The Evolution of the Financial Sector in Belize (1996 -2007)

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2009

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This essay represents the Central Bank of Belize's contribution to a regional review of financial system developments in CARICOM member states and sequentially follows an earlier work that examined the financial evolution of the Caribbean Community over the period from 1970 to 1996. Covering the period from 1996 to 2007, the current study builds and expands on the earlier work and itself represents a launching point for a future study as the work of chronicling the unfolding developments of Belize's financial system continues.

The paper opens with a review of Belize's economic performance before looking at general developments in the financial sector. This is followed by sections devoted to the Central Bank of Belize, its challenges and constraints in implementing monetary policy and its supervision of the financial system. The latter sections are devoted to the commercial banks, the Development Finance Corporation, credit unions, insurance companies and the international/offshore banks. The conclusion contains a brief overview of some of the Central Bank's legislative initiatives and its efforts to upgrade the financial system's payment infrastructure.

1.1 Belize's Macroeconomic Performance 1996 - 2007

As Belize, a former British colony, approaches twenty-seven years of independence, its economy remains small, open and import dependent, highly vulnerable to exogenous and weather-related shocks. While traditional industries, namely sugarcane, citrus and banana, remain dominant on the productive landscape, marine products, papaya, and petroleum have emerged as important export commodities. Corn, rice, beans, cattle, pig and poultry are also key areas of production, allowing Belize virtual self-sufficiency in basic grains and fresh meat. Some diversification in the economic base of the country has occurred with the fostering of information technology based companies under export processing zone status, development of an international banking sector, commencement of duty-free retailing activities aimed at Mexicans at the Belize-Mexico border and development of cruise ship tourism. In the late 1990s, tourism became the top foreign exchange earner bolstered by a short-lived exponential growth in the cruise-tourism sector, while the discovery of oil in commercial quantities in 2006 provided a timely boost to exports and economic growth. Notwithstanding these developments, the country continues to be highly import-dependent with foreign currency earnings remaining vital to economic activity and social well-being.

Since independence, successive governments have stated their commitment to the principle of private sector led growth with government providing the facilitating business environment of basic infrastructure and non-commercial public services. However, the relatively large size of the public sector means that government activities materially impact the country's economic performance with expansionary fiscal policies and pre-election spending splurges boosting GDP growth at the expense of burgeoning external imbalances that must eventually be corrected to protect the fixed exchange rate, while tightened fiscal stances tend to contribute to a deceleration in economic growth.

Illustrating this, the years 1996-1998 were the continuation of a period of fiscal tightening as the UDP government that had assumed power in the latter part of 1993 sought to reduce pressures on the balance of payments and the fixed exchange rate by lowering domestic consumption and bringing the fiscal accounts onto a more sustainable footing. In December 1995, the government instituted a temporary wage freeze and cut its workforce by almost 9% in order to reduce the public sector wage bill. Revenue measures included the implementation of a 15% value added tax (VAT) in 1996. These adjustments initially resulted in a sharp improvement in the fiscal balance which swung from -3.8% of GDP in 1995 to 0.4% in 1996. In the subsequent two years, expenditures outpaced revenues so the fiscal deficit rose to around 2.0% of GDP. Concurrent with its efforts at fiscal discipline, the government facilitated the expansion of commercial free zone merchandising, the creation of an international banking sector, development of information technology based companies under export processing zone status and the initial foray into cruise ship tourism. Concerted efforts in investment promotion and export development were the mandate of BELTRAIDE, a statutory agency that was set up to be a one-stop focal point for investors and companies with export potential.

Since the impact of developmental efforts are generally long-term in nature, while fiscal adjustments are immediate, GDP growth slowed to an average of 2.9% with the lowest growth of 1.4% occurring in 1996, a year in which the fiscal measures contributed to a 1.3 percentage points rise in the unemployment rate to 13.8%, a one-off spike in the rate of inflation to 6.4% and (aided by Taiwanese grant funds) a doubling in the official reserves coverage to 2.7 months of imports. In the real sector, activities contracted in construction, financial intermediation, manufacturing and ‘real estate, renting and business services’. Hotel and restaurant activity also contracted for the second consecutive year. The main growth driver was export agriculture, which pushed up the contribution of the primary sector by 6.9%.

In the subsequent two years, GDP grew by 3.5% and 3.7%, respectively, driven by a surge in farmed shrimp production, continuing growth in distribution, telecommunication services and a strong rebound in tourism. Unemployment remained high and a widening external current account deficit was partially financed by the drawdown of reserves, which fell to 1.6 months of imports. The somewhat heavy handed approach of the government in correcting the fiscal excesses of its predecessor generated a rising tide of public disapprobation particularly when the decision was taken to retrench staff at the midpoint of its term in office. Discontent with the Government’s conservative fiscal strategy ultimately led to a landslide victory for the opposition People’s United Party (PUP) in the 1998 general elections.

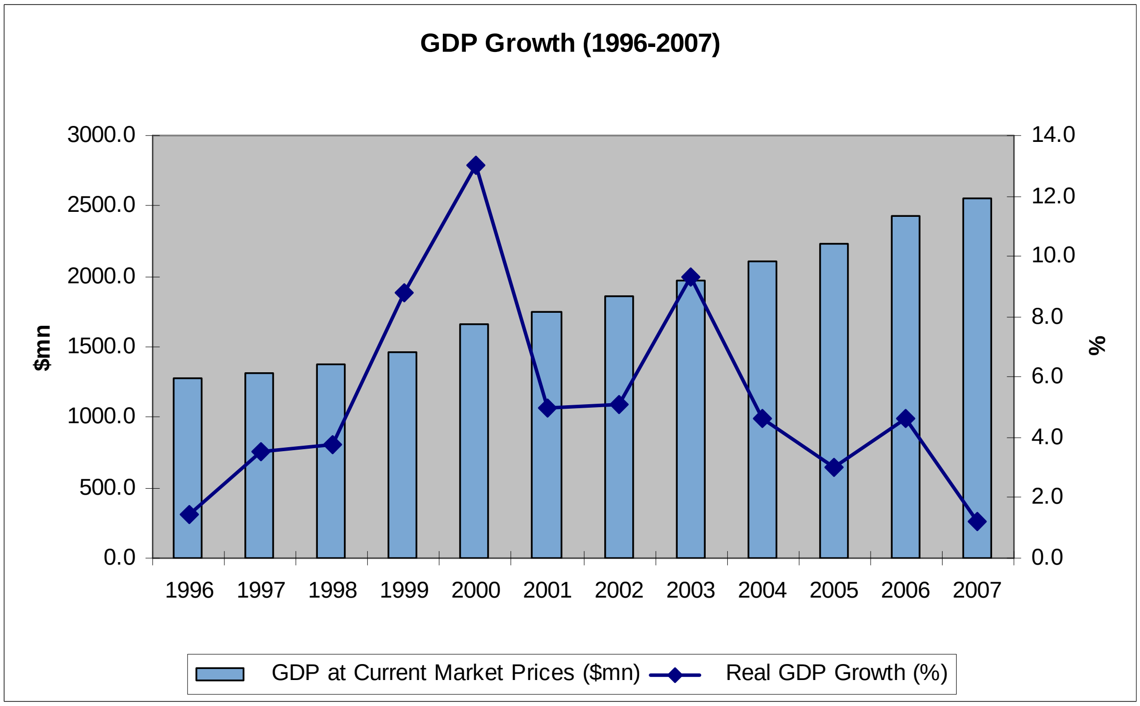
The new administration had made several promises as part of its electoral campaign, prominent among which was the goal of building 10,000 houses and creation of 15,000 jobs. It aimed to deliver on these through expansionary fiscal and monetary policies and proceeded on an aggressive reversal of the previous administration's economic strategy. Having campaigned against the 15% VAT, this was immediately repealed and a sales tax of 8% was substituted. Spending was ratcheted upward significantly as a housing construction boom was launched together with various other infrastructural projects. Capital was raised to finance these initiatives through the sale of public assets such as the telephone, electricity, water and sewerage companies as well as substantial short term external borrowing on commercial terms, On the monetary policy side, commercial bank reserve requirements were lowered and among other things, the banks were allowed to include lending for new housing mortgages as part of their approved liquid asset portfolio. After initially financing its expanding budget deficits externally, the government resorted to increased usage of domestic credit via the central bank's overdraft facility with inevitable negative consequences for the balance of payments and official foreign reserves.

Fueled in part by the surge in domestic consumption and investment, GDP growth averaged 8.2% over 1999-2003 even with some slowdown in growth during 2001 and 2002 because of hurricane and storm damage. Growth was buoyed up as well by a rapid growth in commercial free zone trade, expansion in farmed shrimp production and steady increase in stay-over tourist arrivals that was accompanied by exponential growth in cruise ship arrivals during 2002-2004. This period also saw the development of a small international banking sector, while telecommunications expanded strongly due to investments in preparation for year 2000 readiness and the prospective opening of the local market to competition, since it was expected that the exclusive license enjoyed by the telecommunications company would shortly be ended. The fiscal deficit rose to an average of 7.7% of GDP, while the public sector's external and domestic debt to GDP ratio (excluding contingent liabilities that it was eventually obliged to take on) almost doubled to 94.1%. The upward movement of the debt stock was exacerbated in 2002 and 2003 as the government had to borrow to refinance costly, external short-term debt and set up a sinking fund which was only a portion of what was needed to meet a sizeable Salomon Smith Barney bond repayment that was due in 2005. Pressure on the fixed exchange peg mounted as the external current account deficit soared.

Faced by the persistence of sizeable macro-economic imbalances after four years of fiscal expansion, the Central Bank obtained the green light in the latter part of 2002 to impose a 2.0% increase in commercial bank reserve requirements. No further action was countenanced in 2003, a year in which the sitting government was returned to office for a second consecutive term after successfully contesting the general elections. This turned out to be a brief hiatus since there was an urgent need to bring the country onto a more sustainable footing to avoid a sovereign default on the external debt. The period 2004-2007 was therefore one of fiscal and monetary tightening combined with sustained efforts to obtain new funds from abroad that would enable the government to meet its external obligations. In addition to tightened controls on recurrent expenditures and reduced capital spending, tax rates were increased. The latter included the replacement of the sales tax with a broader based 10% value added tax. Since the government had campaigned against VAT when it was in opposition, the new tax was accorded the name of GST (General Sales Tax). A decision was made to freeze salaries for civil servants but this was rescinded after the National Trade Union Congress of Belize (NTUCB) which includes the powerful teachers union went on a national strike. The business sector had also been exerting pressure for an investigation into the affairs of the BSSB citing issues of governance and lack of transparency where its investments were concerned. The resulting Senate Select Committee investigation revealed substantial irregularities with damaging implications for the long term viability of the social security scheme. These revelations helped to spark a nation wide protest headed by the NTUCB and other civil societies such as the Association of Concerned Belizeans (ACB) who charged the government with mismanagement and corruption and also demanded an investigation into the affairs of the Development Finance Corporation (DFC). Meanwhile, with the foreign reserves under unrelenting pressure, the Central Bank progressively raised commercial bank reserve requirements in 2004, 2005 and 2006 in an effort to reduce growth in credit and foreign exchange demand.

At the end of 2005, the external debt to GDP ratio stood at 87.0%. In addition to refinancing existing debt obligations, funds had to be borrowed to enable the government to undertake the forced buyback of the water utility when its refusal to approve an increase in rates that would enable the foreign purchaser (CASCAL) to achieved the originally agreed returns on its investment caused the latter to invoke the buyback clause contained in the sale/purchase agreement. The bunching up of debt maturities and put options on various international bonds had been making the debt servicing problem an increasingly difficult one to solve especially as international rating agencies were lowering Belize’s credit scores and causing a steady deterioration in the terms being offered by lenders. With its borrowing options vanishing, the government’s only recourse appeared to be to approach its creditors and seek a restructuring of its external commercial debt. Arrangements for this were finalized in February, 2007 when some US$0.5bn in commercial debt was exchanged for a 22 year bond with step up coupon rates. While this provided some short-term relief by smoothing out debt service payments, the government remained under tremendous pressure to improve its fiscal management and long term debt servicing capacity. Adding further to the government’s debt problems was its assumption of debt servicing responsibilities for private sector loans that had been given a government guarantee earlier without adequate public disclosure or consensus.

In the more austere conditions, GDP growth decelerated to an average of 3.4% even though boosted by the start of commercial petroleum production in 2006. The government reduced its fiscal deficit from 6.3% of GDP in 2004 to 1.1% in 2007 and its primary balance reverted from a deficit to a surplus position by 2006. After averaging nearly 20% of GDP in 2000-2003, the external current account deficit/GDP ratio progressively fell to an average of 14% in 2004-2005 before shrinking to around 2% in 2006-2007. The improvement enabled the gross international reserves to climb back up to 2.3 months of imports. The drying up of commercial sources of credit ensured a slowing down in international borrowing as this became confined to bilateral and multilateral sources that offered more favourable payment terms though with certain conditions being attached. It was consequently as a result of pressure from the IDB which had agreed to provide a policy based loan to support the balance of payments that the Government dealt with DFC's insolvency by putting a halt to its lending and refocusing its activities on loan collections.



Public confidence in the government continued to plunge as a series of new disclosures were made of contracts and agreements that appeared to benefit a minority of private investors perceived as closely connected to the ruling administration at the expense of the public purse. The saga of the privatized telephone company, in which it was repurchased, resold, repurchased and resold with substantial losses being generated on each transaction leg, was difficult (to say the least) for the government to explain or defend especially since it was simultaneously seeking to raise revenues by imposing higher taxes on the public. The unpopularity of its revenue raising measures was hence further accentuated by concerns about the lack of transparency in the handling of public finances. One such issue that became a flashpoint for public uprising was a hitherto secret loan guarantee given to a privately owned hospital. The tipping point came when there was a steadfast refusal to reveal the details of the hospital's ownership structure at the same time that the public was being called on to pick up the tab for its sizeable loan payments.

In the broader economy, the strongest growth push came from the advent of a petroleum industry in 2006. Other primary sector activities decelerated and then contracted due to a combination of storm damage, froghopper infestation in sugarcane, banana market uncertainty due to changes in the EU import regime, price cuts in sugar due to EU reform measures, shrimp disease and heightened competition in the international shrimp market. In the secondary sector, Williamson, a major garment factory, began cutting back on production as contracts were shifted to lower cost producers in Central America and Asia. The services sector kept a positive momentum mostly due to continued expansions in telecommunications, a pick-up in financial intermediation and continued investment and expansion in the tourism sector.

In general elections of February 2008, the electorate registered their dissatisfaction with the state of the country's affairs by replacing the incumbent PUP administration with the opposition UDP, which achieved a sizeable parliamentary majority of 25 seats in the 31 member House of Representatives. The challenges faced by the new government included a heavy public sector debt burden; the task of raising living standards in the context of soaring food and oil prices, deteriorating economic conditions worldwide, and escalating crime.

1 .2 Financial Sector Developments

The number of institutions operating in the financial system increased during the twelve year review period with the entrance of a new domestic commercial bank bringing the number in operation to five, the establishment of ten international banks offering mostly offshore services to non-residents and a mutual fund. There was also further financial deepening as the ratio of domestic bank deposit liabilities to GDP rose from 44.1% to 62.7%. The opening of the fifth commercial bank was notable in sparking competition among the banks and leading to a lowering in the weighted average interest rate spread of commercial banks after 16 years of mostly uninterrupted increases.

Table 1.2.1: Financial Institutions Operating in Belize and Total Assets at December 31

	1996		2007	
	No. of Institutions	Total Assets BZ$mn	No. of Institutions	Total Assets BZ$mn
Commercial Banks	4	706.5	5	2,120.5
Credit Unions	11	105.8	13	414.7
International Banks	0	-	9	357.9
Development Bank (DFC)[1]	1	62.5	1	217.2
Insurance Companies	15	52.6	13	148.4

Mutual Funds	0	-	1	31.3
Government Savings Bank	1	1	1	14.5

Sources: Central Bank of Belize, Development Finance Corporation, Ministry of Finance (Treasury), Supervisor of Insurance

(1) As of December 31, 2006

The commercial banks maintained their dominance of the financial landscape with total assets of $2.1bn (84.0% of GDP) at the end of December 2007. While these banks held foreign currency deposits for resident foreign exchange earners, the degree of financial dollarization was low in that there was very limited lending in US dollars (which is subject to Central Bank approval) and the percentage of foreign currency deposits in the domestic banking system was small, declining from 9% of total deposits in 1996 to 3.5% at the end of 2007, the higher ratio at the start of the period being due to one bank's holdings of deposits from non-resident international business companies (IBC). An amendment to the International Banking Act that came into effect in January 2007 caused the transfer of these IBC deposits from the domestic system into international banks and accounted for the downward shift in the ratio of foreign currency deposits in the domestic banking system.

Notwithstanding the growth in the number of financial intermediaries, there was no substantial change in the borrowing and saving instruments available to the general public. Although the need for development of a capital market continued to be a topic of discussion, no concrete steps were taken in that direction. Public trading of shares in the privatized companies (BTL, BEL and BWSL) occurred over the counter with interested buyers and sellers seeking each other out through newspaper advertisements. The Government continued to be the chief issuer of securities for budgetary finance. The privately owned electricity company and the DFC also launched public debenture offerings during the period reviewed. While the former was fully subscribed, the DFC's fell far short of its goal because of well-grounded concerns about its viability and financial soundness. The lending requirements of the commercial banks, the main source of credit, continued to favor large borrowers, many of whom were also able to access financing at internationally competitive interest rates from offshore lenders. Small borrowers and entrepreneurs seeking to engage in non traditional developmental projects faced more obstacles and the situation was not helped by the demise of the poorly managed National Development Foundation of Belize (NDFB) and the severe restrictions placed on the DFC. Credit unions played an important role in filling some of the gaps but small size and lapses in regulatory oversight posed challenges to the continued growth of some of these institutions.

The task of managing the country's fixed exchange rate regime was made more complex and challenging by amendments to the Central Bank Act in 2001 that made it lawful for foreign exchange earners to carry out domestic transactions in US dollars, opened the door for the Central Bank to engage in international derivative transactions as well as the government's decision to authorize the establishment of cambios (foreign exchange bureaus) that operated between 2002 and 2005. The stated intention of the latter was to bring foreign exchange being traded in the parallel market into the official system and thereby reduce the intense pressures being placed on the fixed exchange rate. Since the problem emanated from large fiscal imbalances that the government did not then wish to address in a constructive way, and the country has a fixed exchange rate system, the cambio experiment was doomed to failure. Not only did legitimizing cambios fail to reduce parallel market activity, anecdotal evidence pointed to an expansion in parallel trading that was partly fueled by the licensed cambios. Indications were that the volume of the licensed cambios' parallel trading far surpassed their 'formal' trade. To halt the legitimization of practices that were attracting foreign exchange away from the official system and undermining the fixed exchange rate, the government repealed the cambio regulation in 2005. The return to an orthodox approach to economic adjustments in the ensuing period together with the coming on stream of petroleum exports successfully addressed the foreign exchange imbalance with the result that activity in the parallel market subsided significantly. By 2007, Belize's official exchange rate was held to be largely in line with its equilibrium level.

With their focus on non-resident clientele, the domestically licensed international/offshore banks were originally expected to have little impact on the domestic financial system. However, an amendment to the International Banking Act in 2002 that allowed resident commercial and export processing zone companies to conduct full banking business with international banks operating in Belize enabled the latter to cut into a portion of the foreign exchange earnings that the domestic banks traditionally received as EPZ companies shifted some deposits and borrowing activities from the commercial banks to the international banks. There was a significant reduction in domestic bank liquidity in the aftermath of this piece of legislation.

1.2.1 Central Bank of Belize

Since its establishment in 1982 with the assets and liabilities of its precursor, the Belize Monetary Authority being simultaneously conferred upon it, the legal mandate of the Central Bank of Belize (CBB) has been to foster monetary stability, especially with regards to the stability of the fixed exchange rate, and promote credit conditions conducive to economic growth within the context of the Government's economic policy.

In the years up to 1995, the CBB's regulatory and supervisory oversight was limited to the domestic commercial banks. The passage of the Offshore Banking Act in 1996 expanded its purview to include oversight of offshore banks, the first of which was established in 1998. In a subsequent amendment in 2002, the title of the Act was changed, replacing the term offshore with "international". This amendment also strengthened the CBB's supervisory and regulatory powers. An amendment to the

Credit Union Act in December 2005 further expanded the CBB regulatory oversight by bringing credit unions under its mantle.

As banker and fiscal agent to the government, Section 34 of the CBB Act allows the CBB to make short-term direct advances to the government up to a maximum of twenty percent of the current revenues collected during the preceding fiscal year or fifty million dollars, whichever is greater. Section 35 (2) of the Act had permitted the CBB to hold government securities up to a maximum of five times the aggregate amount of its paid up capital and General Reserve Fund. In April 2006, this was increased to seven times the aggregate amount of the paid up capital and General Reserve Fund.

The CBB's fiduciary role also includes participating in the primary and secondary market for government securities. In 1996, 1997 and part of 1998, Treasury bill rates were market determined. With the coming to power of the new regime in 1998 a government decision was made to fix the yield at 6.0% in the hope that this would cause the banks to reduce their lending rates and this lasted until November 2001 when market forces were once again allowed to operate. After an eleven month period of steady declines, partly due to the entry of the fifth bank which needed a share of this paper to fulfill its statutory reserve requirements, the government determined that the yield should be fixed at 3.25% and it remained at this level over the rest of the period reviewed.

In 1995, the Central Bank had introduced an interbank facility under which banks with excess funds could lend to those with a temporary shortfall in their cash reserve requirements. The offers and uncollateralized take-ups were to be done through the Central Bank with the names of participants being concealed and with the Central Bank's implicit guarantee of credit risk. At the time the facility was launched, the interest rate was set at 10% (1 percent less than the CBB's discount rate). The facility was mostly dormant partly because the use of facsimiles to transmit information made the process cumbersome and partly because of the slowness of the banks to change their mode of operations. In particular, there appeared to be a significant reluctance on their part to reveal operational information to their competitors. Since it had been originally decided that the interest rate should be 1% below the Central Bank's discount rate, the Bank's decision to raise its discount rate to 18% in March 2004 made the cost of borrowing from the interbank facility prohibitive. With practically non-existent demand for interbank loans, the commercial banks did not query the interest rate that had been imposed. However, this situation eventually changed as progressive Central Bank increases in reserve requirements and the commencement of fiscal restraint reduced the growth of bank liquidity and caused them to begin advocating for a reduction in the interbank rate. In July 2006 the link between the discount rate and interbank rate was severed and the interbank facility rate was fixed at 11.0% by the CBB. The use of e-mails for conveying and responding to commercial bank loan requests also made the process more user-friendly and activity in the interbank facility began to accelerate. The Central Bank continued to bear the credit risk of interbank loans and while no immediate change is on the horizon, it is expected that incremental changes will be made to improve the mechanism for conveying information on offers and bids and also to require commercial bank loans to be collateralized, which would make the facility less reliant on Central Bank intervention.

In addition to managing the country's international reserves and administering the Exchange Control Regulations with the aim of maintaining the value and convertibility of the Belize dollar, the CBB has also been equipped with the power to set interest rates on commercial bank loans and deposits, mandate credit volumes and set the terms and conditions on loans. However, since its inception the Bank has generally avoided exercising its latter prerogatives and, apart from setting a minimum interest rate on saving deposits, has restricted its monetary policy initiatives to alteration of the commercial banks two-tier statutory reserve requirements (cash and liquid assets), which were considered to be less disruptive to the credit market.

Although monetary and exchange rate stability are the main goals of the Bank, there are substantial obstacles in the way of its success, principal among which is the subservience of monetary policy to the fiscal stance. In 1998-2003, fiscal dominance and lack of Central Bank autonomy paved the way for the implementation of policies that contributed to large balance of payments deficits, the intensification of pressures on the fixed exchange rate, a burgeoning external debt and economic instability. With the economy having been brought to the brink of a very disorderly adjustment, the need for greater central bank autonomy in the implementation of monetary policy was clearly underscored. The CBB therefore began to explore its options for achieving a decoupling from its role as automatic financier of fiscal deficits as well as a more market approach to dealing with liquidity build-up in the banking system.

1.2.2 Monetary Policy

Monetary policy underwent two swings in the period reviewed. Initially, the stance was restrictive under the UDP government with the aim of moderating credit growth and reducing pressures on international reserves. Next came a period of loosening at the behest of the incoming PUP government to free up monies to help fund a fast paced economic growth program. A gradual process of tightening then had to be undertaken to stem the hemorrhaging of foreign reserves and protect the fixed exchange rate.

For the most part, adjustments were effected through alterations in commercial bank reserve requirements. Given low international reserves (1.3 months of merchandise import coverage) the cash and secondary reserve requirements had been increased in December 1995 from 5% to 7% and from 24% to 26%, respectively, of average deposit liabilities and were maintained at this level up to October 1998. These measures were considered prudent in light of the need to shore up the international reserves. However, their effectiveness was limited in restricting credit expansion since private sector loans continued to grow strongly (averaging over 11% per annum) with a bias toward consumerism rather than productive activities. The fiscal deficit was also creeping back up, though the situation remained manageable.

The August 1998 change in government brought an administration whose agenda included jumpstarting the economy through increased public and private sector investments as well as a housing construction boom. In support of the government's expansionary agenda, the Central Bank (CB) was called on to take several measures in November 1998. In addition to lowering the cash and secondary reserve requirements from 7% to 5% and from 26% to 24%, respectively, banks were also allowed to classify new loans for housing construction (up to 5% of deposit liabilities) as approved liquid assets. The Treasury bill yield was fixed at 6.0% (as per government instruction) on the premise that the improvement in return on the securities would be an incentive for commercial banks to lower their lending rates. To partially counter the negative impact on international reserves from the expected credit expansion, government one-year Treasury notes were issued and banks which purchased these with US dollars were also allowed to include these as approved liquid assets.

Fifteen months later, a further loosening occurred following a public announcement by the Minister responsible for Banks and Banking that the Central Bank would be asked to abolish the cash reserve requirement and reduce the overall reserve requirement from 24% to 19% with the intention of further reducing commercial bank's costs and with the hope that this would reduce loan rates and increase the supply of funds being supplied to the productive sector. The Minister had also indicated that the Central Bank would be establishing credit facilities at the commercial banks with a view to providing lower cost financing for non-traditional export oriented enterprises. The Central Bank responded by reducing the cash reserve requirement for time and savings deposits to 3%, the lowest level permitted by law, and by including in commercial banks approved liquid assets any loans (using the newly available funds) for non-traditional export production. The 5% cash reserve requirement on demand deposits was kept in place since this was enshrined in the legislation.

The policy changes were eventually shown to be of limited effectiveness. While loans for housing construction ratcheted upward, commercial bank lending to the productive sector did not increase significantly. This came as no surprise to the Central Bank since the commercial banks had historically shown themselves to be risk averse and with a tendency to restrict their activity to the already established producers and traditional merchandising sector that thrives in this type of import dependent economy. The banks' weighted average lending and deposit rates declined by 90 and 170 basis points, respectively, resulting in a further increase in their interest rate spread. The fall in lending rates appeared to be more influenced by competition from the DFC, BSSB and a building society, which significantly increased loans for housing construction and other projects in this period. Over a two year span, the heightened activities of these other financial institutions factored into a temporary deceleration in commercial bank lending to the private sector.

With so much funds being pumped into the system, commercial bank excess liquidity increased more than nine-fold between 1998 and 2001. Treasury notes and new mortgages made up a significant portion of their increased holdings. Adding to the system's flushness was government's deficit spending that averaged 7.2% of GDP with financing provided through a spurt of external borrowing mostly by way of high cost, short-term commercial debt (such as bonds and mortgage securitizations), privatization proceeds and the Central Bank overdraft facility. Further monetization occurred as the CB provided $84mn to the DFC representing the Belize dollar equivalent of funds borrowed from a foreign bank on terms that required the same funds to be held in the lending bank as loan collateral. The acceleration in GDP growth to an average of 8.9% in the three years up to 2001 was therefore accompanied by a 50.0% surge in the external public sector debt to 57% of GDP as well as an intensification of foreign exchange pressures with the current account deficit of the balance of payments peaking in 2001 at 21.0% of GDP.

After slowing in 2000-2001, commercial bank credit to the private sector accelerated in 2002 with a 15% expansion while DFC lending also continued to grow robustly. Since the lending focus was on the highly import intensive construction sector, the foreign reserves plunged to precarious levels and the government was forced to undertake a partial refinancing of its external debt to head off a sovereign debt default. The decision was also taken at this time to legitimize cambio activities in an experimental attempt to bring the informal foreign exchange flows into the formal system. By September 2002, the situation was such that the political directorate agreed with the Central Bank's proposal to raise the cash reserve requirements on savings and time deposits from 3% to 5% and from 5% to 7% on demand deposit liabilities with all rates being subsequently harmonized at 6% in November. The impact of these measures was reinforced by a shift of export processing zone (EPZ) deposits from the domestic system to the international banks subsequent to a legislative amendment that allowed export and commercial free zone companies to do full banking business with international banks in Belize. With these companies moving a portion of their foreign asset holdings to the offshore banks, excess statutory liquidity of domestic commercial banks was halved by the end of the year. While declining slightly, the external current account deficit was still a hefty 18% of GDP.

Over the next two years, growth in private sector credit remained robust and the government was also relying on Central Bank financing for fiscal deficits averaging 7.6% of GDP. The gross official foreign reserve position therefore remained precarious with substantial declines in 2003 and 2004 due to the pressures of servicing the public sector external debt. Since most of the debt contracted by the government was short term, Central Bank reserves were significantly below what was required and this led to another round of foreign borrowing to refinance the external debt in 2003. The refinancing bought some time for the government which chose to delay much needed fiscal adjustments. Meanwhile, with excess liquidity rebounding after two consecutive years of decline and with the need to obtain a clearer way of measuring the true position of the banks the central bank made a decision in April 2004 that residential construction loans would no longer be included as part of the commercial banks' approved liquid assets. The secondary reserve requirement was simultaneously reduced from 24% to 19% of deposit liabilities in order to smooth the transition. Loans to the government continued to be included in the list of approved liquid assets however. In November, the Central Bank also decided to restrict the borrowing of commercial banks from affiliates to a maximum of 10% of domestic deposit liabilities in order to prevent their level of foreign indebtedness from rising to unsustainable levels whilst expanding domestic credit for non-export oriented activity. One month later, the cash and liquid asset requirements were also raised by one percentage point to 7.0% and 20.0%, respectively, though the impact of these adjustments was neutralized by further monetization of the fiscal deficit and the Social Security Board's injection of proceeds into the banking system following the enforced sale of its shares in the telecommunication and electricity utilities. Excess liquidity consequently continued its upward trend, ending the year with an overall year on year increase of 69%.

Under the unrelenting pressure of servicing the external debt, the Central Bank ended 2004 with reduced reserves and an external asset ratio of 32%, which was below the legal threshold of 40%. This led to the third major debt refinancing episode in the first quarter of 2005. The funds were provided from external lenders at very onerous terms and with the public sector/publicly guaranteed debt now above 100% of GDP, the government finally acknowledged the need for fiscal adjustments. The year therefore began with a raft of new tax increases to beef up revenues. On the monetary policy front, the Central Bank followed its December adjustment with a further 1% increase in the primary and secondary reserve requirements (to 8% and 21%) in May and simultaneously disallowed the inclusion of long-term loans to Central Government as approved liquid assets. To support these measures, the Social Security Board was also convinced to sterilize a portion of its monthly cash inflows with the Central Bank. Fiscal consolidation efforts yielded a small primary surplus by the third quarter of the year and these gains were maintained through the end of the year. Generally tighter conditions contributed to a deceleration in the growth of private sector credit and growth in the broad money supply decelerated from 14% to 7% in 2005. This was however still insufficient to fully cool the overheated economy and the year ended with a heavy external debt overhang, a lower but still inflated external current account deficit (13.6% of GDP) and reserves shrunken to a mere 0.8 month of import coverage.

The need for the continuation of a tight fiscal and monetary framework was obvious and the Central Bank moved to raise the reserve requirements by another percentage point on January 1, 2006. Also, after an extended delay, the Minister of Finance finally signed a statutory instrument that brought a 2004 amendment to the

International Banking Act aimed at eliminating the co-mingling of resident and non-resident deposits in domestic banks into immediate effect. Removing these large and potentially unstable flows from the domestic system caused a temporary reduction in the deposit base of the largest and most aggressive commercial bank that was offset by term loans from its foreign affiliates. After contracting in January, commercial bank excess liquidity began to expand rather rapidly fed by robust inflows from citrus exports, which was enjoying high prices and petroleum sales, which began in that year. Net domestic credit to the government and the private sector accelerated and the Central Bank therefore intervened once more in September 2006, raising the cash and liquid asset requirements to 10% and 23%, respectively.

Significant improvements in the trade and external current account position underpinned an upsurge in the international reserves, which more than doubled its coverage to 1.8 months of imports. However, this could not dispel the looming threat of a sovereign default given the volume of expensive short-term debt that had been contracted by the public sector. In the latter months of 2006, the government therefore began to explore the possibility of restructuring its commercial debt with external creditors. The restructuring process was completed in February 2007 with a successful debt exchange that provided considerable budgetary relief by lowering interest payments and deferring amortization to 2019. Since then, improvements in the fiscal position have been fostered by petroleum taxes and royalties and bilateral grants, while elevated inflows from tourism, remittances, and foreign direct investment have boosted the banking system's net foreign assets. While growth in private sector credit was strong and bank liquidity was boosted by BSSB deposits subsequent to its unilateral decision to cease the sterilization of its monthly surpluses, the Central Bank maintained an unchanged policy stance in order to provide room for the recovery of the productive sector after the country was hit by hurricane in August of that year. There was some concern about the effect of fiscal loosening prior to the upcoming elections with the Central Bank suggesting the need to offset this by further tightening of reserve requirements before the end of the year. No action was taken however as these concerns were allayed by government assurances that bilateral grants from abroad would boost the official reserves and make the adjustment unnecessary. The imminence of the national elections was also an important factor contributing to the government's reluctance to agree to further monetary tightening at that time.

1.2.3 Supervision of the Financial System

Between 1983 and 1995, the Central Bank exercised supervisory oversight of commercial banks under the aegis of the Banking Ordinance (Chapter 215 of the Laws of Belize). In 1996, this was replaced by the Banks and Financial Institutions Act (BFIA), which strengthened the regulatory authority and scope of the Central Bank. However, while a 2003 IMF assessment of financial sector regulation and supervision in Belize found the Central Bank's licensing procedure to be "sound" it also found it less than optimum that final authority to issue and revoke licenses to financial institutions in Belize rested with the Minister of Finance. Notably, the Offshore Banking Amendment Act of October 2002, by which the Offshore Banking Act was amended and renamed as the International Banking Act, had legally shifted the power to issue and revoke licenses from the Minister of Finance to the Central Bank. That legislative amendment strengthened the supervisory and regulatory powers of the Central Bank over the offshore banks in several ways and specified the sector's compliance with Basle Core Principles. Start up capital requirements for A and B class licenses were increased to US$3.0mn and US$1.0mn, respectively. The Central Bank was also empowered to perform full scope examinations and undertake consolidated supervision that would include holding companies, subsidiaries and other affiliate companies. In November 2002, the Banks and Financial Institutions Act (Unit Trust) Regulations came into effect to provide for Central Bank governance of the activities of unit trust companies/mutual funds licensed under the BFIA.

The Central Bank's regulatory and supervisory framework generally satisfied the international standards set out in the Basel Core Principles for Effective Banking Supervision. A traditional CAMELS (capital, asset quality, management, earnings, liquidity and sensitivity to risk) approach was followed in assessing commercial bank performance with particular attention paid to credit quality. Efforts were also made to ensure that these institutions were in compliance with the Money Laundering (Prevention) Act and Combating the Financing of Terrorism (AML/CFT) regulations. With a view to achieving greater transparency in the system, the Central Bank began publishing quarterly balance sheets, income statements and certain financial ratios for each commercial bank in February 2003.

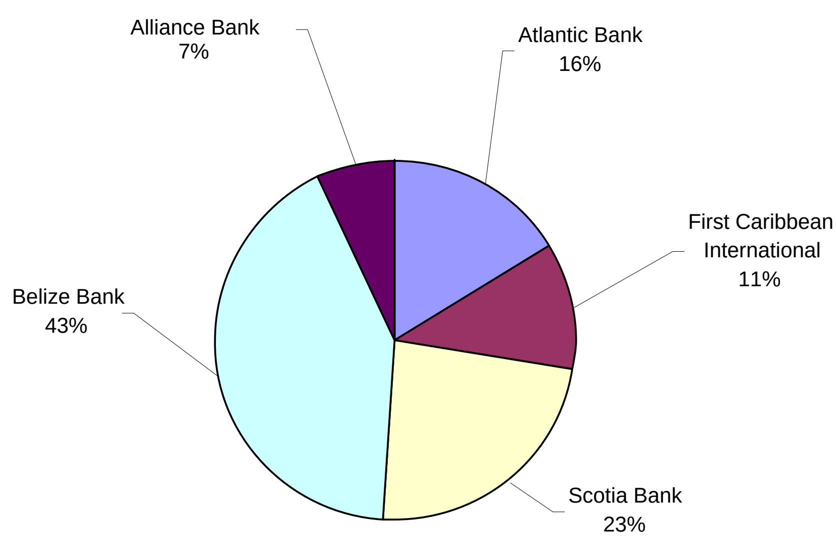
In 2005, subsequent to a CARTAC feasibility study on the Coordination/Integration of Financial Supervisory Authorities, an amendment to the Credit Unions Act was passed to bring credit unions under the Central Bank umbrella by designating the Central Bank's Governor as Registrar of Credit Unions. Oversight of the financial system nevertheless remained diffused across various agencies with the International Financial Services Commission (IFSC) that was established in 1999 being responsible for registering and regulating all offshore activities apart from international banking while domestic insurance continued to fall under the purview of the Supervisor of Insurance who was based in the Ministry of Finance. Following the 2001 terrorist attacks on the United States and the heightening of international concerns about financial flows to terrorist agents, the government passed the Financial Intelligence Unit Act under the aegis of which the Financial Intelligence Unit (FIU) was established in June 2002. Apart from the power to investigate and prosecute financial crimes, the FIU replaced the Central Bank as the flagship institution in charge of implementing the (AML/CFT) laws and regulations. Belize subsequently signed the UN International Convention for the Suppression of the Financing of Terrorism, which permits the FIU to summarily freeze funds or financial assets related to terrorism and money laundering when urgent action is required. On March 8, 2002, Belize also signed a letter of commitment with the OECD stating that it would abide by the principles of transparency and effective exchange of information in respect of civil and criminal matters.

In the review period, modernization and globalization of the financial system continued to pose challenges to the implementation of a risk based approach to supervision as the corporate structures of banks became more complex, requiring greater attention to cross border and consolidated supervision issues. Furthermore, since final authority to approve significant enforcement actions rested with the Minister of Finance, the Central Bank occasionally found itself to be out manoeuvred by banks who were able to exert greater influence in that quarter. The Bank therefore initiated a revision of the BFIA to bring it into greater conformity with international best practices and to increase its regulatory authority to apply administrative penalties for infractions of the law and its regulations. Up to the end of the period reviewed, the legislative amendments had not been submitted to the House of Representatives for enactment.

1.2.4 Commercial Banking Activities

With assets of less than US$2.0bn, Belize's financial sector remains relatively small by international standards. Five domestically licensed commercial banks (Atlantic Bank, Alliance Bank of Belize Ltd, Belize Bank Ltd, First Caribbean International Bank Ltd, and Scotia Bank (Belize) Ltd) account for approximately two-thirds of this amount. All of the banks were locally incorporated except for First Caribbean and the banking sector was entirely private with foreign ownership being dominant.

Chart 1.2.4 (a) Commercial Banks by Market Share at December 31, 2007



Source: Central Bank of Belize

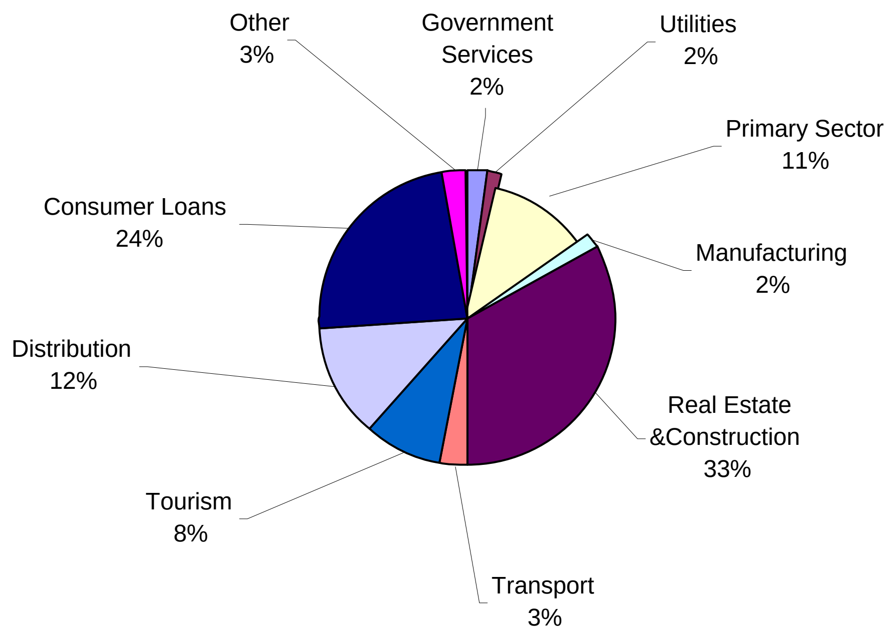
The history of Belize’s banking system can be traced back to 1904 when local investors established The Bank of British Honduras. This institution was acquired by the Royal Bank of Canada in 1912, which monopolized Belize’s banking system until 1949. The latter was obtained by a private investor in 1987 and renamed the Belize Bank Ltd., the country’s largest commercial bank, accounting for a little less than half of the banking sector. The second largest is Scotia Bank (Belize) Ltd. which opened in 1968 as a branch of Bank of Nova Scotia. In 2003, the branch was converted into a wholly owned local subsidiary of the Bank of Nova Scotia International (Bahamas) Ltd. Atlantic Bank Ltd., the third largest commercial bank, opened in 1971 and its majority shares are owned by Sociedad Nacional de Inversiones, S.A., a Honduran company. Next in size is First Caribbean International Bank (Barbados), formed in 2003 by the merger of the Caribbean operations of Barclays and Canadian Imperial Bank of Commerce; its predecessor Barclays Bank had operated in Belize since 1949. The newest entrant to the banking system is Belize’s smallest bank, Alliance Bank of Belize Ltd., which commenced operations in 2001.

While financial intermediation has made forward strides, Belize’s banking infrastructure could benefit from further development. In addition to administering the still fledgling interbank facility, the Central Bank offers a discount facility through which banks may satisfy unforeseen liquidity problems. The records show that use of the latter has been very seldom most likely due to the punitive interest rate that the Central Bank has instituted over the years. A deposit insurance system has not yet been established for commercial banks and the statutory reserve requirements consequently function dually as a monetary policy tool that also provides a measure of prudential reassurance to depositors. The check clearing process has remained largely underdeveloped since the time of the Monetary Authority. Three decades later this system is still labor intensive with representatives of the commercial banks assembling at the Central Bank premises daily to swap checks.

Over the period of this review the number of bank branches more than doubled from 21 to 45 and ATM services that were first launched domestically in 1993 have gradually spread throughout the country. However, since agreement has not been reached on the establishment of a local network switch that would enable interconnectivity, the full efficiencies to be gained from the ATM system are yet to be realized. In the interim, there have been other forms of banking innovation with the start of online banking in 2003 by one bank being a key development. The other commercial banks eventually followed suit and are all currently accessible via the internet, enabling customers to view account details, transfer funds (typically between accounts in the same bank), and pay a limited number of bills online. Three banks recently launched debit card services, exclusively for Belize dollar transactions in the domestic system.

Minimal financial deepening has occurred. On the other hand, there has been a significant increase in monetization as indicated by a 14 percentage point increase (to 68.5%) in the ratio of broad money to GDP over the revision period. The commercial banks continue to limit their portfolio to traditional financial services (demand, savings and time deposits, and demand and term loans). Their loan portfolios are heavily concentrated in the construction/real estate and consumer areas, with much smaller allocations to the sectors engaged in export production. Lending for primary production, tourism, and manufacturing activities accounts for less than a quarter of the consolidated loan portfolio, while consumer, construction/real estate and distribution loans exceed two-thirds of total lending. In the last twelve years, average annual growth in commercial bank loans was approximately 11.6%, relative to average annual growth in real GDP of 5.1%.

Chart: 1.2.4 (b) Commercial Banks Credit Distribution, December 31, 2007



Source: Central Bank of Belize

Public concerns about the high cost of commercial bank loans cite the fact that the weighted average lending rate has never broken the 14% barrier with the banks invariably laying the blame for this on the implicit taxation of reserve requirements imposed by the Central Bank. In this regard, it is noted that during the 1996-2008 period the interest rate spread narrowed from 10% to 7.75% but appeared to be rather more responsive to the increased competition engendered by the addition of a new bank and the liquidity impact of public sector transactions than to changes in reserve requirements. As an example, when cash and secondary reserve requirements were lowered in 1998 and 2000 with banks also being allowed to classify new mortgages as approved liquid assets, the spread increased as an 80 basis points decline in the weighted average lending rate was outweighed by the 170 basis points fall in the weighted average deposit rate. Conversely, when reserve requirements were periodically increased over 2002 to 2006, which was also a period in which the new bank was expanding by cutting into the customer base of the other banks, the interest rate spread narrowed significantly.

Dollarization in Belize remains low as virtually all domestic activity is denominated and transacted in the local currency. To avoid balance of payments vulnerability due to the disruptions that can be caused by speculative portfolio investment flows, domestic commercial banks may not accept foreign currency deposits from non-residents. The banks may also not lend in foreign currency without the Central Bank's approval and they therefore confine their lending in US dollars to exporting firms or those in the tourism industry. An amendment to the International Banking Act in October 2002 allowing international banks licensed in Belize to accept foreign currency deposits from and lend to firms operating in Export Processing Zones, Commercial Free Zones (mostly exporters), and government agencies have somewhat reduced the volume of foreign currency transactions between domestic banks and exporters. Meanwhile, it is understood that because of the economy's structural trade deficit, commercial banks must occasionally rely on funds from head offices and affiliates to support their domestic lending. Bearing in mind the large external imbalances already created by public sector expansion, there was a concern in 2004 that commercial banks could be exacerbating the situation by borrowing exorbitantly from abroad to fund loans for non-tradables. In November of that year the Central Bank therefore decreed that their loans from foreign affiliates should not exceed 10% of domestic deposit liabilities.

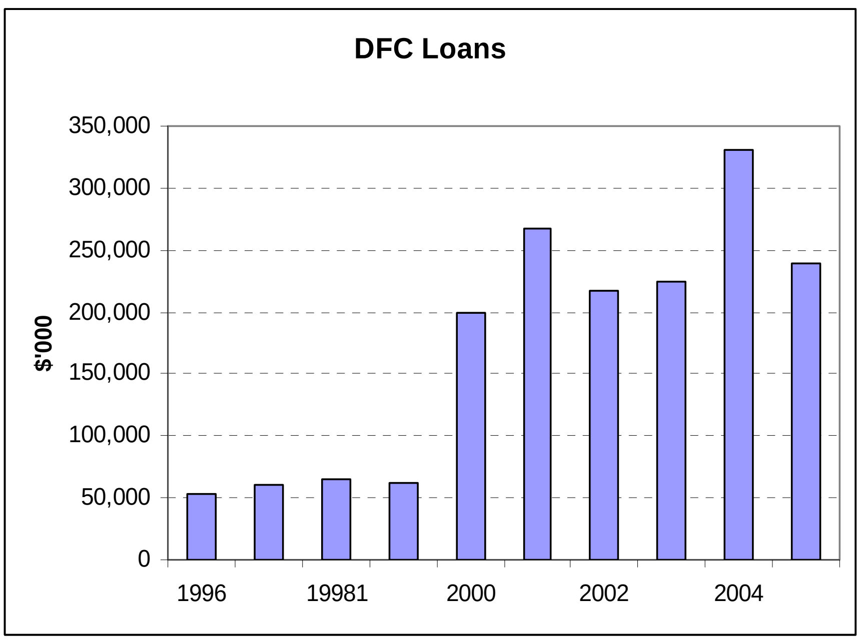
1.2.5 Development Finance Corporation

The Development Finance Corporation (DFC) was established in 1961 as a development bank with a mandate to strengthen and expand the Belizean economy through the provision of financing to all economic sectors, with an emphasis on agriculture, fishing, education, tourism and housing. In the early 1970's the Government of Belize acquired majority control of the institution, and the statutory obligations of the DFC was enshrined in the Development Finance Act of 1973. Its Board of Directors comprised four representatives from the private sector and three from the public sector all of whom were appointed by the Minister of Finance.

After it became a statutory body, the DFC generally relied on funding from the government and long-term concessional loans from the Caribbean Development Bank (CDB) and other bilateral and multilateral agencies such as USAID, the World Bank, CDC, IFAD, and EIB to finance its lending activities.

This conservative approach was dispensed with shortly after the ascension to power of the 1998 PUP administration as the DFC became one of its principal instruments to achieve the government's social and political objectives. With a considerable expansion in lending activity in order to support the government's aggressive housing construction programmes, DFC's loan portfolio grew by 435% over the 1999-2004 period. The corporation also began to rely on commercial sources of credit with the Central Bank transferring to it the Belize dollar equivalent of US$42mn borrowed from the International Bank of Miami, Citicorp Merchant Bank and Citibank Trinidad and Tobago. In 1999 and 2000, funds were received from the Royal Bank of Trinidad and Tobago (RBTT) as a result of several mortgage securitization transactions wherein the DFC and the Belize Social Security Board (BSSB) pledged the income stream from a specific domestic portfolio of mortgages and other loans for repayment. The securitization carried a government subsidiary guarantee, and the Central Bank guaranteed the convertibility of repayments to US dollars. After contributions to sinking funds, annual net inflows from the securitization operations stood at about US$30mn in 1999 and 2000.

In 2001, the DFC's fundraising included the sale of real estate valued at US$40mn to RBTT, subject to a three-year buy-back arrangement. In 2002, additional financing was secured via the Corporation's then newly established special purpose entity (SPE), the Belize Mortgage Company 2002-1, which issued US$40mn 8.5% Class A Bonds due 2012, and US$4.5mn 12% Class B Bonds due 2012, guaranteed by the Government of Belize that became known as the 'North American Securitization Transaction'. By 2002, the DFC and Belize Social Security Board had raised approximately US$150mn in five securitization operations beginning in 1999.



Source: DFC

Issues of non-performing loans began to emerge almost simultaneously with the rapid increase in lending as the institution was directed to drastically lower its lending guidelines. The situation was exacerbated by the government, which, in order to reduce its own fiscal deficit and debt service ratio, transferred the assets and liabilities of large projects that it had already implemented (Los Lagos, Mahogany Heights, soybean) to the DFC. These contributed to the escalation in DFC's loan portfolio of 222% in 2000 and 34% in the following year. Cash flow problems led to an almost 19% decline in lending in 2002 before it began to accelerate once more with a 3.7% increase in 2003 and a 48% expansion in 2004. The sizeable fluctuations in the non-performing loan ratio (30.3% in 2000, 19.3% in 2001, 42.5% in 2002, 26.3% in 2003, 36.4% in 2004) therefore reflected the lowering of the corporation's lending criteria as well as the massive increase in its portfolio. In 2005 and 2006 the non-performing loan portfolio stood at 48.1% and 32.2% respectively.

In describing the corporation's liquidity problems, an Inter-American Development Bank (IDB) diagnostic assessment in October 2004 highlighted its large non-performing loan portfolio, which was exacerbated by high maintenance costs associated with financing the substantial inventory of houses that it had acquired and was holding for resale. The IDB Report also cited weaknesses in DFC's corporate governance and management. One controversial example of this involved the contravention of the Corporation's lending policies in rapidly disbursing the bulk of the proceeds of a US$45mn bond issue to two local companies that were allegedly linked to the ruling administration. Both companies eventually defaulted on their loan obligations and these revelations spawned two high-profile investigations in 2005: an investigation of a Senate Commission on the BSSB, and a Commission of Inquiry into the affairs of the DFC over the period January 1999 through December 2004, with particular reference to its loan and securitization portfolios.

The DFC's illiquidity and substantial external debt obligations inevitably led to the need for government intervention to save the institution from outright collapse. The situation was complicated by the fact that the government was going through its own severe cash flow difficulties and was vulnerable to pressure from the IADB which was providing it with financing via a policy based loan. As a consequence of the latter, the Government announced in November 2004 that the DFC would be liquidated notwithstanding evidence presented to the Cabinet Finance Committee by the corporation's management and staff demonstrating that liquidation was not the most financially viable alternative.

In the years 2004 and 2005, the Development Finance Corporation underwent a restructuring in which its staff was reduced by 110 and fell from 182 to 72 persons, district branches were transformed to customer service outlets (one district office was closed completely), and all key functions were centralized at headquarters. A new Board of Directors was appointed in June 2005 headed by an experienced chartered accountant who assumed the added responsibility of chief executive officer. With the drying up of funding sources, new lending was restricted to financing of the sale of land and housing inventory, and the institution's main focus was placed on loan collection, improvement of loan quality, and reduction of operational costs. Throughout 2006, various loan discount programs that summed to $23.0mn were implemented in accordance with government directives. These included the granting of housing loan discounts to 2,692 homeowners aimed at reducing foreclosures and discounts or complete debt forgiveness to some 1,804 student loan holders. Accounts that met specific eligibility criteria were fully liquidated, with the costs of such programs being met by an offset against amounts owed to GOB by the DFC.

Despite these programs, over 532 loans remained non-performing at the end of March 2007. The corporation also increased its efforts to recover outstanding sums from chronically delinquent clients by placing assets securing these loans up for auction. In 2006 some 137 properties were foreclosed with a gross recovery value of $16.9mn. Guidelines for loan write-offs were revised by the new Board of Directors and a significant portion of severely impaired loans were written off the active loan portfolio. Such loans were not forgiven but were administered separately with collections being pursued through the courts or established collection agencies. The corporation's housing inventories were also revalued in line with the cost-approach making their selling price more attractive to prospective home owners.

In August 2006, the institution's financial problems became the centre of national attention amidst charges of mismanagement when the DFC Commission of Inquiry commenced public hearings with coverage of the proceedings being aired by all local media houses. While this was ongoing, an amendment to the DFC Act was passed in November 2006 formalizing the liquidation process by placing a temporary moratorium on the issuance of new loans and limiting the DFC's activities to loan collections and servicing of domestic and external obligations. GOB would eventually assume external liabilities of about US$65mn associated with the DFC and BSSB securitizations in addition to significant contingent liabilities from the North American Securitization.

The work of the Commission of Enquiry was sharply interrupted by the untimely death of the Commission's chairman in December of the same year, and since the government did not appoint a replacement, only two Commissioners were left to determine if there was any wrongdoing in the operations of the DFC, and, if so, identify those responsible. After a hiatus of several weeks, the Commission recommenced its hearings but with difficulties arising when the two Commissioners differed on major procedural issues. Almost inexplicably, one commissioner decided to preemptively submit a report of his findings to the Prime Minister and this forced the new chairman into the position of eventually having to submit a report that was also of single authorship. From the public's perspective, this represented a sabotage of the Commission of Enquiry's objectives since there could be no conclusive report. Both reports were subsequently kept from publication following court injunctions obtained by the former Chairman of the DFC board, on the basis that each had been written by one Commissioner only.

Since the commercial banks have up to now shown neither the desire nor the capacity to fulfill the DFC's role in project/development financing it was fortuitous that the corporation's death throes were interrupted by the February 2008 change in government. The new administration expressed a desire to resurrect the institution but with more legislative safeguards to prevent a repetition of its recent history. The old

DFC Act (Chapter 279 of the Laws of Belize) was therefore repealed by passage of the DFC Act No. 1 of 2009. This legislation gives the institution far greater autonomy by increasing the number of board directors to nine, a majority of whom are nominated by the private sector. A decision making quorum now entails no fewer than three private sector directors, the chairman of the board and one public sector ex-officio director. The Corporation has become subject to the supervisory oversight of the Central Bank and cannot borrow in excess of $5.0mn without the approval of the House of Representatives. Also in the interest of transparency, the specifics of related party transactions and loans in excess of $1.5mn must be included in its annual reports. Its present scope of operations remains limited due to the paucity of its financial resources but efforts to identify other funding pipelines in addition to the Caribbean Development Bank are continuing

1.2.6 Credit Unions

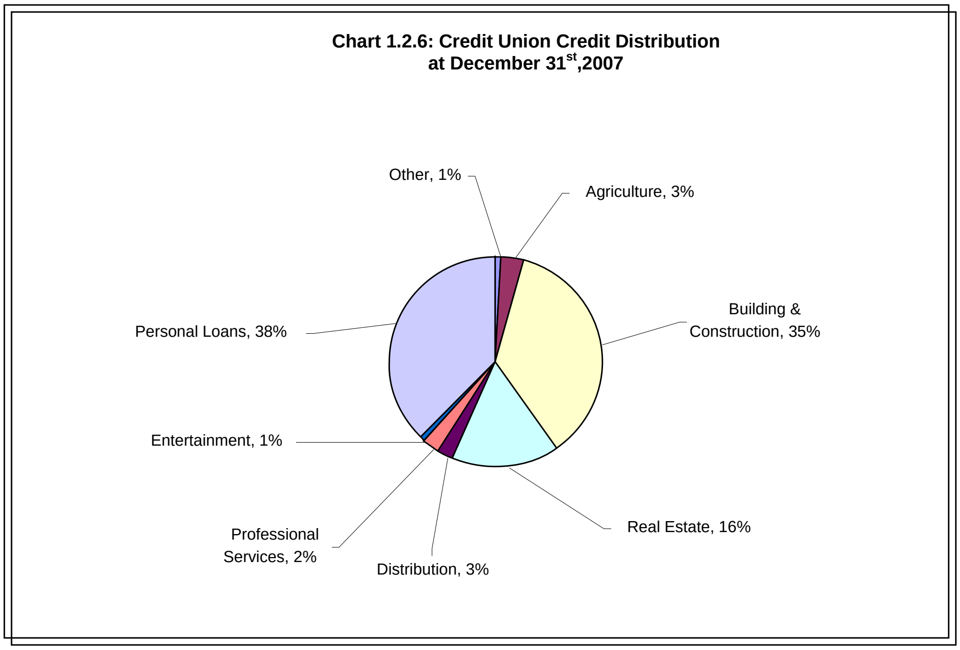
As of December 31, 2007, there were thirteen registered credit unions as compared to 21 in 1995. Total assets were estimated at approximately $410mn (16.1% of GDP) as compared to $106.0mn (8.3% of GDP) in 1996, indicating that the sector had grown by an annual average of 26.5%. Size disparity continued to be notable with the smallest accounting for assets of only $0.2mn while the largest held $279mn and was actually bigger than the country's smallest commercial bank. In addition to the 68% market share of the largest credit union, a position that it has held for a substantial period of time, the balance was almost entirely accounted for by the next seven largest institutions.

Until 2002, the credit unions operated under legislation that had last been amended in 1982. The Credit Unions Act of 2002 significantly expanded the potential scope of operations, and created greater similarities between these institutions and the commercial banks they compete with. In addition to the traditional acquisition of assets through member shares, the credit unions were allowed to commence offering a variety of other services to members among which were term deposits, checking account facilities, discounting of bills, access to automatic teller machines and other unspecified electronic services. Provision was also made for depository and related business services to be offered to the government, private sector and public organizations. The long standing legally instituted interest rate ceiling of 6% on dividends was increased to 8% and the 12% ceiling on their lending rate was removed to increase operational flexibility. However the supervisory structure was kept in place with the Registrar of Cooperatives and Credit Unions, a department of Central Government maintaining responsibility for regulatory oversight.

This was changed in December 2005, with the Credit Unions (Amendment) Act (Commencement) Order which designated the Governor of the Central Bank of Belize as credit unions Registrar. The 2005 amendments were aimed at bringing about integrated supervision of Belize's financial system, upgrading existing credit union supervisory standards in compliance with those set by the World Council of Credit Unions and to institute administrative penalties for non-compliance. By virtue of the legislative amendment, the advocacy role of the Belize Credit Union League was expanded to include training of credit union employees in order to facilitate continuous development of the movement.

Membership in the credit union movement has been traditionally drawn from groups that share similar characteristics such as civil servants, small communities, or church members. Since the typical member would be classified as a small saver, there are significant incentives to do business with credit unions rather than with commercial banks, which are impersonal, require that individuals have a steady source of income in order to open an account and impose more restrictive terms for loans. The commercial banks reserve their highest returns for term deposits held by larger depositors while limiting interest paid on smaller savings deposits to between 4.5% and 6%. In 2007, credit union members received average dividends of approximately 7.4%, compared to the commercial banks' weighted average interest rate on all deposits of 6.0% and their weighted average time deposit rate of 8.4%. Even though the interest rate ceiling for loans was removed in 2002, credit unions have continued to lend at 12% per annum, which, for the larger and more profitable credit unions, is further reduced by rebates that may be as high as 10% of annual interest payments. In comparison, the commercial banks weighted average lending rate exceeds 14% per annum. In addition to lower interest on loans, some credit unions have been offering other incentives such as funeral benefits of up to $4000 for the beneficiaries of members who have a minimum of $125 in savings at the time of death.

In enabling otherwise under-served groups in rural areas to gain access to financial services credit unions contribute positively to the mobilization of savings. However, although located in all six districts of Belize, they vary greatly in terms of size and strength and so the benefits of the movement aren't evenly spread across the country. The largest credit union has nearly 40,000 members, the smallest, has less than 500 members. There is also a significant variability in their performance. The result of previous laxity in regulatory oversight is being shown in the need for several credit unions to significantly reduce the level of non performing loans and improve their overall profitability. Since taking on the responsibility for regulation, the Central bank has reviewed the performance of each credit union and efforts are underway to address the deficiencies that have come to light and to generally strengthen the credit union movement in Belize.



Source: Central Bank of Belize

1.2.6 Insurance Companies

As of December 2007, fifteen insurance companies were registered to conduct business in Belize including five life insurers, eight general insurers and two composites. There was significant growth over the 12-year review period with gross premium income collected by the industry rising 290% (from $28.9mn to $112.6mn). This growth peaked in 2001 with a 32.5% expansion that was driven largely by the entrance of two new players to the industry that were able to make significant expansions in the provision of life insurance and related products such as pensions and annuities. At the end of 2007, life insurance accounted for approximately 29.5 % of premium income with general insurance accounting for the balance.

Developments in the period included two acquisitions, one merger and the rebranding of two companies. The 1998 failure of Jamaica Mutual Insurance Company resulted in the acquisition of its domestic assets by Guardian Life Ltd and also highlighted the risk of contagion as the Supervisor of Insurance had to intervene to stop the funneling of funds from the Belizean branch which was being used to offset losses incurred by the parent company. The Supervisor of Insurance's intervention led to the eventual sale of the company's portfolio.

The 2000 failure of BELINSCO, an insurance company that experienced difficulties in producing accurate and timely financial statements also highlighted the need for improved domestic supervision. BELINSCO was placed under judicial management and eventually liquidated when it was unable to meet claims brought against it. The episode highlighted several supervisory issues that were not being addressed by the Ministry of Finance and led to the reconfiguration of the post of Supervisor of Insurance. Prior to this, the supervision of the insurance sector was just one of the responsibilities assigned to the Financial Secretary.

Originally legislated in 1974, the Insurance Act underwent amendment in 2003 to increase the statutory deposit reserve from 10% to 15% of net premium income, impose stricter controls with respect to change of ownership, reporting periods, and presentation of audited annual financial reports, and grant statutory authority to the Office of the Supervisor of Insurance to conduct on-site inspections and impose sanctions for legal infractions. The amendments brought domestic insurance supervision largely in line with the International Association of Insurance Supervisors (IAIS) Core Principles, with respect to improved guidelines for corporate governance, prudential controls, and market conduct. Other efforts to promote good governance in the industry were also evidenced in the formation of voluntary self regulatory/best practice organizations such as the Organization of Insurance Companies (ORINCO) and the Belize Association of Insurance and Financial Advisors.

The International Insurance Act became law in 1999 to govern the establishment of companies offering life insurance, general insurance, reinsurance and captive insurance business to non-resident clientele. Regulatory purview lies with the Supervisor of International Insurance who is under the aegis of the International Financial Services Commission (IFSC). At the time of this writing the international insurance industry remains embryonic.

1.2.7 International Banks

The Offshore Banking Act became law in 1996 and two years later, Belize's first international bank, Provident Bank & Trust (PBT) was licensed. Growth in the number of licensed international banks was gradual with nine more banks being eventually added to the list. Part of the reason for the slow rate of expansion was the stringent requirements imposed by the Central Bank, which sought to ensure that the jurisdiction continues to build its reputation for safety and transparency. The number of operational banks has since fallen to eight as two have since been granted permission to voluntarily wind up their operations.

Provident Bank & Trust dominated the sector until 2006 when an offshore branch of Belize Bank Ltd known as Belize Bank International (BBI) was established as a consequence of the fact that domestic commercial banks were no longer allowed to continue co-mingling the deposits of residents and those of non-resident international business companies (IBC's). By the end of 2007, BBI held 45% of the total assets of the sector, making it the largest international bank operating in Belize. Total credit extended by international banks has grown by an annual average of roughly 8% with BBI and PBT accounting for over 65% of total lending. In recent years, the international banks became significant contributors to increased investment by non-residents in the territory through their financing of land purchases and construction of condominiums.

Also to be noted is that though the international banks were initially allowed to transact business exclusively with non-residents, their operational scope was expanded in 2003 when the legal definition of "non-residents" was amended to include Belizean based export processing zones and commercial free zone businesses. On the regulatory front, international initiatives to combat money laundering and ensure general compliance with the Basle Core Principles led to the amendment of the Offshore Banking Act in 2002. Its successor, the International Banking Act (IBA) strengthened the regulatory powers of the Central Bank and shifted the authority to license these institutions from the Minister of Finance to the Central Bank. Start-up capital requirements for both B Class and A Class licenses were increased from US$250,000 and US$500,000 to US$1,000,000 and US$3,000,000, respectively, and in addition to gaining unlimited access to information pertaining to operations of international banks, Central Bank supervisors became empowered to perform full scope examinations of these institutions.

International Banks Operating in Belize

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
No. of International Banks	1	2	3	4	7	8	8	8	8	9
Total Deposits US$mn	-	35.6	55.6	93.9	129.1	140.4	143.2	157.1	254.3	292.8
Total Loans US$mn	-	20.1	37.2	61.1	78.3	104.1	109.6	115.6	144.3	174.0
Total Assets US$mn	-	38.6	59.2	100.4	153.2	191.0	196.7	212.3	309.0	357.9

Source: Central Bank of Belize

1:3 Conclusion

While Belize's financial system has experienced some growth and diversification, it remains comparatively underdeveloped partly due to its small size, and, to some extent, its fixed exchange rate which limits the flow of portfolio investment capital to and from the system. Because of its important contribution to price stability and the investment climate, the country maintains full commitment to the exchange rate peg with the determination to focus only on financial innovations that are compatible with the existing framework. This of course would be subject to change if a single currency becomes the operational standard of the CSME.

Over the years, commercial bank expansion has enabled more residents to have their intermediation needs met by the formal financial system. However, relatively high levels of unemployment and poverty cause many to be unable to maintain formal ties to commercial banks and, in some cases, even to credit unions. This gap is being filled by the proliferation of informal and formal moneylenders. In recent years, the number of licensed moneylenders has been increasing and currently number 32, which includes nine new licensees in 2008.

Work continues in the quest to further strengthen the regulatory framework as both the Banks and Financial Institutions Act and the International Banking Act are currently being redrafted and a draft Money Transfer Services Bill has been submitted for legal vetting. With commercial bank excess liquidity continuing to expand in a context of significant variation in bank sizes and strength, the need for the Central Bank to transition to a more effective method of liquidity management has also led to a project to reform the arrangements for fiscal financing that will simultaneously enable the Central Bank to adopt a market approach to liquidity management in addition to its current use of reserve requirements. Other legislative amendments to the Central Bank Act, the Treasury Bill Act and the BFIA to undergird this process would consequently be necessary. The issue of private sector credit expansion via hire/purchase facilities offered by local business houses will also need to be addressed since the current laws do not provide for Central Bank regulation of the sector.

As regards the development of Belize's payments system, progress has hitherto been slow due to a lack of financing for technical assistance and infrastructure and difficulty in obtaining consensus among the commercial banks. While agreement has been reached on cheque standards, agreement on other infrastructure to allow automated cheque clearings is still lagging. A comprehensive reform resulting in establishment of a legal framework for the payment systems, Real Time Gross Settlement (RTGS) system, an automated clearing house and local network switch to allow interconnectivity to ATM's and point of sale (POS) machines to facilitate retail transactions is therefore still in the future.

1.4 Addendum

There have been several developments in the period subsequent to that covered in this review of the financial system, a few of which are briefly mentioned here. In 2009, Phase I of a project to strengthen the Central Bank's capacity for effective monetary policy implementation was implemented with steps being taken to liberalize the yield on 3-month Treasury bills and with the Central Bank ceasing its practice of fixing the interbank lending rate. Instead, an upper ceiling on the interest rate was instituted and banks were encouraged to negotiate with each other in order to improve their management of liquid balances and reduce their cost of funds. In 2010, further efforts to develop the market for government securities included amendments to the Treasury Bill Act, Central Bank Act and the Banks and Financial Institutions Act as well as adjustments to the structure of commercial banks' reserve requirements. The volume of government securities, which has been a limiting factor on market activity, was expanded as the ceiling on total securities issuance was raised. Simultaneous progress was made in reducing Central Government reliance on direct financing from the

Central Bank with the overdraft limit being reduced from 20% to 8.5% of government's prior year current revenues. Given the immediate negative impact on the official foreign reserves of Central Bank advances to the government, the reduction in the overdraft limit was a significant milestone. The Banks and Financial Institutions Act also underwent substantial redrafting during this period and there are expectations that the finished product will be passed into law before the end of 2011.

Work on the modernization of the country's national payments system has been proceeding with a view to reducing the cost of financial transactions and increasing overall efficiency. In furthering the National Payments System Project, the Central Bank secured World Bank technical assistance to conduct a country assessment, prepare a development plan and draft an appropriate legal and regulatory framework. The Central Bank has also been working toward the establishment of a local credit bureau which would increase the flow of information to banks and other financial institutions thus enhancing their capacity to accurately evaluate client risk profiles and price their products accordingly. Internationally, the existence of credit bureaus has resulted in broadened access to the financial system and more efficient allocation of resources. The implementation of the Bank's Credit Bureau Project is being facilitated by technical assistance from consultants of the International Finance Corporation, which is a member of the World Bank Group.