Jwala Rambarran: Financial stability issues in Trinidad and Tobago

Remarks by Mr Jwala Rambarran, Governor of the Central Bank of Trinidad and Tobago, at the presentation of the Financial Stability Report, Port of Spain, 14 January 2013.

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Macroeconomic risks to financial stability

Let me begin with a brief overview of macroeconomic risks to financial stability.

The global recovery remained fragile throughout 2012. The economic recovery in the US lost momentum by mid-June 2012, while the Euro area slipped into recession in the third quarter. Growth prospects in a few large emerging market economies weakened and most Caribbean countries were affected by weaker global growth prospects and high public debt levels.

Perhaps the most serious threat to global financial stability in 2012 came from the sovereign debt crisis in Europe, which renewed financial turbulence, weakened investor confidence and threatened to derail the fragile world recovery. On-going weaknesses in the balance sheets of some banks and governments in the euro area will continue to dominate global financial stability concerns in 2013.

In the United States, fiscal uncertainty surrounding the “fiscal cliff” heightened over the past year, especially as 2012 came to a close. Although US lawmakers passed a bill by January 1st 2013 to avert the automatic spending cuts and tax rises due to take place, the situation was not fully resolved. Instead, three mini fiscal cliffs have been created that would impact risks to global financial stability in 2013.

Reflecting the sentiment in global financial markets, the US Volatility Index, more popularly known as the VIX peaked in June 2012, following the downgrade of several Spanish banks and the request by the Spanish government for bailout funding to recapitalize the banking system. Subsequently, the VIX trended downward following actions taken by the ECB and other central banks to calm markets. Market anxieties were also reflected in the roller coaster performance of global equity and bond markets in 2012.

Financial stability issues in Trinidad and Tobago

Ladies and Gentlemen, this brings me to my second point. While there is an immediate focus on rekindling economic growth in Trinidad and Tobago, the Central Bank is mindful of the threats that a turbulent global setting, sluggish domestic economy and persistently low domestic interest rates pose to the performance and profitability of local financial institutions.

Banking system

Notwithstanding these difficulties, banks which dominate the financial system in Trinidad and Tobago remain very well capitalized, highly liquid and profitable. At the end of September 2012, commercial banks’ regulatory capital to risk-weighted assets stood at just over 25 percent, well above the statutory minimum requirement of 8 percent and among the highest in the Latin American and Caribbean region.

Credit quality improved in 2012, as banks took aggressive steps to restructure and write-off non-performing credit facilities, especially in the luxury real estate sector. One commercial bank also sold a significant portion of a large non-performing facility to its merchant bank subsidiary. Some banks also allocated larger provisions to absorb potential losses, particularly on identified impaired loans. As a result, banks’ non-performing loans declined to around 5.5 percent of gross loans in September 2012, from around 7.5 percent in September 2011.

The low interest rate environment eroded commercial banks' interest income, resulting in the banks continuing to lower deposit rates to counteract the impact on profitability. In addition, banks benefited from a significant increase in dividend income, which assisted in bolstering profitability. In 2012, commercial banks' profitability ratios were, on average, slightly higher than in previous years. At the end of September 2012, the return on assets increased to 2.5 percent from 2.3 percent in September 2011. The return on equity ratio rose to just over 17.5 percent from around 17 percent over the same period.

While the direct exposure of local banks to foreign markets is low in relation to their asset base, continuing economic stress in a few countries calls for on-going monitoring and vigilance. Total foreign country exposure increased to nearly one-third of foreign currency assets at the end of September 2012, from just over 26 percent in September 2011.

The largest foreign exposure of local banks was to the United States, most of which is in the form of US treasury bills. The second largest exposure was to CARICOM, especially Barbados. Local banks, however, have very little direct foreign exposure to the distressed Euro area.

The most recent stress tests conducted by the Central Bank confirm that the banking system remains resilient to significant shocks, supported by ample capital buffers, conservative provisioning, and high profitability. System vulnerability to large shocks to interest rates, exchange rates and even a deposit run appears limited. Nonetheless, some banks exhibited greater vulnerability than others to specific shocks, warranting the need to pay greater attention to their specific risk profiles.

Non-bank financial institutions

The non-bank sector, which comprises finance houses, trust and mortgage finance companies and merchant banks, has been affected more severely than commercial banks by the weaker economic environment. Non-bank financial institutions continued to experience a contraction in their balance sheets, with their assets falling to just under 4 percent of the total assets of the financial system in June 2012 compared with a share of 12 percent in 2008.

Credit quality in the non-bank sector deteriorated in 2012, as a few institutions which extended loans to the luxury real estate, hospitality and tourism sectors were negatively affected by the continued fallout from the global macroeconomic environment. The sale of a significant portion of a commercial bank's non-performing loan facility to its non-bank subsidiary also contributed to the worsening of credit quality. At the end of September 2012, the ratio of non-performing loans increased to around 7.5 percent of total loans, from a little over 4 percent a year earlier.

Low interest rates and subdued capital market activity dampened profitability of non-banks. In the nine months to September 2012, non-banks saw a downturn in profitability, due to a plunge in interest income and a substantial fall in fee income. The return on assets fell to just over 7 percent by September 2012 from 8 percent in 2011, while the return on equity ratio declined to 18 percent from 22 percent over the same period.

Despite these challenges, non-banks appeared to be sufficiently capitalized to deal with financial strains. At the end of September 2012, non-banks' capital adequacy ratio stood at almost 39 percent, well above the statutory limit of 8 percent, and providing some level of financial stability to the sector.

Life insurance companies

The insurance sector as a whole remained relatively stable in 2012 despite the sluggish economic environment which impacted the growth of new and renewal business and despite low interest rates which affected asset performance and profitability. Nonetheless, several non-life companies, particularly those dealing with motor insurance, continued to face issues related to inadequate claims provisioning.

Gross premium income for life insurance companies was driven mainly by growth in non-traditional life business, especially wealth management products. At the end of June 2012, wealth management products accounted for over 53 percent of total insurance contracts, while the share of ordinary life business fell to almost 35 percent of total insurance contracts.

Capital adequacy indicators for the life insurance sector have been trending downwards since 2008, as the industry builds its actuarial reserves to meet the new capital rules in the proposed Insurance Bill. The ratio of capital to technical reserves for life insurance companies stood at 28.5 percent at the end of June 2012, down from 37 percent in June 2008, and well above the international benchmark, which usually ranges between 7–10 percent.

Asset quality has been steadily improving as life insurers reduce their exposures to related parties and as they boost the share of low-risk government securities in their investment portfolios. Asset quality (measured as the ratio of real estate plus unquoted equities plus accounts receivables to total assets) stood at nearly 11 percent at the end of June 2012, compared with almost 15 percent a year earlier.

Limited re-investment opportunities, persistent low interest rates and the rise in operating expenses have all combined to negatively affect the earnings and profitability of the life insurance industry. Hence, the return on investment fell to around 5.5 percent in June 2012 from over 6 percent in the previous year, and the return on equity slowed to 12 percent from almost 14.5 percent over the same period.

At the end of June 2012, the Statutory Fund for the consolidated life insurance sector was in surplus. However, two life insurance companies were non-compliant with the statutory fund requirements and reported deficits. The Central Bank is working with these two life insurance companies to correct the deficiencies in their Statutory Funds.

Non-life insurance companies

In the non-life insurance segment, growth in gross premium income was driven mainly by property business in 2012, as motor business remained tepid. Non-life insurers continued to retain less risk for property business by ceding a larger share to international reinsurers. Consequently, the retention ratio declined to around 42 percent as at June 2012, compared with about 45 percent in June 2011 and over 52 percent in June 2008.

While the asset quality of non-life insurers improved in 2012, concerns remain in relation to debtors, prompting the Central Bank to recommend that companies strengthen their credit collection mechanisms.

The net technical reserves ratio (which is a measure of net technical reserves held relative to net claims paid out) increased significantly in 2012 due to regulatory action by the Central Bank requiring companies to strengthen their claims reserves for motor vehicle business.

Despite the low interest rate climate, the ratio of investment income to net income increased for the non-life industry in 2012. This was due to an increase in income from trade financing activities at one institution. As a result, the return on equity and return on assets ratios both displayed increasing trends.

At the end of June 2012, the non-life industry reported a net surplus in the Statutory Fund in respect of motor insurance business. However, three non-life companies were non-compliant with the statutory fund requirements and reported deficits. The Central Bank is also working with these three companies to correct the deficiencies in their Statutory Funds.

Private pension plan industry

The private pension fund industry in Trinidad and Tobago largely comprises occupational plans administered by insurance companies and annuity-type products sold by insurance companies, banks and trust companies. Three corporate trustees administer assets that represent 90 percent of the total assets owned by pension funds. Based on the information submitted by these trustees, pension plans continued to face challenges posed by limited new opportunities and the prevailing low interest rate environment.

As a result, many pension plans have been forced to hold large amounts of cash in their investment portfolios. At the end of June 2012, pension plans held over $5.2 billion or 16 percent of their funds under management in cash and near cash instruments. Nevertheless, private pension plan assets rose to $32.5 billion, a year-on-year increase of nearly 8 percent to June 2012, and represented nearly 13.5 percent of total assets of the financial system.

According to the valuation reports prepared by actuaries, the number of private pension plans in surplus declined from 97, for the triennial period 2006 to 2008, to 83 for the triennial period 2009 to 2011. In addition, the number of private pension plans in deficit increased from 16 in the triennial period covering 2006 to 2008 to 30 plans in the more recent period from 2009 to 2011. The average funded ratio (assets/liabilities) of all plans remaining in surplus fell to 158 percent in the period 2009 to 2011 from 177 percent in the previous triennial period 2006 to 2008.

More private pension plans recorded deficits mainly on account of the lowering of the interest rate assumption used by actuaries to determine pension plan earnings on long term investments. In 2012, actuaries assumed long term interest rates would average around 5.5 percent, down from an average of 7.2 percent in 2005. Higher than initially projected, salary increases have also contributed to the decline in pension plan surpluses.

Legislative reform and the Central Bank

I now turn to my third point – the work of the Central Bank in strengthening the regulatory and supervisory architecture of the financial system, while preparing the groundwork for much needed legislative changes.

The Bank participated in several meetings with the Legislative Review Committee of Cabinet to finalize policy positions relating to the Insurance Bill based on consultations with ATTIC. The Insurance Bill is expected to be laid in Parliament in the first quarter of 2013.

The Bank also collaborated with the TTSEC to review the draft Securities Insurance Bill, which was laid in Parliament in November 2012 and passed in both the House and Senate. The Securities Act (2012) became law at the end of 2012.

Regarding credit unions, the Central Bank is considering comments received from the industry on the draft Credit Union Bill and is finalizing a response to the industry. This legislation is expected to be taken to Parliament by the middle of 2013.

In November 2012, the Central Bank issued the third and final version of the Policy Proposal Document relating to the new Occupational Pension Plan Bill. The main objectives of the new pension legislation are to protect members and beneficiaries from undue loss and to promote good governance and proper administration of private pension plans.

Finally, the Central Bank is preparing the financial system to comply with the requirements of the Foreign Account Tax Compliance Act (FATCA). FATCA requires financial institutions around the world to enter into an agreement with the US Internal Revenue Service to disclose information pertaining to accounts owned by US citizens, green card holders living in the US or abroad, or non-US entities in which US taxpayers hold a substantial ownership interest.

Conclusion

In summary, the volatile global environment, sluggish domestic economy and persistently low domestic interest rates all pose risks to the performance and profitability of local financial institutions, but the impact varies across the financial system.

- Banks remain very well capitalized, highly liquid, profitable, and resilient to significant shocks.
- Non-banks continued to experience a contraction in their balance sheets, although they appeared to be sufficiently capitalized to deal with financial strains.
- Life insurance companies remained relatively stable even low interest rates affected asset performance and profitability.
- Several non-life companies, particularly those dealing with motor insurance, continued to face issues related to inadequate claims provisioning.
- Private pension plans' funding surpluses are declining partly due to persistently low interest rates.

In closing, I give you the assurance that the Central Bank is prepared to take early and decisive corrective actions to prevent a build-up of unmitigated risks in individual financial institutions, or in the financial system as a whole.

I thank you.