



# **FINANCIAL**

# **STABILITY REPORT**

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# ACRONYMS

AML	Anti-Money Laundering
AMLR	Anti-Money Laundering Regulations
ALM	Asset and Liability Management
BCBS	Basel Committee of Bank Supervision
BCP	Business Continuity Plan
BIS	Bank of International Settlements
BSI	Banking Stability Index
CAR	Capital Adequacy Ratio
CARTAC	Caribbean Regional Technical Assistance Center
CFT	Countering the Financing of Terrorism
CIMA	Cayman Islands Monetary Authority
CPI	Consumer Price Index
CSP	Corporate Service Providers
D-SIDTIs	Domestic Systemically Important Deposit Taking Institutions
DPMS	Dealers in Precious Metals and Stones
DRLA	Directors Registration and Licensing
ESG	Environmental, Social and Governance
FAR	Fund Annual Report
FATF	Financial Action Task Force
FinTech	Financial Technology
FRB	Federal Reserve Bank
FSI	Financial Soundness Indicator
FSP	Financial Service Provider
GDP	Gross Domestic Product
GFC	Global Financial Crisis
G-SIBs	Global Systemically Important Banks
HLA	Higher Loss Absorbency
ICAAP	Internal Capital Adequacy Assessment Process
IMF	International Monetary Fund
KYD	Cayman Islands Currency
MFA	Mutual Funds Act
MSB	Money Services Business
NASA	National Aeronautics and Space Administration
NGFS	The Network of Central Banks and Supervisors for Greening the Financial System
NRA	National Risk Assessment
NPL	Non-Performing Loans
PFA	Private Funds Act
PSE	Public Sector Entity
RBA	Risk Based Approach

ROA	Return on Assets
ROE	Return on Equity
RTA	Registrar and Transfer Agency
SIB	Securities Investment Business
SIBA	Securities Investment Business Act
TCSP	Trust and Corporate Service Providers
VA	Virtual Assets
VASP	Virtual Assets Service Provider

At present, there is no commonly accepted definition of systemic risk. However, systemic risk broadly refers to the risk that financial instability becomes so widespread that it impairs the functioning of a financial system resulting in a severe economic downturn.

The systemic event could be an exogenous shock which means from outside the financial system. Alternatively, the systemic event could emerge endogenously from within the financial system or from within the economy at large.

Financial instability can be defined as any deviation from the optimal saving-investment plan of an economy that is due to imperfections in the financial sector. This is generally accompanied by a decrease of economic welfare.

Systemic risk is therefore a risk of experiencing a severe widespread event which adversely affects several systemically important intermediaries or markets, including potentially related infrastructures. Usually, concerned intermediaries fail and markets become dysfunctional. Systemic risk has a "horizontal" perspective, where the focus is on the financial system, and a "vertical" perspective where the two-sided interaction between the financial system and the economy at large is considered.

In the Cayman Islands context, systemic risk can be defined as the risk that financial instability becomes widespread due to endogenous and exogenous shocks, which can impair the functioning of the domestic financial system, thereby hampering economic growth.

*This publication marks the first annual Financial Stability Report for the Cayman Islands Monetary Authority (CIMA). The report is based on information that is required to be filed by all regulated entities for the financial year-end 2020, where the due date of these submissions is latest June 2021. Most funds have a December year-end with submissions due by June of the following year, and in some cases, funds apply for an additional three-month extension, resulting in filings being received in September. Against this backdrop and the challenges of COVID-19, the reporting period used for this issue is December 2020. The next report will cover 2021 – 2022 data.*



**In the Cayman Islands context, systemic risk can be defined as the risk that financial instability becomes widespread due to endogenous and exogenous shocks, which can impair the functioning of the domestic financial system, thereby hampering economic growth.**

## EXECUTIVE SUMMARY

This is the first edition of the Cayman Islands Financial Stability Report (FSR) which endeavours to shed light on the performance of the major sectors in the domestic financial system as well as salient trends, while highlighting vulnerabilities which can amplify financial stability risks if not kept in check. The FSR also examines qualitative and quantitative analyses of the interconnectedness of the financial system while also highlighting the regulatory and supervisory measures that were implemented from 2020 onwards, to help alleviate some of the issues that emanated due to the pandemic.

The international economy started to rebound within 2021 as evidenced by increased activity in airline, hospitality and other consumer services. The global economy has also experienced accommodative monetary and fiscal policies which has helped further bolster business confidence. However, uncertainty has persisted within 2022 as the world continues to grapple with other turbulent issues including COVID-19 variants, the Russia-Ukraine Crisis, runaway inflation, climate change threats and supply chain disruptions. Nevertheless, despite the nascent global economy recovery, risks to global financial stability have remained well contained.

The Cayman Islands is a significant global financial player in the international financial intermediation arena. The largest contributor to the Cayman Islands' Gross Domestic Product (GDP) is the financial services sector, accounting for close to 41% of the GDP, inclusive of accounting and legal services. The tourism sector accounts for roughly 15% of the GDP. Despite persistent external threats, the jurisdiction has fared relatively well and demonstrated resilience since the onset of the pandemic.

The banking sector is quite material within the jurisdiction. At the end of 2020, the jurisdiction was ranked the 16th largest banking centre in international assets and 14th in international liabilities. In terms of insurance, the jurisdiction has the second largest captive insurance domicile in the world. The funds sector is the most significant within the Cayman Islands' financial sector. The Cayman Islands is the second largest centre for portfolio investments after the United

States, with a strong focus on large institutional investors. In particular, hedge funds represent most of the portfolio liabilities, with about 85% of the world's hedge funds domiciled in the Cayman Islands, although it should be noted that not all the Cayman Islands funds are managed or administered in the jurisdiction. As a conduit of global capital, the Cayman Islands is now the third largest foreign holder of US Securities. The Mutual Fund Administrators are also of material importance to the jurisdiction given their close connection to funds. The Trust and Corporate Service Providers (TCSP) sector is a gateway for significant direct investment inflows and outflows across the various financial sectors. As the world evolves, the new and upcoming Virtual Asset Service Providers (VASP) sector has attracted new players within the space as CIMA builds regulatory and supervisory measures around this new investment vehicle.

CIMA has continued to work assiduously on implementing a wide array of international standards and best practices in financial regulation and further developing its supervisory frameworks. CIMA also recognises that climate and environmental changes can have dire economic consequences which can pose major risks to the financial system. In this vein, CIMA has created an internal working group to examine the regulatory work to be developed within this area. As of February 2022, CIMA also became a member of the Network of Central Banks and Supervisors for Greening the Financial System (NGFS) to keep updated on the international policies and development happening around climate related risks. Further, CIMA is embarking on the development of a macroprudential framework and roadmap with the broader objective of sustainable financial stability.

The developments documented in this FSR alongside the present work being undertaken demonstrates that CIMA is determined to reinforce the integrity of the financial services sector and to uphold the reputation of the Cayman Islands as a robust and credible financial hub.



1919  
PEACE  
MEMORIAL

## Global Macro Financial Update

Despite the possible delay for complete recovery, the International Monetary Fund (IMF) latest growth figures show that the global economy is on a recovery path against the backdrop of measures implemented to combat the COVID-19 pandemic. However, this recovery path is being put to the test due to the existing global environment.

The world is experiencing turbulent and volatile economic conditions with an array of short-term issues including COVID-19, the Russia-Ukraine crisis, runaway inflation, food shortages and supply chain disruptions. Long-term issues include Financial Technology (FinTech) disruptions and innovations as well as climate change and its impact on financial and non-financial corporations.

In the recent months, rapid approval and rollout of various vaccines have boosted the outlook for global recovery. This has seen an uptick in increased activity within the airline, hospitality, and consumer services industry. However, for sustainable global recovery, it is imperative that equitable distribution of vaccines is achieved especially for jurisdictions where the spread of the virus is still surging as this can exacerbate financial vulnerabilities, especially for capital flows to emerging economies. The global economy continues to remain dependent on monetary and fiscal support, which have tightened as investors reassess growth prospects and policy outlooks. The world could see various asset price corrections which coupled with financial vulnerabilities can have a knock-on effect on confidence in the financial system, thereby affecting macro-financial stability.

Emerging markets have large debt and equity financing needs. Portfolio flows (Figure 1) are central to the stability of these economies so market access for financing is crucial.

Since the onset of the pandemic, global policy support has been used to buttress the resulting US high yields spread, however, globally firms are still not fully immunized from its effects, with many being downgraded to below investment grade or having negative outlooks.

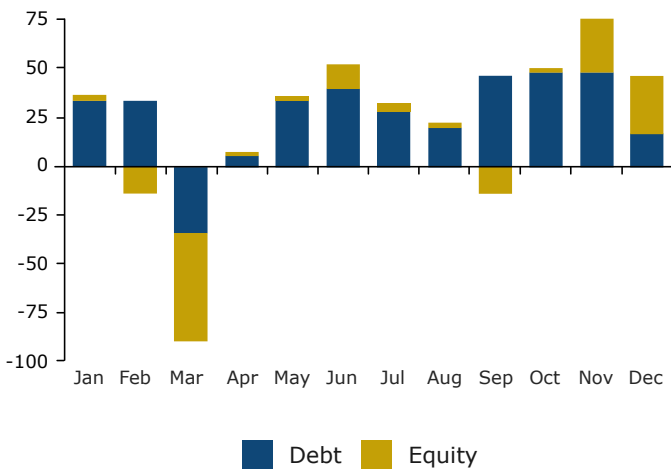
Within the household sector, there has been significant global governmental efforts implemented i.e., support and relief programs, and reduction of interest rates to help reduce debt service burdens, to mitigate some of the financial strains experienced due to the COVID-19 pandemic. Notably, if global policy support is withdrawn too early or in an uncoordinated manner or economic recovery continues to drag, then there is a high probability for an increase in financial stress to the household sector.



# MACROECONOMIC ENVIRONMENT

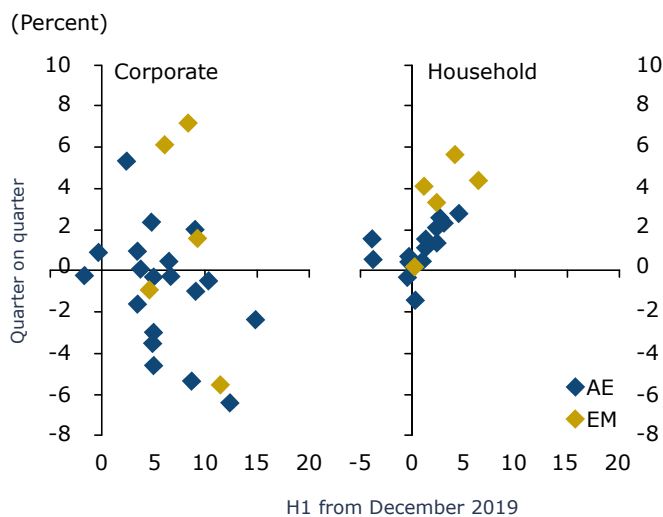
The global banking sector has been quite resilient due to high capital, liquidity buffers and the unprecedented policy support has assisted in maintaining credit flow to households and firms. With other negative factors affecting the world beside COVID-19, the possible delay in recovery can create rising credit exposures and increase nonperforming loans (especially if global policy support measures end), thereby affecting profitability.

Figure 1: Portfolio Flows to Emerging Markets, 2020 (\$US Billions)



Source: Global Financial Stability Report January 2021

Figure 2: Global Bank Loan Growth, 2020 (Percent)

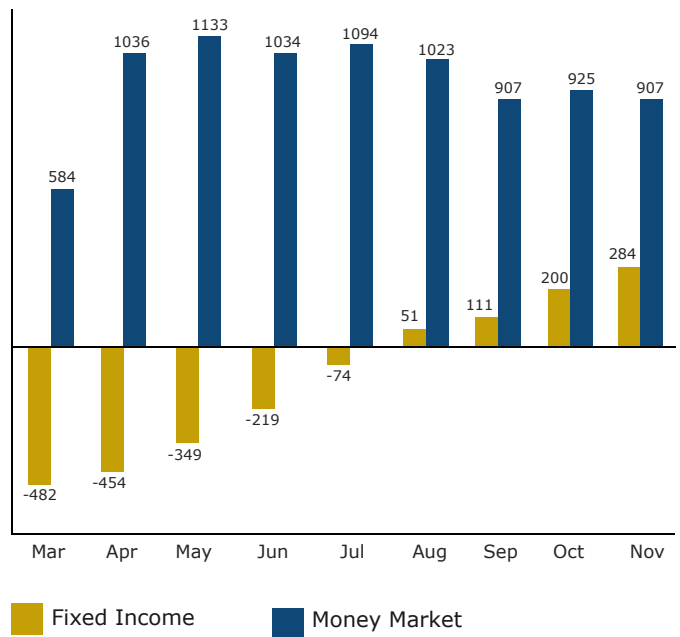


Source: Global Financial Stability Report April 2021

Note: AE = advanced economy, EM = emerging market

There has also been an increase in flows into global investment funds with majority being money market. With a buoyant market environment, investors have been in search for yields.

Figure 3: Flows into Global Investments Funds, 2020 (\$US Billions)



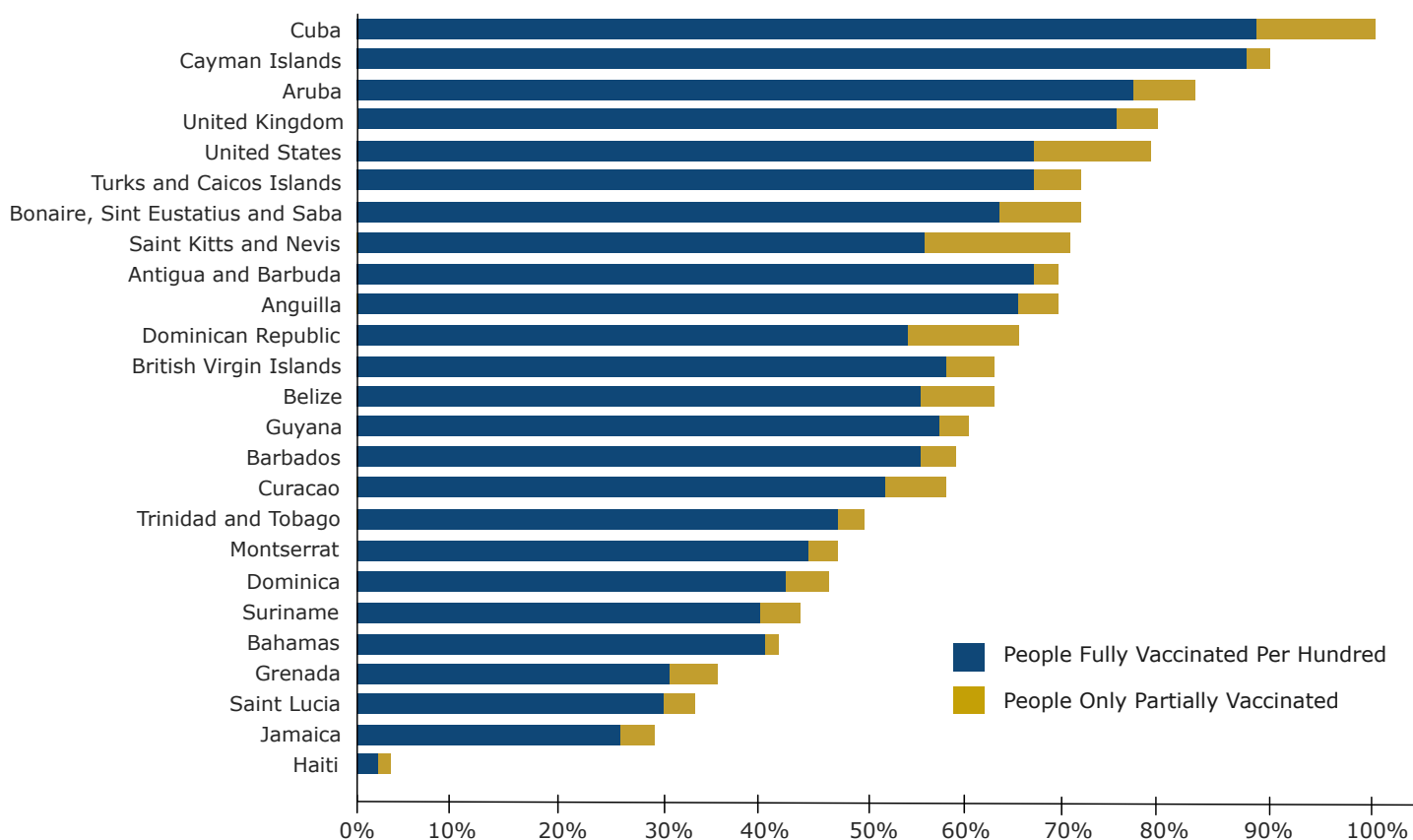
Source: Global Financial Stability Report April 2021

As the world grapples with climate change issues, capital markets are becoming an important funding source (i.e., green bonds and loans, sustainability-linked bonds and loans) for investments towards 'greening'. According to the Global Financial Stability Report April 2020, the rise in sustainable financing as sustainable debt issuance in 2020 being roughly \$650 billion.

Despite the tumultuous period the world is experiencing, at present financial stability risks are at bay, but there is still need to monitor financial vulnerabilities exposed by the pandemic. There is a delicate balance to be achieved where monetary and fiscal support mechanisms continue while addressing financial vulnerabilities, many of which have evolved or increased since the pandemic.

## Regional Economic and Financial Environment

Figure 4: Share of people vaccinated against COVID-19, Dec 2021



Source: Our World in Data

Note: Alternative definitions of a full vaccination, e.g. having been infected with SARS-CoV-2 and having 1 dose of a two-dose protocol, are ignored to maximize comparability between countries

The Caribbean region continues to move at a slow pace of recovery due to vaccine shortages and population hesitancy of taking vaccines. Figure 5 shows that after Cuba, the Cayman Islands is the second in the region in terms of vaccinated persons and fortunately faring better than many developed countries and the rest of the world.

Beside COVID-19 and its many complications, the Caribbean region has also experienced other external shocks including storms, hurricanes and supply chain disruptions which have worsened the growth outlook for the region. The COVID-19 pandemic external shock coupled with the preexisting regional vulnerabilities i.e., fiscal,

external sector and structural issues caused regional growth to contract on average by 6.5% in 2020. The Caribbean region is known for its dependence on tourism and commodities – both of which have been unfavorably impacted by the pandemic. Those economies that used to thrive on service-based revenues contracted by 14.5% in 2020 as across the region the tourism industry became stagnant with widespread lockdown measures. Since then, borders have reopened slowly, with more and more travel restrictions and measures being lifted. It is hoped that there will be a steady recovery as airlines and cruise industries begin to pick up momentum.

## Economic and Financial Environment

The Cayman Islands consists of three islands, Grand Cayman, Cayman Brac and Little Cayman. It is a self-governed overseas territory of the United Kingdom and has one of the highest per capita incomes within the Caribbean region.

The largest contributor to the Cayman Islands' GDP is the financial services sector, which accounts for roughly 40.5% of the GDP, inclusive of accounting and legal services. The second largest contributor is the tourism industry contributing on average 15% to the GDP.

In 2020, the pandemic impacted the Cayman Islands GDP which declined to KYD 4.2 Billion from KYD 4.5 Billion in 2019, a real economic contraction of 6.7%.

There was also an increase in unemployment from 3.5% in 2019 to 5.3% in 2020. The jurisdiction, nonetheless, took stringent public health measures that minimized community transmission of the virus during 2020.

Based on Figure 5, in the fourth quarter of 2021, the Consumer Price Index (CPI) was 120.7, higher by 7.6% compared to the fourth quarter of 2020, with ten of the twelve categories of goods and services recording higher price indices.

According to the Cayman Islands Economics & Statistics Office, the average CPI in 2021 was

115.2, an increase of 3.3% over the average CPI in 2020. This increase of the overall index is driven mainly by higher prices for communication, food and non-alcoholic beverages, health, transport, housing and utilities, restaurants and hotels, and miscellaneous goods and services.

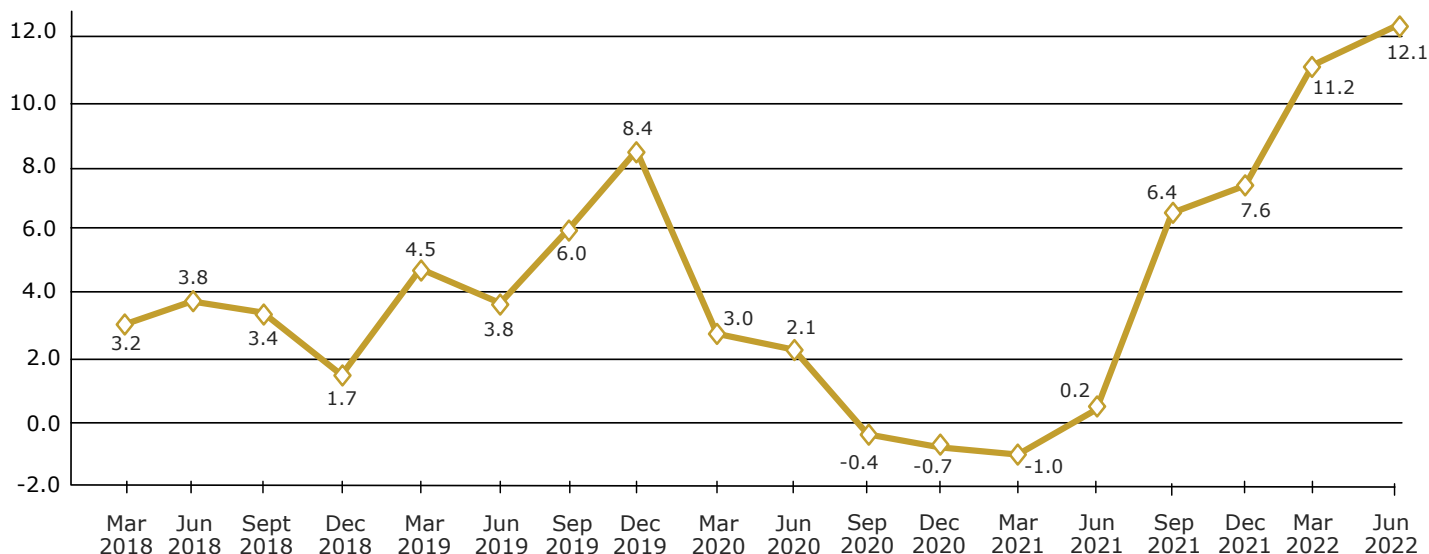
The Cayman Islands is known internationally as a major supplier of cross-border financial services. The financial sector has been resilient during the last two years since the onset of the pandemic. Despite the decline in total banking sector assets and liabilities, the financial system remained strong with economic support measures implemented by the Cayman Islands government.

The jurisdiction also saw an increase in investment funds (number and value) maintaining our position as a leading jurisdiction in offshore investments. Recognizing the growing importance of financial innovations there was an uptake in new investment vehicles i.e., virtual assets (VAs), which resulted in CIMA introducing appropriate regulatory and supervisory measures.

CIMA also participated in the 2021 National Risk Assessment (NRA) which outlined the key risks as it relates to money laundering, terrorist financing and proliferation financing. Further details on the financial services sector will be discussed in the upcoming chapters.

Figure 5: Inflation Rates, 2018 - 2022 (% Change in CPT)

Source: Cayman Islands Economic & Statistics Office





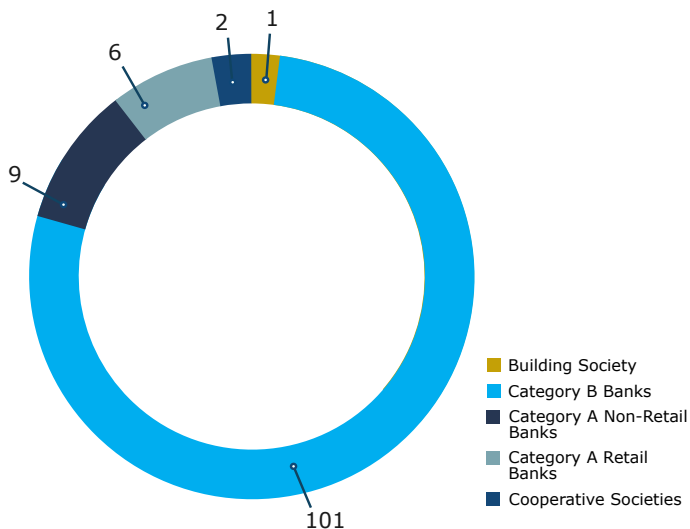
## Deposit-Taking Institutions

The Deposit-Taking Institutions' sector is comprised of banks and the Societies (namely the cooperative societies and building societies).

### The Banking Sector

There are two main categories of banking licenses, namely Category A and Category B. Category A banks are further grouped into Category A Retail and Category A Non-Retail. The Category A Retail banks are authorised to offer retail and commercial banking services to retail and non-retail resident clients.

Figure 6: Number of Deposit-Taking Institutions (2020)

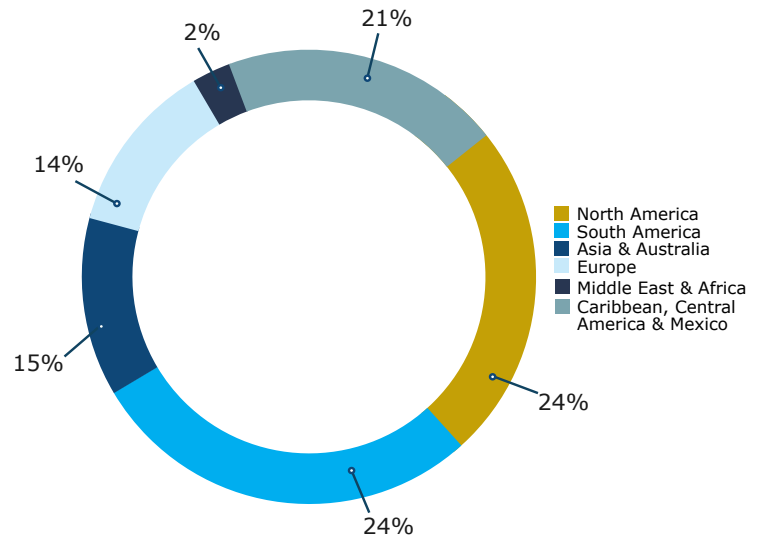


While there was no significant change in the number of Category A banks over the last five years, the number of Category B banks reduced from 116 to 101 as banks continued to consolidate and restructure in pursuit of optimal cost, risk management and governance structures.

As of December 2020, the Cayman Islands was the 16th largest banking centre in terms of international assets (USD 579 billion) and fourteenth in international liabilities (USD 537.8 billion) among the 48 financial centres reported. The banking sector represent over 40 countries as per the distribution in Figure 7.

There was no change in the number of the Societies.

Figure 7: Number of Banks by Region<sup>2</sup>



The Societies mainly provide credit facilities and savings accounts to members who are composed of natural persons residing in the Cayman Islands. The credit facilities that are provided include mortgage loans, auto loans, personal unsecured facilities, amongst others. Although the Societies play a vital role in the domestic financial system, the size of the Societies' operations is small relative to the cumulative Category A Retail banks' activities. As of 31 December 2020, the Societies' total assets amounted to about 3.2% of the Category A Retail banks' total assets.

The domestic banking activities are mainly offered by Category A Retail banks so therefore the performance of the domestic banking sector will be examined.

The Banking sector was generally resilient throughout 2020 despite the economic and operational challenges from the COVID-19 pandemic partly due to the strong financial position of the sector before the COVID-19 pandemic.

Despite the deterioration in some Financial Soundness Indicators (FSIs), the key FSIs remained strong and well above the minimum required, where applicable. See Table 3.

## Unique Nature of the Banking Sector

**Category A Retail Banks:** Category A Retail banks offer retail and commercial banking services to retail and non-retail residents. Category A Retail banks can also provide services to international clients. They can also provide trust, principal offices or registered office services if authorised to provide these services.

**Category A Non-Retail banks:** Category A Non-Retail are restricted from providing banking services to resident clients except to other licensees, employees and to exempt or ordinary non-resident companies not carrying on business in the Cayman Islands.

**Category B Banks:** Category B banks are generally restricted from engaging in the banking business with residents and thus cater primarily to customers outside the Cayman Islands. However, Category B banks can provide specified services to limited categories of resident customers, including another regulated entity, their employees and exempt or ordinary non-resident companies not carrying on business in the Cayman Islands.

One-third of the Category B Banks provide exclusively intra-institutional business (mainly treasury management) and account for 30% of total assets for Category B banks. The rest of the Category B banks offer a wide range of banking and/or trust activity such as private banking, trade finance, and wealth management.

### Structure types

Most of the banks are branches of internationally active banks. Branch structures are exclusively used by Category B banks.

Table 1: Number of Banks by Structure Type

Structure Type	Total as at 31 Dec 2020
Branch	60%
Subsidiary	27%
Affiliate/Private	13%

Category A retail banks are subsidiaries of large international financial institutions with parent companies located in Canada or in the Caribbean region. Similarly, a significant portion of the remaining banks are subsidiaries, branches, or affiliates of large financial institutions.

### Number of Regulated Banks

Over the past five years, the number of Category A banks has remained the same, while the number of Category A non-retail banks reduced by two banks. However, there has been a notable decrease in Category B banks because banks have continued to consolidate and restructure in pursuit of optimal cost, risk management and governance structures.

Table 2: Number of Regulated Banks

	2016	2017	2018	2019	2020
Category A Retail	6	6	6	6	6
Category A Non-Retail	5	5	5	3	3
Category B Banks	148	137	122	116	101

Despite this decline, new Category B licences have been issued. There has been an observed heightened interest in Category A and B licences, especially by large international financial groups, outside of the United States, seeking to leverage on the Cayman Islands' stable offshore banking sector. Notably, during the pandemic there was no drastic reduction in the banking composition within the jurisdiction.

# SECTORAL FINANCIAL STABILITY ANALYSIS

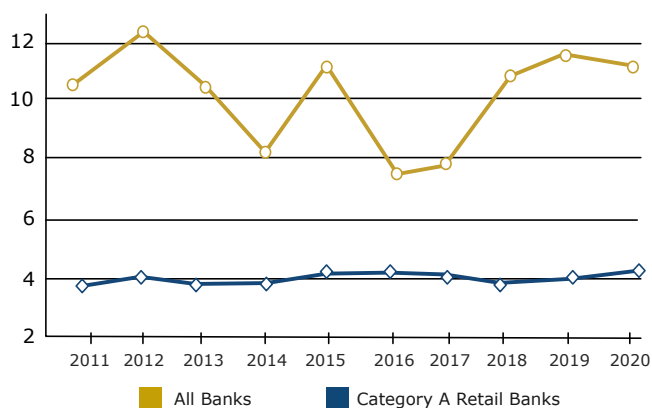
Table 3: Key Financial Soundness Indicators

Key FSI	All Banks (%)		Category A Retail Banks (%)	
	2020	2019	2020	2019
Total CAR <sup>3</sup>	38.0	48.1	26.6	28.5
NPLs <sup>4</sup> to total assets	2.1	0.4	1.7	1.4
Liquid assets ratio <sup>5</sup>	27.6	28.7	34.6	31.8
ROA <sup>6</sup>	0.3	0.0	0.7	2.5

The Capital Adequacy Ratio (CAR) decreased for all banks and for the Category A Retail banks but remained significantly above the minimum required CAR of 11% to 15% as most of the banks operate with a significant capital buffer. The economic challenges from the COVID-19 Pandemic resulted in an increase in the Non-Performing Loans (NPLs) ratio, but the proportion of the NPLs remained low. The Return on Assets (ROA) for all banks marginally improved while the ROA for the Category A Retail banks decreased. The liquid assets ratio for all banks was reasonably consistent with 2019. Detailed explanations on the movements in these ratios will be given in further sections within this Chapter.

In 2020, the total sector resident loans & advances decreased by 4.3%, mainly due to the decrease in exposure by Category B banks. Most resident exposures by Category B banks are to entities registered in the Cayman Islands but not carrying on business in the Cayman Islands. Category A Retail banks' resident loans and advances increased by 7.2% relative to 2019, indicative of a resilient banking sector during the COVID-19 pandemic.

Figure 8: Resident Loans & Advances (\$US Billions)



The increase in resident loans and advances by Category A Retail banks was supported by the strong financial position along with the Government's COVID-19 response measures. Please refer to Chapter 4 for a summary of the COVID-19 response measures implemented by the Government.

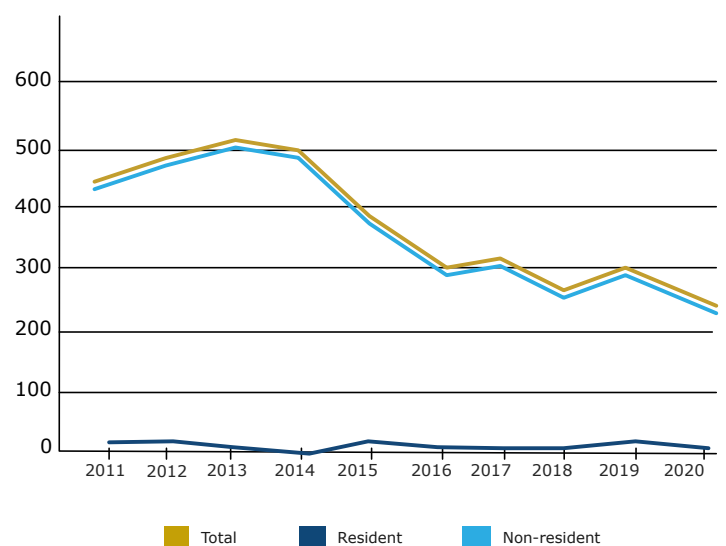
In addition to other operational changes due to the COVID-19 pandemic, the Category A Retail banks implemented forbearance measures, including a loan repayment moratorium to support customers impacted by the COVID-19 pandemic. By the end of 2020, most banks had discontinued the loan repayment moratorium measures without any significant deterioration of the loan portfolios. Please refer to the Household and Corporate sector section for more details on resident credit.

## Loans and Advances

The banking sector's resident and non-resident loans & advances decreased by 4.3% and 18.5%, respectively, and cumulatively resulted in a 17.8% decrease in total sector loans and advances. Resident loans & advances accounted for 5.2% of the total sector loans & advances.

The decrease in total banking sector loans & advances is mainly due to the decline in Category B banks.

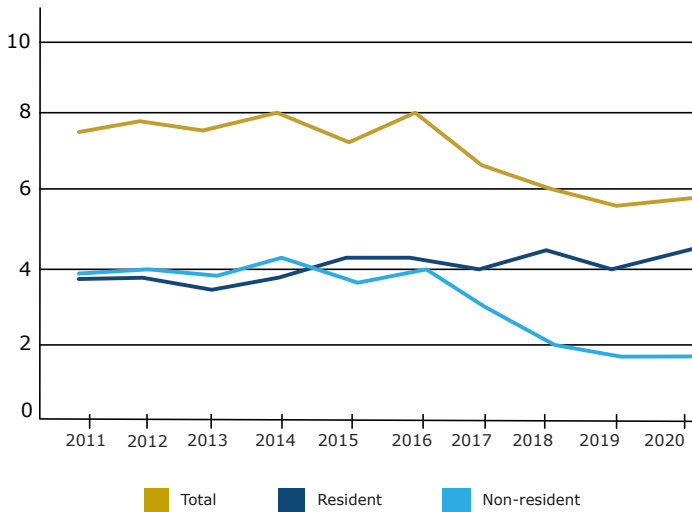
Figure 9: Loans & Advances - All Banks (\$US Billions)



# SECTORAL FINANCIAL STABILITY ANALYSIS

For the Category A Retail banks, the resident loans & advances increased by 7.2%, while the non-resident loans & advances reduced by 14.7%, and cumulatively resulted in a 0.1% increase in total loans and advances.

Figure 10: Loans & Advances - Category A Retail Banks (\$US Billions)

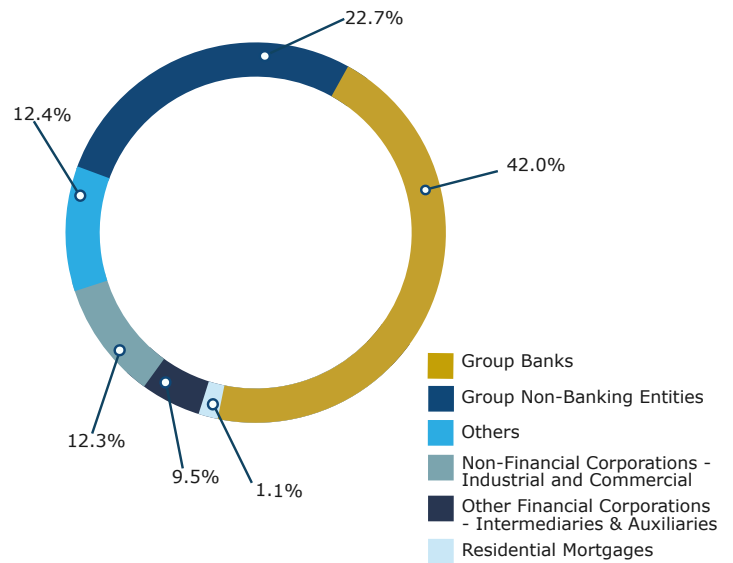


Category A Retail banks resident loans & advances account for 72.5% of the total loans and advances within this sub-sector (See Figure above). The increase in resident loans and advances for Category A Retail banks was mainly driven by an increase in exposures for residential mortgages (6.0%), sovereign (7.7%), and corporate sector (22.6%). These increases were partially offset by a decrease in exposures to Non-Central Government Public Sector Entities (PSEs) (-25.1%) and commercial mortgages (-21.9%). The portion of non-resident loans & advances has continued on a declining trend as the domestic credit continues to grow.

## Loans & Advances by Counterparty Type

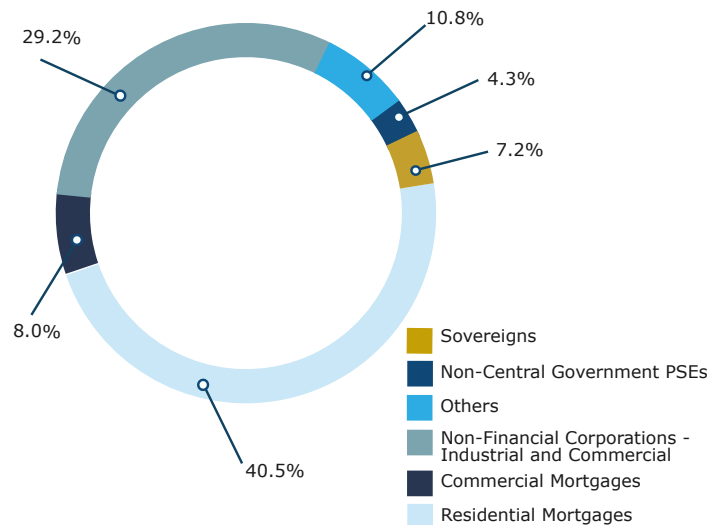
For the entire banking sector, loans & advances to group banking and non-banking entities account for 64.7% of the total loans advances. The significant exposure to groii related entities arises from the Category B banks, some of which are specifically established to provide banking services to related entities.

Figure 11. Loans & Advances by Counterparty Type - All Banks



For the Category A Retail banks, residential mortgages and loans to non-financial corporations – industrial & commercial, account for almost 70% of the loan portfolio. Loans and advances to related entities are minimal and account for less than 1.5% of the loan portfolio.

Figure 12: Loans & Advances by Counterparty Type - Category A Retail Banks



## Asset Quality

The overall banking sector NPLs to total gross loans ratio increased by 180 basis points to 2.1%, while the ratio for the Category A Retail banks increased by 20 basis points to 1.6%. See Figure 17. Despite the economic challenges from the COVID-19 pandemic, the NPLs remained relatively low.



## Banking Sector Performance in Stressed Periods

This section highlights the financial overview of the banking sector in the recent financial crisis - Global Financial Crisis, European Sovereign Debt Crisis and the COVID-19 pandemic.

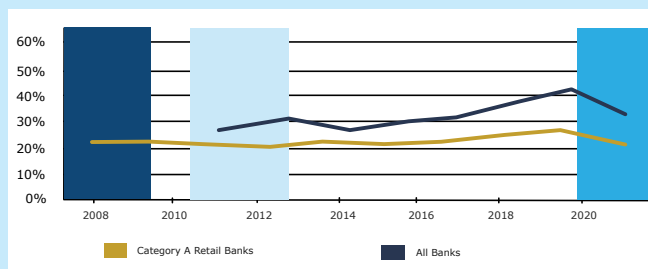
Key

- Global Financial Crisis (2008 - 2009)
- European Sovereign Debt Crisis (2011 - 2012)
- COVID-19 Pandemic (2020)

### Regulatory capital to risk-weighted assets

Despite the notable decrease in Regulatory capital to risk-weighted assets during the GFC and European debt crisis periods, the ratio remained above the minimum required ratio. The CAR in 2020 was higher than the capital positions for the previous stressed periods, indicating a more resilient capital position.

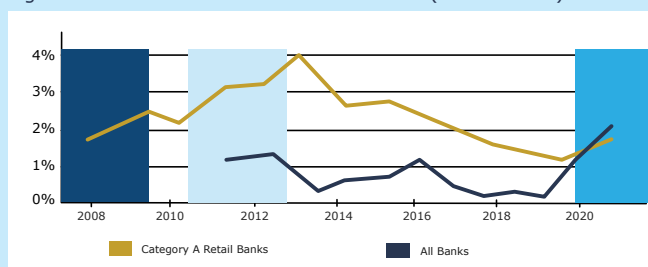
Figure 13: Regulatory Capital Trend (2008 - 2020)



### NPLs to gross loans & advances

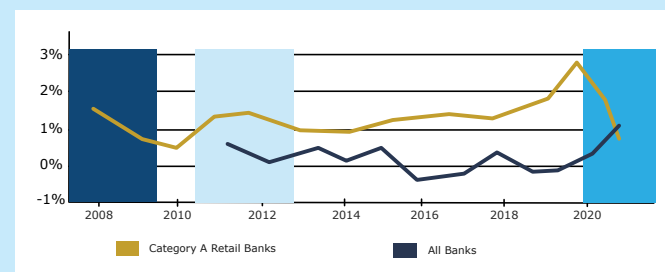
During the Global Financial Crisis (GFC) and European Debt Crisis, NPLs increased, especially for Category A Retail banks; however, never reaching 5% of total loans. Category A banks' NPLs during the COVID-19 period did not reach the levels in the previous stress periods. However, the total sector NPL ratio exceeded the ratio reported during the European Debt Crisis but remained under 3% of total loans.

Figure 14: NPLs to Gross Loans & Advances (2008 - 2020)



During the COVID-19 pandemic, Category A Retail banks posted a significant decrease in ROA. However, the 2020 RoA is slightly higher than the lowest ROA for the period of 2008 - 2020. The entire sector's ROA for 2020 is marginally below the highest ROA for the reported period.

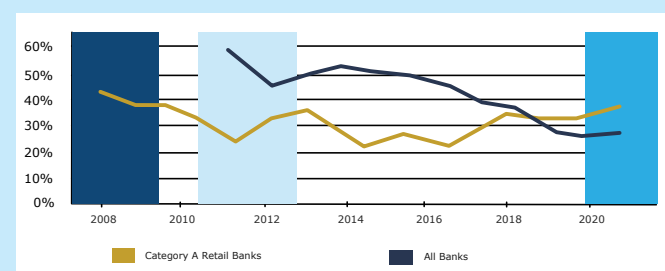
Figure 15: Return on Assets Trend (2008 - 2020)



### Liquid assets ratio

In the previous crisis, all banks liquidity position was strong though banks reported decreases in liquid assets ratio. In 2020, the liquid assets ratio for Category A Retail banks slightly improved compared to the previous stressed period when the ratio had decreased.

Figure 16: Liquid Assets Ratio (2008 - 2020)

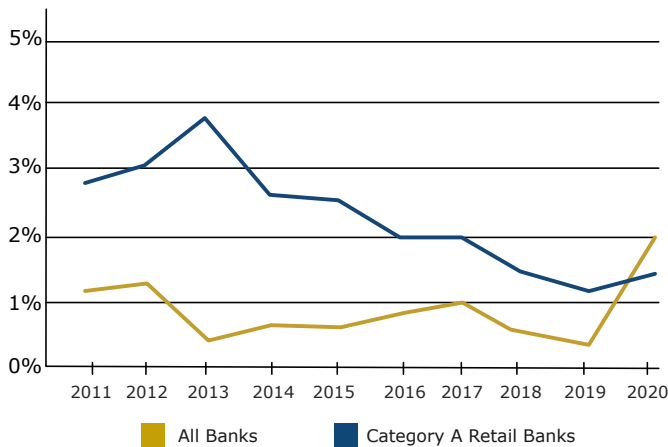


The foregoing shows that the banking sector remained in a robust financial position during the height of the pandemic relative to the previous stressed period. Please see the financial review sections for further details.

Note: Some data for the GFC period is available for Category A Retail Banks only.

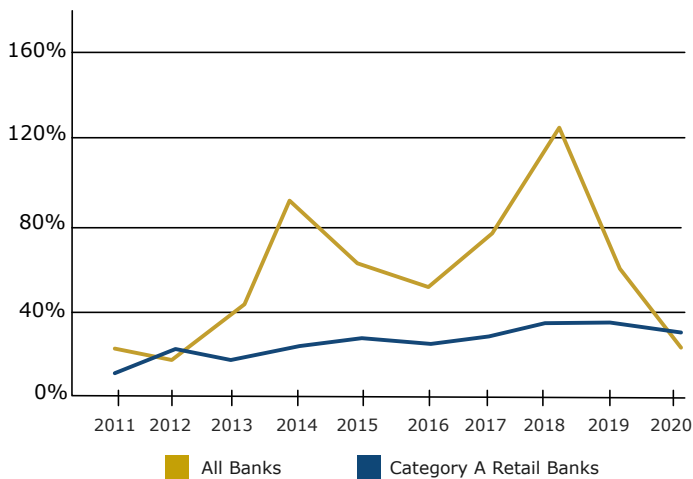
# SECTORAL FINANCIAL STABILITY ANALYSIS

Figure 17: NPLs to Total Gross Loans



Specific loan loss provision to NPLs ratio continued on a declining trend decreasing from 67.6% to 18.1% for all banks and from 36.5% to 29.5% for Category A Retail banks. The decrease was generally due to better credit underwriting and collateralisation measures resulting in lower specific credit loss provisions.

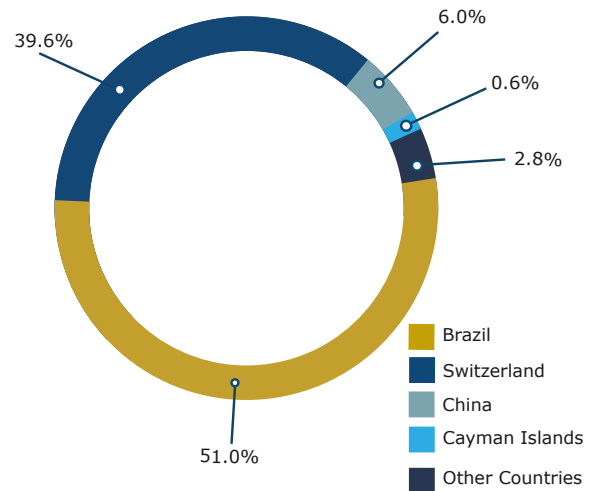
Figure 18: Specific Provisions to Total NPLs



## NPLs by Jurisdiction - All banks

NPLs for banks from Brazil, Switzerland and China increased by over 100%, and cumulatively account for 96.6% of total sector NPLs. The increase in NPLs for banks from these countries is primarily due to higher exposures to sectors impacted by the COVID-19 pandemic for the banks from these jurisdictions.

Figure 19: Non-performing Loans By Jurisdiction - All Banks

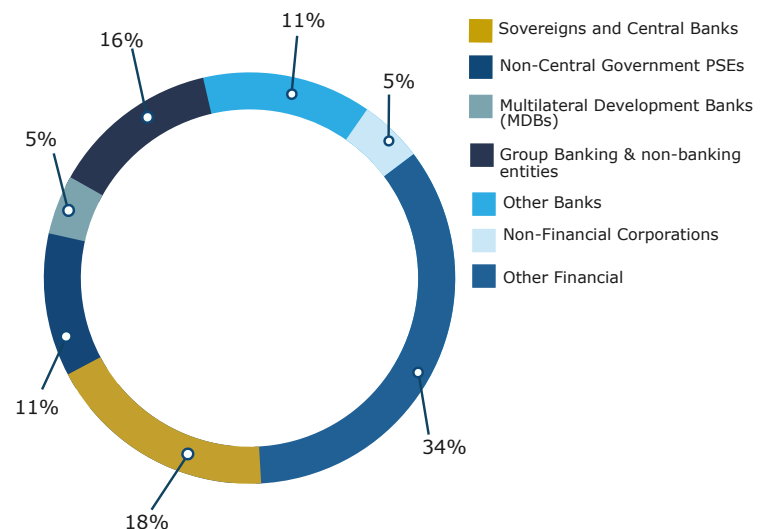


## Investment portfolio

The investment portfolio accounts for 12.7% (USD 75.6 billion) of the banking sector total assets. During the year, the total investment portfolio decreased by 1%. Investments in debt securities account for 72% of the investment portfolio, while investment in equities and funds account for 27% and 1% of the investment portfolio, respectively. The majority of the investment portfolio is held as part of the banking book, with only a very small portion held as part of the trading book.

Investment securities issued by financial corporations, sovereigns & central banks, and group related entities account for 34%, 18% and 16% of the total sector investment portfolio, respectively.

Figure 20: Investments by Issuer Type - All Banks

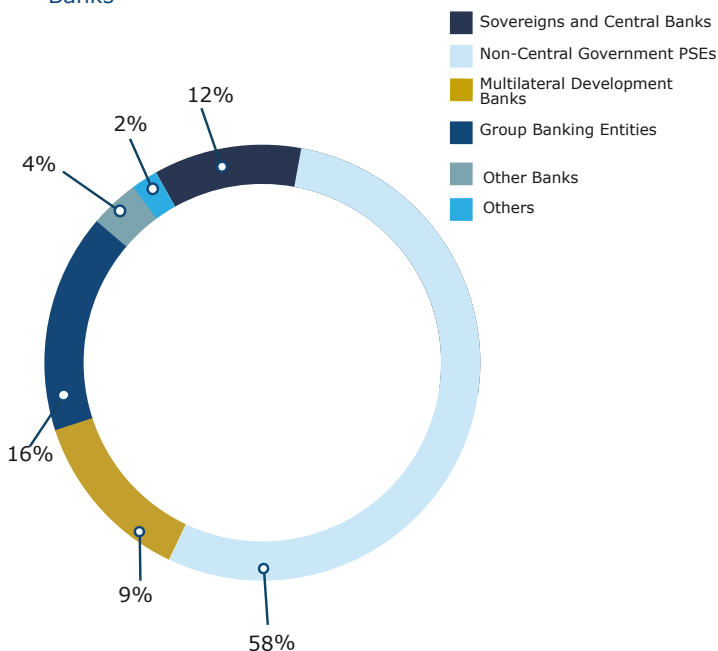


# SECTORAL FINANCIAL STABILITY ANALYSIS

For Category A Retail banks, the investment portfolio accounts for 23.3% (USD 3.9 billion) of the Category A Retail banks' total assets. In 2020, the investment portfolio for the Category A Retail banks increased by 15%. Debt securities and equities account for 98% and 2% of the total investment portfolio, respectively. The investment portfolio is primarily held for liquidity purposes, thus the significant proportion of investments are in debt securities. None of the Category A Retail banks have investments in the trading book.

Investments securities issued by Non-central government PSEs, Group banking entities, and sovereign & central banks, account for 58%, 15% and 12% of the total investment portfolio, respectively.

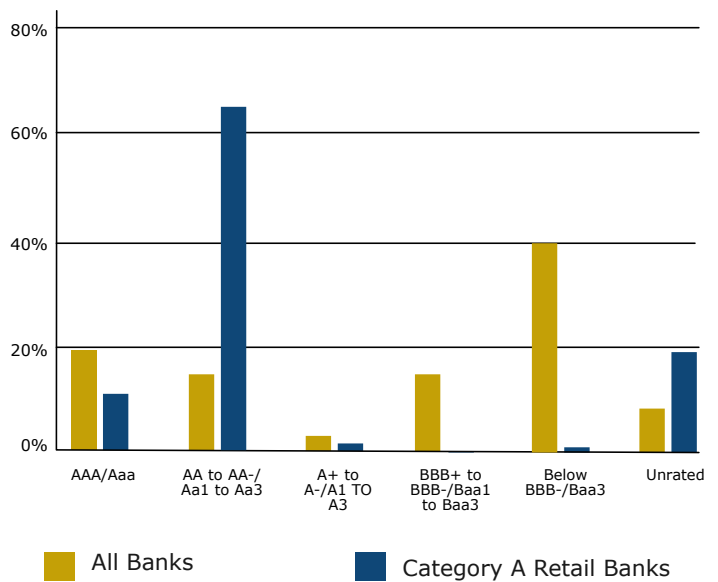
Figure 21: Investments by Issuer Type - Category A Retail Banks



## Investment in debt securities

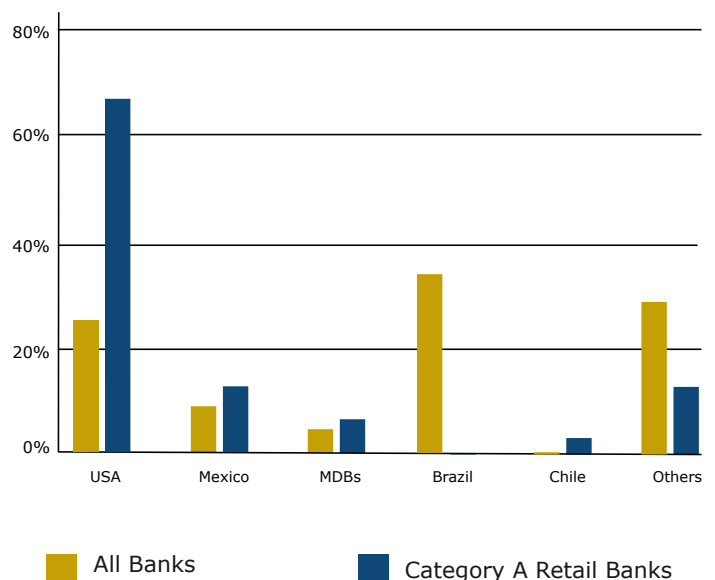
Investment-grade debt securities (AAA/Aaa to BBB-/ Baa3) account for 49% of the total banking sector debt securities investment. For the Category A Retail banks, investment grade debt securities account for over 80% of the debt securities. The high proportion of investment grade securities is consistent with the reliance on investments securities for liquidity purposes.

Figure 22: Debt Securities by Credit Rating



For all banks, debts securities issued by counterparties from Brazil and the USA account for 35% and 24% of the banking sector investments in debt securities, respectively. For the Category A Retail banks, debt securities by issuers from USA and Mexico account for 63% and 13% of the investments in debt securities, respectively.

Figure 23: Debt Securities by Issuer Country



# SECTORAL FINANCIAL STABILITY ANALYSIS

The higher proportion of investments securities by issuers from Brazil, the USA, and Mexico shows that significant macro-economic changes in these countries could substantially impact the investment portfolio and these should be carefully monitored.

## Investment in equities

Issuers of 93% of the banking sector investments in equities hold an investment-grade rating. Additionally, issuers of 99% of the investments in equities are from USA and UK. Although the equity investments are more volatile, the issuers have a strong financial position, as evidenced by a strong issuer credit rating and being based in developed economies. Based on the business model of category A Retail Banks investments in equities are immaterial.

## Funding and Liquidity

Customer deposits account for over 77% (USD 441.7 billion) and over 98% (USD 14.4 billion) of the banking sector and Category A Retail banks funding sources, respectively. Total sector deposits continued on a decreasing trend mainly attributable to the decrease in Category B banks as outlined in Box 1. The customer deposits for Category A Retail banks increased by 15.2% (USD 1.9 billion) during the year. Customer deposits generally have shorter maturity relative to other sources.

Figure 24: Sources of Funding - All Banks

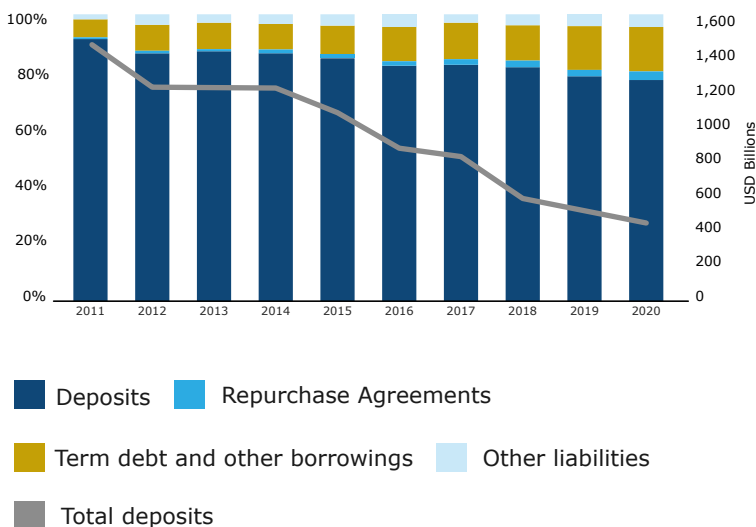
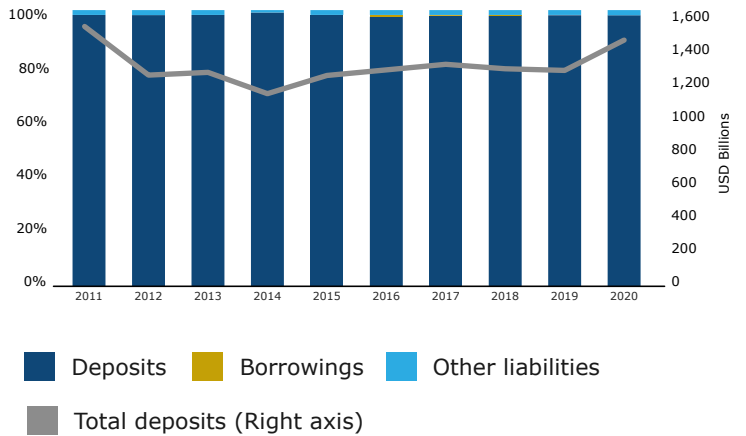
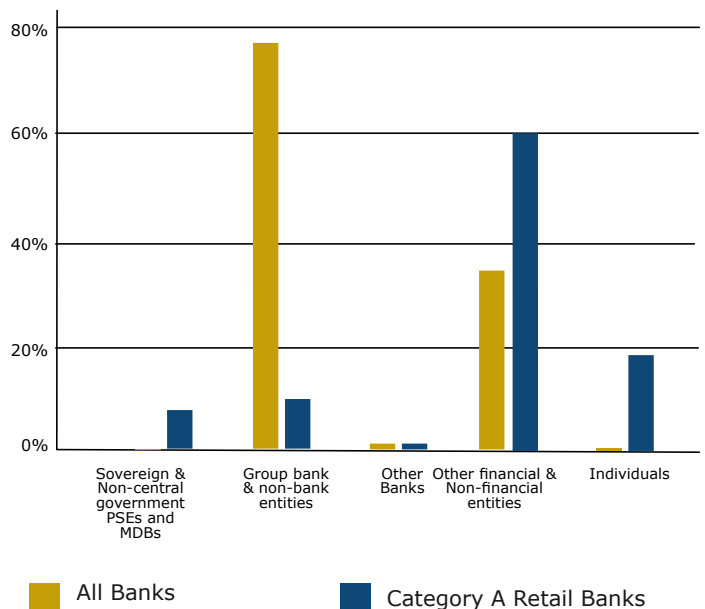


Figure 25: Sources of Funding - Category A Retail Banks



Deposits from Group related entities and corporates account for over 75% and 22% of the total sector deposits, respectively. The higher proportion of deposits from Group related entities is attributable to Category B banks, some of which are specifically established to provide services to Group entities. For Category A Retail banks, deposits from corporates and individuals account for 60% and 19% of total deposits. Please refer to the Household and Corporate sector section for further details on domestic deposits.

Figure 26: Sources of Customer Deposits

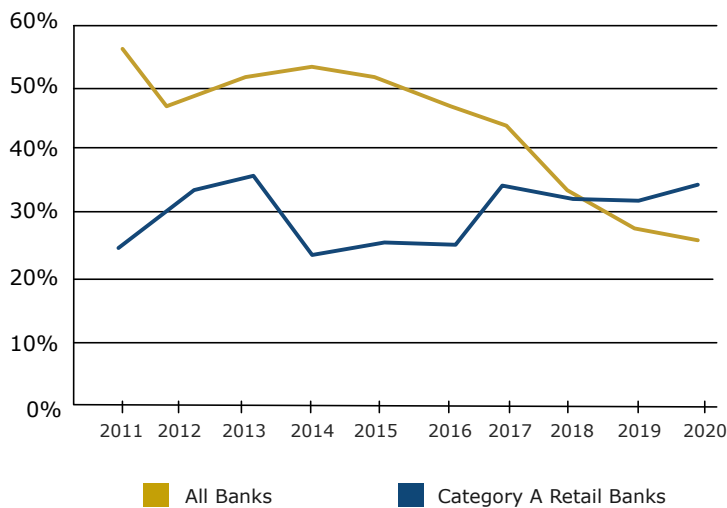


# SECTORAL FINANCIAL STABILITY ANALYSIS

The liquid assets ratio for all banks, which measures the proportion of total assets that are immediately available for liquidity purposes, decreased marginally to 27.6% compared to 28.7% in 2019. The sector's significant liquidity levels are mainly attributable to the Category B banks offering treasury management and sweep services, thus holding a high proportion of cash and cash equivalents.

For the Category A Retail banks, the liquid assets ratio increased from 31.8% in 2019 to 34.6% in 2020. The Category A Retail banks can also rely on the investment portfolio discussed above for liquidity purposes. The strong liquid assets ratio and the investment portfolio support a resilient liquidity position despite higher reliance on customer deposits for funding.

Figure 27: Liquid Assets Ratio



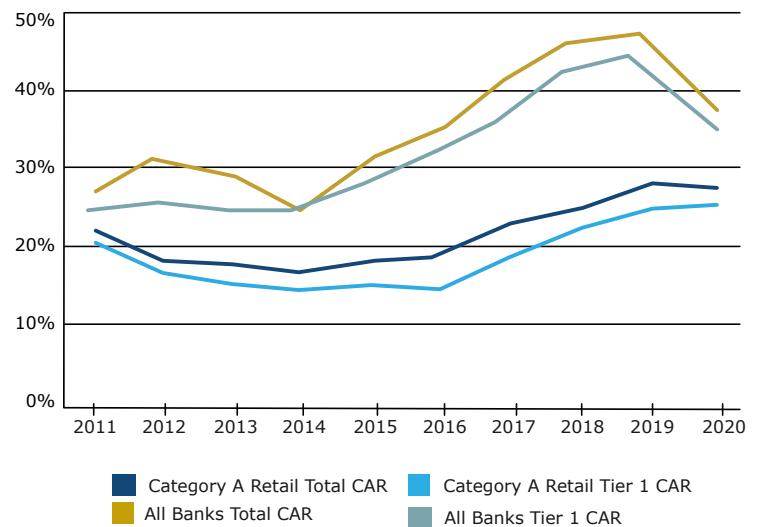
## Capital Adequacy

The sector capital adequacy ratio (CAR), which is the amount of capital a bank must hold as required by the financial regulator, decreased to 38.0% in 2020 compared to 48.1% in 2019. Tier 1 CAR reduced from 44.0% in 2019 to 35.7% in 2020.

Similarly, for the Category A Retail banks, the total CAR decreased to 26.6% compared to 28.5% in 2019. Tier 1 CAR reduced to 24.4% compared to 24.5% in 2019.

The impact of the COVID-19 pandemic mainly drove the decrease in CAR. Despite the decline, the banks continue to maintain a significant buffer above the minimum required CAR of 11% - 15% depending on the bank's structure. Tier 1 CAR accounts for 93.9% and 91.5% of the banking sector and Category A Retail banks' total CAR, respectively. Tier 1 capital is the most stable source of capital for banks.

Figure 28: Capital Adequacy Ratio



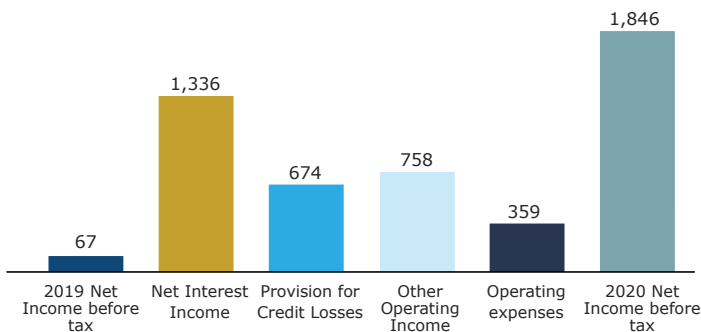
## Earnings and Profitability

Earnings and profitability determine a bank's ability to pay dividends to and grow the shareholders' equity. Relative to 2019, sector net-interest income increased by USD 1,336 million, provision for credit losses increased by USD 674 million, other operating income increased by USD 758 million and operating expenses decreased by USD 359 million and cumulatively resulted in an increase of income before taxes to USD 1,846 million compared to USD 67 million in 2019.

The significant increase in net-interest income is attributable to 44% decrease in interest expense partially offset by 33% decrease in interest income. The reduction in interest income and interest expense is attributable to interest changes and a decline in assets and liabilities by 10.7% and 8.9%, respectively. The decrease in interest expense is higher due to faster repricing of liabilities relative to the assets.

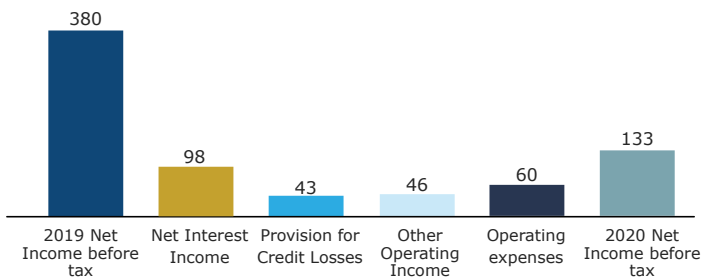
# SECTORAL FINANCIAL STABILITY ANALYSIS

Figure 29: Drivers of Profitability - All Banks (\$US Millions)



For the Category A Retail banks, the net interest income reduced by USD 98 million, provision for credit losses increased by USD 43 million, other operating income declined by USD 46 million and other operating expenses increased by USD 60 million, and cumulatively resulted in a decrease in income before to USD 133 million compared to USD 380 million in 2019. The deterioration in all drivers of profitability is attributable primarily to the COVID-19 pandemic and low-interest rate environment within 2020. For the net interest income, the interest income reduced by 25%, while the interest expense decreased by 43%.

Figure 30: Drivers of Profitability - Category A Retail Banks (\$US Millions)



## Return on Equity and Return on Assets

Relative to 2019, the sector reported a decrease in Return on Equity (ROE) from 10.4% in 2019 to 7.6%, while the ROA increased from -0.02% to 0.3%. The ROE excludes the branches because they are not separate legal entities and do not necessarily have standalone equity, while the ROA includes the branches. The net income/loss for branches was USD -1.05 billion (2019: USD 1.5 billion).

The Category A Retail ROE decreased from 17.9% to 5.3%, while the ROA decreased from 2.5% to 0.7%. The decrease in ROA and ROE for the sector is mainly attributable to the impact of the COVID-19 pandemic.

Figure 31: Return on Equity

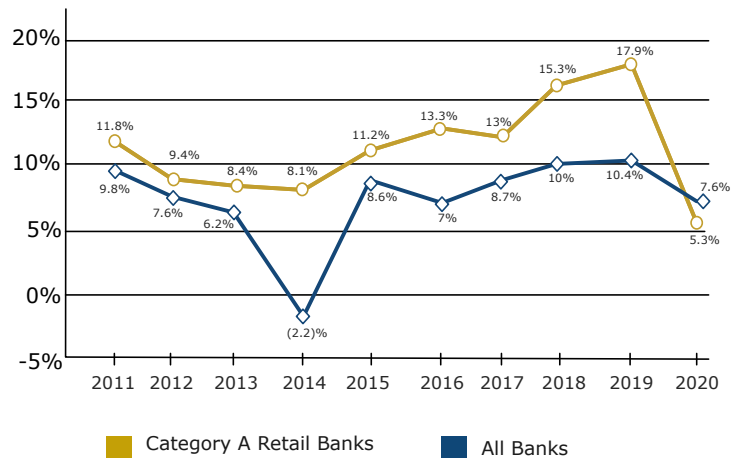
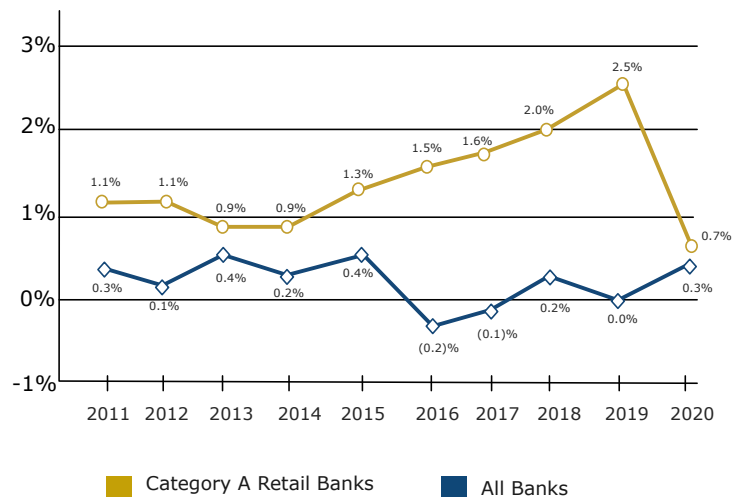


Figure 32: Return on Assets



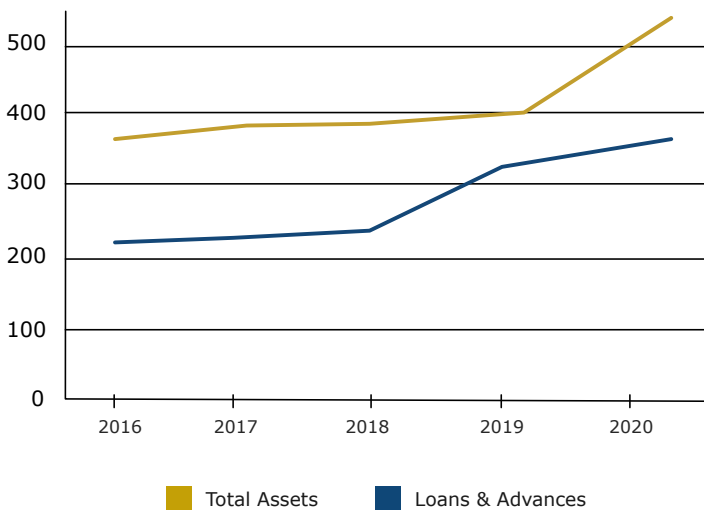
# SECTORAL FINANCIAL STABILITY ANALYSIS

## Societies' Financial Review

### Assets and Loans & advances

The Societies' total assets increased by 22.8% to USD 534.3 million compared to USD 435 million in 2019. Similarly, the loans & advances continued on a growth trend rising by 9.4% to USD 380.7 million. The Societies' credit facilities are mainly to domestic households who are members of the Societies. The Societies' total loans & advances as of 31 December 2020 are equivalent to 9.2% and 14.7% of the Category A Retail banks' total resident loans and total household loans, respectively.

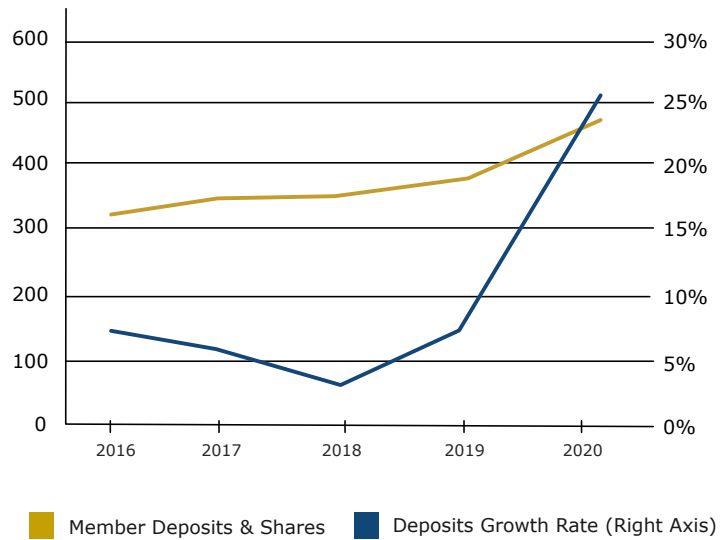
Figure 33: Societies' Total Assets and Total Loans & Advances



### Funding

The Societies are mainly funded by member deposits. During the year, the total member deposits increased by 25.9% to USD 477.3 million. The increase is partly attributable to the Government response that allowed persons to withdraw a portion of their pension as outlined in Chapter 4. This increase in member deposits is also partly responsible for the rise in total assets previously outlined.

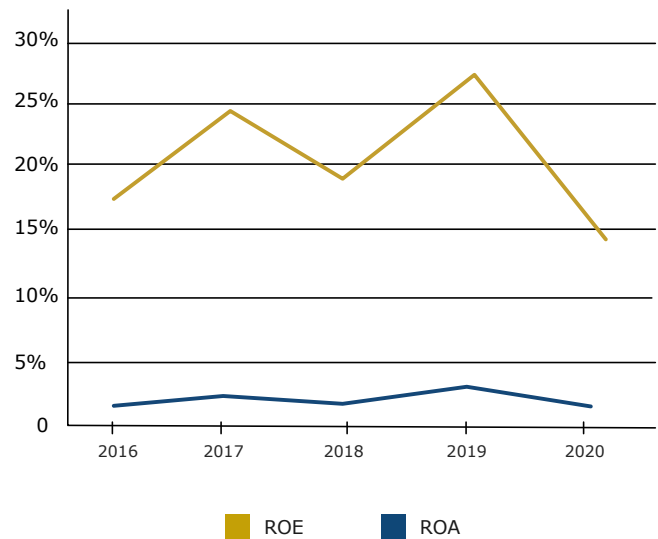
Figure 34: Societies' member deposits (\$US Millions)



### Profitability

The ROA decreased to 1.6% compared to 3.3% in 2019, while the ROE decreased to 14.2% compared to 27.3% in 2019. The decrease in ROA and ROE is mainly due to the decline in net income by 44.6%. The reduction in ROA is also attributable to the increase in total assets.

Figure 35: Societies' Return on Assets and Return on Equity



## Domestic Household and Corporate Sector

Household credit increased by 3.5% to USD 2.6 billion compared to USD 2.5 billion in 2019. Household deposits increased by 16.8% to USD 2.6 billion compared to USD 2.2 billion in 2019. Similarly, the corporate sector credit increased by 11.3% to USD 1.2 billion compared to USD 1.1 billion in 2019, while the corporate sector deposit increased by 3.5% to USD 2.7 billion compared to USD 2.6 billion in 2019.

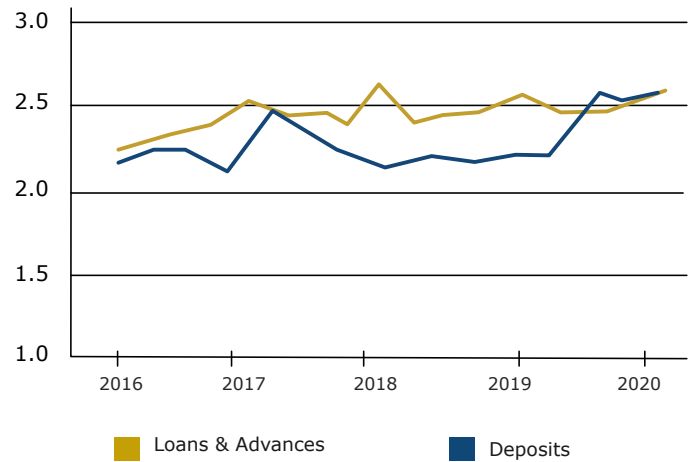
The continued growth of household and corporate sector lending and deposits during the COVID-19 pandemic shows a strong financial position of the household and corporate sector and the strong resilience of the banking sector.

### Household Sector

As indicated above in 2020, household credit increased to USD 2.6 billion. The household credit is equivalent to 46.7% of the Cayman Islands' total GDP. Household over-indebtedness can be affected by unfavourable economic conditions and compromise the stability of the financial system. However, the Cayman Islands household credit-to-GDP is lower than the proportion reported by G20 countries and advanced countries of 59.8% and 77.2%, respectively. The ratio also compared fairly with the proportion for emerging markets of 46.6%.

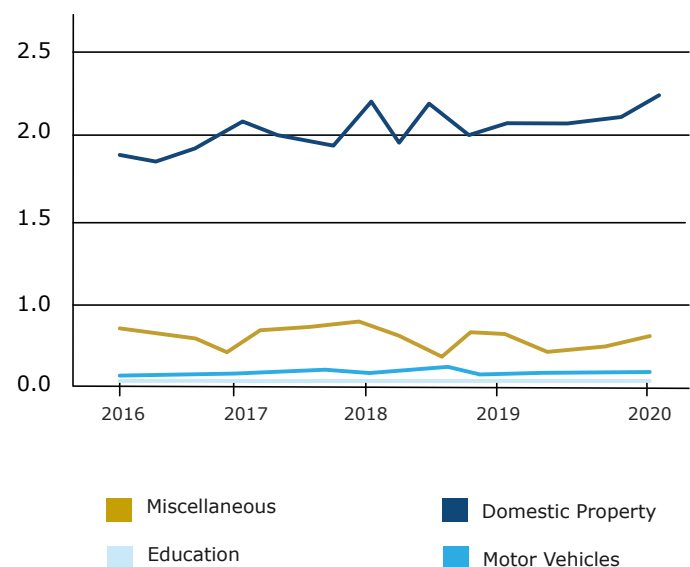
Household deposits are a stable source of funding for banks. The household credit increased to USD 2.6 billion, and for the first time in five years, the total household deposits exceeded the total household credit. Over 80% of the household deposits are savings and fixed deposits, and the rest are demand deposits.

Figure 36: Resident Household Credit & Deposits - All Banks (\$US Billions)



Loans for domestic property account for the largest portion of household credit (USD 2.2 billion or 87.4%). Other components of household credits include motor vehicle, education and miscellaneous. Credit for domestic property and motor vehicles reported year-on-year growth of 6.5% (USD 139 million) and 2.6% (USD 1.8 million), respectively. The growth in credit relating to the domestic property is consistent with the continuing growth of the domestic real estate and construction industry.

Figure 37: Household Loans and Advances by Type - All Banks (\$US Billions)



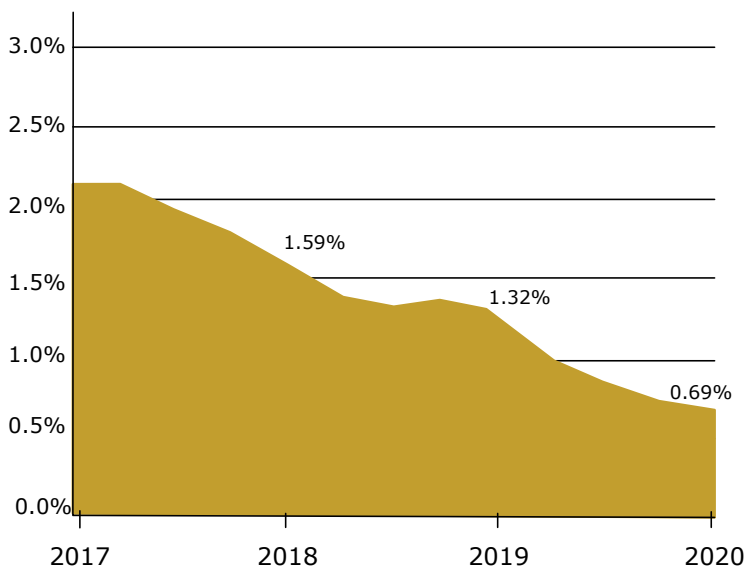


# SECTORAL FINANCIAL STABILITY ANALYSIS

## Foreclosures

Foreclosure is a process through which banks commence a legal process to satisfy the financial obligations owed to the banks if the customers fail to meet the contractual repayment requirements. Foreclosure is generally a lagging indicator of asset quality because the legal process usually commences after the customer defaults. The foreclosure rate continued a decreasing trend by decreasing to 0.69% compared to 1.3% in 2019.

Figure 38: Foreclosure Rate



## Corporate Sector

Corporate sector loans and deposits increased by 11.3% and 3.5% to USD 1.2 billion and USD 2.6 billion, respectively. The corporate sector credit is less than credit to households, while the corporate sector deposits are reasonably similar to deposits from households. The lower credit to the corporate sector shows the corporate sector has a strong financial position. The corporate sector credit is equivalent to 21.8% of the Cayman Islands GDP. The debt levels are not indicative of over-indebtedness in the corporate sector. The corporate sector credit-to-GDP is significantly less than similar ratios for G20, advanced economies and emerging markets of 258.5%, 309.2%, 211.2%, respectively.

Figure 39: Corporate Credit & Deposits - All Banks

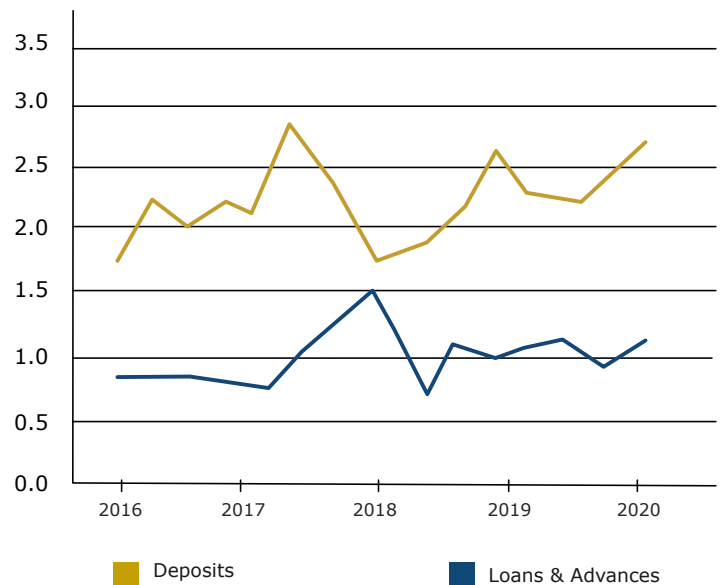
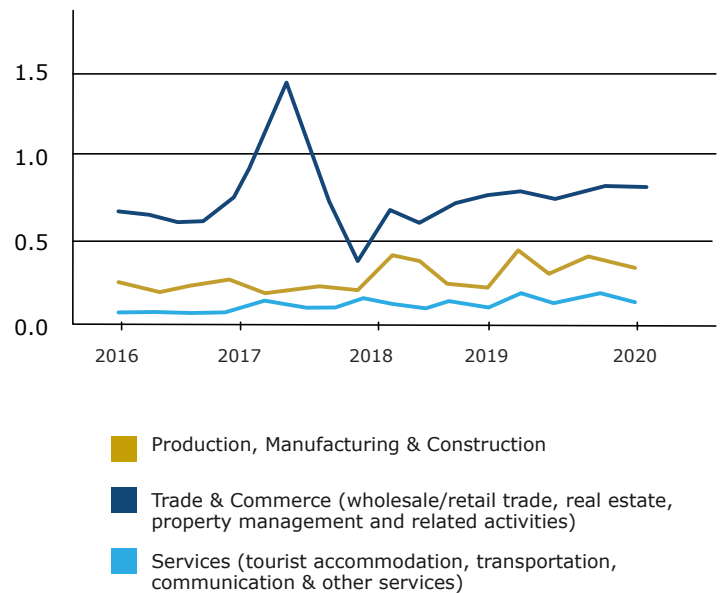


Figure 40: Corporate Credit by Industry - All Banks (\$US Billions)



The corporate sector credit as of 31 December 2020 by client industry is as follows: Trade & Commerce (65% or USD 783 million), Production, Manufacturing & Construction (23% or USD 284 million) and Services industry (12% or USD 140 million). On a year-on-year basis, the corporate credit to the above sectors increased by 11.7%, 9.1% and 14.3%, respectively.

# SECTORAL FINANCIAL STABILITY ANALYSIS

## Interest rate on loans & advances and Deposits

The weighted average lending and deposit rates continued to decline in the year, consistent with the low-interest rate environment during the pandemic. During 2020, the prime lending rate decreased by 50%, while the KYD and USD lending rates year-on-year decrease was 19% and 28%, respectively. The KYD and USD deposit rates decreased by 86% and 82%, respectively. Generally, the deposits have shorter maturities and faster repricing compared to loans and advances.

Generally, the KYD lending rates and deposit rates are higher than the respective USD rates. USD denominated assets and liabilities account for 71% and 66% of the total assets and liabilities, respectively.

Figure 41: Weighted Average Lending Rates - Category A Retail Banks

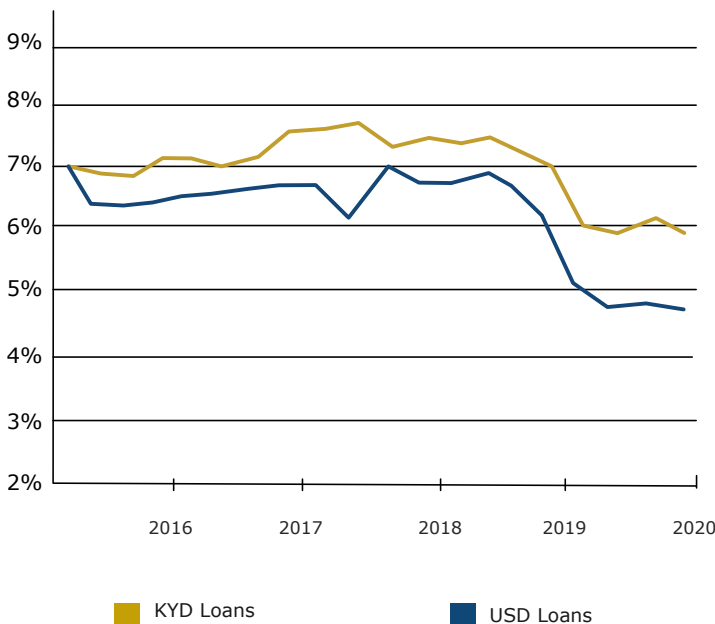
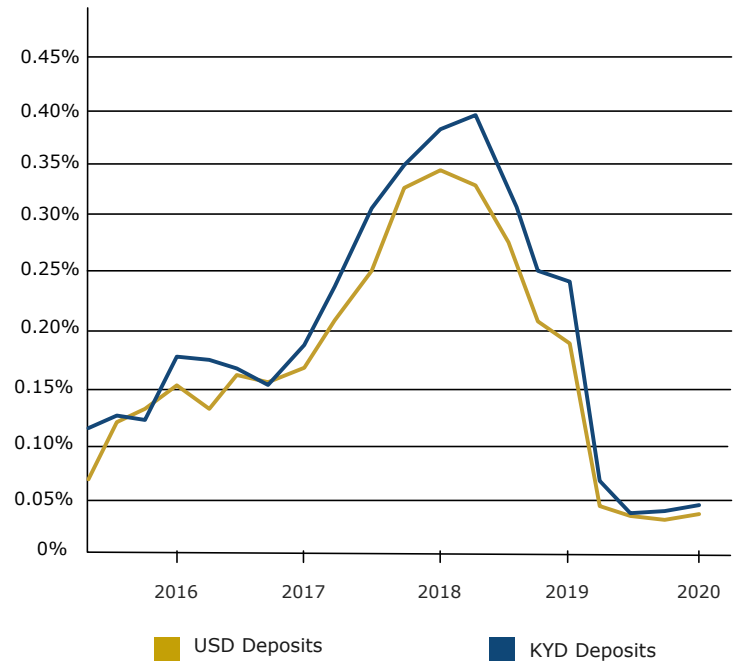


Figure 42: Weighted Average Deposit Rates - Category A Retail Banks



## Regulatory stress testing

In May 2020, CIMA conducted a stress testing exercise to assess the potential impact of COVID-19 pandemic on the Category A Retail banks capital adequacy and liquidity. The stress testing exercise considered the nature of exposures and industry to which each bank is exposed, deterioration of the credit portfolio resulting in increased default rates (especially for the tourism and service industry), collateral held against the exposures, impact of market losses and credit rating downgrade of the investment portfolio, among other factors. The supervisory stress test results indicated that the CAR and liquidity profiles were generally strong in the modelled scenarios.

CIMA's regulatory procedures revealed no significant uptake of the Government's fully guaranteed low-interest loans to small businesses offered through the Cayman Islands Development Bank. These loans were expected to support the small businesses impacted by COVID-19. The low uptake shows that the corporate sector was generally in a strong financial position before COVID-19.

## **Thematic credit review**

In early 2021, CIMA conducted a thematic credit review of financial institutions with domestic lending activities. Part of the objectives of the review was to assess the impact of the COVID-19 pandemic on the loan portfolios of these financial institutions and to understand the nature of concessions granted to customers as well as risk mitigation measures. The review revealed that the loan portfolios were generally resilient through the COVID-19 pandemic. The review also confirmed that many entities had discontinued the previously implemented forbearance and debt payment moratorium measures without significantly deteriorating the loan portfolio.

## **Other regulatory actions**

For dividend payments, CIMA assessed dividend payment applications on a case-by-case basis instead of a complete prohibition of dividend payments. Any proposed dividend payments were carefully evaluated against the impact on capital and liquidity before approval. Additional measures were also implemented by CIMA, such as the extension of regulatory filing timelines and conducting virtual inspections.

The financial overview and the results of supervisory procedures discussed above are supportive of a resilient banking sector throughout the COVID-19 pandemic. Additionally, prior financial data indicates that the banking sector was generally strong in the previous crises. Please refer to the section of the banking sector's financial performance during the GFC, European Sovereign Debt crisis and COVID-19 pandemic. See page 11.

## **Outlook beyond COVID-19**

The outlook of the banking sector beyond COVID-19 is positive. As indicated above, most banks have discontinued the loan repayment moratorium without significant deterioration of the asset portfolio. The Government has reopened the

borders with the jurisdiction seeing the revival of the tourism and service industries. CIMA does not expect a significant impact on the banking sector as Government eases off COVID-19 response measures such as pension payment holiday.

## Trust and Corporate Service Providers

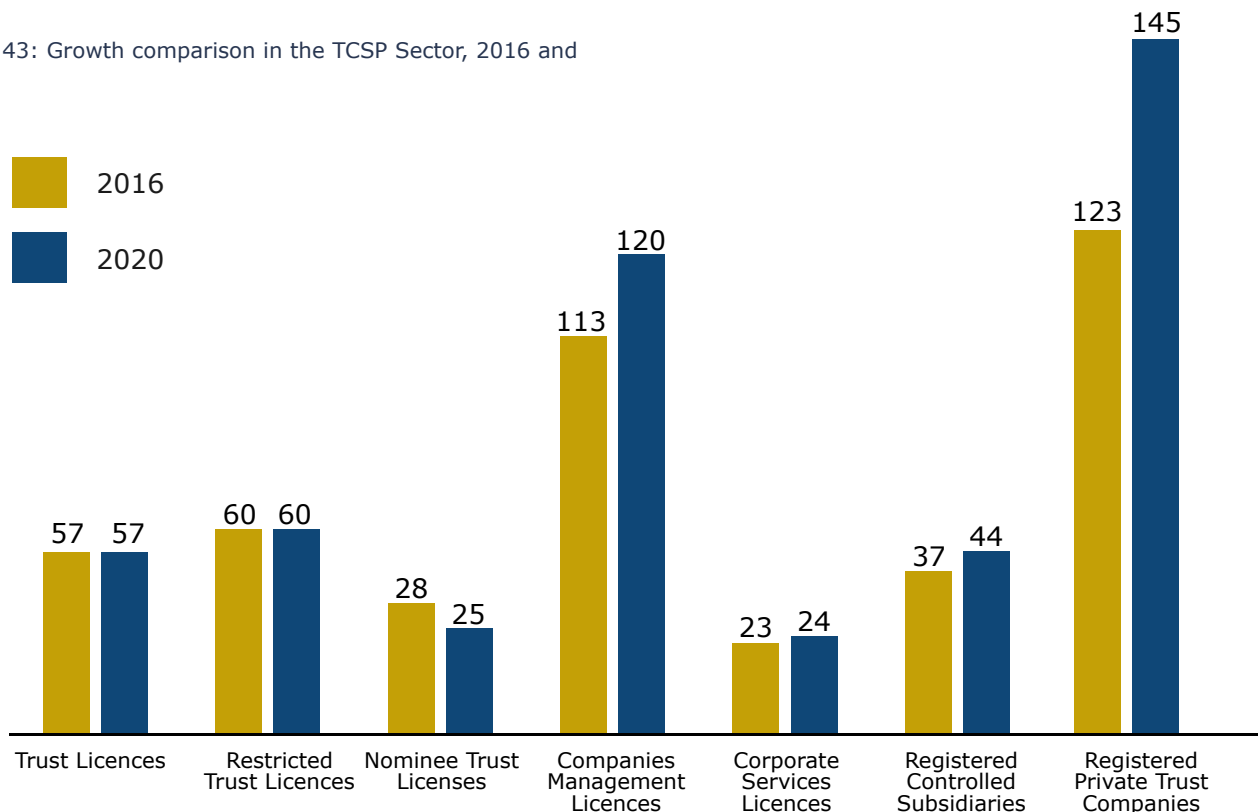
The TCSP sector is comprised of trust companies and corporate service providers (CSP). There are three main categories of companies holding trust licences, namely Trust, Restricted Trust, and Nominee Trust and two main categories of companies holding trust registrations, namely Registered Controlled Subsidiaries and Registered Private Trust Companies. There are two main categories of companies holding corporate services licences, namely Companies Management and Corporate Services.

Compared to 2016, there was no significant change in the number of trust licences. However, the number active trust licences reduced from 145 to 142 as trust licences continued to consolidate and restructure in pursuit of optimal cost, risk management and governance structures. The number of trust registration, however, increased

from 160 to 189 in 2020, largely attributable to increased use by high net-worth individuals as part of their wealth structuring. The number of CSP increased from 136 to 144 in 2020, as the Cayman Islands continues to be an ideal jurisdiction for the establishment of business vehicles, because of its stable legal system, modern and flexible corporate structures and tax neutral status.

As of September 2020, per the Global Financial Centers Index, the Cayman Islands was ranked 78 in the global rankings and ranked 5th in the Latin America & the Caribbean region. The Cayman Islands continue to hold a robust reputation as a financial center, demonstrated by the increased number of company registrations. New company registrations for 2020 amounted to 11,731, which brought the number of active companies domiciled in the Cayman Islands as of 31 December 2020, to 111,568.

Figure 43: Growth comparison in the TCSP Sector, 2016 and 2020



## Nature of TCSP Sector

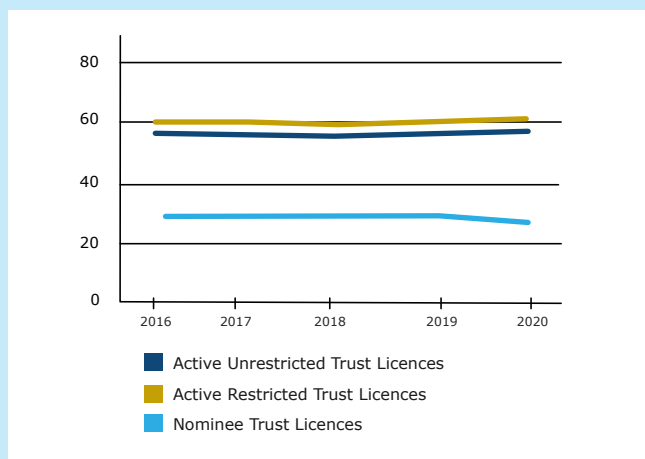
**Trusts:** The Trust Licence holder is authorized to offer trust business within and outside of the Cayman Islands, where licensees can provide trustee, executor or administrator services. They can also provide company management services in connection with their business.

**Restricted Trusts:** The Restricted Trust Licence offers trust business with the restriction that Licensees shall not undertake trust business for persons other than those listed in the undertaking accompanying the application for the Licence.

**Nominee Trusts:** The Nominee Trust Licence offers trust business under a trust licence to a Licensee who is a wholly-owned subsidiary of another licensee and where the sole purpose of that subsidiary is to act as its nominee.

### Regulated trusts

Figure 44: Number of Regulated Trusts



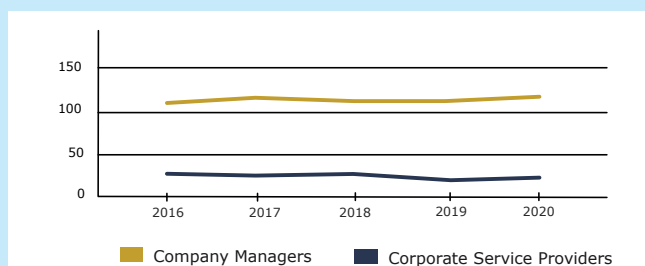
Over the past five years, the number of Trust and Restricted Trust Licences have remained the same, while the number of Nominee Trust Licences has declined. This is as a result of companies holding Trust Licences consolidating and restructuring the type of services provided via Nominee Trust Licences, to be absorbed within their suite of services in pursuit of optimal cost, risk management and governance

structures.

**Company Manager:** The Companies Management Licence offers the provision of corporate services for profit or reward in or from within the Cayman Islands.

**Corporate Service Provider:** The Corporate Services Licence offers the provision of corporate services for profit or reward in or from within the Cayman Islands, similar to the Company Manager Licence. However, the Corporate Services Licence are limited to the following services: company formation agent; registered office provider; establishing and maintaining beneficial ownership registers for companies incorporated and domiciled in the Cayman Islands; provision of accommodation, correspondence or administrative address for a company or for any other person; filing statutory forms, resolutions, returns and notices; and acting as or fulfilling the function of or arranging for another person to act as or fulfil the function of such person.

Figure 45: Number of Regulated CSPs



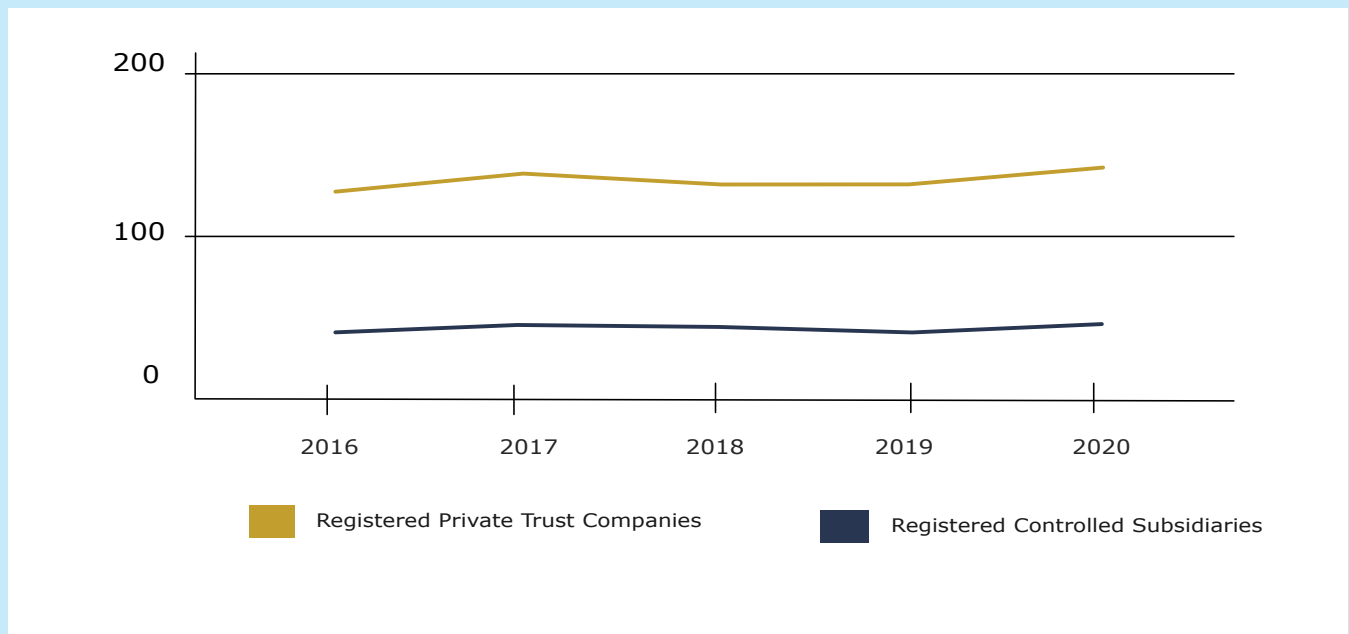
Over the past five years, the number of Company Management Licences have increased by 1% on average, with a sharp increase of 3% seen in 2020. This is consistent with the increase seen for Cayman Islands domiciled companies in the year, where the increased company registrations in the Cayman Islands have triggered a growth for companies management service providers. Over the past five years, the number of Corporate Services Licences have largely remained the same.

# SECTORAL FINANCIAL STABILITY ANALYSIS

**Private Trust Companies:** The Private Trust Company Registration allows companies that are incorporated in the Cayman Islands, the ability to offer connected trust business, such as trust business in respect of trusts of which there is one or more than one contributor to the funds of which are all, in relation to each other, connected persons. Over the past five years, the number of Registered Private Trust Companies have increased due to the increased use of such structures by high net-worth individuals as part of their wealth structuring.

**Registered Controlled Subsidiaries:** The Controlled Subsidiary registration allows Registrants to carry on the business of issuing debt instruments or to carry on other trust business that is connected with the trust business of the Licensee by which the controlled subsidiary is owned. Registered Controlled Subsidiaries have marginally increased over the past five years.

Figure 46: Number of Registered Controlled Subsidiaries and Private Trust Companies



# SECTORAL FINANCIAL STABILITY ANALYSIS

As outlined previously, trustee services are mainly offered by Trust Licensees, with company management and corporate services mainly being offered by Companies Management Licencees.

## Impact of COVID-19 and Responses

The TCSP sector was generally resilient throughout 2020 despite the economic and operational challenges from the COVID-19 pandemic. The TCSP sector's resilience was in part due to the strong financial position of the sector before COVID-19. Overall, the FSIs remained strong.

The ROA for all TCSPs improved while the ROA for each sector marginally improved. The liquid assets ratio was reasonably consistent with 2019.

The ROE for all TCSPs decreased along with the liquid assets to short term liabilities. Whilst the ratios remained strong and well above the minimum required, the subsequent reduction was largely attributable to the COVID-19 pandemic.

Table 4: Key Financial Soundness Indicators

Key FSI	Liquid Assets Ratio (%)		ROA (%)		Liquid Assets to Short-Term Liabilities		ROE%	
	2020	2019	2020	2019	2020	2019	2020	2019
TCSPs	96.42	96.75	12.14	10.01	2.17	4.97	39.60	51.32
Unrestricted Trusts	98.12	96.12	7.72	6.43	2.16	3.36	25.21	32.94
Company Managers	91.97	97.99	4.10	3.43	2.24	12.38	13.38	17.57
CSP	77.71	65.60	0.31	0.16	1.85	1.47	1.01	0.81

## Investment Funds

The following are categories of mutual funds:

**Registered Fund:** Investors whose minimum initial subscription requirement is no less than US\$100,000.

**Master Fund:** A fund with one or more regulated feeder funds.

**Administered Fund:** A fund whose CIMA licensed Fund Administrator also serves as its principal office provider. In addition, these funds do not have a minimum initial subscription requirement, as in the case of registered funds and there is no need to be listed on a recognised stock exchange.

**Licensed Fund:** Operators are required to be approved (no minimum initial subscription requirement).

**Limited Investor Fund:** A fund with less than 15 investors, funds that previously took advantage of Section 4(4) of the Mutual Funds Act (MFA) which exempted certain funds from CIMA's regulatory reach.

**Private Fund:** An entity whose principal business is the offering and issuing of investment interests. It does not include any non-fund arrangements.

**Mutual Fund Administrators:** Entities authorised by CIMA to carry out the following services of a fund: management, administration, providing a principal office in the Cayman Islands, or providing an operator (director, trustee or general partner) to the fund. Entities that are licensed as mutual fund administrators, fall into 3 distinct classifications:

**Full** - Authorises the holder of the license to act or carry-on business as a fund administrator in respect of an unlimited number of regulated mutual funds.

**Restricted** - Limited to no more than 10 funds; and must receive CIMA's prior approval for each new fund. The restricted license authorizes the holder of the license to act or carry-on business as a fund administrator solely in respect of the regulated funds specified from time to time in the license.

**Exempted** - Persons exempted from obtaining an MFA Licence pursuant to section 10(2) of the MFA (2003 Revision).



# SECTORAL FINANCIAL STABILITY ANALYSIS

The Cayman Islands is one of the premier jurisdictions for investment fund domiciliation. The jurisdiction's professional infrastructure, stability, regulatory regime, English common law framework and tax neutrality all supports the growing sector. Regulation of investment funds in the Cayman Islands is comprised of a mutual fund and private fund regime.

## Mutual Funds

Regulated mutual funds are approved under the MFA. As of 31 December 2021, a total of 12,719 mutual funds (comprised of 8,499 registered funds, 3,198 master funds, 295 administered funds, 55 licensed funds and 672 limited investor funds) were approved under the MFA. The total number of mutual funds has shown a steady increase over the last five years. The increase in the last two years was also supported by an amendment to the MFA in February 2020, which removed a previous exemption that now requires funds with 15 or less investors, where such investors had the power to appoint or remove the operator, to register with CIMA. The amendment resulted in a new category of funds, namely Limited Investor Funds, which contributed to the total mutual funds.

Based on the audited financial statement filings for 2020, mutual funds reported a total asset value of US\$8.7 trillion and total net asset value of US\$5 trillion. Total assets and total net assets have also steadily increased over the last five years, even when the contribution of the additional Limited Investor Funds for 2020 is excluded.

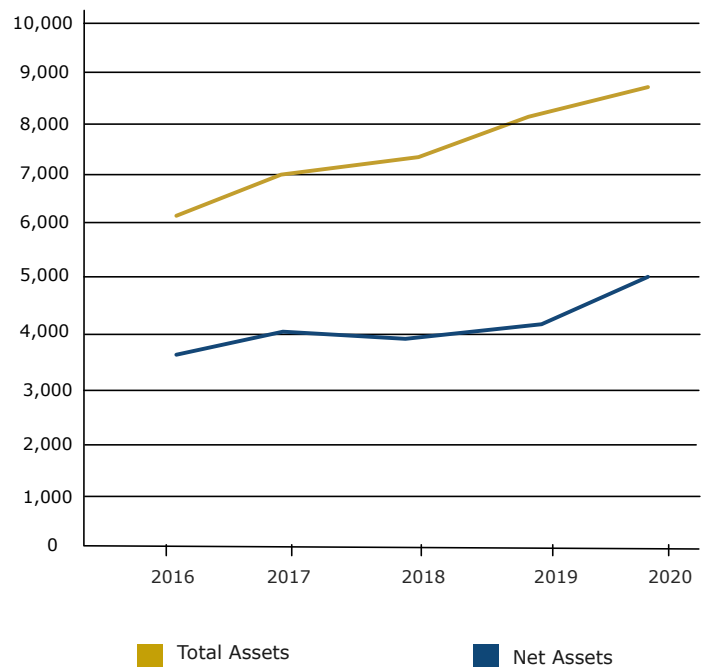
As most funds are not staffed, they engage multiple outsourced service providers, including investment managers, auditors, administrators, and custodians. This results in an increased oversight of the activities in the fund. Directors of mutual funds must be registered with CIMA pursuant to the Directors Registration and Licensing Act (DRLA). All funds must have a local, CIMA approved auditor to sign off on their audited financial statements annually.

Table 5: Active Mutual Funds by Type

Mutual Fund	2017	2018	2019	2020	2021
Registered	7,331	7,654	7,612	7,972	8,499
Administered	331	317	295	294	295
Licensed	81	5	64	59	55
Limited Investor				583	672
Master	2,816	2,946	2,886	2,988	3,198
<b>Total</b>	<b>10,559</b>	<b>10,992</b>	<b>10,857</b>	<b>11,896</b>	<b>12,719</b>

The majority of mutual funds cater to institutional and high net-worth individuals, as the minimum initial investment for most of these funds is US \$100,000. Almost half of registered funds require an initial minimum investment of US\$1 million or more. Registered funds specifically cater mostly to institutional clients, such as pension funds, investment banks, but can also include high net-worth individuals.

Figure 47: Total Assets and Net Assets of Mutual Funds (\$US Billions)



# SECTORAL FINANCIAL STABILITY ANALYSIS

## Private Funds

The Private Funds Act (PFA) came into force in the Cayman Islands in February 2020 and required all existing private or closed-ended fund vehicles established in the Cayman Islands to apply for registration with CIMA. Such funds were exempt from registration under the MFA given their closed-ended status. The PFA requires a private fund to register with CIMA within 21 days of accepting capital commitments from investors, or at least prior to accepting capital contributions from investors. The introduction of the PFA, together with the above-noted amendment to the MFA, demonstrated the jurisdiction's commitment to meeting international standards for regulation, transparency, cross-border cooperation, and economic substance.

As of 31 December 2021, a total of 14,679 private funds were approved under the PFA which represents an increase from the 12,695 approved at the end of 2020. Based on the audited financial statement filings for 2020, private funds reported a total asset value of USD 2.6 trillion and total net asset value of USD 2.4 trillion.

Mutual and private funds (collectively "investment funds") domiciled in the Cayman Islands have minimal linkages to the domestic retail economy. Only ten mutual funds, with a combined net asset value of approximately USD 500 million, are available for subscription to domestic retail investors. Of the almost 11,000 investors in the aforementioned ten funds, only 1,037 are Cayman Islands domiciled investors, holding a net asset value of approximately USD 118 million. Of the foregoing, 812 (78%) are Cayman Islands retail investors, holding a net asset value of approximately USD 29 million (25%).

Investment funds however do constitute a significant part of the product offering of the Cayman Islands as an international financial center. Investment funds have direct links to the local Cayman Islands economy through contracting with domestic service providers such as company

managers, corporate services providers, lawyers, auditors and mutual fund administrators. As such, and in addition to contributing to the real economy in terms of income to the public purse, investment funds also contribute to employment at the various domestic service providers as noted.

Damage to the international reputation of the Cayman Islands as a credible location for clear and legally secure investment fund structures could have a negative effect on the number of investment funds domiciled in the jurisdiction. Consequently, this could negatively affect the contributions of investment funds to the local economy as noted above. The Cayman Islands therefore is committed to, through its regulatory regime and legal framework align with international best practices.

Investment fund registration and de-registration data has shown no significant trends over the last five years that supports any significant damage to the international reputation of the Cayman Islands. It is further supported by the insignificant levels of fund de-registrations on the basis of re-domiciliation to other jurisdictions.

## Fund Administrators

Fund administrators are key service providers as it relates to CIMA's regulatory oversight of funds regulated within the jurisdiction. With a high volume of transactions and investors from around the globe, it is essential that fund administrators licensed by CIMA are well equipped with the appropriate procedures and monitoring systems. Local licensed fund administrators are subject to the provisions of the MFA and are also required to comply with several regulations, policies, and statement of guidance. As part of CIMA's oversight, licensees are subject to onsite inspections to ensure the applicable processes and systems are not only in place, but are effectively being performed, monitored, and evidenced appropriately. The frequency of inspections is determined by the fund administrators' risk rating.

As the providers of the registrar and transfer

## SECTORAL FINANCIAL STABILITY ANALYSIS

agency (RTA) service, fund administrators are the safe keepers of all investor/client due diligence documentation, including related reviews and checks. The fund administrators are required by CIMA to utilize a risk-based approach and to risk rate each investor/client based on specific criteria. The scrutiny of each investor/client will be determined by the risk rating assigned by the fund administrator. As part of CIMA's oversight, fund administrators are also monitored to ensure the appropriate resources are in place to efficiently monitor the number of funds and investors/clients being onboarded. The type of fund administrator license issued by CIMA will specifically determine the number of funds the fund administrator is able to provide RTA or net asset value calculation services to.

Since 2017 there has been a noted decrease in CIMA issued fund administrator licenses. The trend does not necessarily indicate a decline within the fund administrator industry but more so highlights consolidation through mergers that have taken place in the industry.

Table 6: Active Administrators by Type

	2017	2018	2019	2020	2021
Restricted	18	12	10	9	9
Full	78	75	70	66	66
Exempted	1	1	1	1	0
<b>Total</b>	<b>97</b>	<b>88</b>	<b>81</b>	<b>76</b>	<b>75</b>

By design, the regulatory framework of the alternative investment industry of the Cayman Islands allows room for investment funds to be managed by both Cayman Islands domiciled and by non- Cayman Islands domiciled investment managers.

Most investment managers of Cayman mutual funds are based overseas. Based on the Fund Annual Return (FAR) filings submitted for the period 2016 – 2020, an average of less than 10% of the total number of funds were managed by Cayman Islands domiciled investment managers

with the remaining over 90% spread across the Americas, Europe and the Asia Pacific region. Over the same period, USA remains the jurisdiction where more than half of all funds are being managed from. Also, the management of Cayman Islands mutual funds from the United Kingdom and the Euro zone accounts for an average of 10% and 4% respectively of all funds whilst Hong Kong, being the main player within the Asia Pacific region accounts for an average of 8% of total number of funds.

Only 5% of total net assets under management with respect to mutual funds were managed by investment managers within the Cayman Islands which accounts for a total of 708 funds with a total net assets value of USD 253 billion as at the end of the year 2020.

The investment managers operating from within the Cayman Islands are regulated by CIMA through the Securities Investment Business Act (SIBA) and its related regulations. As mandated by law and as a regulatory measure, CIMA issues rules and regulatory policies and procedures which creates binding obligations on the investment managers for which breaches may lead to the imposition of fines or regulatory action being taken against them by CIMA, pursuant to the exercise of its powers under the SIBA and the related regulations.

By the design of the Cayman Islands regulatory framework, the exercise of CIMA's oversight over investment funds is through the directors, trustees and general partners (namely "operators") of the funds rather than through the investment managers. The operators are responsible for ensuring that the funds under their control comply with the relevant laws and regulations. To ensure the mitigation of any potential risk posed to mutual funds by virtue of being managed by investment managers outside the jurisdiction of the Cayman Islands, the DRLA was promulgated among others. The DRLA stipulates the obligations of the appointed directors (as operators) on funds and the actions that CIMA can initiate in instances where they are found to have failed in their duties.

## SECTORAL FINANCIAL STABILITY ANALYSIS

The investment strategy focus of regulated mutual funds in the Cayman Islands are predominantly: Multi-Strategy, Long/Short Equity, Fixed Income, Global Macro and Equity Long Only, categories continue to be the main interest of funds and these accounts for an average of over 66% of the total net assets value for all mutual funds for the period between 2016 to 2020.

As per Figure 48 and with the exception of Global Macro strategy, the net asset value of the other top four investment strategies witnessed a relatively steady growth over the period from 2016 to 2020 even though there were marginal declines in 2018 in their total net asset value contributions before returning to growths in the years 2019 and 2020. The total net asset values in respect of the Global Macro strategy on the other hand witnessed marginal growths over the period 2016 to 2019 before eventually witnessing a decline in the year 2020. Notwithstanding the foregoing, the Global Macro strategy continues to be among the top 5 strategies in terms of its net asset value contributions to the net asset value pool of the industry.

The outbreak of the global pandemic in 2020 with its attendant dislocation of the capital markets were expected to create growth opportunities for funds investing in the distressed debt space, however the number of funds and related net assets values of such funds rather witnessed a decrease. The decrease however was not limited to only the year 2020 as the years from 2016 to 2019 also showed a continual downward trend. The total number of funds with investment in distressed securities as their investment strategy saw a consistent downward trend from 225 funds in 2016 to 168 funds in 2020.

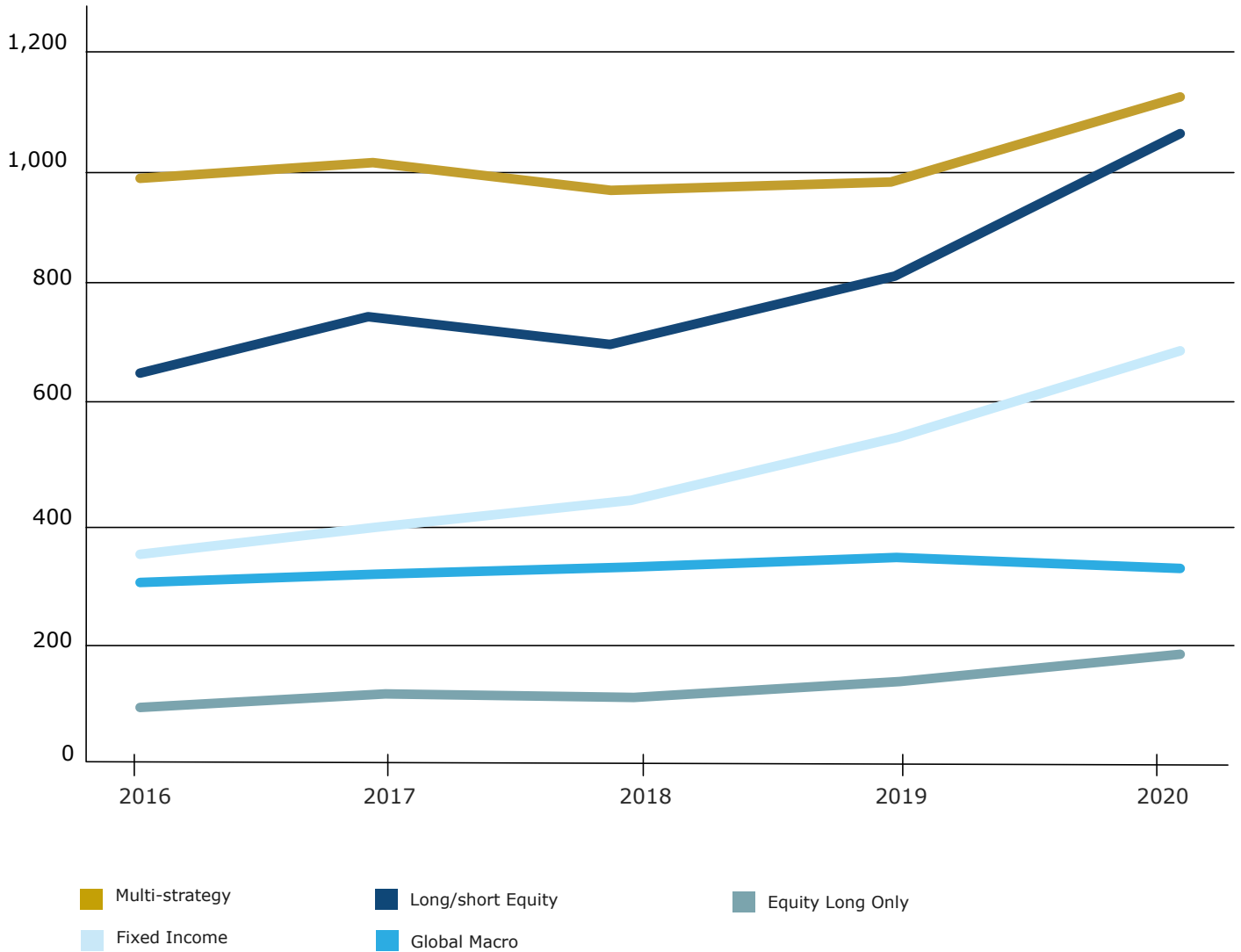
Also, investment in the digital asset space effectively took full swing in the year 2018 with a total of 21 funds with a corresponding net asset value of USD 0.7 billion. Despite the skepticism surrounding this space in being inherently high risk, the number of funds rather saw a steady increase over the period of 2019 and 2020 to 25 funds and 62 funds respectively with a corresponding net

asset value of USD 2 billion and USD 7 billion respectively. It represents an increase of 148% and 334% in terms of the number and the net asset values respectively for funds that invested in the digital asset space between 2019 and 2020.

In line with the global attention that Environmental, Social and Governance (ESG) matters have received in recent times, investment managers have begun to venture into the opportunities it presents. There has been a resultant rise in ESG-focused funds as more investment managers are becoming more aligned with ESG investment strategies.

# SECTORAL FINANCIAL STABILITY ANALYSIS

Figure 48: Trend analysis - NAV of the Top 5 Investment Strategies (\$US Billions)



## Insurance

The insurance industry has two distinct sectors: Domestic and International insurance segments.

**Domestic insurance segment** provides insurance to Cayman residents and businesses through locally incorporated or branches of foreign insurers.

**International insurance segment** provides insurance for foreign risks by insurers incorporated in the Cayman Islands.

There are four main classes of insurer licenses for (re)insurance companies:

**Class A Insurers:** Domestic or external insurer that carries on business generally in or from within the Cayman Islands, providing insurance business to the domestic insurance market or to carry out limited reinsurance business.

**Class B Insurers:** Such insurers are exempted to carry on insurance and/or reinsurance business other than domestic business from within the Islands.

**Class C Insurers:** Such insurers are exempted to carry on insurance business involving the provision of reinsurance arrangements. Class C license applies to fully collateralized international insurers e.g., Insurance Linked Securities and catastrophe bonds.

**Class D Insurers:** Such insurers carry on reinsurance business and such other business as may be approved in respect of any individual licence by the Authority. Class D licence are usually for large open-market reinsurers.

**Insurance Manager:** Any company that provides insurance expertise to or for class B or class C insurers.

**Insurance Agent:** A person (who is not an insurer) to solicit domestic business on behalf of

not more than one general insurer and one long term insurer.

**Insurance Broker:** A person who can arrange or procure, directly or through representatives, insurance or reinsurance contracts or the continuance of such contracts on behalf of existing or prospective policyholders.

Table 7: Number of Insurance Class A-B-C-D Licences

	2015	2016	2017	2018	2019	2020
Class A	31	29	28	27	26	27
Class B	679	683	669	674	618	624
Class C	28	25	24	25	23	23
Class D	1	3	3	4	5	5

Table 8: Number of Insurance Agent-Broker-Manager Licences, 2015 to 2020

	2015	2016	2017	2018	2019	2020
Agents	49	46	47	46	45	46
Brokers	42	42	29	26	23	23
Managers	32	32	28	26	24	23

### What is a Captive?

It is an insurance company formed to insure the risks of its shareholders or its related entities. Therefore, it is considered an alternative risk transfer mechanism used to finance risk. Captives are usually Class B insurers. The Cayman Islands is recognised as the second largest jurisdiction for captive insurance.

# SECTORAL FINANCIAL STABILITY ANALYSIS

There was a total of 770 entities within the insurance industry in the Cayman Islands under the supervision of the CIMA of which 96 and 674 related to the domestic and the international insurance markets respectively.

Table 9: Domestic Market for Insurance Industry, 2020

Licence Type	Total
Class A Insurer	27
Insurance Broker	23
Insurance Agent	46
<b>Total</b>	<b>96</b>

The domestic insurance market consisted of 27 insurance companies licensed under the Class A licence category, 23 Insurance Brokers, and 46 Insurance Agents. The entities in the domestic insurance market are involved in insurance business whereby the insured risk is in the Cayman Islands.

Figure 49: Main Lines of Business for Class A Insurers in Domestic Market

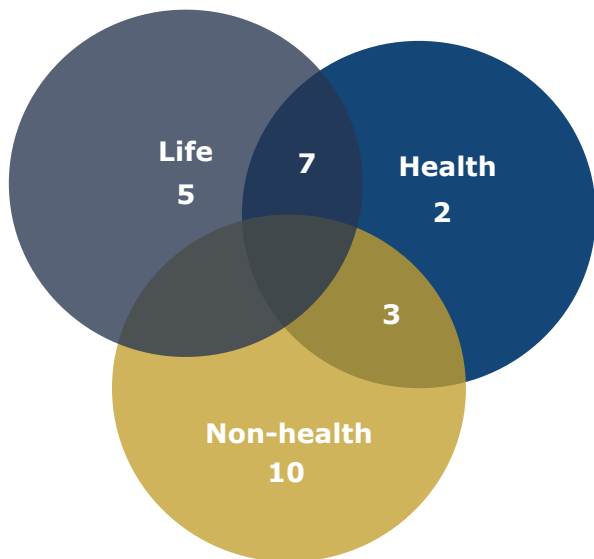


Table 10: International Insurance Market, 2020

Licence Type	Total
Class B Insurer	624
Class C Insurer	23
Class D Insurer	5
<b>Total Intl. Insurers</b>	<b>652</b>
Insurance Manager	22
<b>Total</b>	<b>674</b>

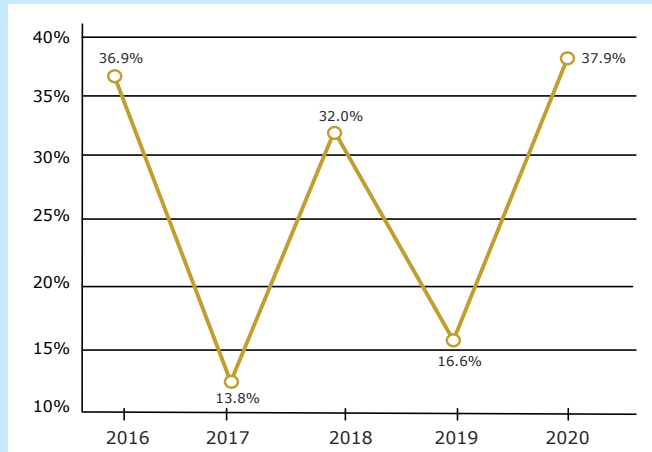
The international insurance market consisted of 652 insurance companies within Classes B, C, and D licence categories, and 22 Insurance Managers. The entities in the international insurance market are involved in insurance business whereby the insured risk is located overseas, outside of the Cayman Islands. These include captive insurance companies providing self-insurance coverage to their overseas parent and affiliates, as well as commercial insurance and reinsurance companies providing insurance coverage to consumers internationally.

During the year 2020, CIMA issued 42 new licences of which 37 were in the international insurance market and 5 in the domestic insurance market. Those issued in the international insurance market consisted of 36 new international insurance companies and 1 Insurance Manager. In the domestic insurance market, all 5 new licences were issued to Insurance Agents. Despite the pandemic and global economic downturn affecting many businesses in 2020, the insurance industry in the Cayman Islands continued to thrive as highlighted by the above-mentioned new formations which compared favourably to 2019 when a total of 36 new licences were issued.

For the domestic Class A Insurers, the following are the major FSIs.

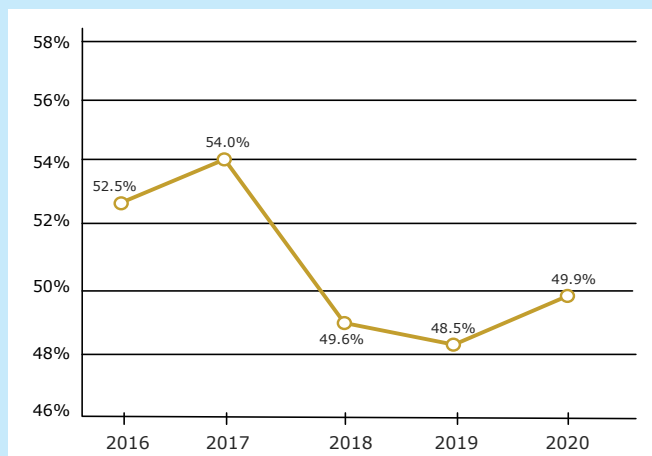
## Insurance Financial Soundness Indicators – Class A Local Insurers

Figure 50: Capital to Total Assets - Non-Life



Capital to total assets provide an indication of the capacity of the sector to absorb losses relative to risk exposures. The years 2017 and 2019 experienced severe catastrophic losses mainly due to storm systems, including hurricanes, ravaging the covered areas. This led to erosion of capital for insurance carriers providing property coverage and explains the volatility depicted in the trend analysis.

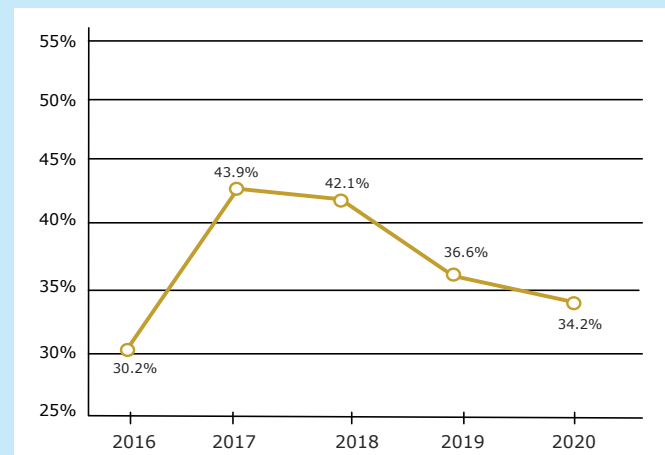
Figure 51: Risk Retention Ratio - Non-Life Indicator



The Caribbean region sits in a hurricane belt, and being recently jostled by earth tremors, the non-life carriers conducting domestic business heavily utilized reinsurance to transfer risk and create capacity, particularly considering the

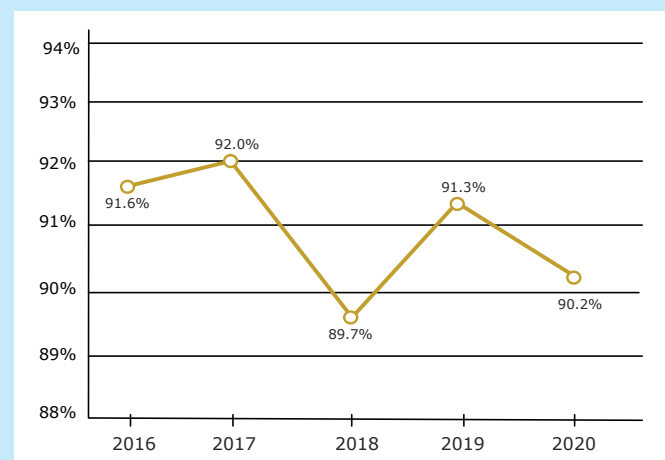
small nature of jurisdictions such as Cayman Islands which will exhibit high concentration risk in the event of catastrophic events. This is captured in the trend analysis in Figure 51 which shows that non-life insurance companies in the domestic market retain just about half of the risks they underwrite.

Figure 52: Capital to Total Assets - Life



Life insurers had peak performance in 2016 & 2017 from net income basis which shored up their capital position. However, there has been a downward trend since then and life insurers have been generating less than impressive performance which may be explained by changing actuarial assumptions on key variables such as interest rates, inflation rates, and mortality rates.

Figure 53: Risk Retention Ratio - Life

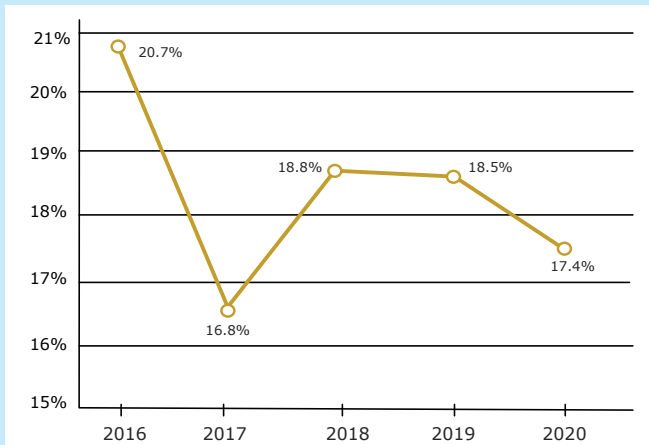




# SECTORAL FINANCIAL STABILITY ANALYSIS

The risk retention ratio serves as an indicator of insurance risk management policy for insurers. The local life business is not as heavily reinsured as the non-life business, therefore the risk retention ratio has averaged around 91% over the last five years.

Figure 54: Expense Ratio Non-Life



The expense ratio compares expenses to the level of premiums generated. The dip in expense ratios for both life and non-life sectors in the 2019-2020 period, is an indication of the impact of the COVID-19 pandemic which saw significant reduction in operational costs as most businesses transitioned to remote working. This phenomenon is also captured in the loss ratios during the period particularly for general lines of business such as auto and health insurance which saw significant reduction in losses during the pandemic.

Figure 55: Expense Ratio - Life

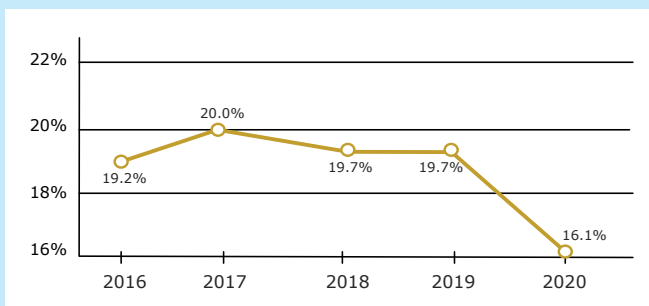
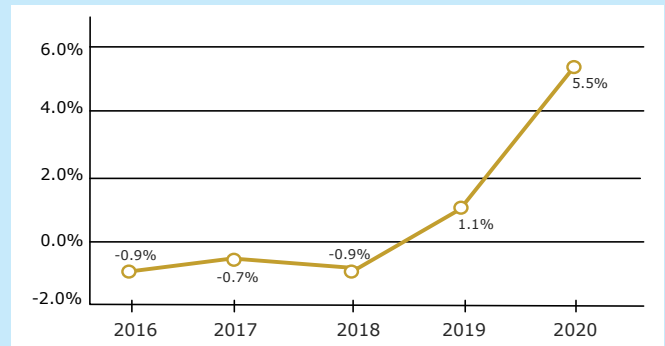


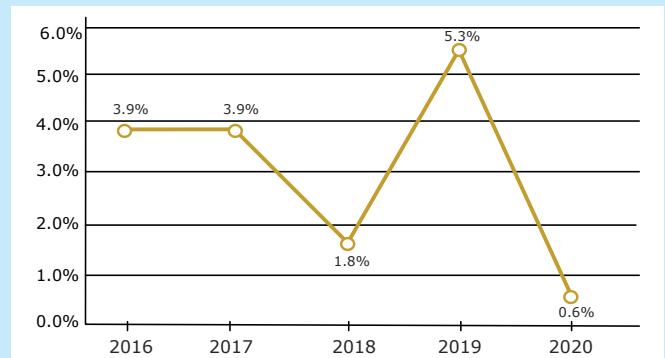
Figure 56: Return on Assets - Non-Life



The non-life or general lines of business experienced a steep increase in the profitability from 2019 to 2020. During the pandemic year, a large domestic insurer experienced an increase in premiums and a simultaneous decline in claims particularly related to elective health procedures. This positively impacted the ROA.

A similar trend was experienced by the ROE indicator which increased from 6.6% in 2019 to 14.5% in 2020.

Figure 57: Return on Assets - Life



The life sector experienced a sharp decline in profitability within 2020 largely attributable to subdued investment performance and rising policyholder liabilities. Life carriers faced significant shifts in key assumptions (lapse rates, inflation rate, mortality rates, interest rates) which led to adverse declines in performance.

A similar trend was experienced by the ROE indicator which sharply decreased from 14.4% in 2019 to 1.7% in 2020.

# SECTORAL FINANCIAL STABILITY ANALYSIS

The international insurance market has fared well over the years, with 93% focused on general insurance business. The total capital to assets ratio has averaged in the last five years to be around 25%. ROE increased from 7% in 2016 and stood at 13% in 2020. The ROA over the last five years have fluctuated around 2-3%.

## Impact of COVID-19

### Tests on Business Continuity Plans

Companies conducting insurance business in or from within the Cayman Islands are either required to have physical presence in the Cayman Islands (mandatory for the domestic insurance market) or to appoint a local representative (mainly for the international insurance market) to provide a place of business in the Cayman Islands, including fully operational offices where books and records are to be maintained. This meant that when the Cayman Islands went into full lockdown in March 2020, companies operating in the Islands almost immediately transitioned their work models from office-based to remote access. Regulators were not spared of this shift in operational arrangements and therefore CIMA also had to completely shift from an office environment to a remote model. This ensured minimal disruption to the insurance market in the jurisdiction. As a result of these changes, CIMA has heightened its supervisory work in assessing the effectiveness of business continuity plans (BCPs) adopted by licensed entities. The BCPs are assessed by CIMA during inspections and licensees are required to conduct regular tests to ensure their BCPs are working effectively and efficiently.

### Expansion of Insurance Programs

With the pandemic challenging most economies and global inflationary pressures escalating, the commercial insurance market (i.e. the international insurance market in the Cayman Islands which is made up of two distinct segments - the captive insurance companies providing self-insurance coverage to their parental organizations and affiliates, and the international insurance

companies providing commercial insurance coverage to third-party consumers) has continued to harden, and premium rates have been increasing on majority lines of coverage. Commercial insurers have also imposed strict terms and conditions and exclusions in their policy contracts. As a result, most owners of captive insurance companies, which is a dominant segment of the international insurance market in the Cayman Islands, have increased their utilisation of captives as a form of self-insurance. Cayman Island based captives have therefore seen expansion in size of insurance coverages provided by them and have also introduced new lines of business. The pandemic has heightened cyber risk and consequently this is emerging as a common and new line of coverage provided by Cayman captives.

### Financial Resilience

CIMA has not observed any material changes to financial condition and strength of its licensed entities. CIMA has been undertaking stress testing on its licensed entities to assess the impact of the pandemic and other global challenges, including catastrophe risk exposures, and early signs are encouraging with no observed economic strain on licensee's capital and solvency positions. One factor influencing this is the high level of capital maintained by licensees, with majority of entities holding capital far above the minimum regulatory requirements.

## Virtual Assets

Since 2020, the world has experienced rapid digitisation as FinTech and new forms of technology continue to drive innovation globally. The world is experiencing rapid adoption of blockchain technologies and cryptocurrencies which is on the cusp of revolutionising the global financial landscape and payment systems. Some have attributed this rapid adoption to the response to the COVID-19 pandemic and as the world began adapting to the pandemic, more and more financial market players are joining the discussions on VAs and VASPs.

In July 2021, the Financial Action Task Force (FATF) released its 12-month review of the implementation of its revised standards on VA and VASPs. While FATF covers over 200 jurisdictions, 128 reported on their progress of which only 41% (52 jurisdictions) reported on establishing regulatory regimes permitting VASPs. The Cayman Islands is one such jurisdiction with the VASP Act being enacted in May 2020, and portions of the Act as well as the VASP Regulations commenced in October 2020.

The VASP Act provides a legislative framework for the conduct of VA business in and from the Cayman Islands; and for the registration of and licensing of persons providing VA services. The VASP Act defines VA, as "a digital representation of value that can be digitally traded or transferred and can be used for payment or investment purposes but does not include a digital representation of fiat currencies".

VA include but are not limited to all digital currencies, security tokens, utility tokens or other digital assets that are tradeable. VA Services applies to services related to the issuance of VA or the business of providing certain services or operations, including the exchange, transfer and safekeeping of VA, as well as the provision of financial services relating to a sale or issuance of VA, including VA trading platform. The VASP Act is in alignment with international standards set by FATF to VA, which

reflects the jurisdiction's continued commitment to FATF standards for anti-money laundering (AML) and countering the financing of terrorism (CFT). The VASP Act framework was implemented in two phases.

Phase one started in October 2020 with the focus on AML and CFT compliance, supervision and enforcement, and other key areas of risk. Under phase one, entities engaging in or wishing to engage in virtual asset services had to be registered with CIMA under the VASP Act. Entities engaging in or wishing to engage in virtual asset services, that already were subject to CIMA's supervision under another regulatory law, had to notify (in the case of licensees) or register with (in the case of registrants) CIMA under the VASP Act. Phase one (registration or notification) targeted three groups:

1. Entities wishing to perform virtual asset services for the first time ("New Market Entrants")
2. Entities providing virtual asset services prior to the commencement of the VASP Act ("Pre-Existing Service Providers"); and
3. Existing Authority licensees that provide or propose to provide virtual asset services ("Other Authorised Entities").

In April 2021, CIMA conducted a comprehensive Sectoral AML/CFT risk assessment of the VA sector – which was based on the information provided through the registration process along with other open-source information about entities in the Cayman Islands. The risk assessment framework used was built on the following components: nature, size and complexity, transactions, products and services, delivery and distribution channels, types of clients and customers, geographic risk associated across all sectors. From this risk assessment, the overall risk rating for VSAPs was determined to be medium-high.

Phase two which is yet to commence, includes licensing requirements, enforcing remaining provisions of the VASP Act, and prudential supervision. As at the end of June 2022, the total number of VASPs registered under the VASP Act was 8.

For registrants on record, the total daily volume transacted was USD 5.1 billion and held a value of USD 4.1 billion in VA. The most popular types of application are VA Trading Platforms (55%), including exchanges that are a gateway to buying and exchanging VA; and Issuances (25%) that raise liquidity via the sale of newly created VAs sometimes through a process commonly called an initial coin offering (ICO); followed by Custodians (15%) that provide the service of safeguarding VAs and include firms that facilitate the custody of VAs.

CIMA intends to establish regulatory sandboxes that will facilitate growth and development of the FinTech Ecosystem in the Cayman Islands. CIMA has created an internal VASP working group which will be leading the development of the sandbox regime in the context of VA.

## Regulatory Sandboxes

The purpose of a regulatory sandbox is to develop a regulatory environment which supports enhancement of the financial services sector and promotes innovation while simultaneously safeguarding the welfare of consumers and promoting the adoption of new robust financial and regulatory/supervisory practices and technologies.

It is a formal regulatory program for market participants to test new financial services or models, with live customers, subject to safeguards and oversight. The controlled environment will facilitate the development of relationships with licensees, as well as testing plans, the licensing issuing process, and test

supervision of a live market. Participating licensees will ultimately transitioned out of the sandbox.

## Supervisory Regime

Section 24 of the VASP Act requires CIMA to take reasonable measures to identify natural or legal persons that are carrying out VSAPs activities without the required license, registration, or waiver. It also gives CIMA the power to supervise, monitor and ensure compliance by VSAPs with requirements to combat ML/TF. Also, CIMA shall receive regular returns, perform onsite inspections and receive auditors' reports. As entities engage with CIMA to become registered and operate legally within the financial ecosystem, it is imperative that they implement the necessary policies, procedures and controls, and procedures to manage and mitigate risks. They are encouraged to apply a risk-based approach to ongoing monitoring as it pertains to customers, type of business conducted and the value and volume of transactions.

To assist with the mitigation of money laundering and terrorist financing risks, CIMA adopted the FATF Travel Rule, via Part XA of the AML Regulations. The Travel Rule is a set of recommendations created to assist AML/CFT efforts by enhancing the audit trails when VA are transferred between entities. The Travel Rule requires at a minimum the names and account numbers of the remitter and beneficiary in a transaction to provide transparency. CIMA will, therefore, continue to maintain constant dialogue with industry to ensure compliance in this area. Travel Rule for VASPs came into effect on 1 July 2022, and the industry is expected to abide by quarterly reporting, with the goal of ensuring compliance with the AML Regulations and meeting FATF requirements.



## CHAPTER 3: SECTORAL MACROPRUDENTIAL ANALYSIS

Despite the pandemic, the financial risks within the jurisdiction remained contained as the domestic financial system remained robust and resilient. However, there are two pertinent vulnerabilities within the domestic financial system that need to be closely monitored i.e., the level of interconnectedness within the financial sector and the exposures of households and the domestic banking sector to the real estate market.

### Interconnectedness

Globalisation has led to an increase in the external assets and liabilities of nations as a share of their GDP. Countries have become more and more inter-linked with each other, as the asset and liability management (ALM) strategies of their sovereigns, financial institutions, and corporations have become increasingly global in nature. The Cayman Islands play a critical role in global financial intermediation and this has become more pronounced over the years.

### Risk maps

In a highly interconnected world, as agents typically fail to take account of the effects of their actions on others, the potential for systemic risk rises. As observed in the run up to the GFC, a build-up of leverage and liquidity mismatches at the same time can leave the financial system vulnerable to adverse changes in the macroeconomic and market environment, and pervasive interconnections can result in a rapid transmission of adverse shocks across the global financial system. The crisis has led to calls for global financial risk maps to understand interconnectedness, track the build-up of systemic risk concentrations, and improve surveillance. Such maps could be used to:

- Understand common themes across countries (e.g., exposures to common networks of intermediaries), the most important risk drivers, and the amplification or mitigation as well as the propagation mechanisms of shocks.
- Analyse the channels for cross-border spillovers and enable policy makers to better understand the risks that their economies face, the

effectiveness of alternative policy options, and more generally reforms of the global financial architecture.

### Vulnerabilities

Financial globalisation has brought various benefits, such as scale, more efficient intermediation of savings, and pooling of risks. However, it has also created or exacerbated many vulnerabilities. The speed with which illiquidity and losses in some markets can translate into global asset re-composition is evidence both of the efficiencies of the transmission and intermediation process as well as the risks associated with interconnectedness. Shocks in one part of the system can be amplified and transmitted through common intermediaries pursuing global ALM strategies that collectively become overexposed to upswing of a credit cycle and overly risk-averse in a downswing.

Banks registered in the Cayman Islands reported total assets of USD 598 billion with 97% of these being cross-border positions. The majority of these asset cross-border positions (USD 512 billion) were loans, with around USD 66 billion from the issuance of securities. Total liability positions were also around USD 598 billion with approximately 90% being cross-border positions. From Figures 58 and 59 there is a steady decline in asset and liability positions for the last five years which was mainly attributable to declines in cross-border positions.

This contraction has resulted in the decline in ranking of the Cayman Islands international banking position from 8th in 2016 to 16th in 2020 and from 7th in 2016 to 14th in 2020 for both cross-border assets and liabilities respectively. In terms of local positions over the last five years, assets booked in the domestic economy have averaged around USD 20,000 billion, while domestic liability positions averaged around USD 57,000 billion.

# SECTORAL MACROPRUDENTIAL ANALYSIS

Figure 58: Total Banking Sector Assets Cross-Border Positions (\$US Millions)

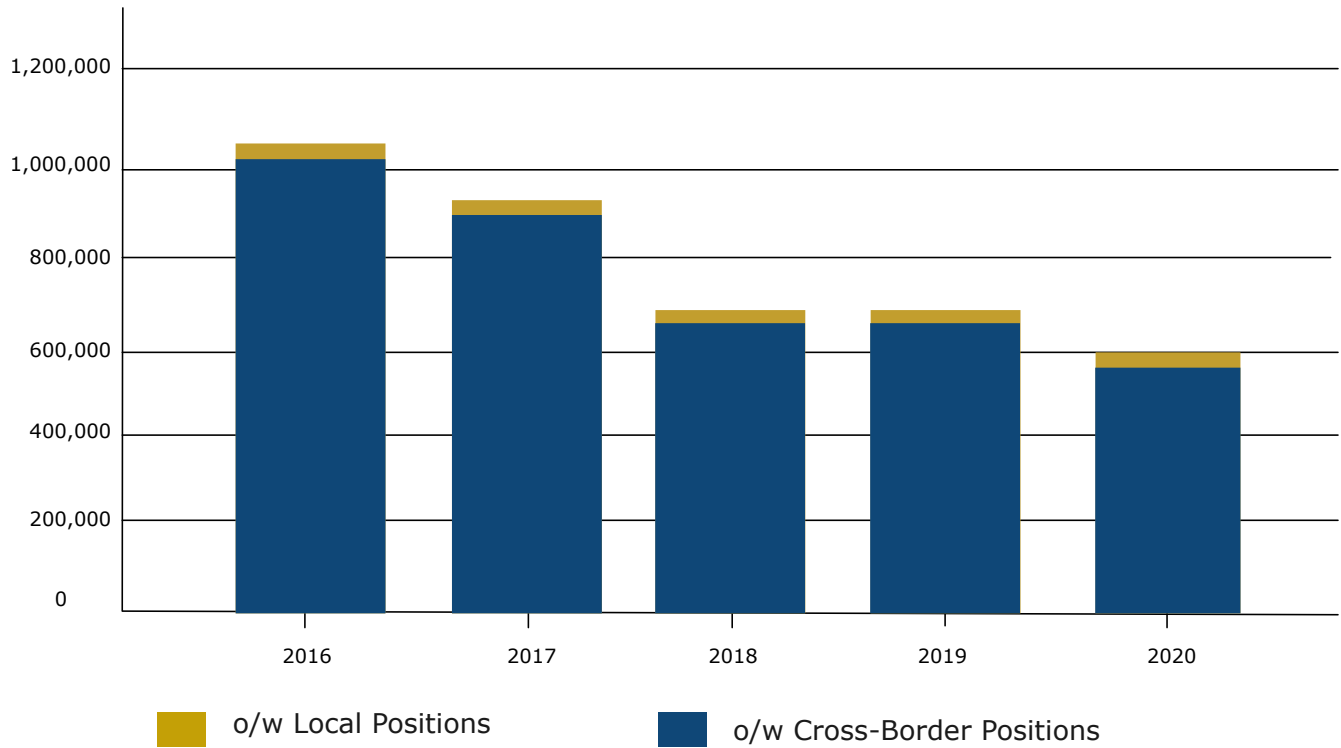
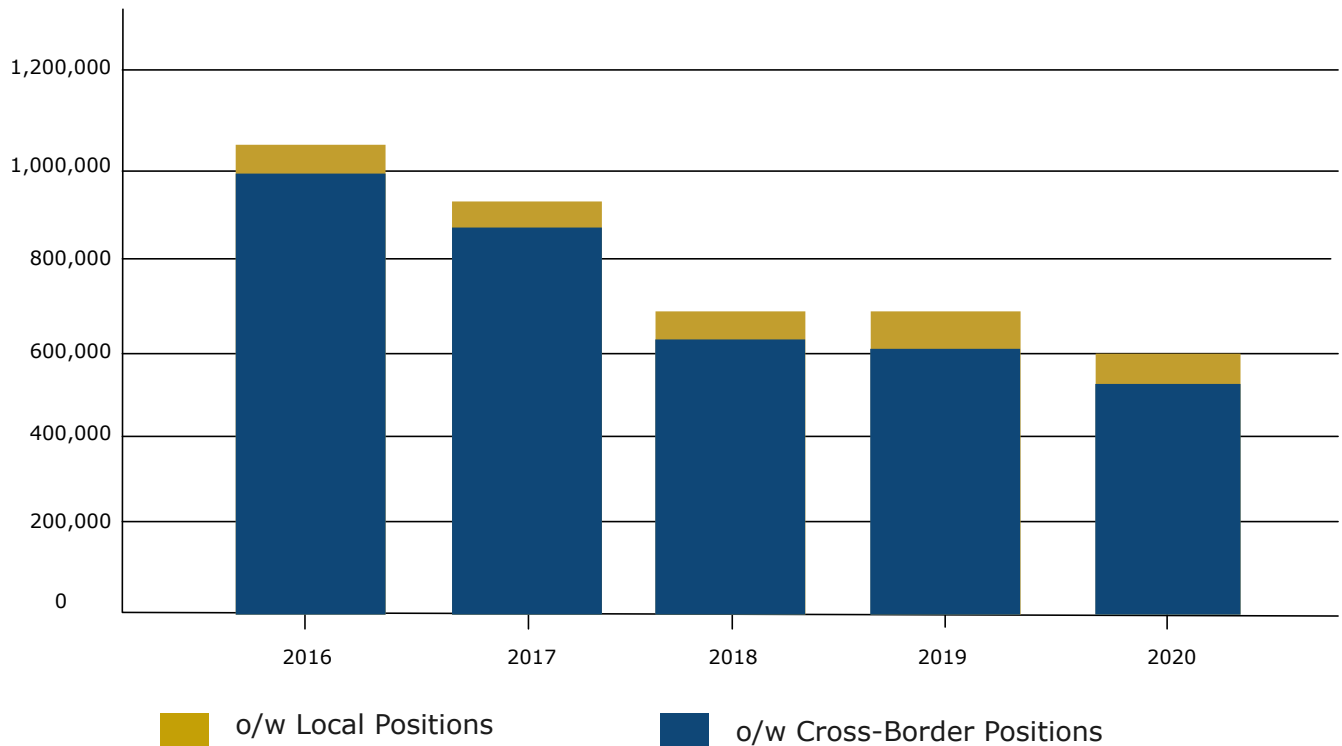


Figure 59: Total Banking Sector Liabilities Cross-Border Positions (\$US Millions)



# SECTORAL MACROPRUDENTIAL ANALYSIS

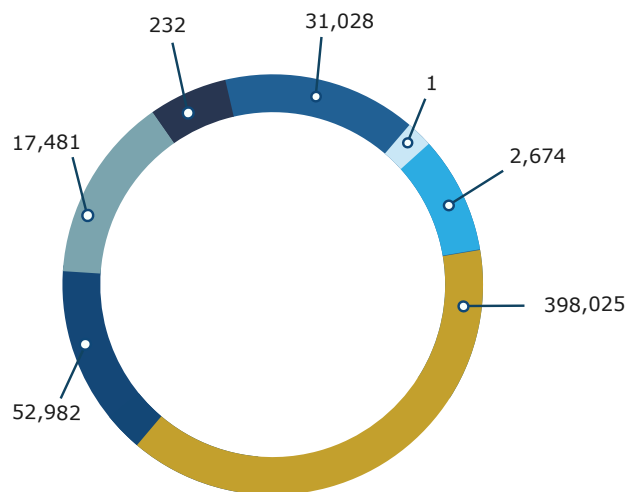
A cross border map for the Cayman Islands' banking sector assets was developed using the locational banking statistics survey submitted to the Bank for International Statistics as of December

2020. The map shows widespread cross-border exposures as the banking sector's interconnectedness is evidently far-reaching to the global community, covering all major continents.

Figure 60: Cross-Border Assets of Cayman Islands Banking Sector

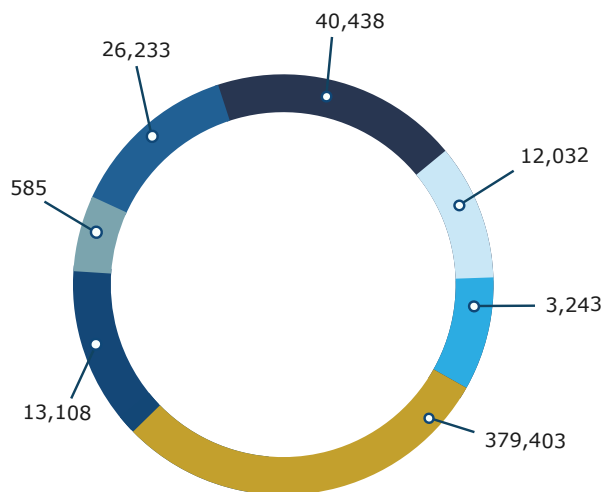


Figure 61: Regional Cross-Border & Domestic Assets (\$US Millions)



- Developed Countries
- Developing Latin America and Caribbean
- Developing Africa, Asia, Pacific & Middle East
- Developing Europe
- Cayman Islands
- International Financial Centres
- Un-allocated - Own issue of Securities

Figure 62: Regional Cross-Border & Domestic Liabilities (\$US Millions)



- Developed Countries
- Developing Latin America and Caribbean
- Developing Africa, Asia, Pacific & Middle East
- Developing Europe
- Cayman Islands
- International Financial Centres
- Un-allocated - Own issue of Securities

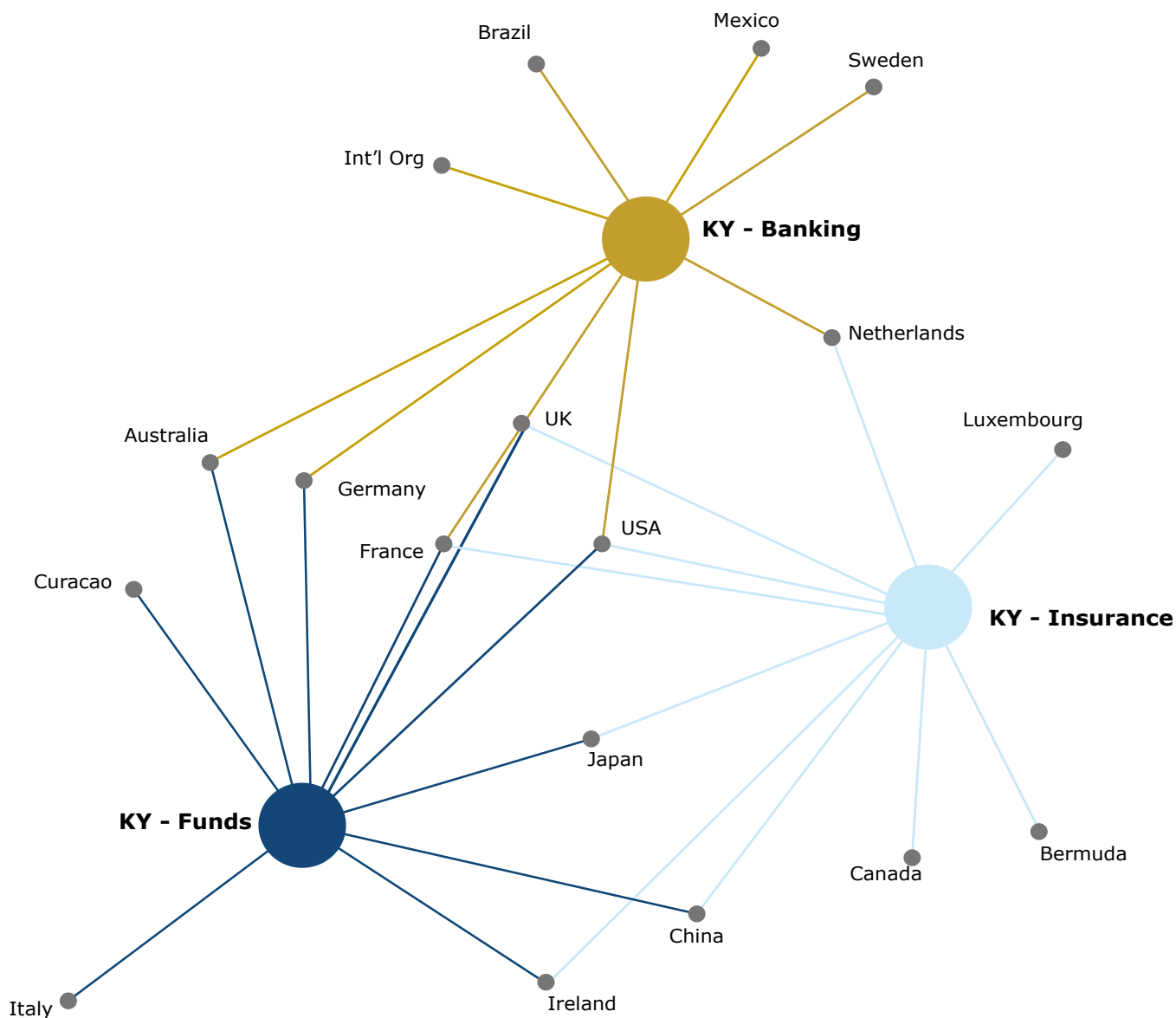


# SECTORAL MACROPRUDENTIAL ANALYSIS

From the USD 598 billion in assets, 78.6% or USD 455 billion was booked with Developed Countries, of which USD 68 billion and USD 386 billion were booked in Europe and Developed Non-European Countries, primarily the United States. 11.5% or USD 66 billion was booked in Latin America & Caribbean (primarily Brazil and Mexico), 6.5% or USD 38 billion was booked in international Offshore Financial Centres (primarily The Bahamas and Hong Kong) and 2.9% or USD 17 billion with Developing Africa, Middle East and Asia Pacific.

Noteworthy is that 62% or USD 356 billion and 71% or USD 381 billion of the banking sector assets and liabilities were booked as interbank assets and liabilities positions, of which 56% or USD 325 billion and 64% or USD 345 billion were intrabank assets and liabilities. This highlights the role of the Cayman Islands' banking sector as a financial intermediary providing liquidity and credit to Parent Group Banks and Other Banks globally. This high level of interconnectedness presents a vulnerability of the banking sector to global regulatory, political and policy issues.

Figure 63: Top Ten Principal Nodes for Coordinated Portfolio Investment for Banking, Funds and Insurance



## SECTORAL MACROPRUDENTIAL ANALYSIS

It is evident that there are common exposures based on the Coordinated Portfolio Investments Survey from the banking, Insurance and Funds Sector, with the USA, France, UK common for all. The United States was the top destination for portfolio investment for all three regulated sectors i.e. banking, insurance and mutual funds.

Further, it can be inferred that the portfolio investments of Cayman licenced entities are concentrated in the major lending economies i.e. USA, Japan, UK, France, Germany, and Australia. This makes these jurisdictions systemically important to the Cayman Islands.

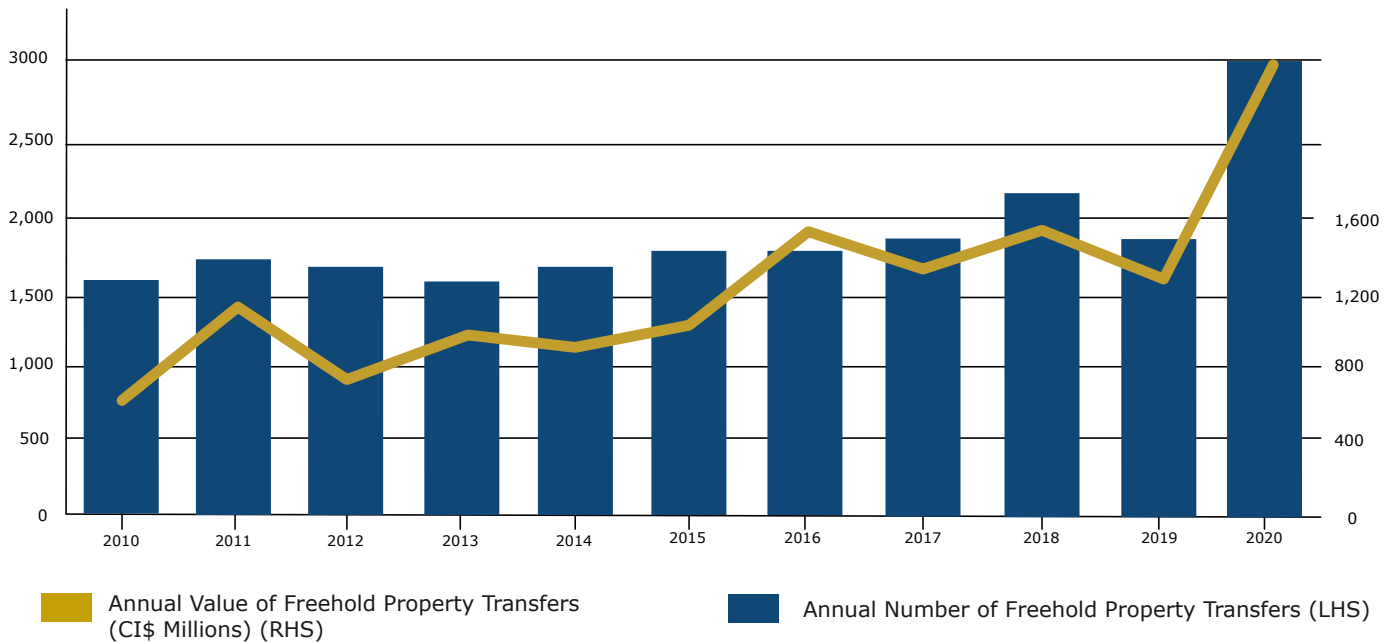
It should be noted that the domestic Cayman licensed entities are only a small fraction of the total licensees. Further, the geographic distribution of portfolio investments for these entities has a much more limited international profile.

With respect to sectoral differences, the funds sector is by far the largest sector and has the greatest geographical diversification due to the underlying nature of the business. The interconnectedness is also of a different nature since the relationship of funds to the broader financial system and economy differs from that of banks and insurance companies.

Against the backdrop of the high level of global interconnectedness of the Cayman Islands, CIMA has taken various stringent measures to ensure ongoing monitoring, using a risk-based supervision approach. These include participation in supervisory colleges, on-site inspections (in-person and hybrid). CIMA has also remained resilient towards meeting the AML/CFT requirements as efforts are continuously focused on enhancing the financial services sector as a prominent industry as well as an economic driver for the islands.

## Housing Market Imbalances and Household Debt

Figure 64: Number vs Average Value of Freehold Property Transfers, 2020 - 2021



Source: Cayman Islands Government Lands and Survey Department

The Cayman Islands real estate market has boomed and seen unprecedented growth over the past decade, with total freehold property transfer values increasing from slightly over KYD 300 million in the post financial crisis to steady year-on-year sales to over KYD 800 million nearly a decade later in 2019. For clarification, a freehold property can be transferred by registration of sale deed and the owner of such an estate enjoys free ownership for perpetuity and can use the land for any purpose in accordance with the local regulations.

The upward trend of real estate sales continued during the first quarter of 2020. However, after March 2020, the real estate sector was forced to slow down production as the Cayman Islands and most of the world went into lockdown due to the outbreak of the novel COVID-19 virus. Regardless, the real estate industry closed more than USD 77 million in sales during the lockdown period based on statistics from the Cayman Islands Real Estate Brokers Association, which included the country's record-breaking sale of the most expensive residential home sold for USD 14 million in April

2020.

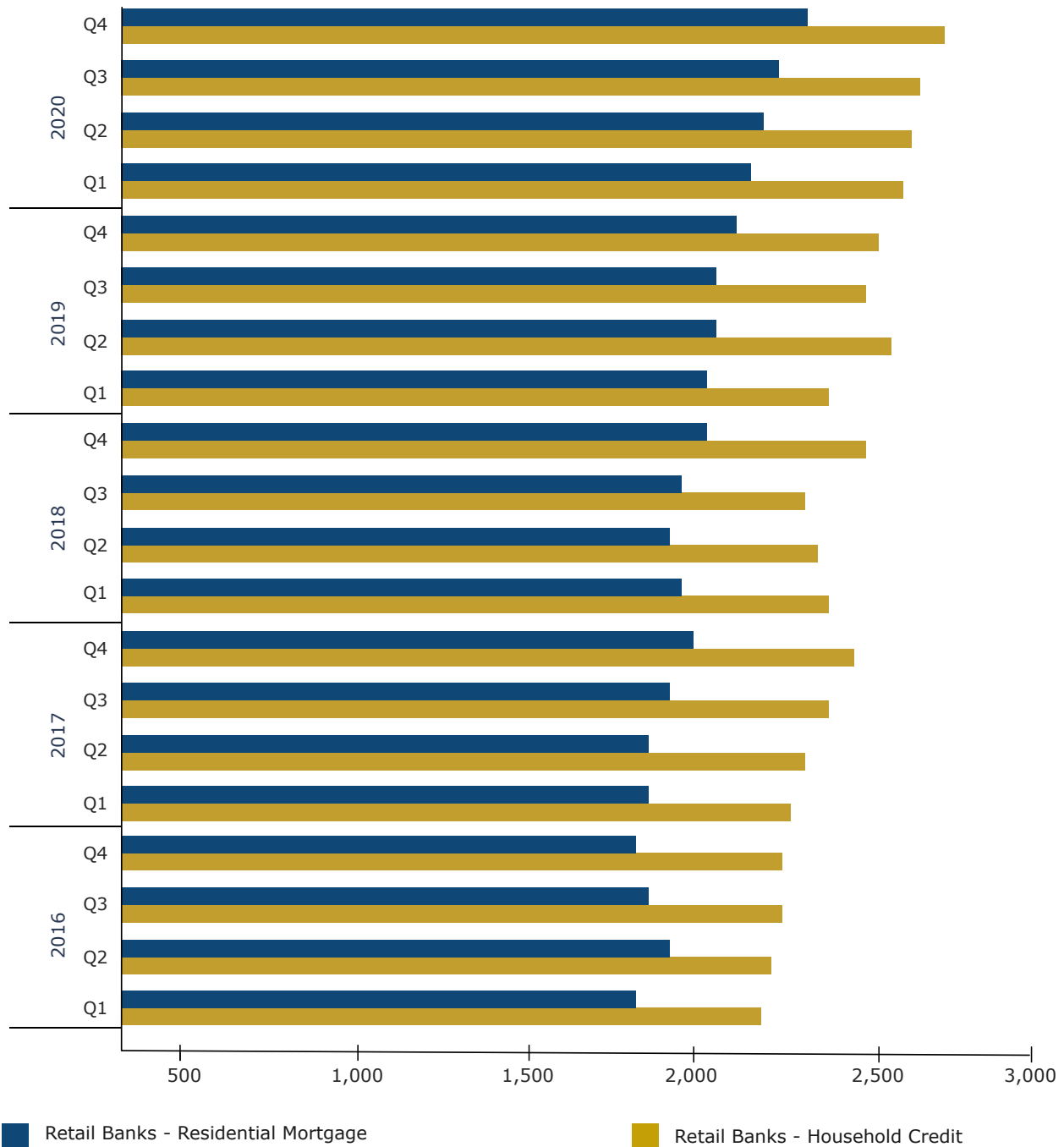
The Cayman Islands residency program allows foreigners, especially those classed as high-net-worth and ultra-high-net-worth to establish permanent residency by investing in luxury properties, by either investing a minimum of KYD 1 million in local real estate, where successful applicants will qualify to apply for a 25-year residency certificate; or investing in minimum of KYD 2 million, where successful applicants will qualify to apply for Cayman Islands permanent residency by investment, among meeting other program requirements. There are no restrictions on foreign ownership, which makes acquiring a property straightforward for international investors. Real estate brokers have indicated that there has been an increase in international buyers (nonresident) as persons seek safer places to relocate or purchase a second home. Foreign investors have substantially driven real estate market activity in 2020 with monthly sales exceeding USD 100 million for the first time in October 2020 and this trend continued in March to May and then in July-August 2021.

# SECTORAL MACROPRUDENTIAL ANALYSIS

From the foregoing, the jurisdiction is experiencing a heightened demand for residential homes, while on the other end of the spectrum, developers are pushing to meet this demand, as the inventory for building material is declining due to supply chain

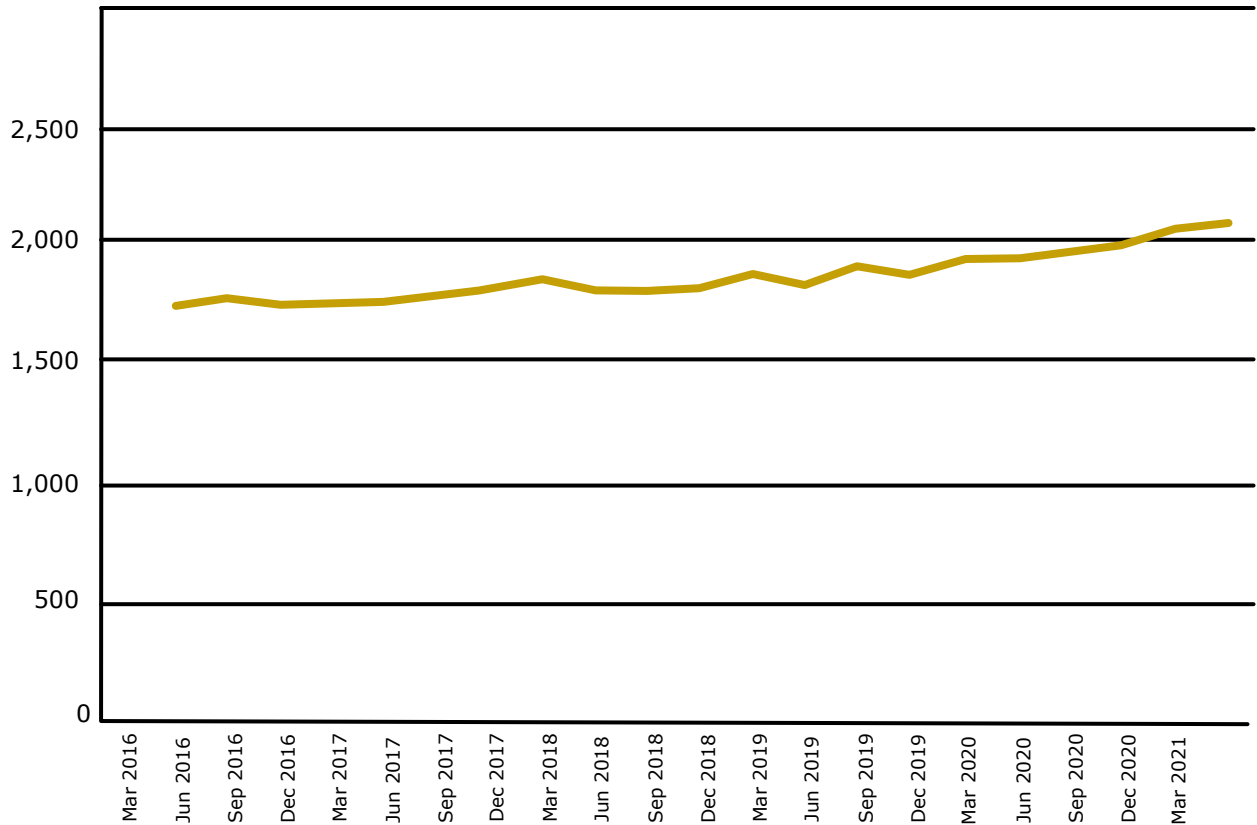
disruptions following the challenges of 2020 and 2021. These factors have played significant roles in the sale prices for listed properties as the average price for real estate increased up to 27% from 2019 to 2020 and continues to grow year-over-year.

Figure 65: Total Household Credit vs Residential Mortgage Loans (\$US Millions)



# SECTORAL MACROPRUDENTIAL ANALYSIS

Figure 66: Residential Mortgage Debt (\$US Millions)



During 2020, many countries experienced a reduction in mortgages as unemployment rose, income declined, and households adopted a more prudent approach towards expenditure by postponing investments in real estate and by revising their consumption patterns. Many households were also not able to acquire new loans or advances due to the financial difficulties they were facing.

This is the opposite of what was seen in the Cayman Islands. For potential resident buyers that could have afforded to enter or re-invest in the local housing market, this investment was heavily financed through lending institutions. One major contributing factor for the rise in mortgages during the pandemic were the accommodating policies implemented by the Cayman Islands Government to ease the economic burdens to households such as allowing persons with a private pension plan to withdraw from their retirement funds. Eligible savers could have withdrawn up to KYD 10,000 plus

25% of the remaining balance from their pension accounts. In total, workers withdrew \$443.5 million in retirement savings in 2020. This provided sufficient funds for residents to pay-off existing debt and perhaps reinvest in the lucrative housing market.

Approximately 90% of household credit is attributable to residential mortgages with roughly 10% directed to households for other purposes. Residential mortgage debt has steadily increased over the last 5 years. There was a notable rise in residential mortgages even during the height of the pandemic – 2020 i.e., household debt burden has increased. This reflects elevated house prices and a large proportion of home ownership. However high indebtedness makes households vulnerable when there are shocks to the income stream, a rise in lending rates (affecting variable rate mortgages) or even when there is a fall in house prices. When households further tighten consumption there is knock-on effect on the economy, amplifying an economic downturn.

# SECTORAL MACROPRUDENTIAL ANALYSIS

## Domestic Mortgage Rates

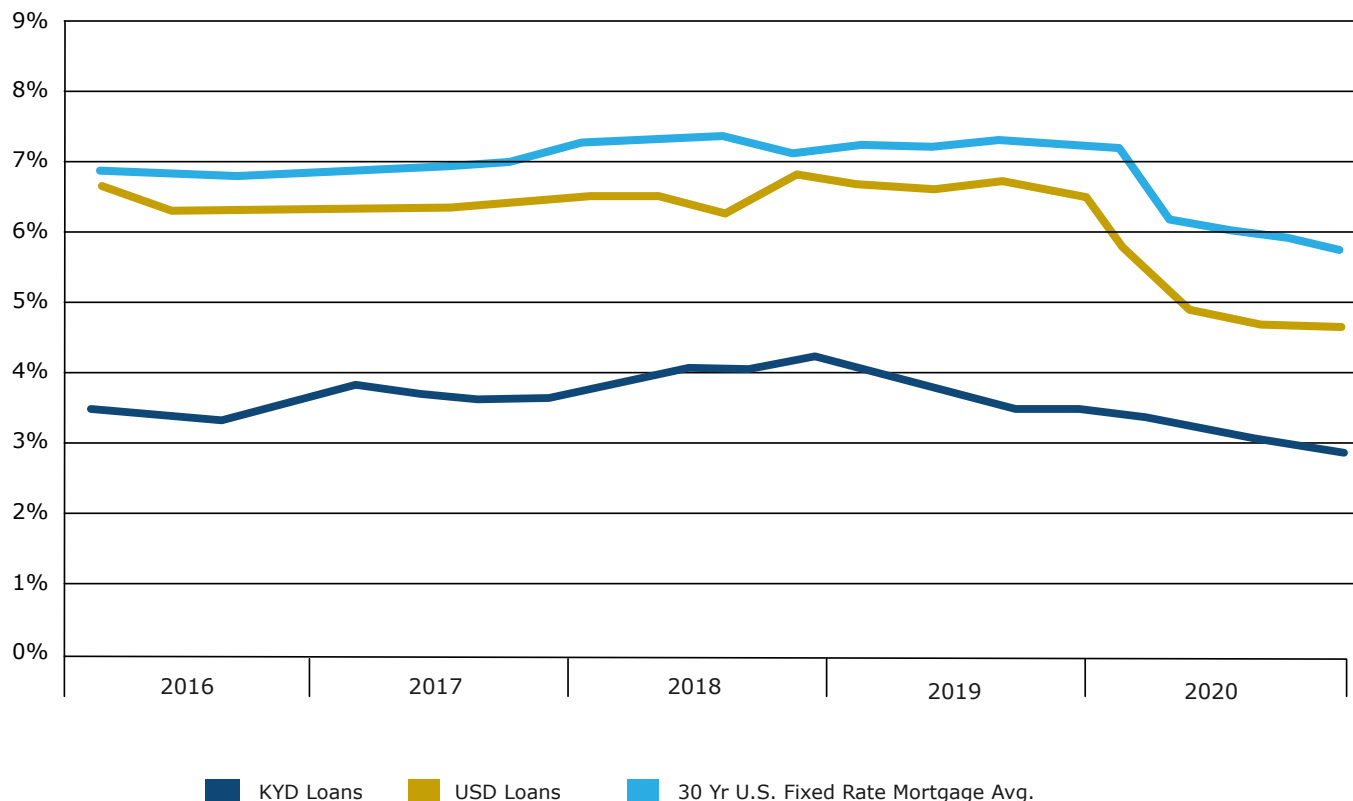
Another motivating factor that influenced potential resident real-estate investors is the low interest rate offered by the lending institutions. Policy interest rates of the major global central banks were slashed during the first quarter of 2020 in an unprecedented response to the COVID-19 pandemic. This policy support, evidenced globally, was necessary to ease the financial burden on businesses and households as well as to provide a much-needed stimulus amidst weakened economic activity.

The US Federal Reserve Bank (FRB) reduced interest rates on two occasions in 2020. On March 3, 2020, the FRB lowered the rate from a range of 1.50 percent to 1.75 percent to a range of 1.00 percent to 1.25 percent. On March 15, 2020, the rate was lowered again by 1.0 percentage point to the range of 0.00 percent to 0.25 percent. This phenomenon was seen across the globe.

The Bank of England had decreased its policy rate by 50 basis points in two tranches during the pandemic, and the Bank of Canada lowered its overnight target rate by half a percentage point on three separate occasions in March 2020 to settle at 0.25 percent.

The Cayman Islands retail banks lending rates are directly determined by the movements in the U.S. interest rates as shown in the Figure 67. The 30-year U.S. fixed mortgage rate is tied to the 10-year Treasury rate, therefore, when the interest rate goes up, the 30-year fixed rate mortgage tends to do the same and vice versa. Throughout most of the pandemic in 2020 and 2021, interest rates have been extremely low. As a result, incredibly high numbers of people have rushed to obtain mortgage loans to buy properties with less expensive debt. The result has been a strong seller's market that has lasted for well over a year.

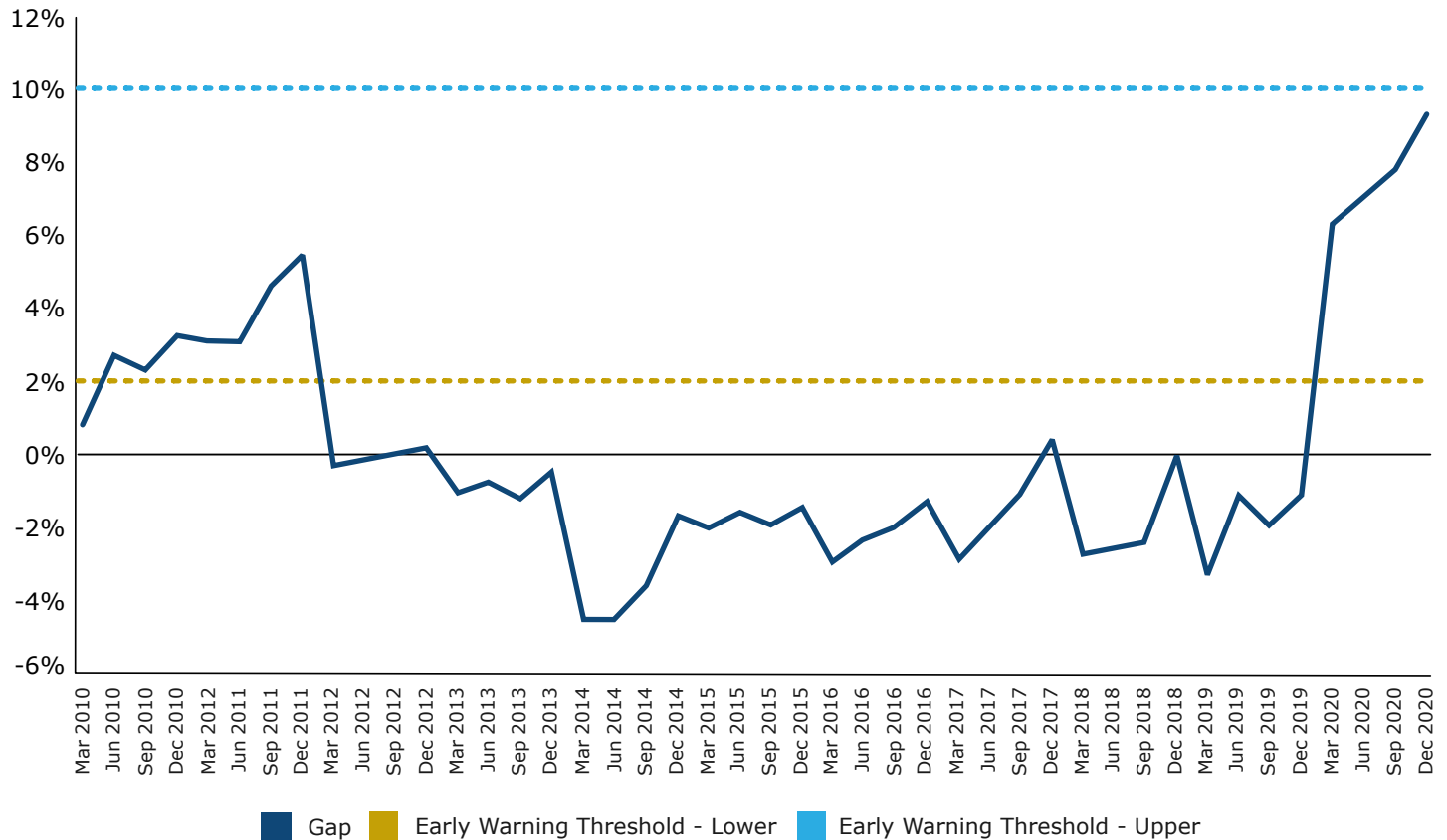
Figure 67: Weighted Average Lending Rates



Source: Cayman Islands Government Economic & Statistics Office

## Household Credit Gap

Figure 68: Household Credit-to-GDP Gap



The credit-to-GDP (“credit gap”) is a macroprudential indicator that measures the risk associated with the loans given to the household sector from banks. Household debt is defined as all liabilities of households (excluding non-profit institutions serving households) that require payments of interest or principal by households to the creditors at a fixed dates in the future. Household debt is calculated as the sum of the following liability categories: loans (primarily mortgage loans and consumer credit) and other accounts payable.

Based on the link between credit booms and financial bubbles, history has shown that a rapid growth in credit lending increases the probability of a financial crisis and/or a marked growth slowdown. Looking at it from a larger prudential standpoint, the ratio of household credit is a popular benchmark of the sustainable levels of credit. The Basel Committee has proposed using

the deviation from longrun trend of the credit gap to calibrate a countercyclical capital buffer.

During the expansion stage of the credit cycle, lending is driven by fierce competition that invokes reduced risk awareness and places emphasis on excessive credit growth that often results in a level of indebtedness that may exceed the equilibrium defined by underlying macroeconomic fundamentals. This leads to a build-up of systemic financial risks that are likely to cause severe crisis upon realization. Thus, it is vital to identify the risks in time and take pre-emptive measures to, avoiding or at least reasonably reducing the real economic effects of the potentially forthcoming crisis.

There is consensus in the relevant literature that the development of the credit-to-GDP ratio is a good base indicator of the sustainable level of lending activity. Country level indebtedness

# SECTORAL MACROPRUDENTIAL ANALYSIS

plays an important role in the growth potential of GDP, as a lower than equilibrium level credit-to-GDP might reduce the growth rate of the economy, while a too high level increases the probability of a financial crisis. To define what level is too low or too high, the equilibrium time-path of the credit-to-GDP ratio must be identified. The primary indicator of financial systemic risk, the credit-to-GDP gap is then defined as the deviation from said equilibrium level. Positive gap values accentuate an increasing potential hazard, while negative values indicate slack in the credit markets.

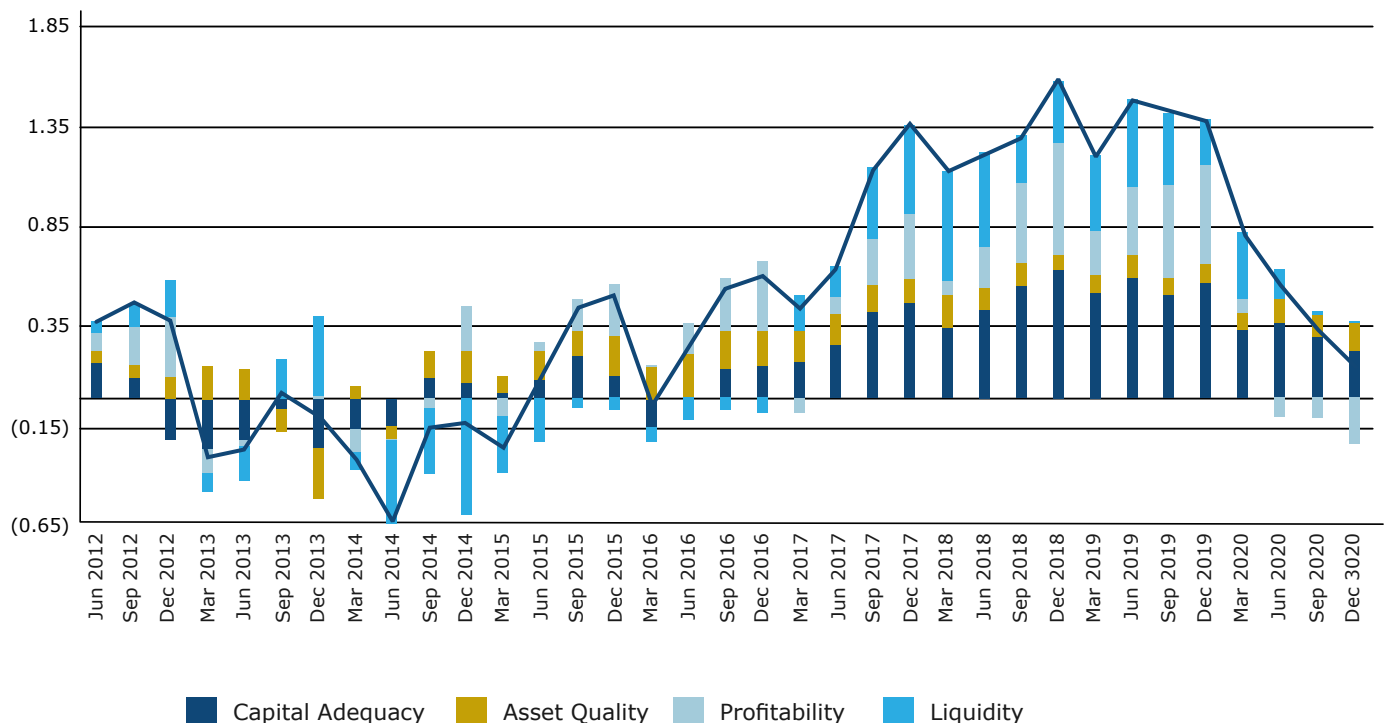
Basel III indicates that when the gap is below a lower threshold of 2 percentage points, the countercyclical capital buffer add-on is zero. It increases with the gap until the buffer add-on reaches its maximum level of 2.5 per cent at the point where the gap exceeds an upper threshold of 10 percentage points.

The methodology employed by CIMA to calculate the household credit-to-GDP gap was derived from the IMF Caribbean Regional Technical Assistance Center (CARTAC) technical assistance, where the 2% threshold is the international baseline for this indicator. Based on the Figure 68, for many years (2012-2019), the Cayman Islands household credit-to-GDP gap was below the 2% threshold. However, there has been a significant increase in the ratio with the growth in household credit during 2020.

Against this backdrop, CIMA is currently working on a macroprudential framework to inform the use of such indicators as the household credit-to-GDP gap in supervisory analysis.

## Banking Stability Index

Figure 69: Banking Stability Index for Retail Banking





The Banking Stability Index (BSI) is an aggregate indicator that measures the soundness of the domestic retail banks in the Cayman Islands. This graph shows the resilience of these class of banks based on a weighted average of four broad categories: Liquidity, Profitability, Asset Quality and Capital Adequacy over a nine-year period. The BSI expresses the indicators as their deviations from the mean. Zero is its threshold. Any level above zero shows that the stability of the system is above average and the farther away above zero the index is, the more stable the system. Similarly, any level below zero is a reflection of some level of instability. Additionally, increasing consecutive values of the index imply improvement, and vice versa. It is vital for the Cayman economy that its banking system is stable and is adequately capitalized. If the banking system is in stress, as it was in the world during the financial crisis, the flow of credit to productive sectors gets hampered which affects economic activity and prospects for economic growth.

From 2012 to 2014, there were 7 domestic retail banks in the Cayman Islands which declined to 6 banks in 2014 Q-4 after the departure of one large international bank which halted domestic business. This was evidenced by the short-term drop in liquidity during 2014 into the early parts of 2015, but the industry quickly stabilized and strengthen thereafter with various acquisitions. From 2012 to 2016-Q1 the BSI fluctuated steadily above and below the average level (zero line), indicating no industry growth during that period. An increase in the index value shows greater stability, hence after 2016-Q1 the BSI increased on average 0.92 standard deviations above the prior 5-year average. This was driven primarily by the overall improvement of capital adequacy, profitability, and liquidity indicators.

In 2020 the BSI declined by an average 0.91 standard deviations compared to the previous year, due to the initial outbreak of COVID-19.

While banks increased provisions in anticipation of COVID-19 related deterioration in loan portfolios, asset quality has remained relatively unaffected with evidence of recoveries of provisions. Capital levels continued to be strong across the retail banks. Lower profitability and earnings were experienced in the banks due to lockdown of the Cayman Islands, against a backdrop of continued low interest environment.

Banks have been funding the many large real estate developments as well as individual mortgages for local and expatriate homebuyers. While some banks applied more conservative underwriting at the onset of COVID-19 pandemic, this was a transient adjustment and banks are taking advantage of the continued strong demand for corporate, commercial, and retail loans.

As the country's border reopened, allowing tourism and service sectors to revive and stimulating economic expansion, it is expected that there will be improvement in the BSI in the near future.

## Domestic Systemically Important Deposit Taking Institutions

In November 2011, the Basel Committee of Bank Supervision (BCBS) issued the framework for dealing with Global Systemically Important Deposit Taking Institutions which was developed post-financial crisis as failures or impairments by large, global financial institutions had severe impacts on the international financial system and the world's economy. Higher Loss Absorbency (HLA) capital requirements were therefore introduced for G-SIBs to mitigate such risk of failures by increasing such institutions capital capacity to absorb these losses.

In October 2012, the BCBS introduced another framework i.e., Domestic Systemically Important Banks (G-SIBs) which focused on a domestic bank's failure and its effect on the domestic economy. National authorities were encouraged to establish a methodology to assess the degree of banks being systemically important to the domestic economy and calibrating the appropriate HLA capital requirements to address the risks posed by such institutions.

Considering this, CIMA has been conducting research on the adoption of a framework for Domestic Systemically Important Deposit Taking institutions' (D-SIDTIs) in the Cayman Islands as well as the calibration of HLA capital requirements applicable to them. All active banks, including branches and non-bank deposit taking institutions are within the scope of CIMA's framework:

- Category A Retails banks
- Category A Non-Retail banks
- Cooperative and building societies
- Category B banks and foreign branches of overseas banks with a physical presence in the Cayman Islands

It should be noted that Category B banks with no physical presence are not included in CIMA's proposed D-SIDTI framework as their resident exposures are mainly with other Category B Non-Retail group banks, non-bank entities and other

CIMA licensees conducting business offshore, which will not have a significant effect on the stability of the domestic financial system.

It is envisaged that this framework will enhance CIMA's Risk Based Approach (RBA) to supervision by applying differentiated intensity of supervision to D-SIDTIs based on the risks they pose to the local financial system and the real economy.

The assessment methodology to be used by CIMA is aligned with the BCBS principles for identifying deposit taking institutions that are of domestic systemic importance which can be summarized as below:

- A quantitative-based measurement approach is being proposed which includes the analysis of four factors i.e., size, inter-connectedness, substitutability, and complexity.
- CIMA has used national discretion to include a fifth factor i.e., domestic context – which will be used to capture the level of systemic importance of any one deposit taking institution to the household sector.



## CHAPTER 4: REGULATORY & SUPERVISORY DEVELOPMENTS

Despite the ensuing pandemic, the jurisdiction has made a concerted effort in 2020 to strengthen its regulatory landscape through various means, including the introduction of new legislation as well as amendments to existing legislation.

The following are the main regulatory developments within the jurisdiction that occurred within 2020:

### Private Funds Act 2020

On 7 February 2020, the PFA took effect and requires close-ended investment funds to be regulated by CIMA. All investment vehicles falling within the scope of the private funds definition and section 3(1) of the PFA must register with CIMA. A key point of the PFA includes a requirement that audited financial statements, signed off by a Cayman Islands' auditor, must be submitted to CIMA within six months of a private fund's financial year end. Since early 2020, Private Funds were required to submit financial data using the FAR and based on the submissions USD 2.475 trillion was reported in Ending Net Assets.

### Limited Investors Fund

Also, on 7 February 2020, the MFA 2020 was amended to replace 'Exempt' licenses with 'Limited Investors Fund' licenses that are required to register with CIMA. The amendment to the MFA requires open-ended funds with fifteen investors or less, to be regulated by CIMA. Prior to the commencement of this Act in February 2020, these open-ended funds were exempted from CIMA licensing and registration under section 4(4) of the MFA. The effect of this amendment was to expand the types of fund vehicles required to be regulated and improve transparency in regulating funds.

Likewise, since early 2020, Limited Investor Funds were required to submit financial data using the FAR and based on the submissions an additional USD 107 billion was reported in Ending Net Assets.

### Leverage Ratio: Rules and Guidelines

CIMA introduced a Basel III-compliant, non-risk-based leverage ratio to supplement existing risk-based capital requirements. The effective implementation date of these Rules and Guidelines was 1 December 2019. The first quarterly reporting by licensees was rescheduled to early Q2 2020 to coincide with the release of a new version of the Regulatory Enhanced Electronic Forms Submissions, commonly referred to as REEFS, version 3.1.

### Monetary Authority (Amendment) (No.2) Act 2020

The Monetary Authority Act (2020 Revision) was amended, and the major changes are as below:

Amendment of section 6 regarding the added principal functions of the Authority:

"endeavor to promote and facilitate innovation, competition, consumer benefits and the development of technology and services that encourage and promote financial inclusion."

Insertion of section 6A regarding the power to adjust regulatory requirements:

"CIMA may at any time during the term of a sandbox licence issued under the Virtual Asset (Service Providers) Act, 2020 -

- a. waive or modify any regulatory requirements imposed in accordance with the Virtual Asset (Service Providers) Act, 2020 or any other regulatory act; or
- b. impose any additional regulatory requirements in accordance with the Virtual Asset (Service Providers) Act, 2020 or any other regulatory act, on the person who holds the sandbox licence, based on the use of innovative technology or innovative methods of delivery, the nature and complexity of the activity, or the supervisory needs of the person who holds the sandbox licence."

## **Regulatory Deadlines Extensions**

To mitigate the COVID-19 impact on regulatory deadlines, CIMA extended its deadlines for quarterly regulatory filings by licensees; and The Cayman Islands Department for International Tax Cooperation formally extended the reporting dates for Cayman financial institutions to complete reporting obligations under the Foreign Account Tax Compliance Act.

partnerships incorporated or registered under the laws of the Cayman Islands. At the end of 2020, there were 36 active Securities Investment Business (SIB) licensees and 1,692 Registered Persons.

## **Virtual Asset Service Providers Act 2020**

At a time where innovation is needed to support the economy given the effects of the pandemic, in May 2020, a new legislative framework for regulating VA and VASP, The Virtual Asset (Service Providers) Act 2020 was enacted in the Cayman Islands. There were 2 phases of implementation, phase 1 of the VASP Act came into force on 31 October 2020. Under Phase 1, entities wishing to engage in VA related services must register with CIMA. Phase 2 is yet to commence.

## **AML (Money Services Business Threshold Reporting) Regulations, 2020**

New regulations were published on 12 November 2020 which defined threshold transactions as a transaction involving a transfer of funds within, into or from the Cayman Islands where the total amount exceeds USD 3,500 in a single transaction or in the aggregate where there is more than one transfer of funds by the same sender or receiver within a period of one month.

The new regulations also set reporting requirements in respect of Money Services Business (MSB) to the Financial Reporting Authority on a quarterly basis.

## **Registered Persons**

The SIBA was amended in 2020 by the implementation of an enhanced supervisory regime for Registered Persons, formerly Excluded Persons. This act applies to companies with limited liability,

## Cayman Islands Government COVID-19 Responses

### Support funding



The Government allocated KYD 3 million from the Government's disaster fund to finance costs associated with COVID-19 Pandemic.

### Vulnerable families



The implementation of one-off payments or grants to the following groups: (a) disabled, seamen, veterans and persons already receiving personal financial assistance from the Government; (b) taxi drivers affected by the fall-out of cruise ship visitors; and (c) Caymanian tourism workers affected by the shut-down. The Government continued to make severance payments to displaced Caymanian tourism workers throughout 2020, and which continued in 2021.

### Pension withdrawal and pension payment holiday



Persons could withdraw up to 100 percent of their pension funds not exceeding KYD 10,000 or 25% of funds above \$10,000, in addition, to the suspension of pension payment.

### Low-cost business loans



The establishment of a loan fund of KYD 5 million to provide loans to 100% Caymanian owned businesses at an annual interest rate of 1% after a six (6) months repayment moratorium. These loans were offered through the Cayman Islands Development Bank.

### Grant fund for small and micro businesses



The creation of a grant fund valued at KYD 9.0 million and which was made available to the small and micro businesses. Assistance to evaluate qualification and to apply for the grant was also provided free of cost.

### Technical assistance



The Government funded KYD 500,000 for technical assistance to Caymanian owned businesses to assist with strategy and balance sheet planning. Similarly, funding of KYD 200,000 was established to help Caymanian owned businesses to receive training to assist them in planning and navigating this economic downturn.

## Execution of Regulatory Functions

Table 11: List of Regulatory Measures Issued and Updated by CIMA

Issued	Standard	Title
June 2020	Statement of Guidance	Guidance notes on the Prevention and Detection of Money Laundering, Terrorist Financing and Proliferation Financing in the Cayman Islands
July 2020	Rule	Rule Segregation of Assets - Regulated and Registered - Mutual Funds
February 2021	Statement of Guidance	Guidance Notes (Amendment) (No.1) - Virtual asset Service Providers
May 2021	Statement of Guidance	Guidance Notes (Amendment) (No. 2) - Securitization

## Core Objectives and Achievements

Supervisory response to COVID-19 pandemic was proactive and comprehensive, it covered a broad range of activities including:

- Notifications to Industry regarding regulatory updates in response to COVID-19 pandemic and invitation to approach CIMA with regulatory forbearance and extension requests.
- Ongoing dialogue bi-laterally with licensees that serve the domestic market as well as multi-laterally with industry associations.
- Issuance of a survey on deployment of BCPs for material Category A, B banks, Money Services Businesses and Cooperative Societies.
- Completion of a stress testing exercise for both capital and liquidity to inform CIMA's decision-making regarding Category A banks.
- Benchmarking of forbearance measures and options against international and regional jurisdictions.

- Provision of forbearance on a case-by-case basis.
- Video meetings and onsite inspections allowed CIMA to seamlessly proceed with its day-to-day functions.

## Other Key Areas of Focus

In January 2020, the Cayman Islands government replaced the Anti Money Laundering Regulations (2018 Revision) with the AML Regulations, (2020 Revision) (AMLRs) and issued the Proceeds of Crime Act (2020 Revision). CIMA also made revisions to the AML Guidance Notes. These changes to the Cayman Islands AML/CFT regime have been designed to bring the Cayman Islands regime in line with the most recent FATF recommendations.

The AMLRs require Financial Service Providers (FSPs) to apply a RBA to their AML/CFT framework. A RBA through risk assessment requires entities to perform risk assessments on its investors/clients, it also requires the entity to conduct a risk assessment on itself and document their risk assessment. Entities must adopt risk assessment policies and procedures appropriate to their size, nature, and complexity.

Risk classification factors may be categorised by types of applicants/customers, countries or geographic areas, and particular products, services, transactions, or delivery channels. FSPs should consider all risk factors in the assessment that is available from credible, and reliable sources.

An AML/CFT NRA identifies the primary AML/CFT risks in a jurisdiction and evaluates mitigants and controls. An NRA is the foundation for the efficient and effective allocation of resources in addressing identified AML/CFT threats. In 2020, the Cayman Islands began planning for an NRA, as the prior full NRA was completed in 2015. The most recent assessment was carried out between January to December 2021. The final report was published in early 2022.

### Future Developments

CIMA has always prioritised infrastructure and human capital as these are crucial to our success. We expect to continue to invest in both these organisational foundations as well as maintain our

focus on enhancing our risk based supervisory approach and gaining even more efficiencies in operations. AML/CFT compliance remains a priority for CIMA and as does stakeholder engagement, particularly with industry.

CIMA also reviewed published amendments to the Guidance Notes on the Prevention and Detection of Money Laundering, Terrorist Financing and Proliferation Financing'. The purpose of this revision was to issue sector-specific guidance in relation to special purpose vehicles, securitization and structured finance arrangement (AML Securitization Guidance).

CIMA will work in concert with government and other regulatory agencies to assess the exposure of the Cayman Islands to money laundering, terrorist financing and proliferation financing risks. This will include extensive engagement with appropriate industry organisations.

The implementation of the Basel III Framework will continue to be an area of focus for the banking sector. A key domestic initiative for the banking sector is the ongoing work on a framework for domestically systemically important financial institutions.

The Cayman Islands continues to respond proactively and with initiative to all recommendations from the FATF. In 2022, the FATF identified only one out of 63 action items from the Mutual Evaluation Report 2019 remaining to be satisfied. Nonetheless, the Cayman Islands government has allocated substantial resources to the remediation of these deficiencies. It is expected that the action item pertaining to the deficiencies, which pertain to prosecutions, will be addressed expeditiously.

The Cayman Islands continues to demonstrate that there is appropriate legislation, structure, and organisations to meet its international obligations as it relates to money laundering, terrorist



# REGULATORY & SUPERVISORY DEVELOPMENTS

financing and proliferation financing. Given the substantial progress, it is anticipated that the Cayman Islands will be removed from the Grey List following another re-assessment.

## Risks of Money Laundering, Terrorist Financing and Proliferation Financing

The Cayman Islands is a major international financial centre offering a diversified cross section of services, numerous financial products and vehicles, and coupled with its proximity to North and Central America - it makes the jurisdiction vulnerable to significant threats from money laundering of foreign proceeds of crime.

The Cayman Islands conducted its 2021 NRA during January – September 2021, where relevant threats, inherent risks and strength of controls were analysed across various sectors. The goal of the 2021 NRA was threefold:

- To consolidate the various topical and sectoral risk assessments based on the risks that evolved since 2017.
- Further deepen and advance the Cayman Islands’ risk understanding in those areas that

were not subject to any topical or sectoral risk assessment since 2017 or those areas that have been added as part of the international agenda (including VASPs)

- Update the Cayman Islands’ national risk understanding in areas where more information is available i.e. legal entities and registered SIBs.

Figure 70 summarises the conclusions of the NRA 2021, taking into account inherent risk ratings and the materiality of the sector. The analysis will assist in the prioritisation of the focus of resources and stringent risk mitigation measures.

Figure 70: Overall Sector Risk Rating

Source: Cayman Islands National Risk Assessment, 2021

	Mutual Fund Admin.	Securities	TCSPs	Banks	VASPs	Insurance	Lawyers	Real Estate Agents	MSB	Accountants including Auditors	Financial Leasing	DPMS	High Value Goods bit DPMS	Money Lenders
Overall Inherent Risk	MH	MH	MH	MH	MH	ML	MH	MH	MH	ML	ML	ML	ML	L
Nature, size, complexity	MH	MH	MH	MH	MH	ML	MH	MH	MH	ML	ML	ML	ML	L
Customers	ML	MH	MH	H	MH	ML	MH	MH	MH	ML	ML	ML	L	L
Product/services/transactions	MH	MH	H	MH	H	MH	MH	MH	H	MH	ML	H	ML	L
Delivery Channels	MH	MH	MH	ML	MH	ML	ML	ML	ML	ML	L	MH	L	L

MH (Medium High Risk); ML (Medium Low Risk); H (High Risk); L (Low Risk)

## Risk Levels of Traditional Sectors

<p><b>Mutual Fund Administrators</b></p>	<p>As of 2020, the Funds sector constitutes the largest sector of the Cayman Islands financial centre. In this sector, the focus is on Mutual Fund Administrators due to the complexity of their business and particularly the RTA services. Mutual Funds Administrators risk score is <b>medium high</b>.</p>
<p><b>Securities</b></p>	<p>Due to the large size and highly international nature of the Cayman Islands SIB sector, regulated SIBs are considered to have a <b>medium high risk</b>.</p>
<p><b>Trust and Corporate Service Providers</b></p>	<p>Considering the inherent risks relating to nature, scale, and complexity of the TCSP sector both Trust Service Providers and CSPs are rated as <b>medium high</b> given the size of the industries in terms of the value of assets under management, the nature of services, and the international nature of the ownership and control of many TCSPs.</p>
<p><b>Deposit Taking Institutions and Banks</b></p>	<p>Rated as <b>medium high</b>. While Category A Banks had an overall medium low risk rating, since it reflects the domestic market, Category B Banks were rated as medium high. A low risk rating was assigned to the Societies.</p>
<p><b>Insurance</b></p>	<p>Approximately 95% of the Cayman based insurance companies (by number and premium values) carry on only general insurance activities. The exposure to ML/TF risks is minimal, as products are typically short-term contracts for long-tail (liability)risks. Therefore this sector was rated <b>medium low</b>.</p>



## CHAPTER 5: FINANCIAL STABILITY & CLIMATE CHANGE

Within recent years financial regulators, international organisations, market participants and other key stakeholders have focused increased attention towards understanding the implications of climate change risks for the financial sector, financial stability, and financial inclusion.

Climate-related risks are not a future phenomenon as they are already impacting the world economy and the financial systems today. In November 2021, on the topic of climate change, world leaders met at the 26<sup>th</sup> UN Climate Change Conference, commonly known as COP26, to negotiate and agree to rules to set us on a pathway of net zero carbon emissions by 2050 as well as to curb the rise in average temperature at a ceiling of 1.5 degrees. These measures are deemed necessary to reduce the impact of climate related risks.

Climate Change is broadly defined as changes in the Earth's oceans and atmosphere and includes inter alia increases in average global temperatures, changes in the frequency and severity of major hurricanes and storms as well as the level or acidity of the oceans. The possible future outcomes arising from climate change is what is termed climate change risks.

For a financial regulator, it is imperative to understand that climate change risks can affect supervised financial institutions directly and indirectly via two channels: physical risks and transition risks.

### Physical Risk

Physical risks take account of the economic costs and financial losses due to physical risk drivers i.e., increasing severity and frequency of extreme climate change-related weather events and longer-term gradual shifts of the climate. Physical risks can be categorised as either acute or chronic.

Acute physical risks, allude to those that are event driven. These generally include lethal heatwaves,

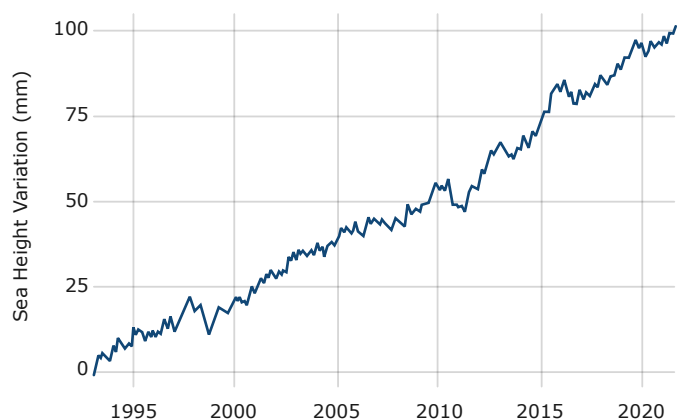
floods, landslides, droughts, wildfires, and storms, including hurricanes, cyclones, and typhoons as well as extreme precipitation. Chronic physical risks are related to the progressive shifts in climate and weather patterns, such as rising sea levels, rising average temperatures, desertification, and ocean acidification.

Physical risks are not new to us, as the world is already feeling its impact. Since the 1980s, the number of extreme weather events has more than tripled. Economic costs associated with natural disasters have exceeded the 30-year average of USD140 million per annum in seven of the last 10 years.

### Sea Levels

The rise in sea level, related to global warming, is caused mainly by the added water from the melting ice sheets and glaciers as well as the expansion of seawater as it warms. Over the years, the sea levels have risen at unprecedented rates. Last measurements in September 2021 indicate that the rate of change is around 4mm per year. With this rate, many parts of the world in the coming years will be under water.

Figure 71: Sea Levels

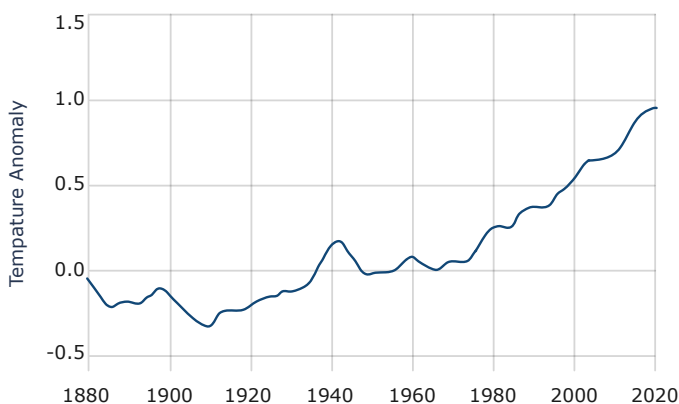


Source: NASA

## Global Temperature

The earth's surface continues to significantly increase in temperature, with recent years being some of the hottest in the past 2000 plus years. Since record keeping began by National Aeronautics and Space Administration (NASA) in 1980, the years 2016 and 2020 tied for the hottest year on record. As of 2021, the average annual temperature change was recorded at 0.85 degree Celsius or 1.53 degrees Fahrenheit.

Figure 72: Global Temperatures

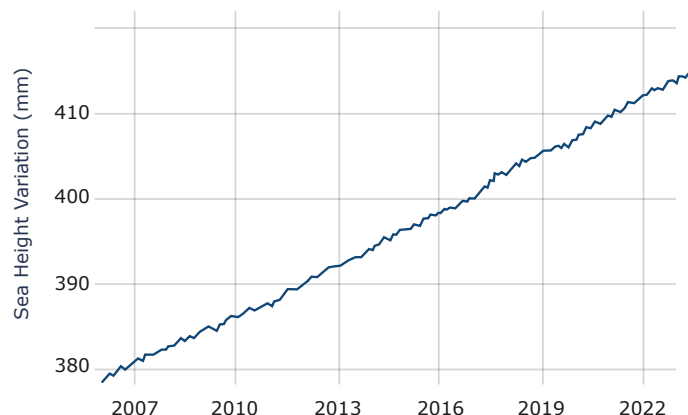


Source: NASA

## Carbon Dioxide Emissions

It has been admitted globally that various human activities inter alia deforestation and burning of fossil fuels have significantly contributed to the increase in carbon dioxide levels in the Earth's atmosphere. Since the 1850s, at the beginning of the industrial era, human activities have increased carbon dioxide atmospheric concentrations by nearly 50%. This is so significant as the damage done in 171 years would take over a 20,000-year period to naturally occur.

Figure 73: Carbon Dioxide Emissions



Source: NASA

## Transition Risks

These are the economic and financial costs associated with the process of adjustment towards a lower-carbon and less polluted economy, brought about by changes in climate and environmental policies, technological changes or shifts in market sentiment.

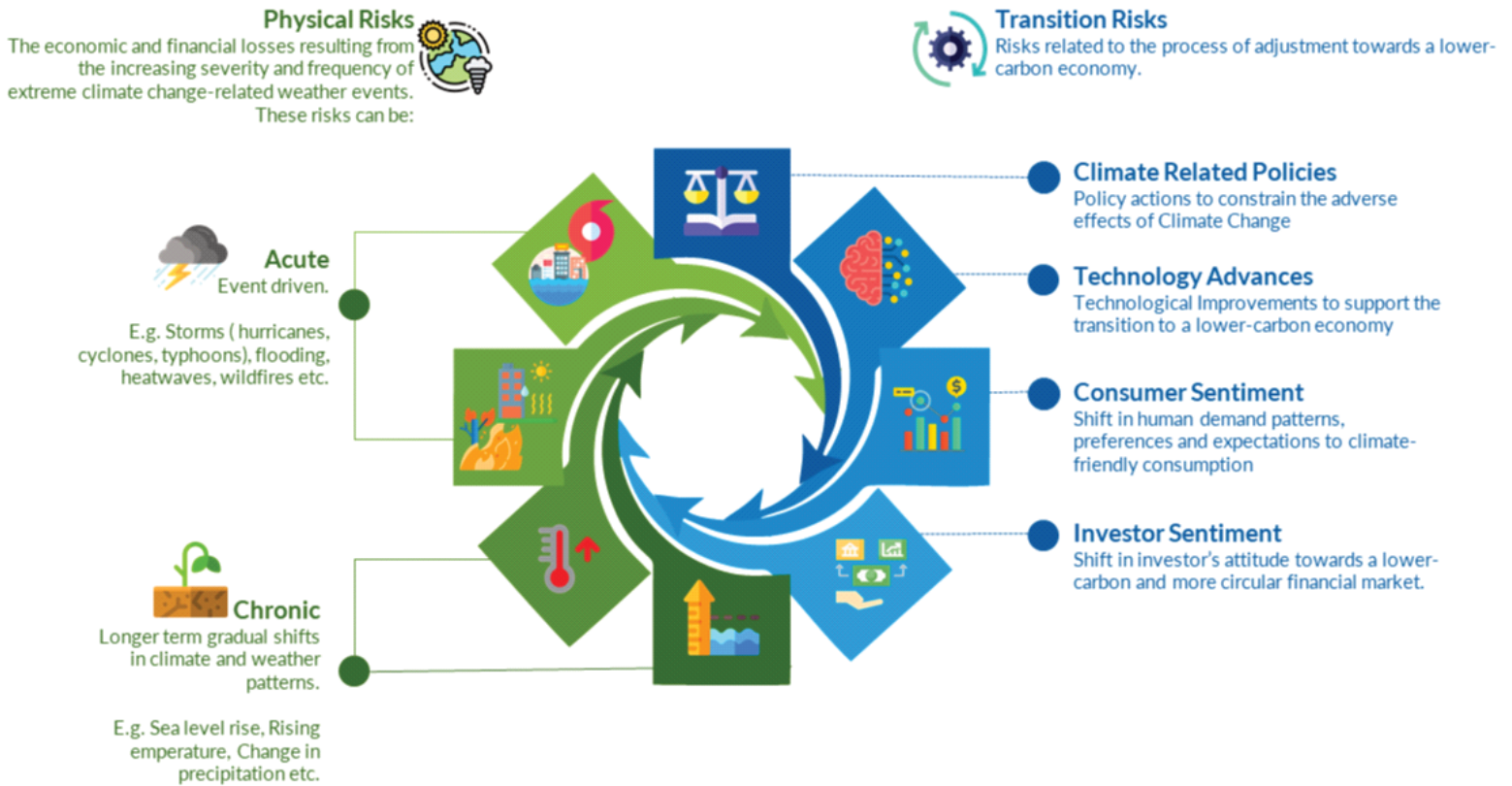
These aforementioned transitions could mean that some sectors of the economy would face big swings in asset values or be faced with higher costs of doing business. The move towards a greener economy can impact companies that produce cars, ships, and planes, or use high amounts of energy to make raw materials like steel and cement.

Transitioning to a lower-carbon economy will entail extensive policy, legal, technology, and market changes to address mitigation and adaptation requirements related to climate change. Depending on the nature, speed, and focus of these changes, transition risks may pose varying levels of financial and reputational risk to organisations.

For example, countries that are more dependent on fossil fuel production and refining may be more vulnerable to transition risks, with an impact not only on the value of companies involved in the fossil fuel sector but also on employment in the sector, and more widely on economic growth and government revenues.

# FINANCIAL STABILITY & CLIMATE CHANGE

Figure 74: Climate Related Risks



Source: The Network of Central Banks and Supervisors for Greening the Financial System

## Transmission Channels and Drivers

The impact of physical and transition risks on the financial system can materialise through microeconomic and macroeconomic transmission channels i.e. causal chains that explain how climate risk drivers give rise to financial risks that impact institutions directly or indirectly through their counterparties, the assets they hold and the economy in which they operate. Climate related risks can lead to increased risks within the financial system in many ways.

### Policy and Legal Risk

Their objectives generally fall into two categories—policy decisions that attempt to constrain actions that contribute to the adverse effects of climate change or policy decisions that seek to promote adaptation to climate change. Some examples include implementing carbon-pricing mechanisms to reduce Green House Gas emissions, shifting energy use toward lower emission sources.

Another important risk is litigation or legal risk. In this scope, litigation risk refers to the possibility that legal action may be taken against an organisation because of its failure to adapt to climate change and failure to mitigate its effects.

### Technology Risk

Technological improvements or innovations that support the transition to a lower-carbon, energy-efficient economic system can have a significant impact on organisations. The development and use of emerging technologies involving renewable energy and battery storage, will affect the competitiveness of certain organisations, their production and distribution costs, and ultimately the demand for their products and services from end users. To the extent that new technology displaces old systems and disrupts some parts of the existing economic system, winners and losers will emerge from this “creative destruction” process.

### Market Risk

Also known as “Systematic Risk”, it refers to the possibility that an individual or entity will experience losses due to factors that affect the overall performance of investments in the financial markets.

In the context of climate change, for example, severe weather events or political measures regarding the transition could lead to re-pricing of financial instruments and corporate debt affecting the value of securities held on financial institutions’ balance sheets (and/or the value of collateral used in some operations). Further, the introduction of a carbon tax can result in investment losses and lower assets’ values, creating stranded assets.

### Operational Risk

Operational Risk is defined in the Basel capital Framework as the risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events. The losses can be directly or indirectly financial.

Extreme weather events can have an impact on financial institutions’ business continuity through, for instance, damage affecting critical functions of the financial entity or of its main service providers. Financial institutions or their customers might face a liability charge from parties who have suffered losses from physical and transition effects and seek to recover these losses from those they view as responsible.

### Credit Risk

Credit risk is the possibility of a loss resulting from a borrower's failure to repay a loan or meet contractual obligations. Credit risk increases if climate risk drivers reduce borrowers’ ability to repay and service debt (income effect) or banks’ ability to fully recover the value of a loan in the event of default because the value of any pledged collateral or recoverable value has been reduced

(the wealth effect). For example, the destruction of a production site by wildfire can increase the probability of default of the company operating the site.

## Liquidity Risk

Climate risk drivers may impact banks' liquidity risk directly, through their ability to raise funds or liquidate assets, or indirectly through customers' demands for liquidity.

There is evidence that natural disasters can lead to liquidity risk within banks. These effects could impact the ability of a bank to fund increases in its assets and meet obligations as they come due without incurring unacceptable losses. Available research focuses on physical risk-related liquidity risk, and there is limited analysis of the potential effects of transition risk drivers on banks' liquidity risk.

Evidence also suggests that post-disaster lending has a significant and negative effect on liquidity buffers. Severe natural disasters can trigger a sharp increase in precautionary demand for liquidity by financial institutions, households and corporates and the central bank may have to intervene in order to preserve financial stability.

## Underwriting Risk

Physical risks in the form of severe or catastrophic weather-related events can have a significant impact on non-life insurers. With a massive increase in insurance claims and higher than expected insurance claim pay-outs, non-life companies could face massive underwriting losses due to the manifestation of these physical risks. This can have a domino effect as non-life insurers may be required to increase premiums to stay afloat or even make the decision to not insure such risks.

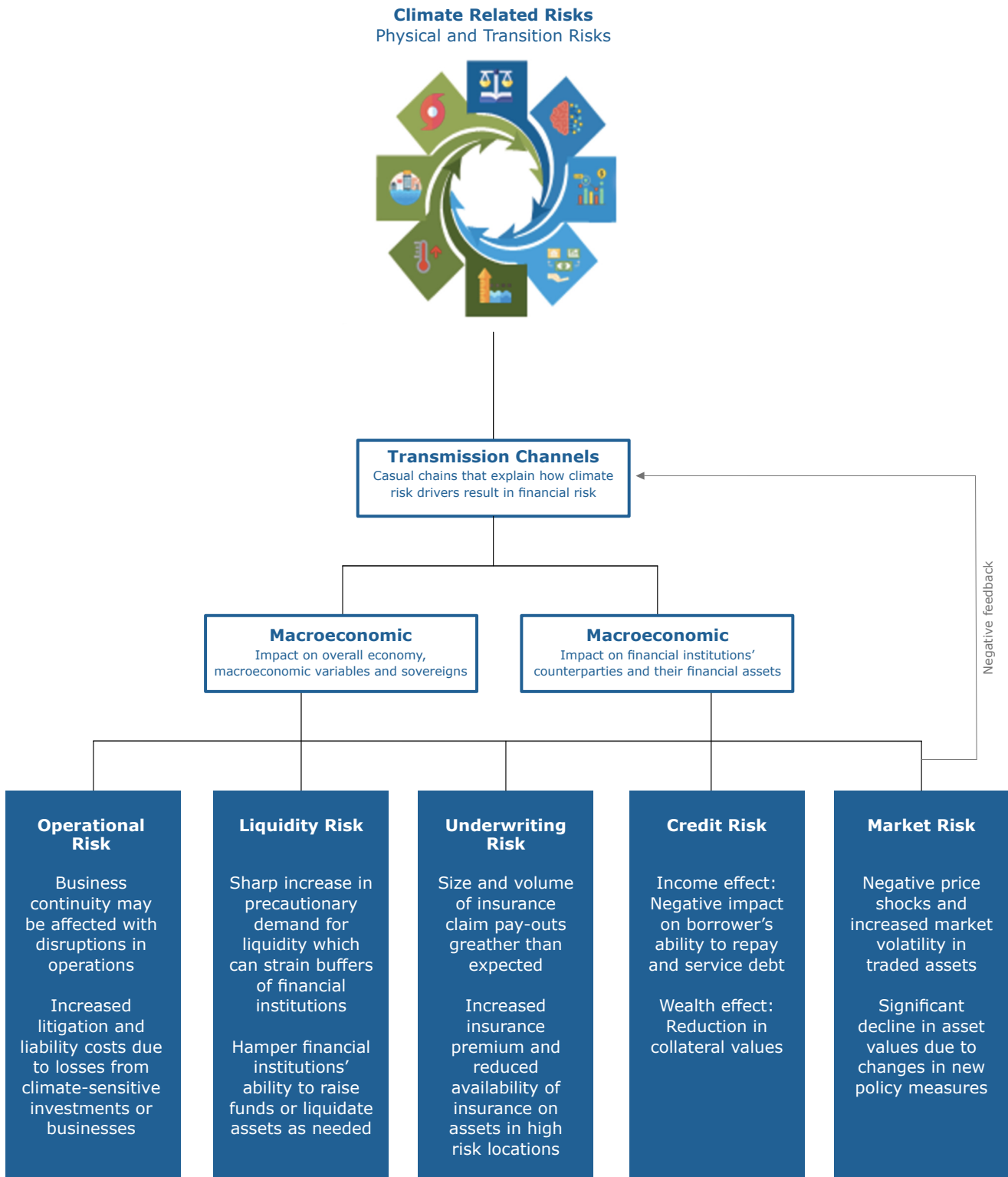
It is imperative to note that all these aforementioned risks can also give rise to negative

feedback loops. These are second-order effects on the financial system, basically exacerbating the climate related problems already being faced.



# FINANCIAL STABILITY & CLIMATE CHANGE

Figure 75: Climate-related risks drivers and transmission channels



Source: Bank of International Settlements

## Climate Change and the Cayman Islands

The following section discusses the possible and current impacts arising from acute and chronic risks in the Cayman Islands and its implications.

### Beach and Shoreline Loss

According to the Intergovernmental Panel on Climate Change, worldwide ocean level rise anticipated at rates of 5 mm per year to 10 mm per year is more than two-fold the nearby perceptions of a normal of 2.4 mm per year from 1976 to 1988. The effect on shoreline assets, especially financially critical resources such as the Seven Mile Beach shoreline on Grand Cayman, could be a cause for concern, as the degree of conceivable shoreline withdrawal beneath these ocean level rise and other scenarios has not been fully mapped. Due to the propensity of recent developments and the improper placement of structures such as dikes, pools and possibly active beach zone buildings, the beach has a limited distance to which it naturally recedes or bends, thus causing problems and erosion.

### Sea-level Rise

The immediate concern most residents have in relation to climate change and these extremely low-lying islands is the impact of sea level rise on personal property, communities and businesses. Land movement of the islands appears to be stable in geologic terms therefore relative sea levels around the Cayman Islands are close to sea surface levels. Based on studies, an increase in sea level between 0.12 m (0.4 ft) and 0.80 m (2.6 ft), or roughly 0.14 to 0.91 cm per year, by 2100 is estimated for the Cayman Islands.

By the high range of sea level rise expected, only 5% of all buildings on the island would be impacted in some way. However, an additional rise of 0.25 m represented by the 1 m (3.3 ft) sea level rise scenario shows a sizeable increase to 14.3% of total buildings affected when compared to the previous scenario.

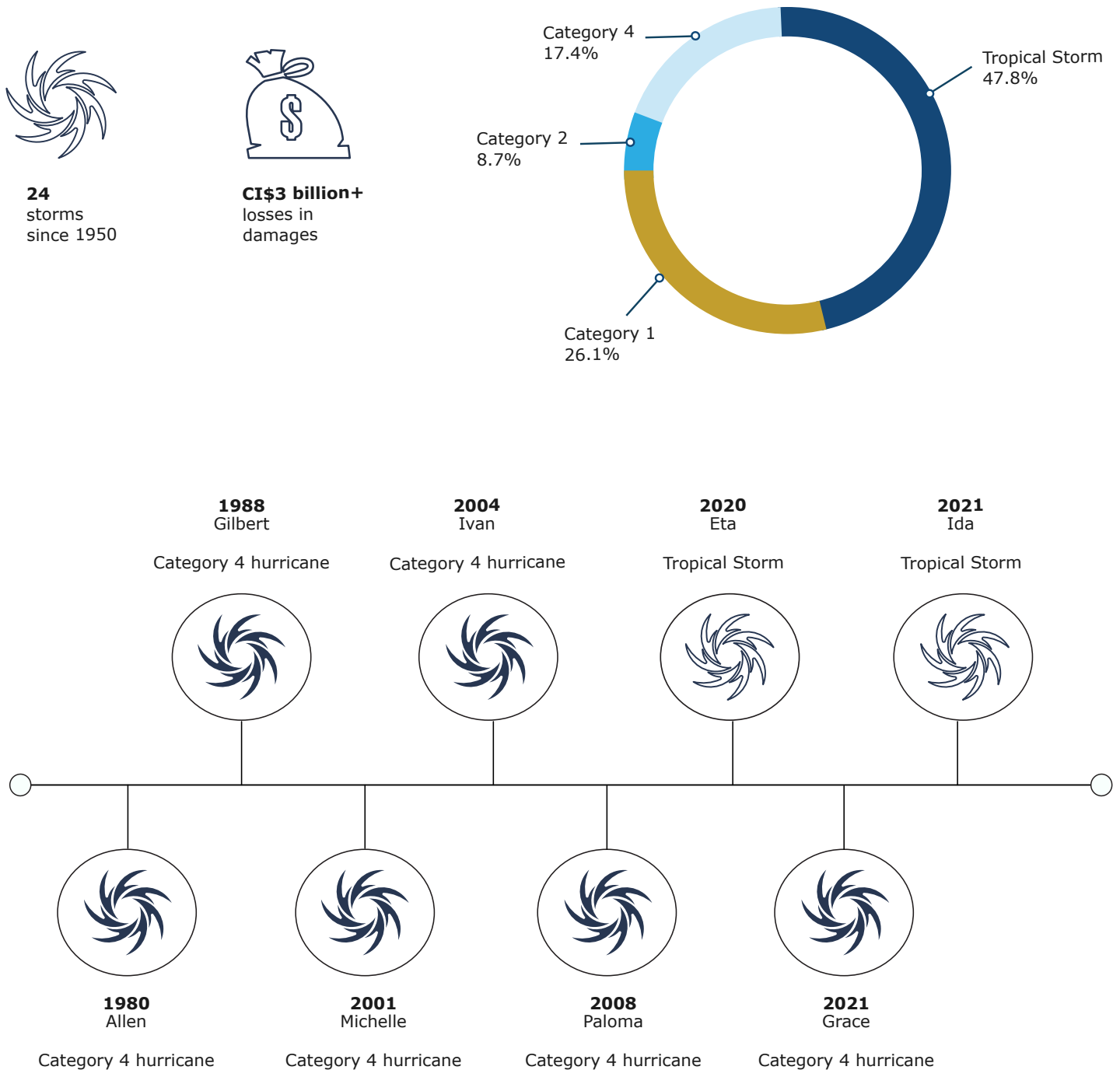
## Hurricanes

Tropical low-pressure systems originating from the propagation of easterly waves are experienced during the summer, the most severe of which are hurricanes (categorized on the Saffir-Simpson scale as sustained wind speeds over 74 mph). The 'hurricane season' typically lasts from June 1 to November 30 and represents the primary rainfall source in the Caribbean and the main contribution to the peak in September-October-November totals.

Direct hits from hurricanes have had devastating socio-economic consequences on the Cayman Islands. Figure 76 highlights damages and losses from the costliest events such as Hurricane Ivan in 2004 which severely impacted the southern and eastern coasts of Grand Cayman leaving total losses of KYD 2.8 billion in its wake. This represented 183% of the country's 2003 GDP and is by far the most devastating hurricane to hit the Cayman Islands. Hurricane Paloma - the second strongest November Atlantic hurricane on record - caused total losses of KYD 154 million with the passage of its eye over the eastern end of Cayman Brac. However, hurricanes do not have to directly hit the Cayman Islands to cause substantial impact.

# FINANCIAL STABILITY & CLIMATE CHANGE

Figure 76: Storms Impacting the Cayman Islands, 1950 - 2021



Source: Cayman Islands Government Department of Environment

## Marine and Coastal Ecosystems

According to the National Oceanic Atmospheric Administration, scientists have determined that the ocean absorbs more than 90 percent of the excess heat, which is attributed to greenhouse gas emissions; as a consequence of this, the issue of climate change is worsened and can lead to more serious and stronger storms, warming sea temperatures and the rise of sea level. All these negative effects have the individual and cumulative potential to significantly impact marine ecosystems such as fragile coral reefs and mangroves. The total value of reef-related shoreline protection services in the Caribbean region has been estimated to be between USD 740 million and USD 2.2 billion per year; however, depending on the degree of development, this coastal-protection benefit could range from USD 2,000 to USD 1,000,000 per kilometre of coastline.

Tropical coral reefs are probably the most sensitive marine ecosystem in the world to global climate change. Higher than normal sea surface temperatures cause increased stress to corals forcing them to live near thresholds levels and resulting in coral bleaching which diminish the coral's energy producing systems; with severe stress often results in coral mortality. The annual average maximum sea temperature around the Cayman Islands is 30°C which is about the temperature threshold for regional corals.

Caribbean coral reefs have evolved for millennia under the influence of hurricanes, but climate change and other anthropogenic factors may be too rapid an onslaught for corals to adapt. More frequent or stronger hurricanes would reduce the ability of reefs to recover after each successive event, with knock on implications for fisheries, dive tourism, beach assets and shoreline protection.

The Cayman Islands Department of the Environment (DoE) has identified several threats to the Cayman reefs. Climate change has been a driver for several of these threats.

Amongst these threats are:

**Coral bleaching**, which is associated with the devastation of coral reefs, which are home to approximately 25 percent of all marine species.

**Active storm season**, as the coral reefs around the Cayman Islands have a narrow shelf upon which the waves break, and the physical strength of these storms can destroy or severely damage the reefs.

**Thermal expansion** of the ocean due to increased sea temperatures, resulting in the corals being 'drowned' at greater depths. While corals can survive at temperatures of up to 27-28°C (82°F), if these temperatures are sustained or occur frequently it debilitates the corals and leave them more susceptible to bleaching and disease.

Coastal mangroves in the Cayman Islands will be challenged to keep pace with and adapt to rising sea levels. Mangroves in both Grand Cayman and Little Cayman receded approximately 20 ft after Hurricane Ivan and Hurricane Gilbert, respectively. More severe storm surges also threaten to drown coastal mangrove systems. These systems have been dissected by coastal roads which now impede natural drainage after storms causing mangroves to drown.

## Global Main Approaches

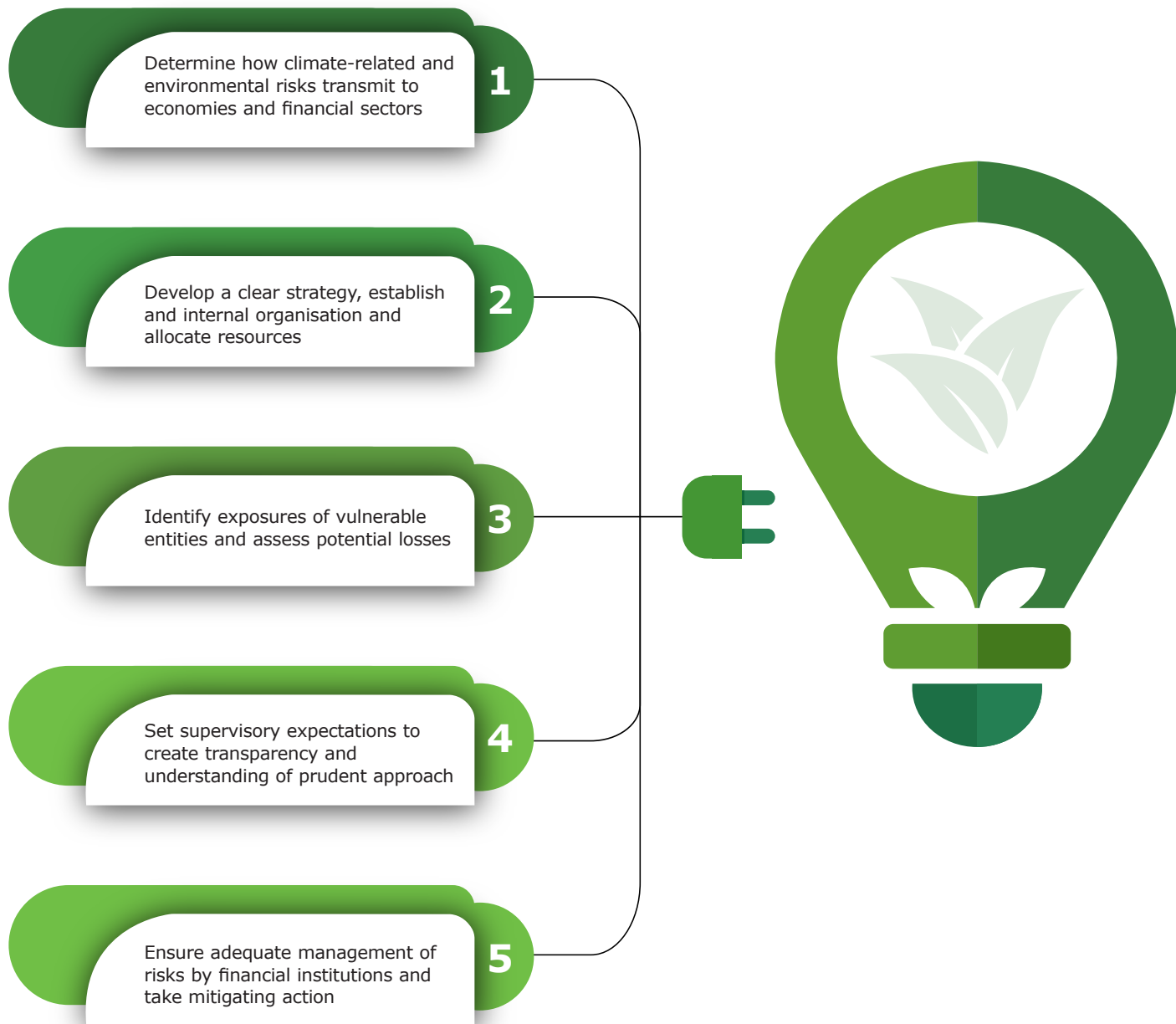
Across the globe, financial regulators are under pressure to develop financial policies and regulatory climate-based frameworks. Over the past few years, regulatory efforts have been focused on three broad areas:

- Measurement of the magnitude of climate related effects and the identification of transmission channels of climate-related risks for the financial system

- Development of appropriate responses for both macroprudential policy (ensuring system stability) and microprudential supervision (safety and soundness of the financial institutions individually)
- Closure of data and knowledge gaps, improve transparency and dissemination of information and promotion of common standards for climate disclosures globally within the financial sector

Central banks and other financial regulators have been involved in various initiatives to increase awareness and capacity building for this important area of climate risk. The Bank of England's Prudential Regulatory Authority was known as the first financial regulator that published a detailed analysis on climate-related risks for the insurance sector in 2015. In the preceding years, Swedish, Dutch and French regulators undertook similar initiatives with available data. In November 2017, the Network of Greening the Financial System (NGFS) was incorporated by 8 central banks and financial regulatory agencies in an effort to "contribute to the development of climate- and environment-related risk management in the financial sector and mobilize mainstream finance to support the transition toward a sustainable economy." The NGFS has grown to over 100 member countries and in February 2022 CIMA became a member. The NGFS has since published five recommendations for members to adopt in the implementation of climate related measures.

Figure 77: Five Recommendations for Members of the Network of Central Banks and Supervisors for Greening the Financial System



Source: The Network of Central Banks and Supervisors for Greening the Financial System

## Surveillance of Climate Related Risks

CIMA recognises that financial institutions, including banks, are exposed to climate-related financial risks regardless of their size, complexity or business models. The BCBS has indicated that the banking system is exposed to climate risk through macro-and microeconomic transmission channels that arise from physical climate risk drivers and transition risk drivers.

CIMA also acknowledges that climate-related risks could affect the safety and soundness of individual banking institutions and can have broader financial stability implications for the economy. Although climate-related financial risk is a complex and developing subject, there is a growing need for regulated entities to integrate climate-related risks into their business strategies and processes. As such, regulated entities should design a plan to incorporate climate-related risks into their business activities and better understand the impact of climate-related risks. At a minimum, regulated entities should plan to integrate climate-related risks in the areas outlined.

**Business strategy and governance:** Each regulated entity's governing body should initiate measures to understand, assess and incorporate the financial risks from climate change within the overall business strategy and risk appetite. Regulated entities are encouraged to revise their risk appetite statement to include the risk exposure limits and thresholds for the financial risks that they are willing to bear. The governing body should aim to document how the entity monitors and manages the financial risks from climate change in line with its risk appetite statement. Additionally, the governing body should ensure that there are clear roles and responsibilities for the governing body, its relevant sub-committees and senior management in managing the financial risks from climate change.

**Risk management:** Regulated entities should take necessary steps to integrate climate risk into the existing risk management framework in line with

the entity's risk appetite. They should implement measures to carry out a comprehensive assessment of climate-related financial risks and set clear definitions and thresholds for materiality, and start establishing reliable approaches for identifying, measuring, monitoring and managing material climate-related risks.

**Supervisory review process (Pillar 2):** For the banking sector, licensees are required to submit Internal Capital Adequacy Assessment Process (ICAAP) reports to CIMA and must incorporate climate-related risks in their respective ICAAP reports. At a minimum, the ICAAP reports should include the planned responses (or measures already implemented, if applicable) to incorporate climate-related risks into the following areas: business strategy, risk appetite, corporate governance, internal controls, integration into the risk management framework, risk identification and measurement, materiality assessment, monitoring and reporting, among others.

In the last ICAAP review by CIMA, it was encouraging to see many banking licensees incorporated climate related risks within their internal stress testing scenarios. It has been recognised that the Caribbean region is inherently exposed to the occurrence of natural disasters in form of physical risk drivers (storms, hurricanes) which has been aggravated by issues stemming from climate change. These can have destabilizing economic conditions which in turn are transmitted and materialised within the financial sector. Therefore, in their ICAAPs many licensees looked at the occurrence of a climate-related event and the amplification of credit or operational risk – through various stress testing scenarios.

CIMA recognised that ESG considerations, or sustainable investing, is increasingly becoming the fastest growing investment strategy within the financial services sector. At a minimum, those charged with governance of regulated funds should have clear roles and responsibilities in managing

# FINANCIAL STABILITY & CLIMATE CHANGE

and mitigating the risks from climate change and other ESG-related risks in line with the fund's set investment objectives and should start establishing reliable approaches for identifying, measuring, monitoring, and managing material ESG-related risks. Additionally, funds are required to ensure clear and ongoing disclosures in the context of their reporting requirements.

The expectations and practices around climate risk are quickly developing and evolving. CIMA will continue to undertake reviews, including assessing the available information, such as best practices

undertaken in other key financial jurisdictions, with the aim of developing a suitable regulatory and supervisory approach for climate related risks and other ESG-related risks. Some of the planned future work in this area include development of detailed climate related scenarios and templates as well as more guidance to the industry on the treatment of climate related risk.

The image below depicts CIMA's plan in addressing climate and other ESG-related risks.





## Challenges Faced

Across the globe and certainly for CIMA, many are in the nascent stage of researching, understanding, measuring and managing these climate-related risks. The quantity and quality of entity-specific granular data as it relates to climate risks is still sparse as systems and procedures are now being introduced to provide more concrete analyses. Further, as work continues to build out climate-related disclosures and taxonomies, there presents challenges around capturing the quantity and quality of individual firms data for climate risks. There is also the gap between the short-term horizon of typical stress tests as compared to the medium to long-term horizon for climate related risks, as there are different time horizons for the materialisation of various effects of climate change.

Against the backdrop, various initiatives around the globe have been launched in an effort to close the data gaps and improve disclosures. Some of these overlapping initiatives include:

- The Task Force on Climate-related Financial Disclosures was launched by the Financial Stability Board to help develop voluntary yet consistent climate-related financial disclosures for investors, lenders and insurance underwriters. The four recommendations deal with the collection, analysis, reporting, and governance of climate-related data and risk metrics for financial and non-financial organisations.
- International Organization of Securities Commissions also announced its intention to work on sustainable reporting standards with the establishment of a Sustainable Finance Network.
- There is a broad partnership with the World Economic Forum, the Institute of International Finance and a number of academic institutions which launched the Future of Sustainable Data Alliance in 2020 to identify and accelerate the reliable ESG data needed to properly inform investors.

- The NGFS has also done tremendous work in the space, and in October 2021 published a progress report on bridging data gaps. This report highlighted the need to converge towards a common and consistent set of global disclosure standards, a global taxonomy and the development of well-defined metrics and transparent methodologies.
- European Commission is also working on ensuring corporate disclosures are holistic to provide the necessary information to understand the impact of climate related risks on firms' finances and risk profile but also the impact of the firms' activities on the environment and the society.

There are many other global organisations with a similar goal – all endeavoring to raise awareness, table conversations and proactively work on practical solutions to address this growing global issue.

## Conclusion

Climate change is multi-faceted, ubiquitous and is posing a global challenge therefore it requires a multi-dimensional and interdisciplinary approach, where regulators, academics, the private sector and government all sit at the same table. If the requisite steps are not taken to address the current trajectory of global temperature future generations will be a severe risk for survival.

Financial ecosystems play an important role in allocating capital and other resources through the economy. This is somewhat two-fold i.e., they are exposed to climate risks since they would provide financing and insurance services to entities who may be impacted by climate effects while at the same time they are the drivers behind economies to transition to a more sustainable approach. Recognising the interlinkages and complexities in this space, it is imperative that financial institutions acquire the necessary skills, expertise, data and models to better assess, manage and mitigate these risks. Across the world, regulators are

stepping up their efforts to address climate-related risks and its link to financial stability. It is envisaged deeper analysis will be explored as more granular data is captured and methodologies are developed.

As CIMA builds out its roadmap in more details over the next year to fully embed climate-related risks in the supervisory framework, it is committed to working with the industry, academia, government, and other global regulators in the area of climate change in an effort to continuously strengthen the resilience of the financial system within the Cayman Islands.



# FINANCIAL STABILITY REPORT



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