

Marion Williams: Barbados' financial system and insurance sector

Address by Dr Marion Williams, Governor of the Central Bank of Barbados, to the Barbados Association of Insurers and Financial Advisers (BARAIFA), Bridgetown, 20 March 2009.

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Introduction

Mr. Chairman, Madam President Mrs. Lorena Best and Past President Mr. Wilton Gale, Mrs. Shirley Clarke, Agents and Financial Advisers, Distinguished Life Underwriters.

When last I spoke with you in early 2008, we were only just beginning to see the fallout from the collapse of the US sub-prime market. While at the time we expected there to be some (limited) effects on demand and financing conditions, our more immediate concern related to the inflationary impact of record-high international commodity prices and oil prices in particular.

Since then, however, circumstances have changed dramatically, and for the worse. It has become clear that we are entrenched in a global financial crisis and economic downturn, stemming from an acute crisis of confidence. The only upside (if one can call it that) to the situation would be that depressed world demand has helped to stabilise international prices and curb inflationary pressures.

Current global conditions therefore pose obvious challenges for Barbados, as economic downturns in our major trading partners and the ongoing turmoil in international financial markets continue to filter through to the domestic economy.

Macroeconomic developments

I think that everyone in this room is aware that the year 2009 will be a difficult year for Barbados, for the Caribbean and the world. With the global economy slowing significantly, and most of Europe and North America in recession; with China experiencing half the rate of growth than is customary and South East Asia, India, Australia and New Zealand experiencing significant downturns, or in recession, the expectation is that this must have a significant negative impact on Barbados and the Caribbean.

The questions that most of us want answered are: How badly is it likely to affect us? How long will it last and what can we do to mitigate its impact? What pre-emptive action can we take, collectively as a government or individually? For BARAIFA members I would expect that one of your main interests would be about how the insurance market will be affected and what are the prospects for the insurance business going forward.

As we all know by now, the softening of global demand, amid tight financial conditions, has triggered economic downturns in our key source markets for tourism. Barbados is a very open economy and because of the structure of our economy, we are more sensitive to the economic performance of the rest of the world. Since tourist travel is spent out of discretionary income, Barbados is very dependent on the economic performance of its source markets.

The UK, our leading source market, has been in recession since the middle of 2008, while the US (our second most important market) has officially been in a recession since the end of 2007, as reflected in significant job losses and declining real output. Indeed, in February 2009, the US unemployment rate reached levels not seen since the recession of the early eighties, while the estimated growth in real GDP for 2008 was the lowest since 2001, when the September 11th terrorist attacks curtailed growth. Although Canada, another key market, has remained relatively buoyant, there are signs of increasing spillover effects from the US

downturn on that economy. The local tourism industry is therefore currently experiencing a significant downturn, which has negatively affected activity in a number of auxiliary services.

Foreign exchange receipts from tourism are likely to be further impacted by huge discounts offered by hotels to encourage visitor travel. Profits in the industry are likely to be adversely affected, even in circumstances where in some cases occupancy has not been severely impacted. Despite shorter work weeks, which is a means of mitigating the macroeconomic as well as the social impact, this is likely to lead to higher unemployment.

After tourism, the international business and financial services (IBFS) sector is the second-most significant contributor to Barbados' foreign exchange earnings and it too has been struggling to maintain profitability in the current climate. In 2008, many entities in the offshore sector were adversely impacted by the dramatic fall in stock and bond prices and by the near collapse of the mortgage market in the US. Many lost significant value on their assets and profits in the sector fell, adversely affecting government revenues which depend on the sector for over 50% of corporate profits, but also dampening the prospects of any significant increase in new registrations in the sector in 2009.

In addition, the recent developments in Antigua, with respect to Stanford International Bank and its related companies, have the potential for deterring potential investors into Barbados, as in the minds of some investors, the Caribbean is seen as one geographical area. It is therefore important to mount a campaign to distinguish Barbados as a domicile with high standards and competent oversight systems. The Central Bank assisted in aggressive marketing of the jurisdiction in 1999-2000 and was active in differentiating Barbados from the less positively regarded kinds of jurisdictions and we propose to mount such a programme again through an increase in the number of articles in journals covering the financial services sector in Barbados. This is particularly important in the context of the distrust in the financial system and the growing complaints about the special tax systems which obtain in international financial centres like Barbados. While the global financial collapse, with its impact on the entire financial system has nothing to do with offshore financial centres as they are commonly called; it is convenient to find scapegoats and to point fingers at others rather than at oneself. In addition, with many countries' government accounts under strain, it is also timely to refer to the revenue forgone by the incorporation of international companies in offshore financial centres, forgetting for the time being the expansion of the corporations that this facilitated.

As a consequence of all these developments, the international business sector in Barbados and elsewhere is likely to have to defend its existence and to use its networks across the world to make the point of the important contribution it makes to global growth. It will be important to make the point that it was the traditional banks and investment houses – the household names – that failed in the US and had to be sold, liquidated or bailed out.

Additionally, the authorities have been seeking on an on-going basis to expand this network to include major emerging and developing economies such as China, India and Brazil, using Barbados as a conduit jurisdiction for OECD entities wishing to invest in these markets.

Although manufacturing and agriculture are no longer as significant as they once were in terms of their overall contribution to GDP, Barbados' exports of manufactured and agricultural products continue to earn valuable foreign exchange. This too is being buffeted by the effects of the global crisis. With the global slowdown affecting the main export markets, exports of goods and services have been constrained.

Developments in financial markets

As the negative effects of the meltdown weakened the US financial system, the magnitude of its severity became apparent as it spread to other advanced economies and led to the collapse of major global financial institutions.

The monetary authorities in the main advanced economies have responded aggressively in a bid to ease conditions, with the US Fed Funds rate and the BOE bank rate reaching new historical lows. This has resulted in the extremely low interest rate environment that currently prevails internationally.

Amid the collapse of the credit markets in the US and waning business confidence there, external financing conditions tightened, and private capital inflows to Barbados slowed, shrinking the capital and financial account surplus to the point where it is no longer sufficient to finance the deficit on the current account. Consequently, we have seen a reduction in the stock of net international reserves (NIR).

The Bank has not sat idly by during this upheaval and has even been somewhat aggressive in its response. We have so far lowered the minimum deposit rate by a cumulative 225 basis points. Our policy rate now stands at 3.00% compared to the 5.25% it was when the extent of the international economic upheaval first became clear in 2007. In fact, the Bank instituted its first interest rate reduction in November 2007 and has gradually lowered not just the minimum deposit rate, but also the discount rate and has implemented a repurchase facility to provide even further assistance should any commercial banks face liquidity constraints.

In line with our interventions, the market seems to be responding in kind, as evidenced by lower deposit rates and consequently lower lending rates. The prime lending rate now stands at 9.00% compared to 10.15% at the end of 2007 while the rate on 3-month treasury bills has declined to 3.84%, a full 100 basis points below where it was at the start of the Bank's intervention. The rates on new government debentures and treasury notes have also been falling.

This current environment may present some difficulties with respect to the search for strong returns, and I would like to take this opportunity to encourage the financially savvy amongst us to continue to embrace the challenge to create new and attractive investment instruments. There are always projects in need of financing and, in light of the lower cost of borrowing, it is perhaps the time for these projects to turn to institutional investors for their funding.

Impact on the domestic economy

As can be expected the deteriorating economic conditions in Barbados' main trading partners are being reflected in the performance of key sectors of the domestic economy. In addition to the tourism industry, the impact on the construction sector is a matter of concern in light of its critical role in supporting employment. Overall therefore, domestic economic activity has slowed markedly in response to the global slowdown, following five consecutive years of above-average growth. This has been reflected in a reversal of employment trends and led to an uptick in unemployment.

Economic prospects

Looking forward, the international prospects for 2009 are not very encouraging. The IMF is projecting a deceleration in global growth this year to just half a percent. This is in sharp contrast to growth of 5.2% and 3.4% respectively, in 2007 and 2008. Furthermore, projections of a gradual recovery in 2010 are extremely tentative. With the slowing of economic activity in Barbados' main trading partners expected to continue through the end of 2009, and possibly beyond, a downturn in the domestic economy is anticipated.

Tourist arrivals are set to fall, with knock-on effects on the wholesale and retail, transportation, storage and communication and business and other services sectors. In addition, even with Government's efforts to fast-track projects, there is likely to be a reduction in commercial and residential activity, particularly given the unfavourable conditions for accessing external project financing.

Commensurate with the downturn in real economic activity, the unemployment rate should trend upwards. On the upside, the moderation in global demand should continue to have a stabilising effect on international commodity prices, which in turn should subdue domestic inflation.

The lower commodity prices should also translate into a lower import bill and a smaller current account deficit, though this outcome is likely to be tempered by the expected reduction in exports. In addition, the surplus on the capital and financial account balance is expected to increase, given the proceeds from the Government's bond issue on the Trinidad and Tobago market. Despite these improvements, the surplus on the capital and financial account may still be sufficient to offset the current account deficit and therefore we expect a decline in the net international reserves (NIR).

The prevailing low interest rate environment is likely to characterise the financial system for some time yet. A positive outcome of this is that it would facilitate Government borrowing from the domestic market to finance what is forecasted to be a larger fiscal deficit relative to 2008. This deterioration is to be expected given the Government's plans to apply various forms of fiscal stimulus, including fast-tracking construction projects already in the pipeline.

Nonetheless, the fiscal authorities will face significant challenges meeting the demands of their countercyclical policy, but at the same time, prevent a significant deterioration in the fiscal accounts. This task is made even more challenging, given that the economic downturn is likely to result in a noticeable slowdown in the growth of tax revenue.

As members of BARAIFA, I am sure that you are particularly interested in the likely impact of all these developments on the insurance sector.

As you are all aware the very public difficulties of the largest insurer in the world AIG in the US continues to bombard the airwaves every day. Despite this there continues to be a demand for insurance in the US. Indeed insurance is the kind of product that is not as fully impacted by the economic climate, as say, travel. There is an element of demand for insurance that actually rises when risks increase. There is also the savings element of insurance which falls with an economic downturn. The extent to which the insurance industry will be impacted will depend on which of these influences predominates.

In the Caribbean, we have had our troubles as the drama unfolding in the insurance sector in Trinidad impacts the rest of the Caribbean. However, the demand for insurance will continue to be strong because of the nature of the product. Customers will continue to want protection and the greater the risk, the greater will be the demand. The savings element of insurance does have a discretionary component and that aspect, to the extent that there are competing instruments for investment, may have to be marketed more aggressively in order to maintain its market share. However, there is no reason to believe that the drama unfolding in the Caribbean is any worse than the AIG saga in the US. There is nothing to suggest that it will adversely impact the industry as an industry in Barbados.

While there are areas in which statutory requirements were short of the targets in the case in point, there is no reason to believe that this is industry wide. Indeed, even in the circumstances, one has to take into consideration the overall assets of the affected organisations where they are involved in multiple activities. While one cannot excuse non-compliance the fact is that the assets of the group in Barbados are multiple times the statutory deficit. We must focus on the facts and evaluate them for ourselves. For many years it has been known, for example, that foreign direct investment is less volatile and more reliable than portfolio investment and that is less susceptible to sudden flight. There is nothing to suggest that these age-old tenets do not hold in today's world.

On a more general level, many of the problems in the insurance industry in the US arose from insuring credit default risk and from the credit default swaps and credit derivatives which served to make it difficult to identify where risks really lay and by whom it was ultimately held. In addition, much of the risk was laid off in the banking sector so that the fortunes of the

banking industry and the insurance industry in the US became intertwined. The domestic insurance industry in Barbados is not engaged in credit default insurance on any significant scale, so that the fortunes of insurance companies are not as exposed to this type of activity. It is important that Barbados does not allow confidence in its institutions to be shaken by these developments.

What is particularly clear is that the period of aggressive expansion in the financial sector will be put on pause and that the year 2009 and possibly 2010 will be years of consolidation and grounding, and of more circumspect activity by the financial sector. It will be a period when opportunities can be grasped by those who are cash rich and when new buyers will take advantage of situational opportunities.

At the product level, hybrid financial products have increased and the definition of what is an insurance product and what is not is becoming blurred. This will have challenges for regulators who will have to become familiar with these variants on the market and determine where they fall and whether they are truly insurance products. This lack of clarity does not become problematic in good times, but for purposes of evaluation of portfolio risk there will be a need to determine the insurance and the savings element of such hybrids. We must however position ourselves to deal with these complexities not by barring them but by adjusting our systems to accommodate them. Innovative thought and design of new instruments should be welcomed but we need to keep pace sufficiently to assess the risk involved and therefore the regulatory implications.

It is the management of the enterprise that is the first base for deciding how an enterprise is run, and if it is in line with the industry standards. The organisation itself and its management have the responsibility to ensure that it is following good management practices.

As we move into the year ahead the economy is expected to go into a down turn and negative growth is possible. In this regard, the extent of international pressures, the pre-emptive measures we take and the speed of our responses, both in the public and private sectors, will determine how quickly the recovery comes. However, we began by saying that Barbados is an open economy and cannot therefore fully insulate itself from international developments. We will however need to work harder to stay where we are. If we make extraordinary efforts we may be able to buck the global trend. In the insurance sector Barbados premiums per capita are ranked high both on a regional and a global basis and the level of insurance penetration is high. The sector therefore approaches the downturn in a strong position.

In this environment there is an advisory role here also for insurance professionals. Customers will need financial advice more than ever. It is an opportunity for the trained insurance professional to give advice to his customers on their financial management. It builds relationships, helps the customer to make the right decisions and opens opportunities for future business with the now better informed customer. In every circumstance we must look for the opportunity.

In conclusion, I would like to leave you with some words of encouragement. Although the challenges that lay ahead seem a bit daunting, Barbados' financial system is currently well positioned to cope with them. Furthermore, the Bank continues to stand ready to do all within its power to ensure that we ride this global crisis out with as minimal damage as possible. With the continued solid cooperation of the other regulators and the wider financial community, we expect that, despite a couple hiccups, the Barbadian financial system will continue to be recognised for its soundness and stability and the insurance sector will continue to thrive.