Financial Stability Committee’s Statement

The Financial Stability Committee (FSC) is pleased to present the second edition of the Financial Stability Report. The annual publication provides a platform to highlight and discuss financial stability issues domestically, as well as global developments, having repercussions on the stability of the country’s financial sector.

Over a decade since the onset of the 2008 global financial crisis, it is now generally accepted that financial stability is a necessary pre-condition for sustainable economic growth and improved social welfare. As members of the FSC, we have been entrusted with the challenging task of maintaining financial stability within the domestic economy. The consultative forum made up of various financial sector regulators and the Ministry responsible for Finance remains committed to identifying and mitigating potential risks to the proper functioning of the Seychelles financial system.

Hence, the financial stability report aims to highlight and communicate these financial stability matters to the public, to create awareness of such issues while promoting transparency. The Report also endeavours to provide an in-depth analysis of the level of resilience of the overall financial sector. Because Seychelles’ financial sector remains primarily dominated by banks, coupled with the fact that there is more readily available data for this sector, other than the insurance industry, the bulk of the analysis will focus on deposit-taking institutions. Nonetheless, as the country’s macro-prudential frameworks are enhanced, and the domestic financial sector becomes more developed and diversified, we will gradually extend the coverage to capture more non-bank financial institutions.

Conscious of the probable threats as well as the potential benefits that will emerge as the jurisdiction taps into the new possibilities, the FSC remains committed to ensuring that the regulatory environment allows for the country to embrace opportunities emerging from innovations in the financial sector in a safe and secure manner, while maintaining financial stability. In this vein, the FSC will continue to focus on identifying, monitoring and taking necessary action to remove or reduce systemic risks, to protect and enhance the resilience of the domestic financial system.

In 2018, the banking industry remained generally resilient to both domestic and external shocks. The sector recorded a robust performance throughout 2018; banks held sufficient capital and adequately managed risks to withstand potential shocks. Similarly, the insurance sector’s performance was also encouraging, as the industry continued to record positive growth. It is important to note, however, that the financial sector also faced several challenges during the year under review. Issues such as de-risking and the associated Correspondent Banking Relationships (CBRs)1, as well as cybersecurity, remained a threat to the country’s financial stability. Potential risks were also identified, emanating from the implementation of a new accounting standard, the International Financial Reporting Standard (IFRS) 9.

Looking ahead, it is evident that the financial sector landscape is continuously evolving. The deepening of the domestic financial sector, coupled with the introduction of new technologies and regulatory standards, are bringing about new opportunities and challenges. Furthermore, the increased complexity and interconnectedness of financial systems globally are potential sources of risks to domestic financial stability.

Financial stability is the condition whereby the financial system, which includes banks, insurance companies and other financial intermediaries, can withstand shocks without significant disruptions2. It is vital that the financial system is able to sustain shocks so that it can continue financial intermediation, providing financial services and supporting sustainable economic growth. Although it is generally accepted that a stable financial system is pivotal for sustainable economic growth, conversely, financial stability is also impacted by developments in the real economy. It should, therefore, be emphasised that economic growth and financial stability should go hand in hand to achieve sustainable development.

The complementary relationship between economic growth and financial stability is becoming more important as global financial markets become more interconnected, and the domestic financial sector deepens, becoming more complex. This is reflected in the broadening range of financial services and products, coupled with the exponential rise in market participants. As a result, the financial system becomes more susceptible to adverse domestic and external shocks. To ensure that the Seychelles financial system remains resilient and able to withstand ever-increasing risks, it is vital that the right regulatory frameworks are in place, both at the micro and macro levels, to allow for the identifying, monitoring and mitigation of systemic risks.

This Financial Stability Report endeavours to assess the key systemic risks to financial stability in Seychelles, including an assessment of the resilience of the financial system and actions being undertaken to remove or reduce such threats. As a small open economy, Seychelles is inherently impacted by developments in the international markets, and this Report provides a summary of global financial stability issues, which were of particular relevance in 2018. The rapid normalisation of monetary policy in the advanced economies, escalating geopolitical events and the continuing global de-risking trend were identified as having the most negative impacts globally. On the domestic front, the global de-risking trend and its implications on CBRs are still ranked highly on the list of potential risks to financial stability. Additionally, cybercrime and cybersecurity issues, which have been on the rise due to advancement in technology, have also been identified as key risks to financial stability. Last but not least, the unsustainability of many State Owned Enterprises (SOEs) and their negative impacts on government budget have also been identified as a rising risk to financial stability.

In line with the national drive to enhance accountability and transparency, the publication of this Report takes another step towards instilling a culture of being transparent and accountable when it comes to matters relating to financial stability. Furthermore, in discussing the main risks faced by the domestic financial sector, as well as highlighting mitigating actions, the Report provides an objective snapshot of the country’s prevailing and foreseeable systemic conditions, which can guide sound policy developments and decision making.

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1 Services allowing banks to provide cross-border transactions to their clients.

2 http://www.cbs.sc/financialstability/MandateAndCommittee.html

Ms Caroline Abel
Chairperson of the Financial Stability Committee
Governor of the Central Bank of Seychelles
2.0 Assessment of Global Financial Stability

Risks to global financial stability increased at the beginning of 2018 compared to the previous year. Although generally conducive to economic growth, global financial conditions continued to tighten, reflecting volatility in the capital markets coupled with growing trade tensions worldwide.

During the first few months of the year, the global financial conditions remained broadly accommodative compared to historical norms, across both advanced and emerging market economies. Amid the improving macroeconomic environment, central banks, particularly in advanced economies, were called upon to gradually continue normalising their monetary policy and communicate their decisions clearly in support of economic recovery. To note that, rising inflationary pressures accelerated the normalisation of monetary policy in the United States (US) where the Federal Reserve has had to raise interest rates at a faster pace than anticipated, leading to tighter financial conditions. This is contrary to the Eurozone, where monetary policy normalisation remained slow.

The second half of the year saw the continued expansion of the global economy, albeit unevenly. In general, the global economic conditions continued to be accommodative and supportive of near-term growth, although the financial conditions in some of the emerging markets somewhat worsened. According to the International Monetary Fund’s Global Financial Stability Report (GFSR), a range of factors was responsible for this development, namely country-specific issues, deteriorating external financing conditions and escalating trade tensions. As a result of the above-mentioned conditions, the growth prospects of the emerging markets have been revised downwards for 2019.

Among the major risks to global financial stability in 2018, the normalisation of monetary policy in advanced economies, escalating geopolitical events and the continuing global de-risking trend were identified as having the most negative impacts on the domestic financial system. The relatively faster normalisation of monetary policy in the US has translated into the strengthening of the US Dollar (USD). Furthermore, rising interest rates have increased the cost of borrowing in foreign exchange. With regards to escalating geopolitical events, uncertainty surrounding the BREXIT negotiations and its potential impact on the European Union and the United Kingdom (UK) remained a global concern. Implications for Seychelles in terms of trade, tourism and development finance are key areas of concern. Other events, including trade tensions between the US and China, also caused uncertainty. This impacted negatively on investor confidence, forcing them to invest in safe haven assets at the expense of developing markets such as Seychelles. The effects of the global de-risking phenomenon, which is one of the new risks to financial stability, remained another pressing concern for the country in 2018. It will be recalled that with rising compliance costs in the aftermath of the global financial crisis there is a growing trend among some global banks to de-risk their customer base and terminate or restrict business relationships with respondent banks perceived to pose too high compliance costs.

3.0 Assessment of Domestic Financial Stability

The domestic financial system was exposed to various risks throughout 2018. Nonetheless, several measures were put in place to mitigate the potential negative impacts of these threats to the country’s financial stability.

The global phenomenon of de-risking and its impact on CBRs remained an issue of concern for the local financial sector during the year under review. Furthermore, cybersecurity and the increasing financial burden of SOEs on government budget were also identified as key risks to financial stability. In addition, 2018 saw the emergence of new threats, emanating from the implementation of IFRS 9.

As mentioned above, over the past few years, financial institutions providing correspondent banking services have adopted a more risk-averse approach, which has resulted in global de-risking. This has impacted the domestic banking industry, whereby some banks have encountered difficulties in sustaining their current CBRs. These issues have an impact on trade and financial flows in an economy, in the event that banks are unable to provide cross-border services. As part of efforts to mitigate the de-risking threat and its impact on the economy, the jurisdiction, through the concerted efforts of relevant stakeholders, was actively engaged in strengthening and seeking additional CBRs worldwide. A coordinated approach is also being implemented to enhance the Anti-Money Laundering (AML) and overall governance frameworks of the country. The initiatives adopted to address the above-mentioned issues are discussed in detailed in Section 4 of the Report which reviews regulatory and legislative developments in the financial sector.

Cybersecurity risk is another pertinent threat with cybercrime being on the rise globally. According to an annual study on ‘Cost of a Data Breach’ sponsored by IBM Security, the global average cost of a data breach in 2018 was US$3.9 million, up by 6.4 per cent over the previous year. According to the same study, the average cost for each lost or stolen record containing sensitive and confidential information also increased by 4.8 per cent year-on-year to US$148. Due to increased reliance on Information and Communications Technology (ICT) platforms, coupled with their increased interconnectedness, the domestic financial system has become more vulnerable to cyberattacks. In light of the dynamic nature of such threats, there is much effort to continually raise the bar to enhance cybersecurity measures as a result of the emergence of new technologies. The high-level commitment of all relevant stakeholders is also vital to bridge the gap and mitigate risks relating to cybersecurity. It is important to note that in the 2018 edition of the Global Cybersecurity Index (GCI), Seychelles was ranked 110th worldwide, compared to 114th the previous year. The index measures the commitment of countries to raise awareness of the importance and different dimensions of cybersecurity. According to the report, Seychelles is grouped among jurisdictions displaying the lowest level of commitment. It is anticipated that the drafting of a Cybersecurity Bill and the various sectoral frameworks will help to better mitigate cyber threats and allow the country to improve its GCI standing.

A key indicator of risks to financial stability emanating from the broader economy relates to the relationship between credit and Gross Domestic Product (GDP). This is depicted by Chart 3.0.1, where the credit to GDP ratio maintained a declining trend from the second half of 2018 onwards. This can be explained by the tighter monetary policy stance adopted during that period as a result of rising inflationary pressures, both domestically and globally. An in-depth analysis on the above-mentioned is provided in the 2018 edition of the Central Bank of Seychelles (CBS) Annual Report.

Chart 3.0.1: Credit to GDP dynamics and trend derived using the Hodrick-Prescott filter

5 A composite index produced, analysed and published by the International Telecommunication Union (ITU) to measure the commitment of ITU Member States to cybersecurity in order to increase cybersecurity awareness
7 For illustrative purposes, a trend line has been added using the Hodrick-Prescott (HP) filter.

The withdrawal of the United Kingdom from the European Union.

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Government finances and the sustainability of government debt are important for overall financial stability. According to an assessment of the country’s sovereign credit rating released by Fitch in June 2018, Seychelles maintained the same BB+ rating with a stable outlook received in 2017. Nevertheless, the country’s external finances and vulnerability to shocks continue to hinder its rating. According to Fitch, “large and persistent current account deficits (averaging 20% of GDP in 2010-2017), high gross external debt (around 100 per cent of GDP) and relatively undiversified sources of foreign exchange (that is, tourism and fisheries) underline Seychelles’ external financing vulnerability”.

In 2018, the government continued to adhere to the commitment of reducing public debt to below 50 per cent of GDP by 2021. As shown in Chart 3.0.2, at the end of December 2018, the aggregate stock of public debt stood at US$862 million, compared to US$900 million at the end of 2017. As a share of GDP, total public debt declined to 55 per cent from 62 per cent the previous year. The drop was primarily driven by a reduction of 5.1 per cent in domestic debt.

Although the government is reducing its overall stock of debt, it is important to note that it still has a sizeable amount of publicly guaranteed debt, as well as potential contingent liabilities. As at year-end 2018, publicly guaranteed debt (mostly domestic) totalled approximately R700 million (3.2 per cent of GDP). In terms of potential contingent liabilities, the main source is non-guaranteed SOE debt, which according to the Public Enterprise Monitoring Commission’s estimate, stood at R2.025 million in the first quarter of 2018. This is estimated to equate to around 9.0 per cent of GDP. Given that the balance sheets of some SOEs are already weak, rising contingent liabilities could further weaken the country’s fiscal position should they be realised, leaving the government to foot the bill. High levels of government debt may result in financial instability by negatively impacting on international investors’ views of Seychelles’ sovereign creditworthiness, resulting in higher refinancing costs. Moreover, a higher stock of public debt means there is a higher probability that it would negatively impact the regulatory capital or Capital Adequacy Ratio (CAR) of banks. Preliminary analysis shows that the adoption of the new accounting standard has contributed towards a R24 million drop in retained earnings for the industry in 2018. The overall impact on CAR is inconclusive at this time, however, specified losses have been booked and the CAR returned lodged; without any transition, banks remained within the regulatory requirements. The implications of the implementation of IFRS 9 will continue to be monitored, and this will be extended to other financial institutions beyond the banking sector.

While various tools are being utilised to assess the resiliency of the banking sector, the changing risks are quantified through a selection of variables within the Ms Muffet Spidergram model (Chart 3.0.3). The model provides an overview of the level of exposure in the last quarter of 2018, in comparison to the same period in 2017. The model maps out five types of risks, while assessing two conditions from the Seychelles perspective.

As of January 2018, IFRS 9 replaced the International Accounting Standard 39 (IAS 39). The latter has been criticised for being backward-looking because banks could only recognise credit losses when there was clear evidence of such. With the implementation of IFRS 9, banks and other reporting entities have to account for impairments on loans (financial asset or instruments) by applying the Expected Credit Loss (ECL) model, contrary to the incurred loss model that was used previously. The ECL model allows for a more forward-looking and timely recognition of loan losses. In addition, it is anticipated that the implementation of IFRS 9 will result in efficient provisioning, reduce procyclicality10 and improve credit risk management, which would enhance financial stability, in the long-run.

From a financial stability perspective, one of the main concerns emanating from the introduction of IFRS 9, is that it would negatively impact the regulatory capital or Capital Adequacy Ratio (CAR) of banks. Preliminary analysis shows that the adoption of the new accounting standard has contributed towards a R24 million drop in retained earnings for the industry in 2018. The overall impact on CAR is inconclusive at this time, however, specified losses have been booked and the CAR returned lodged; without any transition, banks remained within the regulatory requirements. The implications of the implementation of IFRS 9 will continue to be monitored, and this will be extended to other financial institutions beyond the banking sector.

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Ms Muffet Spidergram

‘Ms Muffet’ is a model designed by the IMF to assess changes in four risk categories (macroeconomic, inward spillover, credit, and market & liquidity) and two condition elements (monetary & financial, and risk appetite). Ms Muffet itself is an acronym derived from: ‘MCM Spidergram: a Macro-Financial Environment Tool’

The model can be used to gauge how these components have evolved over two periods of time subject to the availability of the necessary datasets. This model has been designed to allow for a great range of flexibility and allow for the fact that not all jurisdictions will have the entire range of data which this model can make use of. In doing so, it provides for the flexible use of additional information, including the ability to control how this additional data is treated in the model and how it affects other datasets, where relevant and applicable. The outputs obtained from the model is illustrated in Chart 2.0.3.

Note: Away from centre signifies higher risks, easier monetary and financial conditions, or higher risk appetite.

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10 Loan loss provisions are negatively related to GDP growth as economic conditions are key determinant of creditworthiness.
During the year under review, there was an improvement in the overall level of risks faced by the domestic financial system. As indicated by the Ms Muffet Spidergram above, there was a slight reduction in macroeconomic risks at the end of 2018, compared to the same period in 2017. This was primarily due to the improved overall fiscal balance from negative R207 million in 2017 to negative R147 million in 2018. In addition, the external sector side recorded a marked improvement. The country’s current account deficit declined from around 20 per cent of GDP in 2017 to about 17 per cent. This can be explained by the fact that receipts from exports grew faster than import payments, resulting from the good performance of the tourism industry.

Inward spillover risks, on the other hand, recorded a slight deterioration. Although gross international reserves stood at US$549 million at the end of 2018, compared to US$545 million at the end of 2017, this could only cover 3.8 months of imports, which was lower than the figure of 4.2 months recorded at the end of 2017. This was due to strong growth in imports during the year under review.

Market and liquidity risks remained generally unchanged for the period under review. There was a marginal increase in private domestic credit, as a share of resident deposits, from 35.51 per cent in 2017 to 36.05 per cent in 2018. Although there was a rise in overall deposits, the tighter monetary policy stance maintained from the second quarter of 2018 caused the short-term real interest rate to go up, thus minimising the availability of bank credits. In addition, gross foreign liabilities of the sector as a percentage of GDP maintained its upward trend standing at 148.67 per cent at the end of 2018 from 139.53 per cent in 2017, indicative of increased market risks.

Furthermore, the generally tight monetary policy stance mentioned above also meant that risks emanating from monetary and financial conditions decreased significantly at the end of 2018, compared to the same period in 2017. Higher short-term real interest rate resulted in a slowdown in the domestic credit growth from the banking sector, which increased by only 11.54 per cent year-on-year, compared to 17.76 per cent the previous year.

At the end of 2018, the overall risk appetite decreased compared to the same period of the previous year. This outcome was primarily driven by lower investor confidence arising from generally tighter conditions as a higher interest rate environment normally acts as a disincentive to investment.

### 3.1 Assessment of risks to the insurance sector

The Financial Services Authority (FSA) is the regulatory and supervisory body of the domestic insurance market. As at the end of 2018, a total of 14 licensed insurance companies were in operation compared to 13 in 2017. This includes six domestic and eight non-domestic insurance companies. The industry also consisted of 16 brokers, 40 sub-agents and two Principal Insurance Representatives (PIR).

Loans are considered non-performing if the debtor has made zero payments of interest or principal within 90 days, or is 90 days past due.

By nature, the insurance business thrives on efficient risk management. Nonetheless, the peculiarities of the local insurance sector and the country as a whole, give rise to particular risks. As stated in the 2017 Financial Stability Report, limited access to accurate investment valuation has been identified as a critical risk to the insurance sector. In 2018, valuation risk, particularly relating to investments in the real estate sector, remained an area of concern, not only for the insurance industry but for the Seychelles financial sector in general.

Moreover, the potential impact of the above-mentioned valuation risk is amplified since the insurance industry is highly exposed to the real estate sector, particularly in terms of investment. As depicted in Figure 3.1.2 below, in 2017, the investment portfolio of the insurance industry consisted of six components, with the real estate sector accounting for the largest share of 45 per cent of total investments. To note, additional investments include investment-linked insurance plans, wealth management investments plans and minor shares in other companies. Consequently, the insurance sector’s exposure to real estate shocks remains relatively high. In view of this, it is important to note that steps are being taken by the domestic insurance sector to reduce its vulnerability to real estate activities.

### Figure 3.1.2: Investment Schedule

Globally, recent trends have shown that climate change has become a prominent risk to the insurance industry. It is foreseen that an increase in extreme weather events and natural disasters worldwide will negatively impact the insurance business. According to ClimateWise, climate change may lead to growing protection gap, drive up uninsured losses and even make some assets uninsurable. On the domestic front, although the upward trend in weather-related and natural disasters has impacted the insurance market, this has not been on the same scale as what is being experienced in other parts of the world. Nonetheless, it is evident that the industry will have to review its business model to cater for the rise in climate risks.

**Table 3.1.1: Number of Insurance Licensees supervised by the FSA**

<table>
<thead>
<tr>
<th>Types of licences/registrations</th>
<th>2017</th>
<th>2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic Insurance Companies</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>Non-Domestic Insurance Companies</td>
<td>7</td>
<td>8</td>
</tr>
<tr>
<td>Brokers</td>
<td>15</td>
<td>16</td>
</tr>
<tr>
<td>Non-Domestic Brokers</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Agents</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Sub-Agents</td>
<td>37</td>
<td>40</td>
</tr>
<tr>
<td>Principal Insurance Representative (P.I.R.)</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>Insurance Manager</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

**Notes:**
11. Loans are considered non-performing if the debtor has made zero payments of interest or principal within 90 days, or is 90 days past due.

Climate change risks

The environment and the global economy are interlinked and one can have an impact on the other. Consequently, severe climatic changes could affect the economy in several ways, including impacting overall economic activity, workforce productivity or the smooth functioning of the financial markets.

Therefore, climate change poses risks for the stability of the financial system. Climate-related risks arise from the following primary channels or risk-factors:

- Physical risks that arise from climate and weather-related events like storms, floods and droughts, which have the potential to affect the economy.
- Transition risks, resulting from changes in policy aimed at promoting a greener economy (such as the Paris Agreement) and technology (such as the growth in renewable energy), which could mean that some sectors of the economy are impacted by significant shifts in asset values or higher costs of doing business.
- Liability risks (primarily to the insurance sector) relate to threats emanating from claimants seeking compensation for losses incurred as a result of physical or transition risks emanating from climate change.

Figure 3.1.3: Primary channels for climate-related financial risks

Transition Risk
- Disruptive technology advances
- Governments’ climate policies
- Firms in sectors affected by the transition
- Financial Institutions (e.g., Banks, insurers, institutional investors)
- Impact on profit
- Changes in valuations

Physical Risk
- Extreme weather events
- Physical assets, agriculture workers
- Risk to UK financial stability
- Changes in productivity
- Lower asset values
- Changing climatic conditions
- Lower productivity

An analysis of the banking industry’s market concentration using the Herfindahl Hirschman Index (HHI) indicates a decline in the indices for total assets and deposits, which stood at 2,337 and 2,413, respectively, at the end of 2016. However, the HHI for loans and advances maintained an upward trend to stand at 2,476 during the same period. The above-mentioned outcomes based on the HHI suggest that the market structure of the local banking sector remained highly concentrated (Chart 3.2.2). As at December 2016, the three largest banks accounted for more than 80 per cent of the total assets of the banking industry. This was also the case for both the deposit base and loans/advances during the same period.

3.2 Assessment of risks to the banking sector

This section provides a brief overview of some of the key performance indicators in the banking sector, at the industry and country levels, which are of particular relevance to financial stability. It is to be noted that the financial soundness of the individual banks and the industry as a whole are useful measures of financial stability. An in-depth analysis of the banking industry is provided in the Financial Surveillance Report published annually by CBS.

As at end-December 2018, eight licensed banks were operating in the local banking sector, out of which one was conducting solely offshore banking activities. It should be noted that one bank ceased its operation during the year, hence the reduction in the number of operating banks compared to 2017. Another development in this sector in 2018 was the commencement of onshore banking activities by one of the two banks that were conducting offshore banking business.

For the period under review, the banking industry was marked by moderate growth in asset base, reduced credit risk and a marginal increase in profitability, while maintaining adequate capital reserves.

The sector’s asset base observed a year-on-year growth of 10 per cent in 2018, as per Chart 3.2.1, to stand at R21,668 million, equivalent to 99 per cent of the country’s GDP. Two of the main asset components, loans/advances and foreign currency assets, also observed increases of 8.0 per cent and 35 per cent, respectively. The higher growth in the latter is indicative of diversification in the composition of the asset base, which might consequently indicate a higher exposure to foreign currency risk for the industry. Nonetheless, the Net Open Position (NOP), which is a more comprehensive measure of foreign currency risk indicated that the industry’s overall foreign currency risk exposure was generally within acceptable limits throughout 2018. It is worth mentioning that deposits remained the primary source of funds standing at R18,505 million at the end of 2018.

Chart 3.2.1: General banking sector performance indicators

An analysis of the banking industry’s market concentration using the Herfindahl Hirschman Index (HHI) indicates a decline in the indices for total assets and deposits, which stood at 2,337 and 2,413, respectively, at the end of 2016. However, the HHI for loans and advances maintained an upward trend to stand at 2,476 during the same period. The above-mentioned outcomes based on the HHI suggest that the market structure of the local banking sector remained highly concentrated (Chart 3.2.2). As at December 2018, the three largest banks accounted for more than 80 per cent of the total assets of the banking industry. This was also the case for both the deposit base and loans/advances during the same period.

15 Figures for this sector are based on audited data unless otherwise stated.
16 http://www.cbs.sc/Publications/SupervisionReports.html
17 In Seychelles, banks are licensed under a single licensing regime, through which onshore and offshore banking activities can be conducted under the same licence.
18 Figures are based on audited data.
19 The Herfindahl Hirschman Index is a common measure of market concentration, which is also used to determine market competitiveness. It is computed by summing the squares of the market share of each bank. The index takes into account the number of firms in the market and incorporates their respective market share. To interpret the result of the index the following common level of concentration are utilised: an index between 100 and 1000 points the market concentration is low, 1000 to 1800 points the market is moderately concentrated and an index above 1,800 points the market is highly concentrated.
Given the country’s liberalised foreign exchange market, the banking industry is exposed to foreign currency risk through its lending portfolio, among others. The latter arises from the foreign currency denominated loans held by banks. One measure of exposure to this risk is the foreign currency denominated loans to total loans ratio, which stood at 24 per cent at the end of 2018. This ratio has remained above 20 per cent for the past five years, as depicted by Chart 3.2.3. It is noteworthy that movements in the international foreign exchange market, as well as changes in interest rates, are driving factors of foreign currency risks. As stated earlier in the Report, the normalisation of monetary policy, namely in the US, meant that the SCR maintained a depreciating trend vis-à-vis the USD, hence increasing the overall foreign currency risk.

The asset quality of the banking sector, which is an indicator of its vulnerability to credit risk is measured by the percentage of NPLs to total loans ratio. As at the end of December 2018, total NPLs stood at 3.4 per cent of total loans, which is a significant decline when compared to the 2017 figure of 6.30 per cent. This drop was attributed to a movement in the industry’s NPLs, specifically a decline in loans/advances classified in the loss category driven by one bank. Nonetheless, the contraction in the above-mentioned ratio does not necessarily imply a reduced risk to the loan portfolio or improvement in credit quality.

For the year under review, the five sectors dominating the banks’ NPLs were government at 25 per cent, private household at 16 per cent, trade at 10 per cent, real estate at 6.6 per cent and tourism at 5.9 per cent. As illustrated by Chart 3.2.4, tourism and private household have remained among the five sectors with the highest NPLs for the past five years. It is important to note that a significant reduction was observed in NPLs for the tourism sector, which stood at R16 million for the year 2018, compared to R102 million for the year 2017. This is consistent with the positive performance of the tourism industry during the review period.

In terms of sectoral credit concentration, at the end of 2018, the banking industry had the most exposure to the following five sectors: private household (17 per cent), tourism (14 per cent), mortgage loans (13 per cent), trade (10 per cent), and building and construction (8.2 per cent). To note, credit is classified according to the economic activity that the output will be engaged in. For example, the construction of a new tourism project (restaurant or hotel) will be classified under tourism and not under building and construction as would be the case in the credit analysis in the CBS Annual Report. As can be observed in Chart 3.2.5, three sectors; tourism, private household and mortgage, remained among the top five sectors benefitting from the highest amount of loans/advances over the past five years. The credit concentration risk of the tourism sector is amplified by the industry’s vulnerability to external shocks and dependence on visitor arrivals. Additionally, the rapid expansion of the tourism industry in recent years has led to more competitive market conditions, which consequently increases the credit risk of the tourism industry. The banking sector also has a fairly significant exposure to the mortgage sector, which is characterised by large value facilities coupled with generally long tenors, which increase the industry’s sensitivity to credit risk.

For the year under review, the sectoral credit concentration stood at 26 per cent, tourism at 16 per cent, real estate 10 per cent, private household 9 per cent and building and construction 8 per cent. As illustrated by Chart 3.2.5, tourism, mortgage and private household have remained among the top five sectors in terms of loans held by banks. One measure of exposure to this risk is the foreign currency denominated loans to total asset ratio which is a significant decline when compared to the 2017 figure of 6.30 per cent. This drop was attributed to a movement in the industry’s NPLs, specifically a decline in loans/advances classified in the loss category driven by one bank. Nonetheless, the contraction in the above-mentioned ratio does not necessarily imply a reduced risk to the loan portfolio or improvement in credit quality.

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Overall, amid the various challenges, the banking sector remained profitable. The Return on Asset (RoA) and the Return on Equity (RoE) stood at 3.0 per cent and 29 per cent, respectively. Both ratios remained close to the average over the last five years with the RoA averaging at 3.0 per cent and the RoE at 32 per cent. The main contributing element to the movement in the two ratios is the profit before tax, which observed a marginal growth of 1.0 per cent year-on-year.

Banks operating in Seychelles are required to maintain a minimum CAR of 12 per cent. During the year under review, the banking industry remained adequately capitalised. Although a drop of 3.0 per cent was observed in the average CAR, the sector remained above the minimum regulatory requirement of 12 per cent standing at 21 per cent year-end. As illustrated by Chart 3.2.6, the industry has maintained a CAR that is above the required minimum, throughout the preceding five years averaging at 23 per cent.
Risk-weighted assets, which is the denominator of the CAR, indicates the assets and their respective risk levels. Chart 3.2.7 provides an overview of the industry’s assets and their respective risk-weight for the preceding five years. For the year 2018, the total risk-weighted assets for credit risk recorded a year-on-year increase of 15 per cent. The increase was associated with a growth in assets classified under the 20 per cent, 50 per cent and 100 per cent risk bands, while a drop was reported in the 0 per cent risk band. These movements indicate that banks are being exposed to more credit risks. Nonetheless, the CAR recorded for the period under review shows that the industry has adequate capital reserves to cover for the additional exposure.

With an investment portfolio of R3.0 billion as at year-end 2018, SPF is the largest institutional investor in Seychelles. An analysis of the investment portfolio of SPF shows that it is heavily exposed to the real estate sector, which accounts for 50 per cent of the overall portfolio. Standing at R1,486 million and with an average return of 7.0 per cent, the real estate sector remains a key source of investment for the pension fund. Nonetheless, the SPF investment portfolio is not diversified enough, which makes it highly vulnerable to the real estate sector. Consequently, SPF did not purchase any properties in 2018, in line with its new investment strategy adopted in 2017, which is aimed at reducing investments in real estate and put more focus on equities and fixed income, as a means of investment diversification.

Over the years, SPF’s investment has been predominantly domestic-oriented. With a change in strategy, the aim has also shifted to broaden and diversify the asset base and overall geographical mix of its investment portfolio. As a result, SPF has invested over R228 million in overseas equities. The investments are primarily in fixed income instruments, private equities and listed equities on the international stock exchange, which cumulatively account to 8.0 per cent of the total investment portfolio. Nonetheless, investing abroad comes with various types of risks. One of the main exposures arising from foreign investments relates to currency risks emanating from changes in the price of one unit of the SCR relative to another currency. Given that international securities and stock markets are generally more developed than their local counterparts, they tend to be more liquid and are generally marked to market. The higher liquidity allows for easy liquidation of investments at lower costs; however, the marked to market element increases volatility as well as risks.

Similar to many pension funds worldwide, SPF is also facing sustainability challenges emanating primarily from demographic developments, namely decreasing birth rates and rapidly increasing life expectancy. As depicted by Chart 3.3.2 above, currently, contributions are more than sufficient to fund retirement benefits, due to surpluses accumulated over the years, although the actual surplus has dwindled due to higher pension payments. However, this is expected to change in the future. As SPF operates a ‘pay-as-you-go’ scheme, it is forecasted that in future, the number of contributors will be less than the pensioners, who are living longer and increasing in numbers. In addition to financial sustainability, the adequacy of pension benefits is another issue which needs attention. It is equally important that the pension paid out is at a level which allows for a decent standard of living during retirement.
4.0 The Robustness Of The Domestic Financial Infrastructure

This section reviews regulatory and legislative developments in the banking and insurance sectors, as well as financial markets, both domestically and internationally. It also provides an update on the National Risk Assessment (NRA) and its main findings, followed by the Mutual Evaluation of Seychelles’ Anti-Money Laundering and Counter Financing of Terrorism (AML/CFT) framework, which was conducted by the Eastern and Southern Africa Anti-Money Laundering Group (ESAAMLG). The implementation of IFRS9 is also discussed.

The first NRA\(^2\) on Money Laundering and Financing of Terrorism (ML/FT) conducted by the local authorities took place in 2016. The assessment was undertaken using an NRA methodology developed by the World Bank, and the comprehensive report was released in July 2018.

According to the findings of the assessment, the country’s overall ML threat is ranked as Medium High, inclusive of both domestic and foreign ML threats. With regards to the assessment of the national vulnerability, it was found that generally, the country has a strong legislative and regulatory framework, but there is low law enforcement activity. Therefore, the national vulnerability was rated as High because opportunities exist for the financial and the non-financial sector to be used to launder the proceeds of crime. With a low capacity to deal with the threats, primarily due to resource constraints, it was concluded that the overall sectoral vulnerability should be rated as High. In light of the above-mentioned ML threats and vulnerabilities, the assessment concluded that the overall ML risk for Seychelles is rated as Medium High, while the potential threat level in respect of TF risk is rated as Low, as there are no reported cases of TF, to date.

The ESAAMLG conducted the second Round of Mutual Evaluation of Seychelles’ AML/CFT framework, from November 20 to December 5, 2017, and the outcomes were published in September 2018. As per the Mutual Evaluation Report (MER),\(^2\) Seychelles successfully passed the Financial Action Task Force’s (FATF) Quality and Consistency Review process. A position which was adopted by the ESAAMLG Council of Ministers in September 2018. Based on the results of the MER, Seychelles is now under the Enhanced Follow-up Process; and is therefore expected to frequently provide follow-up reports to highlight progress being made.

As part of efforts to address the issue of de-risking, CBS issued a guideline on the governance and management of CBRs in 2018, requesting banks to maintain at least two CBRs for the three major currencies; namely USD, Euro and British Pounds. The guideline is aimed at limiting the effects of de-risking and ensure that banks can continue to provide cross-border transactions. Furthermore, CBS initiated negotiations with the Crown Agents Bank based in the UK, a financial institution providing correspondent banking services, to offer this facility to the banks in Seychelles as well as CBS. This initiative aims to assist banks in establishing the minimum of two CBRs as per the above-mentioned guideline.

To facilitate the adoption of IFRS 9, and to cater for the additional requirements that the accounting rule entails, on April 5, 2018, CBS issued its guidance, which primarily focuses on provisioning for credit risks and accounting for expected credit losses. As per the guidance, banks and other institutions are required to:

- Have equitable policies and procedures, internal controls and applicable accounting frameworks in line with IFRS 9 requirements and applicable laws and regulations set by the CBS.
- Provide adequate and relevant disclosure notes in the audited financial statements regarding the change in classification and measurement of their financial instruments.
- Have policies and procedures that should appropriately validate models used in assessing and measuring expected credit losses, especially in the provision for instruments with significant increase in credit losses.

The NRA is a process of self-evaluating the ML/TF risks in a particular jurisdiction and analysing the main sources and drivers of the risks in order to develop effective and risk-based policies and actions, and allocate available resources in the most efficient way to eliminate, control and mitigate the identified risks to Seychelles.

\(^{2}\)The report analyses the level of compliance with the FATF 40 Recommendations and the level of effectiveness of Seychelles’ AML/CFT system, and provides recommendations on how the system could be strengthened.
5.0 FINANCIAL SECTOR RESILIENCE

Employing the use of scenario analysis, the resiliency of the financial sector is tested based on several plausible 'what if?' situations. Accordingly, the resiliency of the banking sector is reviewed bi-annually using the Čihák\(^{22}\) stress test model. This is to verify whether the banking system can withstand different levels of economic shocks. The scenarios are built based on assumptions, using future potential shocks, at the same time considering past events that may disrupt the financial system, either in part or holistically. It is worth noting that the results illustrated in the report are not bank-specific but are shown collectively. Nonetheless, the impact on the sub-set of foreign banks will be presented. Similar to the 2017 Financial Stability Report, the focus will be on credit risks\(^{23}\) due to the nature of the banks’ operations but will also introduce an element of liquidity testing. To note, foreign banks are privately-owned financial institutions of which the parent companies are based in a foreign country. As at end December 2018, seven foreign-owned banks were licenced by CBS.

The results provide CBS with guidance in adopting relevant policies to minimise the impact on the banks if a crisis was to occur. The model tests whether banks are adequately capitalised in the event of a shock, therefore emphasising on the commercial banks’ CAR ratio. As stated above, the statutory requirement for CAR is currently set at 12 per cent. This is above the international norm of 8.0 per cent set by the Basel Committee to ensure that banks are sufficiently capitalised to withstand any economic shocks. Prudently, CBS has increased the requirement by 4.0 per cent for banks to have an additional buffer in place to cope with any adverse events. Five stress test scenarios were conducted as outlined below.

**Scenario 1: Under-provisioning (Credit risk)**

The Financial Institution (Credit Classification and Provisioning) Regulations, 2010, was assumed to be maintained during 2018, prior to amendments reflecting changes in line with the implementation of IFRS 9. The statutory provisioning rates are as shown in column 1 of the Table 5.0.1. For stress testing purposes, provisioning rates were amended (column 2) assuming there was a change in provisioning regulation.

<table>
<thead>
<tr>
<th>Required provisioning rates (per cent)</th>
<th>Assumed provisioning rates (per cent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pass loans</td>
<td>1 per cent</td>
</tr>
<tr>
<td>Special mention loans</td>
<td>5 per cent</td>
</tr>
<tr>
<td>Substandard loans</td>
<td>25 per cent</td>
</tr>
<tr>
<td>Doubtful loans</td>
<td>50 per cent</td>
</tr>
<tr>
<td>Loss loans</td>
<td>100 per cent</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Assumed</td>
</tr>
<tr>
<td></td>
<td>Provisioning rates (per cent)</td>
</tr>
<tr>
<td></td>
<td>0 per cent</td>
</tr>
<tr>
<td></td>
<td>2 per cent</td>
</tr>
<tr>
<td></td>
<td>10 per cent</td>
</tr>
<tr>
<td></td>
<td>20 per cent</td>
</tr>
<tr>
<td></td>
<td>50 per cent</td>
</tr>
</tbody>
</table>

In addition to the first assumption, haircut on collateral and impact on the Risk-Weighted Assets (RWA) was set at 100 per cent. Of note, the term haircut is used to denote a reduction that is assumed to the value of the assets being used as collateral for the credit facility. In this case, the assumption was that the value of the collateral would be fully wiped out, which is a very worst case scenario but in practice is very unlikely to be the case in most plausible scenarios.

The outcome showed a minimal impact on the CAR, as the overall banking sector was well above the minimum requirement of 12 per cent. A decrease in CAR by 0.2 percentage points from 21 to 20 per cent was observed for the whole sector, while foreign banks were less affected, as the ratio declined by only 0.1 percentage points.

\(^{22}\) The model used is one which has been devised by Martin Čihák

\(^{23}\) Credit risk can be described as the risk of loss from default by debtors whereby future cash flows to pay current debt is highly unlikely.
Scenario 3: Sectorial Shocks to NPLs

A more granular approach to increased NPLs was considered to assess the impact on specific sectors. This included the below sectors with the following percentage changes.

- Health up by 25%
- Real estate up by 10%
- Tourism up by 50%
- Private household up by 30%
- Mortgage loans up by 10%

The sectors were chosen due to their engagement within the domestic economy. Furthermore, the provisioning rate was maintained at 100 per cent, with an adjustment to the weights for housing loans from 50 to 100 per cent. The result of the stress test demonstrates that whilst the CAR of foreign banks stood at 12.8 per cent (80 basis points above the required level), state-owned banks were more adversely impacted. Conclusively, the combination of both ultimately lowered the overall CAR of the entire sector below the regulatory requirement.

Scenario 4: Combination of shocks (Credit risk)

The fourth scenario included a combination of the shocks featured in the previous scenarios. This included the amended assumed provisioning rates in Table 5.0.1, in addition to a 100 per cent haircut on collateral. Credit growth was also maintained at 10 per cent, while NPL on existing performing loans was increased by 20 per cent, with an additional provision of 50 per cent. The same sectors were also hit with similar growth in NPL, as assumed in scenario 3.

The adverse impact on the banking sector was slightly greater than the result obtained for scenario 3. Foreign banks retained a CAR of above 12 per cent, but the overall banking sector’s ratio went below the requirement (11 per cent).

Scenario 5: Failure of the 5 largest exposures

The last scenario for credit risk was that the 5 largest exposures of the banks were assumed to default on their loans. This was done under the presumption that tourism and government revenues would deteriorate, along with 100 per cent provisioning and 100 per cent haircut on collateral.

This had a more severe impact on the banking sector’s capital. The overall sector’s CAR dropped below the minimum requirement settling at 11 per cent and 10 per cent for the whole sector and foreign banks, respectively.
Scenario 6: Simple liquidity test

The sixth scenario determined the liquidity status of the industry in an unfavourable economic condition, testing the impact on a bank’s ability to meet its short term obligations. This may occur from a sizeable deposit withdrawal from a Domestic Systemically Important Bank (D-SIB) or all banks simultaneously. This may trigger a fire-sale of assets, which in turn, may cause prices to fall instantaneously. The liquidity test assumed that withdrawals were carried out at all banks. The impact was assessed over a five-day period to identify whether banks can sustain the number of withdrawals per day. The banks’ assumed withdrawal rates for the different deposit categories are featured in Table 5.0.2.

In addition to the above assumption, the liquid and other assets available in a day was set at 10 per cent and 2.0 per cent, respectively. To note, demand deposits on Table 5.0.2 comprises of checkable and savings deposits.

The impact on liquidity was at a minimal as the banks managed to meet their daily obligations.

Table 5.0.2: Withdrawal rates

<table>
<thead>
<tr>
<th></th>
<th>Domestic</th>
<th>Foreign</th>
</tr>
</thead>
<tbody>
<tr>
<td>Demand deposits</td>
<td>10%</td>
<td>5%</td>
</tr>
<tr>
<td>Time deposits</td>
<td>10%</td>
<td>5%</td>
</tr>
</tbody>
</table>

In addition to the above assumption, the liquid and other assets available in a day was set at 10 per cent and 2.0 per cent, respectively. To note, demand deposits on Table 5.0.2 comprises of checkable and savings deposits.

Table 5.0.3: Results under scenario 6 - Liquidity risks

<table>
<thead>
<tr>
<th>Liquid Stress Test</th>
<th>All Banks</th>
<th>Foreign Banks (FB)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Day #1</td>
<td>LIQUID</td>
<td>LIQUID</td>
</tr>
<tr>
<td>Day #2</td>
<td>LIQUID</td>
<td></td>
</tr>
<tr>
<td>Day #3</td>
<td>LIQUID</td>
<td></td>
</tr>
<tr>
<td>Day #4</td>
<td>LIQUID</td>
<td></td>
</tr>
<tr>
<td>Day #5</td>
<td>LIQUID</td>
<td></td>
</tr>
</tbody>
</table>

The impact on liquidity was at a minimal as the banks managed to meet their daily obligations.

6.0 CONCLUSION

Overall, Seychelles’ financial system is assessed to be generally sound and resilient, from a financial stability perspective. Key indicators, namely credit growth and capital adequacy, remained within acceptable limits, in 2018.

While risks stemming from the macroeconomic environment, and global threats such as de-risking and cybersecurity remain, the primary threats relate to the financial sustainability of some SOEs and their potential impact on government finances and ultimately, financial stability.

Nonetheless, the resilience of the overall financial system is being enhanced through the implementation of several initiatives. New legislations are being drafted, coupled with sectoral guidelines to address cybersecurity risks. Steps have also been taken to tackle the threat posed by de-risking, by prioritising the need to have adequate CBRs. Risk mitigation is to be achieved by moving towards risk-based supervision and through the adoption of codes of conduct in the banking and insurance sectors, respectively, with the ultimate aim of having a more robust financial architecture.

As the domestic financial landscape continues to evolve and new risks emerge, it is vital that all relevant stakeholders adopt a more concerted approach to address risks associated with financial stability in the country.

24 Systemically Important Bank (SIB) is a bank whose failure might trigger a financial crisis. In this context, the banks with the highest volume of deposits are considered.