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CENTRAL BANK OF BELIZE

CREDIT CONCENTRATIONS: A SUPERVISORY PERSPECTIVE

Presented by Manuel G. Vasquez - Director of Banking Supervision - at the Seminar on Financial System Development at the Fort George Hotel, Belize City, 22 and 23 January 1990.

CREDIT CONCENTRATIONS IN FINANCIAL INSTITUTIONS: A SUPERVISORY PERSPECTIVE

Theoretical Background

Experience in other countries suggests that large exposures to a single entity or a connected group are frequent causes of bank failures and difficulties. Supervisory authorities have, therefore, placed particular emphasis on controlling and monitoring large exposures in the supervision of banks. Statutory limitations or specific guidelines on the size of exposures arising from claims on individual or associated customers are applied in a majority of countries usually by relating such exposures to a maximum percentage of a bank's capital. A few countries also impose specific limits on the aggregate amount of individual exposures exceeding a given threshold (eg. a multiple of bank capital), as a means of preventing excessive dependence on a limited number of customers. In France, for instance, the sum of all large loans which exceed 25% of a bank's equity cannot be more than ten times the amount of capital.

In recent years, regulations on loan concentrations have been tightened significantly in a number of countries. In the United Kingdom, for instance, a bank is expected to report to the Bank of England, on a quarterly basis, its ten largest loans (including guarantees) to single borrowers. While there are no statutory

limits on the amount of loans that a bank may extend to any one borrower or connected group, the Bank of England has stated that such loans should not normally exceed 10% of a bank's capital. The Bank of England has further stated that in cases where this 10% guideline is exceeded, it will expect that correspondingly stronger capital adequacy ratios be maintained and that the excess would be subject to thorough examination and justification. In any event, no such exposure should exceed 25% of the capital base of a bank apart from those in the most exceptional circumstances (eg. cash secured or government guaranteed credits). Large exposures were generally to be strongly discouraged.

In the United States, statute [12 U.S.C. 84 (a)(1)] provides that total loans and extensions of credit by a national bank to a person or connected group outstanding at one time and not fully secured by collateral shall not exceed 15% of the unimpaired capital and surplus of the bank. However, state laws could impose different statutory limits on credit exposures of state member banks. Although limitations are imposed by various state and Federal lending limits, as a general rule the three regulatory bodies (Federal Reserve Board, Federal Deposit Insurance Corp., Comptroller of the Currency) consider a concentration of credit to consist of a direct, indirect or contingent obligations aggregating 25% or more of a bank's total equity capital to any one borrower or group of affiliated borrowers.

In recognizing a concentration of credit, it is important to determine the key factors germane to credits within the loan portfolio. Loans concentrated in one borrower are, to a large degree, centered in and predicated on the financial capability and character of that individual or entity. Loans centered in an affiliated group are susceptible to a domino effect if financial problems are experienced by one or a few members of the group. Concentrations within or dependent on an industry (eg. sugar and citrus industries in Belize) are subject to the additional risk factors of external economic conditions which might affect all members of the group.

One concentration of credit which requires good internal reporting and review to ascertain its existence involves loans which may be advanced to a group of borrowers (perhaps unrelated) predicated on the collateral support afforded by the share capital of a corporation. Regardless of whether the issuing entity is a closely-held enterprise or a company whose share capital is widely held, a concentration may exist in the underlying collateral.

Concentrations also occur in banks located in areas economically dominated by one or a few business enterprises. Such banks may grant a substantial percentage of their loans to these enterprises and their employees. Curtailment of operations may result in heavy unemployment where other job opportunities are scarce and cessation

of operations can pose a serious threat to the economy of the entire area. It would be difficult to evaluate the further effects of such a situation on other merchants borrowing at the bank who are heavily dependent on such companies. A clear example of this was the closure of the Libertad Factory of B.S.I. in the Corozal District. It is recognized, though, that concentrations are, in many instances, commonplace and inevitable if banks are to perform the functions for which they are licensed.

It is practically impossible to list all types of concentrations which might exist. The examiner should use informed judgement in deciding the extent of a review to disclose possible concentrations. It would be useful, though, if banks would internally detect and code loans which fall into the various concentration categories and generate reports on outstanding loans in each category.

Statutory Limitation on Credit for Banks in Belize

Section 13(1)(a) of the Banking Act imposes a statutory limit on credit concentrations of 25% of the aggregate of the paid-up and outstanding capital and published reserves of local banks and, in the case of the branches of foreign banks, of their assigned

capital and reserve fund[1] in Belize. Banks wishing to lend in excess of 25% of their equity to any one borrower or group of affiliated borrowers could do so if the Minister of Finance grants his approval after consultation with the Central Bank.

The aforementioned arrangement provides a mechanism whereby banks are allowed to extend credit facilities in excess of the statutory limit of 25% and, indeed, there are now cases whereby banks have been granted permission to lend far in excess of this limit. I do not know what was the underlying objective for the flexibility afforded by Section 13 (1)(a) of the Banking Act which allows banks to exceed the statutory limit. Two possibilities come to mind. Firstly, it was perhaps recognized at the time the legislation was introduced that the banking system in Belize was essentially controlled by the branches of large foreign multinationals. There was only one local bank which accounted for a proportionately small segment of the banking business in Belize. The sheer size of the foreign banks and their capital resources probably influenced the decision of the authorities to provide the flexibility to exceed the 25% (of assigned capital) statutory limit.

Secondly, it could be that the flexibility which allows credit to

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[1] None of the foreign branches are required to maintain reserves in Belize. Section 9 of the Banking Act requires only local banks to build a legal reserve up to at least the level of its paid up and outstanding capital by way of transfers of at least 25% of the annual net profits of the bank.

exceed the 25% statutory benchmark was designed to enable banks to lend to those borrowers whose activities were considered economically (and perhaps socially and politically) desirable.

The view has also been expressed that the process of applying for ministerial permission to exceed the 25% lending limit was deliberately designed to be cumbersome with the objective of discouraging banks to overexpose by influencing them to raise their capital resources and/or to syndicate credit among themselves. This objective, however, could have been achieved more directly and effectively by strictly adhering to the 25% limit rather than allowing banks the flexibility to exceed this benchmark.

The Prevailing Situation in Belize and Prospects for the Future

Over the last couple of years there has been a significant shift in the market share of banking business in Belize from foreign banks to local banks. There are now two local banks in Belize which control a significant proportion of the total banking assets of the country as compared to the beginning of 1987 when there was only one local bank which accounted for a very small share of the banking assets. This major shift in banking ownership and control, I feel, requires a reassessment of the supervisory approach in regulating credit concentrations in banks. As a practical matter, when reviewing risk associated with credit concentrations in the branches of the foreign banks, the supervisor could take the wider

view of the bank's global capital resources. However, this would require adequate consultation by the Central Bank with its foreign counterparts in the country of origin of the relative bank to assess the capital adequacy of the institution concerned. A major drawback to this approach could be the development of a supervisory bias favouring the branches of foreign banks which generally have stronger capital positions than the indegenous banks. Consequently, the branches of foreign banks might attract the biggest and perhaps the most lucrative clientele to the detriment of the local banks' competitive stance and financial condition.

The other approach would require strict adherence to the statutory limit prohibiting any excess above the established threshold. This approach would provide a more even playing field for all banks irrespective of the size of their total capital resources and would in fact encourage banks to syndicate loans and/or increase their <u>local</u> capital resources. It would also serve as a cap on the level of concentration risk which the local banks are now permitted to undertake. The inherent risk in this approach would be that the foreign banks, recognising that their capital is not limited to their local resources, might decide to cease their operations in Belize. Because of the view shared by many supervisors in the Caribbean region that the presence of large reputable foreign banks provides a stabilizing effect on our small financial systems, the exodus of these banks from Belize might not be a desirable and popular outcome.

The Adequacy of the 25% Benchmark for Credit Exposures

The primary objective of lending limits is to prevent one individual, or a relatively small group, from borrowing an unduly large amount of a bank's resources and, by extension, to safeguard depositors against the risk of loss inherent in large exposures. While there is no universal rule as to what constitutes an acceptable degree of concentration risk, it is felt by some supervisors that the 25% statutory lending limit is high, particularly for indigenous banks. The following main reasons are cited:

1. There is no deposit insurance mechanism in Belize. Therefore, earnings and equity are the only primary defenses against losses. Large exposures pose a significant risk to bank capital and solvency.

2. There is no readily available capital market in Belize where a local bank could obtain equity financing fairly quickly if the need arises.

3. Economic activity in Belize is heavily dependent on a few major industries which limits the ability of banks to spread their loans among a relatively large number of borrowers

engaged in different lines of industry (industry concentration risk). Exposures to single or group borrowers up to 25% of equity increases the risk associated with concentrations.

4. The failure of only <u>one</u> bank in Belize would have a pervasive effect throughout the entire financial system of Belize and could jeopardize the operation of the payments mechanism. Controlling and limiting the level of single or group borrowers is a prudent step in safeguarding the stability of the individual members of the system.

A more conservative and prudent regulatory framework would place a lower limit on total credits to single or group borrowers of about 15% of a bank's (unimpaired)[2] capital and reserves. This limit would be applicable only for credits which are <u>not</u> fully secured by marketable tangible security.

Banks wishing to exceed the 15% threshold would be required to obtain tangible marketable security which is at least equal to say, 150%[3] of credits outstanding. One of the operational drawbacks to

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[2] Unimpaired by any diminution of asset value.

[3] This ratio has been used on the assumption that only about 65% of the fair value of non-cash assets held as collateral would be recovered on a forced sale situation. For instance, facilities totalling $65,000 would require collateral cover of about $100,000 (or 150%) which, when foreclosed, would yield about $65,000.

this approach would be that presently there are limited or no readily identifiable and reliable market value quotations in Belize for many collateral items such as real estate and securities. In the case of real estate, a workable solution would be to require valuations from independent professionals. This raises the issue regarding the availability, competence and independence of local evaluators. Under no circumstances, however, would such secured credits be allowed to exceed 25% of the bank's unimpaired capital and reserves other than in the most exceptional circumstances such as when the advances are fully secured by cash, are fully guaranteed by the Government of Belize or the Central Bank of Belize, or are backed by government obligations such as Treasury Bills and Debentures which have the full backing of government.

The ideas and observations outlined above are my personal views on the subject of credit concentrations and form a basis for further discussion on this topic. I would like to take the opportunity to discuss this topic at more length during this seminar.