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Eastern Caribbean Currency Union: Financial System Stability Assessment, including Report on the Observance of Standards and Codes on Banking Supervision

This Financial System Stability Assessment for the Eastern Caribbean Currency Union (ECCU) was prepared by a staff team of the International Monetary Fund as background documentation for the periodic regional surveillance on the ECCU. It is based on the information available at the time it was completed on April 15, 2004. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the ECCU or the Executive Board of the IMF.

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EASTERN CARIBBEAN CURRENCY UNION

Financial System Stability Assessment

Prepared by the Monetary and Financial Systems and Western Hemisphere Departments

Approved by Stefan Ingves and Anoop Singh

April 15, 2004

This Financial System Stability Assessment (FSSA) is based on two joint IMF/World Bank Financial Sector Assessment Program (FSAP) missions that visited the Eastern Caribbean Currency Union (ECCU) during September 1–19, 2003, and October 20–31, 2003. The FSAP team met with the Governor and senior staff of the Eastern Caribbean Central Bank (ECCB), Financial/Permanent Secretaries from the ECCU member countries, other government agencies involved in regulation and supervision of the financial system, banks and other financial institutions, and other private sector participants. The FSAP team consisted of Messrs. R. Barry Johnston (Mission Chief, IMF) and Patrick Honohan (Deputy Mission Chief, World Bank), Messrs. Manuel Vasquez, Francisco Figueroa, Philip Schellekens, Delisle Worrell, and Ms. Ritu Basu (all IMF/MFD), Mr. Patrick Njoroge (IMF/WHD), Messrs. Anthony Maxwell, Marcel Maes, John Aspden (MFD experts), and Ms. Sonia Echeverri and Ms. Adriana Rota (Assistants, IMF/MFD), Mr. Craig Thorburn and Ms. Melinda Roth (WB/OPD), and Mr. Millard Long (WB/Expert). Not all of these participated in both missions.

The ECCU has experienced a sustained period of monetary and financial stability for decades. Its banking sector is relatively deep and, together with the cooperative credit unions, provides access to formal financial services for a very high share of the population. Despite recent macroeconomic pressures, there is continuing confidence in the financial system. The role of the ECCB in underpinning these strengths has been considerable.

Nevertheless, several risks to the financial system were identified by the FSAP team. Perhaps most important is the rapid build-up of government borrowing, combined with sizable domestic loan arrears by some governments, raising the possibility that the ECCB may be called upon to meet a liquidity need attributable directly or indirectly to such arrears. Such support would threaten the credibility of the currency board arrangement that is the basis of the stability in the ECCU. Other risks include: (i) weaknesses in the regulatory and supervisory framework for bank supervision, relative to the requirements of the Basel Core Principles, including lack of risk based capital adequacy and enforcement capacity; (ii) weaknesses in follow-up actions, as well as inadequate frequency of onsite inspections; (iii) substantial levels of nonperforming and other unsatisfactory or worrisome loans; and (iv) the absence of contingencies to deal with deposit withdrawals and capital flight.

To address the risks and strengthen the resilience of the financial sector, the mission made several recommendations. These include: (a) reprioritize ECCB's resources and work program to focus on regulation and supervision of domestic banks and enhance its supervisory powers; (b) strengthen capital adequacy requirements and apply a more rigorous risk-based program of bank supervision, including an increase in the scope and frequency of on-site inspections; (c) strengthen follow-up and enforcement of remedial action; (d) strengthen crisis prevention efforts and develop an operational action plan for systemic crisis management; (e) strengthen supervision of nonbank financial institutions and the offshore banking sector, including through cross-border cooperation mechanisms.

The main authors of this report are Messrs. R. Barry Johnston, Manuel G. Vasquez, and Patrick Honohan.

FSAPs are designed to assess the stability of the financial system as a whole and not of individual institutions. They have been developed to help countries identify and remedy weaknesses in their financial sector structure, thereby enhancing their resilience to macroeconomic shocks and cross-border contagion. FSAPs do not cover risks that are specific to individual institutions such as asset quality, operational or legal risks, or fraud.

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Boxes

Appendix

GLOSSARY

AML/CFT	Anti-Money Laundering/Combating the Financing of Terrorism
CAMELS	Capital, Asset Quality, Management, Earnings, Liquidity, Sensitivity to Market Risks
CARICOM	Caribbean Community
CARTAC	Caribbean Regional Technical Assistance Center
CCCU	Caribbean Confederation of Credit Unions
CFATF	Caribbean Financial Action Task Force
ECCB	Eastern Caribbean Central Bank
ECCU	Eastern Caribbean Currency Union
ECHMB	Eastern Caribbean Home Mortgage Bank
ECSC	Eastern Caribbean Securities Regulatory Commission
ECSE	Eastern Caribbean Securities Exchange
FSAP	Financial Sector Assessment Program
FSI	Financial Soundness Indicators
LOC	Letter of Commitment
LOLR	Lender of Last Resort
MOU	Memorandum of Understanding
NBFI	Nonbank Financial Institutions
NPLs	Nonperforming Loans
RDCC	Regional Debt Coordinating Committee
RGSM	Regional Government Securities Market
SRO	Self Regulatory Organization

I. Overall Stability Assessment

1. The Eastern Caribbean Currency Union (ECCU),[1] has experienced a sustained period of monetary and financial stability at least since 1976 when the Eastern Caribbean dollar was pegged to the US dollar at EC$2.70=US$1. The quasi-currency board arrangement, which has been in place since 1983, has provided a critical anchor for stability and economic development. Despite recent macroeconomic pressures, there is continuing confidence in the financial system. The role of the Eastern Caribbean Central Bank (ECCB) in underpinning these strengths has been considerable. Nonetheless, the FSAP identified several important areas where measures should be taken to preserve financial stability in the ECCU. Perhaps most important among the risks to the financial system are those associated with the buildup of sovereign borrowing and the increase in domestic loan arrears. The banking sector is experiencing high levels of nonperforming loans (NPLs), and there are important deficiencies in the supervisory regime.

A. Strengths of the Financial System

2. **Financial institutions in the ECCU are relatively well-developed.** Depositors and borrowers have access to a diversified range of financial services. The banking sector is relatively deep and, together with the cooperative credit unions, has provided access to formal financial services for a very high share of the population. Monetization is high, and there is limited dollarization.

3. **The ECCB serves as a mechanism for financial and economic cooperation[2] among the ECCU members, and is supported by a dedicated and professional staff.** As the regulator of all banks licensed to conduct business within the ECCU (both domestic and foreign owned but largely excluding offshore banks), the ECCB is well-respected within the region.

4. **An important source of strength of the financial system has been the historical presence of strong foreign banks in the ECCU.** However, the structure of the banking industry is changing with the entry of more aggressive regional banks.

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[1] The ECCU comprises six Fund members: Antigua and Barbuda, Dominica, Grenada, St. Kitts and Nevis, St. Lucia, Saint Vincent and the Grenadines, and two British territories, Anguilla and Montserrat.

[2] Eastern Caribbean countries institutionalized political and economic cooperation through the establishment of the Organization of Eastern Caribbean States (OECS) with the Treaty of Basseterre in 1981. Two years later they set up the Eastern Caribbean Central Bank (ECCB), which replaced the Eastern Caribbean Currency Authority.

B. Threats to Financial Stability

Credit quality and weak banks

5. **The banking system is characterized by unacceptably high levels of nonperforming loans (NPLs).** This is due to a number of factors including weak economic performance, interrelated lending, lending in excess of regulatory limits, and difficulties of foreclosure. The ECCB has placed a large number of the banks on its watch list largely due to high NPLs (those that have NPL ratios of 10 percent or higher). Banks on this list are mostly indigenous banks.

6. **While above Basel norms, the quality of capital of a few indigenous banks is uncertain.** Overstatement of bank capital reflects, inter alia, high levels of unprovisioned NPLs, accrued interest income on nonperforming government loans, and zero risk-weights applied to public sector debt in arrears. Government defaults would directly increase the risk of bank insolvency or severe capital impairment. There would also be indirect knock-on effects on the private sector through defaults by businesses and other private borrowers. While government deposits in the banks are about the same as loans, some of these deposits are earmarked for specific projects and others are not hypothecated to the banks. In addition, there is no assessment of capital adequacy on a group basis.

Lack of contingencies to deal with deposit withdrawals and capital flight

7. **The scope for liquidity support by the ECCB is limited.** The markets for short-term liquidity are segmented with little interbank lending, and the ECCB has a very limited capacity under the quasi-currency board arrangement to provide liquidity or foreign currency support. While the limitations on ECCB lending are a strength of the quasi-currency board arrangement, they place the burden on banks for safeguarding their own liquidity positions. In view of the governments' fiscal positions, governments are unlikely to be able to provide resources or credible guarantees to address banking problems. Illiquidity or insolvency in the banking system could create a loss of confidence which might lead to deposit withdrawals and capital flight. This could threaten the currency board arrangement.

Weakness in domestic banking supervision

8. **The ECCB lacks the necessary supervisory enforcement powers as reflected in weaknesses in follow-up actions.** The proposed revisions to the domestic Banking and ECCB Acts will help significantly but there are areas where ECCB's supervisory authority could be further strengthened, for example, by transferring licensing authority to the ECCB from the Ministers of Finance. Offsite monitoring is hampered by some deficiencies in the quality, timeliness, frequency, and availability of key banking and financial data. These deficiencies are exacerbated by infrequent on-site inspections and validation of prudential returns. More resources are required to enhance onsite inspections of weak institutions and supervise institutions that pose systemic risks to the financial system.

Weaknesses in supervision of NBFIs and offshore banks

9. **Weak supervision of NBFIs and offshore banks, which is the primary responsibility of national authorities, is another source of vulnerability.** While the systemic relevance of these financial institutions is generally less than that of the domestic banks, there are some exceptions. The ECCB has agreed to assist six of its eight member jurisdictions in the supervision of offshore banks but its authority, responsibilities, and accountability in these matters is, in several cases, unclear. The ECCB has not been involved in the supervision of the offshore banks that are affiliated with domestic banks in one jurisdiction, including a very large offshore bank. The shortcomings in the supervision and regulation of offshore banks are broadly similar to those identified for domestic banks (e.g., deficiencies in data, absence of a risk-based capital requirement and inadequate inspection programs) but are more acute for offshore than domestic banking with indications of under-capitalization compared to Basel norms in some banks.

10. **Supervision of the insurance sector should be enhanced to comply with current and emerging international standards.** In view of the significant presence of foreign-controlled insurers, such supervision could benefit from a regional approach that includes home country regulators from Barbados and Trinidad.

C. Addressing the Immediate Risks

11. **A solvent and liquid domestic banking system is fundamental to the maintenance of the ECCB's quasi-currency board arrangement, as well as for sustaining economic growth and development throughout the region.** Achieving lasting financial stability will require enhanced attention to preventive measures, in particular, adopting and implementing risk-based capital standards. The actions will have to be supported by achieving fiscal sustainability.

12. **The ECCU authorities were in broad agreement with the FSAP findings and recommendations.** However, they were sensitive to some of the recommendations, particularly those relating to enhanced powers of the ECCB citing issues of sovereignty and constitutionality in a multi-jurisdiction supervisory framework. A summary of the main recommendations follows in Box 1.

Box 1. Main Recommendations

(a) Immediate priorities

Preventive measures for ensuring financial stability need to be strengthened. The ECCB needs to (i) refocus on its core mandate to promote monetary and financial stability and (ii) be provided with adequate powers to achieve that end. In particular, the ECCB should:

- *Reprioritize its resources and work program to focus on the regulation and supervision of systemically important institutions, especially domestic banks.* In particular, ECCB should realign its resources to on-site inspections;
- *Develop a more structured program of supervision that focuses on the risks inherent in each institution.* The program would determine the scope and frequency of on-site visits, how resources are to be allocated, and areas to be monitored. The program should give priority to developing action plans and implementation of remedial measures by weak banks;
- *Strengthen data integrity and collection practices* to improve the accuracy and completeness of prudential returns submitted by the institutions, especially with respect to capturing all on and off-balance sheet exposures;
- *Strengthen prudential regulations*: set minimum capital commensurate with the risks of each institution; revise guidance on accruals of interest; and provide regulations on market (e.g., foreign exchange) risk;
- *Address the Union-wide risks entailed in government borrowing from banks* by assigning risk-weights for the purpose of establishing minimum capitalization, suspending accrual of interest on nonperforming government debts and requiring provisioning on such debts;
- *Enhance the powers of the ECCB to achieve greater effectiveness in the regulation and supervision of domestic banks*. The granting and withdrawal of domestic bank licenses and other bank regulation enforcement powers presently assigned to national authorities should be transferred to the ECCB; and
- *Give greater attention to financial sector governance*, including the composition of boards of directors, internal audit and control.

The ECCB, in consultation with national authorities, should improve its crisis management capacity. (i) Crisis prevention. The disruptive nature of administrative measures (e.g. deposit securitization, deposit freezes, maturity extensions, etc.)—the most likely tool of crisis containment in the ECCU context—and the associated risks for the currency peg arrangement, underscore the need to strengthen crisis prevention efforts. Monitoring capacity should be strengthened and integrated with a contingency plan that ensures early detection and intervention; and (ii) *Crisis containment.* An operational plan of action should be established to deal with systemic crisis contingencies. Such framework should acknowledge the limited resources of the ECCB for Lender of Last Resort (LOLR) operations and the constraints on the fiscal authorities to provide credible guarantees. The ECCB's emergency powers should make specific reference to the administrative tools to ensure effective implementation.

(b) Refining the regulatory architecture for the remainder of the financial system

The role of the proposed unified national regulators needs to be carefully considered to ensure that, where possible, economies of scale at national and regional levels are exploited. This should help improve the present, quite inadequate degree of supervision—especially of the larger nonbanks—without, however, overburdening the ECCB. In particular:

- Consider transferring lead responsibility to the ECCB for the supervision of the largest nearbanks (two credit unions) identified to be of systemic importance;
- The national regulators should strengthen supervision of the smaller credit unions and other nearbanks at national level;
- Strengthen regulation of insurance by increasing cross-border regulatory cooperation through more formal and structured cooperative arrangements with overseas supervisors; and
- Consider whether independent supervision is required for development banks to enhance their financial performance.

Offshore banks

Strengthen the supervisory and regulatory systems by: aligning the prudential regimes of eight offshore banking laws with those of the uniform domestic Banking Act; issuing and enforcing a comprehensive set of prudential regulations and guidelines, including for risk-based capital; establishing uniform reporting requirements; ensuring that legislation and guidelines are enforced in a consistent and timely manner. Banks that are under-capitalized compared to the Basel 8 percent minimum risk-weighted ratio, should be required to prepare capital contingency plans.

Realign the ECCB's role in offshore banking supervision in light of its resources and priorities. National authorities should be responsible for finding the resources to ensure effective compliance by offshore banks with international standards or to reassess the future of offshore banking in their respective jurisdictions. However, in all cases where domestic banks are affiliated with offshore banks, there should be close cooperation and information sharing between the ECCB and the national supervisory authorities, and agreement on who will be the lead supervisor for the group.

***(c)* Structural issues**

Continue ECCB efforts at institutional development of the ECCU financial system, through building missing markets and infrastructures; fostering competition through the development of a single "financial space," and undertaking educational efforts subject to availability of the necessary human and financial resources. Continue efforts to improve the effectiveness of the legal and judicial system in supporting debt recovery.

II. OVERVIEW OF THE FINANCIAL SYSTEM

A. Financial Institutions

13. Despite the small size of the Union in terms of population and GDP, the financial system is relatively deep[3] and is dominated by commercial banks. There are a total of 39 licensed commercial banks (26 are units of one of six international banking groups). Four of the locally-owned banks are fully or majority government-owned. The foreign-owned banks control over 55 percent of the Union-wide market (measured by bank loans) while the government-owned institutions have 15 percent. In addition to the commercial banks, a large number of **nearbanks** manage assets equivalent to about 24 percent of GDP. The most important of these are 71 cooperative credit unions. (Table 1).

14. One hundred forty six **insurance company** licenses are in place in the region, representing eight life insurance groups and four composites (insurance companies that engage in a variety of insurance products) with a further 45 companies writing non-life (general) business only. Annual premium income in the various jurisdictions ranges between 4 percent and 7 percent of GDP, with assets totaling about 12 percent of GDP.

15. Each ECCU member has a sizeable part-funded **national insurance system**. Total assets of these funds amounted to about 15 percent of GDP. On present policies and demographic trends, these funds should continue to grow for the next several years.

16. There is also an active **offshore financial services sector**. [4] Assets reported by offshore banks in the four jurisdictions assessed[5] total about US$5 billion, with one jurisdiction accounting for approximately 66 percent, and one institution accounting for nearly half of the total. The offshore sector in the ECCU has been under considerable pressure in recent years, and there has been a sharp decline in the number of offshore banks. Currently, there are 53 offshore banks (ten of which are under some form of supervisory intervention) which is about one-third of the number of just a couple of years ago.

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[3] The ratio of M2 to GDP is estimated at up to 95 percent, a relatively high figure for the level of development in the ECCU.

[4] Most of the offshore banks are incorporated in the various jurisdictions as private institutions that are not subsidiaries of other banks operating outside of the ECCU. The offshore banks in the region total 53.

[5] These jurisdictions are Anguilla, Antigua and Barbuda, Montserrat and Saint Vincent and the Grenadines.

Table 1. ECCU: Financial Intermediaries: Number and Total Assets

	Dec. 97			Dec. 99			Dec. 01			Dec. 02		
	Number	Assets EC$m	Assets Percent GDP	Number	Assets EC$m	Assets percent GDP	Number	Assets EC$m	Assets percent GDP	Number	Assets EC$m	Assets percent GDP
Banks	**44**	**7884.7**	**121**	**43**	**9525.6**	**129**	**43**	**10466.5**	**136**	**41** [3/]	**12256.0**	**156**
Private												
Domestic	8	1793.4	27	9	1731.4	23	10	2346.3	31	10	3504.8	45
Foreign	31	4495.1	69	29	5671.1	77	29	6421.8	84	27	6805.0	87
State-Owned	5	1596.2	24	5	2123.2	29	4	1698.4	22	4	1946.2	25
Insurance Companies	**148**	**n.a.**		**127**	**n.a.**		**146**	**950^e**	**12**	**149**	**n.a.**	
Nonlife	88	n.a.		76	n.a.		90	200^e	3	90	n.a.	
Life & Retirement	46	n.a.		39	n.a.		43	}750^e	10	47	n.a.	
Composite	14	n.a.		12	n.a.		13			12	n.a.	
National Insurance Funds	**6**	**n.a.**		**6**	**n.a.**		**6**	**1176.9**	**15 1/**	**6**	**n.a.**	
Other Nonbank	**109**	**n.a.**		**104**	**n.a.**		**100**	**1861.8**	**24**	**100**	**n.a.**	
Finance Companies	8	28.4	0	8	324.7	4	8	371.6	5	8	358.9	5
Mortgage Institutions [2/]	6	242.5	4	5	269.5	4	5	301.4	4	6	348.2	4
Building Societies [2/]	4	n.a.		4	n.a.		4	200^e	3	4	n.a.	
Credit Unions	79	468.2	7	76	556.4	8	73	688.8	9	72	n.a.	
Development Banks	7	n.a.		7	n.a.		7	250^e	3	7	n.a.	
National Foundations	9	n.a.		8	n.a.		7	50^e	1	7	n.a.	

Source: ECCB and staff estimates; ^{e} denotes staff estimate extrapolated from partial information
1/ March 2002.
2/ Mortgage Institutions are licensed under the Banking Act and supervised by the ECCB; Building Societies are established under national Building Societies Acts.
3/September 2003 = 39.

B. Financial Markets

17. **Organized securities trading in the region is centralized** in the recently established Eastern Caribbean Securities Exchange (ECSE) and the Regional Government Securities Market (RGSM). Market capitalization is still very small in comparison to the rest of the financial system and trading is very light. No funds have been raised through equity listings.

18. **The interbank money market** is relatively small and inactive, notably involving foreign banks lending to their affiliates. An organized interbank market, open to all banks in the Union, was put in place in October 2001.[6]

C. Overview of Legal, Regulatory, and Supervisory Arrangements

19. Regulatory jurisdiction over financial institutions is divided between the ECCB and the national authorities. The ECCB is itself governed by a Monetary Council comprising the Ministers of Finance from each of the participating Governments.

20. ***Domestic Banking.*** Banks throughout the ECCU are regulated and supervised under the uniform Banking Act of 1983 under which the ECCB is the supervisor for all private (domestic and foreign) and state-owned banks. Both the ECCB Act and the uniform Banking Act are currently being amended, inter alia, to improve the ECCB's capacity to supervise domestic banks and their affiliates. Under the uniform Banking Act, a number of key regulatory and supervisory decisions, including the licensing and enforcement, are taken by the relevant Ministers of Finance on recommendation from or after consultation with the ECCB.

21. ***Securities.*** The securities sector is supervised under the uniform Securities Act of 2001, which also created the Eastern Caribbean Securities Regulatory Commission (ECSC) and the Eastern Caribbean Securities Exchange (ECSE), the latter with its Depository and Registry subsidiaries.

22. ***Other financial institutions.*** The ECCB is also responsible for the supervision of nonbank financial intermediaries licensed under the Banking Act. There are 13 such institutions, either mortgage or finance companies, some of them being subsidiaries of banks. Insurance intermediaries and nonbank depository institutions (cooperative credit unions, building societies and development banks) are under the jurisdiction of national supervisory authorities, mainly within the Ministries of Finance.

23. ***Offshore financial services.*** National supervisory agencies (NSAs) have been established in seven of the eight ECCU territories. These are largely responsible for the

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[6] The FSAP did not conduct a detailed review of the payments system. A Fund technical assistance mission visited the ECCB in December 2002 to assist the ECCB in reviewing issues related to the payments system.

supervision of offshore banks, trust companies and other offshore services providers (including in some cases internet gaming) in accordance with national laws.

III. Economic Overview

24. **Following the precipitous worsening of economic performance in 2001 against a backdrop of a generally favorable historical trend, the economic situation in the ECCU remains difficult**. After growing at an average annual rate of 3.5 percent in the 1990s, real GDP in the region fell by 1.5 percent in 2001 and stagnated in 2002. Preliminary estimates for 2003 suggest an expansion of about 2.4 percent (Table 2).

25. **The fiscal position of the governments in the region has deteriorated sharply in recent years.** The aggregate stock of public sector debt increased from 78 percent of GDP at end-2000 to 103 percent of GDP at end 2003, and four of the member countries had debt-to-GDP ratios in excess of 100 percent at end 2003. The combined central government deficit was 5.9 percent of GDP in 2003. Acute financing constraints have led some governments (Antigua and Barbuda and Dominica) to accumulate arrears, and in the case of Dominica, a widespread economic crisis led to a stand-by arrangement with the Fund in August 2002, and a successor PRGF arrangement in December 2003. So far there is no evidence of contagion to other countries in the region.

26. **Despite the large current account deficits, gross international reserves of the ECCB have continued to rise and stood at 20 percent of broad money at end 2003.** This reflects continued capital inflows, mainly to finance direct investment for construction and public sector borrowing. Capital account transactions are fairly liberal.

27. **Growth of bank credits has declined relative to deposits.** Broad money (M2) has continued to grow, while net bank lending to the public sector contracted. Private sector credit growth has fallen sharply. The decline in public sector borrowing is largely due to governments' recourse to external borrowing while domestic deposit growth was influenced by increases in social security fund deposits. Commercial banks have built up their foreign assets and to a lesser extent their deposits at the ECCB.

28. **Nominal interest rates have been slow to adjust to declining U.S. interest rates resulting in a significant widening of the EC/U.S. dollar interest differentials**. In the three years to end-2003, mean deposit rates in the ECCU fell by only 70 basis points while U.S. rates fell by over 500 basis points. The widening in differentials appears to reflect a sluggish reaction of ECCU rates rather than declining confidence in the ECCU and the current peg. A 3 percent minimum savings rate is in place as a protection for small savers. Presently, this rate applies to about 20 percent of interest-bearing deposits in the banking system and is somewhat high relative to wholesale deposits in the region. The floor rate should be kept under review and adjusted in line with wholesale market rates.

Table 2. Selected Economic and Financial Indicators

	1998	1999	2000	2001	2002	Prel. 2003
(Annual percentage change)						
National income and prices						
Real GDP	4.0	4.1	2.8	-1.3	0.2	2.4
GDP deflator	2.5	1.8	1.3	1.8	1.0	1.0
Consumer prices, end-of-year	0.9	2.1	3.1	2.0	0.8	1.5
Monetary sector						
Liabilities to private sector (M2)	12.9	10.6	10.6	5.9	6.6	9.7
Net foreign assets	52.9	-11.0	-7.2	40.8	25.8	33.6
Net domestic assets	5.7	10.6	15.2	-1.3	0.9	0.9
of which						
Private sector credit	8.0	10.3	10.4	2.3	1.9	1.1
Credit to central government	1.1	14.4	35.6	1.4	-1.5	-9.7
(In percent of GDP)						
Central government 1/						
Overall central government balance	-2.9	-4.8	-6.4	-7.8	-10.5	-5.9
Total revenue and grants	28.3	27.6	27.0	26.4	27.9	28.6
Total expenditure and net lending	31.3	32.3	33.4	34.2	38.4	34.5
Foreign financing	3.1	2.7	1.5	5.6	9.6	5.6
Domestic financing including arrears	-0.2	2.1	4.9	2.1	0.9	0.3
Central government current account balance	1.7	1.1	-0.6	-1.9	-2.3	-0.7
Total public sector debt, end-of-period	67.5	71.7	77.7	84.0	101.2	102.8
(Annual percentage change)						
External sector						
Exports, f.o.b.	6.0	3.6	9.7	-15.6	2.4	-5.6
Imports, c.i.f.	4.2	6.5	3.1	-8.1	0.4	8.2
Stayover visitors	1.5	-0.7	0.2	-5.1	2.1	7.5
Nominal effective exchange rate; (1990=100) end-of-period (depreciation -) 1/	-2.2	4.0	6.0	1.9	-4.8	-8.8
Real effective exchange rate; (1990=100) end-of-period (depreciation -) 1/	-1.0	3.4	4.3	1.8	-5.7	-9.6
(In percent of GDP; unless otherwise specified)						
External current account balance	-14.1	-16.4	-15.5	-16.7	-19.6	-19.5
Trade balance	-37.7	-38.5	-37.6	-35.4	-34.5	-37.3
Services and transfers	23.7	22.1	22.2	18.7	14.9	17.8
Of which						
Travel	31.1	29.1	28.2	26.2	24.7	27.3
Capital and financial accounts 2/	16.1	17.5	16.1	19.0	21.6	21.0
External public debt (end-of-period) 1/	42.1	45.7	48.6	53.1	65.4	69.1
End-year gross reserves of the ECCB (US$ millions)	357.6	364.6	383.7	446.0	504.8	539.9
In months of imports	3.3	3.2	3.2	4.1	4.6	4.6
In percent of broad money	19.8	18.2	17.4	19.1	20.2	19.7
Currency backing ratio, in percent 3/	90.9	88.0	88.3	92.9	97.1	95.3

Sources: Data provided by the Eastern Caribbean Central Bank; and Fund staff estimates.

1/ Excludes Anguilla and Montserrat.
2/ Includes errors and omissions.
3/ ECCB's foreign assets as a ratio of its demand liabilities.

IV. Strengths and Vulnerabilities of the Financial System

A. Financial Stability Assessment

29. **The ECCU has a history of financial stability anchored in the ECCB currency arrangement.** The ECCB Act of 1983 established the ECCB as the central bank for the ECCU and mandated it, inter alia, to "promote and maintain monetary stability." The mechanisms to do this were enshrined in a quasi-currency board arrangement that placed specific quantitative limits on the minimum foreign currency reserve cover for the ECCB's demand liabilities, and by design limited ECCB credit to governments and the banking system (Box 2).

30. **A source of strength of the ECCU has been the large historical presence of strong foreign banks.** However, the structure of the banking industry is changing with the entry of more aggressive regional banks, and the share of privately-owned banks has increased. The banking system's deposit base has grown steadily for the past several years.

31. **Residents' deposits have remained stable at 89 percent of total bank deposits while deposits of private sector residents have remained at two-thirds of total deposits.** The share of foreign currency deposits varies widely between jurisdictions but has also been quite stable, averaging 15 percent of total deposits, evidencing confidence in the financial system.

B. Current Status of the Domestic Banking Sector

32. **Financial sector indicators for the ECCU provide mixed signals about the underlying strengths of domestic banks' balance sheets in the region** (Table 3).[7]

33. **In particular, nonperforming loans (NPLs) are high for many domestic banks,** especially, but not exclusively, locally incorporated banks, and only a small proportion of NPLs is covered by loan loss provisions (partly explained by reliance on collateral). Additionally, unprovisioned unsatisfactory assets are a worrying share of the total portfolio. The high NPLs reflect, inter alia, difficulties in foreclosure and in some cases connected lending.

34. **Reported risk-weighted capital ratios are above 8 percent,** but may overstate the solvency position of domestic banks. Banks apply a zero risk weight on loans to governments in arrears and in a few cases have accrued interest on such loans. On average, bank's

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[7] The following information only relates to domestic banking statistics collected by the ECCB which does not include data on offshore bank subsidiaries and affiliates. The adequacy and timeliness of loan classification and the availability of other prudential data are however important considerations.

holdings of government obligations are about 15 percent of total assets, but vary considerably across jurisdictions. Nonperforming government obligations do not attract a provisioning charge. There are also indications that a large offshore bank with a domestic bank affiliate would be undercapitalized on a risk-weighted capital basis.

Box 2. The ECCB's Institutional Arrangement, Monetary Policy Instruments and Facilities

The operations of the ECCB are encapsulated in two Acts: The **Eastern Caribbean Central Bank Agreement Act (1983)** which establishes and defines the powers and operations of the ECCB, and the **Banking Act (1983)** which regulates the operations of domestic banking institutions within the ECCU area. The ECCB is governed by the **Monetary Council**, comprising one minister from each member. Responsibility for the general operations of the ECCB is entrusted to the **Board of Directors**, consisting of the Governor, the deputy Governor and one Director from each member.

The underpinnings of the currency arrangement are enshrined in the ECCB Act, by which the currency is pegged at EC$2.70 to U.S$1.00 and requiring the ECCB to hold external reserves for its members of no less than 60 percent of its demand liabilities. However, the policy norm for the minimum reserve cover is 80 percent and has been maintained at over 95 percent for several years. The ECCB is permitted to provide credit to its members under strictly specified limits and within the reserve cover requirements. At the beginning of its fiscal year, the ECCB allocates its global limit on domestic assets, currently 25 percent of demand liabilities, to credit to commercial banks and the participating governments (30 percent and 70 percent of the fiduciary issue, respectively) with each country having its own limit. The global limit has not been exhausted.

The ECCB's monetary instruments and facilities are:

- **Reserve requirement**. Set at 6 percent on all deposits. Reserves are unremunerated, in local currency and are based on the average level of deposits for the week.
- **Rediscount facility for treasury bills**. The ECCB sells to banks treasury bills it has bought in the primary market and which can be rediscounted before their maturity date.
- **Discount rate**. This is the applicable rate at the discount window, but the ECCB has used it more to signal its views about interest rate movements. This was lowered in July 2003 to 6.5 percent.
- **The minimum savings deposit rate**. This is the only remaining interest rate control imposed by the ECCB under its general power to establish a schedule of interest rates and credit limits. It was lowered in September 2002 from 4 percent to 3 percent.
- **Lombard facility (discount window)**. The ECCB may provide emergency liquidity assistance to a bank that is in distress, once the bank has exhausted other liquidity sources, for up to 90 percent of the face value of treasury bills or other securities. This facility has been used very rarely.

The operation of these instruments is reviewed regularly by the Monetary Council. In addition, the ECCB can also provide **discretionary direct lending** to member governments and to a systemically important bank that is in distress.

Table 3. Financial Soundness Indicators

(in percent, unless otherwise specified)	Year Ending Dec. 98	Dec. 99	Dec. 00	Dec. 01	Dec. 02	Sep. 03
Total Capital/Risk Weighted Assets (Locally Incorp. Banks)	16.3	17.9	16.6	17.7	18.9	19.1
Capital/Asset (Locally Incorp. Banks)	10.4	10.5	10.1	10.7	11.1	10.8
Unsatisfactory Assets/Total Loans	12.6	14.9	11.7	13.5	13.7	11.9
Unsatisfactory Assets/Total Loans (Locally Incorp. Banks)	18.0	23.2	16.7	17.4	17.4	16.8
Unsatisfactory Assets/Total Loans (Foreign)	7.1	6.5	6.3	9.1	9.3	6.5
Anguilla	11.2	11.0	10.6	11.0	15.6	20.7
Antigua & Barbuda	8.3	9.2	9.3	12.4	11.3	9.5
Dominica	15.4	17.9	17.4	22.6	19.2	22.2
Grenada	11.3	10.0	8.5	5.9	5.8	5.5
Montserrat	61.9	48.6	34.0	36.8	17.1	5.8
St Kitts and Nevis	16.5	32.5	12.6	11.6	12.7	10.1
St Lucia	12.8	12.4	13.7	18.2	20.6	14.9
St Vincent and the Grenadines	13.3	13.1	10.9	13.0	11.3	10.7
Provision for Loan Losses/Unsatisfactory Assets	26.6	19.7	28.0	28.1	29.7	34.0
Unsatisfactory Assets net of Provisions/Total Capital (Locally Incorp. Banks)	88.7	119.0	82.3	74.6	66.5	60.2
Amount Outstanding by Largest Group/Total Loans	8.0	7.8	7.5	6.4	6.6	6.0
Amount Outstanding by Largest Group/Total Capital (Locally Incorp. Banks)	34.8	31.4	33.5	26.0	24.3	22.8
Amount Outstanding by Largest Sector/Total Loans	45.1	45.7	45.9	46.6	46.4	47.4
Amount Outstanding by Largest Sector/Total Capital (Locally Incorp. Banks)	271.4	264.4	277.2	242.5	219.2	213.3
Loans to Agriculture Sector/Total Loans	2.6	2.8	3.2	3.6	3.9	4.0
Loans to Tourism Sector/Total Loans	7.7	7.8	7.9	7.5	7.9	7.9
Loans to Households/Total Loans	45.1	45.7	45.9	46.6	46.4	47.4
Gross Government Claims/Total Assets	13.3	14.1	15.2	15.0	15.1	15.2
Anguilla	3.0	2.5	2.6	2.7	3.7	4.0
Antigua & Barbuda	16.1	16.2	15.8	14.6	14.1	13.8
Dominica	15.3	15.3	17.1	16.8	14.2	14.1
Grenada	12.9	11.3	13.0	14.3	15.6	15.4
Montserrat	3.3	16.2	19.6	20.4	20.0	21.5
St Kitts and Nevis	21.2	24.1	26.5	28.4	25.8	25.2
St Lucia	9.4	9.3	11.2	9.3	10.5	11.5
St Vincent and the Grenadines	11.8	14.2	14.4	15.2	17.9	17.0
Government Deposits/Total Deposits	17.7	19.0	18.6	18.1	17.8	18.2
Net Profit before Taxes/Average Assets	2.0	2.4	2.2	2.1	1.6	1.7
Net Profit before Taxes/Average Equity (Locally Incorp. Banks)	13.8	18.4	14.9	17.0	12.9	13.7
Net Interest Income/Total Income (Net Interest Margin/Total Income)	47.1	47.5	47.5	46.0	45.5	45.5
Non-Interest Expense/Total Income	44.1	40.2	38.9	37.9	42.3	44.3
Net Liquid Assets/Total Deposits 1/	19.7	20.6	19.6	24.8	27.3	30.5
Liquid Assets/Total Assets 2/	21.0	21.9	20.6	24.3	26.4	29.0
Foreign Currency Deposits/Total Deposits	10.7	14.0	15.7	15.0	15.7	15.3
Net Foreign Currency Assets/Total Capital (Locally Incorp. Banks)	54.1	48.8	1.1	29.0	39.9	84.8
ECCB Reserve Cover 4/	90.9	88.0	88.3	92.9	97.1	96.5
ECCB Gross Reserves/M2	19.8	18.2	17.4	19.1	20.2	19.9
Highest ECCU TB rate - US TB Rate	2.2	2.3	1.2	4.1	5.9	4.7

1/ Net liquid assets for the ECCU nets out the due to and due from banks in territory and in other ECCB territories.

35. **Domestic bank profitability has weakened somewhat** as interest margins have declined and expenses have risen. Profit figures may be overstated in some cases due to understated loan loss provisions and by the accrual of interest on delinquent debts.

36. **Domestic banks appear on their balance sheets to have adequate liquidity** and they maintain net asset positions in foreign currency. Detailed information is not available on off balance sheet commitments. Staff calculations suggest that the net foreign asset position is sufficient to cover banks' foreign currency contingent liabilities.

37. **Loan concentration has tended to be high**. Having been above the regulatory norm of 25 percent for several years, average loan concentration (to groups) in the banking system has now dipped just below that number. The largest sectoral exposure is to the household sector. On the deposit side, public sector bodies, including social security funds, hold large deposit balances with the banks.

38. **The ECCB's own supervisory analysis points to significant weakness in the domestic banking system.** The ECCB's list of banks for intensive monitoring represents 41 percent of ECCU banking assets, of which only 0.4 percent of assets is accounted for by a foreign bank branch. Almost all of the locally incorporated banks are on this list: indeed indigenous banks that met all the ECCB's benchmarks and performed at least as well as their peers accounted for just 2.8 percent of the system's assets.

Credit quality

39. **Credit quality has become a pressing issue for many of the banks in the Union.** Many banks are facing loan recovery difficulties, and in many cases these problems predate the economic downturn of 2001–2002. They have their origins in poor loan approval processes, which in turn reportedly reflect shareholder pressure either for increased market share (in the case of some private banks) or for leniency in respect of favored borrowers (in the case of other banks, including the state-owned banks). There is also a concern that weak accounting practices by some banks may be understating the level of reported NPLs and provisioning requirements. Loan recovery is also hampered by delays in foreclosure procedures and the very limited market for resale of collateral.

Financial accounts

40. **Banks are required by law to maintain adequate records; however, the scope of the work performed by the accountants and the level of disclosures presented in the audited financial statements is very mixed**. All banks must also comply with accounting guidelines set by the ECCB, and audit opinions reviewed stated that they were prepared in accordance with international accounting standards. Some audit reports express an opinion on the bank's level of compliance with the requirements of the Banking Act while others do not. The standard audit approach is to conduct a very narrow evaluation of the accuracy of regulatory (prudential) returns. Some accountants in the jurisdictions visited stated that they do not rely on the work of internal bank auditors because of a perceived lack of independence and experience across jurisdictions.

41. **The quality and reliability of financial reports prepared by a few banks is also adversely affected by the practice of recognizing "interest earned but not collected" from nonperforming government debt**. The ECCB does not require banks to make provisions for delinquent loans to government bodies, and it should not allow banks to continue accruing uncollected interest on nonperforming government debt.

C. Macroprudential Analyses

42. **Maintaining stability in the ECCU requires financial discipline among the members of the Union**. The ECCU framework with multiple sovereign jurisdictions, a single currency pegged under a quasi-currency board arrangement, provides mutual benefits of monetary stability. However, potential problems in one jurisdiction can spill over to others, create a loss of confidence, and affect the stability of the Union as a whole.

43. **Excessive government borrowing is a potential source of instability in the Union.** If one or more national governments become unable to service their obligations, this could impact on the private sector's capacity to pay. If the central bank were to meet the pressure with a liquidity loan, this could lead to pressure on the currency reserves, and the currency board arrangement.

44. **The potential for problems from excessive government borrowing could in principle be addressed through either of two channels**: First, by enacting complementary fiscal rules that bind aspects of fiscal performance and borrowing, or second, through market discipline. However, current arrangements in the region do not allow full play of either channel: there is no binding agreement on fiscal rules and markets are very weak. Moreover, unlike private sector loans, government borrowing from banks attracts a zero risk-weight in the calculation of capital requirements.

45. **Stress tests were conducted to simulate the impact of government defaults and a deterioration in private sector credit portfolios (Box 3).** Staff examined the potential impact on banks' financial condition from defaults by ECCU members whose fiscal positions are in a precarious position, on an individual basis and collectively. The simulated effects of the direct losses from government defaults were combined with simulated effects on private sector credit portfolios.The stress tests confirmed the vulnerability of indigenous banks to government defaults and private sector credit risk. In general terms, the stress tests indicate that practically all indigenous banks are at risk of insolvency or severe capital impairment if their governments were to default and there are knock-on effects to the private sector. Foreign-owned banks would also face significant losses.

46. **A further stress test indicated that individual bank insolvencies are unlikely to have a large direct impact on the solvency of other banks within the system**. This is because the amounts of outstanding interbank balances are not large, either within or between territories. However, there could be indirect effects should the insolvency lead to a loss of confidence in the financial system or the currency peg, resulting in deposit withdrawals and capital flight. The ECCB's capacity to deal with capital outflows is limited (see Section VI).

D. Anti-Money Laundering/Combating the Financing of Terrorism

47. **The ECCB has recently increased the scope of its supervision of domestic banks' compliance with AML/CFT requirements.** The mission noted that the ECCB identified material deficiencies in bank's AML/CFT controls and that it had requested bank management to take corrective action. The results of detailed AML/CFT assessments for Anguilla and Montserrat conducted by the IMF as part of the OFC assessment program indicated that, while jurisdictions have relatively well-developed legal frameworks, significant gaps remain in the development of institutional capacity and implementation, particularly in the offshore bank and nonbank sectors.[8] There have been very few reports of suspicious activity filed in some jurisdictions and prosecutions/convictions for money

> **Box 3. Macroprudential Analysis**
>
> 1. A stress test examined the implications of a further deterioration in the fiscal positions of the governments on the solvency of the banking system. Such a deterioration would likely have knock-on effects on the private sector's capacity to service their debts, inter alia, through government arrears on wages and payments to suppliers. The test assumed a 50 percent and 100 percent loss from default by four ECCU governments, individually and collectively, together with an additional loss to banks, equivalent to 25 percent of their loans to the personal sector. An adjustment to capital for data deficiencies (including possible underprovisioning of NPLs and other deficiencies) was undertaken before the stress test was carried out.
>
> 2. Spillover and contagion effects were examined by reviewing the most vulnerable banks' net positions on the interbank market and the losses they would impose on other banks through the interbank system. The banks' exposure to interest rate risk and exchange rate risk were also calculated. No tests were performed on the vulnerabilities of insurance companies or near banks, because neither sector is large enough to be of systemic significance for the ECCU.
>
> ***Results of stress test***
>
> 1. In the case of a 50 percent loss given default, the loss to the banking system as a whole is 10.7 percent of assets, including losses on consumer loan portfolios. Locally incorporated banks accounting for 28 percent of system assets become insolvent. In the case of a 100 percent default, the loss amounts to 16.6 percent of assets, including losses on consumer loan portfolios, and insolvent locally incorporated banks account for 37 percent of the system's assets.
>
> 2. Amounts owing to other ECCU banks by the banks most vulnerable to insolvency because of government default are about one percent of the system's assets, indicating little risk of direct contagion through the interbank market.
>
> 3. Interest rate risks are negligible and banks would gain from an exchange rate devaluation.

[8] Assessments of the AML/CFT regimes of Dominica, Grenada, St. Lucia, St. Kitts and Nevis and Saint Vincent and the Grenadines, using the common methodology, were conducted in September 2003 by the Trinidad-based Caribbean Financial Action Task Force

(continued)

laundering have generally been negligible. The results of mutual evaluations conducted by the CFATF in September 2003 of five ECCU jurisdictions are not yet available.

V. Review of Supervisory and Regulatory Arrangements

A. Domestic Banking

48. **ECCB is well-respected within the ECCU region** and is supported by a group of well-qualified banking supervision professionals.

49. **Nonetheless, when measured against the Basel Core Principles (BCP) for Effective Bank Supervision, a number of weak areas within the current supervisory and regulatory framework can be identified:**[9]

50. **Independence, powers, and resources.** Enhanced operational independence, enforcement powers, and resources for the ECCB would improve the effectiveness of banking supervisory in the ECCU. In addition, regulatory cooperation arrangements with national authorities within the ECCU or outside the region would enable it to more effectively carry out its supervisory functions. This would involve additional amendments to the proposed revision of the Banking Act in areas such as licensing authority and enforcement powers including the ability to impose administrative fines for noncompliance. Additional resources are also required to conduct more timely and frequent on-site inspections.

51. **Risk-based supervision.** Supervisory strategies should focus on high-risk institutions. Additional supervisory tools are needed to strengthen the risk identification program currently in place and linking the frequency and intensity of on-site inspections to the ECCB's "watch list" of weak banks.

52. **Treatment of public sector obligations**. The ECCB should revise existing guidelines for loan classification and accruals of interest with respect to nonperforming government/public sector debt. It should require risk-weight allocations for such debt and loss provisions when they become delinquent. Current guidelines do not adequately

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(CFATF). The Bank plans to assess the AML/CFT regime of Antigua and Barbuda later in 2004. When completed, Reports on Observance of Standards and Codes (ROSC) for these six jurisdictions will be forwarded separately to the Executive Board. The AML/CFT regimes of Anguilla and Montserrat were assessed in October/November 2002, as part of the Fund's OFC Module 2 program. The ROSCs for these two jurisdictions were sent to the Board in November 2003, and have been published.

[9] The Report on the Observance of Standards and Codes (ROSC) for the Basel Core Principles for Effective Bank Supervision for the Eastern Caribbean Central Bank—Domestic Banking is attached to this report.

recognize the level and trend of risk posed by the government/public sector given the economic condition in the region and the level of government obligations in arrears.

53. **Capital adequacy**. The current capital adequacy risk ratio is set as a minimum for all banks (eight percent) on a non-statutory basis. However, the proposed revisions to the Banking Act will provide for their statutory application. While banks currently report risk-weighted ratios well above the minimum requirement, they do not accurately reflect all the risks facing the banks, including foreign exchange, interest rate, market and nonperforming public debt. The ECCB should therefore enhance its capital adequacy guidelines to reflect all of these risks and strengthen loan loss provisioning requirements accordingly.

54. **Consolidated supervision.** The ECCB should conduct consolidated supervision and in particular obtain comprehensive information on all offshore bank affiliates of domestic banks. For this purpose, the ECCB should fully implement the information sharing mechanism with all of the national supervisory authorities in the ECCU, and assess capital adequacy on a group basis.

55. **Data integrity**. Data quality could be improved by requiring bank auditors to validate the accuracy of the regulatory returns, and by more frequent inspections by the ECCB. Amendments to the Banking Act, as proposed, will give the ECCB the power to request the external auditor to carry out any further audits it deems fit. External auditors will also be required to submit a report to the ECCB on matters of significant consequence to the banks.

56. **Remedial actions and follow-up.** The ECCB should establish an effective and timely process to monitor and enforce compliance with corrective measures by banks to address safety and soundness concerns, and regulatory violations. While the ECCB claims to rely on "moral suasion" to enforce compliance, staff identified instances where deficiencies remained uncorrected for several years.

57. **Cooperation and sharing of information.** The ECCB does not have the legal authority to cooperate nor exchange information with other supervisors within or outside the ECCU region. However, this limitation should be largely addressed by proposed amendments to the Banking Act. The presence of subsidiaries and branches of banks (mainly from Trinidad and Tobago, Barbados, and France) requires that such legal authority be in place to enable formal and informal contact arrangements with home regulators as well as to facilitate consolidated supervision.

58. **Financial sector governance**. Increased attention needs to be given to financial sector governance. The FSAP encountered several instances of lending to directors and shareholders contrary to financial regulations. Improved governance would require greater attention to the composition of Boards of Directors, strengthening internal audit and control functions, and other measures to guard against outside political and other interference in the management of banks.

B. Securities Markets

59. **The 2001 uniform Securities Act provides a strong regulatory framework for the operation and supervision of the regional securities markets.** The Eastern Caribbean Securities Commission (ECSC) is an independent regulator under the Securities Act and, under a letter of agreement with the ECCB, it utilizes four skilled banking supervision staff of the ECCB for ongoing supervision of the sector.

60. **Although the Commission has most of the requisite powers, it lacks a track record in terms of implementation and few aspects of the law and regulations have been tested**. Disclosure standards could be strengthened and conflict of interest guidelines for staff should be developed. The draft Takeover Regulations should be brought into effect and there should be increased emphasis on investor education and public awareness.

C. Supervision of Other Financial Institutions

61. **The supervisory apparatus for other financial institutions needs to be strengthened and problems of insufficient resources addressed.**

Offshore banking [10]

62. The offshore BCP assessment focused on Anguilla, Montserrat, Antigua and Barbuda, and Saint Vincent and the Grenadines. Antigua and Barbuda has 16 offshore banks, Montserrat 11, and Saint Vincent and the Grenadines 10. These numbers have declined in recent years. Each ECCU member has its own unique offshore banking legislation that is distinct from the domestic Banking Act. And whereas the ECCB is the supervisor of domestic banks throughout the ECCU, supervision of offshore banks is the primary responsibility of national regulators. However, except for Antigua and Barbuda and St. Lucia, the ECCB has entered into supervisory arrangements with the national supervisory authorities in six ECCU jurisdictions. Under these arrangements, the ECCB provides support mainly in licensing due diligence and onsite inspections.

63. **The ECCB should coordinate closely with national authorities in the supervision of offshore banks with domestic bank affiliates especially where such offshore banks are**

[10] The offshore banking sectors of Anguilla and Montserrat were assessed under the IMF's Offshore Financial Center assessment program in October/November 2002 and updated during this mission. These BCP ROSCs were sent to the Board in November 2003 and have been published on the IMF's website. A review of the offshore BCP for Antigua and Barbuda was conducted from February 23 to March 5, 2004. The offshore banking sector of Saint Vincent and the Grenadines was reviewed in September 2003 as part of the FSAP and will be issued as a supplement to the Article IV report. The other ECCU members have 0–2 operating offshore banks each.

of systemic importance. [11] In all cases, when domestic banks are affiliated with offshore banks there should be close and ongoing cooperation and information exchange between the ECCB and national supervisory authorities, and agreement on who will be the lead supervisor for the group. In other cases, the ECCB should consider whether it has the means to assist with supervision of the offshore banks and at the same time achieve its core mandate to promote monetary and financial stability. Other considerations are also relevant here. First, the ECCB faces reputation risks from being assigned responsibility for supervision without adequate authority and resources. Second, supervision of offshore entities has somewhat different goals, as these are essentially an export business where countries tend to compete with each other. Third, there is a risk that jurisdictions would "free ride" on the supervisory services of the ECCB to support their offshore activities.

64. **The assessments against the BCPs identified a number of regulatory and supervisory weaknesses.** There are common weaknesses in the area of prudential requirements and accounting standards. In some cases, there is a lack of appropriate enforcement powers and where authority exists, there are indications of repetitive regulatory forbearance. There was also evidence in some jurisdictions of a lack of adequate control over large exposures and connected lending. All four jurisdictions have taken steps to comply with AML requirements, but additional steps are recommended, particularly in the area of supervision for compliance. There is a clear need in most of these jurisdictions to strengthen in law and in practice the requirement that mind and management are present in the jurisdictions.

65. **Capital adequacy requirements are not risk-based, and do not take into account off-balance sheet risks.** The four jurisdictions assessed have minimum capital requirements ranging from US$500,000 to US$5 million, but in at least one jurisdiction there was evidence of the requirement not being adequately enforced. Currently, there are indications that several banks would not meet a minimum Basel 8 percent risk-based capital ratio without the injection of additional capital. The authorities should adopt risk based capital requirements and request banks that are under capitalized compared to the Basel 8 percent minimum to prepare capital contingency plans.

Insurance

66. **Insurance regulation in place in OECS jurisdictions is well below international standards**. The ECCB and governments in the region drafted a common insurance law in 1995; however, it remains to be fully enacted. Solvency requirements, powers for inspection and intervention, controls on corporate governance, and internal controls are largely absent from the draft law. Insurance supervision is chronically under resourced and cannot deliver

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[11] There are offshore bank affiliates licensed in Anguilla, Antigua and Barbuda and Nevis but the ECCB does not have a role in the supervision of such banks in Antigua and Barbuda.

adequate supervision against international benchmarks, but it is not likely to be practical or cost effective to upscale supervisory resources in all jurisdictions independently.

Nearbanks

67. **Supervision of nonbank depository institutions is seriously deficient and suffers from inevitable resource constraints**. In the case of cooperative credit unions, forbearance by the national registrars on the legal ratios is quite common even for the larger societies. Two credit unions were identified as being of sufficient scale, both in terms of assets and number of clients, to be considered of systemic importance and as such warranting transfer of responsibility for their supervision to the ECCB. There appears to be little or no active supervision of building societies, whether by the national registrars or by Ministries of Finance. There is no independent prudential supervision of the development banks and foundations.

Integrated financial supervision

68. **Proposals to establish national sectorally-integrated regulatory bodies would enhance supervision of insurance, nearbanks, and offshore finance**. These bodies should help in exploiting economies of scale at national level for the supervision of nearbanks. The proposed model could be refined, notably in regard to assignment of responsibilities. As the regional domestic bank regulator, the ECCB should have a primary responsibility for the regulation of any onshore depository institutions which are sufficiently large to present systemic risks. This should include at least the largest credit unions and building societies in the region. National regulators should focus their supervision on areas relating to consumer protection, smaller credit unions and other nearbanks, the offshore sector, and on AML/CFT issues where appropriate. Regulation of insurance could be strengthened by increased cross-border regulatory cooperation. Efforts should be made to enhance cooperation with the overseas supervisors (e.g., with Barbados and Trinidad and Tobago insurance supervisors).

VI. Crisis, Contingency Planning, and Debt Management Arrangements

A. Systemic Crisis Prevention and Containment in the ECCU

69. **The range of crisis management options available to any monetary authority in a pegged exchange rate system is narrowly constrained.** In particular, large-scale central bank lending to an illiquid bank would clearly threaten the peg. Weaknesses in the balance sheets of the fiscal authorities further constrain the options for crisis management. Under the current fiscal conditions, a blanket guarantee to boost deposit and creditor confidence runs the risk of being ineffective due to a lack of credibility.

70. **Within the present context, the only tools available for containment of bank runs, given the peg, would be administrative measures,** such as deposit securitization, forced maturity extensions, or deposit freezes. Making public the measures to be taken to prevent a crisis could also help bolster public confidence in the system. It is not clear,

however, that a secure legal framework is in place to underpin such drastic action, which could cause major economic and political disruption.

71. **For these reasons, the focus must be on crisis prevention and early warning systems** and on ensuring that the preconditions of a sustainable currency board arrangement are in place.

- ***Crisis prevention:*** In addition to addressing fiscal unsustainability in the ECCU, efforts also need to be geared towards ensuring that the banking system is sound by addressing existing weaknesses in the regulatory and supervisory framework as identified in Sections IV and V. The strengthening of early-warning systems could also help avert a crisis as it would allow supervisors to identify emerging problems and take remedial actions at an earlier stage. In particular, full-scope examinations of systemically important institutions should be carried out early on to identify emerging vulnerabilities. This would entail receiving information on all such institutions, including offshore bank affiliates and large credit unions.

- ***Crisis containment:*** The ECCU would benefit from establishing an operational crisis contingency framework that is endorsed by all of its members and explicitly addresses the issue of loss sharing in the event of banking failures—the responsibilities of depositors and shareholders, national governments, and limitations on the responsibilities of the ECCB. The ECCB's draft contingency plan should include domestic banks and consider national authorities' and the ECCB's responses in the event of difficulties in systemically important offshore banks and credit unions. The framework should be explicit about the limited resources available for lender-of-the-last resort support and the implications for the ECCB's balance sheet.

B. Debt Management Arrangements

72. **Debt management in the ECCU, which is the responsibility of the national governments, is directed towards satisfying the governments' financing needs, and until recently was underpinned by relatively unsophisticated operations that are centralized in the ministries of finance**. The legislative framework governing public debt management falls into one of two general categories, either a unitary overall framework to consolidate all legislative borrowing authorities (such as the Financial Administration Act, 1997 of St. Lucia), or alternatively, a collection of instrument specific laws, such as a Loans Act, a Treasury Bills Act, and specific acts governing borrowings from various international institutions. Most of the jurisdictions have not yet moved to the unified framework, with the result that they do not have an overall debt ceiling but rather sub-ceilings for individual debt instruments. Few if any of the jurisdictions have advanced debt management systems.

73. **The Regional Government Securities Market (RGSM) offers a new and potentially more transparent and cost-effective approach to debt issuance (Box 4)**. So far a total of eight security issues have been made by three governments (St. Kitts and Nevis, Grenada, and Saint Vincent and the Grenadines). These governments have generally been using the funds raised in the RGSM to retire more expensive domestic debts. Some jurisdictions have also set up a high-level national debt coordinating committee, responsible for the regular monitoring of debt and directing policy on debt.

Box 4. Regional Government Securities Market

The **Regional Government Securities Market (RGSM)** was created as a means of broadening the market for ECCU governments' treasury bills and bonds. By facilitating cross-border issuance and secondary trading, the RGSM would integrate the existing government securities markets into a single regional market. An efficient regional market would be of direct benefit to the governments by lowering their overall borrowing costs, integrate the financial markets in the region by facilitating the free flow of capital, and facilitate the deepening of capital markets which would also foster the further development of the private debt and equity market.

In line with its responsibility for oversight of the RGSM, the Regional Debt Coordinating Committee (RDCC) has mandated each issuance to be supported by a prospectus, prepared by the issuing government, which provides relevant information that includes an overview of economic performance and on debt. The RDCC has appointed the ECCB as the fiscal agent to the governments (to facilitate the issuance of securities, collection and payment of funds, clearance and settlement, registration, etc.) and has identified the Eastern Caribbean Stock Exchange (ECSE) as the facility for the primary issuance and secondary trading of the securities in a regionally integrated market. The ECSE assists in disseminating information about forthcoming primary issuance of securities, provides market access through its electronic platform and a network of broker-dealers, and administers the auction process. Once the primary auction closes, the ECSE then supports secondary trading of these securities.

VII. Longer-Term Development Issues

74. **Access by households and small business to financial services is relatively high in the region** with, for example, a majority of households having at least one institutional account. This largely reflects the exceptionally high penetration of the credit unions, which provide the bulk of microfinance services in the region even though much of their loanable funds are advanced to relatively well-off middle-class borrowers.

75. **Despite the large number of banks and nearbanks, competition within the banking sector is not very strong.** Foreign-owned banks, in particular, appear to enjoy some market power and there is little cross-border competition between the different islands. However, the recent entry of aggressive regional banks may strengthen competition in the sector. As the competitive pressure on local banks increases, it will become increasingly important for the local banks to seek scale efficiencies, including through cross-border cooperation, if they are to contribute to long-term economic growth on a sustained basis.

76. **The investments of the national insurance schemes are dominated by short term assets** in banks, exposures to local governments and statutory authorities, and are socially-oriented rather than being optimized against risk and return. This undermines their potential role as providers of long term, venture and development funds on suitable commercial terms. There is also weak competition in the private insurance sector as reflected in high premia.

77. The limited activity of the organized ECCU **securities markets** reflects the small number of securities available for trading, and the lack of active domestic institutional investors. To achieve cost effectiveness in such a small economy, access to such investors is important including enhancing access to international markets.

78. **Development and integration of a union-wide financial market has been a central theme of the ECCB's activities in the last several years.** This has been a well-conceived and generally well-executed program, which is now beginning to bear fruit, notably in terms of the emergence of a transparent securities exchange. Even when the financial market within the union is more fully integrated, though, it will remain very small in absolute terms and may not be able to achieve on its own the economies of scale offered by the global financial system. International linkages in what has long been a relatively open system will remain important.

REPORT ON THE OBSERVANCE OF STANDARDS AND CODES: BASEL CORE PRINCIPLES FOR EFFECTIVE BANK SUPERVISION

EASTERN CARIBBEAN CENTRAL BANK—DOMESTIC BANKING

This appendix contains summary assessments of adherence to the Basel Core Principles for Effective Banking Supervision with respect to the domestic banking sector of the Eastern Caribbean Currency Union.

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 improvements in financial regulation and supervision.

In domestic banking supervision, assessors noted the need to strengthen the legislative framework to enhance the powers and autonomy of the ECCB and to generally beef up the enforcement process. More frequent and comprehensive on-site examinations are required particularly in light of the high levels of nonperforming loans and perceived gaps in data integrity. Implementation of a risk-based capital framework for banks should be a priority, which adequately reflects the risk of public sector loans. Supervisory practices should develop further in the direction of risk-focused supervision that also takes into consideration ongoing communication with external auditors and overseas supervisors. The need to establish a more formal information exchange mechanism with the home supervisor was also identified as a priority, especially with respect to the consolidated supervision of significant regional banking groups. Draft legislative changes being proposed will address some of these concerns.

General

79. This Report on the Observance of Standards and Codes (ROSC) for the Basel Core Principles for Effective Bank Supervision was prepared by a team comprised of two persons: Messrs. Francisco Figueroa (IMF) and John Aspden (Expert, Financial Supervision Commission, Isle of Man). The report provides a summary of the level of observance of the Eastern Caribbean Central Bank (ECCB) with the Basel Core Principles and compliance and adherence with the ECCB Agreement and uniform Banking Act.

80. The assessment was conducted through interviews and working sessions with ECCB senior management and supervisory staff, as well as visits to selected domestic banks (including indigenous banks, locally incorporated subsidiaries of foreign banks and foreign bank branches), external auditors,` and national supervisory authorities in St. Kitts, St. Lucia, Grenada, and Dominica.

Institutional and macroprudential setting, market structure—Overview

81. The ECCU is comprised of eight members: Anguilla, Antigua and Barbuda, Dominica, Grenada, Montserrat, St. Kitts and Nevis, St. Lucia, and Saint Vincent and the

Grenadines.[12] There are 39 banking licenses granted to domestic banks in the region; although, a number of these represent separate licenses given to the same bank in different territories. A total of 13 of these have been granted to locally owned and incorporated entities, seven to locally incorporated but foreign owned entities, and 19 to branches of foreign incorporated banks. In addition to banks, there are 11 licensed mortgage and finance companies under the direct supervision of the ECCB. There are also a large number of nonbank financial institutions, mainly credit unions and insurance intermediaries operating in the ECCU region. These and other entities constitute part of the financial system and fall outside of the ECCB's regulatory framework, and are largely unsupervised.

82. Domestic banks, including the branches of foreign banks, can operate on a full service basis but are mainly involved in taking deposits and making loans to local residents. In doing this, they compete with some nonbank financial institutions, in particular the credit unions.

83. Banks are currently very liquid as there is a shortage of good quality lending opportunities. As a result, they enjoy a plentiful supply of deposits; national and other indigenous banks can have large deposits from State and local government entities, including from national insurance funds. However, banks carry the risk that confidence could change, causing unexpected withdrawals of deposits and a systemic problem which ECCB does not have the means to contain on its own. The risk would be especially prevalent if a deteriorating economic climate forced State entities to withdraw some of their large deposits to meet other commitments creating a liquidity crunch, and possible runs in banks across the ECCU. The ECCB does not have a well-defined contingency plan for managing banking crises.

84. At end-2002, ECCB's total banking assets amounted to EC$12,256 Million. The financial services sector is mainly concentrated in 11 banks, both indigenous and foreign. Combined, these banks account for more that 52 percent of the total banking assets. The majority of the banks in the ECCU conduct retail and corporate banking with resident customers only. In many of the banks the largest asset is the credit portfolio which is mainly comprised of consumer/personal (includes real estate), public administration, and trade loans. Loan pricing for both retail (real estate mortgages) and corporate customers, is very competitive. On average, loan interest rates range from 9 percent to 13 percent.

85. There are no deposit insurance arrangements. ECCB provides facilities for intraday liquidity support to commercial banks using its Globus Real Time Platform. There is no formal interbank market but occasionally banks lend to each other. This interbank market is fragmented with no lending between indigenous and foreign banks.

[12] Anguilla and Montserrat are overseas territories of the United Kingdom.

General preconditions for effective banking supervision

86. ECCB's functions and responsibilities are set out in the Eastern Caribbean Central Bank Agreement Act 1983 (which is currently being amended). A uniform banking law, adopted at national level throughout the region, provides for the regulating of banking business and includes a role for the ECCB in the supervision of domestic banks. The banking law is also in the process of being significantly amended and adopted at national levels. From a regulatory perspective this is an important piece of legislation as it will extend ECCB's powers and cover a number of the areas identified for action in the BCP assessment.

87. ECCB has an agent in each of the ECCU member countries but they play no regulatory or supervisory role in relation to domestic banks. The international financial services authorities in each country visited are responsible for the supervision for the offshore sector, but not the domestic banking sector. National authorities are responsible for AML/CFT implementation, although ECCB conducts anti-money laundering reviews of compliance as part of its prudential oversight function. 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. Such supervision by national integrated regulators would include both on-shore and off-shore activities.

88. In recognition of individual country positions, a number of key regulatory and supervisory decisions are taken by the relevant Ministers of Finance, after recommendations received from or consultation with ECCB. This arrangement has an adverse bearing on the assessment of the Basel Core Principles and ECCB's regulatory independence. However, it is also recognized that ECCB has a unique role in exercising regulation and supervision across multiple national boundaries.

Main findings

89. Overall, ECCB's level of compliance with Basel Core Principles for Effective Banking Supervision is fair and in need of strengthening in the areas noted below.

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

90. The existing ECCB Banking Act ("ECCB Act") should be strengthened to provide for a more effective system of bank supervision, including enhanced autonomy for the ECCB. A number of regulatory functions, including those powers relating to authorization and enforcement of domestic banking establishments, are exercisable by the relevant Minister of Finance ("the Minister") acting on the recommendation of, or after consultation with, the ECCB. This situation has contributed to a still unresolved case where a Minister granted a banking license seven years ago without consulting the ECCB. That "bank" is still operating and is unsupervised. The ECCB Act is being revised ("the draft new ECCB Act") with changes to strengthen the regulatory and supervisory authority of ECCB. However, a very important element of independence is still missing from many regulatory decisions because of the continued involvement of the Minister. Currently ECCB does not have the power to

share prudential information with national regulators or foreign authorities. The Monetary Council of the ECCB is the highest governing body and is composed of Ministerial representatives of ECCU member states.

Licensing and Structure (CPs 2–5)

91. The permissible activities of institutions that are licensed are clearly defined in the uniform Banking Act. However, as mentioned above, the significant political involvement with licensing—albeit on the recommendation or after consultation with ECCB—is at variance with the Basel principles. The issue also applies to revocation of licenses which requires Ministerial involvement.

92. In addressing the licensing process, Section 5(2)(d) of the draft new uniform Banking Act proposes an explicit requirement for ECCB to include in its investigation of an applicant before making a recommendation to the Minister. This would also include an assessment of whether the significant shareholders, and the directors and management are fit and proper in accordance with specified criteria (Section 27). The draft new uniform Banking Act should be further enhanced to grant the ECCB authority relating to the issue and revocation of domestic banking licenses, as well as enhanced enforcement powers.

Prudential Regulations and Requirements (CPs 6–15)

93. At present, ECCB applies on a non-statutory basis the Basel Capital Accord with a minimum ratio set for all banks of 8 percent. However, this minimum capital ratio should be increased to reflect the perceived risk presented by individual institutions. Under Section 15(2) of the draft new uniform Banking Act, a bank which fails to meet its capital ratio must present a plan to ECCB to comply within six months. It is recommended that this period be shortened—shareholders should be asked to inject new capital as soon as possible. Additionally, ECCB should apply non-zero weights to government/public sector obligations in arrears to adequately reflect the level of risk and degree of uncollectability given the weak economic performance in the region and the level of government obligations in arrears.

94. Another factor directly impacting the adequacy of capital is the high levels of nonperforming loans reported by banks. The majority of banks exceed the 10 percent NPL threshold set by ECCB, and in at least one case the ratio is 69 percent of total loans. ECCB requires banks to review (at least 70 percent of) their portfolios annually on this basis and classify loans in arrears according to specific criteria. ECCB also sets down minimum provisioning requirements. However, concerns over the extent to which (real estate) security can be realized casts doubt on the adequacy of many provisions and the level of reported capital. Of equal importance, exposure to government and/or public sector is significant in some indigenous banks and under the ECCB guidelines, currently nonperforming Government obligations are classified but do not attract a provisioning charge. Three of the banks visited by the mission indicated that they were accruing interest on nonperforming

public sector debt.[13] ECCB's requirements for loan classification and provisioning are used by external auditors as the principal benchmark for their assessment of provisioning adequacy.

95. Two indigenous banks whom the Mission encountered under pressure from ECCB to reduce the level of nonperforming loans established arrangements to remove nonperforming loans from their balance sheets by recording them into special purpose vehicles; however, these arrangements do not provide prudential comfort because the risk typically remains with the bank concerned through intra-group funding.

96. There is no formal requirement for banks to have policies and procedures for market risks. Although some banks have forwarded to the ECCB copies of their policies and procedures, the ECCB had not as yet evaluated their adequacy and suitability. During the Mission, ECCB management presented to the BCP assessors preliminary drafts of risk management guidelines that ECCB is currently developing to address this issue.

97. Banks are exposed to liquidity and interest-rate risk (maturity mismatches), and market risk in the holding of securities. Although ECCB receives a quarterly maturity analysis reports, ECCB has not defined specific guidelines for market, liquidity, and interest-rate risks. In addition, ECCB has not set formal limits or guidance for controlling foreign exchange exposure.

98. The ECCB has begun to integrate AML supervision within its broader prudential oversight function, particularly onsite inspections. In March 1995, it issued basic anti-money laundering guidance notes as part of a wider AML initiative by the Caribbean Group of Banking Supervisors to strengthen AML controls in the domestic banking sector. These guidelines did not have a legal basis and were generally not enforced. Since then, all of the ECCB member jurisdictions, except for St. Lucia, have enacted their own AML guidelines that supersede the ECCB Guidance Notes. The ECCB recently conducted targeted AML examinations of most of the banks.

99. Changes to legislation must also be made to allow ECCB to share information on AML with other regulators within and outside the ECCB area. Banks must also be required to report to the ECCB and AML supervisory authority cases of suspicious activity. By increasing the depth and scope of onsite visits and by incorporating the visits within the prudential supervisory cycle, ECCB will strengthen its capacity and ability to enforce compliance. ECCB will also need to provide ongoing training to its supervision staff. Terrorist financing elements have not yet been specifically incorporated in the examination procedures.

[13] Since the FSAP mission, the ECCB has indicated that only one of the banks now has loan arrears from the public sector and that another has reduced the overdraft exposure below the approved limit.

Methods of Ongoing Supervision (CPs16–20)

100. ECCB does not have in place a coherent and formal risk-based supervisory approach for planning and executing on-site inspections based on the risk profile of the institution and the requirements of the approved supervisory strategy. At least two banks had not received a full-scope on-site inspection by the ECCB in the last five to seven years, and other banks in the last two to three years. In addition, ECCB does not have the authority to monitor the quality of work done by external auditors for supervisory purposes. Currently, there are no requirements for external auditors to check the accuracy of prudential returns. Because on-site inspections are conducted infrequently, ECCB does not carry out regular annual prudential meetings with bank management and boards of directors to discuss the results of the supervisory examinations nor does it conduct periodic discussions with the external auditors relating to bank operations. However, ECCB management stated that during the third quarter of 2002, ECCB initiated a program of meetings with auditors and that a number of contacts have taken place since then.

101. At present ECCB conducts supervision of banks within the system on a solo basis and there are no formal measures in place to exercise consolidated supervision, or formally liaise with regulators of other domestic financial services businesses in the way that consolidated supervision would require. At least in one jurisdiction, it is not involved in the supervision of offshore banks licensed in the ECCU that are affiliates of domestic banks.

Formal Powers of Supervisors (CP 21–22)

102. Presently, ECCB enforces remedial action through Letters of Commitment (LOC) sought from banks and Memoranda of Understanding (MOU) signed with them. The Banking Supervision Manual contains specific guidance on grading the supervisory response according to the importance corrective action required. However, ECCB has yet to fully enforce its authority, backed by legal sanctions, to take an appropriate range of remedial action against, and impose penalties upon, banks, depending on the severity of the situation. ECCB does not perform periodic and timely follow-up on the results of onsite examinations and compliance by banks with obligations under the LOCs and MOUs. Some banks complained about the lack of feedback/response received from ECCB on policy manuals sent to ECCB for review. These banks are working under the premise that “no response from ECCB” translates into an adequate policy manual.

Cross-Border Banking (CPs 23–25)

103. ECCB has very limited contact with overseas parent regulators of branches and subsidiaries of foreign banks operating in the ECCU. Under Sections 16(2), 31(1), and 35(5) of the Uniform Banking Act, ECCB is not permitted to share information with other supervisory bodies. The draft new uniform Banking Act should be further amended to ensure it gives ECCB the powers to extend its channels of communication and exchange of information with other supervisory bodies and/or competent authorities on all types of supervisory issues.

Appendix Table 1. Recommended Action Plan: ECCB

Reference Principle	Recommended Action
Objectives, autonomy, powers, and resources (CP-1)	Further amend draft new uniform banking Act to enhance the autonomy and powers of ECCB to enable it to more effectively exercise its regulatory functions. Also, ECCB should accelerate the process for entering into memoranda of understanding with other domestic and foreign supervisory agencies to begin the process of carrying out effective consolidated supervision, including of offshore bank affiliates.
Capital Adequacy (CP 6)	Adopt and implement a risk-based approach to setting minimum capital ratios for banks. These ratios should take into account all risks within the institution and validated in the course of on-site inspections. Adopt and implement a non-zero risk weight approach for government/public sector obligations to effectively reflect the level of risk inherent on government obligations.
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 government/public sector obligations in arrears to ensure that diminution of value is fully recognized. Specifically, government obligations in arrears should reflect the degree of uncollectability, default, and level of risk as is the case for private sector debt. Also, ECCB's Supervision Department should conduct more frequent and timely on-site inspections to ensure that assets are properly classified and provisions adequately maintained to cover the risk of loss inherent in loan portfolios and other assets.
Country risk (CP 11)	Issue guidance for banks on monitoring and setting limits for country risk, including lending outside the ECCU region and implementing a reporting regime. ECCB's guidance should also address the banks risk management practices.
Market risks (CP 12)/Other risks (CP 13)	Issue requirements/guidelines for banks on risk management policies and procedures, and adopt appropriate supervisory limits for market risk, liquidity risk management, interest rate risk, and foreign exchange risk. Once the framework and guidelines are established, the ECCB should provide adequate training to the supervision staff in order to strengthen their skills and expertise in assessing the impact of these risks on banks and the inter-relationship with the CAMEL components within the risk-based supervisory approach.
Internal controls (CP 15)	Adopt, as proposed, legal provisions enabling the sharing of information and include the countering of terrorist financing. Conduct consolidated supervision to include on-site examinations of bank affiliates and their AML compliance on a group-wide basis. Provide staff with additional training in anti-money laundering (and counter-terrorist financing) issues.
On-site and off-site supervision (CP 16)	Strengthen the frequency of on-site inspections. ECCB should also develop a mechanism for including the results of off-site review and surveillance into the risk profile, supervisory strategy and on-site inspection planning and execution of the visit.

Reference Principle	Recommended Action
Validation of supervisory information (CP 19)	Develop a more comprehensive supervisory plan that includes more frequent and timely on-site inspections and off-site prudential meetings, as well as frequent meetings with senior management to discuss safety and soundness and other supervisory issues. ECCB should also formalize the program for maintaining on-going communication with external auditors as part of its supervisory plan.
Consolidated supervision (CP 20)	Implement, as soon as possible, prudential standards to evaluate capital adequacy that effectively adheres to the risk-based capital standards set out by Basel on the assessment of the overall risk position of a financial/banking group. This should also include the collection of relevant data in order to perform adequate consolidated supervision.
Remedial measures (CP 22)	Strengthen the enforcement process, re-focus resources, and make greater use of existing powers in this area including those proposed in the new draft uniform Banking Act. Also, introduce in the law and implement the application of administrative fines/penalties for noncompliance with prudential guidelines, requirements, and safety and soundness concerns.
Supervision over foreign bank's establishments (CP 25)	Identify and establish formal and informal arrangements with the home supervisors of local subsidiaries and branches of foreign banking institutions to determine the condition of the banking institution on a global basis. Also, the ECCB must establish a process for assessing whether the home country supervisor practices consolidated global supervision and the adequacy of its supervisory function.

Authorities' response

104. In response to the BCP assessment for the domestic banking sector, the ECCB and the national authorities have taken a number of measures to strengthen the supervisory regime in the ECCU. The principal measures that have been taken include:

- Drafted a new domestic Banking Act that will address a number of the recommendations made in this report. Some ECCU governments have already commenced parliamentary procedures for its enactment.

- Regulations and guidelines have been drafted, including for risk-based capital, corporate governance, and loan valuation and provisioning. The draft regulations do not risk-weight ECCU government obligations and do not require provisions for nonperforming government debt as was recommended. Guidelines for *Reporting of Suspicious Activity and Incidents of Fraud for Institutions licensed under the Banking Act* have already been disseminated to the commercial banks and licensed nonbank financial institutions.

- ECCB has begun to strengthen its Bank Supervision Department by restructuring it into six functional units. It has formed a Compliance and Internal Review unit charged with supervisory follow up and enforcement, and has increased the number of supervisory staff positions. ECCB is also enhancing its program of prudential visits and dialogue with the commercial banks and other licensed institutions.

- A revised *Contingency Plan for Weak Banks* has been approved by the ECCB's Board. The plan includes a coordination mechanism for dealing with banking crises and a Financial Sector Crisis Management Committee which has been formed.

- A three-member panel has been appointed to review and recommend terms for the bank's resolution of the Capital Bank issue in Grenada.