

**IMMEDIATE
ATTENTION**

SM/08/258

July 30, 2008

To: Members of the Executive Board

From: The Secretary

Subject: **Aruba—Assessment of Financial Sector Supervision and Regulation**

Attached for the **information** of the Executive Directors is a paper on the assessment of financial sector supervision and regulation for Aruba. Management has consented to a request from the authorities of Aruba to publish the assessment and it will be posted on the Fund's external website after **Wednesday, August 6, 2008**.

Questions may be referred to Mr. Johnston, MCM (ext. 38980).

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

ARUBA

Assessment of Financial Sector Supervision and Regulation

Prepared by the Monetary and Capital Markets Department

Approved by Jaime Caruana

July 24, 2008

This AFSSR is based on the work of an IMF Offshore Financial Sector assessment mission that visited Aruba May 8–21, 2008. The assessment is based on detailed self assessments and background information prepared by the Central Bank of Aruba (CBA), reviews of laws, regulations and working documents, and discussions with the authorities and financial sector representatives in Aruba. The OFC mission comprised Mr. R. Barry Johnston (Head), Ms. Gabriella Ferencz (World Bank) and Ms. Socorro Heysen (Consultant).

The main findings of the OFC assessment are:

- The authorities have, or are in the process, of implementing most of the recommendations of the 2002 OFC assessment. The BCP assessment found notable improvement in compliance compared to the 2002 assessment.
- The CBA will need to upgrade its supervisory capacity in view of its expanding supervisory mandate. Reporting and information systems for offsite monitoring and early warning should be enhanced and onsite supervision should be risk focused.
- The prudential risks associated with the planned deregulation of the financial system from the elimination of credit ceilings will need to be managed. Risk assessment and management systems should be upgraded prior to liberalization.
- The two offshore banks operating in Aruba have many of the characteristics of shell banks, have not been subject to onsite inspection, and pose reputation and financial risk to Aruba. The offshore banks should be subject to the same supervisory review as onshore banks. The CBA should follow up the planned onsite inspections with the management of the banks to understand the risks that the banks pose to Aruba. License revocation should be considered if the inspection and discussions do not yield satisfactory responses.

The main authors of this report are Mr. Johnston and Ms. Heysen

The AFSSR is a summary report on implementation of the indicated financial sector regulatory standards. It has been developed to help jurisdictions identify and remedy weaknesses in financial sector supervision and regulation. The reviews do not directly assess risks such as those associated with asset quality, markets, or fraud that could affect the soundness of financial systems or individual institutions.

TABLE OF CONTENTS

Contents	Page
Executive Summary	4
I. Introduction and Overview	6
II. Bank Regulation and Supervision	11
III. Insurance Regulation and Supervision.....	15
 Tables	
1. Main Recommendations	5
2. Financial Sector Structure.....	6
3. Prudential Indicators of Banking Institutions	7
4. Banking System Growth	12
5. Insurance Sector.....	16
7. Recommended Action Plan to Improve Compliance with the Basel Core	29
8. Summary of Main Findings on the Observance of Insurance Core Principles.....	33
 Appendices	
I. Status Report on the Implementation of the 2002 OFC Assessment	18
II. Report on Observance of Standards and Codes Assessment of compliance with the Basel Core Principles for Effective Banking Supervision	23
III. Factual Update of Insurance Regulation and Supervision	31

ACRONYMS

AML/CFT	Anti-money laundering & combating the financing of terrorism
APFA	Civil Servants Pension Fund
BCP	Basel Core Principles for Effective Banking Supervision
BNA	Bank of the Netherlands Antilles
CBO	Central Bank Ordinance
CBA	Central Bank of Aruba
CP	Core Principle
CSP	Company Service Providers
FATF	Financial Action Task Force
FIU	Financial Intelligence Unit
IAIS	International Association of Insurance Supervisors
ICP	Insurance Core Principles
IMF	International Monetary Fund
MOU	Memorandum of Understanding
OFC	Offshore Financial Center
RCUT	Reporting Center for Unusual Transactions
ROSC	Report on Observance of Standards and Codes
SOC PF	State Ordinance on Company Pension Funds
SOIRFS	State Ordinance on the Identification for Rendering Financial Services
SORUT	State Ordinance on the Reporting of Unusual Transactions
SOSCS	State Ordinance on the Supervision of the Credit System
SOSIB	State Ordinance on the Supervision of the Insurance Business
SOSMTC	State Ordinance on the Supervision of Money Transfer Companies
SOSTC	State Ordinance on the Supervision of Trust Companies

EXECUTIVE SUMMARY

Aruba's financial sector is primarily domestically orientated, with limited offshore financial sector activity. The financial sector is generally well capitalized and profitable.

Financial sector supervision is compliance based and has been carried out in a manner largely appropriate for the size and sophistication of the industry. The authorities have, or are in the process, of implementing most of the recommendations of the 2002 OFC assessment. The BCP assessment found notable improvement in compliance compared to the 2002 assessment. The factual update on insurance supervision observed that several recommendations of the 2002 OFC assessment have been implemented and others would be implemented after the revised State Ordinance on Insurance Supervision (SOSIB) is issued.

Notwithstanding the improvements in supervision, the CBA is confronting a number of challenges related to (i) supervisory capacity; (ii) deregulation; and (iii) shell banks.

Supervisory capacity: The CBA has an extensive and expanding supervisory mandate covering all private financial institutions. In order to conduct effective oversight, the CBA will need to upgrade its supervisory capacity. It will need to enhance its reporting and information systems for offsite monitoring and early warning; onsite supervision should be risk focused. The legal amendments that would grant the supervisor powers to impose fines and administrative penalties and improve disclosure should be enacted. Basel II and Solvency II standards should be implemented gradually consistent with the CBA's expanding supervisory capacity.

Deregulation: The CBA is planning to eliminate credit ceilings by end-2008. Experience suggests that such deregulation will pose prudential risks as banks compete for new business and expand their balance sheets. In preparation, the banks and the CBA should upgrade their risk assessment and management systems:

(i) the CBA should have in place an effective offsite early warning system to identify emerging risks and allow for early remedial action;

(ii) the market information systems needed for risk assessment will need to be developed, including the credit risk bureau; and

(iii) the CBA should engage with the banks to understand their strategies and thus be in a position to assess the overall risks to the financial sector, including through stress testing; and

Shell banks: The two offshore banks operating in Aruba have many of the characteristics of shell banks, and have not been subject to onsite inspection. The shell banks pose reputation and financial risk to Aruba and are generally not appropriate for jurisdictions. The offshore banks should be subject to the same supervisory review as onshore banks, and the planned onsite

inspection by external auditors using CBA supervisory guidance is overdue and welcome. The CBA should also follow up with the management of the banks on their strategies and business plans to understand the risks that the banks pose to Aruba. As with any bank, license revocation should be considered if the inspection and discussions do not yield satisfactory responses.

Table 1. Aruba: Main Recommendations

General

- Strengthen supervisory capacity by hiring additional staff and upgrading the content and timeliness of reports of banks and insurance to the CBA;
- Approve the proposed drafts for the SOSCS and SOSIB, including authority to impose a broader range of corrective actions;
- Improve off site monitoring and develop early warning systems (including through stress-testing);
- Implement risk based on-site supervision;
- Improve disclosure and access to timely market information by banks and insurance companies, including a credit registry with information of credit granted by all financial intermediaries.

Banking

- Implement the planned onsite examination of the offshore banks by external auditors and discuss with management the banks' strategy to better understand the risks they pose to Aruba.
- Manage the potential risks of deregulation. Prior to deregulation the banks and the CBA should:
 - have upgraded their risk assessment and management systems; and
 - understand their strategies for the new environment and the impact of deregulation.
- Develop supervisory systems for interest rate and market risks.

Insurance

- Include market conduct provisions for insurers and intermediaries.

I. INTRODUCTION AND OVERVIEW

A. Introduction and background

1. Aruba, which is part of the Kingdom of the Netherlands, is a small, open Caribbean island with nearly 96,000 inhabitants. The economy is highly dependent on tourism, which generates 43 percent of GDP in export revenues. Strong legal institutions, good governance and openness have brought the country stability and rapid development, and Aruba's per capita GDP (\$21,200) is now one of the highest in the region. However, the heavy dependence on tourism also renders the economy vulnerable to external shocks.

2. Aruba's financial system comprises four domestic and two offshore banks, five specialized lending institutions and credit unions, 25 insurance companies, ten company pension funds, a large civil servants pension fund that is being privatized, and four money transfer companies (see Table 2).¹ Three of the four domestic banks are subsidiaries and one a branch of Netherlands Antillean banks.

Table 2. Aruba: Financial Sector Structure

	Number of institu- tions	2006			
		Total Assets		Capital and Reserves (1)	
		Mill.US\$	Percent	Mill.US\$	Percent
Commercial banks	4	1972	50.2	208	39.6
Offshore banks	2	291	7.4	103	19.7
Bank like institutions	3	336	8.5	118	22.4
Credit unions	2	...	...	...	...
Life-Insurance companies	8	275	7.0	37	7.1
Non-Life Insurance Companies	13	105	2.7	37	7.1
Captive insurance companies	4	...	...	...	...
Company Pension Funds	10	131	3.3	21	4.0
Civil Servants Pension Fund (APFA)	1	819	20.8	-52	n.a.
Total	47	3929	100.0	524	100.0

Source: Central Bank of Aruba

1/ Includes general (unallocated) reserves.

3. Offshore financial sector activity is limited. It comprises two banks, one a branch and the other a subsidiary of Citibank. These banks are in the process of merging, with Citibank running

¹ The Civil Servants Pension Fund (APFA) will fall under the CBA supervision once the State Ordinance on the Privatization of the Civil Servants Pension Fund has been fully implemented. Until then, APFA will remain under the supervision of the Ministry of Finance and Economic Affairs.

down and transferring the operations of the branch to the subsidiary. The branch and the subsidiary are managed out of Citibank's office in Venezuela, and neither has a physical presence in Aruba. The other main offshore activity comprises four captive insurance companies, and non-financial corporate vehicles. The latter sector has shrunk considerably in size (since 2001, two thirds have cancelled their registration).

4. Financial sector indicators show a well-capitalized and profitable banking system (Table 3). The specialized lending institutions are also well capitalized and profitable, and the average coverage ratios in the insurance sector and company pension funds appear adequate. However, there is a shortfall in capital in the civil servants pension fund. The shortfall has been declining and, at end-2006, it was 6 percent of technical provisions.

Table 3. Aruba: Prudential Indicators of Banking Institutions

	2005	2006	2007
Commercial Banks			
Capital adequacy			
Risk weighted capital asset ratio	11.5	13.5	13.1
Asset quality			
Nonperforming loans to gross loans	6.7	6.3	6.5
Non performing loss net of loan loss provisions to paid in capital plus retained earnings	3.8	-0.2	4.8
Earnings and profitability			
Return on assets (after taxes)	2.1	2.4	2.8
Return on equity (after taxes)	28.6	32.1	35.0
Net interest margin to gross income	65.0	66.4	62.1
Liquidity			
Loans to deposits ratio	76.4	75.1	74.9
Offshore Banks			
Risk weighted capital asset ratio	50.4	60.4	24.8
Bank-like institutions			
Capital adequacy			
Risk weighted capital asset ratio	45.0	46.3	46.0
Asset Quality			
Nonperforming loans to gross loans	6.7	6.0	4.9
Non performing loss net of loan loss provisions to paid in capital plus retained earnings	5.9	3.7	1.6

Source: Central Bank of Aruba

5. Aruba is in the process of liberalizing direct controls on bank credit expansion and moving towards a system of indirect monetary controls. The CBA has relied mainly on credit ceilings to control the growth in bank credit. It is planning to phase out the credit ceiling by end-2008, and to adjust non-interest bearing reserve requirements and issue certificates of deposit to manage liquidity.

B. Key findings and recommendations of the 2002 OFC assessment

6. **The principal findings of the 2002 assessment were:**

- **Banking supervision:** The system for banking supervision and regulation in Aruba was found to be compliant or largely compliant with 19 of the Basel Core Principles (BCP). It was materially non-compliant or non-compliant with four of the Principles, relating to credit policies, loan evaluation and loan-loss provisioning, other risks (interest rate risk), and on- and off-site supervision. Specific recommendations were to: (i) strengthen the oversight of banks' risk management by requiring more frequent asset quality reports from banks, and increasing the number of well focused on site credit risk reviews in order to decrease the reliance on the annual audit results of the external auditor; (ii) reinforce guidelines for banks credit policies, and refraining from getting involved in decisions on large loan exposures; (iii) strengthen enforcement of limits on connected lending; and (iv) develop guidelines and policies on banks management of interest rate risk.
- **Insurance supervision:** At the time of the 2002 assessment, the law on regulation and supervision of the insurance sector had only just been adopted, and many measures still needed to be put in place. Recommendations included the need to: (i) provide adequate staffing of the insurance supervision function of the CBA; (ii) enhance the authority of the supervisor to exchange information, and prescribe the "approved assets" that can be taken into account for the calculation of solvency; and (iii) to extend supervision of market conduct to insurance advisors and improve the quality of advice through the use of codes of conduct.
- **Anti-money laundering and combating terrorist financing (AML/CFT):** Aruba had improved its rules and systems, and was cooperating effectively with other jurisdictions on AML. Recommendations included: (i) strengthening the law on company service providers (CSP) by adding explicit fit and proper criteria, identifying and vetting indirect shareholders, prohibiting the issuance of bearer shares by companies formed or managed by the CSP, giving the CSP regulator the power to impose administrative penalties, and limiting the discretion of the regulator to exempt particular CSPs from the full requirements of the law; (ii) enhancing the resources of the Reporting Center for Unusual transactions (RCUT), charged with receiving and analyzing unusual transaction reports, to reflect the expanding scope of its work; (iii) strengthening AML laws in areas such as criminalizing the laundering of all assets, expanding the use of administrative penalties, and authorizing the RCUT to exchange information with other financial intelligence units

without the need for a treaty; and (iv) extending the know your customer rules to cover non-life insurers and insurance intermediaries, notaries, lawyers and accountants.²

7. Appendix I describes the progress with implementing the 2002 recommendations. Most of the recommendations either have been implemented or are in the process of implementation.

C. Key findings and recommendations of the 2008 OFC assessment update

8. The OFC assessment update focused on the banking and insurance, conducting an assessment against the revised (2006) BCP and a factual update of the ICP assessment. The main findings of the assessment are as follows.

Observance of Standards and Codes

9. **The assessment found a high level of compliance with the BCP and a notable improvement with respect to the 2002 assessment.** Aruba is compliant or largely compliant with 26 principles; materially non compliant with two principles (risk management process and interest rate risk) and non compliant with one principle (market risk). The factual update of the ICP found that Aruba has implemented several recommendations of the 2002 OFC.

Supervisory capacity of the CBA

10. ***The review of the BCP and ICP find that supervisory capacity needs to be strengthened.*** The CBA has an extensive and expanding supervisory mandate, covering banks, near banks, insurance, pensions and trust and company service providers. The supervisory challenges will also become more complex with the planned deregulation (see below) and implementation of Basel II and Solvency II. The mission recommends that these latter frameworks be implemented only gradually.

11. ***The CBA will need to upgrade its supervisory capacity.*** Priority should be given to fuller compliance with the core principles, and advancing risk based supervision. There is a need to pass the proposed amendments to the law that would grant the supervisor the powers to impose fines and administrative penalties. CBA should enhance its reporting and information systems for offsite monitoring and early warning. Onsite supervision should be risk based. Implementation would require new data reporting and analysis systems, training of supervisors in risk assessment and on-site inspection techniques, and an increase in staff resources. Implementation should be supported with technical assistance.

² AML/CFT issues will be covered by an upcoming FATF evaluation of Aruba scheduled for November 2008, and are not discussed further in this report. An AML/CFT ROSC resulting from the FATF assessment would in due course be issued to the IMF Executive Board.

Managing risks in a deregulated financial system

12. ***The elimination of credit ceilings, planned for end-2008, poses prudential risks that will need to be managed.*** Aruba has operated for a number of years under a regime of credit ceilings. Banking competition has been limited, and interest margins are high. In many countries, elimination of credit ceilings has been associated with intensification in bank competition and an initial rapid expansion in bank credit that is difficult to control with indirect monetary instruments. In many countries, the rapid credit expansion has been associated with declining credit standards.

13. ***Management of the post liberalization risks would involve a number of factors:***

- The banks and the supervisor should have upgraded their risk assessment and management systems prior to the liberalization;
- Information systems and disclosures needed for risk assessment will need to be developed, including the proposed credit registry;
- The supervisor should engage with the banks to understand their likely strategies in a deregulated environment, and hence be in a position to assess the overall risks of the liberalization, including through stress testing;
- The supervisor should have an effective off site early warning system that would identify emerging risks, as well as the powers for early remedial action;
- The supervisory review should extend to the near banks, as their profitability and risk exposures may be adversely affected by the increased competition from the banks.

Shell banks

14. ***The two offshore banks operating in Aruba have many of the characteristics of shell banks and pose a potential reputation and financial risk.*** To date the CBA has not exercised on-site supervision of these banks. Comfort has been taken that the banks are a branch and subsidiary of Citibank, and subject to U.S. consolidated supervision. The CBA's plans to use external auditors to conduct an on-site examination based on CBA supervisory guidance are welcome. There is a need, in particular, to address market, liquidity and integrity risks in the offshore banks.

15. ***Notwithstanding the planned inspection, shell banking is generally not appropriate for any jurisdiction.*** The CBA should follow up with the management of the banks to understand the strategic reasons for locating the banks in Aruba, their business plans and the potential risks that the business poses to Aruba. The offshore banks should be subject to the same supervisory review as onshore banks. As with any bank, license revocation should be considered if the onsite inspection and discussions with management do not yield satisfactory responses.

D. Outline

16. The rest of the report is outlined as follows: Section II reviews the main findings and recommendations from the assessment of banking; Section III reviews the main findings and recommendations from the assessment of insurance. Appendices describe the progress with implementing the recommendations of the 2002 assessment; provide the BCP ROSC; a factual update of the ICP; and a detailed assessment of the BCP.

II. BANK REGULATION AND SUPERVISION

A. Overview

17. The commercial banks are mainly engaged in domestic lending. The products and services of the commercial banks are mainly in the traditional retail sector, with interest on domestic credit the predominant source of income. Lending by banks in Aruba is largely concentrated in secured personal loans, real estate mortgages, and some commercial lending for small local businesses, which are largely secured. Loan agreements are written so that interest rates are fixed until further notice by the banks, providing them with flexibility in the event of adverse interest rate movements. Historically, however, as rates have been relatively stable, this flexibility is yet to be tested. The assets of the commercial banks are mainly funded via resident deposits. Only a small percentage of the total deposits are non-resident, foreign currency.

18. All four commercial banks operating in Aruba are also supervised on a consolidated basis by the Bank of the Netherlands Antilles (BNA). Of the four commercial banks, one is a branch of a commercial bank domiciled in Curaçao, Netherlands Antilles, while the other three banking institutions are subsidiaries of banks established in Curaçao, Netherlands Antilles. Two of the Curaçao incorporated parent banks are, themselves, owned or in the process of being acquired by internationally active Canadian banks. The other two parents are owned by private interests. The CBA has a good relationship with the BNA and their cooperation and information exchange is supported by a Memorandum of Understanding (MOU).

19. Financial soundness indicators are satisfactory (see Table 3). Risk weighted capital ratios are 13 percent and nonperforming loans net of provisions about 5 percent of capital. Profitability is good reflecting high interest margins and the oligopolistic market structure. Liquidity appears ample. Large loan exposures are about 110 percent of capital.³ Interest rate and foreign exchange exposures are reportedly limited.

20. The main source of financial system risk stems from the one-sided structure of the Aruban economy, which is 80 percent reliant on tourism and services related to tourism. The banks are thus exposed to external shocks. The potential risks for commercial banks

³ Large loans are: loans or lines of credit larger than 15 percent of regulatory capital.

operating in a small and undiversified economy are quite high. Therefore, they must maintain sufficient reserves to absorb possible losses stemming from economic downturns. For that reason, CBA decided to increase the minimum risk-weighted capital assets ratio for banks from 10 to 12 percent, effective January 1, 2007.

21. Aruba's offshore banking sector is very small by international standards, with only two institutions registered. These banks are solely engaged in banking activities to non-residents. The two offshore banks are both affiliated with Citibank, N.A. The offshore banks essentially operate as shell banks, with no physical presence in Aruba, and are managed and operated by the Citibank office in Caracas, Venezuela. Given that the CBA has not exercised the same level of supervision as for domestic banks, with no on-site inspections to date, and limited communications between the Aruba and Venezuelan financial regulators, these banks pose potential risks to Aruba. The offshore banks' recent growth (assets and deposits increased 50 percent and 77 percent during 2007) also makes the need for strengthened supervisory oversight more pressing (see Table 4).

22. The size of bank-like financial institutions is small. This sub-sector consists of FCCA, AIB and Island Finance N.V. These institutions are engaged predominantly in mortgage lending to individuals, financing of social housing projects, long-term project financing and/or granting of personal loans for consumptive and home improvement purposes. Their loans represent nearly 20 percent of the housing loan market in Aruba, but their market share has fallen in recent years. These activities are financed largely through funds obtained from their parent company, other (local) financial institutions, and/or institutional investors. Bank-like institutions are not allowed to attract deposits from the public.

Table 4. Aruba: Banking System Growth

	Millions of US dollars			Annual growth rate	
	2005	2006	2007	2006	2007
<u>Banks</u>					
Assets	1872	1972	2084	5.4	5.7
Deposits	1601	1660	1745	3.7	5.1
Capital and reserves	184	208	226	12.9	8.7
<u>Offshore banks</u>					
Assets	320	291	437	-9.0	50.2
Deposits	225	170	301	-24.5	77.0
Capital and reserves	78	103	126	32.1	21.7
<u>Bank-like institutions</u>					
Assets	337	336	363	-0.5	8.3
Deposits	0	0	0	...	...
Capital and reserves	116	118	127	1.7	8.5

Source: Central Bank of Aruba

B. Bank regulation and supervision

23. Banking supervision in Aruba is carried out in a manner largely appropriate for the size and sophistication of the banking sector but it would benefit from moving to a more risk based approach. However, to date, the CBA has not conducted onsite reviews of the offshore banks.

24. The approach to supervision is currently largely compliance based. The CBA has a broad set of laws and regulations with which it carries out its mandate. It is proactive in addressing noncompliance with laws, regulations and financial reporting requirements.

25. The assessment found a high level of compliance with the BCP and a notable improvement with respect to the 2002 assessment. Aruba is compliant or largely compliant with 26 principles; materially non compliant with two principles (risk management process and interest rate risk) and non compliant with one principle (market risk). The principle on consolidated supervision was considered non applicable as Aruba's banks do not have foreign branches or subsidiaries. The BCP ROSC presented in Appendix II provides an in depth presentation of the assessment and recommendations.

26. Supervision would benefit from a number of refinements to law. In particular, there is a need to pass the proposed amendment to the law which would grant the supervisor powers to impose fines and administrative penalties on banks, management and board members for violations of laws, regulations and reporting requirements. The law should also allow for the CBA to impose the same measures if banks are operating in an unsafe and unsound manner. The law should be passed expeditiously.

27. Enhanced offsite monitoring would support the CBA's move toward a more risk based supervisory focus. Better quality off-site reports would enable supervisors to perform more meaningful financial analysis of banks' financial results. The supervisory approach to credit risk oversight is generally appropriate for the largely retail loan portfolios of commercial banks, but it would be enhanced by improved off site data on loan classification and borrower information. Better information on interest rate and market risks is also needed to ensure that these risks are adequately controlled by banks. The CBA needs to be more proactive in its supervision of interest rate risk and reporting needs to capture interest rate risk in banks to allow for a meaningful GAP analysis. The CBA should also develop its stress testing to help identify emerging risks in the financial system.⁴

28. The CBA needs to enhance its ability to conduct on-site assessments of banking risks and risk management, and it must work closely with banks so they incorporate risk management into

⁴ The authorities have conducted a "dry run" of a possible stress testing framework, and identified areas where additional data would strengthen the assessment of risks in the system.

their operations. On-site exams need to be more effective in obtaining and reviewing banks' strategies, policies and practices to manage risks; and on-site reports should provide an assessment of the adequacy of risk management and specific recommendations for improvement.

29. The CBA has required branches of foreign banks in Aruba, which are not part of an international banking group, to convert to subsidiaries of their parent banks. This move is expected to lead to better access to information on the Aruba operations of these banks, which will enable the CBA to exercise a more effective supervisory oversight. However, this change comes also with added responsibilities, as subsidiaries tend to require closer and broader oversight than branches. A more in depth assessment of corporate governance, solvency, liquidity and risk management of the newly created subsidiaries is likely to be required.⁵

30. The planned move to indirect monetary instruments will foster financial intermediation and a more efficient financial system, but creates new challenges for banks and supervisors. In a deregulated environment, financial deepening is achieved by allowing banks to freely determine the size of their balance sheets. Banks will tend to compete for market share and their margins are likely to narrow. Stronger risk management and supervisory risk assessment will be necessary. To this end, banks will need access to better and timely information at aggregate and individual levels: market data, data on competitors, and borrower databases. The implementation of the planned improvements on the credit bureau should be encouraged by the CBA. Supervisors will need to closely monitor market developments as well as the strategies and actions of individual institutions. Careful oversight will be required to prevent and control the higher risks of loosening credit standards that often come with fast growth.

31. The added responsibilities and risks mentioned, and the move toward a risk based approach to supervision, create pressures on the scarce supervisory resources. The newly created statistical department would free supervisors to dedicate more time to effective supervision. However, supervisory resources are thin, as the CBA Supervision Department has only 10 staff members supervising all banks, insurance companies, pension funds, money transfer companies and, in the near future, also APFA, company service providers and insurance intermediaries. The CBA may need to add a few supervisors. Training on risk management and technical assistance to ensure a smooth transition to a deregulated environment are also suggested.

32. Off-shore banks should be subject to the same level of supervision as the onshore banks and should provide periodic offsite reports to the CBA. The CBA should carry out the plan to hire external auditors to perform an examination of off-shore banks, including on market risks. It is also encouraged to meet with offshore banks management as soon as possible to better

⁵ Branches do not have a separate legal status and are thus integral parts of the foreign parent bank. For branches, their solvency is indistinguishable from that of the parent bank as a whole. So, while there is a general responsibility on the host authority to monitor the financial soundness of foreign branches, supervision of solvency is primarily a matter for the parent authority

understand their plans for their Aruban operations and their financial results. Should the offshore banks not comply with the CBA requirements, the CBA may want to consider closing them to avoid unnecessary risk.

33. The quality of disclosure and transparency of financial results of banks would be enhanced by disclosure of qualitative information regarding risk practices and strategies. In addition, access to banks' financial results, together with qualitative information, should be more accessible.

34. The mission recommends that careful consideration be given to the timing of adoption of Basel II. The authorities have stated their intention to adopt Basel II in 2010-2011, focusing on Pillars 2 and 3 initially. Given limited resources, the CBA's near term focus should be on implementing the recommendations in the assessment that will bring them to fuller compliance with the Core Principals. Countries in general need to be well advanced in risk based supervision before moving to a Basel II type framework. In addition, the commercial banks in Aruba need to upgrade their risk management systems. Implementing risk management is likely to take time and resources in the near term and would have greater benefit than adoption of a new capital regime.

III. INSURANCE REGULATION AND SUPERVISION

A. Overview

35. The insurance sector in Aruba is small and, with the exception of the captives, it is primarily geared toward the local market. In 2006, total assets of the life segment amounted to 11.3 percent of GDP, while total assets of the non-life segment amounted to 4.3 percent of GDP. Most life and non-life insurance companies are currently branches of foreign insurers and, those that are not part of international insurance groups, are in the process of being converted into subsidiaries, in response to the new licensing requirements issued by the CBA in August 2006. None of the companies incorporated in Aruba have foreign branches or subsidiaries. The industry is initiating a process of consolidation, and portfolios of two of the life insurance companies are being taken over by other existing companies. Net premiums in the non life segment have been stagnant over the past five years. The life insurance market expanded 6 percent on average over the past five years; albeit during 2006, net premiums fell by 12 percent.

36. The CBA supervises insurers incorporated in Aruba based on the State Ordinance on the Supervision of the Insurance Business (SOSIB). The SOSIB, effective since 2001, stipulates that life and non-life insurance business must be carried out by separate legal entities. However four companies, which were carrying out a life plus health insurance model at the time the SOSIB was issued, were grandfathered by law.

Table 5. Aruba: Insurance Sector

(Millions of US dollars)	2002	2003	2004	2005	2006
<u>Non Life</u>					
Number of companies			13	13	13
Total assets	77.8	96.7	89.9	90.3	105.2
Capital and reserves	31.3	37.7	29.5	30.8	37.0
Net premiums	31.6	33.6	34.4	31.1	32.1
Coverage ratio 1/	2.6	3.0	2.5	3.0	3.1
<u>Life</u>					
Number of companies			8	8	8
Total assets	203.8	224.7	222.8	252.2	275.0
Capital and reserves	32.5	34.0	28.0	33.4	37.4
Net premiums	26.4	28.1	34.1	39.6	34.7
Coverage ratio 1/	1.3	1.3	1.2	1.2	1.2
<u>Captives</u>					
Number of companies			3	4	4

1/ Weighted assets less borrowings to technical provisions.

Source: Central Bank of Aruba

37. Captive insurance companies are regulated by a 2002 State Decree (SDCIC) that establishes special licensing, reporting and solvency requirements for captives. Captives are required to maintain physical presence in Aruba and to comply with the CBA guidelines on administration and internal controls.

B. Main Findings

38. Insurance supervision is mostly compliance based, albeit the CBA plans to move toward a more risk-based approach. Off-site supervision is based mainly on annual audited financial statements and reports, submitted six months after year end, and quarterly reports on solvency and investments. On-site examinations focus on reviewing compliance with the respective laws and regulations and examining the adequacy of the technical provisions, the investment portfolio, the internal controls and the administrative organization, the AML/CFT procedures, and corporate governance. Given the size and low risks of the insurance sector, on-site supervision is generally carried out on a three year cycle.

39. A proposal for a revised SOSIB has been drafted by the CBA with the technical assistance of the Nederlandsche Bank N.V. and is expected to be submitted for approval by year end. The approval of the revised SOSIB, which includes many of the recommendations of the 2002 OFC, would provide an adequate framework for the implementation of a more risk-based approach to supervision. Some of the main proposed changes are:

- Enhance the powers of the CBA as a supervisor, by broadening the range of sanctions it can apply, including fines for several violations of SOSIB and removing managers and Board members that no longer meet fit and proper requirements;
- Regulate reinsurance companies and insurance brokers and entrust their supervision to the CBA;
- Mandate a risk based capital requirement for insurance companies (Solvency I);
- Explicitly give the CBA authority to issue guidelines on: prevention of money laundering and the financing of terrorism, trustworthiness and expertise of managers of insurance companies; and
- Require that insurance companies disclose their financial statements.

40. In addition to the above, the mission recommends that the revised SOSIB include the following amendments:

- Require insurance companies to submit and publish their annual audited financial statements four months after year end (instead of six months);
- Introduce market conduct requirements for insurance companies and intermediaries, including for instance a mandatory code of conduct.

41. The CBA needs to enhance its offsite monitoring of insurance companies. To this end, the CBA will require more comprehensive and timely supervisory and market information, and is also likely to need more supervisory resources. The CBA requires that insurance companies' balance sheets be certified by an actuary. However, it is suggested that the CBA conduct an independent assessment of insurance liabilities. The CBA states that the size of the market does not justify having an in house actuary and that actuary services are contracted whenever deemed necessary.

42. To foster better risk management, the CBA should ensure that insurance companies have access to better and more timely information of the insurance market. Presently only annual aggregate information is available and with a considerable lag.

43. The mission also recommends that CBA issue guidelines addressing: (i) underwriting and pricing policies and strategies to mitigate and diversify their risks; (ii) accounting standards; (iii) valuation of reinsurance risks; (iv) diversification of financial instruments held; and (v) the use of derivatives and the risk management systems required to control the risk of derivatives activities.

44. For a more detailed presentation of the findings and recommendations refer to Appendix III.

Appendix I: Status Report on the Implementation of the 2002 OFC Assessment

Recommendation	Action	Status	Remarks
1. GENERAL			
1.1. Review Staffing Supervision Department in view of additional tasks and strengthening of the supervision over the different sectors	Hire additional staff in view of new tasks and recommended strengthening of supervision	In progress	The number of staff in the Supervision Department has increased. Further expansion remains necessary to implement a risk based supervisory approach and expand the supervisory activities to other sectors.
1.2 Request legal advice on protection supervisory staff against possible tort action	Request advice from the Dutch Central Bank on this matter	Completed	In general, under the Dutch and Aruban law, it is the employer who is legally responsible for the work of its personnel. Only in cases of gross negligence the employee can be held liable. The employee on its turn cannot be held liable in general if he has acted in good faith.
1.3 Amendment of the State Ordinance on the Supervision of the Credit System (SOSCS)	Drafting of a proposal	In progress	In consultation with the Dutch central Bank the SOSCS is currently being revised. Final draft to be concluded before end 2008.
1.4 Amendment of the State Ordinance on the supervision of the Insurance business (SOSIB)	Drafting of a proposal	In progress	In consultation with the Dutch central Bank the SOSIB is currently being revised. Final draft to be concluded before end 2008.
2. BANKING			
2.1 require CBA's approval for appointment external auditor	A directive requiring CBA's approval for a change in external auditor has been issued by the CBA.	Largely implemented	To have a more solid legal basis for this directive a legislative change remains necessary. To be included in the amendments to SOSCS (refer to answer under point 1.3. above).
2.2 Require banks to publish their financial statements	A directive requiring CBA ordering the banks to publish their annual reports by filing them at the Chamber of Commerce.	In progress	There should be fuller disclosure of banks' financial position. In addition to publishing the financial statements at the Chamber of Commerce, they should be more widely accessible. In addition, qualitative issues should be addressed to understand banks' operations, strategies, and risk management processes. To be included in the amendments to SOSCS (refer to answer under point 1.3. above).
2.3 Introduce provision in the SOSCS allowing CBA to impose monetary	Drafting of a proposal	In progress	Included in the revisions to SOSCS.

Recommendation	Action	Status	Remarks
penalties against a non-complying bank			
2.4 Provide detailed guidelines for credit risk management: including guidelines for loan classification and provisioning	Issue guidelines	In progress.	Guidelines have been issued. However, banks and the CBA continue to rely heavily on number of days past due for problem loans. While this is generally appropriate for retail portfolios, the classification criteria needs to be applied more proactively to individual commercial credits.
2.5 Introduce periodic asset quality reports	Introduce subject reports	In progress.	Subject forms have been introduced but they need enhancements to allow the banks and the CBA to better assess the risk profile of banks.
2.6 Issue guidelines on interest rate risk	Issue guidelines	Largely implemented	While guidelines have been issued, the reporting forms for interest rate risk do not adequately capture the risk and need to be enhanced.
2.7 Increase the number of targeted on-site examinations and extend the scope of offsite surveillance	Increase the number of targeted on-site examinations. Review of asset quality on a quarterly basis	Largely implemented	The number of on-site inspections is around 20 per year. Off site review of asset quality is done on a quarterly basis. Reporting forms have been designed to this end.
2.8 Increase the number of targeted anti-money laundering examinations	The on-site planning has already been amended to increase the number of targeted AML/CFT on-site examinations	Largely implemented	
2.9 Increase cooperation/coordination with MOT (Financial Intelligence Unit)	Conduct regular meetings with MOT and enter into a formal MOU with the MOT	Completed	A MOU was signed with said institution. At least twice a year meetings are held with said institution. Cooperation would be enhanced if the CBA would be obligated to report suspicious transactions to the MOT directly.
2.10 Extend supervision to compliance with the reporting of unusual transactions insofar it concerns banks and insurance companies	During the targeted on-site examinations the CBA reviews of the internal organization and internal controls surrounding the unusual transaction	Largely implemented	The CBA sees to it during the targeted on-site examination in this area that the procedures and internal controls surrounding the MOT reporting are sufficient. MOT continues to conduct substantive testing. The current arrangements work well.

Recommendation	Action	Status	Remarks
	reporting. The MOT has been assigned by law to supervise compliance with the unusual transaction reporting system.		
2.11 Review possibilities to conclude MOU's with other relevant supervisory agencies in the USA	Submit letters to these agencies (FED/OCC) requesting them to enter into a formal MOU with us	In progress.	The authorities in the USA did not find it necessary to enter into a formal MOU in view of the smallness of the Aruban offshore operations of Citibank.
3. INSURANCE			
3.1 Suitability of Captive insurance managers should be taken into consideration as part of the licensing review process	Finalize State Decree Special Provisions Captives;	Completed	State Decree implemented. Suitability of Captive insurance managers included as part of the licensing review.
3.2 Regulate and implement the supervision of reinsurance companies. Include provisions for the use of reinsurance and retrocession arrangements, by insurers and reinsurers respectively.	Drafting of a proposal	In progress	Reinsurance business included in draft of revised SOSIB. Refer to answer under point 1.3 above.
3.3. Supervise all insurance intermediaries (insurance agents and brokers) and establish for their minimum qualification standards.	Drafting of a proposal	In progress	Insurance brokers included in draft of revised SOSIB.
3.4. Introduce a regulation on change of ownership	Introduce a State Decree	Completed	State Decree issued
3.5 Finalize state decree on local representatives	Introduce a State Decree	Completed	State Decree issued
3.6 Issue guidelines on solvency margins	Introduce guidelines	Completed	Guidelines issued.
3.7 Issue guidelines on technical provisions	Introduce guidelines	Completed	Guidelines issued.
3.8. Issue guidelines on corporate governance of insurance companies	Introduce guidelines	Largely Implemented	Policy paper has been issued
3.9 Improve reporting by: (i) requiring that material	Guidelines for (i) issued.	Partially implemented	Only (i) implemented. Revised draft of SOSIB could include the necessary

Recommendation	Action	Status	Remarks
changes to the business plan be notified to the CBA in advance; (ii) reduce the reporting lag of audited financials from 6 months to 4 months; (iii) ask for more frequent and comprehensive reports.			modification to implement (ii).
3.10 Introduce requirement in the SOSIB for external auditors to report significant matters	Drafting of a proposal	In progress	To be implemented in the revised SOSIB
3.11 Introduce requirement in the SOSIB to publish annual accounts	Drafting of a proposal	In progress	A directive was issued by the CBA ordering the insurers to publish their annual reports by filing them at the Chamber of Commerce. However, in order to have a more solid legal basis for this directive a legislative change remains necessary.
3.12 Conclude MOU's with other relevant agencies	The CBA has entered into MOU's with the BNA both for banking and insurance supervision.	Completed	
3.13 Require explicit approval of CBA to open cross border establishments	Drafting of a proposal	In progress	The revised SOSIB will include a provision requiring insurers to seek CBA prior approval to open cross border establishment
3.14 Conduct more structured on-site visits	Introduce checklist for on-site examinations	Completed	For each on-site exam a working progress program is prepared.
3.15 Consider making investment in derivatives and off-balance sheet items prohibited, except for hedging purposes, unless specifically approved by the CBA in individual cases.		Pending	
3.16. Extend the range of violations for which monetary penalties can be imposed	Drafting of a proposal	In progress	To be implemented in the revised SOSIB
3.17. Consider implementing the	Legislative change required	Pending	Consider amending draft proposal of SOSIB to include the regulatory ladder.

Recommendation	Action	Status	Remarks
“regulatory ladder” with prescribed steps, which must be taken as various defined levels of solvency are reached. Steps range from, implementation of an action plan by the insurer, to the appointment of an administrator or liquidator.			
3.18 Consider the introduction of market conduct requirements	Legislative change required	Pending	Improving consumer protection is one of the main objectives of the 2008-11 CBA strategic plan. In this context, the CBA is currently revisiting its policy stance.
3.19 Institute compulsory codes of conduct to prevent the public from receiving misleading advice.	Legislative change required	Pending	Consider amending draft of revised SOSIB to include market conduct provisions for insurers and intermediaries.
3.20 Bring the non-life insurance sector under the reporting and identification requirements	Legislative change is required (SOIRFS/SORUT)	Largely completed	Under the Dutch and Aruba law, only the life insurers and insurance brokers are subject to the unusual transaction reporting system. The non-life insurance companies are however obliged by the AML/CFT directive to have proper identification and customer due diligence procedures in place.
3.21 Require the insurance companies to report all fraud and money laundering cases to the CBA	Issue a directive to this end.	Completed	A directive on the reporting of incidents has been introduced.

Appendix II: Report on Observance of Standards and Codes Assessment of Compliance with the Basel Core Principles for Effective Banking Supervision

A. Introduction

45. With the concurrence of the Central Bank of Aruba (CBA), the mission assessed compliance with the 2006 revised Basel Core Principles for Effective Banking Supervision using the Core Principles Methodology (see Table 6). Compliance with both the essential and additional criteria was assessed at the request of the CBA.

B. Information and methodology used for assessment

46. The assessment was based on the CBA's self assessment of compliance with the Core Principles, a review of the relevant laws and regulations, interviews with the staff of CBA and discussions with auditors and onshore and offshore banks.⁶ The assessors conducted meetings with senior supervisory staff, as well as junior supervisory staff as appropriate, as well as President of the Central Bank. The assessors also had discussions with onshore and offshore banks, the Auditor's Association of Aruba and the RCUT, Aruba's FIU. The work of the assessors was greatly facilitated by the thorough and candid self assessment conducted by the authorities.

C. Overall Supervisory and Regulatory Framework

47. CBA supervises banks, money transfer companies, insurance companies and company pension funds on the basis of the respective state ordinances regulating these sectors. CBA is an autonomous entity. The President of CBA, assisted by two executive directors, determines the policies of CBA. The President is appointed on the recommendation of the Supervisory Board for an indefinite period by the Governor of Aruba, who is the representative of the Queen of the Netherlands. Only the Governor, on the recommendation of the Supervisory Board, can approve the President's dismissal. The political responsibility for the execution of CBA's tasks lies with the Minister of Finance. No operational guidance is given to CBA by the Minister. It is fully independent in setting monetary and prudential policy.

48. CBA is also independent from the Government's budgetary process. Its main source of income is generated from the investments of the official foreign exchange reserves of Aruba, which it holds. After financing its operations, including the supervisory activities, this source of income still leaves CBA with an annual profit, demonstrating that it has sufficient financial resources. In view of the continuous expansion and strengthening of the supervisory framework and increasing associated costs it is in the process of charging (part of) the supervision costs to

⁶ The assessors were Gabriella Ferencz, Lead Financial Sector Specialist (World Bank) and Socorro Heysen (Consultant).

the sectors supervised. At present, only insurance and money transfer sectors are charged in part for the supervisory costs incurred. It is the intention to also charge the banking and pension fund sectors in due time for the supervision costs incurred. In this respect, draft state decrees have been submitted to the government for review and approval.

49. CBA's supervision department, which falls under the responsibility of the executive director in charge of supervision, consists of 10 qualified staff members. The average supervisory experience is about seven years, and there is currently one vacancy for a senior staff member.

50. The legal and regulatory framework is generally adequate for the conduct of banking supervision. There are several proposals to amend laws before Parliament which would strengthen the ability of the supervisory authority to carry out its function. The accounting standards are good and banks are required to have an external audit annually. Disclosure needs some enhancement. There is a lack of transparency given the limited availability of financial reports. There should also be disclosure about the qualitative elements of banks' operations, as part of their financial results.

D. Main findings

Objectives, independence, powers, transparency, and cooperation (CP 1)

51. Four of the six elements of CP 1 were found to be compliant. CP 1(4) was also found to be largely compliant. The powers to address compliance will be greatly enhanced by the passage of the draft law granting the CBA the authority to levy fines, sanctions, and/or administrative penalties to banks, management and board members in the event of noncompliance. CP 1(5) was found to be largely compliant. There is no explicit mention in the law of protection of supervisory staff. The CBA sought legal advice from the Dutch Central Bank on this matter. According to their advice, the Dutch legal system, on which Aruban laws are based, the employer is responsible for the actions of its employees. Only in the case of gross negligence, the employee can also be sued.

Licensing and structure (CPs 2–5)

52. CPs 2-5 were found to be compliant. Licensing criteria are sufficiently broad. No new licenses have been granted for years although there are periodic inquiries. The law adequately defines significant ownership and controlling interest. Although the legal requirements to obtain supervisory approval for proposed changes in ownership and control are adequate, they would benefit from clarification regarding multiple acquisitions below the threshold that could in sum total in excess of the thresholds for notification. The CBA has adequate criteria for reviewing major acquisitions or investments by banks.

Prudential regulation and requirements (CPs 6–18)

53. Some prudential regulations and requirements are adequate and others need improvement. Implementation needs improvement in a number of areas as well.

- CP 10 (large exposure limits), CP 17 (internal control and audit) and CP 18 (abuse of financial services) were found to be compliant.
- CP 6 regarding capital adequacy was found to be largely compliant. The CBA sets the minimum regulatory capital for banks at 12 percent and they all meet or exceed the minimum. However, while the CBA contends that market risk is not an issue for onshore banks it is believed that the offshore banks have trading desks and therefore are exposed to market risk. Market risk needs to be supervised by the CBA at the offshore banks.
- CP 7 regarding risk management was found to be materially non compliant. Supervision continues to be largely compliance based. The CBA needs to enhance its ability to conduct risk based supervision and it must work closely with banks so that they incorporate risk management into their operations.
- CP 8, credit risk, was found to be largely compliant. The supervisory approach to credit risk oversight is generally appropriate for the largely retail loan portfolios of commercial banks. It would be greatly enhanced by improved data and reporting from banks. This would enable the CBA to perform more meaningful financial analysis.
- CP 9 on problem assets, provisions and reserves was found to be largely compliant. While the focus on number of days a loan is past due is generally adequate for retail portfolios, classification of commercial loans should be more proactive and take into account qualitative factors as well.
- Exposure to related parties, CP 11, was found to be largely compliant. The law should clarify that loans to companies where insiders have significant interests should be granted on no more favorable terms than other loans.
- CP 12, country and transfer risk, was found to be largely compliant. Even though the CBA considers these risks to be minimal, it should receive reports more frequently than once a year.
- CP 13, market risk was found to be noncompliant. The CBA states that this risk is small and it would be covered by the 12 percent capital charge. Market risk needs to be supervised in the offshore banks.
- CP 14, liquidity risk was found to be largely compliant. The required liquidity ratios and liquidity reporting requirements are in proportion to the liquidity risks in the Aruban

banking sector. The industry and supervisory oversight would benefit from more proactive liquidity risk management which would address funding and contingency plans.

- CP 15, operational risk, was found to be largely compliant. Certain areas that pose operational risk to banks are examined for onsite but the CBA needs to provide banks with additional guidance in this area and examine for it in greater depth.
- CP 16, interest rate risk, is rated materially non compliant. Interest rate risk may be small in Aruba given that loan terms regarding interest are often stated to be fixed until further notice by the bank. Some corporate loans are at fixed rates. The CBA needs to be more proactive in its supervision of interest rate risk and reporting needs to capture interest rate risk in banks to allow for a meaningful GAP analysis.

Methods of ongoing banking supervision (CPs 19–21)

54. These CPs were found to be largely compliant. The supervisory approach is generally appropriate for the size and complexity of the size of the economy and the portfolios of the commercial banks. The CBA would benefit from better data from the banks to improve the information about risks in banks. Supervisory techniques are generally broad but additional analytical depth is needed. Supervisory reporting needs to be enhanced to provide more risk oriented information.

Accounting and disclosure (CP 22)

55. This CP is largely compliant. Legislative proposals are being prepared to require the CBA's prior approval in the change of its external auditors and requiring banks to publish their annual audited financial statements.

Corrective and remedial powers of supervisors (CP 23)

56. This CP is largely compliant as there are draft amendments to the banking law granting the CBA the authority to impose a tiered system of administrative fines on banks and individual managers and board members.

Consolidated and cross-border banking supervision (CPs 24–25)

57. CP 24 is not applicable as local banks do not have foreign branches or subsidiaries. CP 25 was found to be compliant.

58. Table 6 provides a principle-by-principle summary of assessment results. Table 7 is a recommended action plan to improve compliance.

Table 6. Aruba: Summary Compliance with the Basel Core Principles—ROSCs

Core Principle	Comments
1. Objectives, independence, powers, transparency, and cooperation	
1.1 Responsibilities and objectives	
1.2 Independence, accountability and transparency	
1.3 Legal framework	
1.4 Legal powers	A draft proposal expected to be submitted for approval by end 2008 would give the CBA authority to impose a tiered system of administrative fines, sanctions and remedial measures on banks, management and board members.
1.5 Legal protection	While there is no explicit protection in the law, Aruban law holds that the employer is responsible for the actions of its employees.
1.6 Cooperation	
2. Permissible activities	
3. Licensing criteria	
4. Transfer of significant ownership	
5. Major acquisitions	There should be clarification that any combination of acquisitions of less than 5 percent that results in a 5 percent or more position, needs CBA's prior approval.
6. Capital adequacy	Market risk at the offshore banks needs to be addressed in terms of capital adequacy.
7. Risk management process	The CBA needs to enhance its ability to conduct risk based supervision and it must work closely with banks so they incorporate risk management into their operations.
8. Credit risk	Supervision of credit risk management would be enhanced by improving the quality of data which would allow for more meaningful financial analysis of banks' financial results.
9. Problem assets, provisions, and reserves	While number of days past due is appropriate for a retail portfolio, which is the bulk of banks' portfolios, the CBA needs to ensure that commercial loans should be classified using qualitative as well as quantitative criteria.
10. Large exposure limits	CBA's ability to supervise would be enhanced by better reporting and analysis of large exposures.
11. Exposure to related parties	Loans to companies where insiders have a significant interest should not be granted on more favorable terms than loans to non-related parties.
12. Country and transfer risks	Reporting should be more frequent than once a year.

Core Principle	Comments
13. Market risks	There is a need to address market risk in the offshore banks.
14. Liquidity risk	The CBA needs to ensure that banks have acceptable liquidity risk management strategies, policies and procedures including management of funding requirements and contingency planning.
15. Operational risk	The CBA's guidance and supervision needs to be in more depth.
16. Interest rate risk in the banking book	Current reporting does not adequately capture interest rate risk in banks although the majority of loans are priced so that the banks retain the right to adjust rates.
17. Internal control and audit	
18. Abuse of financial services	
19. Supervisory approach	The approach needs to incorporate more supervision by risk including enhancing reporting requirements to better reflect risks in banks.
20. Supervisory techniques	These are generally broad but additional analytical depth is needed and a greater risk focus.
21. Supervisory reporting	Reports need to be enhanced to provide a more risk oriented approach.
22. Accounting and disclosure	Changes in external auditors should require CBA prior approval. Qualitative information regarding risk practices, strategies, etc should be publicly disclosed.
23. Corrective and remedial powers of supervisors	There are proposals to enable the CBA to impose a tiered system of administrative fines against banks, directors, and officers in the event of a breach of law or regulation. These should be expanded to include the ability of the CBA to impose fines if the banks act in an unsafe and unsound manner.
24. Consolidated supervision	
25. Home-host relationships	

Recommended action plan and authorities' response

Recommended action plan

Table 7. Aruba: Recommended Action Plan to Improve Compliance with the Basel Core Principles

Reference Principle	Recommended Action
1.4 Legal powers	Issue draft proposal to give the CBA authority to impose a tiered system of administrative fines, sanctions and remedial measures on banks, management and board members. Current draft should be expanded to include the ability of the CBA to impose fines if the banks act in an unsafe and unsound manner.
CP 5 Major acquisitions	There should be clarification that any combination of acquisitions of less than 5 percent that results in a 5 percent or more position, needs CBA's prior approval.
CP 6 Capital adequacy	Market risk at the offshore banks needs to be addressed in terms of capital adequacy.
CP 7 Risk Management Process	The CBA needs to enhance its ability to conduct risk based supervision and it must work closely with banks so they incorporate risk management into their operations.
CP 8 Credit Risk	Supervision of credit risk management would be enhanced by improving the quality of data which would allow for more meaningful financial analysis of banks' financial results.
CP 9 Problem Assets, provisions and reserves	While number of days past due is appropriate for a retail portfolio, which is the bulk of banks' portfolios, the CBA needs to ensure that commercial loans should be classified using qualitative as well as quantitative criteria.
CP 10 Large exposure limits	CBA's ability to supervise would be enhanced by better reporting and analysis of large exposures.
CP 11 Exposure to related parties	Loans to companies where insiders have a significant interest should not be granted loans on more favorable terms than non-related parties.
CP 12 Country and transfer risks	Reporting should be more frequent than once a year.
CP 13 Market Risk	There is a need to address market risk in the offshore banks.
CP 14 Liquidity risk	The CBA needs to ensure that banks have acceptable liquidity risk management strategies, policies and procedures including management of funding requirements and contingency planning.
CP 15 Operational risk	The CBA's guidance and supervision needs to be in more depth.

Reference Principle	Recommended Action
CP 16 Interest Rate Risk in the banking book	Current reporting needs to be enhanced to adequately capture interest rate risk in banks although the majority of loans are priced so that the banks retain the right to adjust rates.
CP 19 Supervisory Approach	The approach needs to incorporate more supervision by risk including enhancing reporting requirements to better reflect risks in banks.
CP 20 Supervisory Techniques	These are generally broad but additional analytical depth is needed and a greater risk focus.
CP 21 Supervisory reporting	Reports need to be enhanced to provide a more risk oriented approach.
CP 22 Accounting and disclosure	Changes in external auditors should require CBA prior approval. Qualitative information regarding risk practices, strategies, etc should be publicly disclosed.
CP 23 Corrective and remedial powers of supervisors	There are proposals to enable the CBA to impose a tiered system of administrative fines against banks, directors, and officers in the event of a breach of law or regulation. These should be expanded to include the ability of the CBA to impose fines if the banks act in an unsafe and unsound manner.

Authorities' response to the assessment

59. The authorities indicated that although on certain issues their views differ slightly from those of the mission, they are of the opinion that the assessment is well balanced and gives a detailed view of the areas that need further improvement. They were pleased that the report acknowledged the progress made since the last assessment and the ongoing efforts to strengthen the legal framework and supervisory practices. The authorities stressed their intention to follow up swiftly on the recommendations made in the report and, in this regard, a detailed action plan for furthering compliance with the BCPs will be prepared taking into account the action plan recommended in the assessment.

Appendix III: Factual Update of Insurance Regulation and Supervision

A. General

60. The review of the insurance regulation and supervision in Aruba was undertaken in May 2008, in the context of the update of the Offshore Financial Center (OFC) assessment.⁷ The review is based on the Insurance Core Principles and Methodology (IAIS, October 2003). However, considering the small size of the insurance sector, the review focused on the recent regulatory changes and the follow up of the recommendations of the 2002 OFC assessment. A full-fledged assessment of observance of Insurance Core Principles (ICP) was not carried out.

61. The main information source was a very thorough self-assessment of observance with the ICP conducted by the Central Bank of Aruba, who is entrusted with the supervision of banks, insurance companies, pension funds and money transfer companies. The responsibilities of the CBA with regards to the regulation and supervision of the insurance sector are clearly laid out in the Central Bank Ordinance and in the State Ordinance on the Supervision of Insurance Business (SOSIB). The assessor had access to these laws as well as to directives, guidelines and policy papers that constitute the frame for conducting insurance business in Aruba. Sample supervisory reports were reviewed and interviews with insurance supervisors, representatives of the insurance industry and the external auditors were carried out. The review benefited from the full cooperation of the Central Bank of Aruba and received all necessary information.

B. Main Findings

62. Aruba has implemented several recommendations of the 2002 OFC assessment and others would be implemented after the revised SOSIB is issued. At the time of the 2002 assessment, the SOSIB had just been adopted, and many implementation measures were not yet in place. Currently, minimum requirements for the licensing of captives and for the changes in control of insurance companies have been adopted. The CBA has issued several key guidelines, including the ones on the solvency margin (with a list of approved assets for the calculation of this margin), technical provisions and corporate governance.

63. A proposal for a revised SOSIB has been drafted by the CBA with the technical assistance of the Nederlandsche Bank N.V. and is expected to be submitted for approval by year end. The revised SOSIB is expected to include, among others, the following changes:

- Further enhance the powers of the CBA as a supervisor, by broadening the range of sanctions it can apply, including fines for several violations of SOSIB and removing managers and Board members that no longer meet fit and proper requirements;

⁷ This review was carried out by Ms. Socorro Heysen (Consultant).

- Regulate reinsurance companies and insurance brokers and entrust their supervision to the CBA;
- Mandate a risk based capital requirement for insurance companies;
- Explicitly give the CBA authority to issue guidelines on: prevention of money laundering and the financing of terrorism, trustworthiness and expertise of managers of insurance companies; and
- Require that insurance companies disclose their financial statements.

64. A main goal of the 2008-12 strategic plan of the CBA is to move toward a risk based approach to supervision. The risk based approach requires a strong off-site supervisory function. To this end, the CBA will require more comprehensive and timely supervisory and market information, and additional supervisory resources. The CBA requires that insurance companies' balance sheets be certified by an actuary. However, it is suggested that the CBA conduct an independent assessment of insurance liabilities. The CBA states that the size of the market does not justify having an in house actuary and that actuary services are contracted whenever deemed necessary.

C. Main Recommendations

65. The main recommendations are:

- Provide adequate staffing for the Supervision Department and implement a structured insurance training for supervisors
- Issue the proposed draft of SOSIB including changes outlined above and the following suggested amendments:
 - Require insurance companies to submit and publish their annual audited financial statements four months after year end (instead of six months).
 - Introduce market conduct requirements for insurance companies and intermediaries, including for instance a mandatory code of conduct.
- Require insurance companies to submit to the CBA a more comprehensive set of quarterly reports for supervisory purposes;
- Provide timely and adequate market information on insurance companies;
- Issue guidelines addressing: (i) underwriting and pricing policies and strategies to mitigate and diversify their risks; (ii) accounting standards; (iii) valuation of reinsurance risks; (iv) diversification of financial instruments held; and (v) the use of derivatives and the risk management systems required to control the risk of derivatives activities.

66. For a more detailed presentation of the findings and recommendations refer to Tables 8 and 9.

Table 8. Aruba: Summary of Main Findings on the Observance of Insurance Core Principles

Insurance Core Principles (ICP)	Comments
Conditions ICP1 - conditions for effective insurance supervision	<ul style="list-style-type: none"> ▪ The policy framework and financial infrastructure are generally adequate. Aruba has not issued standards with regards to accounting, actuarial and auditing rules; however, the CBA recommends that insurers apply international accounting, actuarial and auditing standards; and has issued a directive on actuarial report and certification for life Insurance companies.
<u>The Supervisory System</u> ICP2 - Supervisory objectives ICP3 - Supervisory authority ICP4 - Supervisory process ICP5 – Supervisory cooperation and information sharing	<ul style="list-style-type: none"> ▪ The CBA is financed in such way that does not undermine its autonomous position and permits it to conduct effective supervision and oversight. However, more supervisory resources are needed to undertake the added responsibilities of supervising company service providers and conducting an effective risk based supervision. ▪ Aruban law does not contain an explicit provision with respect to the legal protection of supervisory staff. However, under the Dutch and Aruban law, it is the employer who is legally responsible for the work of its personnel. Only in cases of gross negligence the employee can be held liable. The employee cannot be held liable in general if he has acted in good faith.
The Supervised Entities ICP6 – Licensing ICP7 – Suitability of Persons ICP8 – Changes in control and portfolio transfers ICP9 – Corporate governance ICP10 – Internal Controls	<ul style="list-style-type: none"> ▪ SOSIB establishes that licensed insurers must continuously comply with the licensing requirements and management and Board members must comply with the fit and proper requirements at all times (section 7d), but it does not authorize the CBA to: remove key functionaries that no longer comply with fit and proper requirements; or require the owners that no longer comply with licensing requirements to sell their interest.
Ongoing Supervision ICP11 – Market Analysis ICP12 – Reporting to supervisors and off-site monitoring ICP13 -On-site inspection ICP14 -Preventive and corrective measures ICP15 -Enforcement or sanctions ICP16 -Winding-up or exit from the	<ul style="list-style-type: none"> ▪ The CBA does not conduct regular analysis of the market conditions, including trends and future scenarios. The CBA publishes sufficient aggregate annual data of the insurance sector, but this information could be timelier. ▪ The quarterly reporting to the CBA only considers investments by type, and the annual audited reporting, while adequate, is only submitted to the CBA six months after the end of the year. ▪ The CBA is proactive in using the corrective tools and sanctions at hand, but the set of legal tools is incomplete. Presently the SOSIB does not provide for the sanctions by the way of fines against individuals and insurers where provisions

<p>market</p> <p>ICP17 -Group-wide supervision</p>	<p>of the legislation are breached or withhold information. A proposal to amend the SOSIB is now being drafted which will give the CBA the authority to fine insurers that have breached the provisions of the legislation.</p> <ul style="list-style-type: none"> ▪ A procedure for winding up of insurers is not established and the authority of the Court appointed administrator to liquidate all or part of an insurance company is not regulated. Section 21 and 22 does give the CBA the authority to initiate the winding up process via the Court. However, the State Decree regulating the authority of the liquidator has not been implemented as yet. ▪ The SOSIB does not contain provisions limiting or circumscribing the range of activities that a consolidated insurance group may conduct. Nor does it contain explicit provisions requiring prior approval from the CBA for an insurer to open a cross border establishment.
<p>Prudential Requirements</p> <p>ICP18 -Risk assessment and management</p> <p>ICP19 -Insurance activity</p> <p>ICP20 -Liabilities</p> <p>ICP21 -Investments</p> <p>ICP22 -Derivatives and similar commitments</p> <p>ICP23 -Capital adequacy and solvency</p>	<ul style="list-style-type: none"> ▪ The CBA has not issued directives requiring insurers to have in place underwriting and pricing policies and strategies to mitigate and diversify their risks. ▪ While the CBA examines the reinsurance cover during on-site exams, it does not have a frame for the supervision of reinsurers. ▪ The CBA has not issued standards to establish the valuation of the amounts recoverable under the reinsurance arrangements. Insurers are expected to use GAAP and acceptable international actuarial standards. ▪ There are no requirements addressing the mixture and diversification by type of financial instruments held by insurance companies. ▪ No specific guidance exists regarding the use of derivatives and similar commitments or the risk management systems required to control the risk of derivatives activities. However, the insurance are required to disclose all off-balance sheet items in their annual filings to the CBA. In practice the licensed insurers do not use these types of instruments. ▪ Capital adequacy requirements are sensitive to size but not to the complexity and the risks of the insurance operations.
<p>Markets and Consumers</p> <p>ICP24 -Intermediaries</p> <p>ICP25 -Consumer Protection</p> <p>ICP26 –Information, disclosure & transparency towards markets</p> <p>ICP27 – Fraud</p>	<ul style="list-style-type: none"> ▪ Insurance intermediaries are not subject to supervision in Aruba. ▪ Market conduct aspects are not regulated by the SOSIB, so the CBA does not have any legal authority in this regard; and there are no requirements with regards the provision of information to potential policyholders or the handling of complaints. ▪ The SOSIB does not address disclosure requirements. The

	<p>CBA has required insurers to file their annual financial statements in the Chamber of Commerce as a way of publication. However information disclosed is not subject to uniform reporting standards.</p> <ul style="list-style-type: none"> ▪ The CBA has not yet issued guidelines for the prevention of insurance fraud.
AML/CFT ICP28 -Anti-money-laundering, combating the financing of terrorism	<ul style="list-style-type: none"> ▪ Only life-insurers and insurance intermediaries are required to report unusual transactions, suspicious activities or material frauds. Non life insurers and captives are not bound by these requirements.

Table 9. Aruba: Key Recommendations to Improve Observance of Insurance Core Principles

Insurance Core Principles (ICP)	Recommendation
Conditions - ICP1	<ul style="list-style-type: none"> ▪ Set out specific guidelines on accounting standards consistent with IFRS.
The Supervisory System ICP2, 3, 4 and 5	<ul style="list-style-type: none"> ▪ Hire additional staff for the Supervision Department and implement a structured insurance training for supervisors
The Supervised Entities ICP6 , 7, 8, 9 and 10	<ul style="list-style-type: none"> ▪ Issue proposed draft of SOSIB including: <ul style="list-style-type: none"> ○ capacity of the CBA to remove key functionaries that no longer comply with fit and proper requirements; and require the owners that no longer comply with licensing requirements to sell their interest. ○ Bring the supervision of reinsurance companies under its scope. ○ Require prior permission of the CBA to: increase or decrease capital or reserves, increase a qualified holding in another entity, open branches or agencies, transfer assets or liabilities, reorganize and change actuary or external auditor.
Ongoing Supervision ICP11, 12, 13, 14, 15,16,17	<ul style="list-style-type: none"> ▪ Broaden the scope of quarterly reports that insurers submit to the CBA, adding reports to improve the capacity to conduct off-site supervision of reinsurance and other material risks. ▪ Introduce provisions in the SOSIB to impose penalties against board-members and, senior management in the event of non-compliance; and broaden the range of penalties against insurance companies. ▪ Amend SOSIB to require CBA's prior approval for an insurer to open a cross-border establishment. This is a clarification, as it is already implicit in the requirement that insurers require prior CBA approval to any changes in the plan the CBA approved at the time of licensing.
Prudential Requirements	<ul style="list-style-type: none"> ▪ The CBA to issue directives requiring insurers to:

ICP18,19, 20, 21, 22, 23	<ul style="list-style-type: none"> ○ have in place underwriting and pricing policies and strategies to mitigate and diversify their risks. ○ address the mixture and diversification by type of financial instruments held by insurance companies. ○ have CBA specific authorization if they intend to use derivatives or similar instruments for a purpose other than hedging and to implement the risk management systems required to control the risk of their derivatives activities. <ul style="list-style-type: none"> ▪ Amend section 14 of the SOSIB to mandate a risk based capital requirement
Markets and Consumers ICP24, 25,26, 27	<ul style="list-style-type: none"> • Amend the SOSIB in order to supervise insurance intermediaries (brokers and agents) • Introduce in SOSIB market conduct provisions and grant the CBA legal authority in this regard. Require mandatory codes of conduct. • Introduce in SOSIB disclosure requirements for insurers. Required that financial statements be published four months after year end. The CBA to establish uniform reporting standards for this purpose. • The CBA to issue guidelines for the prevention of insurance fraud.
AML/CFT - ICP28	<ul style="list-style-type: none"> ▪ Require non-life insurers and captives to report unusual transactions, suspicious activities and material frauds.