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This report is based on data and information of banks and non-bank financial institutions available up to December 31, 2018 unless stated otherwise in the relevant chapters/sections.

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GOVERNOR'S FOREWORD

Governor Denton Rarawa

2018 was a challenging year for the Solomon Islands' financial sector.

A domestic licensed financial institution, which provided banking services to a key sector in Solomon Islands, was affected by the global de-risking phenomena. The financial institution lost its only Correspondent Banking Relationship (CBR) in early 2018 following a suspension of its CBR in the latter half of 2017. In order to maintain stability in the domestic financial system, the Central Bank had to intervene. The intervention was critical to maintain flows of export receipts back to Solomon Islands as required under the Solomon Islands Exchange Control Act. It was also necessary, to maintain confidence in the domestic banking system. Moreover, the intervention provided the concerned financial institution some breathing space to negotiate and establish a new CBR. Failure to establish a new CBR would have had serious adverse consequences for the financial institution, the financial system and the Solomon Islands economy. Fortunately, the concerned financial institution was able to rectify all gaps identified in its banking platforms and was able to establish a new CBR just in time before the Central Bank withdrew its intervention, at the end of 2018. On this, the Central Bank was very grateful to the Federal Reserve Bank of New York (FRBNY) for its understanding and support in temporarily allowing the concerned licensed financial institution to route all its export receipts back to Solomon Islands via the Central Bank's account with FRBNY. This arrangement had averted a potentially destabilizing macroeconomic situation for Solomon Islands.

During the year, a group of crypto-asset promoters visited Solomon Islands and met with Government officials to promote the benefits of holding crypto exposures. However, the Central Bank cautioned the Government against taking any forms of crypto-exposure given the high level of global uncertainty associated with crypto assets.

Across 2018, Solomon Islands' financial sector remained fundamentally strong, although few areas of concerns persist. These concerns are: infiltration of shadow credit institutions into the system, weak enforcements of standards by some government agencies, deficient governance practices by some licensed financial institutions, weak underwriting practices, weather and climate variability risks, and market and liquidity risks. If these concerns are not addressed, they could lead to amplification of domestic financial system vulnerabilities or alternatively could easily materialize into colossal risks for Solomon Islands' financial sector over time.

The Central Bank, through the Financial Stability Committee, took a number of decisive policy actions to mitigate risks to financial stability across 2018. Section 3 to this report discusses those policy actions. Nonetheless, given that risks are dynamic in nature, and cannot be completely eliminated, the Central Bank will continue to remain vigilant on issues that come to its fore and will not hesitate to take decisive policy actions to protect and enhance financial system stability, which is one of the Central Bank's core mandates.

I hope this edition of FSR will provide you with insights into Solomon Islands financial sector performances, vulnerabilities and risks affecting the domestic financial system, and actions that the Central Bank had taken in 2018 to maintain stability in the system.

Denton Rarawa
Governor & Chairman of the Financial Stability Committee

CHAPTER 1: SUMMARY

The global economy, according to the International Monetary Fund, maintained its economic expansion in 2018. It grew by 2.5 percent in the second-half of 2018 extending further the growth of 2.1 percent recorded in the first-half of 2018. The US economy expanded in 2018 while economic growth in UK, China and Japan declined over the year to 2018.

The Bank of England had released its stress testing results for UK banks. The results indicated that UK banks were better prepared to withstand shocks associated with a simultaneous downturn in UK and global economies including any disorderly Brexit. China and Japan implemented some control measures. The former country to contain growth of its thriving non-bank financial sector while the latter to control activities of HFT trading firms. Australia and New Zealand banking system remained fundamentally strong in spite of the banking scandal in Australia and in spite of the high level of debts in the household and the dairy farming sectors in New Zealand. Banks in the Pacific remained profitable and operated within their regulatory and prudential bounds during the year but risks associated with the global derisking phenomenon, high levels of household debts, and limited onshore investment opportunities persisted.

Solomon Islands financial system remained vulnerable to weather and climate change risks; cyber threats; activities of shadow credit institutions; non-performances and weak enforcements of standards by some government ministries; and vulnerabilities associated with persuasive cryptocurrency marketing strategies.

Risks to financial stability remained at elevated level and the system remained exposed to: (i) credit risks arising from weak underwriting standards and pressure to increase market share, (ii) risks associated with responsible persons position and weak oversight; (iii) risks relating to aging legislations and discretionary decisions; (iv) investment risk arising from fluctuations in interest rate and exchange rate movements; (v) valuation risks; and (vi) liquidity and concentration risks stemming from limited domestic investment and growth opportunities.

Solomon Islands banking sector maintained its strong performance. Despite limited expansion opportunities, the sector recorded a net surplus of $126.98 million and its total assets reached $6.1 billion at end of 2018. Banks continued to provide banking services to their customers but credit remains the major risk of the banking sector.

The insurance and superannuation sectors maintained their performances. Low insurance penetration rate and ageing legislation remained a prudential concern for these two sectors. Two credit unions were placed in the watchlist of the Central Bank and risks highlighted in the 2017 edition of the Financial Stability Report remained at elevated level in 2018. Governance and operational risks are key risks affecting the sector.

Actions that the Central Bank has taken in 2018 to contain the impact of the risks in the system are discussed in Chapter 3 of this Report.

CHAPTER 2: INTERNATIONAL & DOMESTIC DEVELOPMENTS

The global economy, according to the International Monetary Fund[1] , maintained its economic expansion in 2018. Notably, the global economy grew by 2.5 percent in the second half of 2018, up from the 2.1 percent growth registered in the first-half of 2018. In the United States (US), real GDP grew 2.9 percent in 2018 from 2.2 percent in 2017 and the financial conditions had remained broadly accommodative. Interest rates remained low, one of the lowest since the last Global Financial Crisis, risk-taking appetite had remained firm, and asset valuations had arisen in major markets. In Europe, the United Kingdom grew 1.4 percent in 2018, down from 1.8 percent registered in 2017. Meanwhile, the Bank of England had released its annual stress testing results for United Kingdom (UK) banks in the fourth quarter of 2018. The results, which were positive overall, showed that UK banks were capable of withstanding shocks associated with deep recessions occurring concurrently in the UK and in the global economy. Moreover, the results also showed that the UK banks were capable of withstanding a disorderly Brexit and continuing to perform their intermediary roles. Risk-taking appetite in UK had remained strong overall in spite of it losing some steam during the year. And even though the growth of credit had grown slightly faster than the economy, and the spreads in corporate bonds and mortgage loans had arisen, the UK's level of household and corporate debts had remained manageable overall.

The lower interest in advanced markets, particularly the US economy, had rendered Emerging Market Economies (EME) to obtain cheaper capital offshore and invested in riskier assets. However, as the market conditions in the US improved in 2018, EMEs' financial conditions had begun to tighten. For example, the rise in the US bond yields had induced outflows of capital from EMEs to the US while the appreciation of the US dollar had led to the increase in the sovereign and corporate debt levels of EMEs. These open up the exposure of EMEs to external vulnerability risks.

Within the Asia-Pacific region, China's economy grew by 6.6percent in 2018, down from 6.8 percent in 2018, but the financial conditions remained stable overall as Chinese authorities had eased monetary policy to counter the effects of external pressures and tighter regulations. During the year China's regulators introduced a number of control measures to contain the growth of its thriving non-bank financial sector. Report filing rule, which compelled peer-to-peer lenders' strict compliance, was one of the control measures that had been introduced. Unfortunately, peer-to-peers lenders had described the rule to be complicated and the rule had so far forced fintech firms to shelve their plans to float on stock market. In addition to the report filing rule, China's regulators had also launched a formal licensing regime for lenders and furthermore had imposed limits on loan sizes and barred platforms from guaranteeing investors' capital. Notably, these reforms were aimed at containing financial integrity and reputational risks to the financial system that may be associated with illegitimate operators' outlandish activities. Those operators had made outlandish promises to investors.

Fisheries is one of the key sectors in terms of activities contributing towards the economy in 2018.

In Japan, the Japanese economy grew 0.8 percent in 2018, down from 1.9 percent in 2017. During the year, the Japanese authorities had tightened the rules surrounding High Frequency Trading (HFT). This review was aimed principally at correcting the perceived deficiencies about the HFT activities where the market participants had viewed the HFT firms to be the potential source of financial instability due to their high-speed trading activities. Moreover, the market participants had also viewed the HFT activities to be the potential headspring for disadvantaging retail investors given that 70 percent of the firms trading in the Tokyo Stock Exchange are HFT firms. Altogether, HFT firms are now obliged to register with Financial Services Agency, and to demonstrate their risk management mechanisms and processes' effectiveness.

Closer to Solomon Islands, the Australian authorities had established a Royal Commission in late 2017 to investigate a scandal in the Australian banking system. The scandal included allegations of unethical and illegal corporate practices where some banks had been accused of engaging in money laundering activities, of charging dead people fees for financial advice, of engaging in irresponsible lending practices, and of misleading regulators. As a result, the Australian Prudential Regulation Authority

1 WEO October 2018

(APRA) had taken steps to review its oversight practices so that it could focus on conduct issues as well. Despite the scandal, the Australian financial system remained fundamentally strong overall and the banks had continued to serve Australian households and businesses. Across the Tasman Sea, the New Zealand financial system remained fundamentally strong overall as well but risks to the financial system persisted. In particular, the high levels of indebtedness in the household and dairy farming sectors remained a concern given their potential to elevating financial risks. Notwithstanding, the pace of household debt accumulation had declined and this would ease pressures to the system going forward. Correspondingly, NZ banks too had been shifting their funding strategies from offshore funding sources to long-term onshore funding sources. This shift in funding strategy would minimize the exposure of NZ banks to market risks, particularly interest rates and currency risks, going forward.

In the Pacific, the small island economies' banking system had remained largely stable. They remained profitable and met their minimum capital adequacy and other prudential requirements. Nonetheless, risks associated with correspondent banking relationship phenomena, limited onshore investment opportunities, growths in personal lending, emergence in impersonating activities, in cyber-attacks, and in the rising levels of household debts persisted.

Domestically, the Solomon Island's economy strengthened further. According to CBSI's provisional estimates, the economy had grown by 3.9 percent in 2018, up from the 3.7 percent growth registered in 2017. Strong activities in agriculture, fisheries, and forestry sectors, as well as in industrial sector (particularly construction activities), services sector (particularly financial intermediation and wholesaling and retailing-related activities) and the public sector, particularly policing force, had been the driving forces behind this growth. In line with these outcomes, labor market conditions improved and headline inflation rose to 4.2 percent but this rise was within the Central Bank's target range. With regards to the external sector, the Solomon Islands international trading, banking, and finance activities in 2018 had supported to have reduced the current account deficit and had bolstered the country's international reserves to 12.5 months of import cover.

In the financial sector, one licensed bank had lost its only USD Correspondent Banking Relationship (CBR) in the first quarter due to the global de-risking phenomena. The Central Bank intervened to prevent disruption in the inflows of export proceeds to Solomon Islands and to maintaining confidence in the domestic banking system. Moreover, the intervention gave the concerned bank rooms to negotiate and establish a new CBR. By end of 2018, the concerned bank managed to establish a new CBR. It would have been detrimental to the financial system and the macro-economy at large had the CBR not established.

Licensed banks and non-bank financial institutions remained profitable overall. This had helped them to build up their capital and liquidity buffers. The implementation of IFRS 9 standards have had some negative impacts on their profitability in 2018 but this impact was perceived to be a one-off transitory issue and their level of profits are expected to return to their trend soon.

Vulnerabilities and risks that Solomon Islands financial sector are exposed to are discussed in Chapter 3 of this Report.

Agriculture Sector: Two local workers grating coconut for the virgin coconut oil crushing mill in Isabel Province.

CHAPTER 3: VULNERABILITIES, RISKS & MACROPRUDENTIAL POLICY RESPONSES

1. Vulnerabilities

Solomon Islands financial system and its infrastructure performed reasonably well in 2018, despite the persistence of few vulnerabilities and risks to the system as outline below.

Vulnerabilities Relating to Climate Variability Risks

Solomon Islands is among the top ten[2] highly vulnerable countries in the world that are susceptible to weather and climate variability risks. Increases in average temperatures, changes to precipitation patterns, rising sea levels, and changes to the frequency and ferocity of extreme weather events such as droughts and storms have serious adverse consequences for the agriculture, fisheries, and tourism sectors. A drop in the production of agriculture and fisheries, or a drop in the occupancy rates of resorts and hotels, will disrupt revenue inflows and weaken the ability of retail and corporate borrowers in these sectors to generate income and service their loans on time. Delays in loan repayments affect the quality of assets in the system. A sustained rise in the level of toxic assets in the system will erode the liquidity and profitability buffers of banks and credit institutions, and therefore may have implications for financial sector stability. For these reasons, the government and its stakeholders must work together to develop appropriate risk mitigation mechanisms that are appropriate and cost effective for Solomon Islands, and to ratchet up the country’s disaster preparedness, to minimize financial losses associated with adverse weather and climatic conditions.

Vulnerabilities Relating to Cyber Security Threats

Work on the underwater submarine communications cable linking Solomon Islands and Australia is due for completion in late 2019. Notably, Solomon Islands will benefit from this project through better bandwidth, faster transfer speed, and reliable internet connection and low costs. Notwithstanding, this project, once complete and becomes operational, will bring with it a wide range of risks that have the potential for undermining financial sector stability. Notably, the increase in bandwidth will significantly increase the amount of data traffic between Solomon Islands and the rest of the world. This will increase the exposure of the financial institutions, infrastructures and market to cyber-related risks. The frequency and ferocity of unauthorized exploitations of systems, information breaches, ransom malware attacks, hackers’ and/or impersonators’ of activities, and other types of cyberattacks will definitely rise proportionally. Should any of these unauthorised breaches be successfully executed, the cost to the economy can be colossal and detrimental. For this reason, all stakeholders must be prepared and vigilant. To ensure this, stakeholders must work together and put in place a robust cyber risk mitigation system now. This is critical to protecting all valuable and critical information assets of banks and non-bank financial institutions, government and quasi-government institutions, as well as households and businesses.

Vulnerabilities Relating to Infiltration of Shadow Financial Institutions

Solomon Islands has so far registered two Micro Finance Institutions (MFIs), one a membership-based MFI and the other a non-membership-based MFI. The MFIs are financial institutions registered to provide loans to households. They are not licensed by the Central Bank. As such, they are not subject to the Central Bank’s stringent regulatory and supervisory oversight like licensed banks and non-bank financial institutions.

The MFIs provide loans to the marginal socioeconomic segment of the society, as well as to the formal sector employees. Their presence in Solomon Islands has some advantages. Firstly, they provide the formal sector employees with optional choices of credit sources. Secondly, they offer financial services to the marginalized women that would not have otherwise been provided by the traditional financial institutions. Thirdly, the existence of such financial institutions contributes to broadening the financial system in Solomon Islands. Finally, their services are highly rated. Customer satisfaction is high given that their decision turnaround time for accessing loans are much shorter. Because of this, they are perceived to be more customer-oriented than licensed banks and credit institutions. In spite of these positive observations, the MFIs, specifically those providing the loan services to the formal sector employees, have the potential to contribute to financial sector vulnerability if no proper regulatory and supervisory mechanisms are put in place now by the responsible authorities.

The MFI providing loans to the formal sector employees, because it is lightly regulated, has lax underwriting standards. As a result, employed households are exploiting this gap to obtain additional loans[3]. This was in spite of them having active loans with licensed banks and credit institutions and in spite of them having high debt-to-income ratios. Having additional exposures, particularly when the debt-to-income ratios are already high, only contributes to exacerbating the debt burdens and default

2 World Risk Report 2018

3 Generally, households who exploited this gap are those that have existing loans with banks and are locked out of obtaining additional loans due to ineligibility reasons

risks of households. In addition, it also contributes to increasing the credit and liquidity risks of licensed banks and credit institutions and therefore can undermine financial sector stability in the future.

Due to laxity in the regulation and supervision of MFIs, criminals may exploit them to launder funds or obtain funds to support and fund illicit activities. Persistent illicit activity is a risk. They must be eradicated and prevented from entering Solomon Islands financial ecosystem. This is because they have the potential to eroding the integrity of domestic financial system and to lifting the financial and sovereign risk profile of Solomon Islands. The government, therefore, must develop and implement an appropriate framework for MFIs. Importantly, such a framework must be effective and robust enough to enable the responsible government department to regulate and supervise MFI's conduct and operations.

Vulnerabilities Relating to Cryptocurrencies

Promotion of cryptocurrencies such as bitcoins had risen in recent years. In 2018, a group of crypto-asset promoters visited Solomon Islands. They met with Government officials to promote the benefits of holding crypto exposures and to explore ways of operationalizing cryptocurrencies to promote financial inclusion. Although platforms used for crypto-assets may have some advantages, all stakeholders must be aware of risks associated with crypto-assets before undertaking any commitments. This is because crypto-assets are highly volatile and are highly illiquid assets. Moreover, because they can be difficult to trace, criminals may be using them for money laundering, terrorism financing, tax evasion, and other criminal activities. All these criminal activities have potential to undermine the financial integrity and reputation of Solomon Islands financial sector.

Vulnerabilities Relating to Non-Performance and Weak Enforcements of Standards

Weak enforcement of 'standards of risk' has undermined the insurance underwriting landscape in Solomon Islands. If this continues, licensed insurance underwriters may be unwilling to underwrite certain classes of risk and this may unnecessarily expose domestic businesses and households to high levels of catastrophic and financial risks. In 2018, some licensed insurance underwriters had begun the process of de-risking some classes of risks due to the low demand for and the perceived level of riskiness of those classes. These classes include:

- the comprehensive insurance coverage for motor vehicle. This class of insurance is not compulsory in Solomon Islands. Hence, its uptake in Solomon Islands has been very low and this is increasing the liability risks of insurance underwriters. To minimize risk of de-risking, the responsible authorities should consider making comprehensive motor vehicle insurance compulsory, like Compulsory Third Party Insurance, in Solomon Islands.
- the insurance coverage for certain classes of buildings for failing to meet the minimum safety standard like installation of basic firefighting equipment.
- the insurance coverage for certain classes of construction and logging company workers for failing to meet the minimum safety requirements like wearing safety boots, helmets and so on.

In addition to the weak enforcements of standards of risks by the respective Solomon Islands authorities, banks and non-bank financial institutions are also highly vulnerable to risks associated with the lengthy delays in registration of mortgage charges. The respective government department responsible for this important requirement is very slow in registering charges on mortgages. This resulted in a huge backlog of registration, which spanned several years' back. The Government must rectify this issue as quickly as possible given that this issue is exposing financial institutions to huge financial risks and is unnecessarily forcing banks to de-risk lending to certain sectors, especially home loans. Moreover, this issue is also unnecessarily muting the borrowing appetite of potential homeowners and is unnecessarily constricting the money creation activities of financial institutions.

2. Risks & Macroprudential Policy Responses

Credit Risks arising from weak underwriting standards, and pressure to increase market share

During 2018, the level of asset quality in the financial system remained a key concern for financial system stability. Some banks and non-bank financial institutions, in an endeavour to grow their market shares, had relaxed their underwriting standards and lending criteria by accepting new risky loan proposals and risky refinancing loan proposals. Although credits had been extended to borrowers[4] , which was good for businesses and the economy, those loans turned to non-performing within a short span of time. This became a prudential concern given that no thorough assessments were made on the debt-servicing ability of new borrowers and on the refinancing proposals so credit risks had just been transferred from one institution to another. Under current trajectory, the overall loan performance is expected to deteriorate in 2019. The expected slowdown in economic growth, the anticipated high persistency in the level of debt burdens, and the limited domestic growth opportunity will push the quality of available assets in the system down.

The Non-performing Loans ratio (NPL), which measures the level of loans that does not generate income for banks,

4 Loans were given to new borrowers for personal and business use and to current borrowers for loan refinancing purposes.

persisted above the Central Bank's internal threshold of 5 percent since 2017. This level of NPL persistency is associated with chronic delays by the central government to release payments to government's contractors and service providers, who in return rely on government payments to repay loans. Some behavioural factors also contributed. Retail and corporate borrowers had also been diverting income meant for loan repayments to other purposes and this complicates the efforts of banks and credit institutions to reduce their level of exposure to non-performing assets.

For credit unions, the rising level of NPLs are driven by the blatant disregard of lending policies. This had led to the general rise in the level of unsecured loans approved and the rise in the level of emergency loans approved, which is a prudential concern. Members who obtained credits from these two loan products had done so in excess of their savings and repayments' ability, resulting in problematic loans. Credit unions are small operations, thus they lack proper management information and loan tracking system. Moreover, because credit unions operate on the principles of voluntary service, board oversight had also been weak. These factors had effectively weakened the ability of credit unions to perform timely loan reviews and to execute timely recovery actions.

The rise in the level of NPL in the system exposes Financial Institutions (FIs)[5] to risks given that high NPLs reduces income earnings from original loan contracts, and creates additional administration costs. Reduction in anticipated income and profitability will encumber efforts of FIs to reverse the declining profitability trend and to augment liquidity and capital buffers. In an effort to minimize credit risk, some FIs curtailed lending to high-risk sectors and to applicants or businesses with a single source of income, particularly income from the Government. This constrains businesses from obtaining additional working capital to expand activities.

To minimize the impact of credit risks to the system, the Central Bank has instructed banks and non-bank financial institutions to strengthen their underwriting standards for assessing loan and refinancing proposals to ensure they meet minimum credit standards. Additionally, the Central Bank had also encouraged banks and non-bank financial institutions who are not yet members of the Credit Bureau of Solomon Islands to become members. Although membership is voluntary, their membership to the credit bureau would guarantee them access to vital customer information or track record that are useful to assess credit application. The Central Bank had also been vigorously enforcing prudential standards on asset classification and minimum provisioning requirements and on large credit exposures. Strict enforcements of these standards help in determining the true level of available quality assets in the system.

For credit unions, the Central Bank has informed them the importance of engaging in secured lending practices. This lending strategy will mitigate loan losses and reduction in capital and reserves going forward. If unsecured lending and granting of emergency loan practices persist, the Central Bank may consider using directives to change the behaviour of credit unions toward risky lending practices.

Risks to Key Persons, Positions and Weak Oversight (non-performances of assigned responsibilities)

Solomon Islands National Provident Fund (the Fund) is the largest licensed non-bank financial institution in Solomon Islands. At the end of 2018, it accounted for 35 percent of total assets in the financial system and has a fiduciary responsibility to its members. The board is the highest decision-making body of the Fund. It is responsible for providing the overall governance, management, and strategic direction of the Fund. Decisions it makes have rippling effects on the financial sector. They impacted the balance sheet movements of banks and non-bank financial institutions and the level of liquidity available in the system. For these reasons, it is prudent that only individuals with good standing and reputation hold positions of higher responsibilities in the Fund.

Unfortunately, the Fund has a weak fitness and propriety framework for assessing individuals to the Fund board. Notably, individuals that had been appointed to the board of director positions in the past had been chosen on the basis of the ministerial discretion and on the basis of the Fund-Employer relation, therefore may be subject to weak fitness and propriety assessments. This mode of selection is a risk to the stability of the Fund for it had brought in individuals with questionable reputation or individuals with ulterior motives to serve in the Fund board. Hence, this had been the source of ill or compromised investment decision-making and the source of negative publicity in the past. During 2018, a civil society was publicly questioning the fitness of some directors and the probity of certain investment decisions. Those negative publicities have the potential to elevate the reputational risk of the Fund and to erode the trust and confidence that members have in the administration of the Fund. Hence, only fit and proper individuals must serve in the Fund board.

This issue is also prevalent across the credit union sector. Individuals appointed to serve in the board and in the various subcommittees of the board had lacked the necessary skills to perform their oversight responsibilities. This had contributed to weak governance, chronic mismanagement of credit union finances, and dwindling membership confidence in credit unions as an alternative bank for members. The decline in membership confidence needs to be reversed as it may impact negatively on income and balance sheets of credit unions as well as complicates effort by the Registrar of Credit Union's office to grow the credit union movement in Solomon Islands.

To mitigate risks associated with appointments of unfit and improper individuals to key positions within finan-

5 FIs include banks, credit institutions and credit unions

cial institution, the Central Bank had developed a prudential standard on 'Fitness and Propriety of Individuals Holding Responsible Persons Position. This standard provides a minimum guideline on what banks and non-bank financial institutions must consider prior to appointing individuals to key positions, in particular, directors to board of directors and chief executive officer positions, within banks and non-bank financial institutions. Notably, the standard is aimed at strengthening accountability and good governance practices by ensuring that only individuals with right levels of competency, skills, character, reputation, and experience are appointed. This prudential standard will become effective in the second half of 2019 and it will be applicable to all licensed banks and non-bank financial institutions in Solomon Islands.

Risks Relating to Ageing Legislation and Discretionary Decisions

Financial sector legislations are important supervisory instruments. They protect financial consumers and households from moral hazards that are inherent in certain decisions. In addition, they provide order and stability to the financial system. Unfortunately, all financial sector legislations in Solomon Islands are outdated and lacked precision to deal with changing financial landscape. Outdated legislation is a risk to the financial system. It diminishes effective supervision and undermines the ability of financial sector supervisors to respond promptly to identifiable risks to banks and non-bank financial institutions and to the Solomon Islands financial ecosystem. A classic example of risks associated with outdated legislation relates to the apparent conflict between the Financial Institutions Act (FIA) and the Solomon Islands National Provident Fund Act. Gazette Notice 81 of 2002 had subjected the Fund to FIA and in so doing to the Central Bank supervision. However, the FIA is meant for banking business and not for the superannuation business. Hence, some provisions within the FIA conflicts with the Solomon Islands National Provident Fund Act. Those conflicting provisions had created confusion over the years. It had also undermined the ability of financial sector supervisors to undertake corrective actions to combating identifiable governance and operational risks in the Fund over the years. In addition to the conflicting provisions, the current Solomon Islands Provident Fund Act permits adhoc decision-making process by giving the responsible minister the power to approve requests from members to withdraw their funds for purposes outside of the regulated withdrawal criterion. This practice had been going on for sometimes but had picked up noticeably in 2018. Admittedly, this practice is a risk to the Fund. It encouraged infiltration of political decisions into the governance and operational machineries of the Fund. Moreover, it had opened up the door to actual and potential conflict of interest situation, had undermined the consistency in the decision-making processes, and had created the uncertainties in forward liquidity planning in the Fund.

The credit union sector legislation is also an ageing legislation and is a risk to the growth and development of the credit union movement in Solomon Islands. It is also a risk to the stability of credit unions and need urgent review. The current legislation for example compelled financial sector supervisors to get ministerial approval prior to taking corrective actions against problematic credit unions. Unfortunately, getting ministerial approvals have significant time lags. During times of financial distress, a delayed action compounds financial risk. Specifically, a delayed supervisory action plan rapidly accelerates financial losses and credit union members are the ultimate losers in the end.

In response to risks associated with ageing legislations, the Central Bank is working with the Economic Reform Unit within the Ministry of Finance and Treasury to stress to the newly installed Democratic Coalition Government for Advancement (DCGA) the importance of reviewing the ageing financial sector legislations. To this end, the decision by the DCGA Government to document the review of the Credit Union Act and the Insurance Act in its action plan for the first hundred days is a step in the right direction.

Investment risk arising from fluctuations in interest rate and exchange rate Movements

Banks and non-bank financial institutions have investment portfolios offshore. Offshore investments accounted for 8 percent of their total portfolio and their income from this source had been volatile since 2017. The volatility in interest rate and exchange rate has affected banks and non-bank financial institutions but the impact is much more noticeable in the superannuation sector. The Fund registered substantial losses in value terms[6] compared to 2017 due to adverse currency movements. This loss could have been minimized had the Fund utilized hedging facilities. Under current setting, risks of asset revaluation loss emanating from offshore investments remained at elevated levels. This, coupled with higher utility and telecommunications' costs, continues to impact negatively on profitability of banks and non-bank financial institutions.

In response to the investment risk arising from fluctuations in interest rate and exchange rate movements, the Central Bank encourages the Fund to monitor developments in offshore financial markets and to diversify its investment portfolios. This can be investing in baskets of regions rather than in just one region and in just one currency. Moreover, as the Fund had outsourced the administration of its offshore investments to a third party, the Central Bank had also impressed on the Fund the importance of engaging only credible and reputable fund managers to manage its offshore investments and to adhere to the prudential standard on investment for the Fund issued by the Central Bank.

6 The Fund recorded a revaluation loss of $13 million at end-2018, higher than the revaluation loss registered in 2017

Valuation Risks

Unrealized gains from unlisted shares had been influencing the level of profitability of some non-bank financial institutions. For example, the notable increase in the level of profit for the superannuation sector had emanated from unrealized gains. The valuation methodology employed determines the value of unrealized gains. Prudent practice requires consistency in valuation methodology employed. Unfortunately, valuation methodology used changes purposely to suit the bottom line. Frequent or unjustifiable changes to the valuation methodology employed is a risk. It has the potential to overvaluing assets and overstating profits leading eventually to rising reputational risks and could erode the reserve of the fund in the long term.

To mitigate risks associated with gains from unlisted equities, the Central Bank encourages non-bank financial institutions to apply a consistent valuation methodology, which is to be performed only by qualified and accredited expertise in the field. Moreover, the Central Bank also encourages non-bank financial institutions to ensure that other factors contributing to valuation risks are incorporated in the valuation exercise. These factors may include the completeness of data, movements in the market, financial modelling limitations, and quality of data analysis. Taking all these factors into consideration would help non-bank financial institutions obtain near-to-right estimates of the unrealized gains, which is critical to producing realistic financial picture.

Liquidity risk remained a concern for some banks and non-bank financial institution

About 40 percent of all registered credit unions in Solomon Islands experienced substantial liquidity crunch during the year. This had emanated from high levels of non-performing loans (NPLs), which is projected to persist in 2019 given that those NPLs were all unsecured loans. The rise in the level of NPLs had been constricting the main income source of credit unions and the stock of available funds for lending to members and meeting operational expenses of credit unions. This issue is slowly taking a toll on credit union movement resulting in dwindling membership confidence and rising memberships' withdrawal demand.

To reduce the impact of the liquidity crunch in the credit union sector, the Central Bank has instituted various stabilization measures with the affected credit unions in 2018. In particular, it took over the administration of payments and directed the affected credit unions to call for extraordinary meetings for members to vote in new officers to oversee the administration of their credit union. Moreover, the Central Bank had also directed the affected credit unions to initiate recovery actions against legacy borrowers and to tighten their underwriting standards for loans by putting a tight lid on all unsecured lending practices. To help the affected credit unions' recovery plans, the Central Bank had developed a loans repayments' schedule spreadsheet. The spreadsheet should assist credit unions in financial and liquidity planning going forward.

Concentration risks stemming from limited domestic investment and growth opportunities

Credit issued to private sector by banks and non-bank financial institutions is concentrated in five economic sectors. These sectors are: personal, distribution, construction, tourism, and communication. Similarly, in-country investments in the real and financial sectors so far are confined in three areas – shares, time deposits, and rental properties. This concentration reflected limited business opportunities and is associated with structural issues affecting the country. In addition, lack of prioritization by successive governments to grow, and develop other economic sectors contributed to this concentration and large credit exposure risks. As a result of all these factors, concentration risks and large credit exposure risks persisted and are likely to remain so unless the government develops other undeveloped economic sectors, and diversify the distribution of national projects to other provinces that Solomon Islands has comparative advantage in to create employment and income. This strategy should induce banks and non-bank financial institutions to extend credit beyond Honiara and beyond the five economic sectors mentioned above. In this way, banks and non-bank financial institutions will be able to expand their money creation activities and at the same time diversify risks across the economy.

The DCGA government's strategy to reform land, prioritize Tina Hydro project, develop and grow other economic sectors, and to diversify distribution of national projects to other provinces, are welcomed and are steps in the right direction. These strategies will help in reducing concentration risks and in reducing costs of doing business in the long-term.

During the year, the Central Bank had also cautioned a non-bank financial institution from investing in same sectors to reduce concentration risks and from acquiring equities from corporations with weak balance sheets. For offshore investments, the Central Bank had urged one

CHAPTER 4: DOMESTIC FINANCIAL SECTOR DEVELOPMENTS

non-bank financial institution to engage credible and reputable fund managers only to manage its offshore investments and to have in place mechanisms to review investment performances and conduct of its fund managers going forward.

1. Banking Sector

The Solomon Islands' banking system remains resilient with four institutions operated as commercial banks and two as credit institutions, serving a very vital market for economic development. The banking sector dominates the Solomon Island financial sector, holding 61.3 percent of the financial sector's total assets in 2018. Its dominance signifies the central role it continues to play in the financial system.

The banking sector in Solomon Islands is foreign owned, and establishing a business model driven by strategic directions more tailored to advanced economies is a challenge for these banks to serve consumers' and the financial services needs of the country as a whole. Furthermore, with limited growth avenues, these players are at times disrupting their own business models to maintain profitability and this poses risk to the system. Banks, being profit motivated pursues an objective of profit sustainable growth as a priority to maintaining the sector's resilience today.

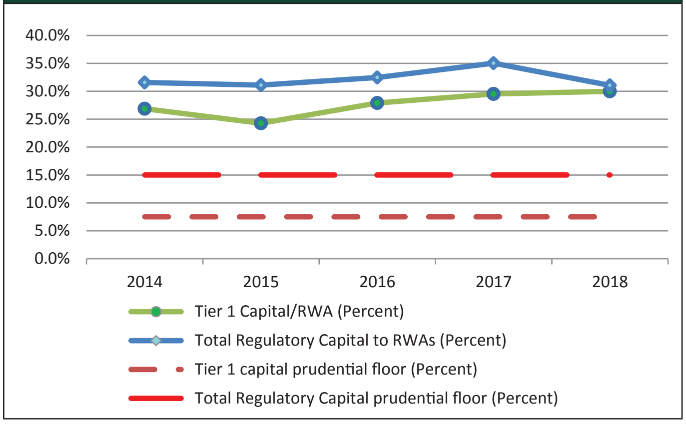
Overall, the banking sector in Solomon Islands remains profitable. Total asset has reached $6.119 billion as at end-December 2018. The continuous build-up of its capital level through retained earnings continues to cushion the bank against unexpected losses, as well as allows for expansion of business. The quality of banks' assets is deteriorating as measured from loans and advances past due 90 days or more, but are well secured and manageable at institutional level. The Banks continue to trade within prudential limits by holding open foreign currency positions within the Central Bank of Solomon Islands (CBSI) prudential requirements.

1.1 Capital Adequacy

Total regulatory capital for the banking sector stood at $757.7 million as at end-December 2018. An increasing trend has been witnessed over the last five years on the amount of capital the sector has been holding, reaching its peak at end-March 2018, but since then has tapered off, and reaching the current level. The fall reflects the amount of retained earnings that has been repatriated to the parent bank offshore in 2018 by means of dividend payment. Total dividend paid during the year was $114.8 million. This amount is broadly within expectation given that all banks operating in Solomon Islands are foreign owned.

Despite the fall in the capital level, the banking sector has ample capital. It holds 16.1 percent in excess of the required minimum regulatory threshold of 15 percent as at end of December 2018. Overall, the sector has a capital coverage ratio of 31.2 percent. This implies banks are well capitalised to meet unexpected shocks that may arise in the near-term (Chart 1.1).

Chart 1.1: Banking Sector Capital Adequacy



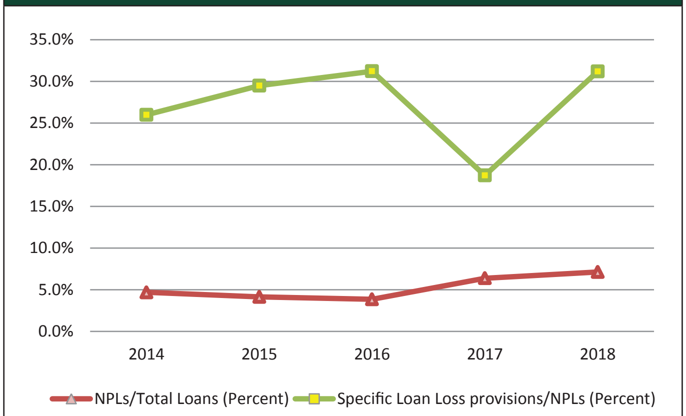
Source: CBSI

1.2 Asset Quality

The banking sector continued to concentrate its lending activities to the key economic sectors namely, personal, distribution, and construction, with lending to tourism, transportation and manufacturing picking up recently over the years. Some banks have tried to extend credit to the Micro and Small Medium Enterprises sector (MSME), however, this sector is perceived to be of very high risk given that businesses in this sector are still in their infancy stage. However, MSME sector has a potential to grow if it is well developed.

For the year ending 2018, total loans and advances reached $2.424 billion. Of the total exposure, 7.2 percent are classified under Non-Performing Loans (NPLs). Personal sector continues to dominate NPLs of which 69.1 percent is

Chart 1.2: Banking Sector NonPerforming Loans (NPLs)



Source: CBSI

NPLs to housing, 30.5 percent is NPLs to households for personal use, and 0.3 percent is NPLs to land purchase. Despite the high NPLs, personal loans are mainly secured against Solomon Islands National Provident Fund's 2/3 pledge held as collateral by the banks (Chart 1.2).

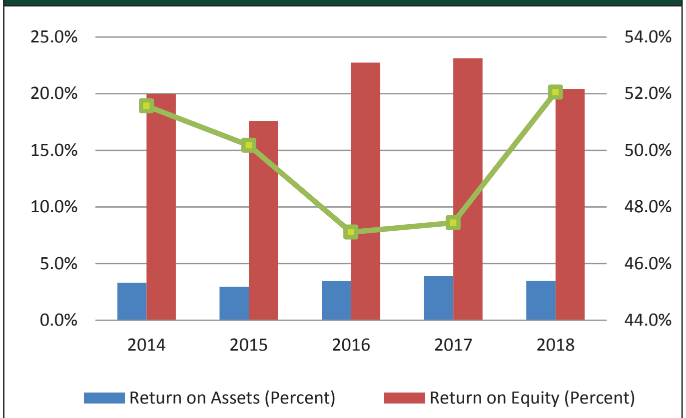
NPLs to the construction sector might pose some risks if banks continue to entertain the deficiencies existed with how funds are being disbursed to borrowers for construction purposes. Most loans in this sector fall into arrears due to poor fund management by borrowers during the construction process, thus incurring additional cost and further delay to the completion of projects, which jeopardised the repayment capacity of the borrower. An additional factor to have increased NPLs is the unavailability of an active market for leased properties both for commercial and residential purpose. Loans to this sector are mostly serviced by rental income from these properties. Though these loans are adequately secured, the timely sale of collateral for recoveries remains an issue that is outside the control of the industry.

The continuing delay by the government to release payments to government's contractors and service providers, as well as landlords, who in turn rely on government payments to repay loans, remains a major contributing factor to the high NPLs in 2018.

1.3 Profitability

Despite the high operational cost incurred during the year, profitability of the banking sector remains strong. Total operational cost (non-interest income) went up higher, representing 52.1 percent of total gross income in 2018 (Chart 1.3). A 10.8 percent increase from $209.7 million recorded in 2017 is noted during the review period. The high operational cost is not only felt by banks operating in the country but also globally across the banking industry. Therefore, banks, as part of their strategic direction, have started to improve their Information Technology (IT) system and embrace digital innovation as part of improving cost efficiency.

Chart 1.3: Banking sector Profitability



Source: CBSI

Despite the banks going into digital platform to reduce cost and improve the efficient delivery of financial services, this has not reflected on the reduced manpower need of the bank to sustain operations. Personnel expenses represent 30.1 percent of total operational cost of the industry in 2018, maintaining the level witnessed since 2010. Administrative and occupancy expenses accounts for 21.9 percent and others (Board of directors' expenses 0.9 percent, outsourcing services fees and expenses 12.4 percent, depreciations on fixed assets 9.5 percent and others 25.3 percent) all totalled to 48.1 percent in 2018.

To leverage the high operational cost, some banks have reduced their interest expenses paid to depositors as part of their strategic decision, and maintaining high fees and charges as reflected by the percentage increase of 84.9 percent witnessed in 2018, coupled with other non-interest income which almost doubled for the same period recording a 94.1 percent increase compared to 2017. Net gain on foreign currency revaluations slumped in 2018 after one of the banks lost its USD corresponding bank having significant negative impacts to its earnings during the year and is felt across the industry. This reflects the important role banks continue to play in the foreign exchange market and in return provides a major source of income for the banks.

In terms of provisioning for losses expenses, this totalled to $19.3 million as at end-2018, a 10.5 percent drop from the same period a year ago. The fall was associated with a drop in general loan loss provisions by almost four times the total recorded in 2017 at $1.7 million. The decrease was offset by increase in specific provisions on loan losses by 30.8 percent due to increased problem loans noted during the period.

Interest income on loans and advances remains the core source of income for the banks at 54.5 percent in 2018, buttressed by non-lending income. Despite the strong earnings, ongoing pressure on profitability remains, given high NPLs, which if not managed well at institution level, can erode banks' profitability and gradually have trickle-down effects to capital.

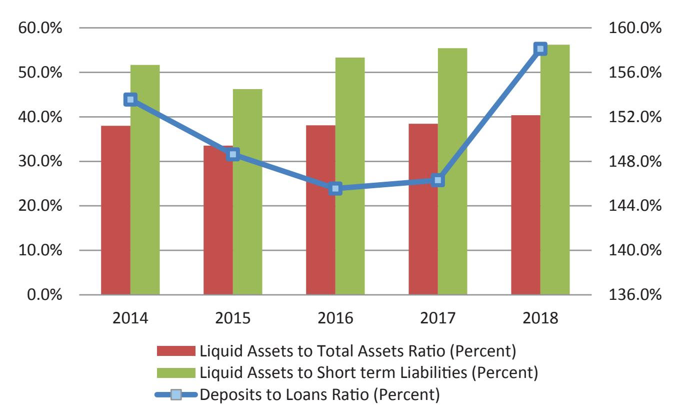
1.4 Liquidity

Liquidity remained high within the banking sector during 2018, with deposits to loans ratio at 158.1 percent and liquid asset to short-term liabilities ratio at 56.2 percent (Chart 1.4). This indicates banks have sufficient funds on hand to meet obligations as they fall due, and even to expand asset base. Due to low potential growth in lending activities, the banks' function of wealth creation is slowing down leaving much of banks' deposits underutilised.

The government has a greater role to play to diversify sectorial developments to allow growth opportunities across the country. Otherwise, idling funds will only incur additional holding cost to the banks as has been witnessed by rising interest paid on deposits in 2018 totalling to $17.9

million; a growth by 18.9 percent compared to 2017.

Chart 1.4: Banking sector Liquidity

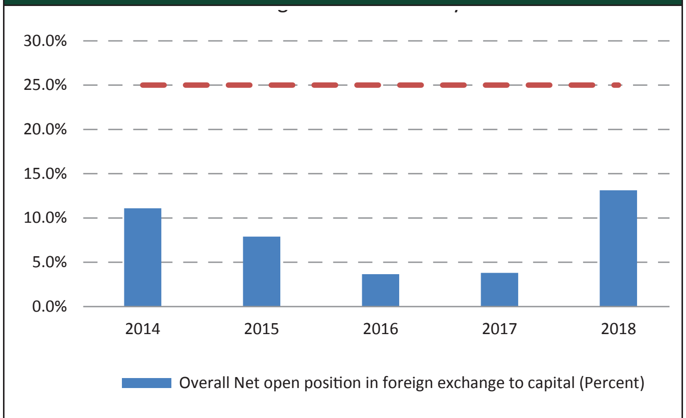


Source: CBSI

1.5 Sensitivity to Market Risk

With the high capital level held by the banking sector, sensitivity to market risk ratios remains low. Single foreign currency (FX) open positions and overall foreign currency positions remain well within prudential limits at 15 percent and 25 percent, respectively. As at end of December 2018, overall net foreign currency open position was at 13.1 percent with a total exposure at SBD equivalent of $133.2 million to total capital at $944.0 million (Chart 1.5). FX transaction exposures are measured using the net FX cash flows method where open foreign currency positions in each currency is computed as of the close of each business day divided by the financial institution's total capital. During the year, no breach has been recorded indicating banks are conducting business in a profitable yet prudent manner.

Chart 1.5: Banking Sector Sensitivity to Market Risk



Source: CBSI

2. Superannuation Sector

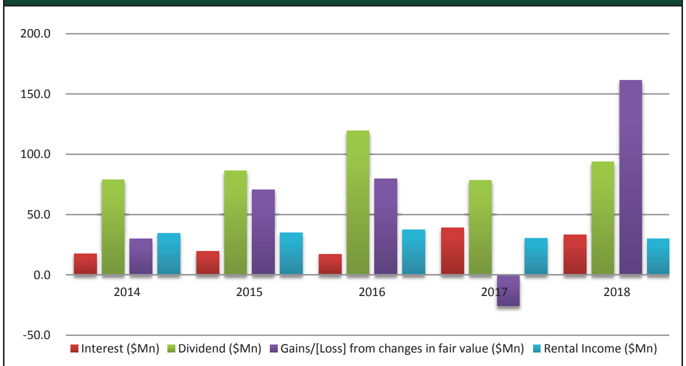
Solomon Islands National Provident Fund (the Fund) is the only licensed superannuation fund in Solomon Islands. It was established as the formal savings and retirement scheme for formal sector employees. In 2018, the Fund introduced a new product, 'YOUSAVE', to promote financial inclusiveness in Solomon Islands. The product was aimed primarily at bringing people in the informal sector to become formal members of the Fund. As members, they can save money for their children and for their own retirement. In addition to providing the retirement schemes, the Fund is also mandated to provide a mandatory minimum annual crediting rate of 2.5 percent to the members. Since its inception in 1973, the Fund has grown significantly, having considerable strengths, both on the membership and on the asset size, which signifies the important role the Fund plays in influencing the level of liquidity in the system, and the movement in the balance sheet of some banks and non-bank financial institutions. In addition, the Fund has also grown to become a crucial source of funding for the rest of the economy.

The Funds' total membership (active and non-active members) grew by a percentage point to 144,849 members, which are inclusive of the informal sector. About 4 percent of the total membership are from YOUSAVE contributors. From 2017 to 2018, assets of the Fund grew by around 11 percent to $3.5 billion.

2.1 Financial Performance

The Fund recorded an operating profit of $234.6 million for the year ended 31st December, 2018[7] . The outcome was underpinned by income earned on unrealized gains from unlisted equities, dividend income from shares, rents from rental properties, and interest on loans. (Chart 2.1). The trend of the Fund's profitability has been fluctuating due to the movements in the unrealised gains / (loses). Despite the uncertainty in the movement of the value of unlisted equities, the Fund continued to make positive profit in the financial year. Return on investment increased to 10.8 percent, higher than the return recorded in 2017.

Chart 2.1: Superannuation Sector Investment Income



Source: CBSI

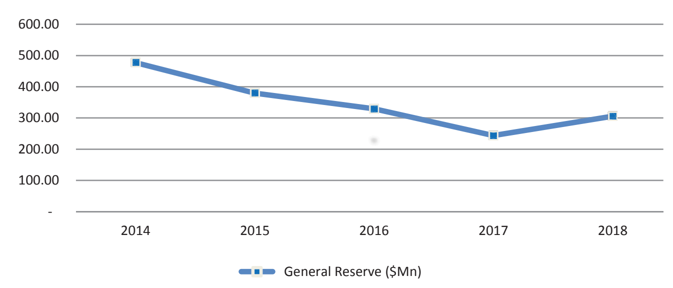
Given the positive earnings, the Fund's general reserves increased by 25 percent to $305.84 million. The general reserves account is one of the important accounts of the Fund given its direct linkage to the Special Death Benefit

7 In 2017, the fund made an operating profit of $46.2million

(SDB) scheme of the Fund. The amendment to the SINPF Act in 2018 resulted in the increase of SDB premium from $5 to $30 from each member per year. The increased in the premium deduction will see increase in overall funds for the SDB scheme, however, there is no guarantee that this increase is sufficiently enough to meet the demand for SDB given the fixed supply of SDB premium and the uncertainties associated with the demand for SDB. This demand-supply mismatch will make the Fund vulnerable to liquidity risk in the future. In 2018, the demand for claims on SDB had outstripped the supply of deductibles and the excess demands are being matched with drawdowns from the general reserves account (Chart 2.2), which is a risky practice going forward.

The Balance sheet of the Fund grew by 9 percent. This stemmed from growths in total investment of the Fund over the year (Table 2.2).

Chart 2.2: Superannuation Sector General Reserve



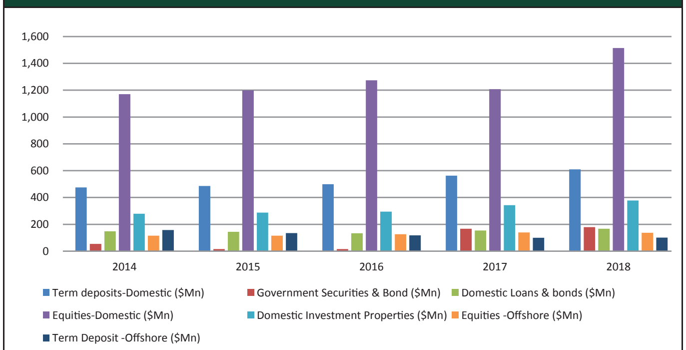
Source: CBSI

With regards to asset composition, investment assets accounted for 89 percent of the total assets. Cash and non-interest-bearing deposit accounts, non-financial assets, and other assets constituted 9 percent, 4 percent, and 3 percent of the total assets, respectively. The apportioning of assets comprehensibly supports the main vision statement of the Fund and that is to provide a decent life to its members during and after retirement.

The investment portfolio of the Fund grew by 15 percent to $3.1 billion in 2018 from $2.7 billion in 2017. New equity investments and term deposits made during the year were the main contributors to this growth.

The Fund investments were allocated into two broad categories: i) 92 percent were invested in domestic markets; and ii) 8 percent in overseas markets. From the allocation, domestic shares and equities comprises 49 percent of the portfolio and accounts for one-half of the total portfolio. Despite heavy reliance on domestic equities, the Fund is embarking on an investment strategy that attempts to rebalance the current investment portfolio to ensure a balance between risk and returns in order to achieve the main objective of the Fund. The allocation of other asset is shown on Table 2.1 and Chart 2.3.

Chart 2.3: Superannuation Sector: Investment Composition



Source: CBSI

Table 2.1: Superannuation Sector Asset Allocation

Other Asset Allocation	Share ratios, Dec 2018 results
Domestic term deposits	20%
Domestic properties	12%
Domestic bonds and securities	6%
Domestic Loans	5%
Offshore equities	4%
Offshore term deposits	3%

In terms of the Fund's liabilities, members' contributions accounted for 97 percent of total liabilities while other liabilities constituted the remaining 3 percent. Meanwhile, the membership profile of the Fund shows that 16 percent of the Fund membership are at retirement age representing 15 percent of the total members' contributions. Members nearing the retirement age accounts for 13 percent of membership and comprising 24 percent of the total contributions (Chart 2.4). In line with these statistics, the Fund Board and Management need to come up with appropriate policies now to mitigate risks of Fund not meeting its retirement payout demand obligation and other current and future obligations as they fall due.

On liquidity, the core liquid[8] assets to total assets of the Fund stood at 5.5 percent while core liquid assets to short-term liabilities[9] persisted above 82 percent suggesting that the Fund had ample liquidity to meet its obligations and commitments as they come due. Nonetheless, the Fund must not be complacent with this liquidity position. Rather, it must continue to monitor the performances of its onshore and offshore investments and the trend of its operational costs, including the trend in the demand for SDB. A proper investment mix planning is essential to meet the demands for compulsory withdrawals in the face of continuous rise in lenders' claim and other unspecified withdrawals, particularly those withdrawals that are associated with discretionary ministerial decisions.

8 Core liquid assets includes cash and demand deposits held with the banking sector

9 Short term liabilities include total value of contributions owed to members aged 51 and above and other liabilities.

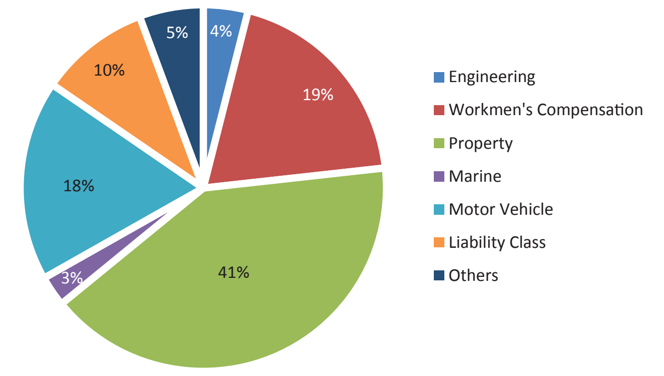
3. Insurance Sector

2018 has been a challenging, yet a fruitful year for the local insurance sector. Insurance is still deemed to be an involuntary expense in Solomon Islands partially due to the general lack of understanding and awareness of insurance products, services, and benefits. Nonetheless, in view of the obstacles in the growth of the insurance sector, it has performed reasonably well in 2018. The asset base of the sector grew by 11 percentage points to $136.6 million in 2018. This accounted for 1.4 percent of the overall financial sector's total assets. At the end of the year, two licensed general insurers and one composite licensed insurer` continued to operate insurance business in Solomon Islands. Insurance brokers however increased to four with a new entrant being issued a license to operate insurance broking business at the closure of 2018. Insurance agents on the other hand, remained unchanged at three. While the year ended successfully for the insurance sector, emerging risk due to climate change and technology brought new challenges for this segment of the economy. However, the sector continued to perform its mandated role by providing protection against financial losses associated with natural calamities, as well as enhancing financial resilience to shocks within the economy.

3.1 Lines of businesses

The sector showed improvements in its top-line growth with gross premium inflow grew by 10 percent in 2018. Record showed that premium income for workmen's compensation and motor vehicle were the major drivers for the increase in gross premium. However, on an aggregate basis, premium inflow from property class of insurance still represents the largest portion recorded during the year. It accounted for 41 percent of the total premium written. This include premium paid for both commercial and household insurance for insurance protection against fire and other weather perils. Workmen's compensation insurance followed suit with total premium written accounted for 19 percent of the overall premium recorded. Premium stemming from motor vehicle insurance constituted the other 18 percent of the overall premium, while the remaining 22 percent were shared between engineering, marine, liability and other classes of insurance [Chart 3.1].

Chart 3.1: Insurance Sector: Share of Premium Income by Class



Source: CBSI

2018 was a year of strategic realignment for the domestic insurance industry as domiciled insurers reassessed their risk appetite to leverage their exposures. Considering property insurance, properties that are below insurable standards and exposed to higher risk were removed from their books. This saw a decline in gross premium inflow from property insurance by 11 percent to $29.2 million over the year. Whilst this will benefit the insurers, it places the property owners and financiers in a vulnerable position to financial losses associated with catastrophic events. Workmen's compensation, on the other hand, surged by 57 percent due to tightening of premium rates by local insurers. The increase was mainly in terms of premium volume rather than the number of policies issued, as insurer are increasing their premium charges to reflect the amount of risk associated with this class of insurance. Gross premium income for motor vehicle also increased, by 6 percent. Causes for variations in gross premium are not limited to the factors mentioned above, as the case will not be the same across different classes of insurance. For instance, premium income for insurance classes of engineering deemed seasonal, as it depends considerably on availability of development projects due to improved economic conditions. Other classes (which include health insurance) are subjected to affordability, due to consumers' low disposable income. However, despite both external and internal pressures, gross written premium rose from $65.0 million in 2017 to $71.4 million in 2018.

3.2 Profitability, reinsurance and liquidity

The sector's profitability remained stable despite a decline in its net profit after tax. The latter resulted from a drop in net underwriting from $39.5 million to $34.7 million [Table 3.1]. This came on the back of an increase in net claims by 12 percent (Table 3.1). Net written premium (premium net of reinsurance) also increased but at a relatively slower pace (Table 3.1). In spite of this sluggish growth, the sector's profitability remained stable as net premiums are more than the sum of net claims and management expenses recorded during the year.

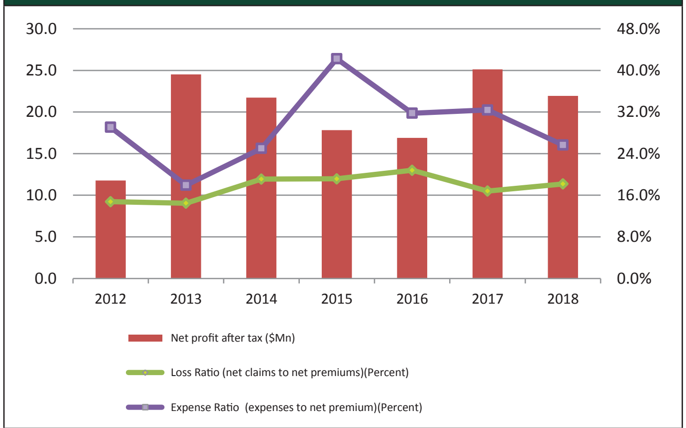
Table 3.1: Insurance Sector Movement in profitability ratios

Metrics	Profitability ratios, Dec 2018 results
Net Written Premium	increased by 3% due to increase in gross premium
Net profit After tax	declined by 18% from 14.7Million to 12.1 Million
Net Claim	increased from 7.2 Million in 2017
Net Expense	declined on an average of 18% to 21% from 2016 to 2018
Combine ratio	declined by 11% to 43.8 percentage points in 2018
ROE	declined by 1%

In 2018, the insurers continued to honour their obligations through payments of claims to their policyholders. In terms of insurance claims, the sector experienced two-fire incident during the first half of 2018 that amounted to approximately $6 million. High costs of goods, along with unavailability of local loss adjustors, made it expensive for local insurers to settle their claims. These contributed to the increase in claims recorded during the year (Table 3.1). Despite the increase in claims, the sector's overall loss ratio[10] remained stable at 18.2 percent (Chart 3.2), indicating strength of the sector's ability to maintain excess assets over liabilities to cushion unexpected losses.

The availability of excess assets reflects insurance sector's strength of solvency, which was also attributed to continuous decline in expenses, a trend witnessed since 2016 (Table 3.1). The sector's overall expense dropped further in 2018 from $13.9 million to $11.3 million. As a result, the sector's expense ratio declined over the year (Chart 3.2).

Chart 3.2: Insurance Sector: Profitability



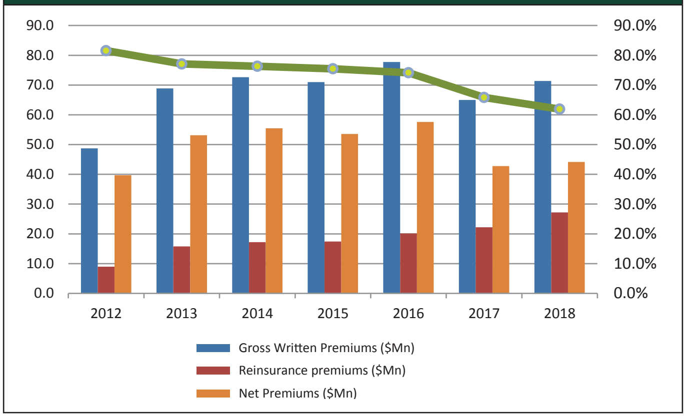
Source: CBSI

Overall, the sector's combined ratio[11] remained sturdy, despite registering a decline in 2018 (Table 3.1). The result was underpinned by stable inflow of premium income, coupled with sufficient cost control and risk management measures undertaken by the players within the sector.

The sector's profitability can also be seen from its return on equity ratio. Despite a marginal decline experienced in 2018 (Table 3.1), the sector's ROE remained stable, registering 45.5 percent at the end of the year. This reflects the sector's profitability and income generating capacity which is reflected by the sector's favourable underwriting performance; backed by growth in the sector's overall premium income.

The sector continued to efficiently manage its risk exposure through reinsurance arrangements with offshore reinsurers. By reinsuring its risk, local insurers minimize the impact of losses on their solvency; hence maintaining stability in the insurance sector. With a total of $71.4 million premium worth of risk receipt over the year, 62 percent of the total risks were retained while approximately 38 percent was ceded on reinsurance. This also signifies the strength and capacity of local insurers to cover insurance risks that exist within the economy (Chart 3.3).

Chart 3.3: Insurance Sector: Risk Retention Ratio



Source: CBSI

In terms of the sector's liquidity position, short-term liabilities grew by 10 percent while liquid assets rose by 32 percent. The increase in the former stemmed from an upturn in reinsurance payables and outstanding claims owed to policyholders while the increase in the latter resulted from an increased in currency and deposits held with commercial banks. As a result, Liquid assets to short-term liabilities rose from 134.3 percent in 2017 to 162.1 percent in 2018 (Chart 3.4), implying that the sector is adequately cushioned to settle immediate losses in the event of any rising claims.

In spite of the stable position, which was supported by favourable premium income and efficient cost control, the insurance sector needs to be vigilant, as new risks emerge due to climate change and the advancement of digital technology. Demand for specific classes of insurance to cover risk related to climate change will continue to rise, putting pressures on insurance companies to readjust their risk appetite in order to maintain their foothold in the property insurance market. Proceeding internet - fibre optic cable connectivity will boost internet speed once completed. This will increase vulnerabilities to cyber related risk, and hence the demand for cyber insurance. To that end, local licensed insurers need to develop specialized products targeting different client needs without compromising their liability exposure. This also include shifting from traditional risk management practices to creating incentives for customers who willingly undertake rigorous risk mitigation strategies to protect their risk.

4. Credit Union Sector

Although the sector only represented 1 percent of the overall financial sector, its unique ownership structure signifies the important role credit unions performed to provide microfinance to their members.

Credit unions, if managed prudently, could be an affordable channel to provide access to finance, and to some ex-

10 Defined as the ratio of net claims over net premium

11 Defined as the ratio of claims and expense over total earned premium

tent, to the unbanked and in so doing promote financial inclusion activities.

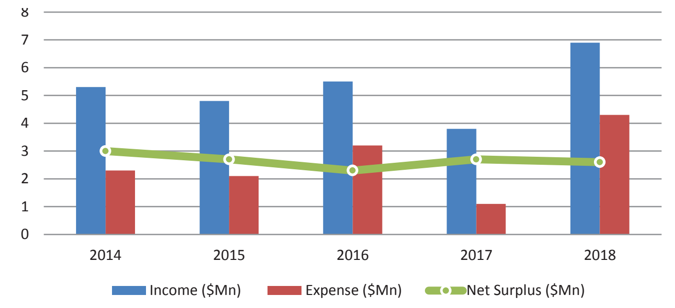
However, the sector continued to encounter a lot of challenges. These challenges mostly relate to governance issues due to the nature and size of credit union operations. Credit unions are small operations so they lack credible management information system and good internal control mechanisms. Lack of these basic infrastructures and policies have effectively undermined the prudent management of credit unions.

The total registered credit unions in the official registry were 175. In 2018, only ten credit unions were deemed active.

4.1 Financial Performance

Based on the financial report of the 10 active reporting credit unions, the sector recorded a net surplus of $2.9 million, up 7 percent in 2017, reflecting a 14 percent increase in interest income earned from loans (refer Chart 4.1).

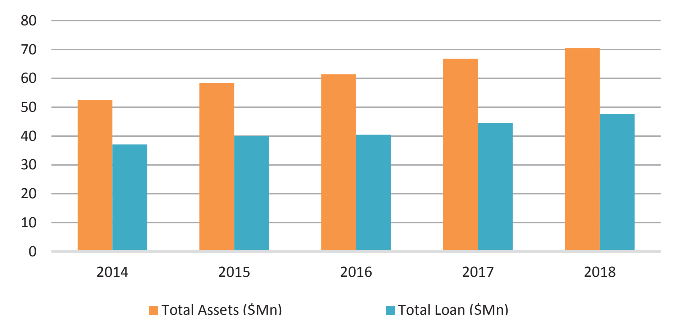
Chart 4.1: Credit Union Sector: Performance



Source: CBSI

Return on assets (ROA) for the sector persisted at 4 percent while return on equity (ROE) declined to 20 percent over the year (Table 4.1 - Apendix 4).

Chart 4.2: Credit Union Sector: Asset Growth

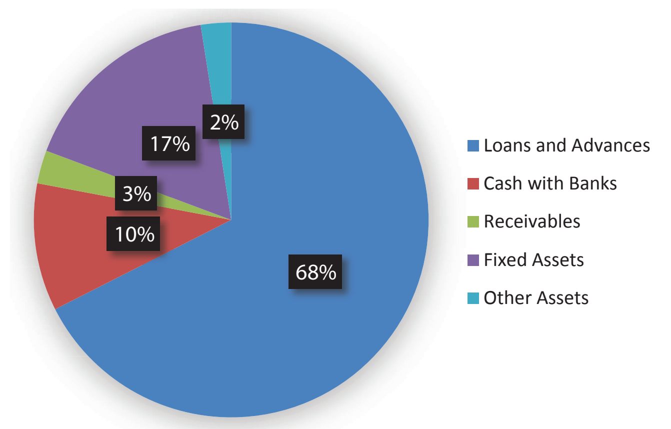


Source: CBSI

The indicator that gauges the level of efficiency shows that the sector will still be able to cover 47 percent of its operational costs.

During 2018, assets edged up by 4 percent to $69.7 million due to the increase in lending activities. Of these total assets, loans granted to members represented 67 percent, which in value terms amounted to $45.9 million (Chart 4.2).

Chart 4.3: Credit Union Sector: Asset Allocation



Source: CBSI

Non-current assets constituted 85 percent of the total assets. This high proportion could potentially expose the sector to liquidity pressure and cash flow problems and in turn could undermine their intermediary function (Chart 4.3). Meanwhile, building and properties comprised 18 percent of the allocation, indicating that the sector is digressing from its core business to other types of investments that requires technical knowledge to manage on behalf of the members.

To manage and ensure the sustainability and resilience of the sector, individual credit unions must adopt and put in place adequate controls and comply with the legal requirements and policies that govern their operations.

During the year, two credit unions were placed on the watch-list as the Office of the Registrar of credit unions (RO) adopted stringent measures to ensure proper administration and governance to combat risks of mismanagement and abuse of members' funds.

The Central Bank also conducted two onsite examinations in 2018 on two credit unions of which one is provincial based, apart from the normal quarterly consultations and monitoring undertaken with the sector.

The Bank will continue to provide the oversight function through onsite examinations and offsite surveillance to ensure individual credit unions manage the members' funds prudently.

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Appendix 1: Banking Sector

Table 1.1 Banking Sector Financial Soundness Indicators

Capital Adequacy	Dec-14	Dec-15	Dec-16	Dec-17	Dec-18
Total Regulatory Capital to RWAs (CAR) >15%	31.6%	31.1%	32.5%	35.0%	31.1%
Net NPL to Capital & Reserves	8.1%	7.3%	6.6%	12.2%	11.8%
Asset Quality					
NPL to Total Gross Loans <2% to <8%	4.7%	4.1%	3.8%	6.4%	7.1%
Specific LLP to NPLs (Coverage Ratio) >20% to <100%	26.0%	29.5%	31.2%	18.7%	31.2%
Earnings & Profitability					
Return on Assets (ROA) >2% to <6%	3.3%	3.0%	3.5%	3.9%	3.5%
Return on Equity (ROE)	20.0%	17.6%	22.7%	23.1%	20.4%
Net-interest Income to Gross Income	56.7%	55.0%	56.3%	55.0%	54.6%
Cost to Income Ratio >35% to <65%	51.6%	50.2%	47.1%	47.4%	52.1%
Non-interest Income to Gross Income	43.3%	45.0%	43.7%	45.0%	45.4%
Personnel Expenses to Noninterest Expenses	30.4%	31.1%	31.1%	33.9%	30.9%
Effective interest rate-loans					
Interest income /total gross loans	11.9%	9.9%	11.1%	11.1%	21.5%
Effective interest rate-deposits					
Interest expense/total deposits	0.3%	0.3%	0.3%	0.3%	0.7%
interest spread	11.6%	9.7%	10.8%	10.7%	20.8%
Liquidity					
Deposits to Loans Ratio >70% to < 150%	153.6%	148.6%	145.6%	146.3%	158.1%
Liquid Assets to Total Assets Ratio	38.0%	33.5%	38.1%	38.4%	40.4%
Liquid Assets to Short term Liabilities > 30% to <70%	51.7%	46.2%	53.3%	55.4%	56.2%
Sensitivity to Market Risks					
Net open position in foreign exchange to capital <25%	11.1%	7.9%	3.6%	3.8%	13.1%

Source: CBSI

Table 1.2: Banking Sector Income Statement (SBD million)

		Dec-14	Dec-15	Dec-16	Dec-17	Dec-18
1	Interest income	200.45	194.52	243.59	258.20	261.79
2	Interest expense	8.76	10.12	12.41	15.12	17.93
3	Net interest income (=1-2)	191.70	184.40	231.17	243.08	248.86
4	Non-interest income	146.32	151.06	179.69	199.03	202.99
	(i)Fees and commisions receivable	28.00	20.94	24.09	26.74	35.93
	(ii) Gains or losses on financial instruments	96.02	102.96	124.45	147.69	119.31
	(iii) Prorate earnings					
	(iv) Other income	22.29	27.17	31.16	24.60	47.76
5	Gross income(=3-4)	338.02	335.46	410.87	442.11	446.84
	Non-interest expenses	174.31	168.32	193.57	209.75	232.59
	(i)Personal costs	53.04	52.38	60.21	71.18	71.95
	(ii)Other expenses	121.27	115.94	133.36	138.57	160.64
7	Provisions (net)	27.30	34.53	29.61	21.57	9.33
	(i) Loan loss provisions	26.80	34.53	28.61	21.66	9.16
	(ii)Other financial assets	0.49	0.00	1.00	-0.09	0.17
8	Net income (before extraordinary items and taxes)(=5-(6+7))	136.42	132.61	187.69	210.79	204.93
9	Extra-ordinary items	0.00	0.00	0.00	0.00	2.50
10	Income tax	49.72	43.34	60.00	76.04	75.45
11	Net income after extraordinary items and taxes)(=8-(9+10))	86.70	89.27	127.69	134.75	126.98

Source: CBSI

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Appendix 1: Banking Sector (continues)

Table 1.3: Banking Sector Balance Sheet (SBD million)	Dec-14	Dec-15	Dec-16	Dec-17	Dec-18
12 Total assets(=13+14=25)	4,141.16	5,060.96	5,397.53	5,687.81	6,119.24
13 Non-financial assets	113.00	141.17	135.78	162.36	174.23
14 Financial assets (=15 to 18)	4,028.16	4,919.79	5,261.75	5,525.45	5,945.01
15 Cash and deposits	1,622.29	1,796.47	2,193.38	2,306.26	2,711.08
16 Loans (after specific provisions)	1,668.37	1,959.56	2,165.40	2,303.26	2,436.93
(i) Gross loans	1,688.94	1,959.56	2,191.72	2,331.05	2,436.93
(ii) Specific provisions	20.58	23.89	26.31	27.79	54.16
17 Debt securities	653.74	724.51	768.06	766.33	773.82
18 Other assets	83.76	463.14	134.91	149.00	77.34
19 Liabilities(=23+24)	3,420.47	4,276.43	4,519.86	4,697.34	5,104.85
20 Currency and deposits	3,297.14	3,836.67	4,288.67	4,441.74	4,918.05
21 Loans	3.96	3.10	4.91	2.32	5.54
22 Other Liabilities	119.38	436.67	226.28	253.28	181.26
23 Debt (=20+21+22)	3,420.47	4,276.43	4,519.86	4,697.34	5,104.85
24 Capital and reserves	720.69	784.53	877.67	990.48	1,014.39
25 Balance sheet total (23+30=12)	4,141.16	5,060.96	5,397.53	5,687.53	6,119.24

Source:CBSI

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Appendix 2: Superannuation Sector

Table 2.1: Superannuation Sector Financial Soundness Indicators					
	Dec-14	Dec-15	Dec-16	Dec-17	Dec-18
Total Superannuation Sector Assets					
Total Assets to Total Finanical system Assets Ratio	38.1%	35.9%	35.2%	34.2%	34.6%
Total Assets to Gross Domestic Product Ratio	34.5%	34.4%	35.9%	36.8%	39.9%
Capital Adequacy					
Total Capital & Reserves to Total Assets Ratio	19.4%	15.0%	12.1%	9.1%	10.9%
Asset Quality					
Substandard Investments to Total Investments Ratio	3.0%	3.9%	3.8%	2.2%	2.0%
Investment Assets to Total Assets Ratio	90.2%	85.3%	80.5%	85.5%	89.8%
Earnings & Profitability					
Return on Assets (ROA)	0.3%	1.4%	0.1%	0.1%	6.8%
Cost to Income Ratio	59.5%	52.4%	128.2%	92.0%	29.5%
Liquidity					
Liquid (core) Assets to Total Assets Ratio< 50%	1.9%	9.4%	13.3%	10.6%	5.6%
Liquid Assets to Short term Liabilities Ratio	22.3%	99.5%	141.8%	84.6%	43.4%

Source: CBSI

Table 2.2: Superannuation Sector Income Statement (SBD million)						
		Dec-14	Dec-15	Dec-16	Dec-17	Dec-18
1	Interest	17.6	19.6	17.3	39.0	33.4
2	Dividend	79	86.4	119.4	78.4	93.9
3	Gain/Loss from Changes in fair value	29.9	70.5	79.8	-25.7	161.4
4	Rental Income	34.6	35.2	37.6	30.5	30.1
5	Gross Investment Income	161.2	211.8	254.1	122.3	318.8
6	Other Income	20.4	4	4.2	3.6	13.8
7	Total Income	181.6	215.7	258.4	125.8	332.6
8	Less: Operating Expenses	74.6	73.3	87.7	79.6	98
9	Net Operating Income	107	142.4	170.7	46.2	234.6
10	Interest Paid to Members	243.2	189.5	220.9	133	166.6
11	Net Income after Interest	-136	-47	-50	-87	68

Source: CBSI

Table 2.3: Superannuation Sector Balance Sheet (SBD million)						
		Dec-14	Dec-15	Dec-16	Dec-17	Dec-18
Assets						
12	Cash and non IBD	50.5	263.0	407.0	330.6	192.3
13	Investments	2,498.3	2,426.8	2,545.5	2,697.9	3,106.8
14	Non-Financial Assets	86.5	95.3	96.9	103.7	122.7
15	Other Assets	48.4	41.2	43.1	37.8	46.3
16	Total Gross Assets	2,683.7	2,826.3	3,092.5	3,169.9	3,468.1
Liabilities & Reserves						
17	Contributions	2,099.0	2,334.1	2,620.9	2,780.9	2,992.0
18	Special Death Benefits	0.5	0.2	0.0	0.0	0.0
19	Other Liabilities	12.6	10.5	12.3	9.3	14.3
20	Provision for Loss	32.6	31.7	52.8	54.7	58.3
21	Accumulated Depreciation	23.5	30.1	36.4	41.1	30.9
22	Reserves	515.5	419.7	370.1	284.0	372.6
23	Total Liabilities & Reserves	2,683.7	2,826.3	3,092.5	3,169.9	3,468.1

Source: CBSI

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Appendix 3: Insurance Sector

Table 3.1: Insurance Sector Financial Soundness Indicators

	Dec-14	Dec-15	Dec-16	Dec-17	Dec-18
Capital adequacy					
Net premium to capital	74.8%	84.7%	94.7%	74.4%	79.6%
Capital & reserves to total assets	58.8%	55.7%	42.4%	46.5%	40.6%
Asset quality					
Debtors to total assets	25.7%	24.9%	28.5%	24.5%	17.0%
Debtors to(gross premium + reinsurance recoveries	44.7%	39.5%	52.2%	45.8%	31.0%
Reinsurance and actuaries issues					
Risk retention ratio(net premium to gross premium)	76.3%	75.5%	74.1%	65.8%	61.9%
Earnings & profitability					
Loss ratio (net claims to net premiums)	19.1%	19.2%	20.8%	16.8%	18.2%
Expenses ratio (expenses to net premiums)	25.0%	42.2%	31.6%	32.4%	25.7%
Combine ratio(net claims and expenses to net premiums)	44.1%	61.4%	52.6%	49.2%	43.8%
Return on equity (ROE)	42.1%	35.7%	32.4%	45.8%	45.5%
Liquidity					
Liquid assets to short term liabilities	190.3%	158.8%	115.5%	134.3%	162.1%

Source: CBSI

Table 3.2: Insurance Sector Income Statement (SBD millions)

		Dec-14	Dec-15	Dec-16	Dec-17	Dec-18
1	Total premium	72.7	71.0	77.8	65.0	71.4
2	Outward reinsurance	17.2	17.4	20.1	22.2	27.2
3	Premium net of reinsurance (=1-2)	55.5	53.6	57.6	42.8	44.2
4	Unearned premium reserves	0.7	-4.2	5.5	-7.4	-2.0
5	Net earned premium (=3-4)	54.8	57.7	52.1	50.2	46.2
6	Gross claims expenses	10.5	10.6	12.5	8.3	11.5
7	Total recoveries	-0.1	0.4	0.5	1.1	3.5
8	Net claims expenses (=6-7)	10.6	10.3	12.0	7.2	8.0
9	Commission expenses	2.4	3.5	3.5	3.5	3.5
10	Total underwriting results (8+9)	13.0	13.8	15.5	8.7	10.5
11	Underwriting results (5-10)	41.8	43.9	36.7	41.5	35.7
12	Other operating income	0.3	0.2	0.2	0.1	0.1
13	Other operating expenses or management expenses	11.5	19.1	14.8	10.3	7.8
14	Net profit (loss) before tax (=11+12+13)	30.6	25.1	22.1	31.3	28.0
15	Income tax or provisions	8.9	7.2	5.2	6.2	6.0
16	Net Income (loss) end of current period (=14-15)	21.7	17.8	16.9	25.1	21.9

Source: CBSI

Table 3.3: Insurance Sector Balance Sheet (SBD million)

		Dec-14	Dec-15	Dec-16	Dec-17	Dec-18
17	Total Assets (= 18 + 19)	126.1	113.4	143.5	123.5	136.6
18	Nonfinancial assets	3.3	1.9	5.5	2.3	0.2
19	Financial assets (= 20 to 26)	122.8	111.5	138.0	121.1	136.5
20	Currency and deposits	73.0	62.5	75.7	38.4	65.0
21	Loans					
22	Debt securities	16.7	17.5	16.0	46.5	47.3
23	Insurance technical reserves	32.5	28.2	40.9	30.3	23.2
24	Other assets	0.7	3.3	5.4	6.0	0.9
25	Liabilities(= 10+ 11)	52.0	50.2	82.6	66.0	81.1
26	Insurance technical reserves	47.1	50.4	79.4	63.2	69.3
27	Other liabilities	4.8	-0.2	3.3	2.9	11.8
28	Capital and reserves	74.1	63.2	60.8	57.5	55.5
29	Balance Sheet Total (= 25+ 28 = 17)	126.1	113.4	143.5	123.5	136.6

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Appendix 4: Credit Union Sector

Table 4.1: Summary of Credit Union Sector Financial Performance and Soundness Indicators

	Dec-14	Dec-15	Dec-16	Dec-17	Dec-18
Balance Sheet (SBD million)					
Total Loans	37.1	40.1	40.5	44.5	47.6
Total Assets	52.6	58.4	61.4	66.8	70.4
Total Deposits/Savings	39.6	48.1	45.7	50.3	51.6
Total Share Capital	13.2	10.3	10.6	11.7	15.2
Income Statement (SBD million)					
Income	5.3	4.8	5.5	3.8	6.9
Expenses	2.3	2.1	3.2	1.1	4.3
Net Surplus (Loss)	3	2.7	2.3	2.7	2.6
Statistics					
Membership	6,124	6,232	6,089	6,253	6,700
No. of reporting Cus	10	10	10	10	10
Indicators					
Return on asset (ROA)	6%	5%	4%	4%	4%
Return on equity (ROE)	23%	25%	24%	24%	20%
Loan to Assets	69%	68%	65%	67%	66%
Efficiency ratio (cost to income)	43%	49%	43%	44%	47%

Source: CBSI