# FINANCIAL SECTOR REFORM IN THE BAHAMAS: AN INDUSTRY ASSESSMENT OF LEGAL AND REGULATORY INITIATIVES AND EMERGING CHALLENGES FROM THE GLOBAL SECTOR

**by**

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## *Abstract*

Following the spate of financial crises in several countries more than two decades ago, consensus was forged among the international community on the importance of strengthening the architecture of the international financial system. Consequently, international agencies developed systems for monitoring and supervising the activities of banks and other deposit-taking financial institutions. Programs of on-site inspection are well established and are complemented by off-site assessment of prudential returns.

Moreover, the Central Bank of The Bahamas along with other Caribbean central banks has played an active role in global efforts towards implementing the minimum standards recommended by the Basel Committee and other international agencies for strengthening supervisory systems and promoting soundness in the banking system. As a result, a number of legal and regulatory initiatives have been implemented by The Central Bank of The Bahamas and other regional central banks. Nevertheless, with the continuous enhancement of the macro-prudential indicators and improved methods of assessment, The Bahamas and other Caribbean countries face new challenges from the implementation of new and improved methods. Hence, this paper highlights the legal and regulatory initiatives taken by The Bahamas thus far, and expounds upon some of the emerging challenges in response to newly set standards from the global financial sector.

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[1] The views expressed in this paper are those of the authors and do not necessarily represent the Central Bank of The Bahamas. The paper should be considered a work in progress and as such the authors would welcome any comments on the written text or any of the issues cited. The authors would also like to thank all staff of the Research Department for their valuable assistance.

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## SECTION I: INTRODUCTION

Following the Mexican, East Asian and the United States savings and loans (S&L) banking crises of the 1980s and 1990s, reforming of the financial sector garnered high priority in the international financial scene. Financial innovation has continued unabated, with institutions rationalizing and consolidating, while transactions and services are rapidly going electronic and online. As a result, financial stability is of key concern to countries the world over, since financial instability can contribute to economic instability. Financial crises typically entail large social and economic costs, which are visited throughout the populations of countries where employment opportunities dwindle and wages collapse when GDP drops sharply and currency values plummet. Hence, financial stability assessment is used to review the main sources of risk and vulnerabilities likely to affect the stability of the financial sector and to evaluate its capacity to absorb the impact of adverse disturbances, with a view to making the necessary changes to the financial sector.

More specifically, for the Caribbean the financial systems have been remarkably free of contagion from the rest of the world. Financial flows, interest rates and exchange rates have been unaffected by the Mexican, East Asian and the United States S&L crises. A few Caricom countries have experienced periods of instability, but they were associated with domestic economic instability and the domestic market for foreign exchange, and did not coincide with financial instability in international markets. Nevertheless, the Caribbean economies have been actively involved in the reformation of their financial sectors. Caribbean regulators have played an active role in global efforts towards implementing the minimum standards recommended by the Basel Committee and other international agencies for strengthening supervisory systems and promoting soundness in the banking system. Moreso, they are now all working towards the implementation of the Basel Committee's Core Principles for Effective Banking Supervision, and the adoption of international accounting standards for banks. Caribbean regulators have also taken a number of measures, including the enactment of new legislations, in close association with the Caribbean Financial Action Task Force (CFATF), to counter the use of the region's financial system for money laundering.

Further, approximately five (5) years ago The Bahamas and a few other regional economies that are engaged in significant off-shore banking business were accessed by a number of multilateral agencies (Organization of Economic Co-operation and Development, Financial Action Task Force, Financial Stability Forum), which individually identified various aspects of the offshore financial services in these economies that pose a threat to financial stability. For The Bahamas these included non adherence to internationally accepted standards for supervision, co-operation, and information sharing and absence of personal or corporate income tax, creating a tax havens or "engaging in harmful tax competition". Consequently, The Bahamas and a few other regional economies were placed on a list of non co-operative jurisdictions (blacklist) since they were viewed as ports predisposed to money laundering and tax evasion. The scrutiny and subsequent blacklisting prompted massive legislative and regulatory reform of the financial sector in The Bahamas and other Caribbean countries.

Therefore, this paper offers an industry assessment of legal and regulatory initiatives pursued by The Bahamas, in addition to some emerging challenges from the global sector. Following the introduction, there is Section II, which consists of a review of previous significant financial crises, while Section III reports on the legal and regulatory changes that have taken place thus far in The Bahamas. Section IV expounds upon some emerging challenges for The Bahamas and other CARICOM countries from the global sector and section V, which consist of the general findings, concludes the paper.

## SECTION II: REVIEW OF SIGNIFICANT FINANICAL CRISES

Following the Savings & Loan financial crisis in the United States in the 1980s, the Mexican financial crises in the 1980s and 1990s, and the East Asian crisis of the latter 1990s, the international financial community embarked upon a series of agreements and doctrines with which to overhaul finance and banking frameworks, to ensure stable, transparent, and flexible guidelines, in which to structure the legal and regulatory efforts for financial markets across countries. In an effort to move toward a more sophisticated, adequately regulated and trans-national financial environment, representatives of both developed and developing countries have contributed to forums regarding upgrading of existing financial rules and regulations as it relates to both national development and growth of the global financial sector.

Lessons learned as a result of such crises called for more accurate and in-depth analysis of the macroeconomic environments of countries. Features of countries which had experienced a downturn in its financial markets were characteristically similar in each country case despite differing economic systems. Macroeconomic instability across countries coupled with unexpected market responses and weak regulatory frameworks exacerbated fragile economic conditions. In designing new and improved regulatory guidelines, policymakers have kept at the forefront the potential for such crises to have negative affects on neighbouring jurisdictions and regions. Relatedly, the need for full comprehension and adherence to the newly established methods of assessment and implementation across countries and regions in the global financial system became of paramount importance.

These three major financial crises of the 20th century became principle case studies for analysis of macroeconomic weaknesses, changing economies and eventual financial regulatory reform. The aftermath of the S&L crisis in the US resulted in great upheaval for financial regulators and the development of the industry. With costs to the taxpayer totalling roughly $153 billion, due in part to unmanaged asset/liability gaps leading to interest rate exposure, speculative investments in junk bonds, fraud, and losses from lending to and investing in the commercial real estate sector *(Jameson, 2002),* American industry regulators took an active and unrelenting approach to upgrading tests and measures to predict potential weaknesses in its financial system.

*The US Savings & Loan Crisis (Early 1980s)*

The S&L industry was established to provide mortgages to increase opportunities for home ownership across the country. To facilitate the operation of such a niche market, the industry created several regulatory bodies to oversee its activities. Original attempts at regulation for this specialist segment dates back to the 1930s. In 1932, The Federal Savings & Home Loan Banking Board (FHLBB) was created to regulate the entire S&L industry. Meanwhile, the Federal Savings and Loan Insurance Corporation (FSLIC) which provided deposit insurance to protect the deposits of its members, was established in 1934. Symptoms of impending cash flow deficiencies arose in the 1960s when the industry realised that the S&Ls were not adequately competing with commercial banking institutions for funds in the market *(ibid).* As expected, this situation quickly resulted in an insufficient amount of funds available for lending to its mortgage customers for most S&Ls. This, coupled with the rise in inflation and the deregulation of interest rate markets in the 1970s, created a volatile cash flow situation for S&Ls.

Underlying regulatory deficiencies stimulated further volatility for the sector. In the 1960s, the regulatory boards for the S&L sector applied an interest rate ceiling on what could be offered to its depositors. Consequently, this unchanging rate made the S&Ls less competitive in the market as additional financial products and services were offered by commercial banks in the 1970s at interest rates set by the market. To become more competitive, the regulatory boards, in the 1980s, abolished the interest rate ceiling and allowed its institutions to compete with commercial banks for funds. However, the approach taken by the S&Ls at this time was to offer higher interest rates to prospective depositors, thereby further widening the gap between their funding abilities and the interest being made on its existing deposits. This crisis was further exacerbated by the sharp increase in oil prices in the late 1970s, which severely affected rates of inflation and increased interest rates markedly. This oil crisis was the fatal blow for many S&Ls which soon found themselves in a position of insolvency.

Subsequently, the 1980s were characterised by newly formed legislative and regulatory mechanisms to ward off insolvency. New legislation was created to allow institutions to operate even when their net worth had fallen to low levels of just 3% of insured accounts; levels of insured deposits were raised from $40,000 to $100,000 emphasizing the importance of deposit insurance; changes in the federal tax regulations were established under the Economic Recovery Tax Act of 1981; and equity capital was considered a part of reserves in 1982. These few legislative changes enabled the re-emergence of many insolvent S&Ls which were then permitted to attract a larger pool of depositors over the succeeding years.

*The Mexican Financial Crisis (1981-82)*

The symbiotic relationship that existed between the United States and Mexico in the 1980s contributed significantly to its financial crisis. When interest rates rose in the United States the money supply was reduced, output stockpiled and employment opportunities decreased *(Mabry, 2001)*. As the US purchases roughly 65% of Mexico's output, the increase in the cost of money in the US contributed greatly to the reduction in Mexico's export earnings. The resultant increase in the cost of US imports, which sells approximately 65% of its output to Mexico, resulted in a sharp decrease in revenues for the Mexican economy. According to Mabry, in 1981, Mexico projected $20 billion in oil revenues but recorded takings of just $12 billion. Meanwhile during the same year, its tourism product registered earnings of only $900 million for the same year. The economic policy decisions taken by the Reagan government to offset the U.S. recession were specifically taken to increase the prime rate to 17%, resulting in an increase in the Mexican debt burden by approximately $2.5 billion for that year. Mexico's economic policy of foreign borrowing to fund its national development projects further worsened its crisis situation. In 1982, the Mexican national budget called for 34% of its financing to come from foreign borrowing.

By 1982, Mexican economists were projecting inflation rates of 60%, prompting significant capital flight with one-third ($3 billion) of the value of peso accounts exchanged for dollars. Within months, roughly ninety-percent of accounts were dollar accounts despite a higher rate of return offered on peso accounts. The expected devaluation of the Mexican peso incited the government to take several policy decisions including reducing government spending by 8%; suspending its nuclear energy program and floating of the fixed-currency peso. The government also implemented a two tiered-exchange rate system for essential and non-essential imports; income taxes were suspended, despite the increase cost in basic consumer commodities; foreign currency trading was suspended; private Mexican banks were nationalised; the Banco de Mexico was made to act as a decentralised agency; strict controls on the currency were enforced as the government took control of the flow of all domestic credit, and all payments on debt principal were suspended until 1983.

These policy shifts made the country unattractive to foreign investors. In response, the US government began to pre-empt waves of illegal migration by offering to assist Mexico with an advanced $1 billion dollar loan for petroleum and a $1 billion dollar loan from the Commodity Credit Corporation to help service its national debt. Effectually, the United States realised that it is essential to ensure that one of its major trading partners remained in an economically stable position, as it will undoubtedly have an effect on the stability of the US economy.

The turn around in the Mexican economy came in the latter part of 1983 when Miguel de la Madrid became the 60th President and worked to reverse the effects of the economic and financial crisis from 1981-83. De la Madrid instituted an economic stability plan which included notable policy decisions such as liberalising the trade sector, removing restrictions on capital flows, negotiating a new foreign debt agreement with the US, and decentralising critical institutions enabling them to be more market oriented. These decisions resulted in a sharp decrease in inflation rates by 1993, economic growth that averaged 3.1% between 1989 and 1994; an increase in foreign investment; and growth in domestic credit.  The country under de la Madrid began to experience consistent levels of overall economic growth into the 1990s.

*The Asian Financial Crisis (1997-98)*

The report presented to the US Congress on the Asian Financial Crisis of 1997-98 entitled *"CRS Report: The 1997-98 Asian Financial Crisis"* detailed two main problems integral to the collapse of financial economies in Thailand, Indonesia, South Korea and the remaining countries of the Asian region.  The collapse of the financial system which included (1) a shortage of foreign exchange leading to a devaluation of currencies in the region; and (2) the underdeveloped financial sectors in these countries which included inadequate mechanisms with which to allocate money around the region.

The depreciation of the currencies in 1997 saw a decline in the value of the Thai baht, the Malaysian ringgit, the Philippine peso and the Indonesian rupiah.  Once an equilibrium value was found at a lowered rate, a subsequent devaluation of several additional Asian currencies took place for the Taiwan dollar, South Korean won, Brazilian real, Singaporean dollar, and the Hong Kong dollar.  Policy responses by respective governments included selling foreign currency reserves, buying respective currencies and raising interest rates *(Nanto, 1998).*  These decisions slowed economic growth for each country and the region as a whole.

A weakness of the Asian model of bank borrowing and lending has influenced the growth of the business community in the region.  With its industrial policy focused squarely on production, a significant proportion of companies have relied on banks to fund the creation and expansion of businesses by offering lower interest rates for such production oriented commerce.  In turn, Asian banks typically rely on borrowing from the international market to fund loans as opposed to utilising available government tools such as issuing government bonds and stocks to raise capital for national development ventures.  As nepotism fuelled the business climate in Asia, business owners who were well-connected garner great influence over business and political decisions in the country. Subsequently, they obtained greater access to financing than other business owners and local consumers seeking loans and mortgages.

Policy adjustments made to address the Asian financial crises led to high current account surpluses, flexible exchange rate policy, high reserves, and lower exposure to short-term debt. Nevertheless, according to the European Commission they are still concerns with regards to capital flight, depreciation of the exchange rate and insufficient progress on structural reforms for the financial sector in particular.

The underlying vulnerabilities which existed in the macro-economies of the US, Mexico and East Asia, fuelled the crises that each area underwent. As noted by Chairman of the US Federal Reserve, Alan Greenspan, several factors have lead to the demise of the financial systems in these jurisdictions including *excessive bank lending, weak institutions, corruption, political instability, inadequately regulated financial systems, excessive borrowing in unhedged foreign currencies, moral hazard, excessive leverage interest rate and currency risks, underdeveloped securities markets and inadequate legal structures*. Additionally, the perceptions held by the international community regarding the economic stability of countries had great influence over the extent of crises in these countries.

Overall, the similar characteristics that lead to the financial crises in the 1980s and 1990s had devastating effects on the economic growth of countries and regions. Therefore, reversal of these crises calls for sound macroeconomic policies, a strong financial system, low rates of inflation, a small budget deficit, current account stability and a liberalised financial market. Ensuring, as much as possible, macro-economic and political stability through comprehensive regulatory framework should work toward counteracting any potential threats to countries financial systems. It is essential that these indicators be achieved in order to avoid financial disruptions.

## SECTION III: LEGAL AND REGULATORY CHANGES IN THE BAHAMAS

The financial system in The Bahamas is characterized by its dualistic nature, a thriving off-shore sector alongside a domestic sector, separated by exchange controls. The majority of banks in The Bahamas is subsidiaries of larger foreign banks and in the case of the local sector controls most of the asset base. The dualism that prevails was responsible for intense scrutiny by a number of multilateral agencies (Financial Stability Forum, Organization for Economic Co-operation and Development) beginning early 2000. These multilateral agencies individually identified various aspects of the offshore financial services in The Bahamas that posed significant threat to financial stability. As a result, at the end of 2000 The Bahamas commenced the revamping of its financial legislation and regulations by introducing a new regulatory framework.

In the wake of these supra-national initiatives and the impending US Treasury led Qualified Jurisdictions (QJ) initiative, the Government embarked on an ambitious overhaul of financial sector legislation—enacting on the 29th December, 2000, the following new laws:

- The Banks and Trust Companies Regulation Act, 2000
- The Central Bank of The Bahamas Act, 2000
- The Financial Intelligence Unit Act, 2000
- The Proceeds of Crime Act, 2000
- The Financial and Corporate Service Providers Act, 2000
- The Financial Transactions Reporting Act, 2000
- The International Business Companies Act, 2000
- The Evidence (Proceedings in other Jurisdictions) Act, 2000 and
- Criminal Justice (International Cooperation) Act, 2000

These laws worked to strengthen the existing financial supervisory framework of The Bahamas and ensure that the country's financial sector adheres to internationally accepted standards and procedures. Moreover, in 2001 the Central Bank's Supervision Department technical resources were expanded to establish a group of specialists to conduct on-site examinations under the coordination of a Senior Bank Supervision Consultant. Two senior on-site supervision experts were recruited to supervise the commencement of this work and to assist with the development of an expanded supervisory team.

The on-site examinations initially focused on the implementation by banks and trust companies of the statutory and regulatory requirements regarding know-your-customer (KYC) and anti-money laundering policies, procedures and controls, contained in the Proceeds of Crime Act 2000, the Financial Transactions Reporting Act, 2000 (as amended), the Financial Intelligence Unit Act, 2000 (as amended) and Regulations made pursuant to these statues. However, the coverage of the examinations was expanded in August 2001 to encompass the full range of banking and trust activities, including risk management, control systems, safety and soundness issues and corporate governance.

In May 2001, regulations regarding the information required of applicants seeking a bank and/or trust license were issued by the Governor of the Central Bank. These regulations clearly establish the minimum information and documentation necessary to enable the Bank to carry out comprehensive due diligence (fit and proper criteria) on proposed shareholders, directors and senior management. Documents required cover identification; work experience; financial propriety and character of the proposed principals and officers; business plans and financial projections; summary of internal procedures and controls to be utilized by the proposed entity; organizational structure – inclusive of reporting lines and duties and responsibilities of members of the board and executive officers.

Regulations regarding the use of the words ‘bank’, ‘trust’ and any derivative thereof by persons in The Bahamas were also issued in May 2001. These regulations specify the requirements for applicants - not to be licensed to conduct banking or trust business - to apply to for the approval of the Governor to use these restricted designations in the formal name of the entity in question.

Additionally, Guidelines regarding the requirements for the transition by managed banks to meaningful physical presence were issued in May 2001. In accordance with revised standards implemented at the end of 2000, no banking or trust entity may be licensed in The Bahamas unless strict minimum operating requirements are met, as detailed in the Guidelines.

Corporate Governance Guidelines, requiring the implementation of comprehensive risk management controls and systems appropriate to the nature of the business and operations of licensees, were issued in December 2001. These Guidelines further outline the duties and responsibilities of directors with respect to governance of licensees.

During the third quarter of 2001, a declaration, to be completed and fielded by Directors and Senior Officers of all licensees was introduced. This document required individuals to reveal all affiliations with other entities, assist in identifying any potential conflicts of interest, and or issues in the individual's past which may lead to disapproval by the regulator.

At the end of 2001 the Financial Intelligence Unit (FIU) issued Suspicious Transactions and Anti-Money Laundering Guidelines covering record-keeping and suspicious transactions reports rules, the obligation of the institutions to appoint a Money Laundering Reporting Officer and Compliance Officer, and outlining and education and training requirements of relevant staff.

A special Policy Unit, which focuses on monitoring developments in financial regulation and policy, was established within the Bank Supervision Department. The Unit is tasked with providing analysis of latest developments/emerging issues in bank supervision, recommend changes to existing policies, legislation, regulations and guidelines and constitutes the nucleus of the Bank's participation on international committees, working groups, etc., devoted to policy development.

In other financial sector developments, 2002 witnessed further structural changes in the banking sector, as institutions responded to the Central Bank's new physical presence requirement, and adjusted to tighter regulatory measures affecting the provision of financial services. The on-site examination methodology was updated to reflect, not only jurisdictional requirements, but also to take into consideration changes in international standards. A risk rating system, and risk focused approach to the on-site examinations, also became fully operational in 2002.

Financial sector developments during 2003 were headlined by amendments to the regulatory framework for combating money laundering and the enhanced legal framework for the investment funds industry. On December 31, 2003, the Government enacted amendments to the Financial Transactions Act (FTRA), 2000 and the Financial Transactions Reporting Regulations (FTRR), 2000, to align The Bahamas' anti-money laundering regime and know-your-customer (KYC) standards with the new risk-based approach of the Financial Action Task Force's Revised 40 Recommendations on Money Laundering. The amendments impose additional customer identification requirements when risks posed by business relationships warrant them, and an obligation for financial institutions to update KYC documentation whenever a material change occurs in the nature of existing relationships. In addition, the trigger value for the reporting of transactions under the Suspicious Transactions Reporting Guidelines was raised to $15,000 from $10,000, with Bahamian dollar facilities of $15,000 or less exempted from having to satisfy the KYC documentation.

As regards the securities industry, an enactment of the Investment Funds Act (2003) and associated Regulations, which repealed and replaced the Mutual Funds Act, 1995, took place during the year. While encompassing the narrow definition of international funds which The Bahamas sought to attract under the 1995 law, the Act introduced a distinction between funds marketed and administered for sophisticated wealthy investors, standard funds – which may be sold to less sophisticated investors but subject to tighter supervision – and Specific Mandate Alternative Regulatory Test (SMART) funds.

In addition to the legislative changes given above, The Bahamas has concentrated on deepening and extending its already close relationship with its principal trading partner, the United States of America. The Government of The Bahamas negotiated with The

United States of America, the enactment of a bilateral Tax Information Exchange agreement, with the intent to cement close cooperation between the two countries in areas of enforcement of existing revenue laws while respecting the rights of sovereign states to set tax and revenue policies most suitable to their economic and social environment.

Overall, for more than a decade all CARICOM countries have been actively amending and introducing new legislation to ensure adherence to international regulatory standards, as well as strengthening the region’s anti-money laundering efforts. In general, Caribbean regulators have played an active role in global efforts towards implementing the minimum standards recommended by the Basel Committee and other international agencies for strengthening supervisory systems and promoting soundness in the banking system.

Currently, financial stability assessment in the region is guided by the Basel Core Principles for Effective Bank Supervision (Basel I), which provides a comprehensive blueprint for an effective supervision system. The Basel Committee developed a comprehensive set of twenty-five (25) core principles as a reference point for effective banking supervision and these core principles are the assessment tools used by all Central Banks in the Caribbean for assessing the financial system soundness.

According to the Basel Core Principles for Effective Bank Supervision (April 1997), the twenty-five (25) basic principles that need to be in place for a supervisory system to be effective relate to preconditions for effective banking supervision (principle 1), licensing and structure (principles 2 to 5), prudential regulations and requirements ( principles 6 to 15), methods of ongoing banking supervision (principles 16 to 20), information requirements (principle 21), formal powers of supervision (principle 22) and cross-border banking (principles 23 to 25).

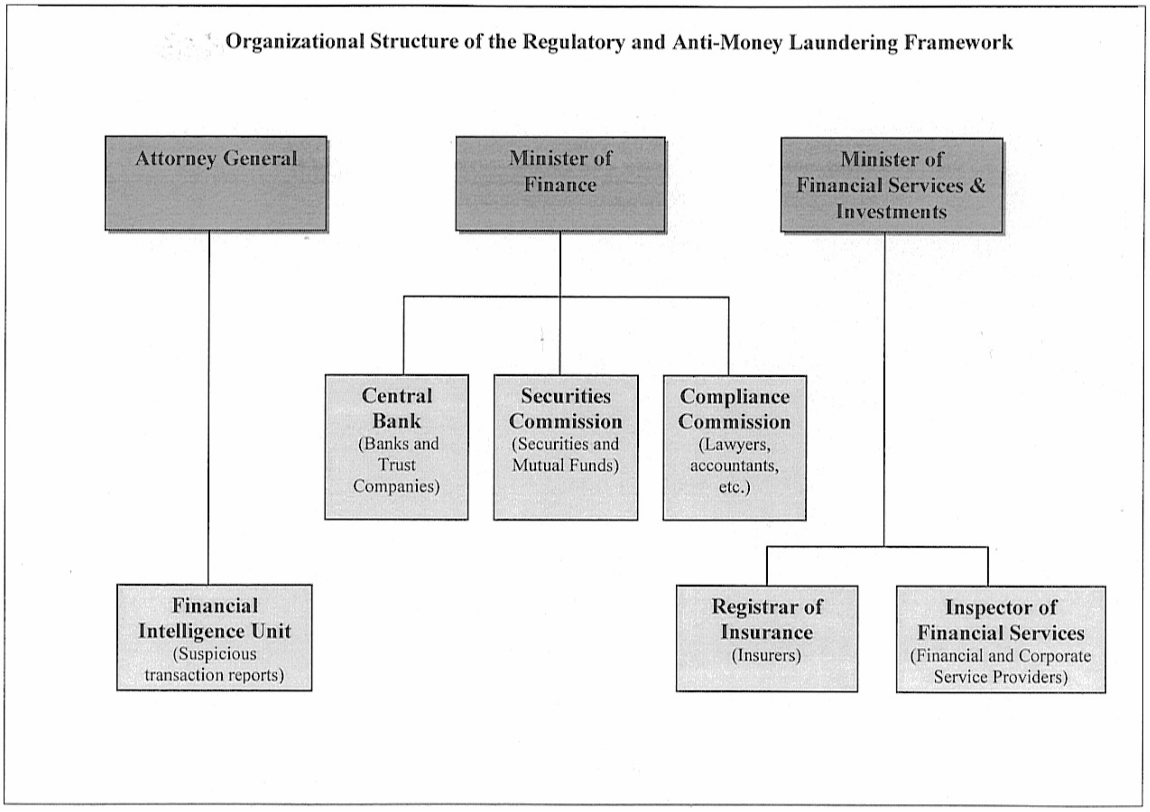
Additionally, onsite examinations have become an integral part of the supervision of banks in the region. These safety and soundness examinations cover a wide range of issues, particularly the financial position of banks, the quality of credit being extended and corporate governance arrangements. Also, the introduction of deposit insurance as a requirement for the domestic banking system is now embraced by regional economies. Further, there was the establishment of the Caribbean Group of Central Bank Supervisors (CGCBS), who are working closely on the development of consolidated banking supervision within the region.

Moreover, Caribbean regulators, in close association with the Caribbean Financial Action Task Force (CFATF) have taken a number of measures to counter the use of the region's financial system for money laundering. Countries have enacted anti-money laundering legislation, established financial intelligence agencies and have issued anti-money laundering guidelines to financial institutions. Regulators and law enforcement agencies continue to work closely with the international Financial Action Task Force (FATF) and CFATF in ongoing efforts to upgrade the regulatory framework.

## SECTION IV: EMERGING CHALLENGES FROM THE GLOBAL SECTOR

With continuous steps being taken to minimize the negative consequences of risk-taking by financial institutions, there has been progressive upgrading of current methods of assessment of financial institutions and the implementation of new ones. Even though the steps being taken are commendable and are an integral part of the supervisory process going forward, The Bahamas, and all other CARICOM countries will face some specific challenges with regards to the implementation of these new and improved methods. Already there is a call by the International Monetary Fund for the reforming of The Bahamas financial regulatory structure.

**Figure 1: Financial Regulatory Structure For The Bahamas**




*Source: IMF Country Report For The Bahamas, April 2004*

Currently there are a number of key regulatory agencies which carry out the regulation of the financial sector, namely, The Ministry of Finance, The Central Bank of The Bahamas, The Securities Commission, Compliance Commission, Finance Intelligence Unit, Registrar of Insurance and Inspector of Financial Services (See Figure 1). The Central Bank is responsible for licenses and supervises the banks and trust companies, the Securities Commission of The Bahamas overseas the securities and mutual funds industry. Companies managers and related service providers are the responsibility of the Inspector of Financial and Corporate Service, whereas the insurance industry falls to the Registrar of Insurance, with the Compliance Commission charged with ensuring compliance with the Anti-Money Laundering (AML) obligations. Additionally, the Financial Intelligence Unit receives, analyzes and pass for investigations any suspicious transactions reports submitted by financial institutions. However, the functions of these agencies are duplicitous and overlapping.

According to the IMF Review of Financial Sector Regulation and Supervision (April 2004) Report, although the demarcation of functions of these agencies appear straightforward, the structure of the market poses some serious challenges to minimizing the risk of regulatory overlap. For instance, many trust companies are registered by the Securities Commission as broker-dealers and are equally engaged, directly or through subsidiary operations, in the incorporation and management of offshore companies. Additionally, the scope of the Compliance Commission's remit is defined by statues in terms of activities that also include some of the normal business of financial institutions subject to regulation by other bodies. Also, it appears that some company service providers and trust companies are engaged in very similar activities, but are supervised under quite different regimes. The report highlighted that the respective agencies supervise activities in both the domestic and offshore sectors under a general legal and regulatory framework that does not apply differential regimes between the two sectors. Therefore, it was recommended that all reporting lines for the regulatory agencies be consolidated under the Ministry of Finance in line with international common practice to avoid potential conflict of interest.

Despite the simplicity of the Basel I Accord (Basel I), which was easy to understand and less complex to implement and was adopted by all Caribbean countries, they were several issues with its implementation. Therefore, with countries still focused on completing the implementation of Basel I, it is expected that the New Accord which is more complex and expensive to implement, since it deals exclusively with capital adequacy, will pose new challenges for The Bahamas and the CARICOM region as a whole.

Shortcomings in the implementation of the Basel I Core Principles 6-14 for Small Offshore Financial Centres (SOFCs) included, ensuring that minimum standards set for capital adequacy are fixed at an appropriate level.  This called into question the ability to determine safe levels of capital to avoid risk exposure.  Prudential regulation procedures have been determined to be inadequate, in that for many SOFCs, there is an absence of a credit policy to guide the decision-making of banks.

In the case of The Bahamas, the IMF's report conducted in April 2004, which reviewed the country's financial sector's regulation and supervision guidelines, reported that The Bahamas' progress on implementing its Prudential Regulations and Requirements has been staggered. The Central Bank of The Bahamas has broadened its standards of prudential regulations and requirements within the jurisdiction by initiating the development of a more comprehensive framework of guidelines in order to better manage its risk. Further amendments to the Prudential Regulations and Requirements are still being undertaken by the country's financial executives to fully comply with this core principle.

With respect to its capital adequacy levels, the Central bank maintains the Basel I Capital Accord Principles framework. In fact, the Central Bank upholds either a minimum of either 8% of risk assets or 5% of total assets, whichever is greater, effectually applying a dual system of capital adequacy. More difficult to address and subsequently to regulate in SOFC is *connected lending*, where banking officials lend to related parties. In such a small jurisdiction such as The Bahamas, this is a difficult task due to the small size of the population. The Central Bank, however, has already examined this issue and has developed a draft policy where lenders are subject to various requirements and the process is dealt with at an 'arm's length', as required by the Basel Core Principles (BCPs).

As regards supervisory efforts, SOFCs have encountered complications with carrying out inspections due to a lack of inspection procedures and to a lesser degree, vague and unclear inspection instructions. To further complicate this problem, there has been a lack of human resources equipped with the necessary skills to undertake inspections, coupled with the inadequate training given to such supervisors carrying out these tasks. It is therefore credible that insufficient attention has been paid to risk over the years. Additionally, under the Basel I, rule 19 specifies that *"banking supervisors must have a means of independent validation of supervisory information either through on-site examinations or use of external auditors"*. Several SOFCs have been unable to provide sufficient independence for its analysis of on-site assessments; nonetheless efforts towards a more independent regulatory body are being pursued by several countries, including The Bahamas.

In 2001, the Central Bank of The Bahamas instituted an on-site inspection program to supplement its existing off-site program of assessing the overall position of banks. A cross-training exercise was also implemented to introduce analysts to on-site examinations with the aim of improving the understanding of the operations of institutions. The country also specified that offshore centres establish a physical presence in the country in order to comply with the BCPs request of conducting on-site inspections to assess for anti-money laundering activities.

Therefore, the New Basle II Accord is anticipated to provide an improved and more comparable way to look at risk-taking across organizations. Accordingly, it is expected to allow market participants, supervisors and the banks themselves to be more effective in detecting changes in risk levels, and to better assess the appropriateness of particular capital levels supporting such risks.

Additionally, the preparations for and the final implementation of the New Accord, is supposed to increase resources applied to improving bank risk management practices. This should result in pricing becoming more reflective of risk and more efficient capital allocation across firms, borrowers and industries. Basel II is anticipated to lead financial institutions to deepen and accelerate their efforts to improve the evaluation, quantification and disclosure of risk. Implementation of Basel II is through three Pillars. Pillar one relates to *minimum capital adequacy*; Pillar two, *supervision review process*; and Pillar three, *market discipline*. However, implementation of these three Pillars will prove challenging for The Bahamas.

For Pillar one a vast amount of empirical work will be required for calculating credit risk, operational risk and market risk, which are all part of calculating the minimum capital requirements. For most, if not all countries in the region, including The Bahamas, no empirical work is done with regards to credit risk coefficients. Enormous amount of empirical work is normally conducted by the G-10 countries but not by the developing economies.

The New Capital Accord has provided countries with over sixty (60) options for implementation at national discretion. However, for countries in the region that serve as host jurisdiction for the developed countries, they would need to follow closely which positions are taken by these countries. Reason being, countries might adopt different approaches, thus forcing The Bahamas, which is host to subsidiary banks, to learn all approaches of the New Accord, as some countries parent offices might adopt the more advanced approaches.

Further, even the outright application of the standardized approach might prove challenging for The Bahamas. The standardized approach involves the use of ratings agencies to determine the risk weighting for assets. Therefore, this would require the Central Banks in the region to review rating agencies for over 40 countries to determine if they meet the Basel criteria, an exercise which can prove costly and time consuming.

According to Basel II, under pillar two, supervisors should regularly review the process by which banks self-assess their capital adequacy, in terms of the level and quality of capital held in relation to their risk positions. Therefore, a more in-depth review of capital adequacy will be required during the examination process. Central Banks will have to assess via on-site examination, the system and records by which licensees routinely monitor their capital adequacy between report dates. Thus, strengthening of this policy and increasing transparency are issues that The Bahamas would be required to examine.

For Pillar three, market discipline, the emphasis is on the disclosure of both quantitative and qualitative information of banks activities by shareholders, depositors and other market participants. Implementation of this pillar will be an added cost to the banks due to more frequent disclosures. Disclosures will have to be semi-annual for all public licensees and quarterly for large retail banks. Moreover, if the disclosures are to be credible then it will necessitate the checking and auditing of banks by external auditors. Along with the extra cost to banks there will also be resource and expertise considerations for local audit firms as certain disclosures are not currently made.

Furthermore, in preparing for Basel II supervisors will have to address their own capital needs, that is human capital. Supervisors will need a higher degree of knowledge, skill and experience. To implement a framework of the complexity and scope of the advanced approaches of the New Basel Accord there is need for highly qualified supervisors, since many aspects of Basel II will require a considerable amount of judgement and experience. As supervisors engage in the qualification of institutions for Basel II and then conduct ongoing monitoring, they will need to become intimately familiar with many technical aspects of the framework and have the ability to assess each institution in context.

More specifically, supervisors will be required to keep pace with the latest developments in the industry and be able to differentiate among them in terms of appropriateness. One of the many proposed attractive characteristics of the New Accord framework is its flexibility for incorporating new best practices without having to be fundamentally restructured. However, for The Bahamas and all other Caricom countries some amount of restructuring will be necessary since the flexibility that would be experienced by the more advanced economies, due to the systems in place, are currently absent in the developing countries.

In addition to the New Capital Accord (Basel II), the IMF has recently proposed in its financial sector assessment programme, the use of Financial Soundness Indicators (FSIs). FSIs are a new body of economic statistics that reflect an amalgam of influences. These are indicators of the current financial health and soundness of the financial institutions in a country and of their corporate and household counterparts. They include both aggregated individual institution data and indicators that are representative of the markets in which the financial institutions operate. FSIs are calculated and disseminated for the purpose of supporting macro-prudential analysis which is the assessment and surveillance of the strengths and vulnerabilities of financial systems, with the objective of enhancing financial stability and limiting the likelihood of failure of the financial system.

**Table 1: Financial Soundness Indicators: The Core and Encouraged Sets**

| | |
|---|---|
| **Core Set** | |
| Deposit-takers | |
| Capital Adequacy | Regulatory capital to risk-weighted assets |
| | Regulatory Tier 1 capital to risk-weighted assets |
| Asset Quality | Nonperforming loans to total gross loans |
| | Nonperforming loans net of provisions to capital |
| | Sectoral distribution of loans to total loans |
| | Large exposures to capital |
| Earnings and Profitability | Return on assets |
| | Return on equity |
| | Interest margin to gross income |
| | Non-interest expenses to gross income |
| Liquidity | Liquid assets to total assets (liquid assets ratio) |
| | Liquid assets to short-term liabilities |
| Sensitivity to Market Risk | Duration of assets |
| | Duration of liabilities |
| | Net open position in foreign exchange to capital |
| **Encouraged Set** | |
| Deposit-takers | Capital to assets |
| | Geopolitical distribution of loans to total loans |
| | Gross asset position in financial derivatives to capital |
| | Gross liability position in financial derivatives to capital |
| | Trading income to total income |
| | Personnel expenses to non-interest expenses |
| | Spread between highest and lowest interbank rate |
| | Customer deposits to total (non-interbank) loans |
| | Foreign currency-denominated liabilities to total liabilities |
| | Net open position in equities to capital |
| | Assets to total financial system assets |
| Other Financial Corporations | Assets to GDP |
| | Total debt to equity |
| Non-financial Corporate Sector | Return on equity |
| | Earnings to interest and principal expenses |
| | Net foreign exchange exposure to equity |
| | Number of applications for protection from creditors |
| | Household debt on GDP |
| Households | Household debt service and principal payments to income |
| | Average bid-ask spread in the securities market |
| Market Liquidity | Average daily turnover ratio in the securities market |
| | Real estate prices |
| Real Estate Markets | Residential real estates loans to total loans |
| | Commercial real estate loans to total loans |

*Source: Compilation Guide on Financial Soundness Indicators, IMF, September 2003*

The FSIs are divided into core and encouraged sets. The core set examines capital adequacy, asset quality, earnings and profitability, liquidity and sensitivity to market risk. On the other hand, the encouraged set deals with deposit takers, other financial corporations, non-financial corporate sector, households, market liquidity and real estate markets (See Table 2).

Compilation of FSIs would be a new endeavor for The Bahamas and all Caricom countries. Because of the wide range of data sources that need to be drawn upon, the Caribbean will be confronted with some *strategic issues* when attempting to compile such information. These issues revolve around the decision whether to have a separate agency act as single regulator or continue with the current structure whereby the Central Bank via its Bank Supervision Department, remain responsible for the assessment of the stability of the financial sector.

Given the range of data sources that potentially need to be drawn upon, it is not likely for all data to be available in one agency, so the job of compiling FSI data will certainly involve more than one agency. However, the FSI Guide recommends that one agency should be given the primary responsibility for calculating and then disseminating FSIs. Once the lead agency has been determined, the strategic decision will be whether to establish a unit in the lead agency that focuses specifically on the FSI data-set or whether an existing unit should add this task to its workload.

Furthermore, for most FSI related series, legal backing for data collection would be required and this is absent from the legal framework of most CARICOM countries, including The Bahamas. Adequate legal backing would provide the statistical agency with the necessary support to encourage the private sector to report the data required.

In addition to strategic issues, they are a number of *managerial issues* pertaining to the implementation of FSIs. Most important, is the coordination with other agencies, the development of agencies mandates and consultation with both data suppliers and users.

Data for compiling FSIs are likely to be supplied by different agencies, hence a number of management challenges would arise. For instance, procedures are needed to ensure that the concepts used and data compiled by the different agencies are consistent, or at least reconcilable. To this end, the lead agency would need to develop expertise in the international guidance for compilation of FSIs, and also act as their guardian within the economy.

There are also *practical issues* of increased resource cost from collecting new data series. Collecting new data for compilation of FSIs could prove to be an added burden to agencies that have to supply the data. Hence, in determining the need to collect new data, authorities would need to determine the likely impact and importance of the additional data series for compiling and monitoring FSI data.

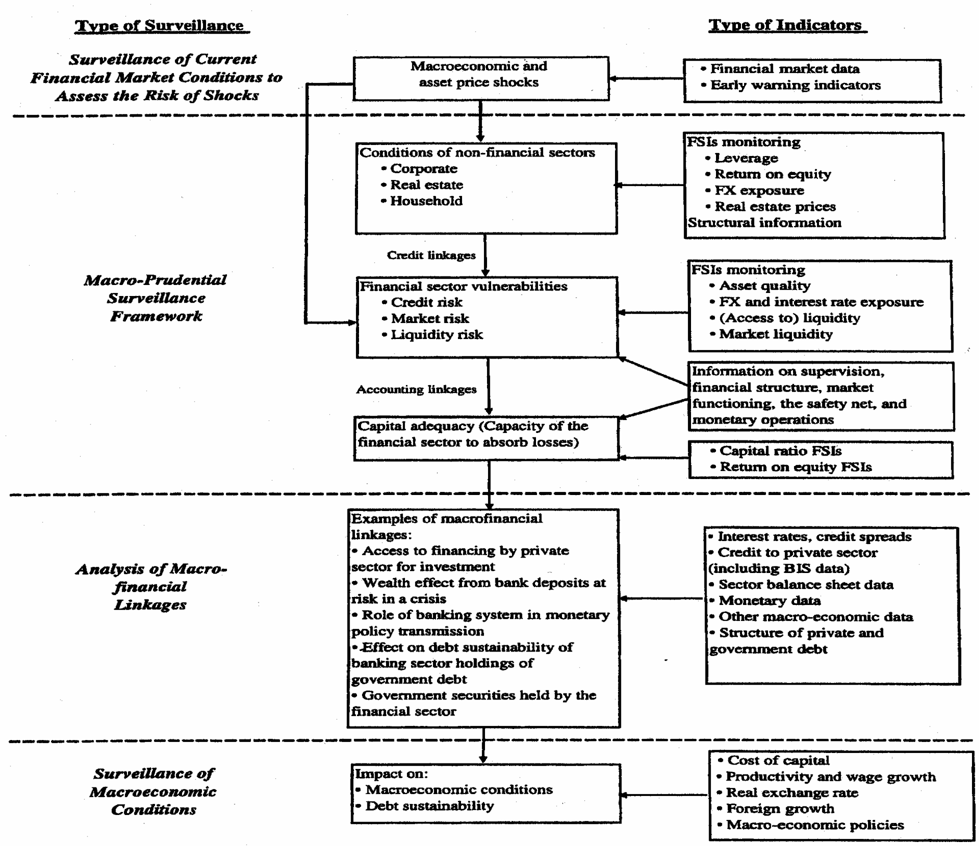
In addition, analytic work is now focused on determining the utilization of FSIs in combination with aggregate stress testing. Aggregate stress testing involve applying standardized shocks to deposit-takers' balance sheets and then aggregating the results across deposit-takers, to obtain the impact on the sector as a whole. Stress testing also provides a way to access certain types of risks that are hard to measure precisely using FSIs, including derivatives and off-balance sheet exposures. However, stress testing is not conducted by any of the Caricom countries. Hence this new and improved method of testing would require careful study and analysis by The Bahamas and the other regional economies.

Moreso, another challenge relates to financial regulators[2] autonomy. Political interference in financial sector regulation and supervision contributed to the depth and magnitude of nearly all of the financial crises of the past decade. Independence for financial regulatory agencies is very important, since an independent regulator can ensure that the rules of the regulatory game are applied consistently and objectively over time. If bankers know in advance that insolvent banks will be closed they will behave more prudently, thereby

[2] For CARICOM countries the Central Banks are the financial regulators

reducing the likelihood of a full-blown banking crisis. However, when politicians become directly involved in enforcing regulations, they may be influenced by other considerations in making their decisions, which then take on an ad hoc quality.

**Figure 2: Analytic Framework For Financial Stability**




*Source: IMF Compilation Guide on Financial Soundness Indicators, Draft September 2003*

Therefore, regulatory independence in The Bahamas and the Caribbean is critical for effective rule-making. Agencies need an appropriate degree of autonomy in setting prudential regulations, within the broader legal framework. Supervisors who can define regulations are in a better position to respond quickly and flexibly to changing needs and trends in the international markets. Thus, an important challenge for The Bahamas and the Caribbean is adhering to the call of international agencies to have fully independent and accountable regulators and supervisors, in the interest of long-term financial stability.

## SECTION V: CONCLUSION

Financial sector reform is taking place in all countries across the world to ensure financial stability. History has taught us that financial instability can create economic instability in neighbouring jurisdictions. Therefore, from the perspective of ensuring global financial stability, it is critical for all countries to adopt the proposed new and improved methods of assessment of the financial sector. The introductory phase of these new approaches will no doubt be challenging to The Bahamas and the entire region. Nevertheless, since these new methods of assessment involve more detailed risk analysis, which would lead to better risk management practices, it is necessary for The Bahamas and all other Caribbean countries to start focusing on the adaptation of these advanced methods of assessment.

Basel II is expected to provide a useful and credible basis for improving bank practice today and allowing for future improvements, which is vitally important, since banking is and will remain a highly dynamic industry. However, supervisors need to be attentive to changing best practices and ensure that Basel II does not inhibit adoption of new banking practices and financial instruments.

Further, stress testing and FSIs are different but complementary approaches to assessing risks to financial stability. FSIs allow more continuous monitoring of specific strengths and vulnerabilities over time, while the stress test gives an estimate of the losses associated with these vulnerabilities from a one-time, plausible shock to the relevant macroeconomic risk factor. However, since these are all new methods of accessing financial stability within the Caribbean, there would be challenges with the initial compilation, as the region would need to ensure the development of the necessary expertise and techniques.

Supervisory independence is also critical to enforcing rules, imposing sanctions and managing crises. To protect their integrity, supervisors should enjoy legal protection when carrying out their responsibilities so that they cannot be sued personally for their actions. Further, supervisors should be given sole authority to grant and revoke licenses because they have the best view on the composition of supervised sectors.

Once necessary frameworks are adjusted and implemented, it is inevitable that The Bahamas and the countries of the Caribbean region will experience significant upgrading of its financial sector systems. Although not without challenges the process of implementing Basel II, conducting stress testing and calculation of FSIs, will enhance financial and economic stability within The Bahamas, the rest of the Caribbean and globally.

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