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SM/08/239
Correction 1

February 4, 2009

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Barbados—Financial System Stability Assessment—Update**

The attached correction to SM/08/239 (7/11/08) has been provided by the staff.

Factual Error Not Affecting the Presentation of Staff's Analysis or Views

Page 18, para. 26, line 7: remove: "The tax break to credit union members, which was in place during the 2002 FSAP, has now been extended to mutual funds and equities.[16]"

Questions may be referred to Mr. Espinosa, MCM (ext. 38589).

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

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Department Heads

hand, a 10 percent appreciation would slightly reduce the CAR from 10.2 percent to 9.9 percent, without bringing any bank below the regulatory threshold.

- **Liquidity Risk.** Liquidity risk was tested by assuming a sudden, large deposit run on the subsidiaries of foreign banks (e.g., simulating a reputational shock to the parent company abroad), equivalent to a run on deposits of 30 percent in a 30-day period. No banks become illiquid under this scenario, although two banks would suffer significant strain—the ratio of liquid assets to short term liabilities would decline from 57.3 percent to 31.6 percent for subsidiaries, and from 60.8 to 36.1 for branches. The same deposit run would potentially leave one foreign branch illiquid. Should the external funding dry up, the ratio of liquid assets to short-term liabilities would decline to 50.4 percent for subsidiaries, and to 53.6 for branches, while no banks would become illiquid (i.e. suffer negative cash flow).[13]

Table 1. Stress Testing: Summary of Results

Case	CAR Official Data	Adjusted CAR 1/	Baseline	CAR After Shock	Number of Banks CAR<8%	Number of Banks CAR<0%
Credit Risk						
Baseline 2/	10.8	10.2	8.4	-	1	0
"Perfect Storm" Scenario 3/	10.8	10.2	-	3.6	4	1
Interest Rate Risk						
+500bp	10.8	10.2	-	8.4	1	0
-500bp	10.8	10.2	-	11.9	0	0
Exchange Rate Risk						
10 percent depreciation	10.8	10.2	-	10.5	0	0
10 percent appreciation	10.8	10.2	-	9.9	0	0

Source: authorities and staff estimates.
Notes:
1. Adjusted CAR correspond to the CAR after introducing a 5% provisioning rate for "Special Mention" loans, increasing the provisioning rate for "Substandard" loans to 20 percent, and migrating 20 percent of "Pass" loans to "Special Mention."
2. The Baseline case is based on WEO projection of macroeconomic variables for 2008.
3. The Macroeconomic Scenario includes a 15 percent decline in tourism, a 15 percent decline in the construction sector, a recession in the US of -3.0 percent of GDP, and an increase in oil prices of 50 percent.

[13] No formal inter-bank contagion analysis was carried out due to the lack of individual interbank lending activity data. However, the fact that interbank lending amounts to 5 percent of total excess reserves suggests that interbank contagion is not a significant concern. Contagion from a foreign parent bank may also be limited because funding from foreign parent banks amounts to only 10 percent of total funding.

Credit Unions

25. **The credit union sector has continued to expand and compete with banks in the consumer lending segment.** Although there have been no new registrations in the last five years, the combined assets of the 34 credit unions[14] are equivalent to about 14 percent of GDP**,** compared to 10 percent during the 2002 FSAP. The sector remains highly concentrated with the two largest credit unions accounting for 71 percent of total assets and 73 percent of the total membership. Smaller banks express frustration at the tax breaks and lower compliance costs afforded to the credit unions, because, from their perspective, this puts them at a competitive disadvantage.

26. **Official figures understate the actual loan delinquency rates in the credit union sector.** The official rate was 6 percent rate, as of September 2007, but does not consider arrears on past due loans over 30 days.[15] Return on equity for the largest credit union was 6 percent for 2007, while the loan-to-deposit ratio for the sector stands at 87 percent. Loan origination polices for the largest two credit unions have improved since the 2002 FSAP due to enhancements made to the credit policy guidelines and member financial education programs. ~~The tax break to credit union members, which was in place during the 2002 FSAP, has now been extended to mutual funds and equities.~~[16]

B. Institutional Investors

National Insurance Scheme

27. **The National Insurance Scheme (NIS) is the social safety net program providing pension and other social welfare benefits, including unemployment insurance and severance schemes. It was set up by national legislation in 1967 and is governed by a tripartite board that comprises representatives from government, labor, and employers.** The actuarial review of December 1999 indicated an actuarial deficit and the expectation that, other things being equal, the fund would be exhausted by 2030. In response, a pension reform in 2002 increased contributions and adopted a range of parametric reforms to benefits, including a gradual increase in the retirement age to 67 years by 2018. The reforms significantly lengthened the time horizon for investment of the assets of the NIS. As of February 2008, NIS' assets were valued at BDS$2.7 billion (about 30 percent of GDP) up from BDS$1.4 billion in 2002. Current actuarial estimates indicate that assets will continue to grow until around 2030, or longer under more optimistic assumptions.

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[14] The largest two credit unions have assets of $252 million and $134 million, eight "medium" credit unions have assets which range from $34 million to $7.5 million , and the remaining 24 "small" credit unions have combined total assets of US$28 million.

[15] Late payment is considered past due only after 90 days.

~~[16] The first BDS$10,000 generated from combined investments in credit union, mutual fund and equity holdings are tax exempt.~~