# STRUCTURE OF FINANCIAL INSTITUTIONS/MARKETS IN BELIZE

**Paper presented at a Guest Lecture Seminar for the Business Students Association of the University College of Belize**

**Presented by: Manuel G. Vasquez**
**Senior Manager**
**Financial Sector Supervision Department**
**Central Bank of Belize**



**April 3, 1996**

*The views expressed in this paper are those of the author and do not necessarily reflect those of the Central Bank of Belize.*

## Introduction

Most discussions on the growth and structure of financial markets and institutions begin, not unreasonably, with a review of the various categories and numbers of financial intermediaries that form the domestic financial sector. Often, we are provided with statistics of their numbers, sizes and general operating attributes. This is a sensible and often necessary line of approach to the understanding of the financial market. In the case of Belize, this is a rather simple task given the relative low level of sophistication of the intermediation process and the undiversified structure of the financial market. There currently exist only four commercial banks, fourteen insurance companies, twenty one active credit unions, the Development Finance Corporation, one active building society, BIMCO, NDFB, and a small number of money lenders (J L's and other pawn shops).

The capital markets of Belize are still in their embryonic stage with only a handful of equity and debt issues having been issued in public offerings. These include shares and debentures issued by BTL, BEL, the Government and the Central Bank of Belize. The Government is by far the largest issuer of securities. Its outstanding treasury bill issues currently total $70mn. These securities are for very short durations averaging about 91 days. Government has also issued longer term treasury notes ($20mn), bonds ($15mn) and debentures ($11.7mn) with maturities ranging from 5 to 15 years. BEL has the second largest outstanding debt issue with total debentures of $21.5mn. So far, no legislation has been enacted for the regulation and administration of securities trading in Belize but the Central Bank is considering work in this area.

It is important to note that the Social Security Board is also an important player in our financial system even though it is usually not categorized as a "financial institution". Through its legal mandate to levy contributions from employers and employees, this entity has the ability to raise significant sums of resources, a large portion of which is invested through the banking system. Therefore, it has the potential to exert significant influence on money and credit in our financial system.

Similar to the Social Security Board, insurance companies are also significant mobilizers of resources in our financial system. Some aspects of their operations even resemble those of banks in that they offer quasi-deposit investment instruments and they also make loans. That is why they are sometimes referred to as the "hidden bankers". Insurance companies are governed by the Insurance Act of Belize. Supervision and regulation are rather limited when compared to banking entities. Only one person in the office of the Supervisor of Insurance is partly responsible for the oversight of the 14 insurance companies now operating in the country. Nonetheless, despite their relative larger number when compared to banks, total reported assets in the insurance sector amounts to only $25.3 million.

In an effort to better understand the insurance sector, the Central Bank has commenced work on a study of this industry that would facilitate a better appreciation of their role in the intermediation process. The results of this study may also suggest ways in which the regulatory and supervisory framework now in place may be improved to safeguard the interest of policy holders and the public interest.

The impact of credit unions on our financial system cannot be understated. In 1995, credit to the private sector by these entities totalled approximately $77mn of which about 80% was from one institution. Liabilities (savings) owed to the private sector amount to some $88mn of which one institution controlled about 84% in 1995. At this level of credit to the private sector, it would be a fair assessment to say that this large credit union has had a greater impact on credit in the financial system than the DFC whose total loans portfolio has been less than $50mn.

Responsibility for the regulation and supervision of credit unions rests with the Registrar of Cooperatives. A recent CARICOM study on the harmonization of regional regulatory and supervisory practices suggests that consideration should be given to strengthening supervisory practices and capabilities in this office. This is especially important given the significant intermediation role of one of its members.

Notwithstanding their small number, commercial banks perform a central role in the financial system of Belize. With assets totalling $669mn, deposits $570mn and loans $440mn, banks are by far the biggest financial intermediaries. The level of assets in the banking sector, most of which are financial assets, equaled 68% of the gross domestic product of the country in 1995. Against this background, it is clear that a proper understanding of their functions and operating characteristics is critical for making an informed assessment of the structure of the domestic financial system. To this end, I will provide brief comments on the following areas which I hope will assist you in better understanding the attributes of our financial market. These are:

1. the macroeconomic environment for banks;

2. principal characteristics of banks. What sets banks apart from other commercial entities;

3. the legal and regulatory infrastructure;

4. the principal risks to which banks are exposed; and

5. an overview of recent developments in the financial sector of Belize.

## PART I

### The Macroeconomic Environment

In Belize, as in most other developing countries, commercial banks have traditionally played a dominant role in mobilizing financial resources for financing economic activity. The scale and influence of banks in the intermediation process, that is, in pooling savings for lending, perhaps can be best illustrated by the ratio of deposits to gross domestic product (current dollar GDP) which was 58.0% at the end of 1995. In Latin American countries this ratio ranges from a low of 14% for Argentina to a high of 36% for Chile. The reason behind the relatively high ratio for Belize probably has more to do with the fact that banks are the only major vehicle for private and institutional savings and in the degree of public confidence in our banking institutions. The high ratio may also be due to the relative underdevelopment of money and capital markets in Belize. The lower ratios prevailing in Latin American countries may be a reflection of a legacy of destabilizing economic policies including hyperinflation, large currency devaluations, negative real rates of return on savings, capital flight and nationalization of important segments of the economy. Many of these countries have also experienced severe structural adjustment programmes which may have reduced the level of savings in the system. All of these factors contribute to the erosion of investor confidence in the banking sector of those countries.

Banking institutions generally are highly sensitive to the macroeconomic environment and the financial policies of government. Government economic decisions, as well as those of the Central Bank, influence the functioning of financial institutions. Failure to maintain macroeconomic stability has deleterious effects on the operations of banks which may lead to banking difficulties. This is true both in times of excessive expansion and in times of contractions. The table on the following page shows the relative growth rates in loans and deposits in the banking sector as well as the weighted average lending and deposit rates over the past decade.

**Loan & Deposit Growth Rates (1986-95)**

| Year | 86 | 87 | 88 | 89 | 90 | 91 | 92 | 93 | 94 | 95 |
|---|---|---|---|---|---|---|---|---|---|---|
| Loans(%) | - 5.5 | 21 | 28 | 14 | 13 | 20 | 11 | 4 | 5 | 8 |
| Deposits(%) | 6 | 22 | 16 | 22 | 20 | 13 | 9 | 2 | 8 | 15 |
| Avg. lending rate | 14.4 | 13.8 | 13.3 | 14 | 14.3 | 14.3 | 14.4 | 14.6 | 15 | 16.3 |
| Avg. deposit rate | 8.3 | 7.2 | 5.7 | 6 | 6.3 | 6.4 | 6 | 6 | 6.1 | 7.2 |
| Net avg. margin | 6.1 | 6.6 | 7.6 | 8 | 8 | 7.9 | 8.4 | 8.6 | 8.9 | 9.1 |

Standard deviation:
lending rate 0.80%
deposit rate 0.798
net margin 0.96

From the table above, it can be seen that the latter part of the 80's and up to 1991 experienced significant growth in both loans and deposits. It is particularly interesting to note the sharp decline in the growth rate for loans which decreased from 20% in 1991 to 4% in 1993. Deposit growth declined even more from 20% in 1990 to 2% in 1993. Since then it has increased moderately to 8% in 1995. A peculiar feature of banking in Belize can be observed in the behavior of lending and deposit rates. Whereas the weighted average deposit rate appears to fluctuate more, the average lending rate has generally exhibited an upward trend. However, the standard deviation of both rates are the same at 0.80% but the net interest margin has been rising at a rather steady rate from 6.1% in 1986 to 9.1% in 1995. This volatility is reflected in a higher standard deviation at 0.96%.

## PART II

**Special Characteristics of Banks**

What is special about banks that attracts so much regulation and oversight by the Government and why is the banking industry so prone to crisis? To answer this question I believe it is fitting to describe some of the more fundamental features of banks as they relate to their structure and the financial system in which they operate. These features are by no means unique to banks operating in Belize and it can be said that they have universal application.

***Banks are highly leveraged.*** A highly leveraged bank means that it puts other people's money at risk in managing its portfolio of investments with only a small proportion of owners' funds at stake. The leveraged nature of banking operations has two critical implications. The first has to do with the function of capital as a "cushion" for losses that may arise from adverse economic shocks. With only a small amount of capital this cushion is rather flimsy and relatively small shocks can drive a bank into insolvency. The amount of capital held by a bank would therefore determine its ability to weather disruptive volatility in the economy and as well as other factors that may undermine financial soundness.

The other concern about the highly leveraged character of banks is that it can create unscrupulous incentives for bankers to make excessively risky investments. Although acting in this manner may be in the interest of shareholders, it is highly detrimental to that of depositors and other creditors. This is the classic **moral hazard** problem that induces bank managers to hold excessively risky portfolios because shareholders receive all the benefits if the outcomes are good, while depositors and taxpayers pay the price if outcomes are sufficiently bad to drive the bank to bankruptcy.

***Banks are illiquid.*** As part of their financial intermediation function, banks perform an explicit transformation of maturities, taking relatively short-term deposit liabilities and investing them in longer-term loan assets. In Belize, commercial bank lending tends to be somewhat short term but the banking system is nonetheless illiquid from the point of view of the relative maturities of its assets and liabilities. This illiquidity derives from the fact that although loan contracts are of short duration, they are usually rolled over or renewed thereby transforming them into long term commitments. This creates a significant mismatch in the duration of assets and liabilities. Thus, whatever the stated legal maturity of its loan portfolio, the banking system is illiquid in the sense that an attempt to rapidly liquidate its portfolio would undermine the financial condition of borrowers and simultaneously reduce the value of the bank's own assets.

This illiquidity has important implications for the flow of credit upon which the real economy depends. Macroeconomic shocks to banks' funding sources, especially deposits, are extremely disruptive requiring them to hold stocks of liquid reserves to allow them to honour deposit withdrawals and to meet lending commitments.

***Banks Process Information.*** The financial intermediation function of banks in the economy has to do with the generation and processing of private information about borrowers. Through their business relationship, banks are strategically positioned to know about their customers' ability to service their loans. In this context it is not cliche to state that a person's lifestyle may be reflected in the activity of his cheque book. In contrast, both depositors and bank supervisors are at an informational disadvantage vis-a-vis the banks. Without this knowledge, depositors would not be in a position to learn in a timely manner whether their bankers are lending to creditworthy borrowers. A similar constraint faces bank supervisors. The information possessed by supervisors about a bank's asset quality is a small subset of the information available to bank managers. The caveat here is that during lending booms banks would find it more difficult to asses the creditworthiness of borrowers and to determine what loans are experiencing problems. It should therefore be clear that supervisors will be at least as deep in the dark, and probably more so than bank managers.

***Banks manage the payments system.*** Another important feature of banks is that an important class of their liabilities provides a vehicle through which the payments system operates. Demand or chequing accounts, in conjunction with the cheque clearing system, provides this vehicle and it is important to ensure that it operates without disruption. The inability of one bank to honour its commitments may undermine the ability of otherwise healthy banks to honour theirs. The failure of one institution can therefore create a domino effect of interruptions with undesirable consequences for the payments system and the real sector. This is generally referred to as "systemic risk".

The efficient functioning of the payments system also has important implications for the structure of bank liabilities. It requires, in particular, that the bank maintains an adequate pool of liquid assets to satisfy claims on its deposits and implies that a substantial fraction of its liabilities should be owned by a large number of very small savers (core deposits). Core deposits have historically been a stable source of funding for banks. However, as mentioned before these depositors are generally ill-equipped to obtain timely and reliable information about the quality of a bank's assets and management. If depositors suspect difficulties, they may create a run on the bank as they take their funds to other seemingly safer institutions or keep it at home. Such runs are highly undesirable and are considered an inefficient way to discipline bank managers for imprudent banking practices.

## PART III

**The Legal and Regulatory Environment**

Because of the important role of banks in our financial system, a fair degree of regulation and supervision is dedicated to their operations. Since the beginning of 1996, new legislation was put in force in Belize that regulates the activities of banks and other financial institutions. The new law, (Banks and Financial Institutions Act, 1996) attempts to modernize the approach to the supervision of banks in a number of ways without compromising the degree of operational freedom of supervised entities. In some ways it attempts to control the risks to which banks and depositors are exposed in an indirect manner. For instance, it has provisions for the following:

a) limits on concentration of credit and insider dealing;

b) minimum standards for bank capital (leverage) and liquidity;

c) examination and audit of banking operations;

d) suspension of bank officers for improper conduct; and

e) asserting control over the assets and affairs of insolvent institutions.

f) external auditors to play an enhanced role in the supervision of licensees.

The requirement for banks to maintain a minimum level of capital is designed to limit leverage and ensuring that shareholders have something of value to lose when risky loans go bad. The objective here is to mitigate the problem of "moral hazard" mentioned earlier. Capital standards are therefore considered an important first line of supervisory defense in the attempt to discourage excessively risky investments.

## PART IV

**Banking Risks**

Banks are exposed to a large number of risks, not only those arising from macroeconomic circumstances but from within the bank itself. Some persons believe that it is only the real economy that should concern the authorities and that the financial sector is just a necessary complement to that sector. This however reflects a superficial understanding of the dynamics of banking and experience has shown that while the real sector is important, banking risks may emanate from a number of sources including those that are endogenous to banks. Some of these risks are discussed below.

***Poor Management.*** Management is perhaps the single most important contributor of banking risk determining whether a bank can operate satisfactorily during economic recessions and whether a bank fails even during periods of economic prosperity. Poor management is usually manifested in overextension, quick growth, poor lending policies, weak internal controls and poor planning. These could lead a bank to incur losses, capital erosion and ultimately bankruptcy.

***Overextension*** generally refers to "doing too much" in any of a number of areas such as lending too much in comparison with the level of capital and deposits. It may also mean diversifying in product or geographical terms where the bank lacks familiarity. A good example of product diversification in developed countries is the entry of foreign banks into derivatives business and the control risks to which they expose themselves. Although discussion of these risks is beyond the scope of this paper, the recent cases of Barings, Orange County, Bankers Trust/Procter & Gamble are instructive.

***Quick growth*** or excessively aggressive growth may also lead banks to financial difficulties. Whether the objective is to become first in the ranking of size or simply the motivation to gain preeminence and respect in the community its serves, growth for the sake of growth is risky. In the haste for growth, prudent lending criteria may be jeopardized and loan quality may suffer.

***Poor lending policies*** may lead a bank to invest resources in areas that are too risky and may not be recovered. Bankers should always be mindful that those resources are ***other people's money*** that have to be repaid. These are not the bankers' money. Typical indicators of poor lending policies include concentrated lending, connected lending and weak loan administration procedures and controls. Other risks associated with poor lending policies are interest rate risk, currency risk and liquidity risk.

## PART V

**Overview of Recent Developments in the Financial Sector of Belize**

The passage of the new Banks and Financial Institutions Act was an important milestone in the development of the financial sector of Belize. In addition to modernizing the approach to the supervision and regulation of commercial banks, it also provides for the licensing of a number of non-bank financial institutions such as investment/merchant banks, brokerage firms, finance companies and collective investment schemes (mutual funds). We now have in place the legal infrastructure that would allow for the orderly development of these types of entities. The formation of these entities would also introduce competition in the market for financial services which will enhance the efficiency of financial intermediation in Belize. It is also hoped that in the near future, the legal framework to facilitate the formation of a more active capital market will be developed.

The government has stated its intention to promote the development of the budding offshore financial services industry. So far, Belize has enacted legislation for international business companies, trusts and ship registration. Two more Bills have been tabled before the House of Representatives. One will provide for the establishment of offshore banks and the other will criminalize money laundering. It is expected that these two Bills will be enacted within the next two months. Other areas to be considered for the development of Belize as an international financial center is the enactment of laws to provide for offshore insurance companies (captive insurance), limited partnerships, mutual funds and company management services. It is also being considered to establish a Financial Services Commission to be responsible for general oversight of the offshore sector.

The development of an offshore financial services industry has the potential of generating significant economic benefits for the country. These benefits relate to an increase in the level of employment particularly in the professional and service sectors of the economy. Government would also earn additional revenues from registration and licensing fees as well as from increased taxation due to higher levels of employment. There may also be significant spillover benefits in telecommunications, tourism and agriculture.

Developing a vibrant offshore center also carries with it certain international responsibilities and risks to the good name of Belize. The Central Bank is fully aware of these responsibilities and will do all that is within its sphere of influence to ensure that offshore banking is carried on from within Belize with the utmost professionalism and integrity. It is also supporting the enactment of legislation that would criminalize money laundering in an effort to reduce the risk of that occurring from within our borders. To this end, the Offshore Banking Bill that is now before the house makes provision for the Central Bank to be the primary regulator for offshore banks. The Central Bank also intends to play an active role in any other form of offshore financial sector development with a view to preserving and fostering Belize as a responsible international financial center.

## *References*

Central Bank of Belize, Statistical Digest 1994

Laetitia Solis, "An Overview of Financial Instruments and Capital Market Operations in Belize", Paper for the XXVII Annual Conference of Monetary Studies, 1995.

Economic Development Institute of The World Bank, "Financial Regulation", 1992, Edited by Dimitri Vittas.