 | 70.8 | 117.5 | 40.3 | 67.7 | 60.9 | 109.7 | 72.4 |
| Specific provisions-to-gross lending | 1.9 | 2.6 | 2.3 | 1.6 | 1.1 | 0.8 | 0.8 | 0.7 |
| *Banking sector earnings and profitability* | | | | | | | | |
| Return on equity | 21.0 | 23.9 | 20.4 | 32.5 | 25.2 | 27.2 | 27.3 | 25.9 |
| Return on assets | 2.4 | 2.9 | 2.5 | 4.3 | 3.2 | 3.4 | 3.4 | 3.5 |
| Interest margin-to-gross income | 62.9 | 62.1 | 62.8 | 50.9 | 58.4 | 61.7 | 61.4 | 65.2 |
| Non-interest expenses-to-gross income | 62.9 | 59.2 | 64.7 | 54.9 | 60.7 | 51.1 | 48.3 | 49.7 |
| Spread between average lending and deposit rates | 8.8 | 9.1 | 8.7 | 7.4 | 7.1 | 7.4 | 7.9 | 8.3 |
| *Banking sector liquidity* | | | | | | | | |
| Liquid assets-to-total assets | 17.8 | 16.1 | 15.9 | 14.8 | 15.0 | 20.1 | 17.0 | 22.1 |
| Liquid assets-to-total short-term liabilities | 24.8 | 22.6 | 22.3 | 20.5 | 21.9 | 26.9 | 22.6 | 30.0 |
| Customer deposits-to-total (non-interbank) loans | 145.3 | 147.2 | 142.3 | 128.3 | 119.3 | 125.8 | 118.0 | 124.7 |
| Foreign currency liabilities-to-total liabilities | 32.6 | 34.3 | 34.4 | 37.8 | 35.8 | 34.6 | 33.8 | 32.7 |
| *Banking sector sensitivity to market risk* | | | | | | | | |
| Net open positions in FX-to-capital | -11.8 | -18.2 | -36.8 | -0.9 | -13.9 | -3.5 | -12.1 | 0.5 |

Source: Central Bank of Trinidad and Tobago.

Banks' external credit exposures have increased somewhat in recent years but remain at manageable levels. As at end-December 2008, these offshore exposures accounted for 12 per cent of total assets of the banking system. A potential source of vulnerability results from the fact that about three-quarters of the external exposure is concentrated in the CARICOM region where whose economies are subject to the same exogenous shocks.

### *Credit Quality*

The significant increase in commercial bank credit since 2001 has been accompanied by a reduction in the share of non-performing loans, from a level of around 3.5 per cent at the beginning of the decade to around 1 per cent in 2007-2008. As shown in Table 3.2, these delinquency rates are significantly lower than those in CARICOM *(See Table 3.3)* or indeed in most developing countries.

The data for commercial banks show almost no delinquency (0.1 per cent) in their mortgage portfolio. This could be related to three factors viz: (i) prior to the transfer of the loan portfolios of the affiliated trust and mortgage companies in 2003-2004, the mortgage portfolios of the commercial banks were extremely small and selective, (ii) the transfer itself covered only the highest quality loans, and (iii) even when the commercial banks became active in mortgage lending, they adhered to the strictest standards including capping loan to value ratios at between 80 and 90 per cent.

A potential area of vulnerability in respect of the mortgage loan portfolios of the commercial banks is the tendency for the banks to keep these loans on their books to maturity rather than discount them in the secondary market. This tendency is explained by the banks' chronic excess liquidity condition which increases their need for acceptable assets and reduces the urgency for additional funding resources.

Even while reducing the ratio of non-performing loans, the commercial banks have, over time, increased their level of provisions, such that non-performing loans (adjusted for provisions) as a proportion of capital have been negative over the period 2007-2008.

## *Capital Adequacy*

The banking system has remained well-capitalized throughout the decade. While there has been a modest decline since the early 2000s, the average level of regulatory capital to risk-weighted assets over the last three years to 2008 has been in excess of 18 per cent. The level compares with a minimum regulatory requirement of 8 per cent. The significant capital buffer is an excellent indicator of the banking system's ability to cope with internal challenges (such as an increase in non-performing loans) as well as exogenous shocks.

The level of Tier 1 capital was similarly robust averaging some 16 per cent over the past three years. [2] The statutory minimum requirement for Tier 1 capital is 4 per cent.

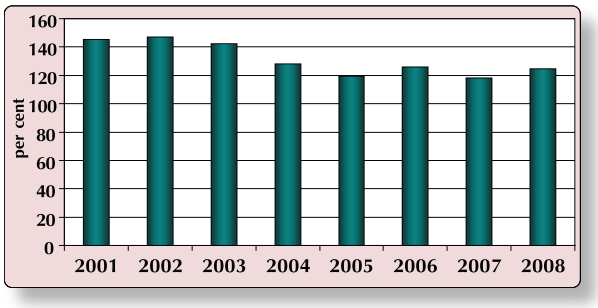
## *Liquidity*

The banking system has a chronic tendency toward systemic excess liquidity. This tendency stems mostly from the government's substantial non-oil fiscal deficit (which is financed from draw-downs of revenues from the energy sector) and is reinforced by the banks' inherent conservative lending policies. A bank's excess liquidity is normally available for the purchase of government treasury bills or for lending in the inter-bank market. Since these opportunities are invariably limited, banks normally have large non-interest bearing excess deposits at the Central Bank.

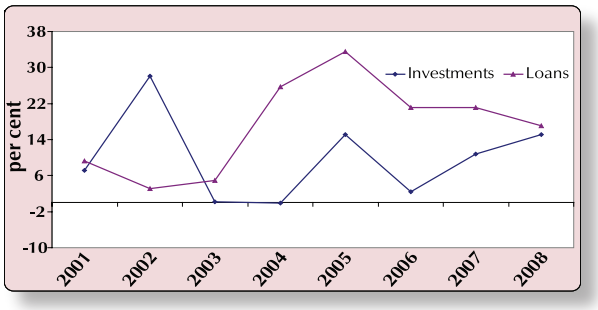
Since February 2008, in the course of a process of monetary tightening, the reserve requirement for the commercial banks was increased from 11 per cent to 17 per cent of prescribed liabilities. Notwithstanding this increase in 2007-2008, the average level of excess reserves was the equivalent of 4 percentage points. The broader liquidity indicator – the ratio of liquid assets to total assets - has averaged a healthy 11 per cent in 2007-2008. Another indicator, which underscores the high level of liquidity in the banking system is the ratio of deposits to total loans, which has averaged 134 per cent since 2001.

[2] Tier 1 capital comprises ordinary shares, audited retained earnings and non redeemable, non cumulative preferred shares.

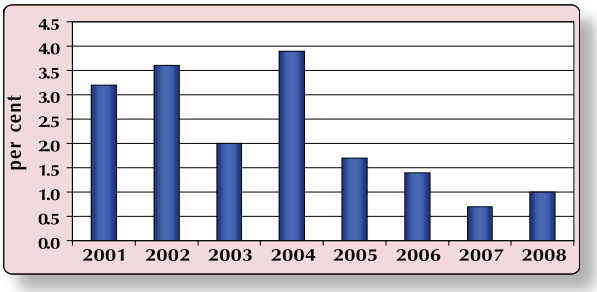
## Chart 3.2
## Customer Deposits to Loans, 2001- 2008



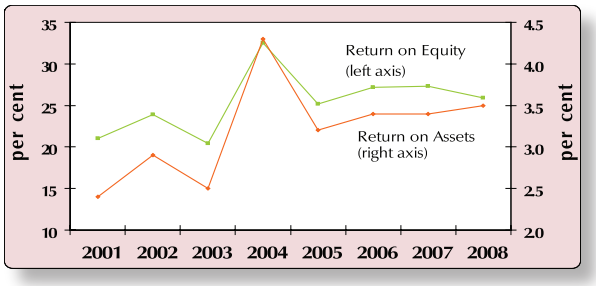

## Chart 3.3
## Commercial Banks:
## Loans And Investments (Annual Growth), 2001 - 2008




## Chart 3.4
## Commercial Banks:
## Non Performing Loans to Total Loans, 2001 - 2008



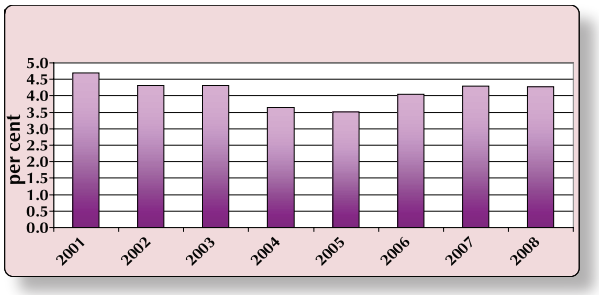

## Chart 3.5
## Commercial Banks:
## Return on Assets and Return on Equity, 2001 - 2008




### *Earnings and Profitability*

Throughout the decade the banking sector has registered robust profitability levels. Strong profitability has meant that retained earnings remain an important source of banks' Tier 1 capital. Even following a major consolidation of the banking system leading to an increase in competition, the rate of return as a percentage of capital (return on equity) has averaged 26 per cent in the period 2006-2008. Over this period, the rate of return on assets has averaged 3.4 per cent, which is relatively high by international standards. (Table 3.3) The profitability of the banking sector is also reflected in the steady increase in the value of bank shares on the domestic stock exchange.

## Chart 3.6
## Commercial Banks:
## Net Interest Margins, 2001 - 2008



## Table 3.3 Commercial Banks: Financial Soundness Indicators, 2001 - 2008

(i) Regulatory Capital to Risk Weighted Asset

| Per Cent | | | | |
|---|---|---|---|---|
| | 2005 | 2006 | 2007 | 2008 |
| Brazil | 17.9 | 18.9 | 18.7 | 16.6 |
| Chile | 13.0 | 12.5 | 12.2 | 12.1 |
| Colombia | 14.7 | 13.1 | 13.6 | 13.4 |
| Dominican Republic | 12.5 | 12.4 | 13.9 | 15.8 |
| Mexico | 14.5 | 16.3 | 15.9 | 15.3 |
| Barbados | 13.0 | 12.0 | 10.8 | 13.9 |
| Guyana | 14.3 | 15.4 | 15.0 | 14.9 |
| Jamaica | 17.9 | 16.1 | 14.5 | 13.9 |
| Trinidad & Tobago | 18.2 | 18.0 | 19.0 | 18.8 |

(ii) Non Performing Loans to Total Loans

| Per Cent | | | | |
|---|---|---|---|---|
| | 2005 | 2006 | 2007 | 2008 |
| Brazil | 3.5 | 3.5 | 3.0 | 2.9 |
| Chile | 0.9 | 0.8 | 0.8 | 0.9 |
| Colombia | 2.7 | 2.6 | 3.3 | 4.0 |
| Dominican Republic | 5.9 | 4.5 | 5.0 | 3.8 |
| Mexico | 1.8 | 1.4 | 1.3 | 1.4 |
| Barbados | 5.5 | 4.5 | 2.9 | 3.4 |
| Guyana | 13.9 | 11.5 | 10.6 | 5.2 |
| Jamaica | 2.3 | 2.2 | 2.0 | 2.6 |
| Trinidad & Tobago | 2.2 | 1.6 | 1.1 | 1.0 |

(iii) Return on Assets

| Per Cent | | | | |
|---|---|---|---|---|
| | 2005 | 2006 | 2007 | 2008 |
| Brazil | 2.9 | 2.7 | 2.9 | 2.0 |
| Chile | 1.3 | 1.3 | 1.1 | 1.2 |
| Colombia | 2.7 | 2.5 | 2.4 | 2.4 |
| Dominican Republic | 1.8 | 1.9 | 2.5 | 1.7 |
| Mexico | 2.7 | 3.1 | 2.7 | 1.8 |
| Barbados | 2.1 | 2.7 | 2.5 | 2.2 |
| Guyana | 0.4 | 0.5 | 0.5 | 0.5 |
| Jamaica | 3.7 | 3.5 | 3.5 | 4.1 |
| Trinidad & Tobago | 3.2 | 3.4 | 3.4 | 3.5 |

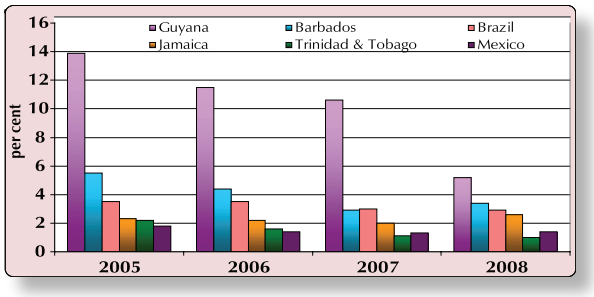
(iv) Return on Equity

| Per Cent | | | | |
|---|---|---|---|---|
| | 2005 | 2006 | 2007 | 2008 |
| Brazil | 29.5 | 27.3 | 28.9 | 20.4 |
| Chile | 17.9 | 18.6 | 16.2 | 18.9 |
| Colombia | 22.1 | 20.2 | 19.5 | 20.0 |
| Dominican Republic | 22.4 | 21.7 | 28.0 | 28.0 |
| Mexico | 24.4 | 26.2 | 19.9 | 12.8 |
| Barbados | 25.2 | 27.6 | 21.4 | na |
| Guyana | 5.7 | 6.9 | 6.8 | 6.3 |
| Trinidad & Tobago | 25.2 | 27.2 | 27.3 | 25.9 |

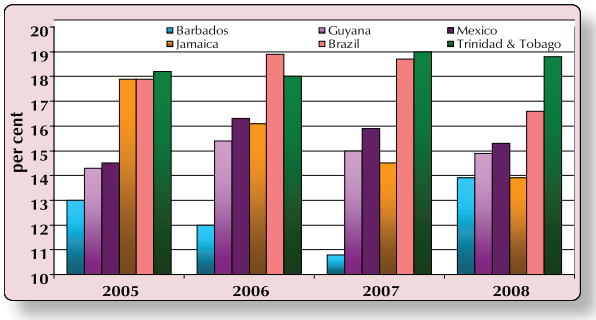
Source: Global Financial Stability Report, April 2009 and data from the Central Bank of Barbados, Guyana and Jamaica.

## Chart 3.7
## Financial soundness indicators for selected countries, 2005 – 2008

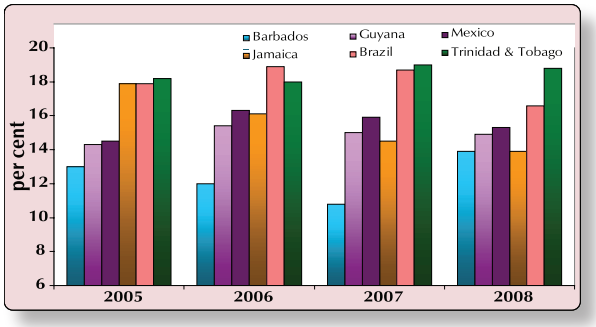
(i) Non Performing Loans to Total Loans




(ii) Return on Assets




(iii) Capital Adequacy




The banking system's strong profit performance has been underpinned by the maintenance of high interest margins, which have accounted for an average of over 60 per cent of gross income over in the period 2006-2008. Strong interest earnings have been supported by a marked reduction in non-interest expenditures to gross income.

### *Some Other Prudential Considerations*

The conservative risk posture of the commercial banks is reflected in other operating indicators. Thus, for example, banks have kept their foreign exchange exposures at comfortable levels, with foreign currency loans to total loans remaining under 25 per cent.

The banks have made efforts to contain asset/liability imbalances by (i) increasing the share of adjustable rate loans in loan portfolio, and (ii) preventing maturity mismatches by sticking to loans with a maximum maturity of 3 - 5 years.

# CHAPTER 4

## THE EVOLUTION OF FINANCIAL STABILITY INDICATORS: NON-BANK FINANCIAL INSTITUTIONS (2001 – 2008)

The current financial crisis across the world is first and foremost a crisis in the banking sector. However, the activities of the non-bank sector have contributed both to the emergence and to the scale of the instability that has ensued. In developing countries, non-bank financial institutions play an essential role in the financial system in terms of the quantum of resources mobilized and the range of services they provide. Their operations could therefore have an important impact on financial stability.

This chapter focuses on the non-bank financial institutions licensed under the FIA and the insurance companies, which are licensed under the Insurance Act of 1980. The non-bank data are classified in two groups viz: (i) the finance companies and merchant banks, and (ii) the trust and mortgage finance companies. The finance houses specialize in installment loans while the merchant banks provide various forms of corporate credit. The trust and mortgage finance companies provide mortgage lending and are involved in bond underwriting. As discussed in Chapter Two, the trust and mortgage finance sector has undergone widespread changes over the past few years as some institutions have seen part of their operations shifted to their commercial bank parents. *(See Box 4.1)*.

### BOX 4.1
### TRUST AND MORTGAGE FINANCE COMPANIES

Since 2004, the volume of business undertaken by trust and mortgage finance companies fell sharply as most of the mortgage activity was transferred to the affiliated parent commercial bank. The fall off in activity is reflected in both deposit and loan accounts. The number of deposit accounts fell from 13,707 (2004) to 2,715 (2008) while loan accounts declined over the same period to 2,720 from 9,839.

As the trust and mortgage companies now focus primarily on trustee business, the winding down of their mortgage activity is clearly reflected in the results for income and profitability. Return on equity fell from 26.8 per cent in 2004 to 12.5 per cent in 2008, while a similar decline was observed in return on assets which fell to 2.7 per cent in 2008 from 5.2 per cent in 2004.

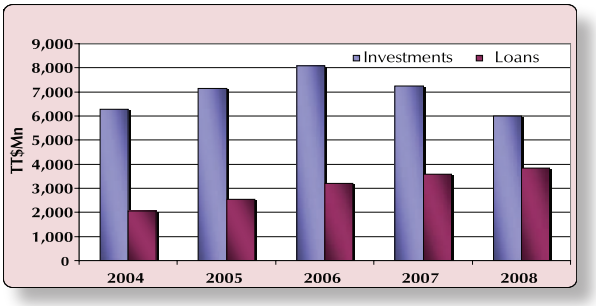
The asset quality of the mortgage loans which remained on the books of these institutions was unaffected by these changes as the share of non-performing loans to total loans fell from 2.3 per cent in 2004 to 0.2 per cent in 2008.

## Finance Companies and Merchant Banks

Over the past few years, the continuation of the process of financial liberalization and the use of modern risk management techniques have brought commercial banking services to many customers that were previously excluded. To meet this competition, the non-banks have been forced to increase interest rates to obtain funding. This has served to squeeze profit margins. Invariably also, the non-banks are forced to serve less-creditworthy borrowers which usually leads to higher levels of loan delinquency. The reduction in profitability and the higher incidence of loan delinquency have in turn increased vulnerability and have forced some consolidation in the sector. The high interest rate structures and the high level of non-performing loans were among the factors that contributed to the failure of CLICO Investment Bank (CIB) in early 2009.

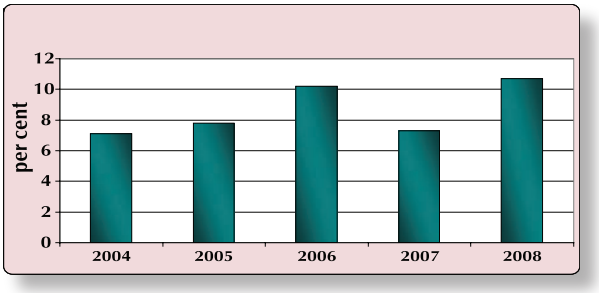
The overall performance of this group was impacted by the activities of CIB whose assets accounted for about 70 per cent of the total in 2008 compared with 41 per cent in 2001. Between 2004 and 2008, the assets of the finance houses and merchant banks grew more slowly than at the start of the decade. The slowdown was directly attributable to a fall in investments which had risen sharply between 2004 and 2006 but declined thereafter. In 2008, investments accounted for 34.1 per cent of total assets compared with 62.1 per cent in 2004. While the share in total assets of investments and loans and advances fell, "other assets" which is comprised mainly of equity in subsidiaries and affiliates rose to 25.8 per cent of total assets. If CIB is excluded from the group however in 2008, average total assets grew marginally in 2008 (1.3 per cent) compared with an average of 20 per cent in the three preceding years.

### Chart 4.1
### Finance Houses and Merchant Banks: Investments and Loans, 2004 - 2008



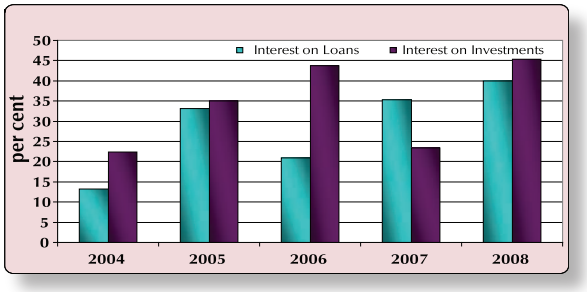

The delinquency ratio for this group is significantly higher than that for commercial banks with the ratio of non-performing loans rising from 7 per cent to 10.7 per cent of total loans in 2008.[1] Despite the deterioration in asset quality, loan loss provisions have not quite kept pace with the decline.

### Chart 4.2
### Finance Companies and Merchant Banks: Non-performing Loans as a Per Cent of Average Total Loans, 2004 – 2008

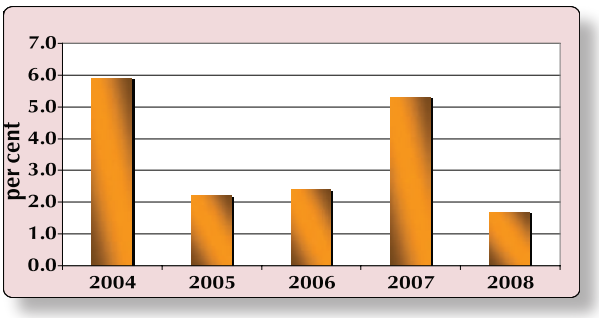



[1] If CIB is excluded for 2008, the ratio of non-performing loans to total loans stands at 2.9 per cent

## Chart 4.3
## Finance Houses and Merchant Banks: Distribution of Interest Income, 2004 - 2008




## Chart 4.4
## Finance Houses and Merchant Banks: Return on Assets, 2004 - 2008




Over the period under review, operating expenses continued to grow while operating income declined sharply for one member of the group. As a result profitability ratios, that is, net profit after tax as a percentage of total assets, fell from 5.9 per cent in 2004 to 1.7 per cent in 2008. While this result is in stark contrast to the performance of the commercial banks, if CIB is excluded, the return on assets for the group amounts to 3.5 per cent and the return on equity 12 per cent for 2008.

Since 2003, there has been a sharp increase in capital market activity by the non-banks. These operations have involved the underwriting of private placements by the domestic private sector as well as by regional governments and corporations. Some of these long-term securities are then stripped and distributed to investors according to their different time preferences. The "underwrite and distribute" model reduces the exposure of the underwriters themselves. However, the model has been shown to carry inherent risks since without the obligation to hold some of the securities there is a tendency for due diligence to be less robust than it should be. Indeed there have been several defaults on regional issues in the past few years. However, while there was some negative fallout, this was mitigated by new business. Since 2006 however, there has been more liquidity in the financial system, a decline in offerings by the central government as well as a reduction in regional activity by these institutions.

**Table 4.1 Finance Companies and Merchant Banks: Summary of Performance Indicators, 2004 – 2008 (per cent)**

| | 2004 | 2005 | 2006 | 2007 | 2008p |
|---|---|---|---|---|---|
| **Profitability** | | | | | |
| Return on Assets | 5.9 | 2.2 | 2.4 | 5.3 | 1.7 |
| Return on Equity | 41.6 | 12.1 | 16.1 | 33.4 | 12.0 |
| Net Interest Margin/Total Assets | -4.9 | 0.9 | 0.6 | 0.7 | -0.3 |
| **Efficiency** | | | | | |
| Total Operating Expenses/Total Operating Income | 59.7 | 83.6 | 72.6 | 80.4 | 109.1 |
| **Asset Quality** | | | | | |
| Nonperforming Loans/Gross Loans | 7.1 | 7.8 | 10.2 | 7.3 | 10.7 |
| Accumulated loan loss provisions/Gross Loans | 3.0 | 3.3 | 2.8 | 2.1 | 2.3 |

## Insurance

Insurance companies lower the level of risk in the economy as individuals and firms buy protection against certain defined events. In this way, they promote financial stability as they transfer risks to those better equipped to deal with them. Risk reduction also occurs to the extent that insurance firms mobilize essentially long-term liabilities, which are available for investments into long term assets (asset/liability matching).

The buoyant economic conditions since 2001 supported strong growth in all product lines of the insurance industry. The non-life sector blossomed because of the boom in real estate and consequently mortgage insurance, while sales of motor insurance policies increased in line with the surge in automobile sales.

Activity in the life insurance sector also increased significantly over the period and there was a major transformation of the industry, in part, due to the surge in product innovation. Several companies began to introduce deposit-like products with an increased focus on wealth management. In addition, there was an increase in the linkages between banks and insurance companies either through bancassurance or through conglomerate structures. These changes greatly increased the vulnerability of the sector and exposed specific companies to increased risks. Indeed, two companies which departed the most from traditional insurance products and adopted higher risk portfolio management strategies – Colonial Life Insurance Company and British American Insurance Company – found themselves in serious stress and had to be intervened by the Central Bank in early 2009.

### *Life Insurance*

Gross premium income of the life insurance sector increased by an average of 11.3 per cent a year in the period 2003 – 2008. This growth was mainly in the area of wealth management products, especially short-term deposit like products. In 2008, for the life insurance component of the industry about 72.6 per cent of total policy holder liabilities were in respect of these deposit-like products. This compared with an average of 49.6 per cent in 2004.

Growth in investment-driven products places significant reliance on the performance of the investment portfolios of the life insurance companies. However, on average, the performance of the life sector's investment portfolios has been deteriorating since 2003. The average return has fallen from 10.9 per cent per annum in 2003 to 5.1 per cent per annum in 2008. With the increased concentration in wealth management products and the declining returns

on the investment portfolio, there has been a change in the sector's exposure. In addition to the risks from mortality and morbidity, the sector is now exposed to interest rate and credit risks.

Since 2006, the industry has experienced a sharp decline in pre-tax profit margins. For example, pre-tax profits represented 6.1 per cent of gross premiums in 2006 and this declined to a loss margin of 1.7 per cent in 2008. This decline is directly attributable to the increased emphasis on wealth management products as companies earn profits on these policies based on the spread between the interest rate credited to policyholders and the performance return of their investment portfolio. As already noted, the average return on investment for life insurance companies has declined resulting in reduced profit margins.

## BOX 4.2
## THE MAIN ELEMENTS OF THE CIB/CLICO BAILOUT STRATEGY

In January 2009, the Central Bank, invoking the powers granted under Section 44D of the Central Bank Act, intervened in the CLICO Investment Bank (CIB) and two insurance companies, the Colonial Life Insurance Company (CLICO) and the British American Insurance Company (Trinidad) Limited (BA). The action was taken to protect the bank's depositors and the policy holders of the insurance company, after both institutions were unable to meet their obligations. Both CIB and CLICO are subsidiaries of CL Financial (CLF), a local conglomerate, with significant regional and international reach. In addition to financial services, CLF's interests cover investments in energy, real estate, manufacturing and distribution, spread over 40 companies in 28 countries. BA is a subsidiary of British American Insurance Company Limited which is owned by CLF.

### CLICO INVESTMENT BANK

CIB is a registered non-bank financial institution accounting for 11.4 per cent of the total assets of the banking system. As at December 2008, about 42 per cent of the bank's loan portfolio was to affiliated companies.

CIB's financial distress could be traced to the following factors:

- A loan portfolio which was risky in nature and of relatively poor quality.
- This was aggravated by very poor loan administration with the result that CIB was an outlier with non-performing loans significantly higher than the sector average.
- The loan portfolio also included a high proportion of project loans which did not provide cash flow for the bank and therefore further hampered the bank's liquidity position.
- CIB's investment portfolio carried an equally risky profile with government securities holdings significantly lower than that of similar non-banks.
- In order to mobilize funds, CIB paid interest rates which were significantly higher than the average for similar institutions. About 70 per cent of total deposits were related party deposits.
- Funds were also mobilized through the issue of investment certificates which were not always covered by liquid investments held in trust.
- In addition to the above, CIB's operations were affected by poor financial record-keeping and weak corporate governance.

## BOX 4.2
## THE MAIN ELEMENTS OF THE CIB/CLICO BAILOUT STRATEGY (continued)

### CLICO AND BA

CLICO (Trinidad) and BA (Trinidad) and BA account for 52.5 per cent of insurance liabilities in Trinidad and Tobago.

As with CIB, CLICO's operations reflected several weaknesses occasioned, in part, by its assigned role in the CLF group. Some of the major vulnerabilities were:

- A shift away from traditional insurance to a focus on the mobilization of short term deposit-like instruments paying guaranteed above-market interest rates.
- An asset-liability mis-match deriving from a concentration of long term assets (real estate and non-traded equities) whose rates of return depended heavily on capital appreciation
- The limited liquidity of the assets was reduced by the high level of leverage while the significant share of intra-group assets further increased portfolio risks.
- As was the case with CIB, the impact of these various vulnerabilities was compounded by poor corporate governance practices.

With policy-holders concerned about the impact of slumping property values and declining commodity prices on CLICO's finances, there was a sharp increase in withdrawal requests which created liquidity pressures. At the same time, preliminary information submitted by CLICO showed a sizeable statutory fund deficit clearly indicating an inability to meet maturing liabilities.

Against this background and requests for assistance on behalf of CLICO, BA and CIB, the Government, the Central Bank and CL Financial reached agreement on a Memorandum of Understanding MOU). The MOU's main objective was the provision of loan assistance by the Government and the Central Bank to protect the interests of third-party CIB depositors and CLICO and BA policy-holders and in so doing contribute to restoring CLICO and BA to health and ensuring stability in the financial system.

### *Non-life Insurance*

Over the eight years to 2008, the non-life insurance sector has shown strong growth in gross premiums averaging 12.9 per cent per annum. In 2008, total premium income amounted to $2.25 billion (1.5 per cent of GDP) an increase of just under 1.5 per cent from the previous year.

Non-life insurers depend heavily on reinsurance for protection, although the proportion of premiums paid to reinsurers has been gradually falling. Overall, premiums retained by insurers increased from 56.3 per cent in 2000 to 63.7 per cent in 2008.

Claims net of reinsurance have ranged between 59 per cent and 67 per cent of retained premiums over the last four years. The 2008 result of 59.9 per cent was marginally higher than in 2007. The accuracy of the claims cost depends to a large extent on whether the reserves for outstanding claims set by individual insurers are adequate. At the industry level reserves have been increasing, but there are some concerns about the adequacy of the level of reserves for some companies. In 2008, the industry paid commissions to intermediaries that averaged 12.0 per cent of gross premiums and incurred management expenses of 12.4 per cent of gross premiums. These ratios have been reasonably stable in recent years.

Between 2005 and 2008, the non-life segment of the industry reported total net claims and expenses in excess of net premium income. This implied that the combined ratio exceeded 100 per cent. While there has been a reduction in this ratio, it continues to exceed 100 per cent. If the ratio does not fall below 100 per cent the industry will continue to rely on investment income to meet its obligations and will have some difficulty in maintaining its capital base. Investment returns have been low over the period, although there has been a marginal increase between 2005 (3.4 per cent) and 2008 (5.1 per cent).

While profit results for individual companies vary widely, in 2008 the non-life sector reported pre-tax profits of 4.6 per cent of gross premiums, or 9.0 per cent of shareholders' funds.

In 2005 and 2006, the industry experienced a small pre-tax loss, while in the last two years modest profits were reported. Nonetheless, there are still concerns that the profits for the sector may be over-stated given the reserve adequacy concerns in providing for claim liabilities.

## Statutory Funds

The Insurance Act requires companies to cover their long term insurance liabilities by assets held in trust in a statutory fund. The law also specifies the quality of the assets that could be credited to the fund. By and large most insurance companies have operated within the strictures of the law and have met the statutory fund obligations. Significant statutory fund deficits in 2008 were among the deficiencies exhibited by the two insurance companies that were intervened in early 2009. Table 4.3 shows trends in the statutory fund for life insurance companies over the period 2003 to 2007.

## Table 4.2 – Insurance Companies: Financial Soundness Indicators – 2004-2008

| (per cent) | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|
| **Increase in Premium Income** | 9.2 | -3.9 | 13.2 | 50.0 | 10.4 |
| **Retention Ratios** | | | | | |
| **Life** | 97.9 | 94.5 | 97.7 | 98.2 | 98.5 |
| **Non-Life** | 48.9 | 61.9 | 61.0 | 64.6 | 63.7 |
| **Performance Ratios (Non-Life)** | | | | | |
| **Loss Ratio** | 58.7 | 65.3 | 67.1 | 59.4 | 59.9 |
| **Expense Ratio** | 29.4 | 43.6 | 42.0 | 41.2 | 40.3 |
| **Combined Ratio** | 88.1 | 108.9 | 109.0 | 100.5 | 100.2 |
| **Investment Income/ Investment Assets** | | | | | |
| **Life** | 9.7 | 4.3 | 2.8 | 5.3 | 5.1 |
| **Non-Life** | 7.0 | 3.4 | 3.6 | 3.9 | 5.1 |

## Table 4.3 – Insurance Companies: Trends in the Statutory Fund – 2003 - 2007

| | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|
| Trinidad and Tobago Government Securities | 1,252.1 | 1,502.3 | 1,643.2 | 1,335.4 | 2,358.9 |
| | (8.5) | (8.8) | (9.5) | (7.7) | (11.7) |
| Mortgages | 565.1 | 648.7 | 686.4 | 794.8 | 1,096.4 |
| | (3.8) | (3.8) | (3.9) | (4.6) | (5.5) |
| Real Estate | 584.3 | 662.6 | 897.9 | 1,235.1 | 1,776.4 |
| | (3.9) | (3.9) | (5.2) | (7.1) | (8.8) |
| Trinidad and Tobago Equities | 5,878.9 | 6,433.6 | 6,582.4 | 6,966.9 | 6,991.4 |
| | (24.7) | (38.0) | (38.2) | (40.5) | (34.7) |
| Other Local | 3,663.6 | 6,623.2 | 4,889.4 | 4,772.43 | 5,872.4 |
| | (24.7) | (39.2) | (28.6) | (27.7) | (29.1) |
| Foreign Assets | 2,832.8 | 1,022.8 | 2,514.9 | 2,072.8 | 2,019.1 |
| | (19.1) | (6.0) | (14.6) | (12.1) | (10.0) |
| **Total** | **14,776.5** | **16,893.4** | **17,214.2** | **17,177.1** | **20,114.6** |

Source: Report on Insurance and Pensions, Central Bank of Trinidad and Tobago.
Numbers in parentheses are percentage contribution.

The Insurance Act includes limits on the portfolio composition of the assets that are in the fund as well as a local assets ratio of 80 per cent (which implies a limit of 20 per cent on foreign assets). The limits on the portfolio composition are on equity holdings (50 per cent) and real estate (20 per cent). Given the limited scope of the local capital market, there are few options for high quality, readily liquid assets available. The data for the three year period 2005 – 2007 show that investment in equities constituted 37.8 per cent. This ratio is heavily influenced by data for CLICO and BA whose asset portfolio was dominated by shares of related companies. Excluding CLICO and BA the percentage of shares in the asset portfolio is relatively low. The largest holdings for these companies are government securities, bank deposits and mortgages.

# CHAPTER 5

## THE INTERNATIONAL FINANCIAL CRISIS AND THE DOMESTIC FINANCIAL SYSTEM

The international financial crisis, which began sometime in late 2007 and intensified in the second half of 2008 placed severe strains on banks' balance sheets, particularly in the United States and Europe. The collapse of Lehman Brothers in September 2008 led to increased concerns over the solvency of many other financial institutions as credit spreads widened and equity prices declined sharply. In the United States (US), the United Kingdom (UK) and in other countries in Europe unprecedented government intervention was needed to forestall systemic banking crises.

The international financial crisis contributed significantly to the severe recession in the advanced economies. The US, for instance was plunged into the deepest recession since the Great Depression. Economic activity is estimated to have declined by 6.25 per cent on an annual basis in the last quarter of 2008 and is projected to decline by 2.6 per cent in 2009. Unemployment has currently reached a level of 9.7 per cent and is projected to exceed 10 per cent later in the year. The European Union and most other developed countries have also seen their economies in recession and facing high unemployment rates.

In most of these economies governments introduced specific measures to support weak banking systems and sizable fiscal packages to help pull the economies out of recession. These measures are beginning to bear fruit as banking systems have stabilized and the flow of credit has resumed, albeit at a trickle. In the US there are initial signs that the recession is bottoming out and that economic growth could resume by the last quarter of the year.

### Implications for the Caribbean

The first round impact of the crisis on the Caribbean financial system was fairly limited for several reasons. **Firstly** banks in the region had not invested heavily in sub-prime mortgages, **secondly** bank credit expansion in the region is based predominantly on deposit mobilization and only marginally on foreign loans and **third** the foreign banks in the region were, in the main subsidiaries of Canadian banks, which were not seriously affected by the international financial crisis.

Of the regional jurisdictions, Jamaica was probably the most seriously affected because of the decline in the value of its global bonds, much of which were held by domestic commercial banks. The Bank of Jamaica had to establish a US$300 million facility to provide support to the commercial banks.

All the economies in the Caribbean have been seriously impacted by the second round effects of the global crisis, through declines in trade (including tourism) and financial flows and especially the fall-off in remittances. Jamaica, for example, has experienced a decline in emigrants' remittances, the second largest foreign exchange earner, of an estimated 17 per cent in 2008. An even larger fall is expected in 2009, along with a sharp reduction in tourist arrivals. Throughout the region, there have been hotel closures and the postponement of hotel investment projects in the Bahamas, the OECS, Barbados and elsewhere. By June 2009 four CARICOM members had sought assistance from the IMF under the Exogenous Shock Facility which provides policy support and financial assistance to low income countries facing exogenous shocks. As a significant amount of Trinidad and Tobago's trade and investment occurs within the Caribbean, the domestic economy will also be impacted by such developments.

### Impact on Trinidad and Tobago

The domestic economy began to feel the impact of the global crisis through two main channels viz: the fall in international commodity prices and lower external demand

for energy and non-energy exports. International oil prices declined from a high of US$147 per barrel in July 2008 to US$54 per barrel in November 2008. There were similar declines in the prices of other energy exports. These were accompanied by sharp declines in the production and exports of oil, urea, ammonia and methanol. The downturn in the energy sector, its potential impact on government operations and tightening bank credit conditions created concerns among businesses and consumers which resulted in lower domestic demand further impacting on the pace of economic activity. This was reflected in declines in manufacturing and construction activities. Based on current trends, the outlook is for a decline in real GDP of around 1.0 per cent in 2009.

After a fall from 4.6 per cent to 3.9 per cent in the last quarter of 2008, the rate of unemployment rose to 5 per cent in the first quarter of 2009. Declining demand also contributed to lowering inflation from 14.5 per cent at the end of 2008 to 8.4 per cent in June 2009. The June rate was the first time inflation had fallen to single digits since April 2008 (9.28 per cent).

Asset prices registered sharp declines in 2009. In the first seven months of the year the Composite Index declined by 32.9 per cent following a fall of 14.2 per cent in 2008. Real estate prices are also in retreat with the index of real estate prices posting a decline of 4.7 per cent in the first quarter of 2009.

In an effort to support economic activity, the Government shifted its fiscal policy stance by opting not to compensate for the decline in commodity tax revenue. Accordingly a revised budget announced in January 2009 provided for an overall fiscal deficit of $1.9 billion (-1.3 per cent of GDP), compared with the original budget target which envisaged virtual overall balance. The latest projections (September 2009) indicated that fiscal operations may, in fact, yield an even larger overall deficit, of the order of $8.5 billion (-6.3 per cent of GDP).

Monetary policy in 2009 has had to face the challenge of striking a balance between the twin objectives of inflation reduction and supporting the fiscal stimulus. Thus the repo rate has been lowered gradually by 150 basis points through August, triggering a parallel lowering of the commercial banks' prime lending rate. Short term money market rates have declined precipitously, reflecting the impact of excess liquidity in the banking system. To date, the reduction in commercial banks' lending rates has not resulted in any noticeable pick-up in bank credit demand.

The economic slowdown is having some negative repercussions on the financial system. However, because of its strong capital base, conservative operating policies and robust overall health, the banking system is well positioned to cope with the change in economic conditions. As mentioned earlier, the international crisis and the growth slowdown have, however, created serious strains in the operations of three non-banks – two insurance companies and an investment bank – which have been intervened by the Central Bank to protect the interest of depositors and policy-holders. These three institutions are members of the largest conglomerate (CL Financial) in the CARICOM region. While the intervention (and the subsequent closure of the investment bank) has not had systemic consequences, the contagion impact is being felt in the financial systems of Trinidad and Tobago and of the region as a whole. As regards Trinidad and Tobago, the available data show some deterioration in many of the financial soundness indicators of the banking system in the first half of 2009.

## Banking Indicators

### *Deposits*

Notwithstanding the slowdown in economic growth and the increase in joblessness deposits of the banking system increased by 6 per cent in the period January-May 2009, roughly the same rate as for the corresponding period of the previous year. Part of the increase is attributable to the shift of deposits from CIB, which was intervened by the Central Bank, to the banks.

### *Loans*

Credit outstanding to the private sector declined in absolute terms in the first five months of 2009. This compared with an increase of 8 per cent in the corresponding period of 2008. Consumer credit declined by 4.7 per cent in the first five months of 2009 compared with a 1.6 per cent increase in the corresponding period of 2008. The rate of growth of real estate loans and business loans also slowed in 2009 to 3.4 per cent and 8.1 per cent, respectively.

### *Non-performing loans*

Against the background of negative growth and rising unemployment, borrower default rates have increased in each of the first two quarters of 2009. However, at 1.9 per cent of total loans the delinquency ratio remains significantly below the 4-5 per cent level that obtained in the early 2000s. Asset quality may deteriorate further during the rest of the year as rising unemployment impacts household budgets. At the end of June 2009 credit card loans outstanding amounted to $1,676 million or about 4 per cent of total loans outstanding.

Preliminary data suggest that there has not been an increase in past-due residential mortgages. However, the risk inherent in an increase in mortgage loan arrears is mitigated by the fact that most of these exposures appear to be soundly collateralized, with the major banks reporting that few residential mortgages have a current loan to value (LVR) in excess of 90 per cent.,

### *Capital*

Data through March 2009 indicate that banks' statutory capital ratio increased slightly to 19.0 per cent. The sizable capital buffer ensures that banks are able to absorb the credit risk that may arise from a deterioration in the loan portfolio.

### *Profitability*

There has been a marked increase in provisions largely to cover possible losses on loans extended to corporations in the CLF Group. The increase in provisions combined with the slowdown in loan growth and the increase in non-performing loans may lead to a decline in profitability in 2009.

# CHAPTER 6

# ADDRESSING SYSTEMIC RISKS AND VULNERABILITIES

## Risks and Vulnerabilities

Notwithstanding the improvement in many of the soundness indicators, by 2008, the evolution of the financial system masked a range of structural and institutional vulnerabilities that were held in check by the favorable global and domestic economic environment. Moreover, the favourable macro-economic performance created other vulnerabilities that affect financial stability. Thus for instance, the significant increase in incomes and savings during the decade, in the face of limited domestic investment opportunities, put upward pressure on asset prices (both real estate and equity), increased the balance sheets of pension funds and insurance companies and encouraged the private sector to hold foreign assets.

Some of the other vulnerabilities that were exposed over the period were:

- The dominance of **mixed conglomerates** with sizeable intra-group exposures tended to reduce transparency and created increased risks for the financial institutions of the groups.

- The **legal and supervisory framework** was not upgraded to cope with the evolution of the financial system. In particular, financial legislation did not provide for consolidated supervision to deal with complex conglomerate structures

- Several important financial institutions, most notably the **statutory corporations**, lay beyond the purview of regular regulatory oversight. In addition the credit union sector, which had expanded significantly during the decade and had assumed many banking functions, was subject to very limited prudential regulation.

- The level of **concentration in the banking and insurance sectors** also carried potential risks. In the banking sector, for instance, in 2008 two commercial banks accounted for 52.5 per cent of total deposits; in the insurance sector there was a similar situation in which the two largest insurance companies accounted for 85 per cent of the sector's liabilities.

- The **illiquid domestic capital market** and the predominant "buy and hold" strategy also impact on the level of risk in the financial system. Together these limit secondary trading and complicate the establishment of fair market value for securities

## Improving the Legislative Framework

As noted above, the changes to financial legislation and the Bank's supervisory methodology have lagged behind the pace of innovation and expansion in the financial system. As regards the former, for instance, the main piece of financial legislation, that is, the **Financial Institutions Act (FIA)** dated back to 1993, with a few amendments made in 2006 to address particular issues. Since the enactment of the **Insurance Act (IA)** in 1980, there were minor modifications in 2004 to effect the transfer of supervisory authority over the insurance industry from the Office of the Supervisor of Insurance in the Ministry of Finance to the Central Bank and in 2006 to address the investment limits for pension plans. The failure of the legislation to keep up with the rapid developments in the financial sector served to increase the vulnerability of the sector and contributed to the recent problems in the non-bank sector.

In recent years the Central Bank has embarked on a concerted effort to upgrade the legislation and to enhance supervisory practices. Initiatives on the legislative front have included i) the enactment of a new FIA in late 2008 ii) the addition of emergency powers in the IA 1980 pending the introduction of new Insurance legislation to

be presented to Parliament towards the end of the year iii) the introduction of new credit union legislation to govern prudential regulations and thereby replace the Cooperative Societies' Act that dates back to 1971 and iv) new legislation to cover occupational pension schemes.

The new FIA has addressed some of the obvious deficiencies of the old legislation. Since some of these major shortcomings are also contained in the current insurance legislation, several provisions will be harmonized. Some of the new provisions relate to:

(1) Consolidated Supervision

Consolidated supervision of a conglomerate is essential in a globalized economy as it focuses on the entire group and therefore helps to reduce opportunities for regulatory arbitrage and the shifting of risks, within the group. Moreover, because the group is being assessed as a whole, it allows the regulator to take corrective action to prevent the deterioration of one entity from negatively affecting the operations of related entities.

(2) The Establishment of Financial Holding Companies

Mixed group structures, comprising regulated financial institutions and unregulated commercial entities make it difficult to assess and contain the risks to which the regulated entities are exposed. In order to deal with this challenge, the new FIA requires the restructuring of mixed groups to include a financial holding company that will be regulated.

(3) Application of Credit Exposure Limits

Financial entities are exposed to substantial counterparty credit risks in their investment as well as loan portfolios. All counterparty credit risks will be subject to a large exposure limit. This includes exposures to connected parties.

(4) Prompt Action to Treat with Non-Compliance

Enforcement of the various acts through criminal prosecution before the Magistrates' Court, does not allow for prompt and timely action. The new legislation gives the Central Bank greater authority to impose administrative fines as an alternative to criminal penalties.

(5) Establishment of Audit Committees

Financial Institutions will be required to establish an Audit Committee and the Chair must be an independent director.

(6) Certification of the Internal Controls Environment

The Management and Board of a licensee will be required to sign off on the adequacy of the internal controls and other risk management systems of the organization.

(7) The Development of Policy to Guide Related Party Transactions

The Board of a licensee will be required to establish and maintain policies and procedures to guide transactions between licensees, connected parties and employees.

In order to help contain the repercussions from the run on the two insurance companies of the CL Financial Group, in February 2009, the Central Bank Act was amended to give the Central Bank the legal authority to take steps to protect the interests of policy holders of any insurance company licensed under the IA 1980. In February 2009, the IA was also amended to give the Bank the authority to:

(1) Issue Compliance Directions

The intervention process was replaced with a more timely and efficient mechanism by enabling the Central Bank as regulator to issue compliance directions, which can be either to "cease and desist" or "to perform" a particular action.

The Central Bank also has the ability to issue an immediate compliance direction in cases of urgency, without giving prior notification to the insurer.

Compliance directions could be issued to insurers or any controller, officer, other employee or agent of the insurer, or principal representative of a foreign insurer or any other person.

The recipient of the compliance direction retains his right to make representations to the Central Bank, as well as the right of appeal to the High Court.

(2) Suspend Operations

The judicial management provisions of the IA were replaced by provisions similar to those of the new FIA which empower the Central Bank to restrict the licence or to take control of a troubled company and suspend its operations. Depending on the situation, this period of regulatory control could lead either to the resolution of difficulties and resumption of normal business activities or to a recommendation by the Central Bank that the company be wound up.

(3) Seek Injunctive Relief

The Bank can seek an injunction from the Court to take immediate action either to compel someone to take a course of action or, alternatively, stop a course of action. This has become necessary as it is recognized that there are situations when immediate action may be necessary to protect the interest of policyholders or the financial system. The Central Bank will therefore have the ability to seek injunctive relief, either as a complement to or in lieu of the usual enforcement process.

(4) Strengthen the Statutory Fund

The requirement to maintain assets in the statutory fund to match policyholder liabilities has been strengthened. The statutory fund will now be required to be maintained throughout the year, with the necessary "topping up" of assets to be done on a quarterly basis.

Work is proceeding on a new Insurance Act, which is expected to be presented to Parliament in early 2010. In addition to the harmonized provisions under the FIA, the new IA will provide for:-

(1) Increases in the Minimum Capital Requirements for Insurance Companies

The required capital of one and three million dollars, for general and life insurance companies respectively, are inadequate to protect the interest of policyholders. In line with the capital requirement for licensees registered under the new FIA, a minimum amount of fifteen million dollars is being proposed for insurance companies.

(2) The Introduction of Risk-Based Capital Requirements for Insurance Companies

In addition to increasing the minimum capital required, the new Act will enable the Central Bank to introduce a risk-based capital regime.

(3) The Introduction of Consumer Accounts for Intermediaries

A significant area of reform for the intermediaries is the introduction of a consumer account similar to client fiduciary accounts operated by attorneys, to prevent commingling of policyholder funds. The Bank will determine the rules for the operation of this account and formulate the nature, scope and frequency of reporting on the operation of this account.

The proposed introduction of these requirements is a significant milestone in the effort to enhance the regulatory and supervisory process. This should afford greater protection to policyholders.

# Appendices

**Appendix I:** **Institutions Licensed under The Financial Institutions Act, 2008 as at December, 2008**

**Appendix II:** **Insurance Companies Registered under the Insurance Act, 1980**

# Appendix I
# INSTITUTIONS LICENSED UNDER THE FINANCIAL INSTITUTIONS ACT, 2008 AS AT DECEMBER, 2008

- Bank of Baroda (Trinidad and Tobago) Limited
- Citibank (Trinidad and Tobago) Limited
- FirstCaribbean International Bank (Trinidad and Tobago) Limited
- First Citizens Bank Limited
- Intercommercial Bank Limited
- Republic Bank Limited
- RBTT Bank Limited
- Scotiabank of Trinidad and Tobago Limited

- AIC Finance Limited
- ANSA Finance and Merchant Bank
- Caribbean Finance Company Limited
- Citicorp Merchant Bank Limited
- CLICO Investment Bank Limited*
- Development Finance Limited
- Fidelity Finance & Leasing Company Limited
- General Finance Corporation Limited
- Guardian Asset Management
- Island Finance Trinidad & Tobago Limited
- First Citizens Asset Management Limited
- First Citizens Trustee Services Limited
- Intercommercial Trust and Merchant Bank Limited
- RBTT Trust Limited
- RBTT Merchant Bank Limited
- Republic Finance & Merchant Bank Limited
- Scotiatrust & Merchant Bank Trinidad and Tobago Limited

* Under management by the Central Bank pursuant to Section 44D of the Central Bank Act as of January 31, 2009

# Appendix II
# INSURANCE COMPANIES REGISTERED UNDER THE INSURANCE ACT, 1980

## ACTIVE LIFE INSURANCE COMPANIES

- Bancassurance Caribbean Limited
- Colonial Life Insurance Company (Trinidad) Limited
- Cuna Caribbean Insurance Society Limited
- Guardian Life of the Caribbean Limited
- Maritime Life (Caribbean) Limited
- Sagicor Life Inc.
- ScotiaLife Trinidad and Tobago Limited
- Tatil Life Assurance Limited
- The Demerara Life Assurance Company of Trinidad and Tobago Limited

## ACTIVE GENERAL INSURANCE COMPANIES

- Bankers' Insurance Company of Trinidad and Tobago Limited
- Capital Insurance Limited
- Citizen Insurance Company Limited (In Compulsory Liquidation)
- Colonial Fire & General Insurance Company Limited
- Export-Import Bank of Trinidad and Tobago (Eximbank) Limited
- Furness Anchorage General Insurance Limited
- Goodwill General Insurance Company Limited (In Compulsory Liquidation)
- GTM Insurance Company Limited
- Guardian General Insurance Limited
- Gulf Insurance Limited
- Maritime General Insurance Company Limited
- Motor and General Insurance Company Limited
- Motor One Insurance Company Limited
- Sagicor General Insurance Inc.
- The Great Northern Insurance Company Limited
- The New India Assurance Company (Trinidad and Tobago) Limited
- The Presidential Insurance Company Limited
- Trinidad and Tobago Insurance Limited
- United Insurance Company Limited

# Appendix II
# INSURANCE COMPANIES REGISTERED UNDER THE INSURANCE ACT, 1980 (continued)

## ACTIVE COMPOSITE (LIFE & GENERAL) INSURANCE COMPANIES

- American Life & General Insurance Company (Trinidad and Tobago) Limited
- British American Insurance Company (Trinidad) Limited
- Mega Insurance Company Limited
- Reinsurance Company of Trinidad and Tobago Limited
- The Beacon Insurance Company Limited

## INACTIVE LIFE INSURANCE COMPANIES

- Caribbean Atlantic Life Insurance Company Limited (CALICO) (Under Judicial Management)
- Cuna Mutual Insurance Society (De-registered)
- Nationwide Insurance Company Limited (In Compulsory Liquidation)
- Sun Life Assurance Company of Canada
- United Security Life Insurance Company Limited

## INACTIVE GENERAL INSURANCE COMPANIES

- Mountain General Insurance Company Limited
- Nationwide Insurance (Casualty and General) Company Limited (In Compulsory Liquidation)
- Royal Caribbean Insurance Limited

## INACTIVE COMPOSITE (LIFE & GENERAL) INSURANCE COMPANIES

- Caribbean Insurance Company Limited
- The Western General Insurance Company Limited (De-registered)

## ACTIVE ASSOCIATION OF UNDERWRITERS

- Lloyd's Underwriters

Central Bank of
Trinidad & Tobago

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