



Stress Testing on Financial Firms in Trinidad

As the global economic and financial problems continue to steadily filter down to every economy of the world, there is increasing evidence that the woes of the global economy have reached the shores of Trinidad and Tobago. Indeed, financial institutions in Trinidad and Tobago can learn from the mistakes that resulted from the near collapse of financial systems across the world so as to prevent the same impact on the domestic economy. The first sign of trouble in the domestic financial system was the liquidity troubles of the powerful CL Financial Group, which accounts for over 25% of Trinidad's and Tobago's GDP. The need for a government bailout highlights flaws in the regulatory framework of financial institutions in Trinidad and Tobago both in terms of the inadequacy of legislation, insufficient monitoring and decisive actions not taken when the warning signs appeared.

During 2002–2007, Trinidad and Tobago's GDP growth averaged 9%; per capital income doubled in U.S. dollar terms; both the unemployment rate and the public debt ratio were halved; and the country has acquired one of the strongest credit ratings in the region. With the global economic outlook continuing to deteriorate at a disturbing rate, lower global energy prices and falling US demand, the government will be forced to scale back its ambitious public investment program, which it considers essential for the long-term development of the country. Evidence of this general pessimistic view on the Trinidad and Tobago economy can be seen in the Central Bank forecasting real GDP growth of 0% - 1% in 2009, compared to an estimated expansion of 3.5% in 2008. The slowdown in the country's GDP will inevitably impact upon the financial markets in Trinidad and Tobago.

The CL Financial Group in Trinidad and Tobago; Bank of America, AIG, GM, Citigroup, Lehman Brothers and Bear Stearns in the United States were all companies once thought to be stable, secure and unfaltering. However, many have faltered and some have even failed. The US government has approved credit lines and loans to AIG of US\$180 billion, the auto industry US\$25 Billion, Citigroup US\$280 billion, Bank of America US\$142.2 Billion and in Trinidad and Tobago government has lent CL Financial an estimated US\$1.75 billion in an effort to stabilize these institutions. These companies with their vast assets in the world economies have had their weaknesses exposed with errors in financial products built, and inappropriate lending practices leading to significant losses.

In the United States the Fed has decided to utilize a bank stress test to look at the banks' financial strength to see if they can stay afloat in difficult times. It basically seeks to answer the question 'will the bank or financial institution fail if the economy worsens and bank difficulties increase'?

Banks have always had to provide information to regulators, and they've probably run scenarios themselves to manage risk. Unfortunately, in the absence of a common methodology for stress testing, financial institutions use different analysis and different criteria. It is expected that this new stress test methodology will evaluate how banks will do in a worst-case-scenario. According to the methodology used by the Fed, 19 banks were asked to project estimated losses on loans, mortgage securities and other packaged products, including off-balance sheet positions estimated for 2009 and 2010 based on the adverse forecast in a "stressed economic environment."(Wall Street Journal). Figure 1 gives an indication of the expected losses in some sectors in a worst-case scenario, while Table 1 shows the results of the stress test conducted by the Fed.

Figure 1: Expected losses under a 'more adverse scenario'



Source: CNNMoney.com

Table 1: Results of Stress Test

Bank	Total assets	Market value	Worst-case loss estimate	Capital needed
Bank of America	\$1.6 trillion	\$86.5 billion	\$136.60 billion	\$33.90 billion
Wells Fargo	\$1.1 trillion	\$105.1 billion	\$86.10 billion	\$13.70 billion
GMAC ¹	\$172.7 billion	\$225 million	\$9.20 billion	\$11.50 billion
Citigroup	\$996.2 billion	\$21 billion	\$104.70billion	\$5.50 billion
Regions Financial	\$116.3 billion	\$3.6 billion	\$9.20 billion	\$2.50billion
SunTrust	\$162 billion	\$6.6 billion	\$11.80 billion	\$2.20 billion
Morgan Stanley	\$310.6 billion	\$29.4 billion	\$19.70 billion	\$1.80 billion
KeyCorp	\$106.7 billion	\$3.4 billion	\$6.70 billion	\$1.80 billion
Fifth Third Bancorp	\$112.6 billion	\$3.1 billion	\$9.10 billion	\$1.10 billion
PNC	\$250.9 billion	\$19.8 billion	\$18.80 billion	\$600 million
JPMorgan Chase	\$1.3 trillion	\$132.4 billion	\$97.40 billion	\$0

Source: CNNMoney.com

The stress test entails assuming a scenario that banks and financial institutions view as the worst possible economic news, and then calculating if they've got the capital reserves to cover projected losses under that scenario. In Trinidad and Tobago the importance of establishing a common stress-testing model for financial institutions of varying sizes and risk profiles is paramount and a regulatory framework for the financial sector of each country that ensures we do not fall into the same problems which the Unites States experienced.

Fears have been quelled somewhat because of the strength of the banks in Trinidad and Tobago, which can be attributed to the stability in the banking system and financial sector. However, factors like the recent collapse of the financial corporations across the world and the need for the government to intervene in certain local institutions still make an argument for Trinidad and Tobago banks to adopt a common methodology of stress testing. Despite the favorable ratios and reserves among financial institutions there is still a need for stress testing the banks and financial institutions to capture the scenario of a deep Trinidad recession or other world issues that could affect the financial fabric of Trinidad's Economy.

Table 2 shows forecasts for some key economic indicators for Trinidad and Tobago, which can be used in formulating some of the assumptions for a possible stress test of the Trinidad and Tobago banking sector.

Table 2: Key Economic Forecasts for Trinidad and Tobago**Forecast summary**

(% unless otherwise indicated)

	2007 ^a	2008 ^a	2009 ^b	2010 ^b
Real GDP growth	5.5	3.5	0.9	1.9
Industrial production growth	6.5	4.1	-0.1	1.8
Gross agricultural production growth	-6.0	-6.5	-1.5	1.1
Unemployment rate (av)	4.5 ^c	5.5	7.9	7.1
Consumer price inflation (av)	7.9 ^c	12.0 ^c	6.3	7.6
Consumer price inflation (year-end)	7.6 ^c	14.5 ^c	3.8	8.6
Short-term interbank rate	11.8 ^c	12.4	9.5	9.5
Central government balance (% of GDP) ^d	1.8	1.2	-1.6	-1.0

Source: Economist Intelligence Unit

What are the key questions to be asked to conduct a Trinidad and Tobago banking sector stress test? What if unemployment rises to 7 % or close to or over 10%? Home prices in Trinidad have not seen the rapid drop as in US but prices have decreased, so what if home prices plunge? Another realistic question is what if overall economic growth drops from the expected growth of 0%-0.9% to negative growth? These results will reveal how much more capital the banks really need to stay solvent and keep lending. A downturn would make it harder for consumers and businesses to repay loans, which would cause banks' assets to lose value. These tests would give the transparency necessary for the public to judge the strength of the financial system.

All these possible scenarios at one point would have been thought impossible with a booming economy, high oil and gas prices and huge amounts of foreign currency hitting our shores. But we have seen the fall of some of the world's strongest economies and unparalleled credit events and these should be lessons for banks in Trinidad and Tobago. Stress testing can help in the country's preparedness for any financial catastrophe which may ensue.

FINANCIAL & ECONOMIC INDICATORS

As at 14 May, 2009

<u>Exchange Rate/US\$</u>	<u>Closing Value</u>	<u>Previous Week</u>
Yen	95.80	99.12
Euro	1.36	1.34
Jamaica	88.99	88.85
Guyana	204.40	205.20

<u>Commodity Prices</u>	<u>Closing Value</u>	<u>Previous Week</u>
Crude oil (US\$/bbl)	58.62	56.71
Natural Gas (US\$/mmbtu)	4.08	3.95
Gold (US\$/Troy Ounce)	926.50	910.70

Eurobond Indices (As at 14-May-09)

Lehman Brothers Global Aggregate Index (Return % YTD)	-0.48
JP Morgan EMBI+ (Basis points)	506
JP Morgan Central America and Caribbean Index (CACI) (YTD return %)	14.07

<u>Policy Interest Rates (%)</u>	<u>Closing Value</u>	<u>Previous Week</u>
United States	0-0.25	0-0.25
Euro Zone	1.00	1.00
Japan	0.09	0.11
Brazil	10.16	10.25
Trinidad	8.00	8.00
Jamaica	17.00	17.00
Barbados	3.00	3.00

<u>Market Interest Rates (%)</u>	<u>Closing Value</u>	<u>Previous Week</u>
US 90-day T-Bill	0.15	0.18
US 10-Yr Treasury	3.09	3.34
3-month UK Libor	1.37	1.43
Japan 90-day T-Bill	0.37	0.38
Brazil 90-day T-Bill	10.03	9.70
TT 90-day T-Bill	2.32	2.32
Jamaica 90-day T-Bill	19.82	19.82
Barbados 90-day T-Bill	3.92	3.92

Sources: Bloomberg, CMMB, Central Bank of Trinidad and Tobago, Bank of Jamaica, Central Bank of Barbados, www.lehman.com

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