Highlights of the Macroprudential Report for *June 2018*

October 2018

FINANCIAL STABILITY DEPARTMENT

Preface

Bank of Jamaica frequently conducts assessments of the resilience and strength of the financial system. These financial system stability assessments inform the Bank's macro-prudential policy decision making. This report provides highlights of those assessments for the reporting quarter. The document is organized according to five objective assessment areas, the analysis of which utilizes leading and coincident indicators relevant to the specific type of vulnerability. The aim of the report is to:

1. *Convey Bank of Jamaica's financial system stability assessment.*
2. *Make clear the link between the Bank's assessment and any policy action taken.*
3. *Provide information on matters related to financial system stability.*

Table of Contents

Overview: 8
Objective 1: Mitigate and prevent excessive credit growth and leverage 8
Objective 2: Mitigate and prevent excessive maturity mismatches and market illiquidity 8
Objective 3: Limit direct and indirect exposure concentrations 9
Objective 4: Limit the impact of interconnectedness and systemic importance 9
Objective 5: Strengthen the resilience of the financial system 10

Overview:

During the June 2018 quarter, risks to financial stability remained low. The reduction in the Government of Jamaica's debt and the accommodative monetary policy stance influenced a continued downward trend in domestic interest rates and strong holdings of liquid assets by banks.

Against this backdrop, the financial system demonstrated continued expansion of domestic credit during the quarter. Coincident indicators of systemic risk associated with the financial cycle, have not signalled excesses. Financial institutions have not demonstrated any significant extension in their financial leverage. In addition, despite the steady uptick in private sector debt levels, household and non-financial corporate entities' overall debt-burden are assessed as sustainable.

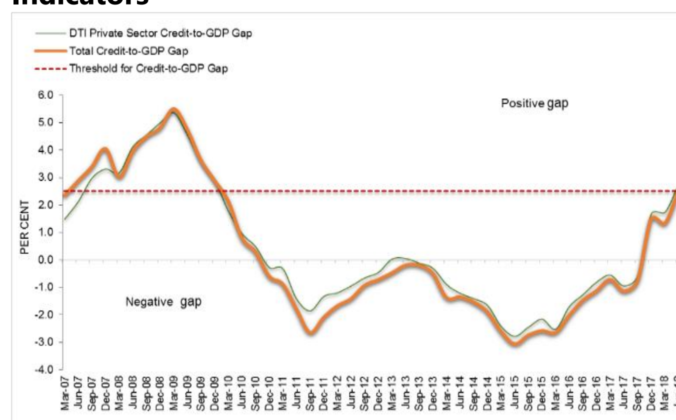
Objective 1: Mitigate and prevent excessive credit growth and leverage

1.0 Total credit including corporate bond issues increased by 7.0 per cent for the review quarter, injecting approximately $59.5 billion additional private sector debt financing in the system compared to the previous quarter.[1] This resulted in an annual percentage growth of 25.7 per cent compared to the 19.5 per cent annual growth recorded in the first quarter of 2018. Notably, private sector credit also experienced a substantial increase, with $31.1 billion in additional credit extended relative to the previous quarter. Private sector credit also recorded an annual point-to-point growth rate of 23.4 per cent for June 2018 in comparison to 19.7 per cent annual growth for March 2018.

1.1 These credit developments occurred against the backdrop of a more favourable credit environment for borrowers. Based on Bank of Jamaica's Credit Conditions Survey, there has been a steady easing of lending conditions since 2015, reflected in increases in the allowable maximum loan-to-value and maximum debt service ratios.

1.2 In identifying the financial cycle, the credit-to-GDP gap indicators demonstrated persistence in the expansionary phase in Jamaica's credit environment. The *total credit-to-GDP gap* indicator increased to 2.5 per cent for the June quarter of 2018 (see Chart 1.0).

Chart 1.0 Evolution of Credit-to-GDP Gap Indicators



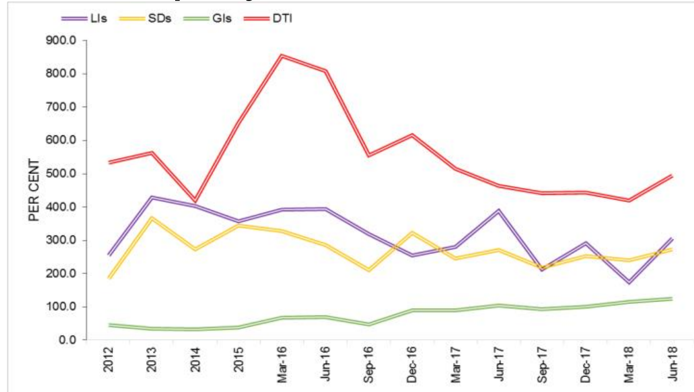
Objective 2: Mitigate and prevent excessive maturity mismatches and market illiquidity

2.0 For the June 2018 quarter, the ratio of average liquid assets to average prescribed liabilities for DTIs showed improvement for the June 2018 quarter relative to June 2017. When assessed relative to liabilities due within 30 days, there was a marginal reduction in liquidity coverage across the DTIs and Non Deposit Taking Financial Institutions (NDTFI) sectors.

[1] Private Sector Credit is comprised of deposit-taking institutions' (DTIs') loans and advances to the private sector excluding credit to overseas residents and other financial institutions. Total DTI Credit used to calculate the credit-to-GDP gap, is comprised of private sector credit plus corporate securities held by DTIs plus public sector credit. The credit-to-GDP gap indicators measure the deviation of credit-to-GDP variables relative to long-term trends to signal excessive credit risk accumulation.

2.1 For the DTI sector, this outturn resulted from sharper growth in long-term assets relative to long-term liabilities. Similarly, the deterioration in liquidity transformation metrics across the general insurance and securities dealers sub-sectors was due to a greater than proportional growth in short-term liabilities relative to liquid assets (see Chart 2.0).

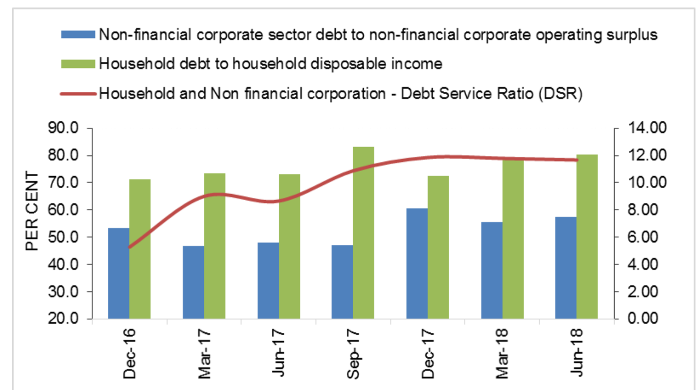
Chart 2.0 Liquidity Transformation[2]



Objective 3: Limit direct and indirect exposure concentrations

3.0 While there was continued expansion in domestic credit, the concentration in credit exposure to households compared to non-financial corporates remained relatively unchanged for DTIs for the review quarter. In addition, debt sustainability measures such as debt to GDP and net financial position to GDP, were relatively unchanged.

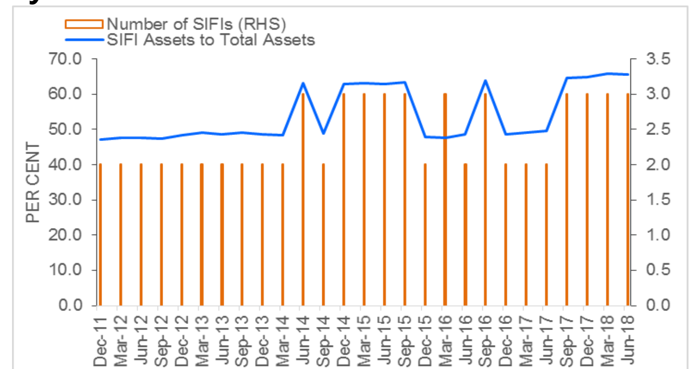
Chart 3.0 Household and NFC Debt Ratios[3]



Objective 4: Limit the impact of interconnectedness and systemic importance

4.0 Regarding measures of systemic importance, the number of domestic systemically important financial institutions (D-SIFIs) remained at three for the June 2018 quarter relative to the previous quarter. At end-June 2018, total SIFI assets as a share of the total assets decreased marginally from 65.7 per cent in the March 2018 quarter to 65.6 per cent (Chart 4.0).[4]

Chart 4.0 Total Assets of SIFI Groups to Total System Assets



[2] (i) Liquidity Transformation = short term liabilities [≤ 30 days] / liquid assets. Liquid assets include high quality liquid assets, such as cash and equivalents, short-term investments and government securities with a 0% risk weight.

[3] Debt service ratio measures the amount of income used for interest payments and amortizations and takes account of the maturity profile of outstanding loans along with the average interest rate per quarter.

[4] The D-SIFI framework currently used by the Bank follows the methodology outlined in Brämer and Gischer (2012), which assesses the significance of banking groups based on four key categories: (1) size, (2) interconnectedness, (3) non-substitutability and (4) complexity. The score for banking group i for period j is computed as follows:

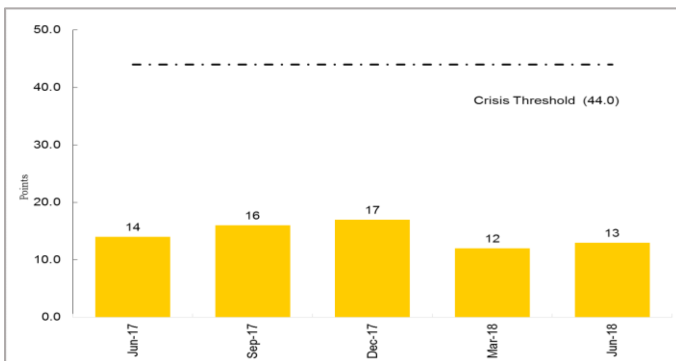
$$SCORE_{ij} = \frac{A_{ij}}{\sum_i^n A_{ij}} + \left(\frac{(LFC_{ij} + DFC_{ij})}{(\sum_i^n LFC_{ij} + \sum_i^n DFC_{ij})}\right) + \left(\frac{(LH_{ij} + LNFC_{ij} + LGG_{ij} + LCS_{ij})}{(\sum_i^n LH_{ij} + \sum_i^n LNFC_{ij} + \sum_i^n LG_{ij} + \sum_i^n LCS_{ij})}\right) + \left(\frac{(TS_{ij} + IS_{ij})}{(\sum_i^n TS_{ij} + \sum_i^n IS_{ij})}\right)$$

where, A represents total resident assets, LFC represents loans to financial corporations, DFC represents deposits from financial corporations, LH represents loans to households, LNFC represents loans to non-financial corporations, LGG represents loans to the general government, LCS represents loans to community service and non-profit organizations, TS represents trading securities and IS represents investment securities.

Objective 5: Strengthen the resilience of the financial system

5.0 The performance of composite indicators of macro-financial conditions was largely similar to that of the previous review quarter. The macro-financial index was 13.0 points at end-June 2018 relative to 12.0 points at end-March 2018, largely reflecting an increase in exchange rate volatility (Chart 5.0).[5] The outturn of the macro composites was largely influenced by stronger global GDP growth coupled with declining domestic interest rates, and low inflation.

Chart 5.0 Macro-Financial Index for Banking Sector



5.1 A macroeconomic stress-testing model was used to assess the resilience of the banking sector to macroeconomic shocks. The macro-stress test results showed that the commercial banking sector remained resilient to adverse shocks to the real economy and financial markets. This resilience was due to their strong capital position as well as the sector's ability to generate interest income under all the stress scenarios examined.

[5] The Aggregate Financial Stability Index aggregates microeconomic, macroeconomic and international factors to form a single measure of financial stability. A higher value indicates increased financial stability while a lower value indicates deterioration in financial sector stability.