

**St. Vincent and the Grenadines: Report on Observance of Standards and Codes—
Basel Core Principles for Effective Banking Supervision—Offshore Banking**

This Report on the Observance of Standards and Codes on Basel Core Principles for Effective Banking Supervision—Offshore Banking for **St. Vincent and the Grenadines** was prepared by a staff team of the International Monetary Fund as part of the Eastern Caribbean Currency Union Financial Sector Assessment Program and as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on **April 14, 2004**. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of **St. Vincent and the Grenadines** or the Executive Board of the IMF.

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ST. VINCENT AND THE GRENADINES

**Report on the Observance of Standards and Codes: Basel Core Principles for
Effective Banking Supervision—Offshore Banking**

Prepared by the Monetary and Financial Systems Department

April 14, 2004

This report contains a summary assessment of adherence to the Basel Core Principles for Effective Banking Supervision with respect to the offshore sector of the St. Vincent and the Grenadines.

The assessment has helped to identify the extent to which the regulatory and supervisory frameworks are adequate to address the risks in the financial system. It has also formed the basis for recommendations made for improvement in financial regulation and supervision.

Assessors identified the need to enhance prudential supervision including introduction of a risk-based framework for capital and implementation of prudential requirements that establishes guidelines for large exposures and connected lending. Assessors also noted that supervisory capacity is thin. The absence of meaningful mind and management in the jurisdiction concerned is also an issue that poses a challenge for effective supervision. Data integrity weaknesses and the absence of effective enforcement mechanisms were also cited as material deficiencies.

Contents	Page
I. Observance of Standards and Codes: Basel Core Principles for Effective Banking	
Supervision	3
A. General	3
B. Main findings	4
Table	
1. Recommended Action Plan: St. Vincent and the Grenadines.....	8

I. OBSERVANCE OF STANDARDS AND CODES: BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

ST. VINCENT AND THE GRENADINES—OFFSHORE BANKING

A. General

1. This Report on the Observance of Standards and Codes (ROSC) for the Basel Core Principles for Effective Banking Supervision was prepared by Marcel Maes and Tony Maxwell, independent bank supervision experts. The report provides a summary of the level of observance of the regulation and supervision of offshore banks licensed by the Offshore Finance Authority of St. Vincent and the Grenadines (OFA) with the Basel Core Principles.
2. The assessment was conducted through interviews and working sessions with OFA senior management and supervisory staff, as well as through visits to two offshore banks and their external auditors. The mission also took account the participation of the Eastern Caribbean Central Bank (ECCB) in the supervision of offshore banks, which has been formalized through a July 2001 Administrative Procedures agreement between the ECCB and the OFA. Working sessions with ECCB's senior staff addressed the involvement of the ECCB in licensing, offsite monitoring and onsite supervision of offshore banks. Supervision of domestic banks in St. Vincent and the Grenadines, and in the other member countries of the Eastern Caribbean Currency Union (ECCU), is the responsibility of the ECCB and has been subject to a separate assessment.

Institutional and macroprudential setting, market structure—Overview

3. St. Vincent and the Grenadines (St. Vincent) is part of the ECCU, which is comprised of eight members: Anguilla, Antigua and Barbuda, Dominica, Grenada, Montserrat, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines.¹ Although the number of licensed offshore banks has been sharply reduced in the last two years, from about 30, there still remain 10 banks with offshore-banking licenses.
4. The activities of these banks, as measured by total assets and liabilities, appear to be rather limited at the moment. Aggregated assets of the St. Vincent offshore banking sector represent only US\$109 million as of June 30, 2003. Moreover, two banks represent 62 percent of the sector's aggregated assets, highlighting an important degree of concentration.
5. Loans, which represent 55 percent of total assets include a number of large exposures exceeding 25 percent of capital and/or are connected to bank managements or shareholders. The Mission was advised by several sources that loans are frequently collateralized by cash,

¹ Anguilla and Montserrat are overseas territories of the United Kingdom.

CDs and equities (so-called “back-to-back lending”), which would reduce their risk of loss. Reported nonperforming loans are low. There was no data available on off-balance operations.

6. As the reduced number of licensed offshore banks noted above testifies, the St. Vincent authorities have taken significant steps in the past few years to rid the jurisdiction of a number of suspect banks. This assessment acknowledges progress, while highlighting a number of areas that need to be further strengthened to achieve compliance with the Core Principles.

General preconditions for effective banking supervision

7. OFA’s functions and responsibilities are set out in the International Banks Act, 1996 (IBA), as amended in 2000 and 2002. An Administrative Procedures Agreement dated July 2001 between OFA and the ECCB defines the role of the ECCB in vetting offshore banking license applications, offsite monitoring and onsite supervision. The 2002 IBA amendments specify an advisory role for the ECCB in reviewing license applications, prescribing ratios and deposits, and a direct role in receiving audited accounts and quarterly returns. A new IBA, drafted in collaboration with CARTAC, should—when enacted—further strengthen the legislative basis of the role of the ECCB.

8. OFA is responsible for AML/CFT implementation, although ECCB conducts reviews of compliance. ECCB is exploring the concept of a more integrated approach to regulation and supervision of financial institutions in the ECCU, encompassing shared responsibility and a harmonized approach between ECCB and the national regulators in its member states.

B. Main findings

Objectives, Autonomy, Powers, and Resources (CP 1)

9. The St. Vincent and the Grenadines Offshore Finance Authority Act, 1996, and the International Banks Act, 1996 (as amended) set out the framework for offshore bank supervision in the jurisdiction. Under the IBA, the Minister of Finance has considerable direct and indirect authority over the decisions and actions of the OFA. Notwithstanding, in recent times the OFA has reportedly enjoyed substantial operational independence. However, the OFA’s role and legal independence on matters such as the power to set prudential rules administratively should be enhanced.

10. Other weaknesses that need to be addressed include the development of in-house supervision capacity in the OFA. OFA examiners have recently started working closely with ECCB examiners, but there is a concern about the ECCB’s own capacity to free up adequate resources for this task, given its domestic bank supervision responsibilities. Also to be addressed are the lack of a legal framework for setting prudential standards and providing supervisory staff with explicit protection in law against the cost of defending actions in court.

Licensing and Structure (CPs 2–5)

11. The permissible activities of institutions that are licensed are clearly defined in the International Bank Act. However, as mentioned above, the significant political involvement with licensing, albeit on the recommendation or after consultation with the ECCB, is at variance with the Basel principles.

12. Other significant issues flagged under these Core Principles include the need to establish clear and internationally acceptable standards against which to assess proposals made at the time of license applications. These include standards for corporate governance, operational policies and procedures, internal control procedures, and oversight of the bank's various activities. Given the structure of offshore banking in St. Vincent, there is a need to strengthen in law and in practice the requirement that mind and management be in St. Vincent in order to facilitate effective supervision. Laws or regulations are needed to address acquisitions and investments, including the types and amounts of acquisitions and investments needing prior supervisory approval.

Prudential Regulations and Requirements (CPs 6–15)

13. Laws and regulations do not require offshore banks to calculate and consistently maintain a minimum capital ratio. The ECCB and CARTAC are collaborating on developing a set of guidelines for banks, including a guideline on capital adequacy, which the OFA intends to adopt for the St. Vincent offshore banks.

14. The review of the IBA, currently underway, should provide for the necessary mandatory regulations requiring offshore banks to calculate and consistently maintain a minimum capital adequacy ratio. The definition of capital, method of calculation, and the ratio required are not to be lower than those established in the Basel Capital Accord.

15. The required capital ratio should also reflect the risk profile of individual banks, in particular credit risk and market risk. Both on-balance-sheet and off-balance-sheet risks should be included, and the revised laws or regulations or the supervisor should define the components of capital, ensuring that emphasis is given to those elements of capital available to absorb losses. Where applicable, capital adequacy ratios are also to be calculated and applied on a consolidated bank basis.

16. Banks are required to have a comprehensive manual on credit policy, but the OFA has not yet issued any guidance for the development and implementation of policies and practices.

17. There is no explicit supervisory requirement for banks to make credit decisions free of conflicting interests, on an arm's-length basis, and free from inappropriate pressure from outside or connected parties. The existing prudential returns regarding credit will also have to be supported by a comprehensive set of definitions, inter alia, on large exposures, connected lending and nonperforming loans. Appropriate additional data on the delinquency of loans should also be required.

18. These comments are to be placed in the more general context of the limited size of the offshore banking industry in St. Vincent. On June 30, 2003, total reported assets of the offshore banks amounted to just over US\$100 million of which total loans represented only US\$57 million.

19. The OFA has not yet issued any formal guidance requiring that banks establish and adhere to adequate policies, practices, and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and reserves. The ECCB and CARTAC are collaborating on developing a set of guidelines, including a guideline on risk management, which the OFA intends to adopt for the St. Vincent offshore banks. The ECCB and OFA monitor classification and provisioning policies on the basis of the quarterly prudential returns and onsite examinations. Off-balance-sheet exposures are not explicitly included in the system for classification and provisioning.

20. There are no existing laws, regulations, or other guidance from the supervisor requiring banks to have in place internal controls that are adequate for the nature and scale of their business. However, ECCB's examination procedures include determination that the banks have in place internal controls that are adequate for the nature and scale of their business, specifically, dealing with organizational structure, accounting procedures, checks and balances, and safeguarding assets and investments.

21. The location abroad of a substantial part of the skills and resources of the back office and control functions relative to the front office of some offshore banks may also frustrate the supervisory authorities in determining the presence of an appropriate balance in these two functions.

22. The relatively small size of the offshore banks also represents an impediment to the establishment of an independent and professional internal audit service in each bank.

23. The OFA acknowledges the importance of money laundering risk for the remaining ten offshore banks, and is commended for stepping up its supervisory efforts in order to address a number of deficiencies. The anti-money laundering (AML) regime in St. Vincent follows the internationally accepted practice that all suspicious activities should be reported to one centralized Financial Intelligence Unit (FIU), which is a prerequisite for membership into the Egmont Group. St. Vincent became a member of the Egmont Group in 2003 after one year of the FIU being in operation. However, the suspicious transactions reporting system applicable to offshore banks could be enhanced with more explicit guidance for determining which activities to report. Furthermore, offshore banks should be required to report to the supervisor material safety, soundness and/or reputation concerns arising from suspicious activities and incidents of fraud. Guidelines or mandatory rules should be considered to implement this requirement.

Methods of Ongoing Supervision (CPs 16–20)

24. Neither the OFA nor the ECCB conducts routine analysis of trends and developments. Analysis is hindered by the fact that St. Vincent reporting forms are not in a

standard ECCB format and are hand written. However, the forms are presently being modified to the standard ECCB format and electronic filing of returns will be required for the April quarterly returns in 2004. There needs to be timely and forceful follow-up when problems are identified, in particular when the problems relate to breaches of the requirements of the IBA.

25. The OFA must enhance its understanding of the activities of its banks through more in-depth on-site examinations and meetings with management. OFA's ability to achieve this will be substantially improved when the recent policy directive that at least one employee must be senior management level is put into law and fully enforced. The OFA must also require banks to notify it of any material adverse developments, including breach of legal and prudential requirements.

26. The OFA does not have the authority to establish the principles and norms regarding the consolidation of accounts, nor to impose the accounting techniques to be used. It does not have the power to collect consolidated data nor to set prudential standards on a consolidated basis. It also does not have the power to collect information on other companies (parent and affiliate companies) that are members of the same group as the bank, although such information is apparently provided when requested.

27. The OFA should have the right to oppose the appointment of a bank auditor. In addition, the OFA should require the external auditor to review once a year the accuracy of prudential returns and receive a copy of the auditor's management letter. Post-audit meetings between the external auditor and the OFA should also take place as a matter of policy. The OFA should also have the authority to make use of external auditors to examine specific aspects of banks' operations.

Formal Powers of Supervisors (CP 21–22)

28. Presently, the OFA gives effect to its powers in seeking remedial action through letters of commitment sought from banks and memoranda of understanding (MOUs) signed with them. However, there is no provision in law for the OFA to enforce these agreements, other than through the provisions of Section 18, which requires Ministerial concurrence. OFA should develop a formally defined set of supervisory responses to problems found in banks ("ladder of compliance"), which varies depending on the severity of the situation, and which is legally enforceable.

29. The OFA should develop closer working relations with external auditors. Laws or regulations should set, or the OFA should have the authority, in appropriate circumstances, to establish the scope and standards to be achieved in external audits of individual banks. The OFA should also be given the right to revoke the appointment of a bank's auditor.

30. The OFA must ensure that remedial actions are taken in a timely manner. The OFA should also be granted the power to apply penalties and sanctions not only to the bank, but—when and if necessary—also to management and the board of directors.

Cross-Border Banking (CPs 23–25)

31. At present, the OFA has virtually no reason to be in contact with overseas regulators; although, this could change in the future. Before authorizing any overseas operations of offshore banks, the IBA should be amended to authorize the OFA to examine affiliates both in St. Vincent and overseas, and to grant explicit power to the OFA to close overseas operations, or impose limitations on their activities, where the OFA determines that the supervision of a local operation by the bank and/or by the host country supervisor is not adequate.

Table 1. Recommended Action Plan: St. Vincent and the Grenadines

Reference Principle	Recommended Action
Objectives, autonomy, powers, and resources (CP 1-3)	Amend the IBA to give the OFA the power to set prudential rules administratively.
Investment Criteria (CP 5)	Define what types of acquisitions and investments need supervisory approval.
Capital Adequacy (CP 6)	Adopt and implement a risk-based approach to setting minimum capital ratios for banks, and actively enforce breaches of statutory capital requirements.
Credit Policies (CP7)	Issue guidance for the development and implementation of credit granting and investment policies, procedures and practices. Require banks to make credit decisions free of conflicting interests, on an arm’s-length basis, and free from inappropriate pressure. Reinforce existing prudential returns regarding credit. Require appropriate additional data on the delinquency of loans.
Loan evaluation and loan loss provisioning (CP 8)	Provide additional guidance to banks and auditors to strengthen the classification of and provisioning for nonperforming assets, including off-balance sheet assets, to ensure that diminution of value is fully recognized.
Large Exposure Limits (CP 9)	Issue guidelines that clearly set limits for single large exposures, including large exposures to closely-related groups.
Connected Lending (CP10)	Issue guidelines giving a comprehensive definition of related parties; requiring that such loans be made on arms-length terms and conditions, and setting appropriate limits.
Country Risk (CP 11)	Issue guidelines requiring, at a minimum, that bank policies and procedures give due regard to the identification, monitoring and control of country risk and transfer risk.
Market risks (CP 12)	Issue guidelines requiring that banks have suitable policies and procedures related to the identification, measuring, monitoring and control of market risk, and have set appropriate limits.
Other risks (CP 13)	Issue guidelines requiring that banks have in place comprehensive risk management processes to identify, measure, monitor, and control liquidity, interest rate, and operational risk, as well as all other risks and a requirement for appropriate board and senior management oversight.
Internal Control and Audit (CP14)	Issue guidelines setting out the requirements for board of directors and senior management to understand the underlying risks in their business, and requiring that they be committed to and legally responsible for the control environment.

Reference Principle	Recommended Action
Internal controls (CP 15)	Amend the suspicious transactions reporting system applicable to offshore banks. Require offshore banks to report to the supervisor material safety, soundness, or reputation concerns arising from suspicious activities and incidents of fraud.
Bank Management Contact (CP 17)	The OFA must further develop its understanding of the activities of its banks, including risks in loans and investments offshore, through frequent and more probing contacts with management.
Off-site supervision (CP 18)	Laws and regulations must establish, or the supervisor must be given the authority to establish the principles and norms regarding the consolidation of accounts as well as the accounting techniques to be used in the preparation of prudential and statistical returns.
Validation of supervisory information (CP 19)	OFA should have the explicit legal authority to oppose the appointment of a bank auditor, and take steps to increase working relationships with external auditors on matters such as accuracy of prudential returns.
Consolidated supervision (CP 20)	OFA should acquire the legal authority to review the overall activities of a bank and impose prudential standards on a consolidated basis.
Accounting Standards (CP 21)	Laws or regulations should set, or the supervisor should have the authority, in appropriate circumstances, to establish the scope and standards to be achieved in external audits of individual banks.
Remedial measures (CP 22)	Strengthen the enforcement process particularly to deal with persistent problems.

Authorities' response

32. The BCP assessment of St. Vincent and the Grenadines' offshore banking sector has been of significant value to the Offshore Finance Authority in its efforts to constantly strengthen the supervisory regime. Consequently, the OFA has already acted on many of the recommendations made in this report. The principal measures that have been taken are outlined below.

- Drafted a new offshore Banking Act that will address many of the recommendations of the BCP mission. In particular the draft law will:
 - Strengthen the legal basis for the ECCB's role in the supervision of offshore banks;
 - Introduce provisions for issuing credit and equity restrictions and guidelines;
 - Strengthen the power of the Authority to enforce a capital adequacy ratio system;
 - Impose restrictions on credit and investment policies;
 - Empower the OFA to issue prudential guidelines for large exposure limits, connected lending, country risk, market risk, internal audit and control, consolidation of accounts, etc.;

- Empower the OFA to approve bank auditors and to disqualify them; and
- Introduce a 'ladder of compliance' allowing for graduated remedial action.
- Develop a risk based-assessment program that links the results of offsite risk assessments to the scope and focus of onsite inspections.
- Recruited a new Examiner/Compliance Officer and enhanced staff training at all levels on various topics, including risk management, internal controls and anti-money laundering.
- As a result of regulatory concerns, the OFA revoked one offshore bank's license.