

Rating

Rationale



Eastern Caribbean Home Mortgage Bank

USD 30 million Debt Issue (Notional)	CariAA	(Regional Scale Foreign Currency)
	CariAA	(Regional Scale Local Currency)

Analytical Contacts:

Arjoon Harripaul
Tel: +1-868-627- 8879
E-mail: aharripaul@caricris.com

Sherry Ann Persad
Tel: +1-868-627 8879
E-mail: spersad@caricris.com

RATIONALE SUMMARY

Caribbean Information and Credit Rating Services Limited (CariCRIS) has re-affirmed the ratings of *CariAA* (Foreign Currency Rating) and *CariAA* (Local Currency Rating) on its regional rating scale to the debt issue (notional) of the size of USD 30 million of Eastern Caribbean Home Mortgage Bank (ECHMB). These ratings indicate that the level of creditworthiness of this obligation, adjudged in relation to other obligations in the Caribbean¹ is **high**.

The ratings on ECHMB continue to reflect the Bank's low credit risk business model, excellent asset quality and its status as a regional financial institution with support from the premiere financial institution in the Eastern Caribbean Currency Union (ECCU). Also supporting the rating is the highly experienced and qualified management team that is well supported by a reputable Board of Directors (BOD). Additionally, ECHMB's operational and underwriting systems are strong, underpinned by its

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¹ The term Caribbean as used here covers the following countries: Bahamas, Barbados, Belize, Costa Rica, Dominican Republic, Guyana, Haiti, Jamaica, Panama, Suriname, Trinidad and Tobago and the following countries in the OECS: Anguilla, Antigua & Barbuda, Dominica, Grenada, Montserrat, St. Kitts & Nevis, Saint Lucia and St. Vincent & the Grenadines. Refer www.caricris.com for a more detailed explanation on CariCRIS ratings and rating definitions.

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legislative and operational framework. The ratings are tempered by the challenging market conditions and relatively high liquidity in a couple of markets contributing to a fair degree of geographic asset concentration. In addition, there are constraints on ECHMB's resource-raising ability via public issues by competition from both corporates and sovereigns in the ECCU.

The "with recourse" feature of the mortgages purchased by ECHMB ensures the pool has 100% performing loans as any mortgage in default for three (3) consecutive months is either replaced with a performing loan or the Primary Lender (PL) is called upon to realise the security constituted by such mortgage. Consequently, the business model is characterised by low credit risk leading to excellent asset quality. Also contributing to the low credit risk of the business is the stringent adherence to the policy guidelines for both mortgages and PLs. These requirements are monitored by ECHMB on a continuous basis while on-site surveillance at all PLs is conducted annually. The strength and resilience of the financial system in the ECCU also lends support to the low credit risk business model.

ECHMB's credit risk profile is not constrained by any one sovereign as its operating domain is the eight (8) participating member countries of the Organisation of Eastern Caribbean States (OECS) region. Its shareholding is spread throughout the wider Caribbean region with its largest shareholder, the ECCB, holding 25%. This affiliation with the ECCB has enabled the Bank to enjoy synergistic benefits including drawing on the expertise and experience of the ECCB Governor who has held the position of Chairman of the Board since its inception in 1996.

Both the management team and the BOD are well respected, highly qualified and possess vast experience in the financial and business community within the OECS and wider Caribbean region. The Chief Executive Officer (CEO) also has vast international experience in a number of industries. The Bank has generated profits since its inception and has paid dividends from its third year of operations.

ECHMB's underwriting and operational systems are strong, underpinned by its legislative and operational framework. Both operational and underwriting procedures are well documented and are stringently adhered to, contributing to the low credit risk of the business. The underwriting process is of international standard and ECHMB provides training for professionals in the mortgage industry throughout the region to maintain these high standards. However, some of these guidelines were relaxed on specified occasions, with BOD approval, on the condition that these exceptions would be resolved within a fixed time frame.

The financial performance of the Bank has been modest, with marginal growth in profits and total income, while return on assets (ROA) averaged 1.5% in the last three years. The company's dividend payout ratio continues to be aggressive averaging 49% of profits attributable to shareholders in the last three years. Despite the challenging environment, management had always been able to maintain a positive interest rate spread of at least 2%, as stipulated in its operational policy.

These rating strengths are tempered by the following:

In the last couple of years, the ECCU's financial sector has been characterised by high liquidity (though declining), increased competition in the mortgage market and erosion of mortgage yields creating challenging conditions for ECHMB's operations. Consequently, the Bank's mortgage portfolio is concentrated in four markets: Saint Lucia which accounted for 24%, Anguilla 22%, St. Vincent and the Grenadines 20% and Antigua and Barbuda 15% as at December 2008. Additionally the Bank is a price taker in the financial markets in which it operates; interest rates for mortgages purchased and bonds issued are market determined. ECHMB's customers are exclusively the indigenous financial institutions in the region as the internationally owned banks have used alternative sources for liquidity management.

ECHMB's resource-raising ability via public issues has been constrained by the simultaneous placements of sovereigns in the ECCU region, evidenced by the under-subscription of its June 2007 issue. The limited pools of investors have focussed on yields which tend to be higher for sovereign issues. Additionally, the unpredictability in timing of sovereign placements as well as the market distortions emanating from above average returns offered by some large regional financial institutions poses challenges for ECHMB. In order to mitigate this risk the Bank has been exploring alternative funding sources. To this end, the Bank secured its first loan from the Caribbean Development Bank (CDB) on favourable terms in FY2008.

DETAILED RATIONALE

Low credit risk business model leading to excellent asset quality

ECHMB's business model is underpinned by a "with recourse" feature for all mortgages purchased for its portfolio from PLs leading to low credit risk and excellent asset quality. The asset base which is predominantly mortgages (90% of total earning assets as at December 2008) comprises only performing loans in its portfolio. All thirty six (36) mortgage pools from the fifteen (15) PLs (as at December 2008) are monitored on a daily basis and any mortgage which has been in default for three consecutive months is either replaced with a performing loan, or the PL is called upon to realise the security constituted by such mortgage. As a result the mortgage pool always consists of 100% performing loans leading to excellent asset quality. In addition, the PLs are contractually obliged to remit mortgage payments to ECHMB on the 28th day of every month whether or not the PL has received payment from the mortgagors, further enhancing the low credit risk model. CariCRIS believes the maintenance of the "with recourse" feature is critical for the business model's low credit risk.

To mitigate potential credit risk in its mortgage pool ECHMB conducts due diligence on every mortgage to ensure strict adherence to the criteria listed in its policy guidelines. Some of the attributes that must be met are as follows: all mortgages must be residential, owner occupied properties, the value of the mortgage loan must not exceed EC \$1 million and the property must be secured by a first lien (second charges are allowed under specified circumstances). With respect to the terms of the mortgage; the maturity must not exceed 30 years, the maximum loan to value ratio must not be in excess of 90% and all properties must be insured, unless otherwise approved by the BOD. Additionally, the PLs are legally obligated to review all variable rate mortgages in ECHMB's purchased pool at least every six months and advise mortgagors of any change in the interest rates subject to ECHMB's approval. CariCRIS believes this right to re-price is critical as a risk mitigation tool in a declining interest rate scenario.

While stringent adherence to the operating policy guidelines significantly reduces exposure to the credit risk of individual mortgage holders, ECHMB is exposed to the credit risks of the PLs. To mitigate this risk, the Bank strictly adheres to a list of criteria that must be met by the PLs. These criteria are as follows: capital adequacy of EC \$3 million and a capital to asset ratio of not less than 8%, must be subject to the regulations of an approved regulatory body, must have operational experience and expertise in loan underwriting and administration of at least three years and must agree to submit to

periodic audits and reviews of its mortgage underwriting process. Additionally, all PLs must commit to improve and maintain mortgage underwriting standards via prescribed training. The PLs must also maintain proper mortgage security documentation and a minimum delinquency ratio within its mortgage portfolio. In addition to annual on-site visits, ECHMB continuously monitors the PLs to ensure the above requirements are met. The relationship with the PLs is governed by a legally constituted “sale and administration” agreement. The Bank has declined applications by financial institutions that have not met the stipulated requirements.

ECHMB’s current business environment is a definite source of credit strength. The banking system in the ECCU has been relatively resilient to external shocks, experienced strong growth the last few years, and continues to be highly liquid, with a capital adequacy ratio of 19.2% in 2007 well above prudential norms. Additionally, non-performing loans (NPLs) to total loans have declined to 2.5% as at December 2007 but, CariCRIS expects NPLs to increase as the global recession deepens. It is also noteworthy that there have been no bank failures in the ECCU since the establishment of the ECCB in 1983. However, the recent financial upheaval (Stanford Financial Group and CL Financial Group) has introduced some uncertainty in the regional financial and business community.

In FY2008, ECHMB increased the geographical reach of its mortgage portfolio from five to seven countries with its entrance into Anguilla and Montserrat, thereby reducing its geographical asset concentration. The mortgage portfolio comprises St. Vincent and the Grenadines (231), Saint Lucia (230), St. Kitts and Nevis (149), Anguilla (90), Antigua and Barbuda (75), Montserrat (46) and Grenada (43) as at December 2008.

Regional financial institution with support from the premiere financial institution in the ECCU

ECHMB is a regional player; its shareholders comprise sixty three (63) financial institutions domiciled throughout the Caribbean region, whilst its mortgage market is the eight member countries of the OECS (excluding the British Virgin Islands – BVI). The Bank’s credit risk profile is not linked to or constrained by any one sovereign as its mandate is to buy and sell mortgages in the eight participating member countries of the OECS, though currently it only has business in seven. As a regional player, the Bank has the advantage of borrowing in lower cost markets and investing in markets with higher yields which contributes to its earnings.

The OECS region's premiere financial institution, the ECCB, is ECHMB's largest shareholder accounting for 25%. ECHMB's affiliation to the ECCB provides synergistic benefits for its operations particularly with respect to its bond issues. Additionally, it has also benefited from the experience and expertise of the ECCB's Governor who has held the position of Chairman of the BOD since ECHMB's inception. This association has increased the competitiveness of ECHMB's bonds in the regional capital market as investors have linked the risks of the two institutions. However, there is no formal support mechanism available to the ECHMB from any of its shareholders.

Highly experienced and qualified management team well supported by a reputable Board of Directors (BOD)

The management team is highly qualified and possesses extensive experience in the financial and business community within the OECS and the wider Caribbean. The CEO, who assumed the position in June 2007, has extensive international experience in a wide array of industries. Apart from the Manager, Research and Marketing (tenure of 7.5 years), the rest of the management team is relatively new with tenure ranging from 1 to 3 years. The Manager, Mortgage Underwriting has vast experience in commercial lending practices in Saint Lucia.

The BOD is also amply qualified, highly regarded and have extensive experience in the financial and business community within the region and internationally. The management team is well supported by the BOD as all major decisions (inclusive of bonds issued and the purchase of pools of mortgages over EC \$3 million) require Board approval.

The management team has been able to generate and grow profits from its first year of operations. Asset growth was marginal over the financial years 2004 – 2007. Over the last 21 months to December 2008 the CEO has adopted a much more aggressive strategy resulting in a considerable increase (249%) in the mortgage portfolio. There is ample opportunity for ECHMB to grow its mortgage portfolio as its currently represents around 10% of the indigenous banks' mortgage portfolio of EC \$1.9 billion (as at December 2008). Additionally, ECHMB's foray into the credit union sector provides another avenue to grow its mortgage portfolio. CariCRIS expects that the mortgage portfolio will continue to grow but at a more moderate pace in light of the current financial environment.

The strategic focus for management in the medium term is to create a greater presence in the market, expand its product line, increase its activity in the capital market and improve the mortgage underwriting standards in the region.

Strong operational and underwriting systems emanating from strict adherence to legislative and policy guidelines

ECHMB's strong risk management systems are underpinned by its legislative and operational framework. The legislative framework provides broad guidelines for both the management and BOD. All major transactions undertaken by management require Board approval, for example, the purchase and sale of mortgages over EC \$3 million. The daily operations are guided by the "policy statement of general and operational policies" which was updated in October 2007. This policy statement (first developed by the IFC as a shareholder) lists all the criteria requirements for selection of both the mortgages purchased as well as PLs. CariCRIS believes ECHMB's stringent adherence to the policy statement with respect to criteria requirements for the mortgages and PLs have added to the low credit risk of the business.

ECHMB's manual of mortgage underwriting standards governs selection and review of mortgages as well as the due diligence of the PLs. Prior to the purchase of each mortgage, ECHMB's staff conducts due diligence to determine whether all the criteria listed in its operational policy are met for the PLs, borrowers and mortgage loans. In addition to the criteria for the mortgage and PLs, the following are examined for the borrower: the applicant's sources of income, total income, credit history, debt to income ratio (which should not exceed 40%) and the valuation of the mortgaged property.

ECHMB ensures that these international underwriting standards are maintained in the industry by conducting Mortgage Underwriting Seminars in conjunction with the Canada Mortgage and Housing Corporation (CMHC) and the Real Estate Institute of Canada (REIC), along with local and regional resource persons. These seminars target all financial players in the mortgage industry and afford participants the opportunity to gain an internationally recognised qualification – Certified Residential Underwriter (CRU). To date, about 200 professionals from the ECCU, Barbados and Jamaica have attended the training modules with more than 50 attaining the CRU designation. To maintain standards, PLs are obligated to ensure that all mortgage underwriters become professionally certified.

Adequate insurance coverage is also a critical component of its underwriting standard and is used as a risk mitigation tool by the Bank. All PLs must have blanket fidelity and errors and omissions insurance which protects ECHMB from any errors made by PLs' staff. In addition, all mortgage loans purchased for ECHMB's pool must have life insurance covering the loan balance. The purchased pool of mortgages must also have peril insurance on the mortgaged property in an amount equal to the principal balance of the loan or the replacement cost of the mortgaged property whichever is less. CariCRIS believes these high underwriting standards contribute significantly to the low credit risk of the business.

Moreover, ECHMB continuously monitors the mortgage pools with a lag of one day, whilst PLs are obligated to report any changes to the pools as soon as they occur. In FY2008, the Mortgage Interface System was implemented at four of the fifteen PLs improving the real time monitoring of the mortgage pools. Management's focus has been on the larger PLs and anticipates this project to be completed by mid 2009. CariCRIS expects that there will be significant strides in the real time monitoring of the mortgage pools further enhancing efficiency following full implementation of the Mortgage Interfacing System. Additionally, the staffing capacity in the Underwriting department has been strengthened.

As occurred on specified occasions in the past, strict adherence to some policy guidelines were relaxed in FY2008 as ECHMB focused on the credit union sector to build its mortgage portfolio. According to management all exceptions to these criteria were brought to the Board and gained approval prior to purchase. These exceptions were granted approval on condition that the PLs work together with ECHMB on resolving the various issues within a fixed time frame. This situation was deemed necessary to facilitate business opportunities in the credit union sector.

Additionally, mortgages which were replaced in the pools (on a continuous basis) were never re-registered in the different countries. As a consequence ECHMB has no legal rights to these mortgages and will have no recourse if the PLs fail. Management has identified this as critical and is currently in the processing of rectifying this situation.

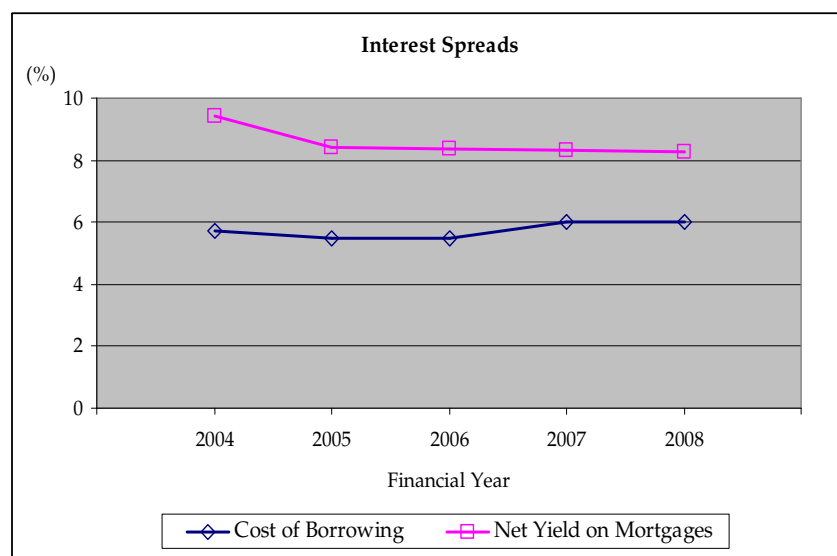
Modest financial performance characterised by marginal growth in profitability

ECHMB has been profitable since its inception twelve years ago. The Bank's tax-exempt status contributes to its profitability. Total income grew marginally with a 3-year CAGR of 3.5% while growth in Net Interest Income (NII) averaged 6.6% over the last four years.

Profits after tax (PAT) have recorded marginal declines since FY2006, falling by 7% in FY2008 to EC \$1.9 million from EC \$2 million in FY2007. ECHMB's ROA has declined steadily in the last four years from 1.9% in FY2005 to 1.2% in FY2008, low relative to banks in the OECS and the wider Caribbean region. Though there has been a marginal decline in its financial performance in the last two years, CariCRIS believes that there will be improvements in the medium term given management's strategy to aggressively grow its mortgage portfolio. In CariCRIS' stressed scenario, assuming that interest spreads between mortgage rates and cost of borrowing decline to 1.6% in FY2009 and 0.6% in FY2010, ECHMB will continue to be profitable with a PAT margin of 0.6%.

The operational policy statement stipulates that the company shall earn a positive spread of at least 2% per annum unless otherwise determined by the BOD. For the period 2003 - 2006 when interest rates fell, ECHMB was able to maintain a 2% spread and in its twelfth years of operations has never earned less than 2%. This has been attained as the average cost of borrowing hovered around 6.2% whilst the average yield on the mortgage portfolio was around 8.5% in 2008 (Chart 1). ECHMB's partnership with the PLs is governed by a legally constituted "sales and administration" agreement through which the PLs consent to administer and service the purchased mortgages for an administration fee. This fee allows ECHMB some degree of flexibility in achieving this 2% minimum spread. In FY2008, the "Sales and Administration Agreement" was amended giving ECHMB the right to reduce the administration fee when interest rates are falling ensuring that margins are maintained.

Chart 1



Source: ECHMB's Financial Statements

The company continues to maintain an aggressive dividend policy which has averaged 49% of profits attributable to shareholders in the last three years. The Bank has paid dividends to shareholders every year since its third year of operations; its first dividend was EC \$7.50 per share. Since 2001 an annual dividend of EC \$10 per share has been paid.

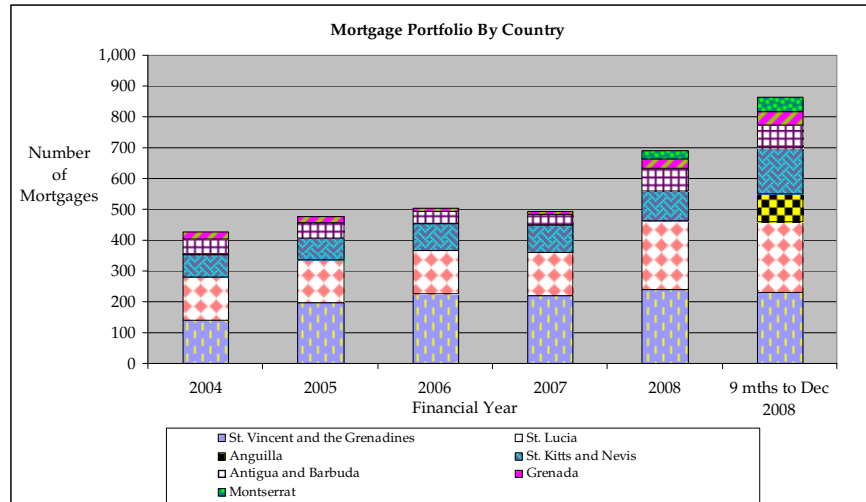
These rating strengths are tempered by the following:

Challenging market conditions with consistently high liquidity in some key markets contributing to asset concentration in three markets

In the last couple of years high liquidity in the ECCU region has led to increased competition in the mortgage market and erosion of mortgage yields creating challenging conditions under which the Bank has to operate. The interest rates on mortgages are at an all time low, with some PLs offering rates as low as 7.25%. The mortgage market has been transformed into a vibrant market where small and larger PLs are actively competing for market share. This intense competition has enabled customers to negotiate better terms and conditions on mortgages, including 100% financing, lower interest rates, cash back and other long-term tangible benefits.

Though its mandate includes eight participating member countries of the OECS, the Bank currently has operations in seven, as challenging conditions in some markets preclude the need for ECHMB's services. High liquidity in Dominica has resulted in low mortgage rates making it unviable for ECHMB to operate in this market. As a result, ECHMB's mortgage portfolio is highly concentrated in four territories: Saint Lucia which accounted for EC \$41 million (29%), St. Vincent and the Grenadines EC \$36.4 million (26%), Antigua and Barbuda EC \$28.1 million (20%) and St. Kitts and Nevis EC \$18.6 million (13%) as at November 2008. In December 2008, 4 new mortgage pools were obtained from Anguilla totalling EC \$40.3 million, reducing concentration levels (Chart 2). CariCRIS expects concentration levels to decline further as management seek to diversify the mortgage portfolio.

Chart 2



Source: ECHMB – Underwriting Department

Additionally, refinancing activities have intensified as interest rates have declined posing further challenges for ECHMB. The company has had to implement measures to mitigate these inherent risks to remain competitive. Going forward, ECHMB’s challenge will be to maintain a mortgage pool in which yields are higher than its cost of borrowing.

Furthermore, ECHMB is a price taker in the financial markets for the interest rates of both its mortgage portfolio and bond issues. The average interest rates for the pool of mortgages purchased are market determined in the respective countries. On the financing side, the rates are also market determined, averaging 6.2% over the last year. Evidence of the challenging market conditions was seen in the 16th bond issue (in June 2007) which had a shorter maturity of 2 years to enable the Bank to maintain its yields in a declining interest rate and highly competitive environment.

ECHMB’s operations have also been limited by the size of the indigenous financial institutions’ mortgage portfolios as the internationally owned and managed commercial banks have not used ECHMB’s funding facility as a means of managing liquidity. As at December 2008, the mortgage market in the OECS (excluding building societies, credit unions and insurance companies) was EC \$3.4 billion of which indigenous banks held EC \$1.9 billion. CariCRIS believes there is great potential to continue to grow its business as ECHMB’s mortgage portfolio of EC \$185 million (as at December 2008) represents only 9.8% of the indigenous market, notwithstanding the fact that some of these existing mortgages may not meet ECHMB’s qualifying criteria.

ECHMB's resource-raising ability via public issues is constrained by competition from both corporates and sovereigns in the ECCU

All bonds issued by ECHMB are tax-exempt for both individuals and corporates (up to a maximum of EC \$250 million of total bonds outstanding) within the OECS region making it a relatively attractive investment. Nevertheless, its ability to raise resources via public bond issues is constrained by competition from both corporates and sovereigns in the ECCU. Limited investment funds causes investors to chase after yields which are generally higher from sovereign issues. This was quite evident as ECHMB's last public issue (on June 29th 2007) was undersubscribed by around EC \$10 million when the Government of Antigua and East Caribbean Financial Holdings Company (ECHF) simultaneously placed issues. CariCRIS expects the unpredictability in the timing of sovereign placements to continue to pose challenges for ECHMB. Furthermore, the market is characterised by a limited pool of investors where the purchasers of the bonds are the same as the originators of mortgages, many of whom are also shareholders of ECHMB. This lack of scope in the capital market limits investment opportunities. CariCRIS anticipates that the relatively underdeveloped nature of the regional capital markets will continue to inhibit ECHMB's operations. In order to mitigate these risks the Bank has been exploring alternative funding sources. To this end it accessed its first loan from the CDB on competitive terms in early 2008, with disbursement in 2009. CariCRIS believes the current economic environment, tight credit conditions and uncertainty in the financial markets may also impact ECHMB's ability to access funding in the regional markets.

Rating Sensitivity Factors

- Removal of the "with recourse" feature in mortgages purchased
- Relaxation of the mortgage underwriting standards
- Significant changes in asset concentration
- Significant reduction in interest spreads
- Significant decline in rate of growth in mortgage portfolio

BUSINESS DESCRIPTION

Eastern Caribbean Home Mortgage Bank (ECHMB) was created pursuant to the ECHMB Agreement Act (1995) and commenced operations on April 22nd 1996. Its primary objective is the development of the secondary mortgage market within 8 participating

member countries of the Organisation of Eastern Caribbean States (OECS) namely Anguilla, Antigua & Barbuda, The Commonwealth of Dominica, Grenada, Montserrat, Saint Kitts and Nevis, Saint Lucia and St. Vincent and the Grenadines.

ECHMB is a privately managed corporation and the current sixty three (63) shareholders are strictly financial institutions from the OECS as well as the wider Caribbean. These financial institutions includes the Eastern Caribbean Central Bank (ECCB), commercial banks, social security agencies, insurance companies, mortgage companies, building and loan associations and credit unions. The largest shareholder, the ECCB, holding 25%, is the premiere financial institution in the Eastern Caribbean Currency Union (ECCU). The other main shareholder, CLICO Barbados (accounting for 20%), purchased the shares held by Trinidad and Tobago Home Mortgage Bank in 2007.

The main activity of the Bank is the purchase and sale of mortgages so as to develop and maintain a secondary market for residential mortgages in the member territories. The management is currently focused on increasing its product range and introduced a mortgage origination product for Primary Lenders (PLs).

Table 1
Summary Financial Performance

	9 mths to Dec 2008	FY2008*	FY2007	FY2006	FY2005
	<i>EC \$'000</i>				
Total Assets	208,324	173,170	130,807	129,966	128,670
Equity Capital	10,000	10,000	10,000	10,000	10,000
Tangible Net Worth	19,423	18,601	17,594	16,971	15,719
Total Income	4,377	5,277	4,898	4,998	4,765
Operating Expenses (incl. Depreciation)	2,844	3,387	2,868	2,747	2,378
PAT	1,533	1,890	2,030	2,252	2,387
	%				
Total Expenses/Total Income	65.0	64.2	58.6	55.0	49.9
PAT/Average Earning Assets	0.8	1.3	1.6	1.8	1.9
Tangible Net Worth/Adjusted Assets	9.3	10.7	13.4	13.1	12.2
	<i>Times</i>				
Debt/Tangible Net Worth	9.6	8.2	6.4	6.6	7.1

Source: ECHMB Financial Statements

* FY - Financial Year runs from April to March

April 2009