Table 2. The Bahamas: Status of Implementation of 2004 OFC Key Recommendations

Key Recommendations of the 2004 OFC Assessment	Status
General	
Consolidate the reporting lines for the regulatory authorities under the MoF	Implemented
Complete the comprehensive review of the overall regulatory framework to determine the most efficient structure for the local environment	Ongoing
Introduce statutory protection against civil and criminal liability for all staff of, and official appointees to, the regulatory authorities, while performing their duties in good faith	Implemented
Banking	
Clarify the extent to which the branches and subsidiaries of foreign banks may pass information to their head office and parent bank for consolidated risk management and supervisory purposes	Implemented
Establish a properly resourced policy unit within the Bank Supervision Department (BSD) and address the issues on which action is required	Implemented
Securities	
Narrow the powers of the minister to dismiss members of the Securities Commission so that just cause is the grounds for dismissal	Implemented
Complete the work on the draft mutual funds law and on the amendments to the securities legislation and present to parliament as soon as possible	Implemented
Establish a clear policy with respect to the confidentiality declaration required from overseas regulators in order to permit efficient exchanges of information in line with the practice adopted by the CBoB	Implemented *This and related issues resolved by the SIA*
AML/CFT	
Ratify all the relevant international conventions	Implemented[1]
Enact legislation to criminalize and make other provisions in relation to the financing of terrorism	Implemented *The Anti-Terrorism Act was enacted in 2004*
Rationalize the legal framework with respect to money laundering in order to reduce the number of highly prescriptive requirements and to permit financial institutions to develop a risk-based approach	Implemented
Reduce the number of exceptions to the high level principle of requiring financial institutions to identify their customers	Implemented
Extend the time permitted to financial institutions to undertake the process of customer identification on pre-2000 Bahamian dollar accounts, and consider introducing a risk-based approach to resolving the outstanding accounts	Implemented
Revise the provisions relating to the obligation to identify beneficial owners/beneficiaries of corporate entities, trusts, partnerships, etc., to ensure that the legal requirements present no exceptions	Implemented
Review the list of countries and institutions that underpin the “eligible introducer” provisions to ensure that they do not weaken the customer identification requirements	Implemented

[1] The following United Nations (UN) Conventions have been ratified: (i) the International Convention for the Suppression of the Financing of Terrorism (October, 2005); (ii) UN Convention against Transnational Organized Crime (September, 2008); (iii) Protocol Against the Smuggling of Migrants by Land, Sea and Air, supplementing the UN Convention Against Transnational Organized Crime and the Protocol to Prevent, Suppress and Punish Trafficking in Persons, especially Women and Children, supplementing the UN Convention Against Transnational Organized Crime (September, 2008); (iv) Protocol Against the Illicit Manufacturing of and Trafficking in Firearms, Their Parts and Components and Ammunition, supplementing the UN Convention Against Transnational Organized Crime (September, 2008); and (v) the Inter–American Convention on Mutual Legal Assistance in Criminal Matters (2009).

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I. Macro-Financial Performance and Structure of the Financial System

A. Macro-Financial Context

8. **The Bahamian economy has continued its recovery from the first wave of the global financial crisis.** The economy has gradually picked up after a 5 percent decline in output in 2009 and GDP is expected to grow at about 2.5 percent in 2012, thanks to a rebound in tourism and large investment projects (see Appendix Table 8). The external current account deficit is expected to widen further during 2012–14, mainly reflecting considerable foreign direct investment (FDI)-related imports, notably in connection with the US$3.5 billion Baha Mar project. However, reserves remained reasonably strong at US$829 million at end-2012.[1]

9. **Downside risks center in the tourism sector, on which the economy is highly dependent.** Tourism is vulnerable to a weakening of the U.S. economy; a prolonged increase in oil prices; or a large-scale hurricane, especially one that destroyed key infrastructure. The recent increase in central government debt, which is expected to reach 54 percent of GDP by the end of FY 2012/13, constitutes a further potential source of risk, although the government has expressed its commitment to fiscal consolidation.

10. **Monetary policy is centered on a fixed exchange rate with the U.S. dollar, while capital controls afford considerable scope for policy independence.**[2] After holding the discount rate steady for six years, the Central Bank of the Bahamas (CBoB) lowered it by 75 basis points to 4.5 percent in June 2011—against a background of subdued price pressures and an adequate reserves position—with a view to providing additional support to the struggling recovery.[3]

11. **Domestic credit growth has weakened in recent years.** It fell to 1 percent in 2011 from a peak of 14.3 percent in 2006 (Figure 1), reflecting the impact of the recession. The composition has shifted towards credit to the public sector, as the government expanded securities issuance to fund its fiscal needs. Holdings of government securities and loans to the public sector have increased to 14 percent of total bank assets in 2011 from 7 percent in 2006. More than 80 percent of total public debt is domestic and it is largely held to maturity by commercial banks, public corporations, and pension funds.

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[1] Equivalent to two months of imports of goods and services. Gross international reserves covered 100.4 percent of reserve money at end-2011, well above the required legal minimum of 50 percent.

[2] The Bahamian dollar (B$) has been set at parity with the U.S. dollar since 1970. See Annex IV for a detailed description of exchange and capital controls in The Bahamas.

[3] Reserve requirements have been unchanged for decades and the CBoB has not used direct credit controls on banks since August 2004.

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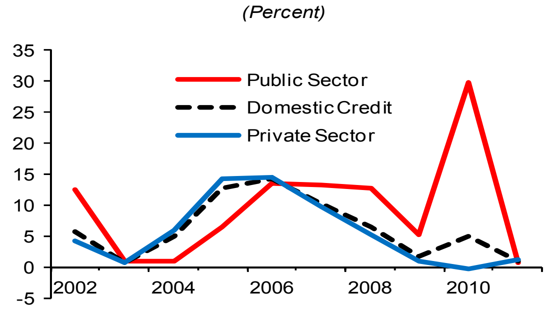
Figure 1. The Bahamas: Onshore Banking System Annual Credit Growth



Source: Central Bank of The Bahamas.

B. Financial System Structure

12. **The Bahamian financial system is large, reflecting the country's longstanding status as a major OFC** (Table 3).[4] Total gross assets in the system were equivalent to 96 times GDP at end-2011. The Bahamas has one securities exchange with 19 issuers and capitalization of around 35 percent of GDP. There is no derivatives market. At end-2011, there were 271 banks and trust companies with active licenses, of which 155 were restricted (mainly nominee trust companies).[5] Banks licensed in The Bahamas held US$595 billion in assets, with offshore banks accounting for 98 percent of the total. The overwhelming majority of assets are located outside The Bahamas, although some 80 percent of the assets of the onshore commercial banks are domestic.

13. **The economic contribution of the financial sector to the economy is significant.** It is responsible for about 15 percent of GDP and some 9 percent of tax receipts, although the banking sector directly accounts for only 2.5 percent of overall employment.[6] Most of the contribution comes from the onshore sector, despite its relatively small size in terms of assets. Offshore banking contributes less than 3 percent of GDP, employs only about

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[4] Based on the BIS International Banking Statistics (as of December 2011), The Bahamas is the fourth largest OFC by assets after the Cayman Islands, Hong Kong SAR, and Singapore.

[5] There is a multiplicity of types of licenses for banking institutions. 8 Authorized Dealers (commercial banks) carry on business in The Bahamas and deal in Bahamian dollars. 83 Non-Resident Banks operating under public licenses are mainly subsidiaries and branches of international banks and carry on offshore activities only, including trust services, wealth management and group treasury activities. 4 Restricted License Banks carry on business only with specified persons. 10 Authorized Agents have only a limited presence in The Bahamas and are managed by a resident bank in The Bahamas. 6 Non-Active banks are in the course of voluntary wind-up.

[6] The main sources of government revenues from the financial sector are stamp taxes, license and registration fees and work permit fees for non-Bahamian residents.

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Table 3. The Bahamas: Financial System Structure

	Number	Assets 5/ (B$ billion)			Assets Relative to 2011 GDP (Percent)			Assets Relative to Total Financial System Assets (Percent)
		Domestic	Foreign	Total	Domestic	Foreign	Total	
Banks 1/	91	9.7	585.4	595.1	125	7,517	7,642	79.6
Of which:								
Onshore Commercial Banks	8	9.7	2.4	12.1	125	30	155	1.6
Domestically Owned	*3*	*2.7*	*0.1*	*2.8*	*35*	*1*	*35*	*0.4*
Foreign Owned	*5*	*7.0*	*2.3*	*9.3*	*90*	*30*	*120*	*1.3*
Subsidiaries	*4*	*6.9*	*2.3*	*9.2*	*89*	*30*	*119*	*1.2*
Branches 2/	*1*	*0.1*	*n.a.*	*0.1*	*1*	*n.a.*	*1*	*0.0*
Offshore Banks	83	--	583.0	583.0	--	7,486	7,486	78.0
Other Local Financial Institutions 3/	10	0.1	2.8	2.9	1	36	38	0.4
Offshore Public Trusts	15	--.	59.7	59.7	--	767	767	8.0
Restricted banks and Trusts 4/	21	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	
Nominee Trusts	134	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	
Insurers	100	1.3	1.2	2.5	17	15	32	0.3
Of which:								
Domestic Insurers	72	1.3	--	1.3	17	--	17	0.2
Property and Liability	*11*	*0.4*	*--*	*0.4*	*5*	*--*	*5*	*0.1*
Life and health	*11*	*1*	*--*	*1*	*13*	*--*	*13*	*0.1*
Agents and Brokers	50	--	--	n.a.	--	--	n.a.	
External Insurers	28	--	1.2	1.2	--	15	15	0.2
Captive Insurers	*12*	*--*	*n.a.*	*n.a.*	*--*	*n.a.*	*n.a.*	
Non-captive Insurers	*7*	*--*	*n.a.*	*n.a.*	*--*	*n.a.*	*n.a.*	
Insurance Managers	*5*	*--*	*n.a.*	*n.a.*	*--*	*n.a.*	*n.a.*	
Intermediaries	*4*	*--*	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*	
Pension Funds	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	
Credit Unions	10	0.3	--	0.3	3	--	3	0.0
Investment Funds	713	--	86.8	86.8	--	1,114	1,114	11.6
Others	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	
Total 5/		**11.4**	**735.9**	**747.3**	**146**	**9,450**	**9,596**	**100.0**
Memo item:								
Gross Domestic Product in 2011				7.8				

Sources: Bankscope; Central Bank of The Bahamas, Company accounts; The Insurance Commission of The Bahamas; IMF(WEO); IMF staff estimates.

1/ Institutions licensed as a public bank or a public bank and trust in The Bahamas.

2. The foreign branch operating as a commercial bank in The Bahamas has significant foreign assets but because of its business model these foreign assets are reported in the assets of the offshore banks.

3/ Banks and trusts registered as resident financial institutions but that deal mainly with non-residents and savings and loan institutions that deal only in Bahamian dollars.

4/ A restricted bank, bank and trust, or trust is an institution permitted to carry on business only for specified persons usually named in its license.

5/ Assets and number of institutions are at end-2011 or latest available: banks, other local financial institutions and trusts are at end-2011; number of insurance companies at end-2011 and insurance companies' assets at end-2010; credit unions are at end-2010; investment funds' assets under management are at end-2009 and number of funds are at June 2011.

Notes:

--indicates that the entity does not hold the type of assets.

n.a. indicates that data is not available.

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½ percent of the labor force, and contributes less than 1 percent of GDP to government revenues, as it does not operate in the mortgage market that garners most of the stamp taxes (Table 4).

Table 4. The Bahamas: Economic Contribution of Banks and Trust Companies
(In B$ Million)

	2003	2004	2005	2006	2007	2008	2009	2010	2011
					Onshore				
Employment 1/	3,208	3,275	3,424	3,557	3,766	3,791	3,689	3,716	3,705
Salaries	129.5	133.7	142.5	151.3	167.4	182.3	163.8	171.8	171.2
Government Fees	6.7	7.6	8.8	8.6	8.9	8.9	14.8	14.5	19.9
Capital Expenditure	11.9	28	12.5	16.3	18.3	24.2	16.4	20.6	15.6
Total Expenditure	237.2	288.9	266.2	291.9	307.7	347.9	329.2	349.7	363.6
					Offshore				
Employment 1/	1,045	1,068	1,027	1,134	1,223	1,220	1,216	1,192	1,090
Salaries	66.4	74.2	68.6	75.7	107.3	107.9	116.9	114.8	117
Government Fees	9.7	11.3	9.2	9.6	10.4	10.7	11.2	10.7	9.0
Capital Expenditure	3.6	6.7	5.1	10.7	9.4	9.0	4.6	4.2	6.8
Total Expenditure	159.6	170.5	159.7	182	215.7	222.6	225	232	231.7
Memorandum									
Total employment 1/	154,965	158,340	161,789	165,312	168,912	172,591	176,350	180,191	184,115
Private consumption	4,488	4,629	5,116	5,470	5,600	5,791	5,413	5,594	6,136
Gross private fixed capital	1,377	1,341	1,757	2,186	2,086	1,777	1,605	1,400	1,636
General government taxes	815	831	925	1,094	1,197	1,267	1,130	1,109	1,282
Nominal GDP	6,954	7,100	7,719	7,974	8,319	8,239	7,806	7,700	8,074

Source: The Central Bank of The Bahamas.
1/ Number of employees

14. **The domestic (onshore) banking sector and the international (offshore) financial center are effectively segmented.** Intra-group lending operations are very modest and offshore entities are prohibited from holding balances in Bahamian dollars except to finance local expenses, cannot invest in domestic securities and have limited exposure to domestic real estate markets given strict capital controls. Any lending facility offered to non-residents and secured by Bahamian dollar assets is subject to explicit authorization by the CBoB.[7] Onshore commercial banks are allowed to deal in B$, but their foreign exchange (FX) transactions with residents are restricted within limits established under delegated authority from the central bank.[8] Intra-group lending between the onshore and offshore sectors consists of a single onshore commercial bank that provides liquidity to two offshore affiliates (in

[7] Offshore banks do not conduct business with Bahamian residents, but they can provide mortgages to non-residents that wish to purchase residential real estate in The Bahamas.

[8] The current limit on net FX open positions for onshore commercial banks is the lower of 5 percent of Tier 1 capital or US$5 million.

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compliance with statutory prudential rules).[9] Direct ownership links between the offshore and onshore sectors are extremely limited. Commercial banks and other credit institutions need exchange control approval to make loans to residents in foreign currency.

15. **Prudential rules apply equally to the onshore and offshore sectors, including on capital adequacy, liquidity, and large exposure ratios.** However, capital adequacy rules do not apply to the large majority (by assets) of the offshore sector since well over 90 percent of the assets of the offshore sector are held in branches. All offshore entities must be licensed under regulations that include requirements for verifying that new licensees are subject to home country consolidated supervision and that the home country supervisor concurs with the establishment of the new licensee in The Bahamas. The CBoB maintains at least annual contact with home regulators of parent institutions and home regulators are invited to inform the CBoB of any information that should be highlighted to it. Licensees are required to prepare financial reports on a consolidated basis and the CBoB contacts either the licensee or the overseas regulator should any material concerns arise.

Onshore financial sector

16. **Foreign-owned banks account for over three quarters of the onshore commercial banking sector's assets.** Of the eight onshore commercial banks, three are domestically owned while there are four subsidiaries and one branch of foreign banks. The sector is fairly concentrated with the three largest banks holding 68 percent of total assets.

17. **Commercial banks are primarily funded by deposits and equity (71 percent and 18 percent respectively).** Capital and interbank market funding is currently negligible. The share of equity funding has increased since 2003, partly due to conversion of foreign branches into subsidiaries, which resulted in liquidity provision from parents being converted into capital.

18. **The commercial banks engage in traditional banking activities, primarily providing residential mortgages and consumer finance to Bahamian residents.** The share of credit in banks' assets was roughly 75 percent at end-2011, more than 90 percent of which was to the private sector (Figure 2). Domestic residential mortgages accounted for 41 percent of total loans to residents at end-2011. Exposure to the public sector has increased significantly since 2008 to 14 percent of total assets, driven primarily by lending to the central government. In the absence of a secondary market, two-thirds of government securities are held to maturity, mitigating market risks for banks. There is some evidence of rapid credit growth from credit unions and retailers, albeit from a very low base.

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[9] The onshore entity has a net exposure to these two affiliates that has averaged 5.5 percent of its total assets over Q1 2006 through Q1 2012.

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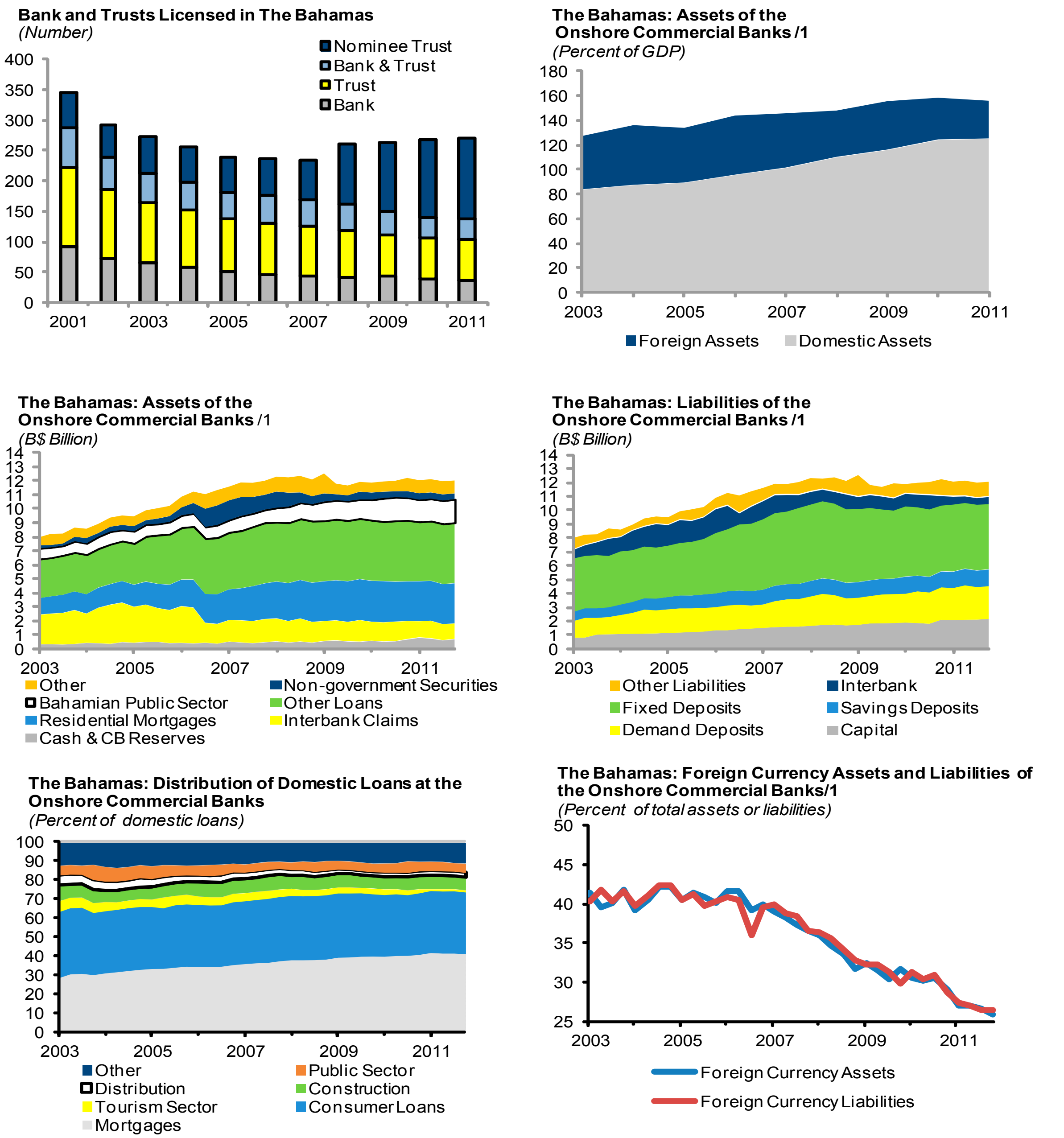
Figure 2. The Bahamas: Assets and Liabilities of the Onshore Commercial Banks



Sources: Central Bank of The Bahamas; IMF staff calculations.

1/ Excludes the Bahamian subsidiary of a North American bank registered as an onshore commercial bank because of the subsidiary's specific business model and its large holdings of foreign assets that are funded with foreign liabilities. The subsidiary's domestic assets are relatively small.

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19. **There are 10 other local financial institutions focused primarily on wealth management services to residents and non-residents.** These institutions hold B$2.9 billion in assets, 97 percent of which are offshore. Most of the issuers on the stock exchange, the Bahamas International Securities Exchange (BISX), are financial institutions.[10] Stocks are bought primarily by buy-and-hold investors, with the BISX averaging only two trades per day.

20. **There is a small credit union sector with 10 institutions, B$272 million in assets and 27,700 members at end-2011.** The sector is highly concentrated, with the largest institution accounting for 52 percent of total assets. The Bahamas Cooperative League acts as the credit unions' umbrella association and provides central services to its members. Supervision is by the Department of Cooperative Development within the Ministry of Agriculture and Marine Resources, but will be moved to the CBoB after the merger, sale or liquidation of three very small and weaker credit unions with a combined shortfall estimated at about B$0.5–1.0 million.

21. **The stock of Bahamian government securities has grown substantially since 2007, reaching 45 percent of GDP in 2011.** Onshore commercial banks are the largest holders with 32 percent of outstanding volume at end-2011 (Figure 3). Commercial banks have absorbed 58 percent of net issuance since 2007. Foreign private capital markets absorbed another 39 percent as the government issued two large external U.S. dollar bonds in 2008 and 2009. The government securities market has a fairly evenly distributed maturity profile with an exceptionally long average maturity of around 14 years, thus limiting government rollover risk.

Pensions and insurance

22. **The pension system in the Bahamas consists of a social security benefit, a separate plan for public sector employees, occupational pension plans, and individual retirement plans offered by financial firms.** Approximately one fourth of the Bahamian workforce participates in occupational pension plans. The assets managed by these funds grew steadily, exceeding B$1.1 billion by 2007, but fell to under B$0.7 billion by 2011 due to the crisis, mainly because of recaptures by unemployed contributors. Private schemes are managed conservatively, with nearly half their assets in public sector securities and bank deposits. Pending the passage of occupational pension legislation, private pension funds are not currently regulated.

[10] Two of the onshore commercial bank subsidiaries of foreign banks have partial listings on the BISX, and all three indigenous banks are also listed.

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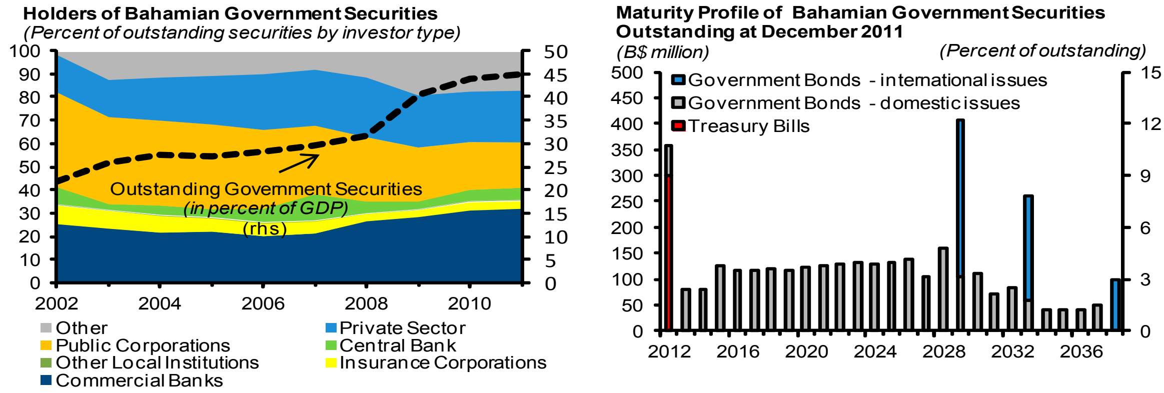
Figure 3. The Bahamas: Government Securities Investor Base and Maturity Profile



Source: Central Bank of The Bahamas.

23. **The insurance sector in The Bahamas, which is primarily domestic, has stagnated, although it has achieved high penetration levels.** The sector is dominated by five nonlife insurers and four life insurers writing between eighty to ninety percent of the business. The economic crisis and the low interest rate environment reversed the growth experienced through 2008, with the insurance premium having declined in recent years to around the level of five years ago. With expenditure on insurance already equivalent to over nine percent of GDP, levels characteristic of advanced economies, prospects for further growth are limited. Confidence in the sector has been severely affected by the failure of CLICO (Box 1).

24. **The Bahamas' exposure to hurricanes requires high dependence on international reinsurers.** The top five nonlife insurers reinsure 60 percent to 80 percent of their risk. More than 90 percent of the reinsurers used are A rated by A.M. Best and belong to the top 25 reinsurers globally. Insurers sell popular long-term products like whole life policies, which have been priced with assumed long-term fixed interest rates of 3 percent to 11 percent that will be difficult to achieve in the current environment, while other savings products include annual return guarantees. Only recently have the products started to be linked to domestic interest rates, implying insurers could be affected by negative spreads.

Investment fund industry

25. **The Bahamas has a large investment fund industry.** There are 713 registered or licensed funds, although this has declined from 803 in 2008 due to challenging market conditions and consolidation of some fund operations into foreign jurisdictions (Figure 4).[11]

[11] The only category registering an increase in the number of funds was SMART funds, which typically target a small number of investors.

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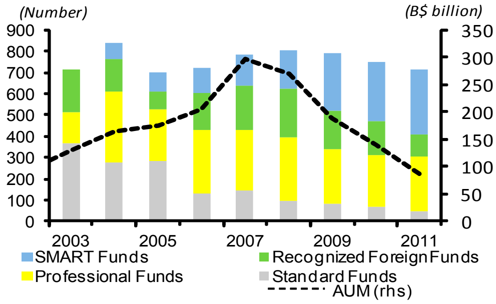
The funds held B$86.6 billion of assets under management (AUM) at end-2011, down sharply from B$298 billion in 2007. There are only three fund managers located in The Bahamas, managing twelve funds, with the main business activity in this industry being fund administration.

Figure 4. The Bahamas: Investment Funds Licensed or Registered and Assets Under Management



Sources: Securities Commission of The Bahamas

Box 1. CLICO Bahamas Liquidation Update and Recommendations

CLICO Bahamas Limited (CBL) has been under liquidation since 2009. Actuarial calculations show liabilities of B$120 million with a significant shortfall in the value of the corresponding assets. CBL owns 100 percent of CLICO Enterprises Limited (CEL), a Bahamian-established investment company, and some small non-financial entities. 63 percent of CBL's assets are a B$73 million loan to CEL. CEL used that money, in turn, to invest in Wellington Preserve Corporation (WPC), a Florida company that held 523 hectares of land in West Palm Beach, of which 238 hectares have been sold, netting B$10 million after taxes and fees.

Complex creditors' claims need to be sorted out. Policyholders, banks and two affiliated companies, CLICO Suriname and CLICO Guyana have all filed claims against CBL. In addition, CLICO Trinidad, a Trinidadian insurer fully owned by Colonial Life Financial (CLF) (which is also the ultimate owner of CBL) is alleging a B$52 million claim against CEL and is trying to stop the $10 million from going to CBL for the benefit of its policyholders and other creditors. At the same time, CBL holds a guarantee of B$58 million for the loan made to CEL from CLF. Discussions are ongoing to offset such guarantee with the B$52 million claim.

The government of The Bahamas has committed to issue a guarantee of B$30 million to support policyholders. The government has encouraged policyholders of CBL to maintain their policies in place in the meantime and continue to pay premiums. Currently, CBL is paying all health insurance related claims and the life claims up to B$10 thousand per policyholder, with any outstanding balance being accrued until the liquidation is finalized.

Concerns and recommendations

The liquidation of CBL needs to be accelerated. Once the government guarantee is issued, immediate disposal of the life and annuities business should be started to avoid continuing to increase the liabilities as policyholders keep their policies in place due to the seemingly attractive returns. The disposal of the health insurance activity due to its shorter-term character and viability as an ongoing concern should be pursued independently of the life and annuities business. CBL, although still acting as an insurer, needs to update financial statements, which have not been issued since 2009.

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Offshore financial sector

26. **The Bahamas is host to large global international financial institutions.** There are 98 banks and trust companies operating under public licenses in the offshore sector, including 24 euro-currency branches of foreign banks and trust companies and 74 Bahamian incorporated subsidiaries (out of which 56 are foreign-owned). Aggregate assets in the offshore banks amounted to US$583 billion at end-2011.

27. **The business models of large international banks are diverse.** Wholesale banking accounts for some 80 percent of assets of the total system. The largest entities act as a booking center for intra-group funding operations, and do not receive deposits or other funding from external third-parties.[12] Some offshore banks offer overnight sweep accounts for a diversified customer pool outside of The Bahamas. A significant private banking/wealth management industry caters to sophisticated high and ultra-high net worth individuals domiciled globally, and its revenues stem from fee-based income, with the risks of asset deterioration borne by clients rather than by the financial institutions. Finally, some offshore banks undertake investment banking activity, assisting foreign affiliates of the parent company's customers to raise working capital, often acting as a booking center for Latin American offshore business operations. The offshore sector is highly concentrated and branches account for the lion's share of its assets (Table 5). Nine branches of global banks headquartered in Europe, the United States, and Brazil collectively account for over 90 percent of the offshore sector. These do not operate under the host country's regulations on capital, since there is no required delegated capital situated in the branches.

Table 5. The Bahamas: Largest Offshore Entities
(In US$ million)

Type	Business Model	Assets, March 2012
Branch	Wholesale Banking	282,002
Branch	Wholesale Banking	85,015
Branch	Investment Banking	43,239
Branch	Private Banking/Wealth Management	29,527
Branch	Investment Banking	13,256
Top five entities		*453,039*
Largest fifteen entities		*504,821*

Source: CBoB and IMF Staff estimates.

28. **Offshore banks are primarily funded by intragroup cross-border funding, as well as non-resident deposits** (Figure 5). The former is due to some large international

[12] Liquidity management is centralized at the regional/global level and managed from outside the jurisdiction.

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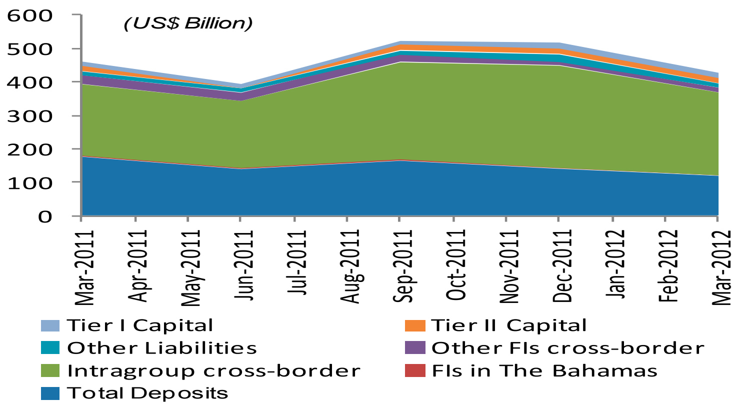
banks operating a central treasury model, that is, the parent located in one jurisdiction grants its branches and subsidiaries in third jurisdictions access to the parent's global pool of liquidity via The Bahamas. Such operations are located in The Bahamas for a variety of reasons, including local expertise, administrative ease, exchange control in the home jurisdiction, and in some cases, tax advantages.[13]

Figure 5. The Bahamas: Liabilities of the Offshore Banks



Source: CBoB and IMF Staff calculations.

29. **Despite sustained challenges to global banking from the financial crisis, offshore banking in The Bahamas proved resilient.** A 15.1 percent contraction in balance sheets and a 10 percent decline in fiduciary assets in 2009 were due to lower market valuations and the sale of business lines as part of broader balance sheet deleveraging by global parents, but the trend was reversed as total assets picked up by 12.6 percent in 2011. The views expressed by the industry for its prospects are mixed. While heightened regulatory uncertainty due to ongoing global initiatives may lead to outflows from international financial centers, concerns over tax hikes on wealthy investors in other jurisdictions and heightened political risk in Europe could increase the attractiveness of The Bahamas as a global hub for international financial services.

C. Liquidity Management

30. **Despite commercial banks' holdings of substantial amounts of excess liquidity, the interbank market is inactive.** The lack of high yielding domestic instruments and strict controls on foreign currency net open positions limit banks' ability to take risky positions, leading them primarily to park excess liquidity in non-remunerated deposits at the CBoB.

[13] Such tax advantages do not apply for institutions whose parents are in jurisdictions that apply taxes on a consolidated global basis.

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Banks have stopped actively bidding for fixed term deposits, and the consequent softening in deposit rates has led to a widening of interest margins since 2010.

31. **Lower deposit rates have not fed into inflation amid subdued economic conditions and given the U.S. dollar peg.** Given the current depressed state of demand, an autonomous surge in imports (as opposed to a pickup related to inward investment flows) appears unlikely. The CBoB monitors monthly how excess reserves may affect banks' behavior and feed into macroeconomic aggregates. Nonetheless, the CBoB should step up efforts to forecast developments in excess reserves to prepare for a future period in which such reserves could translate into import surges, necessitating pre-emptive corrective action.

II. The Onshore Financial Sector - Risks and Resilience

A. Banking Sector

32. **The Bahamian onshore banking system is profitable, has an extremely strong and high-quality capital base and high liquidity, and virtually no exposure to cross-border funding or FX risk.** (Appendix Table 8).[14] Commercial banks are subject to a target capital adequacy ratio (CAR) of 17 percent and a trigger CAR of 14 percent, much higher than international norms. Failure to meet the thresholds triggers supervisory intervention.[15] At end-2011, the actual aggregate CAR was at about 28 percent, well above the CBoB's required ratios, with Tier 1 capitalization at 25 percent.[16] All banks reported CARs above the regulatory target of 17 percent at end-2011. Banks are somewhat heterogeneous though with one commercial bank's CAR around 50 percent, while most were clustered around 20 percent (Figure 6). The ratio of liquid assets to total assets was around 20 percent at end-2011.

33. **Banks remain profitable, although profitability has moderated, mainly due to increased provisioning expenses that have doubled since 2008** (Figure 7). Banks benefit from high net interest income that remained steady at around 5 1/2 percent during 2007–11 despite the recession, and return on assets (ROA) is at the top of the range of Caribbean peers. Return on equity (ROE), at 17 percent since mid-2007, is more in line with Caribbean peers and broader international norms due to the high level of capital (Figure 8).

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[14] A lack of bank specific balance sheet data prevents the computation of FSIs on offshore banks.

[15] A breach of the 17 percent target ratio results in discussions with the CBoB to develop a plan to restore capital, while a breach of the 14 percent trigger ratio would result in the CBoB taking enforcement actions on the bank to restrict lending/asset growth until capital is restored.

[16] A couple of banks have some preference share capital but the CBoB has instructed them to phase this out in anticipation of the adoption of Basel III.

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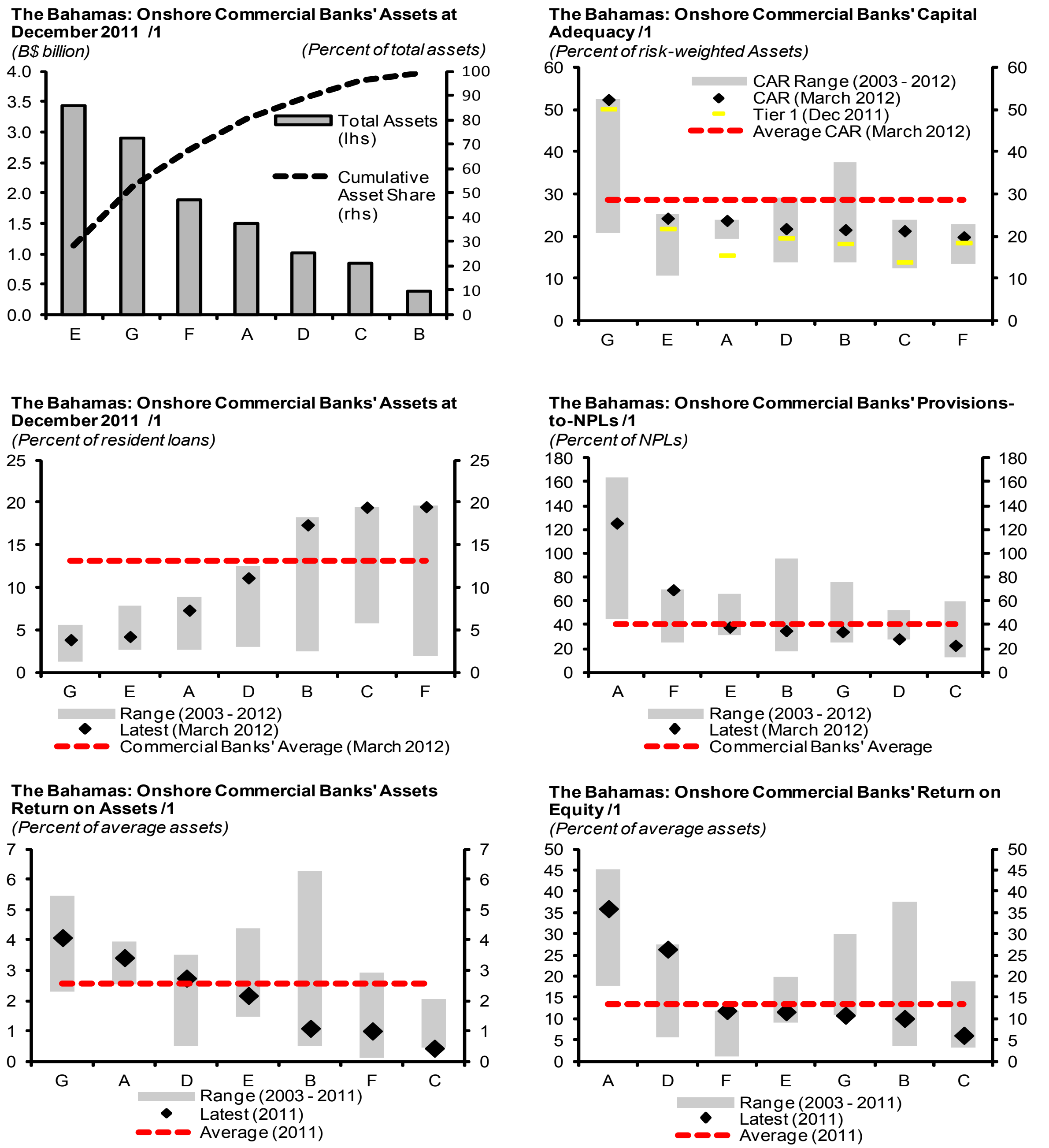
Figure 6. The Bahamas: Performance of Onshore Commercial Banks



Source: Central Bank of The Bahamas; IMF staff calculations.
1/ Excludes the Bahamian subsidiary of a North American bank registered as an onshore commercial bank because of the subsidiary's specific business model and its large holdings of foreign assets that are funded with foreign liabilities. The subsidiary's domestic assets are relatively small.

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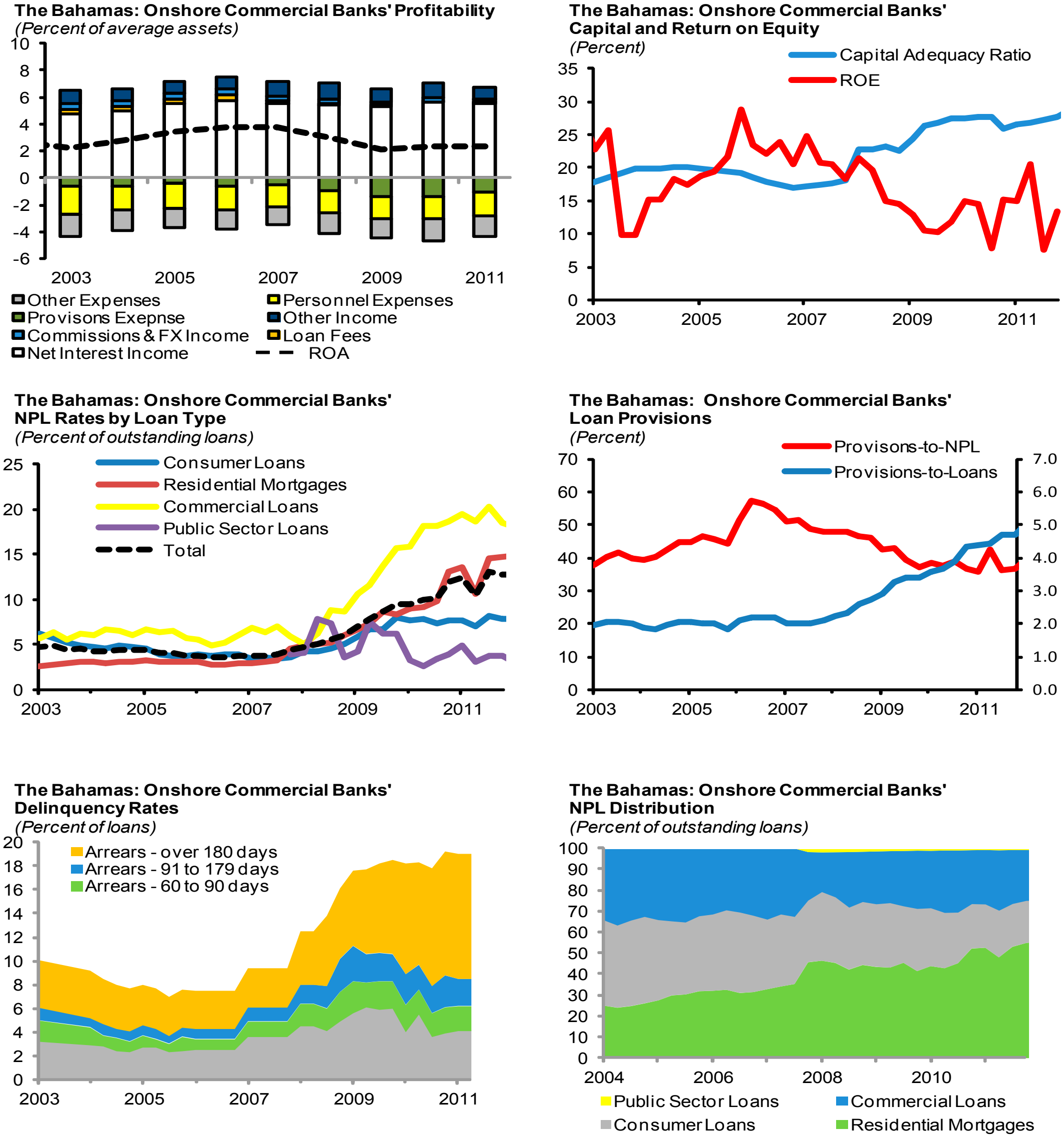
Figure 7. The Bahamas: Performance and Soundness Indicators of Commercial Banks



Sources: Central Bank of The Bahamas; IMF staff calculations.

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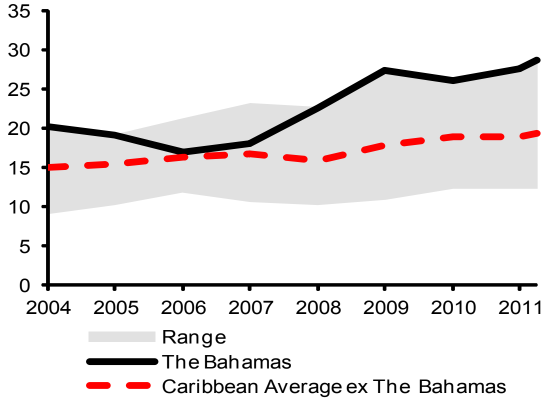
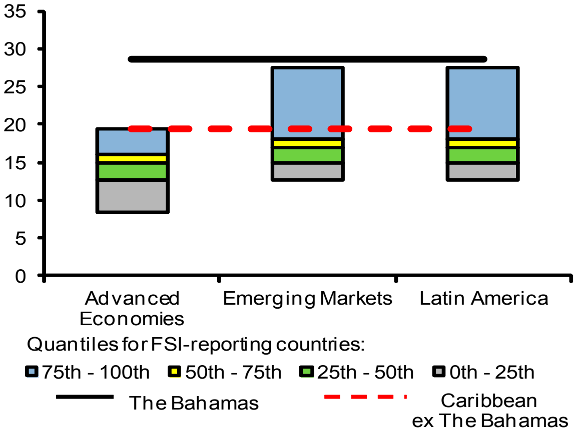
Figure 8. The Bahamas: Selected Peer Countries: Capital and Return

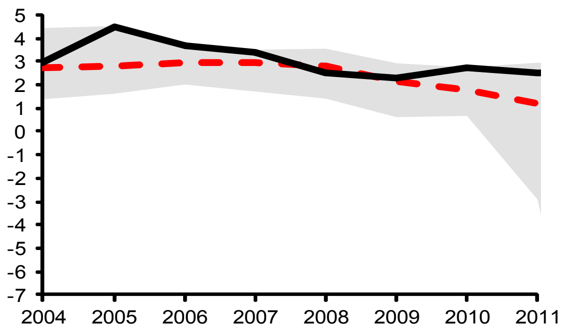
Capital Adequacy Ratio: Commercial Banks in The Bahamas and Comparison with Caribbean Peers
(Percent of risk-weighted assets)



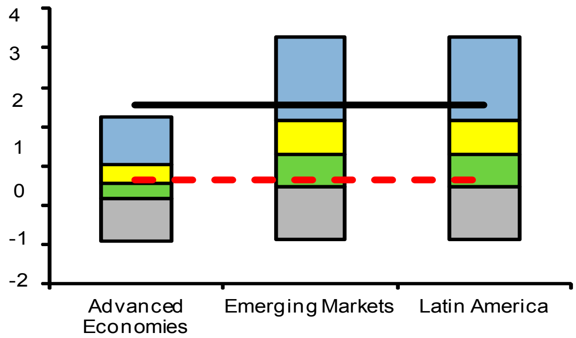
Capital Adequacy Ratios in March 2012: Commercial Banks in The Bahamas and International Peers
(Total regulatory capital to risk-weighted assets, in percent)



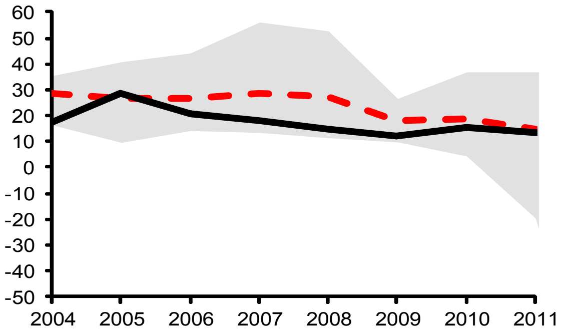
Return on Assets: Commercial Banks in The Bahamas and Comparison with Caribbean Peers
(Percent of NPLs)



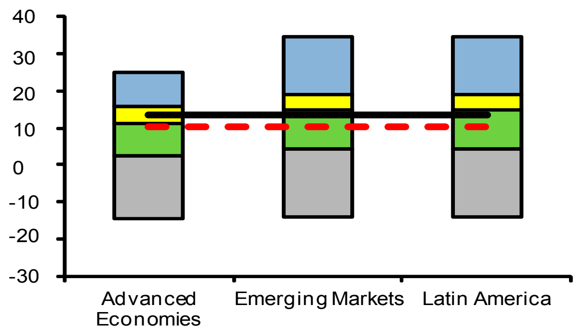
Return on Assets in 2011: Commercial Banks in The Bahamas and International Peers
(Percent)



Return on Equity: Commercial Banks in The Bahamas and Comparison with Caribbean Peers
(Percent of NPLs)



Return on Equity in 2011: Commercial Banks in The Bahamas and International Peers
(Percent)



Sources: Country authorities; IMF; IMF staff estimates.
Notes: Data for The Bahamas at March 2012; data for other Caribbean countries at December 2011, except for Belize and Guyana at March 2012; Caribbean peers are Barbados, Belize, Guyana, Jamaica, Suriname, and Trinidad and Tobago; quantiles shown are for FSI-reporting countries based on latest available FSI data; The Bahamas is not an FSI-reporting country and is not included in the quantiles for the FSI-reporting countries.

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34. **A sharp rise in NPLs is concentrated in mortgages (55 percent) and commercial loans (24 percent).** The severe decline in tourism due to the U.S. recession led to a rise in the NPL ratio from 3.8 percent in June 2007 to 12.8 percent in March 2012, higher than the Caribbean regional average (Figure 9). Loan quality appears to have been stabilizing since mid-2011 as tourism activity has picked up and large FDI projects have resumed. Nonetheless, delinquencies remain high at 19 percent of total loans and delinquencies greater than 180 days have increased, indicating deterioration within NPLs.

35. **High NPL rates on mortgages (14.9 percent at March 2012) partly reflect bank's reluctance to foreclose on properties as house recovery values are low.** By contrast, bank NPL rates on consumer loans (which are often unsecured) are only 7.8 percent since banks write these off after they are delinquent for 180 days. Commercial loans have the highest NPL ratio at 18 percent. Differing asset mixes help explain the significant variation of NPLs across banks, which range from 4.3 percent to 17.7 percent, with banks that have a larger share of mortgages reporting higher NPLs. Provisioning rates similarly vary from 23 percent to 126 percent with higher rates for those banks that have a higher share of consumer loans.

36. **High NPLs do not pose an immediate threat to banks.** The CBoB meets regularly with the banks and closely monitors the evolution of problem loans and collateral. It has pushed banks to be more aggressive in their collateral valuation practices, including accounting for the time cost of recovery. It also may require independent credit and collateral valuations for problem mortgages, based on onsite examination reviews, and especially where provisions do not appear to be realistic. Moreover, although mortgage collateral values are estimated to have fallen 20–30 percent, stress tests applied conservative haircuts of up to 60 percent and worst-case scenarios assume no offset from collateral. The tests indicate that banks' very high capital ratios represent a significant buffer, although extreme credit shocks would pose challenges for those banks with weaker capital positions. There is some degree of uncertainty on the overall evolution of house prices since reliable indices are not available and there are relatively few transactions on which to base firm judgments. Hence, monitoring would be enhanced by the development of real estate price indices.

Stress tests

37. **The resilience of seven of the eight onshore commercial banks was assessed through top-down (TD) and bottom-up (BU) stress tests** (see Box 2 for details).[17] Both sets of tests assessed banks' solvency and liquidity risks using end-2011 data and resulted in similar findings. Stress tests were not conducted on the offshore banking system due to a lack of bank-specific balance sheet data.

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[17] One of the onshore commercial banks is a foreign branch that operates mainly offshore and was excluded from participation in the exercise because as a branch, it has no required delegated capital.

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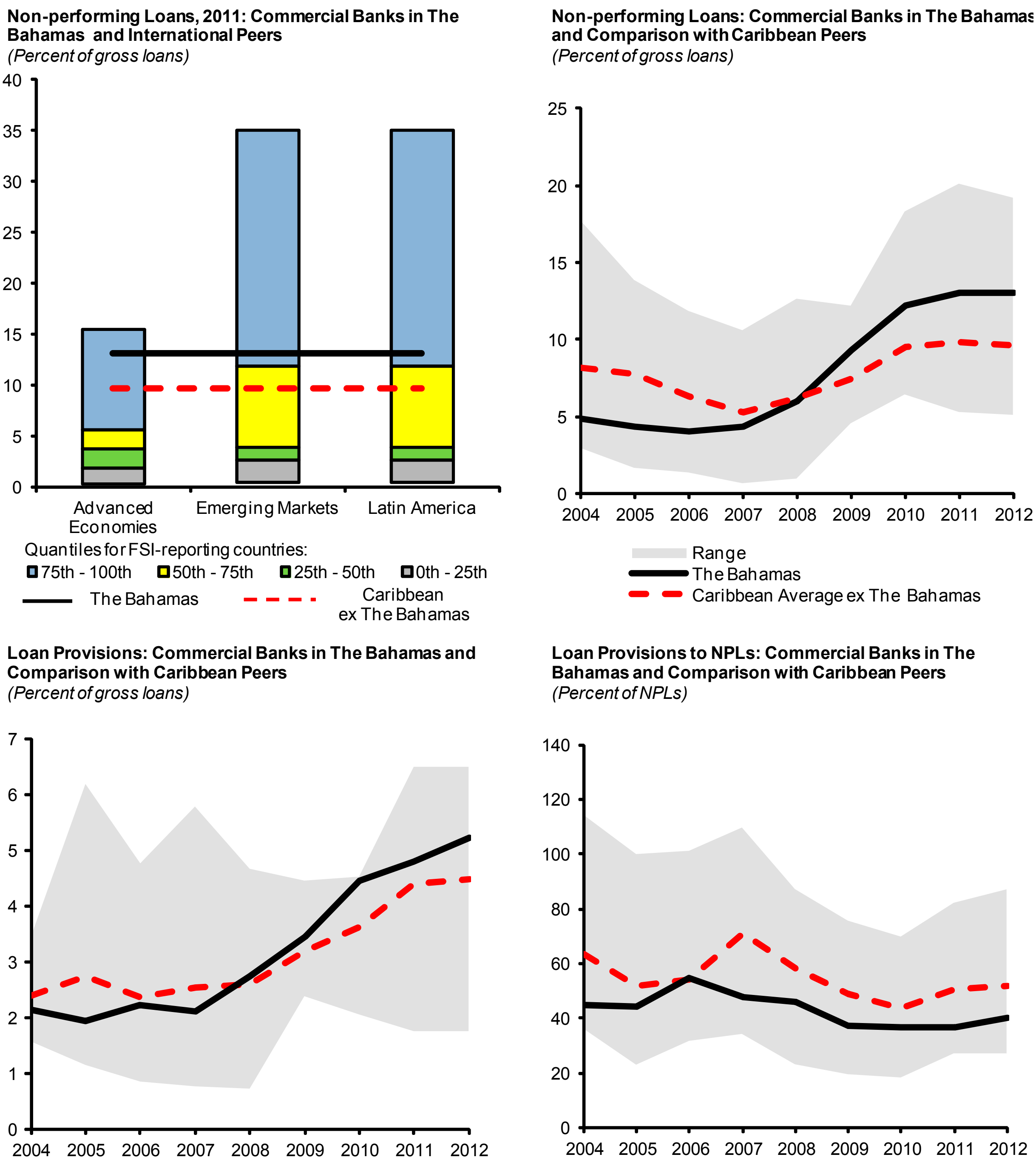
Figure 9: The Bahamas: Selected Peers: NPLs and Provisions



Sources: Country authorities; IMF; IMF staff estimates.
Notes: Data for The Bahamas at March 2012; data for other Caribbean countries at December 2011, except for Belize and Guyana at March 2012; Caribbean peers are Barbados, Belize, Guyana, Jamaica, Suriname, and Trinidad and Tobago; quantiles shown are for FSI-reporting countries based on latest available FSI data; The Bahamas is not an FSI-reporting country and is not included in the quantiles for the FSI-reporting countries.

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Box 2. Stress Test Scenarios and Methodologies

The solvency tests covered credit risk, credit concentration risk and market risk. Single factor tests based on a balance sheet approach measured the impact of a deterioration of loan quality, sectoral concentrations, a default of large borrowers, and shifts in the yield curves in domestic and foreign currency. Behavioral and regulatory responses were modeled through payout ratios and loan restructurings. Banks were allowed in some of the tests to use collateral, after conservative haircuts, to offset losses.[1]

Macro stress tests assessed potential short- and medium-term risks from five scenarios: (i) a baseline scenario based on the April 2012 IMF World Economic Outlook (Scenario 1); (ii) a global recession, which would have spillover effects to The Bahamas through a slowdown in tourism receipts (Scenario 2); (iii) a substantial and prolonged increase in oil prices due to a supply shock, which leads to a slowdown in tourism receipts and an independent effect on NPLs through a decline in disposable income (Scenario 3); (iv) a slowdown in FDI flows (Scenario 4); and (v) a large-scale hurricane which would cause a disruption in tourist arrivals (Scenario 5).

The macro scenarios were calibrated using econometric and statistical methods. The impact of tourism receipts, oil prices and FDI flows on GDP growth was based on the CBoB macro model, whereas the impact of the hurricane scenario on tourism and GDP growth was calibrated on historical data. The macro-financial projections were derived from IMF staff regression estimates that link bank-level NPLs to lagged GDP growth, the real T-bill rate, and the oil price index. The macro shocks were assumed to occur in the second half of 2012 and their impact to gradually decrease over the next several years. Each scenario simulated light, medium and severe shocks, roughly corresponding to one, one and a half and two standard deviations from the baseline, which resulted in different trajectories for banks' NPLs and CARs (Figure 10).

[1] Collateral was considered in the credit risk stress tests that focused on the entire credit portfolio. However, a breakdown of collateral by loan classification categories and sectoral exposures was not available and so the stress tests on loan migrations and sectoral credit risk abstracted from collateral effects. The large exposures credit risk stress tests also took a more conservative approach and abstracted from collateral coverage. When collateral was considered in the bottoms-up large exposures credit risk tests, the impact on capital was minimal since the collateral provided adequate coverage.

38. **Solvency stress tests suggest that the banking system as a whole is in a position to withstand a range of adverse scenarios.** Of five scenarios tested, the one involving a combined shock to tourism revenues and oil prices would have the most severe impact. This would lead in the worst-case outcome to an increase in already high NPLs of almost 100 percent, but even under this scenario, the system's CAR would remain above the regulatory trigger of 14 percent.[18] Nevertheless, there are pockets of vulnerabilities and some banks with higher NPLs and lower capital, including a large bank, would breach the regulatory 14-percent benchmark.[19] The risks from a large-scale hurricane appear

[18] In the worst-case scenario aggregate NPLs reach 25 percent of total loans and represent a substantial drag on profits through reduced net interest income and increased provisions. Therefore, this scenario has a considerable impact on banks' capital.

[19] The systemic potential of individual bank problems is contained by the low level of interbank exposures.

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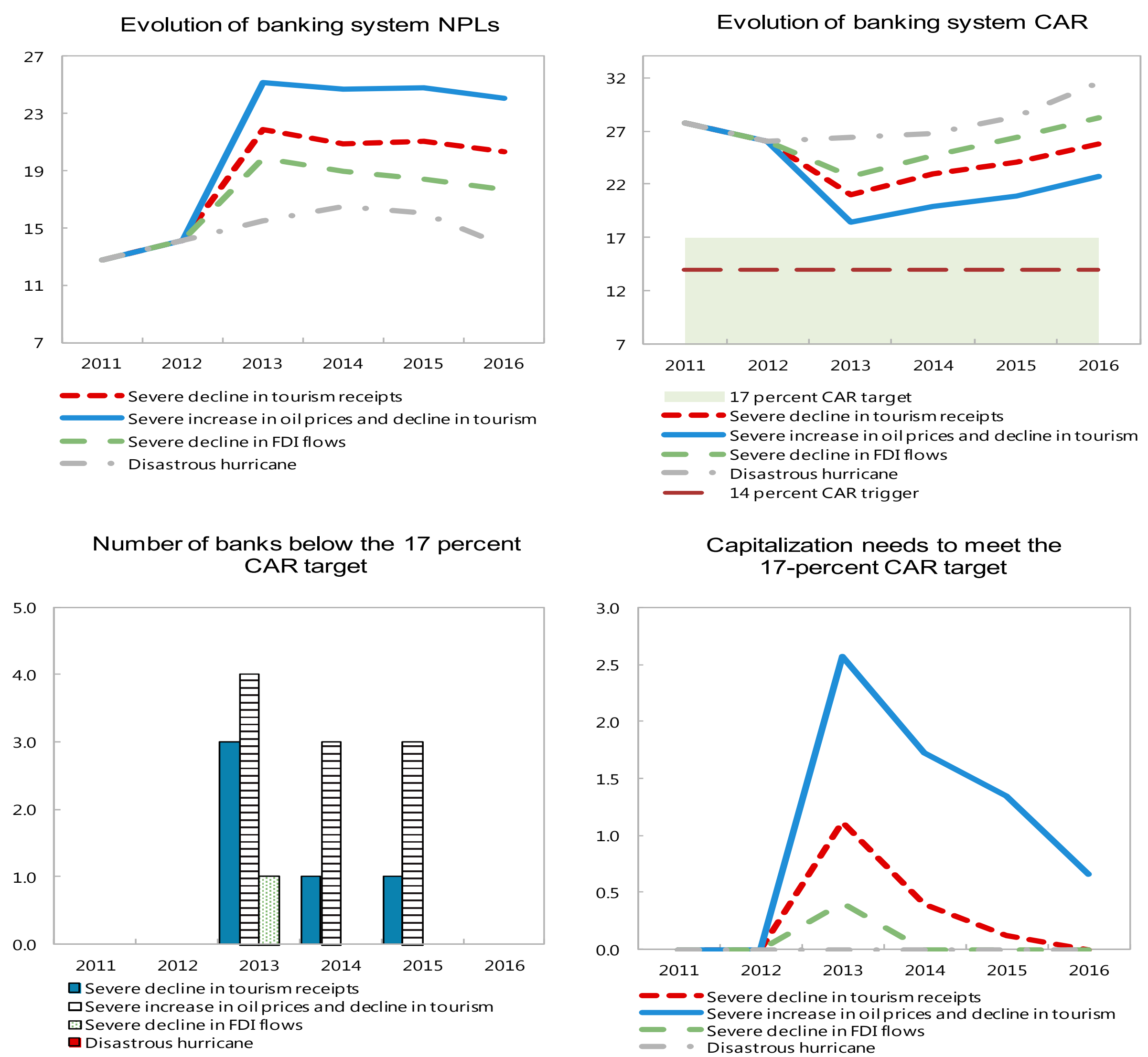
significantly mitigated by the practice of relying on reinsurance proceeds to quickly rebuild damaged infrastructure.

Figure 10. The Bahamas: Macro Stress Test Outcomes

(In percent)



Source: National authorities and IMF staff estimates.

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39. **Sensitivity analysis revealed credit risk as a key source of risk for the banking system.** The analysis modeled the impact of NPL increases of up to 300 percent on banks' profitability and internal capital generation through reduced net interest income and higher provisioning. The tests adjusted the baseline CAR for a fraction of restructured loans which are likely to return to NPL status.[20] There is some heterogeneity among banks. While the system's CAR is able to absorb a 100 percent increase in NPLs, this outcome is affected by a large outlier with a CAR of 51 percent. Excluding this bank, the system's post-shock CAR would stand at around 11.5 percent (Table 6) and under more severe shocks would fall below the 8 percent Basel minimum. However, it should be recognized that increases of NPLs of 100 percent or greater are very severe in light of the initial high level.

40. **The banking system is fairly robust against concentrations in mortgage lending.** At around 15 percent, mortgage NPLs are already high so that, as with NPLs more broadly, a 100 percent increase in NPLs would constitute a significant shock. Mortgage risk stress tests conservatively assumed new NPLs would be 100 percent provisioned and did not take into account offsets from future profits and collateral recoveries. Still, a 100 percent increase in NPLs on mortgage loans pushes only one bank below a 14 percent CAR and none below 8 percent, and leaves the system's CAR at 21 percent, or 16.7 percent excluding the bank with an initial CAR of 51 percent. More severe tests combining shocks to real estate and tourism-related loans (since the quality of these tend to be correlated in economic downturns) would drive around one third of the banks below the 14 percent regulatory trigger ratio, although again, these tests did not take into account collateral coverage.

41. **Market risk is limited, with only modest risk arising from fluctuations in interest rates.** Currency and equity price risks are contained due to banks' limited exposures. Market risks stemming from holdings of government securities are also limited as these are generally held to maturity and both bank loans and government securities are issued mainly at adjustable rates.

42. **Banks' liquidity positions are more sensitive to deposit outflows than wholesale funding shocks due to their dependence on customer deposits** (Table 7). The system could cope with deposit outflows of 5–10 percent of total deposits (although some banks with lower liquidity buffers appear sensitive to shocks to the deposit base), but larger deposit outflows may present some challenges, although such scenarios have a low probability. Nonetheless, banks could tap official liquidity since the CBoB is committed to redeem all government securities at full value.

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[20] Haircuts of up to 60 percent were applied on collateral given the degree of uncertainty about housing prices and banks were assumed to retain 50 percent of projected profits. However, a regulatory restriction forbidding any dividend payments was assumed for medium and severe shocks.

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Table 6. Summary Stress Test Results: Sensitivity Tests
(In percent, unless indicated otherwise)

	All banks	All banks 1/	Domestic	Foreign
Reported CAR (December 2011)	27.7	21.9	22.4	29.5
Adj. CAR	26.0	19.7	19.3	28.3
Credit risk				
NPL increase				
100 percent	16.8	11.5	13.3	18.1
150 percent	12.5	7.8	10.9	13.1
200 percent	7.2	2.9	6.8	7.3
Credit downgrades				
30-percent downward loan migration	24.7	18.8	19.7	26.5
100-percent downgrade of all loans	18.5	12.8	14.9	19.8
Credit concentration risk				
Large exposures (without collateral)				
Default of the single largest borrower	21.2	14.5	18.4	22.2
Default of the 3 largest borrowers	17.8	11.7	16.9	18.1
Default of the 5 largest borrowers	15.4	9.4	15.7	15.3
100-percent increase in sectoral NPLs				
5 largest industries	21.4	14.2	17.0	23.0
Mortgages and tourism-related loans	22.1	15.0	18.2	23.5
Mortgage loans 2/	20.9	16.7	20.0	21.3
Interest rate risk				
Parallel shifts of the yield curve 3/				
+200 basis points	24.3	17.7	16.9	26.9
-200 basis points	25.9	19.7	19.3	28.2
+400 basis points	22.3	15.1	14.0	25.2
Steepening of the yield curve	23.1	16.2	15.3	26.1
Inversion of the yield curve	26.0	19.7	19.3	28.3

Source: National authorities and IMF staff estimates.

1/ Excluding one bank with a 51 percent CAR.

2/ The stress test conservatively abstracts from future profits and collateral recoveries.

3/ Impact on exposures in domestic and foreign currency. Based on a duration gap analysis that measures the impact on capital.

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Table 7. The Bahamas: Liquidity Stress Test Results
(In percent unless indicated otherwise)

	All banks		Domestically-Owned		Foreign-Owned	
	Liquid assets to total assets	Liquid assets to total deposits	Liquid assets to total assets	Liquid assets to total deposits	Liquid assets to total assets	Liquid assets to total deposits
Baseline as of December 2011	20.0	24.9	20.8	26.3	19.8	24.5
Deposit withdrawals						
5 percent	16.6	20.8	17.1	21.8	16.4	20.5
10 percent	13.2	16.8	13.4	17.4	13.2	16.7
20 percent	4.7	6.1	3.9	5.3	4.9	6.4
Wholesale funding withdrawal						
5 percent	19.6	24.5	20.8	26.3	19.3	23.9
10 percent	19.3	24.1	20.7	26.2	18.8	23.4
20 percent	18.6	23.2	20.6	26.1	17.9	22.3

Source: National authorities and IMF staff estimates.

43. **Spillover risks are generally insignificant.** Domestic bank lending to other onshore financial institutions is negligible. Default risk through interbank exposures is also negligible given very limited interconnectedness within the interbank market. Financial stability concerns from potential financial distress in foreign parent banks appear likely to be muted since international banks transact with overseas counterparties with no material exposure to commercial entities within the jurisdiction and the financial safety net is restricted to the onshore banking sector. In addition, the direct impact of the offshore financial sector on the real economy is limited**.**

44. **The potential for reputational and other risks stemming from the offshore sector or a foreign parent falling into difficulties seem to be manageable.** Vulnerabilities are mitigated for offshore institutions by the CBoB's supervision of their governance, data retention, and know-your-customer activities. Risks from a foreign parent would appear to be mitigated by the high capitalization of onshore banks. The forthcoming AML/CFT assessment will help the authorities to identify any steps that might be needed to contain domestically-sourced reputational risk stemming from money laundering or terrorism financing activities.

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B. Insurance Sector

45. **Nonlife insurers are managing underwriting risk well.** Combined ratios (claims and expenses over premiums) below 100 percent indicate soundness. The ratio of liabilities to equity is low (below two) and solvency ratios are above regulatory requirements. Investments are liquid in accordance with the type of liabilities underwritten by nonlife insurers. Government bonds and cash are the preferred investment instruments with three insurers having over 70 percent of their assets in these classes of investments. Reinsurance is available at a reasonable cost and, as noted, more than 90 percent of the reinsurers used are A-rated by AM-Best and belong to the top 25 reinsurers globally. Reinsurance has proven effective, with quick claims payments made on several occasions, including in 2011 after Hurricane Irene.

46. **Asset-liability matching for long-term products needs attention.** Liabilities are discounted using the projected performance on the existing investment portfolio for the discount rate. The majority, if not all investment, is local due to exchange control restrictions. Insurers hold high levels of mortgages due to a lack of fixed rate long term local investment instruments. This lack, if combined with a further reduction in interest rates, would create significant strains in the sector. Advances in risk-based supervision should help to capture such vulnerabilities and may lead to requirements for insurers to increase their technical reserves.

C. Capital Markets

47. **The securities market is small and illiquid.** Although most large Bahamian companies are listed, secondary market trading activity is very limited. Institutional investors are faced with a shortage of viable assets for investment other than real estate and Government of The Bahamas bonds. Exchange control provisions have resulted in a stock market that is effectively closed to overseas investors and issuers.

III. Financial Sector Oversight and Infrastructure

48. **Since the 2004 OFC assessment, there has been clear and material progress in key areas of financial sector oversight.**[21] Most importantly, the approach to regulation and supervision, including with respect to AML/CFT supervision, has been shifting to risk-based approaches, with some agencies already approaching global best practices.

49. **Financial sector supervision is carried out by the three prudential regulators (the CBoB, the SCB, and the ICB).** In addition, the Compliance Commission supervises the AML/CFT framework for financial sector businesses that are not subject to prudential supervision. Supervisory coordination is undertaken through the Group of Financial Service

[21] Insurance standards were not assessed in the 2004 assessment.

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Regulators (GFSR) which includes as members all four supervisors. Representatives of the government attend GFSR meetings. Members are signatories to a Memorandum of Understanding (MoU) allowing information sharing as needed to effectively supervise the financial sector. The MoU outlines the arrangements for consolidated supervision of the single conglomerate/group in The Bahamas, including, but not limited to, regular communication, monitoring of capital and inter-group transactions and to some extent mutual decision-making regarding supervisory approvals and reprimand. The GFSR meets at least on a quarterly basis, but ad-hoc working groups meet more regularly as required.

A. Banking

50. **Compliance with the Basel Core Principles for Effective Banking Supervision (BCP) is good.** The CBoB has made significant enhancements to its supervisory process and regulatory guidance since the 2004 OFC assessment. The blend of onsite, offsite, and quarterly supervisory discussions with the banks that the CBoB considers as systemic provides coverage of the significant banking risks. Guidelines establish benchmarks for the classification of credits and for specific and general provisions, and the CBoB's assessments of compliance with credit risk management and impaired assets requirements is in compliance with BCP requirements.[22]

51. **To the extent there are shortcomings, they relate to the need for additional guidance that is warranted in some risk areas.** Draft guidance on interest rate, market, and operational risks should be finalized and implemented. Although the CBoB performs consolidated supervision based on its broad legal authority, guidance on consolidated supervision would enhance transparency to the market and aid examiners in their work.

52. **A risk-based supervisory approach is nearing full implementation.** The approach supports the Basel II capital guidelines' Pillar II process. Components of the system include: (i) categorizing banking risks into four categories (business risks, controls, oversight, and governance and financial soundness); (ii) categorizing banks into four impact categories based on size, fiduciary assets, number of employees, and Bahamian dollar deposits; and (iii) risk rating the individual risks of the banks on a scale from one to five. All these elements are analyzed to develop a risk mitigation program for the supervision of each bank. Supporting the offsite supervisory aspect, an electronic reporting system to collect and compute financial indicator ratios has been in place from 2010. The system is being enhanced to include market risk reporting effective September.

[22] The CBoB requires a one percent general reserve in addition to specific provisions.

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53. **The CBoB supervises both banks and trust companies,[23] and onshore and offshore supervision follow the same principles.** A number of different banking licenses exist. Distinctions among them relate primarily to the onshore/offshore nature of banking business in The Bahamas, although some types of licenses are legacy related. The CBoB closely supervises both sectors but, consistent with risk-based principles, adjusts the scope of supervision to reflect the risks of each sector and each bank, and their systemic importance. A regime of information sharing, including with foreign supervisors, and regulatory colleges supports CBoB supervision.[24]

54. **The CBoB has well-trained and dedicated staff in its banking supervision department.** However, it needs to review its staffing complement, with particular emphasis on recruiting specialist staff where it currently lacks in-house expertise.

B. Insurance

55. **Insurance supervision in The Bahamas has significantly improved in recent years.** New insurance legislation was enacted in 2009 and the ICB was established with a highly qualified staff and the power and independence to properly supervise the industry. The ICB has powers to make rules and to enforce and take regulatory action against insurers and intermediaries for violations of the Insurance Act and regulations. The ICB has already undertaken a major clean up of non-active insurers and a range of other measures that have positively impacted the insurance market, including the introduction of penalties that dramatically lowered overdue premium receivables, financial requirements for insurers, brokers and agents, quarterly supervisory meetings with insurers, and annual stress testing for life insurers. However, there is need for recapitalization of one insurer and the liquidation of CLICO and its sister insurer BAICO should be handled in a manner that maintains as much as possible the credibility of the ICB as the supervisor of market solvency.

56. **The ICB has an independent Board.** However, the first Board members terms' coincided with each other as well as with the national election schedule, presenting challenges to continuity and possibly to the independence of the Board. A new board was appointed in July 2012.

57. **There is currently sufficient reinsurance capacity and the ICB is strongly engaged in reinsurance supervision.** Solvency oversight reflects appropriate supervisory review of the adequacy and efficiency of insurer risk transfer strategies given the size, nature

[23] Trust companies are largely engaged in asset and wealth management activities, although many banks also undertake trust business.

[24] The CBoB participates in a number of regulatory colleges on a regular basis, notably those convened by Canadian authorities. Colleges cover both thematic reviews (including on crisis management principles) as well as reviewing specific financial institutions.

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and complexity of the business. It also includes reinsurance considerations in determining capital adequacy. Any shortage of reinsurance capacity could limit the ability of local insurers to provide coverage in the jurisdiction and options to mitigating a shortfall in reinsurance capacity could be given consideration, such as the issuance of catastrophe bonds.

58. **Fully implementing a consistent risk-sensitive solvency framework should be a high priority.** The current solvency regime uses a simple factor-based test and not risk-based capital. The ICB is aware of the drawbacks of such a simplistic solvency regime and for large insurers, it has required independent actuaries to calculate the minimum capital requirement based on the Canadian solvency regime.

59. **Risk-Based Supervision (RBS) is still in its initial stages and essential onsite and offsite supervisory tools need development.** The ICB has only recently developed a standardized QRS and is making progress in developing ladders of intervention for progressive escalation of regulatory and remedial intervention. The ICB commenced comprehensive onsite examinations in September 2012. In addition, market conduct enhancements are needed to improve consumer protection.

C. Capital Markets

60. **Compliance with the International Organization of Securities Commissions (IOSCO) Principles is generally high, although some weaknesses need to be resolved.** The new SIA has reinforced the supervisory powers of the SCB and secured its independence and the SCB is now better resourced. The SIA also provides an effective framework for the sharing of information and cooperation between the SCB and other regulators, domestic and foreign. Recent amendments to the SIA are intended to enable the SCB to become a full signatory to the IOSCO Multilateral Memorandum of Understanding (MMoU).

61. **The SCB is converting its powers into a practical regulatory methodology.** The full impact will only become apparent at the end of 2012 and into 2013 as these initiatives are implemented. Compliance and its enforcement will create challenges for the SCB, licensed firms, the corporate sector, and the legal and accounting professions.

62. **Supervision consists of a mix of off-site review and on-site inspections, periodic and "for cause."** On-site inspections are comprehensive, tailored to match the business models of particular categories of licensees and require the exercise of judgment by examiners. The coverage of some categories of locally domiciled professionals in the investment funds industry (such as fund managers and custodians) is insufficient.

63. **Regulation of the investment funds industry has not kept pace with regulatory developments globally.** The current governing legislation is a disclosure-based regime and does not provide sufficiently for the SCB to set mandatory asset management standards. Also, the SCB could take a more proactive stance in its due diligence and by expanding the scope of its inspections.

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D. Pension Funds

64. **Occupational private pension funds are not yet regulated.** There is pending high level legislation to regulate the fast growing industry with the main objectives being to reduce abuses, lock-in retirement savings and allow for portability. Occupational pensions will not be mandatory and the legislation does not prescribe the form of pension plans that will be allowed. This is appropriate as it allows for free negotiation between employers and employees.

65. **Regulation will be urgently needed for proper implementation of the bill.** The bill addresses concentration, liquidity, and liability matching requirements for defined benefit plans. Strict licensing procedures will be of paramount importance to create a sound system.

E. Payments and Securities Settlement Systems

66. **Major reforms started in the early 2000s have placed the Bahamian payment system closer to best international practices.** They include among others: (i) the creation of a large-value real-time gross settlement system (RTGS) in 2004; (ii) the establishment of The Bahamas Automated Clearing House (BACH) in 2010 for check and direct credit/debit clearance; (iii) a new Payment Systems Act (PSA) brought into force in 2012 providing the legal basis for the CBoB's oversight of, and the settlement finality in, the payment system; and (iv) the creation of the National Payment Committee, as an advisory body to the CBoB, the composition and responsibility of which is currently under discussion.

IV. Crisis Management and Financial Safety Net

67. **The current framework for financial crisis management and resolution requires strengthening.** With the Bahamian financial system suffering only modest and indirect spillovers from the global financial crisis, crisis management, resolution, and safety net frameworks were not tested. The authorities are committed to filling gaps in the framework expeditiously by developing the NFCMP.

68. **The CBoB is the primary financial agency responsible for crisis management and the financial safety net.** The financial safety net consists of CBoB authority to extend emergency liquidity assistance (ELA); a DIC which has authority to provide financial assistance to troubled institutions; and access to the payment system. The DIC's operations are carried out by CBoB employees via secondment of staff and the provision of administrative services. The CBoB's licensing, supervision, and regulation of financial institutions supports these crisis management and safety net functions, including the role of acting as an early warning system for financial problems. It is planned that supervision of credit unions will be added to the CBoB's duties by the end of the first quarter of 2013.

69. **The breadth of the financial safety net is clearly demarcated and covers only the onshore banking sector.** The deposit insurance system covers only Bahamian dollar

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deposits in onshore banks.[25] The lack of deposit insurance coverage for credit unions constitutes a gap in the financial safety net and should be remedied, as intended, after the sector has been cleaned up and come under the supervision of the CBoB.[26] The ELA facility is appropriately confined to onshore banks and supervision resources are also properly targeted toward onshore financial institutions through more frequent examinations. If offshore institutions become troubled, CBoB would work with the home country supervisor to facilitate a resolution, but safety net support would have to be provided by the home country government, although there are as yet no explicit ex ante agreements with foreign supervisors to provide such support. The continued exclusion of the offshore sector from the safety net is appropriate, given its large size relative to the economy's domestic resources and its very limited potential for spillovers to the domestic economy and financial system.

A. Crisis Management

70. **The authorities have committed to implementing an effective crisis management plan.** However, there is currently no formalized plan in place that lays out a framework for coordinated decision making and clarifies roles and responsibilities among the MoF, CBoB, DIC, and the non-bank financial supervisors in case of a crisis. The CBoB has taken the lead in considering the range of topics that must be addressed to make such a plan complete.

71. **The development of an NFCMP has commenced.** The plan should, as envisaged, create or task a body to facilitate the coordination of action and communication during a crisis. It should define the roles and responsibilities of the main institutions and authorities in the event of a crisis. In addition, the legal framework needs to be reviewed to ensure that the relevant officials have sufficient legal authority to undertake the actions envisaged in the plan. The plan should include an explicit mechanism for financial assistance to troubled institutions beyond current DIC powers, but should make explicit the sequencing of the sources of any capital support, with primacy placed on contributions by the parent company and, in the case of a foreign-owned subsidiary, the home country government. The CBoB should update its 1991 guidelines on the discount window, through which ELA would be provided, to develop procedures specifically to address a system-wide liquidity crisis.[27] Procedures should also be developed on communications among the authorities in the case of a crisis.

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[25] Under exchange control regulations, individuals and companies designated resident for exchange control purposes must, with some exceptions, hold their deposits in Bahamian Dollars.

[26] The Credit Union League, which is the Apex body for credit unions, currently administers a stabilization fund for the purpose of protecting credit union depositors. Every credit union contributes to this fund on an annual basis. The Credit Union League also has retained earnings which may be used to cover deposits in the event of a crisis.

[27] Issues to be addressed should include the objective of assistance, eligibility, collateral, interest rates, transparency, and other conditions for assistance.

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B. Systemic Risk Management

72. **A Systemic Risk Surveillance Committee (SRSC) has been constituted to monitor financial stability of the onshore banking sector and oversee system-wide stress testing.** At present, it is self-contained within the CBoB but a representative of the MoF should be more directly involved in an observer role on a periodic basis.[28] The CBoB has begun development of an inaugural financial stability report on systemic risk. The first such report should be issued by the end of the first quarter of 2013.

73. **The CBoB has designated all onshore commercial banks as systemic for the purpose of supervision, but there also needs to be a more narrowly tailored definition to determine which banks would be eligible for solvency support or other extraordinary intervention.** An impact analysis might classify only a small number, if any, of the eight onshore banks as systemic in this latter sense.[29]

74. **The powers to provide financial assistance under law need to be clarified and appropriately circumscribed.** Currently, the legal provision for financial assistance such as solvency support is granted to the DIC, with resources derived primarily from the DIC and the Government, as deemed necessary. However, the DIC does not currently appear to have the financial capacity to provide such financial assistance for medium to large scale single institution resolutions, much less for a systemic crisis, and while it has powers to issue bonds, it is not clear it could do so successfully in a systemic crisis. The ability of the DIC to draw upon government resources should be made both more concrete and appropriately circumscribed.[30] Consideration should also be given to how the failure of a systemically important financial institution not currently insured under the DIC would be addressed.

C. Deposit Insurance

75. **A system of deposit insurance has been in existence since 1999.[31]** The level of coverage at B$50,000 is in line with similar jurisdictions and protects approximately

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[28] The Finance Minister and Governor of the CBoB meet regularly to discuss matters of import, including any crisis management and safety net issues.

[29] In international practice, designation as a systemically important financial institution (SIFI) within a particular financial system indicates that the failure or disruption of the institution could threaten the stability of the financial system. A small subset of institutions is typically designated as SIFIs based on characteristics such as size, interconnectedness, substitutability, or other measurable criteria.

[30] For instance, limitations should be placed on which types of institutions (e.g., the acquiring institution rather than the failing institution) and under which circumstances (e.g., only when an institution is of systemic importance) solvency support would be provided. Additionally, procedures should be developed to address the parameters under which financial assistance would be provided.

[31] The system was created after the 1997 failure of Gulf Union Bank, to whose depositors coverage was retroactively applied.

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96 percent of depositors by number. The system would benefit from a number of operational changes including to: strengthen transparency and disclosure, undertake a deeper examination of the level of equity capital, reconsider the time allowed for payment of depositors, develop a strategic planning process and identify backup sources of funding (Box 3).

D. Receivership, Resolution, and Liquidation

76. **The legal provisions for receivership and resolution would benefit from consolidation that would give clarity about the boundaries of the specific resolution powers available to the CBoB and DIC.** There are two separate legal frameworks for receivership and resolution of commercial banks operating in the domestic market, one under the BTCRA and one under the Protection of Depositors Act (PDA).[32] While the risk of overlap is ameliorated by the provision under the PDA that the DIC must comply with the directions of the CBoB and must act on its advice, the risk of confusion would be minimized by consolidation into a single framework.

77. **Additionally, operational procedures should be in place for these functions that goes beyond the general language contained in the statutes.** Winding-up procedures are court-based under the Companies Act and not specific to financial institutions. Administrative procedures specific to the complexities of bank operations should replace those under the Companies Act.

[32] Only the CBoB has power to appoint a receiver or receiver manager of an offshore financial institution.

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