



How the Bahamian Financial System Serves Bahamian Society:
Why Our AML/CFT Reputation Is Important

Remarks by

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The Bahamas Anti-Money Laundering and Countering the Financing of Terrorism Risk
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How the Bahamian Financial System Serves Bahamian Society: Why Our AML/CFT Reputation Is Important¹

Remarks by John A Rolle, Governor, Central Bank of The Bahamas at *The Bahamas Anti-Money Laundering and Countering the Financing of Terrorism Risk Management Conference*, Nassau, Bahamas, 17 September, 2018.

Introduction

Good morning. I propose to review the ways in which the Bahamian financial services industry serves Bahamian society, and also touch upon a few ways in which this can be and will be improved. I will then outline why the Bahamian jurisdiction's AML/CFT reputation is a critical determinant of our financial services industry's ability to prosper and grow, and summarise our current international standing, as represented in various league tables.

The take away from this that we must transform the domestic financial sector in ways that promote more internally self-sustaining growth; fortify the international sector in ways that protect and expand upon its direct economic contribution; and that we must exploit and amplify the positive feedback from the direction of enhanced AML/CFT frameworks in favour of increased economic resilience, and from the direction of targeted financial sector development, access and inclusion in favour of increased AML/CFT effectiveness.

Why We Care about the Financial Services Sector - the Domestic Story

The Bahamian domestic financial system provides all the benefits typical to a country of our size and economic development. We have direct financial intermediation of savings— across a wide range of sectors and activities. We have risk pooling, and we have specialist services such as payments processing. In particular:

- The banking sector provides a safe place to store liquid funds, allocate credit, and process payments;
- The insurance sector provides risk pooling and investment products; and
- The securities and pensions sector provide investment products as an extension of the savings process.

A well-functioning domestic financial sector serves society by making us safer, wealthier, more resilient to financial distress; and better able to manage the risks and returns in the real economy. It should also distinguish itself by converting savings into investments, or into uses that generate net positive, long-term benefits.

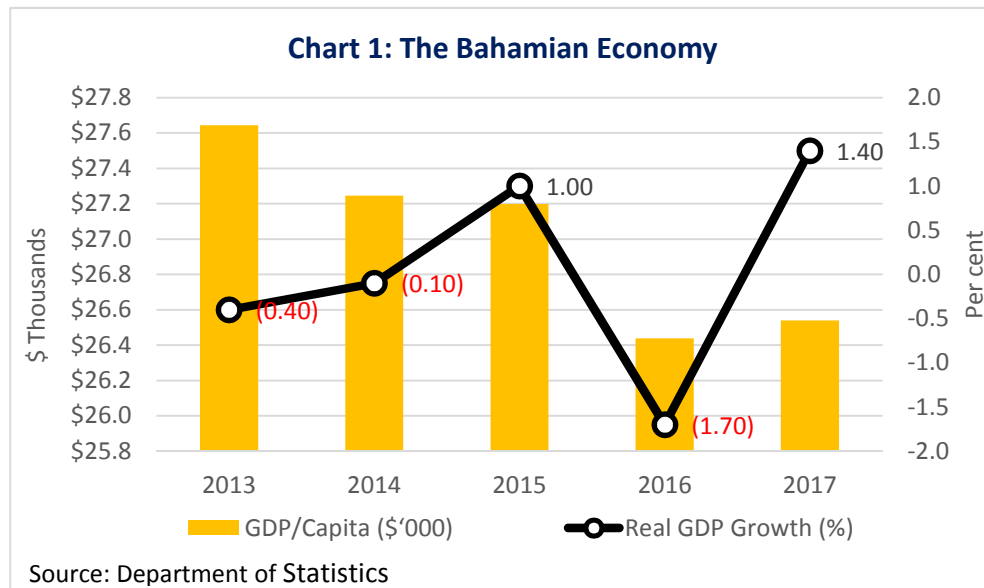
¹ As prepared for delivery.

How does the Bahamian financial sector stack up against these criteria? In some ways well, in other ways not so well.

The Bahamian Economy

It will be helpful for this discussion for us all to be reminded of the following facts.

First, the Bahamian resident population is less than 400,000, so in population terms we are quite a small country. We are also significantly small in terms of our weight in the global economy, and in terms of how sensitive we are to fluctuations of a policy or economic nature that radiate in our direction from the outside world. On the other hand, The Bahamas enjoys a fairly high average per capita income, even though this position has not improved in some years.



After the 2007 to 2010 global financial crisis, the Bahamian economy suffered through an extended period of challenges, including falls in asset values, and on average near-zero income growth. The recovery is only now becoming entrenched, but at levels of potential growth that are still unsatisfactory.

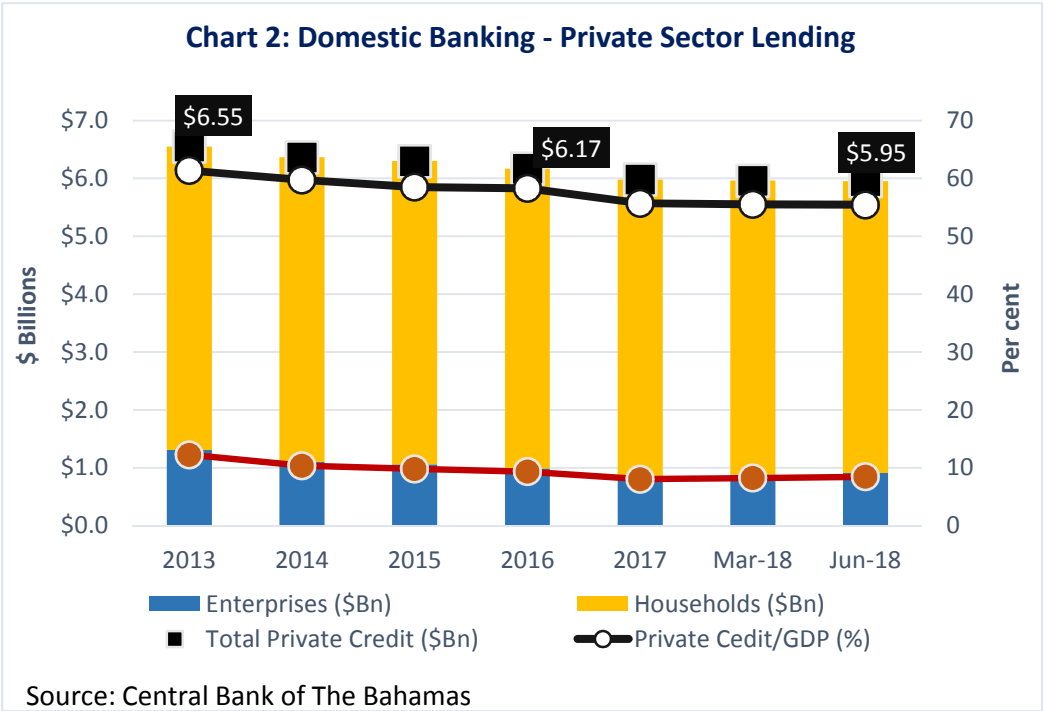
How do we then achieve more substantial and sustainable economic growth? Part of the answer is that we must foster a domestic financial system that better supports such growth and in more instances, can seed such growth. I wish to emphasise, however, that the financial system cannot manufacture economic growth out of thin air. As it now stands, our financial system does best at supporting the growth potential that is created in the economy. Most of the enterprises that attract domestic bank credit are in sectors that do not earn foreign exchange. Their prospects are linked to the second round effects of thriving foreign exchange earning sectors such as tourism. This is what economist would term as a “pro-cyclical” dependence. It can only be reduced if more of the credit provided by banks helps to expand those local enterprises that are either direct earners of foreign exchange or those that help conserve on our foreign exchange dependency.

It is also important to remember that the financial system is the second largest industry in The Bahamas, comprising 15 to 20 per cent of GDP depending upon the definitions used. A growing financial industry generates jobs, and they tend to be well-paying jobs.

The Bahamian public and private sectors have identified a great many reforms necessary to improve the underlying growth potential in our economy. As these reforms are delivered, the financial system will help translate potential growth into actual growth.

Domestic Banking Sector

Our domestic banking system is soundly capitalized and nowadays solidly profitable. However, it is not sufficiently incentivized to allocate or provide credit in ways that would better serve the economy.



In the five years from 2013 to 2018, domestic private credit shrank from \$6.5 billion to under \$6 billion. Even more so remarkably, commercial loans fell to well under \$1 billion, and well under 10 per cent of GDP. Unfortunately it speaks to the pro-cyclical constraints on credit just mentioned; to the low-quality information environment surrounding borrower risks and to a reward structure most favoring consumer lending over other forms of credit. It is not simply reversible by lowering interest rates, because the credit stimulus—skewed to consumer financing—would exhaust rather than sustain the support we value for the fixed exchange rate.

To give a sense of perspective on this level of lending, the Bahamian private credit to GDP ratio is currently about 55 percent. The same ratio among the large and developed economies in the G20

ranges from around 150 to over 200 percent. Currently, Canada has the highest ratio at 267 percent. We are in the curious situation where the carrying or sustainable capacity for credit in Canada is several multiples greater than is being sustained in The Bahamas, where we are both serviced by the same leading institutions—and arguably, technology and capital are not the hurdles to be surmounted.

I am not advocating an expansion in Bahamian private sector credit to these much higher levels. But in comparison to other countries, Bahamian bank lending could stand to be larger, and still be prudent. That is, particularly, if we incentivise more lending of the right mix, to fund more counter-cyclical business and investment growth. In the process, the economy could also be sustainably larger and more prosperous. The transformation needed is to decrease the number of cents out each dollar of income earned that must be spent on imports.

There are five conditions precedent for confident bank lending:

- Sufficient capital
- Sufficient liquidity
- Sufficient information about borrowers
- A clear ability to collect on problem loans
- Confidence in the general prospects for the economy

Bahamian banks at this point have plenty of capital and liquidity. What they lack is borrower information, and perhaps confidence in collecting problem loans, and/or confidence in the business prospects for The Bahamas.

The Central Bank is already progressing several initiatives that will improve bank confidence to lend. This includes a program of reducing the industry's aggregate non-performing loans, establishing a Bahamian credit reporting bureau, and commencing a program to move more domestic transactions from cash to electronic methods. Just in 2017, the Central Bank relaxed capital controls on access to financing in foreign currency for enterprises, that would make our credit policies more countercyclical, and therefore of a more sustained impact on stronger growth.

Two issues are highly relevant in the AML/CFT context.

First, “sufficient information” about a customer extends beyond the customer's financial standing, to the customer's potential to ensnare the bank in a financial crime matter. The Central Bank, the Bahamian government, and the public sector overall have undertaken a great many reforms, in this area that you will hear about during this conference. One benefit from these reforms is that Bahamian banks and other financial institutions will be able to deal with their customers with greater confidence regarding the customer's non-involvement in financial crime. Furthermore, through its regulation and supervision, the Central Bank will be able to demonstrate to interested stakeholders that the Bahamian banking system is reasonably well insulated against AML/CFT risks.

Our colleagues at the other Bahamian financial regulators have taken or are taking similar steps to lift public and private confidence in the AML/CFT robustness of their regulated entities. We can never guarantee that no customer will ever put tainted money into a Bahamian financial institution. We are, however, approaching the day when we can undertake that no Bahamian financial institution has a substantial or systemic exposure to laundered money or terrorist financing.

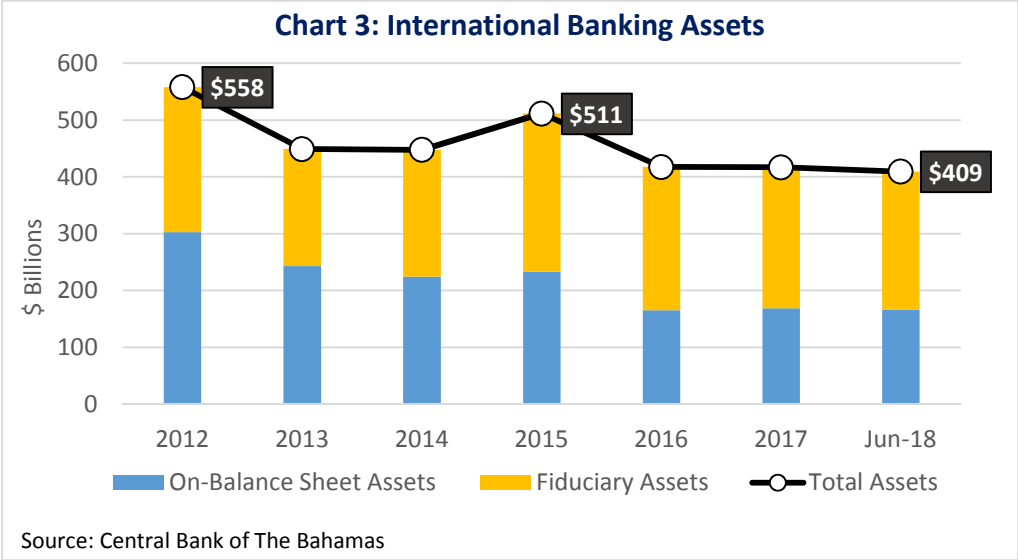
The second AML/CFT confidence issue is more macro than customer-focused. The Bahamas, in common with many other small countries, still faces a material threat from diminished or cut-off access to international correspondent banking or “de-risking”. We face the actual consequences of more difficulty in undertaking cross-border transactions. This difficulty extends beyond the financial system to all businesses. Faced with de-risking threats, domestic banks may validly conclude that the Bahamian economy is more vulnerable to correspondent banking abandonment than they find comfortable.

Our work on lifting AML/CFT risk management, and all the other regulator work, will over time reduce this risk.

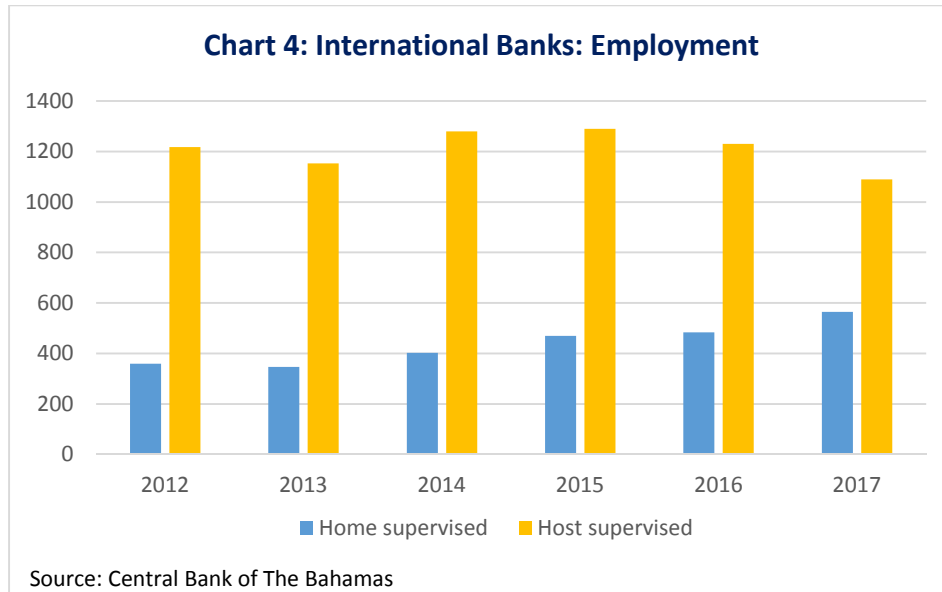
It’s worth noting that moving the bulk of Bahamian payments from cash to electronic will generate a great many benefits for our society and economy. Among these benefits, commercial borrowers will be able to document their receipts and expenses more credibly, and over time this must help in obtaining bank loans.

The International Banking Sector

Moving to the international banking and trust sector, I will show you two hopefully interesting slides.



Funds held by the sector in The Bahamas have decreased in the past several years. In broad terms, The Bahamas is no longer in the business of hiding money from international tax authorities. We have seen a considerable return of now-compliant clients to their home jurisdictions, or alternatively to the United States.



Nevertheless, employment in the sector has remained more or less constant over the past several years. So jobs are holding up, despite the decrease in funds under management. The Central Bank’s interpretation of this is that the remaining international clients are receiving value-adding trustee, advice, and management services. Those services make for “stickier” clients, and they also require more staff per client.

We also observe that home-supervised institutions, which have no overseas parent, have been growing their staff relative to host-supervised institutions. In 2012, about a quarter of the industry worked for Bahamian-owned or headquartered firms, and this proportion has increased to a third. We expect to see the Bahamian-owned international banking sector continue to increase in proportion to the offshore-owned sector.

Where does this leave the international banking and trust sector? Clearly, smaller than it was a few years ago in balance sheet terms, but still substantial. The average wage for the jobs in this sector exceeds \$100,000 per year. Furthermore, the sector supports a great many service jobs in areas such as accounting, law, and consulting.

The Central Bank expects that the number of international banks and trust companies will decrease some more, as several small entities have indicated their intent to exit The Bahamas. This does not necessarily mean that funds in the system, or employment, will materially fall. We are hopeful that the sector is finding a base from which it can grow.

If we are not in the money-hiding business, what business is this sector pursuing? In a few cases our licensees have highly specific business strategies, but the more general approach is preserving private wealth, increasingly focused on Latin American clients.

This suggests that if The Bahamas wishes to preserve and grow its international banking and trust sector—and we do—both the public and private sectors will need to consider how best to become and retain the Western Hemisphere’s jurisdiction of choice for private wealth preservation.

In following this strategy, we will need to continue grappling with AML and to a lesser extent CFT issues. It is obviously the case that there is dirty money in Latin America. But it is equally obvious that there are clean businesses and investors in Latin America, and in most cases they would be well-advised to keep some of their family wealth offshore. The Bahamas needs to be the natural place where clean money from clean clients finds a home.

Maintaining a substantial international banking and trust industry in The Bahamas materially complicates our efforts to improve our jurisdiction's international reputation for AML/CFT risk management. Those who arbitrate such matters globally consider that private banking in small population centres such as Nassau is an automatically high risk business.

We are increasingly forming the view, contrary to this conventional wisdom, that properly regulated and supervised international banking and trust business need not be high risk in AML terms. As our jurisdiction has dispensed with money in hiding, and concentrated on money needing more active services, what has become clear to us is the following:

- a) First, that supervised financial institutions know their remaining customers closely;
- b) Second, that not only customers but funds and transactions are scrutinized at the individual level; and
- c) Finally, that the typical client is performing around one transaction per month, so this is not a high volume proposition.

At this point we are still in transition, and our supervisors and examiners have identified a considerable list of improvements necessary in the industry. But nothing about this list and our other supervisory findings suggest that the Bahamian international sector is irremediably high risk. We are rather more of the view that, given another one to two years of newly intense supervision, under considerably improved regulation, this sector will become solidly medium risk. We look forward to industry's cooperation in achieving this outcome, and in helping to demonstrate this outcome to the world's AML risk arbiters.

Sovereign AML Ratings Agencies

Speaking of AML risk arbiters, the Central Bank has identified six providers of AML sovereign risk ratings. The first and most extensive of these is the Financial Action Task Force and its nine regional affiliates—most relevantly in our case the Caribbean Financial Action Task Force. Second and most accidentally, we have the U.S. State Department's INCSR Volume II, which is an annual list of so-called high-risk jurisdictions. In spots three to six, we have four subscription based services, which operate on very similar weighted index approaches.

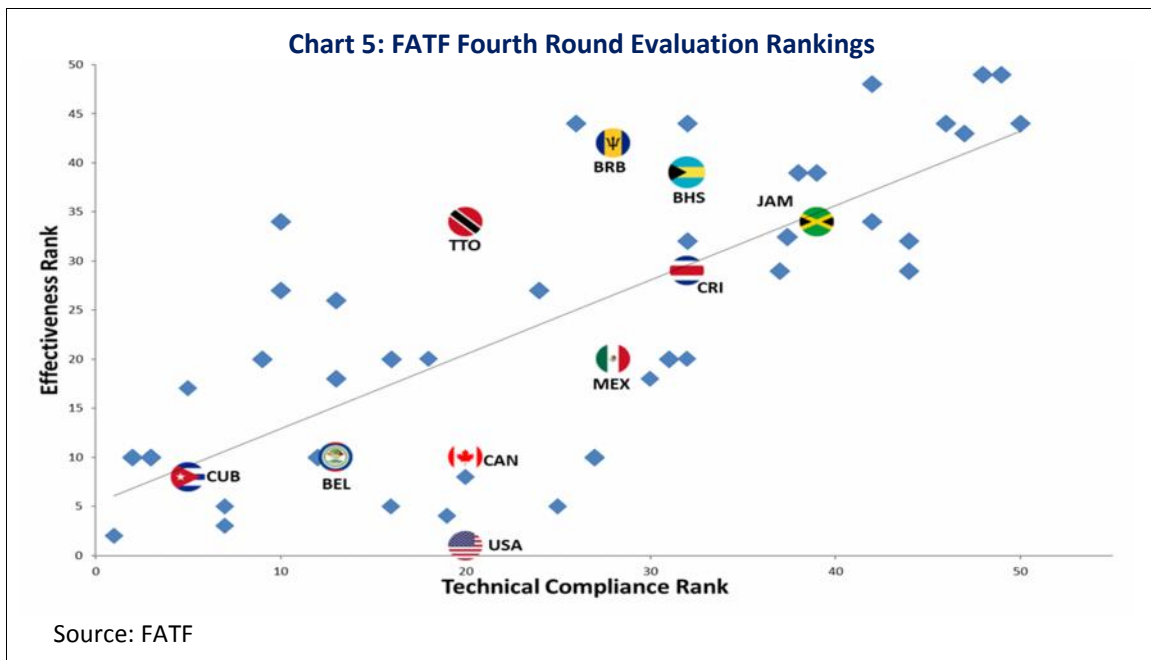
The Central Bank's AML Analytics team maintains a watching brief on all six of these ratings, particularly as regards The Bahamas. We are normally rated towards the high risk end of the spectrum, but in this space there is a strong bias towards high risk weightings.

Let's look at each ratings provider.

First, the FATF, which helpfully provides comparisons for all countries it has assessed through mutual evaluation reports. There are in fact two ratings: a compliance

rating based upon 40 technical assessments, and an effectiveness rating based upon 11 judgement categories. All 51 of these sub-ratings are based upon a four step scale. There is no official method to convert these 51 ratings into one or two aggregate ratings, but it is easy and common for interested parties to perform this conversion themselves.

The current position of The Bahamas against about 50 other recently FATF-rated countries is show on the next slide. The horizontal axis gives our position on technical compliance, and the vertical axis our position on effectiveness. In these ratings small numbers are better than big numbers, and it can be seen that The Bahamas is in the middling group, but at the less good end of that group, particularly on the effectiveness rating.



Nearly all of you would be aware that the CFATF issued the Bahamian ratings in 2017, but another exercise is in progress now, with a new assessment scheduled to be published in a couple of months. We expect that the re-rating will appreciably improve the Bahamian position on this map of relative AML/CFT strength, as reflected through the FATF ratings universe.

Regardless of how one feels about the FATF in general and the Bahamian assessment in particular, it is clearly the case that the FATF approach is:

- Credible;
- Fully documented;
- Reasonably consistent in global application; and
- Represents a great deal of work by experienced AML professionals.

Only the first of these characteristics applies to the next rating source, the US State Department's *International Narcotics Control Strategy Report* (INCSR). In the absence of a credible competitor to the

FATF assessments, many around the world have launched on to this list as the second major source of sovereign AML risk information.

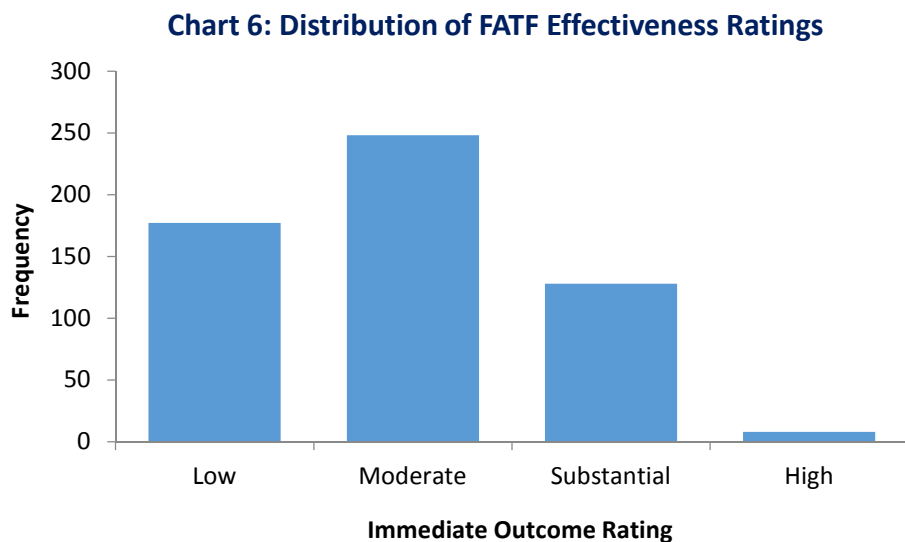
The problem with this approach is that the INCSR is not any sort of rating model. It is simply a list prepared through the relevant American embassies and coordinated in Washington. The underlying analytic support for this list, we understand, is a single page questionnaire, which is filled out locally, not necessarily by an AML professional.

Our intent is not to criticise the State Department. They have never claimed that the INCSR is any sort of AML ratings tool, but it is simply a statutory requirement under relevant American legislation.

At any rate, in the INCSR universe, The Bahamas is on the list, as are 75 percent of the countries considered by the State Department.

Now we move to the four subscription services: Thomson-Reuters, about which you will hear more later today; IBM; the Basel Governance Institute; and KnowYourCountry.com. All four of these providers deploy a weighted average approach to risk scoring, within which the FATF and State Department assessments are typically the two largest inputs. Other inputs include items such as global transparency, rule of law, and economic league tables.

The Bahamas tends to rate somewhere in the medium to high risk range with these four subscription services. KnowYourCountry, for example, has us as *medium risk* and rated 139th out of 219 jurisdictions. The Basel Governance ratings has us as *high risk*, and in the ninth out of ten deciles of countries.



Why are AML sovereign ratings important? Because, singly and in aggregate they often form a material input into the risk considerations of correspondent banks and others who deal with The Bahamas. The effect is similar to debt ratings agencies: If Moody's and Standard & Poor's lists a country as sub-investment grade, it becomes much harder and more expensive to raise funds. If the AML ratings

agencies list a country as high AML risk, it becomes harder for that country and its institutions to operate effectively in the global financial markets.

Financial inclusion

Now, let's talk about financial inclusion.

"Financial inclusion" is something of a buzz phrase globally, but that hardly detracts from its importance. It is easy to conclude that Bahamian financial inclusion is not nearly as complete as it needs to be. Our populace is still not fully banked on either the deposit/transaction or the credit side of the balance sheet. Our insurance penetration, investments, and pension participation are a long way from what might be optimal. Our capital markets are neither large nor liquid in global terms. Then there is the geographic issue that inclusion in the Family Islands is in some cases markedly less than in New Providence.

Neither the Central Bank nor any other agency can fix this on their own, but collectively we can do quite a lot to create a more inclusive Bahamian financial system. We look forward to providing advice to the government on this point.

Financial inclusion is not mainly about AML, but it does generate two distinct AML advantages. The first is that cash intensity in the economy will drop, in favor of electronic transactions. This makes our society and economy safer and more efficient, and it makes large and possibly suspect cash transactions easier to identify. The second advantage flows indirectly from the increased data intensity of the financial system. It will become harder for financial criminals to hide in the undocumented recesses of a non-inclusive system.

The Central Bank and other agencies are already progressing a number of financial inclusion initiatives. In our case, these include joining the Alliance for Financial Inclusion, or AFI, and adopting that body's Maya Declaration. The AFI has already helpfully created a number of national inclusion benchmarks which we can adapt for Bahamian use. The AFI also provides many case studies, research reports, and other information, which will help us generate ideas for Bahamian financial inclusion.

The Central Bank's digital currency initiative, for which we received expressions of interest through September 15th, is a financial inclusion, AML and economic efficiency prospect. The returns against these metrics will crystallize at varying pace over time. It would be fair to say though that the future of retail payments appears to be centered on mobile phones rather than cards, and much more so than in-branch bank transactions.

The Central Bank's promotion of a credit bureau, as already noted, should assist in financial inclusion, as Bahamian lenders will become more confident that they understand their prospective lending customers. We are shortlisting potential operators of the bureau this month, and plan to complete the licensing process for the successful bidder before the end of 2018.

Finally, the Central Bank recently released updated Guidelines for AML/CFT risk management. Among a great many other items, these Guidelines have substantially streamlined the documentation requirements to open a simple B\$ bank account. This will make banking easier for all Bahamians, and also make banking available to some of our residents who previously couldn't open a bank account.

Where to from Here?

In forecasting the future, it's important to remember that we know, but can't predict the timing or incidence, of some major negative shocks. These include hurricanes, global recessions, and sudden panics in the international financial and banking markets. What we can assert, however, is that The Bahamas is not yet as well positioned for these shocks as we would like to be, or as we intend to be.

Most obviously in the context of this conference, The Bahamas has become, and will continue to become, a more robust jurisdiction in managing AML/CFT risks. This has direct benefits in discouraging criminality, corruption, and terrorism, and large indirect benefits in giving the world's major financial markets and institutions the confidence to deal with us on good terms.

Improved financial inclusion will also lead to improved resilience. Our banking system will become bigger and safer. There is the prospect for our insurance, funds management, and pension industries to grow, which creates better risk pooling and a larger pool of long term investable funds for The Bahamas.

Outside the sphere of this conference, we see the Bahamian Government and associated parties undertaking many initiatives to reduce societal risk.

We are a small country facing a somewhat uncertain future. Provided we manage our risks sensibly and proactively, however, I am confident that The Bahamas can aspire to a great future. Part of that great future involves a Bahamian jurisdiction that both is and is accepted as sound in managing its AML and CFT risks.

Thank you for your attention today.