Monitoring and Assessing Risks to Financial Stability in the Caribbean

Remarks by **Deputy Governor Alwyn Jordan**
at "Best Practices for Preparing a Financial Stability Report," a Peer-to-Peer Visit by the Centrale Bank van Aruba and the Turks and Caicos Islands Financial Services Commission

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On behalf of the Central Bank of Barbados, it is my great pleasure to welcome you to this peer-to-peer exchange seminar. I'd like to extend a special welcome to Dr. Petr Jakubik from CARTAC, whose initiative has brought us together for this important event.

This is not just another training seminar – it is a dynamic platform for the exchange of ideas, the sharing of expertise and the building of frameworks for future collaboration. In today's rapidly evolving global landscape, where financial stability and economic resilience are increasingly intertwined with central bank regulation, peer exchanges like this are vital. They help us remain agile, informed and equip us with the latest knowledge and best practices to meet the challenges we face as central bankers and regulators.

It is therefore a pleasure to be here today to discuss this issue with you, which is at the heart of economic development in the Caribbean. We all know that at first glance, financial stability may seem like a dry, technical topic, but for us in the Caribbean, it is central to safeguarding our economic well-being. As the global financial system becomes more interconnected, our economies are exposed to a variety of risks – both natural and man-made. Today, I want to highlight why financial stability is crucial for our region, with particular emphasis on challenges such as climate change, external shocks, and the evolving financial landscape. I will also shed some light on the difficulties faced by Caribbean central banks and other regulators in preparing comprehensive Financial Stability Reports.

We all know that financial stability is about ensuring that various entities such as banks, insurance companies, financial markets, and payment systems operate smoothly without triggering major disruptions. **When financial stability is maintained, businesses can secure credit, households can borrow and save, and governments can finance development. It is therefore the backbone of economic resilience.**

For the Caribbean, the stakes are particularly high. We are a region of small, open economies that are highly dependent on external trade, tourism, and foreign investment. Our economic structure makes us extremely vulnerable to external shocks, whether they are related to global financial conditions, natural disasters, or geopolitical events. Any significant disruption to the financial system, whether from internal weaknesses or external shocks can therefore quickly lead to a financial crisis. The resulting economic hardship can take years, or even decades, from which to recover. A very good example of this phenomenon was seen during and after the Global Financial Crisis.

Vulnerability to Climate Change

But let me start by addressing one of the major external risks to Caribbean economies, namely the climate crisis. Our region is one of the most vulnerable to the impact of climate change. Indeed, when we refer to climate vulnerable economies, Caribbean countries are always the highest ranked by any measure. Rising sea levels, more intense storms such as hurricane Beryl, which caused significant damage to a number of Caribbean islands in late June, prolonged droughts, and flooding have become our unfortunate reality. These **climate-related risks have a direct bearing on financial stability, as these systems don't just devastate homes and infrastructure, they can also have adverse effects on the financial system**.

For example, the destruction of infrastructure can lead to loans becoming non-performing, as businesses and households may default on their debt. Banks and other large financial entities in turn, may face liquidity problems, which can trigger a systemic crisis. Furthermore, as governments attempt to rebuild after the event, this often leads to an increase in public debt, which puts further strain on their ability to finance essential services and infrastructure. Imagine the strain on our resources that would have occurred had any of our islands been hit by the back-to-back hurricanes that recently devastated Florida and other states along the US South coast.

Climate-related risks are particularly challenging to manage because of their unpredictable nature and the difficulty in quantifying their economic impact. Caribbean regulators must therefore continuously monitor these risks and implement forward-looking policies to mitigate their effects on the financial system.

The Impact of Global Economic Shocks

In addition to climate change, external economic shocks pose another serious risk to financial stability in the Caribbean. Our economies are heavily reliant on global trade, tourism, and remittances. Any disturbance in the global economy such as a recessions in our major trading partners or sudden changes in commodity prices can ripple through our financial systems. Take, for instance, the fallout from the COVID-19 pandemic, which brought the world to a standstill in 2020. It was an economic shock of unprecedented proportions for the Caribbean. Indeed, our tourism sector, a lifeline for many economies, came to a grinding halt, leaving governments and businesses scrambling to stay afloat.

Central banks in the region had to take swift action to ensure liquidity in the financial system, lower interest rates, and support government stimulus efforts. But **the pandemic highlighted an ongoing challenge: our financial systems are vulnerable to global crises, and the lack of diversified economies in the region makes recovery more difficult**. Regulators must therefore constantly balance the need to maintain stability, while responding to these shocks in an agile and effective manner.

Navigating the New Financial Landscape

But this is not the only challenge facing us as regulators, as the financial landscape is also evolving rapidly. The rise of fintech, digital currencies, and shadow banking, has created new opportunities for financial inclusion and innovation. However, it also presents new risks. Digital currencies, while offering the potential for greater financial inclusion, bring concerns about regulatory oversight, cybersecurity, and monetary policy transmission. **Caribbean countries have been the pioneers in developing digital currency frameworks, but it still requires careful consideration of the impact on financial stability**.

Shadow banks – non-bank financial intermediaries that provide similar services as traditional banks – such as payday lenders or firms offering "buy now, pay later" options for buyers, are another concern. Given that these entities generally operate outside the regular regulatory framework, they are often opaque, and central banks may lack the tools to properly oversee their activities. They can, therefore, pose systemic risks without the safeguards that apply to the formal financial sector. If these institutions fail, the resulting financial contagion could spread quickly throughout the economy. Developing effective regulatory frameworks for shadow banks is therefore critical to ensuring financial stability in our region.

The Value of Financial Stability Reports

It is against this backdrop that Caribbean central banks face the herculean task of monitoring, assessing, and mitigating these risks. One of the key tools at their disposal is macroprudential policy, which is still in its initial stage of implementation in most Caribbean economies. However, central banks have made significant improvements in communicating the risks to the public via their Financial Stability Reports (FSR). These FSRs, as you all know, provide a comprehensive assessment of the financial system's health and highlight any emerging vulnerabilities. However, preparing a comprehensive FSR is a very challenging exercise, especially in the Caribbean context.

One of the most significant challenges is the lack of comprehensive and timely data. Many countries in the region struggle with collecting and analysing the necessary data to fully assess financial risks. **Without high-quality data, it is difficult for central banks to make accurate forecasts or take pre-emptive action. Improving data collection and our analytical capabilities must therefore be a priority for the region**, if we are to produce meaningful and effective reports.

Moreover, we know that preparing a high-quality FSR requires specialised knowledge in areas such as macroprudential policy, risk modelling, and scenario analysis. Given the complexity of financial systems and the fast-paced evolution of risks, Caribbean regulators must therefore invest in training and development, to ensure that they have the expertise required to produce comprehensive reports.

In our context, the Financial Stability Report of Barbados has evolved over the years, reflecting the growing complexity of the financial landscape in the country. I'd like to highlight some of the key milestones that have shaped this journey, all of which have been implemented as a result of our partnership with our sister regulator, the Financial Services Commission (FSC) and our collaboration with CARTAC (Caribbean Regional Technical Assistance Centre).

A major accomplishment was the introduction of stress testing in 2016, as this allowed us to simulate how our banking sector would perform under adverse shocks. **This tool gave the Bank, as a policymaker and regulator, a clearer understanding of the vulnerabilities that might emerge during a financial crisis, helping us better prepare for potential disruptions**. This was a crucial step in ensuring that our banks and financial institutions remain resilient, even in the face of global uncertainties.

As our financial system grew more diverse, it became essential to extend our focus beyond traditional banks. In 2018, the FSR began to include a detailed analysis of non-bank financial institutions (NBFIs) such as insurance companies, pension funds, and credit unions, though our collaboration with the FSC. This was a key milestone because non-bank financial institutions are integral to our economy, and their health is equally as important as that of the banking sector. By broadening the scope of the FSR, we now have a more comprehensive picture of the overall financial system.

The next significant development occurred four years later in 2020, when we made an important breakthrough in acknowledging the significant risk that climate change poses to our financial system. With the inclusion of climate-related financial risk analysis, the Central Bank aligned Barbados with the global efforts to manage climate-related financial risks, underscoring our commitment to resilience.

The results of this work, led by Dr. Saida Teleu and her team, were incorporated in Barbados' 2023 FSR. With the invaluable assistance of the Coastal Zone Management Unit, we've implemented a climate stress test, focusing on projecting damage to the accommodation sector, which is deeply intertwined with our tourism industry. This collaboration has allowed us to assess the potential impacts of climate-related risks on financial stability in a more data-driven and precise manner.

In the most recent FSR, the Bank has also successfully undertaken a significant revamp of its publication, with improvements that underscore our commitment to both innovation and comprehensive risk management. One of the key upgrades has been the introduction of a dynamic balance sheet approach to stress testing. Unlike traditional methods, this approach allows us to incorporate explicit macroeconomic scenarios and extend our stress testing over a longer horizon. This dynamic perspective offers us deeper insights into how our financial system would respond to shocks in a changing economic environment. Additionally, we've developed a non-performing loan satellite model, giving us a more accurate assessment of credit risk in our financial system.

We also recognised the growing importance of the real estate sector, and so we've enhanced our analysis of this sector. Real estate is not only a critical component of household wealth, but also a significant driver of lending and investment activity, making it essential to the stability of our financial system.

As the financial landscape changes, so too must our approach to assessing risks. In this regard, the 2023 FSR also incorporated the risks posed by digital financial services, fintech, and cybersecurity and issued a survey to the industry to gather vital data. This addition was particularly important given the rapid rise of cyber-crime and the increasing use of online financial services, and the recent publicised cyber-related breaches at the Barbados Revenue Authority and one of our credit unions give testament to this fact. **As a country, we are keen to embrace innovation, but it is equally important that we understand and manage the risks that come with these technological advancements**.

These most recent advancements significantly upgraded our report. Indeed, the Bank's FSR has now become, in our humble opinion, the regional benchmark for integrating climate change into financial stability assessments. However, we are keen to share our insights with our regional colleagues and we thank CARTAC for sponsoring two peer-to-peer missions, including this one, which serve to further strengthen financial stability efforts throughout the Caribbean.

Each of these milestones reflects our Bank's commitment to ensuring a resilient financial system. From stress testing and climate risk analysis to the inclusion of cyber risks and more robust data analytics, we are continuously improving the tools and strategies we use to safeguard financial stability.

But our work doesn't end here. The financial system is always evolving, and we must stay ahead of the curve. By building on these achievements and addressing new challenges, we will continue to protect the financial well-being of Barbados, ensuring that we are resilient in the face of both local and global uncertainties.

I am honoured to also explore some of the significant milestones achieved by two of our regional counterparts – the Financial Services Commission of Turks and Caicos and the Central Bank of Aruba – in their efforts to enhance their financial stability reporting.

Let me begin with Turks and Caicos. Your financial system plays a vital role in your country's economy, particularly in your banking and offshore sectors. In collaboration with CARTAC, the FSC made great strides in developing its stress testing framework, which is very similar to the one we recently implemented, as a multi-factor and multi-period macroeconomic-stress test that can account for both domestic economic shocks such as a downturn in tourism and external shocks like global financial market volatility. By extending the horizon and refining the scenarios, the FSC is now better equipped to gauge the potential vulnerabilities within its financial system.

We know that the Central Bank of Aruba does not currently publish a Financial Stability Report. However, the Bank does perform stress tests on its banking sector, the results of which are usually discussed with the banks individually via bilateral meetings. In 2023, the Bank conducted a stress test on the banking sector, with a key focus on concentration risk. This scenario analysis was driven by the developments in the US banking system that took place that year.

We will hear directly from these two institutions about their journey to enhance and assess financial stability in their respective jurisdictions. Over the next few days, you will participate in a diverse and robust line-up of sessions that promise to deepen our understanding and sharpen our capabilities.

I encourage all of you to actively participate in these discussions, as the true power of peer-to-peer learning lies in the collective wisdom and shared experiences of those in this room. Each of us brings a wealth of knowledge and experience, and together, we have the opportunity to generate innovative solutions that can strengthen the financial stability of our institutions and economies.

I commend CARTAC, and Petr specifically, for hosting these peer-to-peer exchanges, which provide unique value to our professional growth. While we are all experts in our respective areas, there is tremendous strength in collaboration. This seminar is therefore a perfect opportunity to foster connections, engage in thought-provoking discussions, and together, to drive the innovation and progress that our institutions and economies need to thrive.

I would like to take a moment to recognise and thank the organising team, especially the Financial Stability Unit led by Saida, who have worked tirelessly to put together this exceptional event, as well as Karen, who has done an excellent job in coordinating this event. Your dedication and efforts are deeply appreciated.

I would also like to extend a special thank you to our speakers, including those from our sister regulator, the FSC, and our colleagues from the Turks & Caicos and Aruba, who have prepared valuable content for us. We look forward to the knowledge and insights you will bring to the table.

In closing, I urge each of you to take full advantage of the opportunities this seminar provides. Whether through the formal sessions or during informal conversations during the coffee breaks, I encourage you to use this time to build stronger networks, exchange ideas, and learn from one another. Once again, thank you all for being here. I look forward to the meaningful discussions and practical takeaways that will undoubtedly emerge over the next few days and I wish everyone a productive and successful seminar.

Thank you.