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Cayman Islands: Off-Shore Financial Center Assessment Update—Assessment of Financial Sector Supervision and Regulation

This Assessment of Financial Sector Supervision and Regulation on the **Cayman Islands** was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed in October 2009. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of the Cayman Islands or the Executive Board of the IMF.

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CAYMAN ISLANDS

ASSESSMENT OF FINANCIAL SECTOR SUPERVISION AND REGULATION

Prepared by the Monetary and Capital Markets Department

Approved by José Viñals

October 2, 2009

This report is based mainly on information obtained during a mission from March 2 to 13, which reviewed developments in the supervisory and regulatory framework since the first Offshore Financial Sector assessment mission in October 2003, and on subsequent consultations with the authorities.

The team members comprised Ms. L Effie Psalida (Head), Mr. Mariano Cortés (both IMF), Mmes Su Hoong Chang (consultant, insurance sector) and Tanis MacLaren (consultant, securities and investment funds), and Mr. Richard Pratt (consultant, banking).

The main findings of the OFC assessment update are:

- Substantial progress has been made in the implementation of the 2003 OFC assessment recommendations, including, importantly, regarding CIMA's independence and resources.

- To strengthen its risk-based approach to supervision, CIMA should conduct formal risk assessments and focus its supervisory efforts more directly on the key risks facing the jurisdiction such as reputational risk. Regarding consolidated supervision, CIMA should formulate a robust framework for supervising licensees cross-sectorally to help prevent regulatory arbitrage or supervisory gaps.

- Formalizing and validating the assumptions underlying CIMA's supervisory approach that relies on overseas supervisors and domestic professionals will strengthen CIMA's reliance approach to supervision, but it does not necessarily mitigate all the risks to the Cayman Islands.

- There is scope for enhancing regulatory reporting and disclosure requirements by financial entities, such as shortening the period for filing required documents; and requiring all insurers to disclose their use of derivatives and similar commitments regularly.

The AFSSR is a summary report on implementation of the indicated financial sector regulatory standards. It has been developed to help jurisdictions identify and remedy weaknesses in financial sector supervision and regulation. The reviews do not directly assess risks such as those associated with asset quality, markets, or fraud that could affect the soundness of financial systems or individual institutions.

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ACRONYMS

AML	Anti-Money Laundering
BCP	Basel Core Principles for Effective Banking Supervision
CFT	Combating the financing of terrorism
CI	Cayman Islands
CIMA	Cayman Islands Monetary Authority
CSX	Cayman Islands Stock Exchange
DNFBP	Designated nonfinancial businesses and professions
EU	European Union
FATF	Financial Action Task Force
GN	Guidance Notes
IAIS	International Association of Insurance Supervisors
ISD	Investment and Securities Division of CIMA
IOSCO	International Organization of Securities Commissions
KYC	Know Your Customer
LEG	IMF Legal Department
OFC	Offshore Financial Center
MAL	Monetary Authority Law (2008 Revision)
MCM	IMF Monetary and Capital Markets Department
MFL	Mutual Funds Law (2007 revision)
MLR	Proceeds of Criminal Conduct Money Laundering Regulations, 2003
NAV	Net Asset Value
SIBL	Securities Investment Business Law (2004 Revision)

Executive Summary

The 2009 OFC assessment update took place in the context of an ongoing global financial crisis whose aftermath could pose challenges to the Cayman Islands.

Substantial progress has been made in the implementation of the 2003 OFC assessment recommendations. The assessment had noted that the implementation of financial regulation and supervision was broadly in line with international standards. Its main recommendation included increasing the independence and resources of CIMA, formalizing appropriate supervision and discipline enhancing transparency, modernizing the Mutual Funds Law, and the introduction of appropriate solvency requirements for insurers. CIMA has made considerable progress toward implementing cross-sectoral recommendations as well as in the banking and the investment funds and securities areas, but some actions remain to be taken in the insurance area.

CIMA has adopted a risk-based approach to supervision, but needs to broaden the approach by conducting a full risk assessment. So far, CIMA's implementation of a methodology to rate individual financial institutions has not been placed in the context of an overall risk assessment that takes account of the unique features the financial system in the Cayman Islands (e.g., very large number of banks without a physical presence; the large number of captive health insurance companies). Thus a system-wide risk assessment by the CIMA Board is recommended. Such an assessment should anchor CIMA's implementation of risk-based supervision, i.e., focus its supervisory regime more directly on the key risks facing the jurisdiction.

On supervision, CIMA in part relies on the work of overseas supervisors, highly skilled financial service providers, e.g., external auditors, lawyers, insurance managers, and other professionals. This reliance-based approach may be appropriate provided there is a full understanding of the relevant home and host regulatory systems and all parties have a common understanding of their responsibilities. To this effect, CIMA needs to draw up specific agreements with each home supervisor that make clear which risks are addressed by which supervisor according to whose rules, with the understanding that bilateral agreements do not provide full-proof mitigation of risks to the Cayman Islands. CIMA should also review for consistency the reporting obligations of auditors, actuaries and insurance managers and their legal immunities, and, where necessary, document their expectations of such professionals.

CIMA has the necessary authority to supervise and enforce the regime but some enhancements might be warranted. The powers granted to CIMA should be consistent across the various statutes it administers, e.g., on the issuance of compliance orders. To provide a more credible deterrent, increasing the monetary penalties that CIMA has the authority to apply would also be helpful.

The Cayman Islands' regulatory framework for the investment funds and securities markets exhibits high levels of implementation of the IOSCO Principles but some enhancements might be warranted. Implementation of electronic filing of mutual fund reports is an important efficiency and transparency enhancement, but the filing period could usefully be shortened.

CIMA has initiated a review of its licensing and solvency regimes for insurance companies that could facilitate implementation of more risk-based supervision. At present, CIMA's approach to the supervision of all Class B insurers—comprised primarily of captives—has initiated a risk-rating framework. Class B insurers with high risk rating and those placed on a watchlist are monitored more closely. A threshold level is not established for Class B insurers to be regulated as captives. A more calibrated regulatory and supervisory approach that takes into account the wide range of risk profiles of the different types of Class B insurers will strengthen CIMA's supervision of the sector. An effective implementation of a risk-based solvency regime inter-alia calls for an appropriate regulatory reporting framework, market-consistent valuation of assets and liabilities, appropriate asset concentration and counterparty limits, and suitable forms of capital.

CIMA has made commendable efforts to strengthen its AML/CFT framework but, as in other financial centers, risks remain. In particular, guidance notes changes have emphasized the importance of ensuring that introducers have adequate due diligence systems covering all customers, and the ongoing monitoring of customer accounts requirements and the ban on business with shell banks have been recently enshrined in law. There remain risks arising from the legacy of customers accepted before these provisions were brought into effect. CIMA will need to focus on enforcement to ensure that practices are brought rapidly into line with requirements.

Current levels of staff are considered adequate by CIMA but the implementation of the mission's recommendations may call for additional resources. CIMA needs to review periodically the adequacy and quality of its human resources to facilitate the effective implementation of risk-based consolidated supervision. CIMA has emphasized its own commitment and that of the government to providing the resources needed. This is highly encouraging.

The government, CIMA and the industry need to keep abreast of international developments to ensure that the regulatory regime in the jurisdiction incorporates appropriate elements of international best practice. CIMA's continued sharing of information and cooperation with other regulatory authorities is key to the jurisdiction's continued growth, particularly given the current global context. Recent changes to Cayman legislation on co-operation, MLRs and other supervisory requirements are welcome steps in that regard.