The Financial System

During a three-week period in July, the financial system's regulatory framework was subjected to a comprehensive examination as a team of International Monetary Fund (IMF) and World Bank consultants conducted Belize's first financial sector assessment programme (FSAP). The focus was on identifying vulnerabilities and assessing the flexibility and suitability of domestic arrangements for managing threats to the stability of the financial system. Arising from the examination were several recommendations for legislative revisions to the Central Bank Act, the Banks and Financial Institutions Act (BFIA)and the International Banking Act (IBA) as well as for the effecting of immediate improvements in standards for commercial bank loan loss provisioning, loan classification and collateral valuation in order to ameliorate systemic risks. Recommendations were also made for the upgrade of the Central Bank's anti-money laundering/combating the financing of terrorism (AML/CFT) supervisory practices and for the preparation of an action plan geared to address balance sheet weaknesses arising from excessive exposure of some commercial banks to large non-performing loans.

Strengthening of Regulatory Framework

Proceeding from this, and in the context of the heightened level of non-performing loans in the banking system, the Central Bank took steps to revise the prudential guidelines in order to bring these in line with international standards and compensate for the elevated risk levels. The purpose of the revisions was twofold: to ensure that in extending future credits, banks will prudently emphasize the financial and repayment capacity of their customers and not place undue reliance on the collateral offered, and second, to ensure that banks that have taken on unusually high levels of risk in the past are carrying the levels of provisions required to absorb potential losses.

The Central Bank consequently issued circulars under Section 81 of the BFIA and Section 45(1) of the IBA that revised the methodology for determining the appropriate classification of loans and other assets, prescribed new procedures for establishing and maintaining loan loss reserves and specified the appropriate accounting treatment of interest on loans and other interest bearing assets. The revised circulars became effective on 1 December 2011. In order to close a legal loophole in the IBA, the Central Bank also issued a circular to prohibit banks from acquiring assets for sale from borrowers in exchange for the settlement of their indebtedness and to require corrective action where any such transaction has already taken place.

The Central Bank also took action with a view to increasing the flexibility of the commercial banks and providing more scope for lending to the private sector on improved terms through a reduction in the minimum interest rate on savings deposits from 3.5% to 2.5% as of 1 October 2011. The domestic commercial banks were simultaneously instructed to calculate interest on the daily available closing balances held in savings accounts rather than on the minimum balance held in such accounts during a designated period, whether monthly, quarterly or annually, as had been the standard practice. In the interest of greater transparency, the commercial banks were also required to disclose their annual nominal and effective interest rates on savings deposits to customers and to the general public.

During the year, additional work was done to complete the draft revisions of the BFIA. Revisions were also done to the model by-laws for credit unions. Several sections of the document including those dealing with deposits, tenure of office and meetings of members were reviewed and discussed with stakeholders and it is expected that a completed draft will be submitted to the Minister for final approval as mandated by Section 16 (1) of the Credit Unions Act by June 2012. In the upcoming year, it will also be necessary to revise the Statutory Rules and Orders or the Credit Union Regulations as commonly known, which date back to 1948 and which are essentially obsolete and no longer beneficial as a tool for promoting the safety and soundness of credit unions.

Supervision Issues

In fulfilment of its responsibility to ensure the safety and soundness of the financial system, the Central Bank undertook on-site examinations of one domestic bank, three international banks and three credit unions during the year. The examinations evaluated statutory compliance, adherence to AML/CFT regulations, institutional viability and prudential performance as it relates to solvency, liquidity, capital adequacy and risk management.

Ten applications for credit facilities that exceeded 25.0% of the banks' paid-up and unimpaired capital and reserves were submitted to the Central Bank in accordance with Section 21(2) of the BFIA. Approval was granted for five facilities that amounted to $38.1mn, as compared to the $70.3mn approved during the previous year.

The Central Bank continued its enhanced monitoring and regulatory oversight with a focus on transparency as well as safe and sound banking practices. To this end, it issued four directives to a domestic bank to address parallel banking practices, the reversal of in-kind shareholding contribution, preservation of capital and restoration of soundness, and large credit restrictions.

In June 2011, the Unit Trust Corporation (Belize) Limited requested and received the Central Bank's permission to voluntarily wind-up its operations. The voluntary winding up process is expected to be completed by 30 June 2012.

As stipulated by law, a Credit Union Appeals Tribunal was established with effect from 1 January 2011. Members were appointed by the Prime Minister and Minister of Finance after consultation with the Belize Credit Union League and will serve for a three-year term.

Domestic Commercial Banks

Notwithstanding the writing off of some $45.0mn in non-performing loans, commercial banks' assets increased by 2.2% during the year with a 20.3% rise in cash and balances due from banks more than making up for a net fall in loans of 0.3%. Non-performing loans crept up by 3.3% even with the loan write-offs. To tackle this head-on while encouraging bankers to focus on the repayment

Chart 4.1: Commercial Banks' Assets, Loans and NPLs

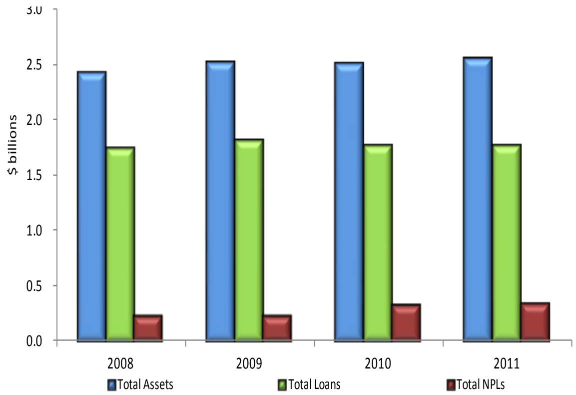


Chart 4.2: Commercial Banks' Capital Adequacy Ratios

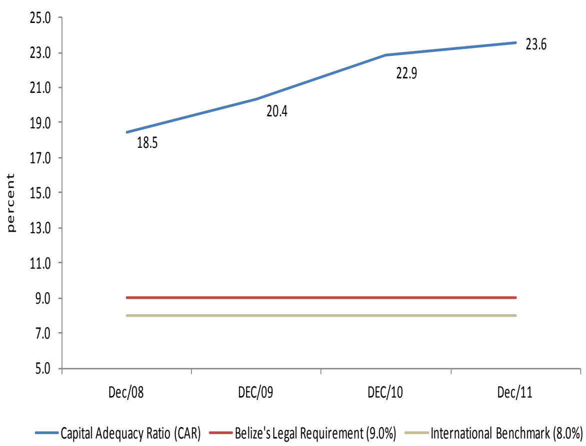
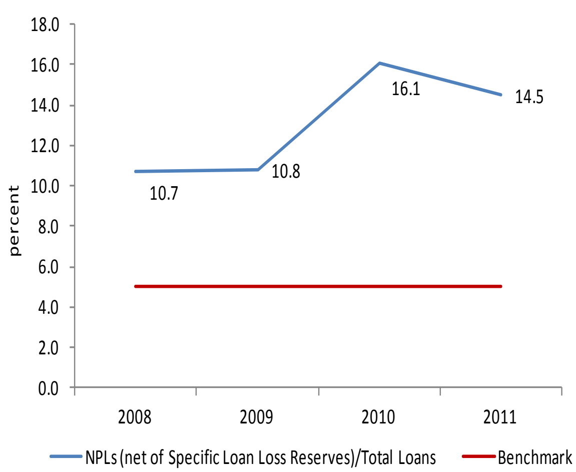


Chart 4.3: Non Performing Loans - Commercial Banks



capacity of borrowers rather than on the value of their collateral, the Central Bank directed the banks to increase their provisions for non-performing loans on 1 December. This was in line with recommendations stemming from the FSAP and brought the system into conformity with international prudential standards. The write-offs and increase in loan loss provisioning reduced the ratio of non-performing loans (net of specific provisions) to total commercial banks' loans and advances from 16.1% in 2010 to 14.5%.

On the liabilities side, deposits rose by 5.2%, and bank liquidity continued on an upward trend. Thus, while customers continued to hold the bulk of their money in time deposits, which comprised 53.9% of all deposits, this represented a reduction from the 60.6% share held at the end of December 2010 as some banks became increasingly reluctant to renew contracts for the more costly time deposits. The share of demand and savings deposits consequently increased to 22.7% and 23.4%, respectively.

Loan write-offs and more stringent loan loss provisions led to a 10.0% decline in the retained earnings of the commercial banks and, as a consequence, their primary capital fell by 2.7%, compared to the 3.6% growth registered for 2010. On the other hand, the capital adequacy ratio (CAR) of the domestic banking system improved by 3.1% to 23.6% due to the said write-offs and increased provisioning, with individual CARs ranging from 10.9% to 53.7% in relation to the mandated legal requirement of 9.0% and the minimum internationally accepted requirement of 8.0%. As commercial banks started the tough but necessary adjustments to deal with the high level of

Chart 4.4: Commercial Banks' Profitability Ratios

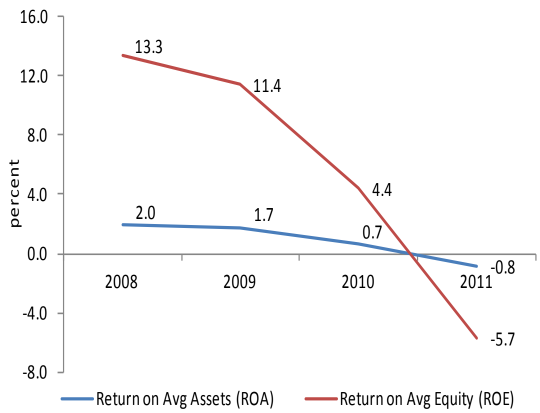


Chart 4.5: Commercial Banks' Efficiency Ratios

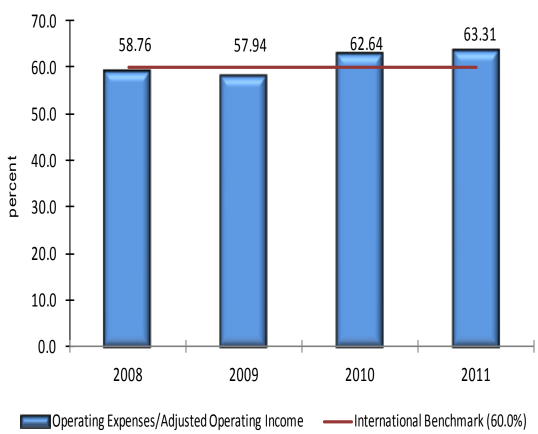
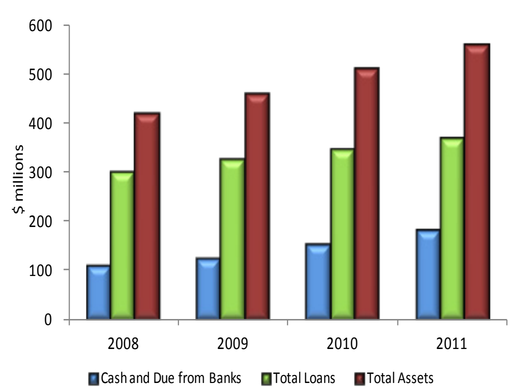


Chart 4.6: Five Largest Credit Unions - Loans, Assets and Cash and Due from Banks



non-performing loans in the system, the banking sector swung from a net profit of $20.7mn at the end of December 2010 to a net loss of $20.8mn. Consequently, return on equity (ROE) and return on assets (ROA) contracted by 5.7% and 0.8%, respectively. There was also an initial spike in expenses that caused the efficiency indicator to deteriorate further from 62.6% in 2010 to 63.3% in 2011, compared to the international benchmark ceiling of 60.0%.

Credit Unions

Unlike the commercial banks, the activity of credit unions was unabated with the five largest credit unions (the Group) recording a 9.8% growth in assets, underpinned by increases of 19.9% in liquid assets (cash and balances due from banks) and 6.0% in loans and advances to customers. While the Group's aggregate non-performing loans rose by 6.9% over the year, their specific loan loss provisions increased by 21.4% and the net result was an improvement in the ratio of non-performing loans (net of specific provisions) to total loans from 4.1% for 2010 to 3.6%. On the other hand, a 25.2% fall in interest income decreased their net profits by 24.9% to $25.0mn and shrank the ROA from 6.9% in 2010 to 4.6% and the ROE from 36.4% to 23.3%

International Banks

Almost on par with the previous year's 23.6% increase, growth in the assets of the international banks was 21.7%, underpinned by a combined increase of 45.2% in cash and balances due from banks and government securities/investments.
As in the previous year, deposits grew by a robust 24.2% to US$461.7mn. Demand deposits accounted for 55.0% and time and savings deposits comprised

Chart 4.7: Five Largest Credit Unions' NPLs

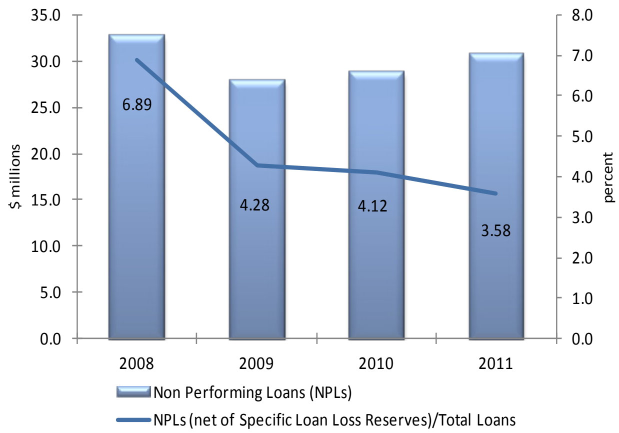


Chart 4.8: Five Largest Credit Unions - Profitability

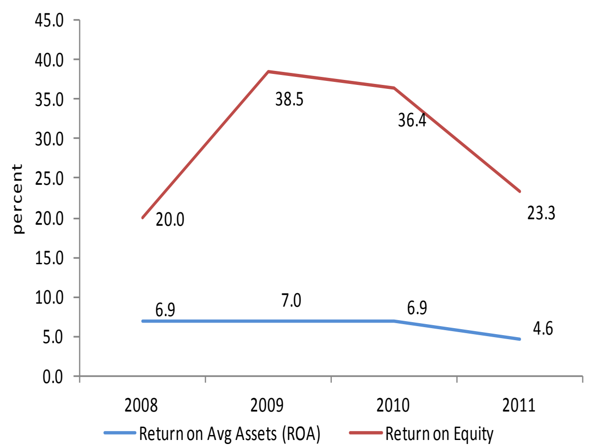
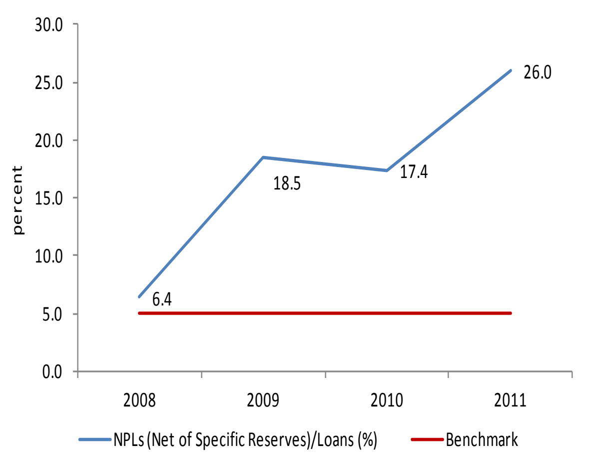


Chart 4.9: Non Performing Loans - Internatonal Banks



23.0% and 16.0%, respectively. Recovering rather weakly from the US$1.0mn decline of 2010, the international banks registered a US$2.3mn increase in total loans over the year. However, the aggregate level of non-performing loans rose by 73.1% (US$30.6mn), causing the ratio of non-performing loans (net of specific provisions) to total loans to worsen from 17.4% in 2010 to 26.0%. Total capital, nonetheless, edged up by 1.8%, resulting in a CAR of 25.6% with individual banks reporting ratios of 14.9% and higher, well above the legal requirement of 10.0% and the 8.0% minimum requirement established by BASEL, the global international standard.

Under pressure from a 9.8% drop in interest income due to the hike in non-performing loans, and a more than doubling in other expenses due to a marked increase in specific loan loss reserves, net income fell by 45.6% to US$6.6mn. ROE and ROA were consequently reported at 7.1% and 1.2%, respectively, with the former being below and the latter being borderline relative to the international benchmarks of 10.0% for the ROE and 1.0% for the ROA.