The Financial System

In 2013, the Central Bank continued to focus on regulatory activities aimed at strengthening the performance of banks and credit unions, macro-prudential monitoring to reduce systemic vulnerabilities and build resiliency, and on-going projects to modernize Belize's financial infrastructure.

These efforts were fruitful as the ratio of NPL (net of specific provisions) to total loans for the domestic banking system registered a further decline during the year. Initially, the Central Bank had agreed to phase-in periods spanning three and five years for specific commercial banks to fully meet the heightened requirements for loan loss provisioning instituted at the end of 2011. Those periods were slated to end in 2014 and 2016, however, due to the earlier than anticipated improvement in the banks' balance sheets, the Central Bank reduced its specific loan loss provision requirement from 70.0% to 50.0% of the outstanding loan balance for all loans and other assets classified as "loss", which are fully secured by mortgages in the beginning of April. In the case of the credit unions, the decision was made to require the standardization of procedures for loan classification and loss provisioning and the alignment of these with international best practices. In this regard, two orders were issued under Section 51(7) of the Credit Unions Act that came into effect on 28 March 2013, and guidance was also provided for the restructuring of loans.

Given the importance of safeguarding the stability of the financial system, the Central Bank instituted a framework for macro-prudential oversight that focused specifically on the interconnectedness of financial institutions, the real economy and international developments. Systemic risks were tracked and assessed through the use of financial stability indicators and stress tests. A draft memorandum was also prepared to formalise cooperation between the Bank and the Office of the Supervisor of Insurance.

Efforts to modernise the financial infrastructure proceeded as programmed with assistance being received from the Canadian International Development Agency (CIDA) and the International Financial Corporation (IFC). Notable progress was made in laying the groundwork for the establishment of a national credit bureau. A credit reporting conference was held in April to sensitise stakeholders, and credit reporting legislation and regulations were subsequently drafted. The project timeline includes legal vetting by the Solicitor General's office early in 2014 prior to the process of parliamentary enactment that would hopefully be completed by mid year. Further work would include the formation of a Data/Information Technology (IT) Working Group, the issuance of a credit bureau licence and implementation of an awareness campaign to heighten stakeholders' knowledge of credit reporting.

The Financial System *continued*

The project for modernization of the national payments system (NPS) also remained on track. The Bank held consulations with key stakeholders and, with World Bank assistance, drafted a NPS Bill, which was submitted to the Solicitor General's office for review. In addition, an updated high level request for proposal, which outlines the requirements for the NPS solution that is slated for implementation in early 2015, was developed.

On the anti-money laundering front, Belize was subjected to heightened scrutiny and criticism from the Caribbean Financial Action Task Force (CFATF) during the year. In an effort to address the deficiencies identified by the CFATF, the Government enacted thirteen legal amendments between January and October. The legislative milestones were however not achieved in consonance with the deadlines set by the task force. The CFATF Plenary in November consequently opined that the country was still not significantly compliant and issued a second public statement in 2013, calling on member countries to consider taking counter measures against Belize to protect their financial systems from possible money laundering and terrorist financing risks. Adding to the potential difficulties, the global Financial Action Task Force (FATF) International Cooperation Review Group (ICRG) unilaterally decided to evaluate Belize's AML/CFT regime at its upcoming February 2014 Plenary. Further work would therefore be required to bring the country into substantial compliance with the sixteen core and key recommendations by May 2014 and with all the remaining FATF 40 + 9 Recommendations by November 2014, the deadline for resolving the deficiencies cited in the third round of mutual evaluations.

Given the urgency of addressing the AML/CFT concerns raised by the CFATF, the Central Bank worked closely with the Financial Intelligence Unit (FIU) to ensure that the necessary amendments were made to the banking laws, and this interagency cooperation was formalised through a Memorandum of Understanding. The Bank's anti-money laundering off-site and on-site surveillance of the financial sector was strengthened with technical assistance being received from the IMF. All banks and credit unions were required to submit monthly reports on their customer base, products and services to facilitate the off-site monitoring and analysis of the financial risks specific to each institution, and several guidelines relevant to the on-site examination process were drafted to improve its effectiveness.

Supervision Issues and Licensing

The Central Bank's mission includes the assurance of a safe, sound and efficient financial system, and in this regard, the Bank conducted on-site examinations of one domestic bank, two international banks, one credit union and a financial institution during the year. Bank examiners assessed the

The Financial System *continued*

performance of these institutions in relation to solvency, liquidity, capital adequacy and risk management and also focused on statutory compliance including adherence to the AML/CFT regulations framework.

Under Section 57(2) of the Domestic Banks and Financial Institutions Act, 2012 (DBFIA), commercial banks are required to obtain the Central Bank's approval for credit facilities that exceed 25.0% of their paid-up and unimpaired capital and reserves. Of the fourteen applications that were submitted in 2013, nine were approved by the Central Bank. These facilities summed to $110.5mn as compared to the total of $150.5mn approved in the previous year. The international banks also submitted nine such applications as required under Section 21:02(2) of the International Banking Act (IBA) with the Central Bank granting approval for two applications that totalled US$35.8mn.

Domestic Commercial Banks

Chart 3.1: Asset Quality

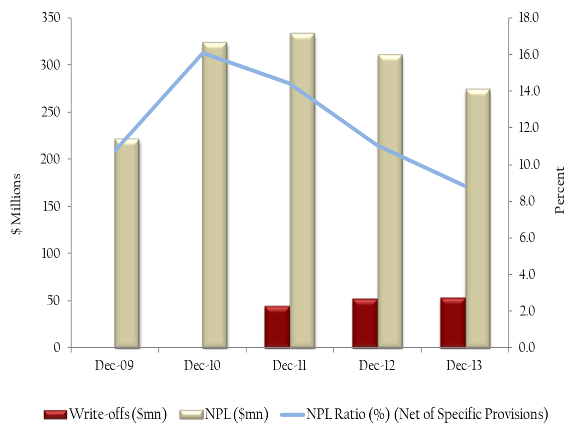
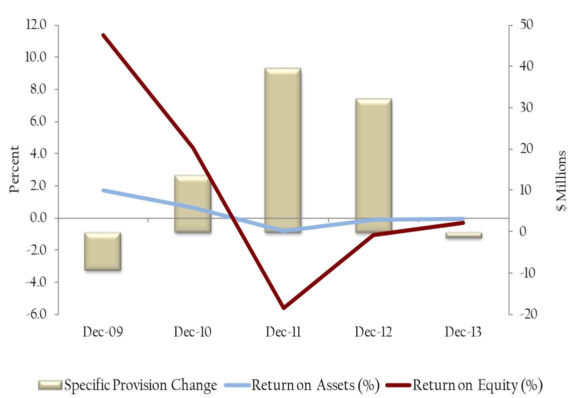


Chart 3.2: Profitability



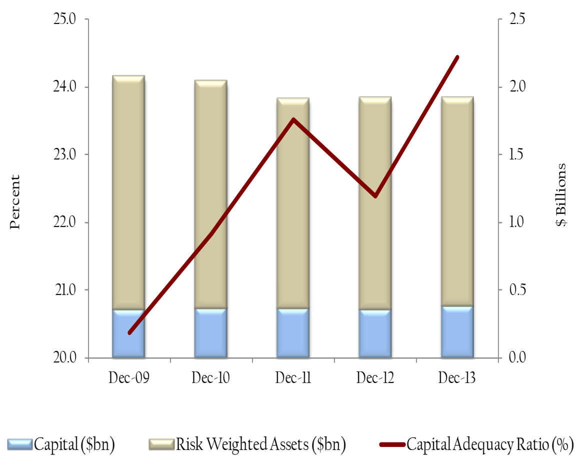
A notable development was the issuance of a domestic banking licence to the National Bank of Belize Limited, which is fully owned by the government, and which brings the number of licenced domestic commercial banks in Belize to six. The new bank subsequently opened its doors for operations on 2 September with the announced mission of serving the financial needs of low and middle income customers, including civil servants. Meanwhile, Handels Bank & Trust Company Limited, which was licenced on 25 July 2006, commenced the voluntary wind-up of its operations in February in accordance with Section 38(1) of the IBA.

Domestic Commercial Banks

Adjustments aimed at strengthening the balance sheets of the commercial banks continued with the writing off of an additional $52.7mn in NPL during the year.

The Financial System *continued*

Chart 3.3: Capital Adequacy

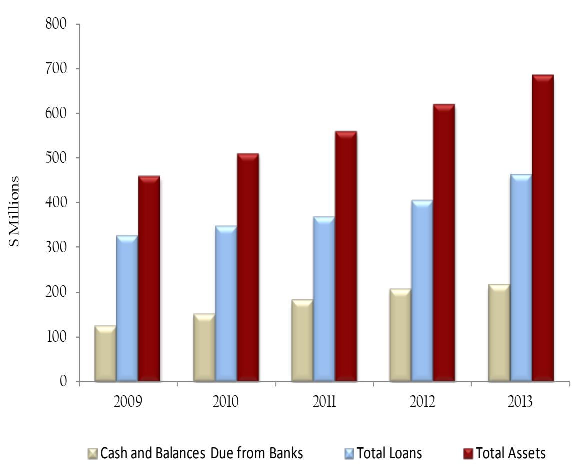


The write-offs were integral to the phasing in of upgraded standards for loan loss provisioning and resulted in an 11.7% decline in NPL to $274.0mn. Loan loss provisions rose from 40.8% to 46.0% of NPL, and the ratio of commercial banks NPL (net of specific provisions) to total loans fell from 11.0% to 8.8%.

Losses were recorded for a third consecutive year, however, the quantum has been progressively diminishing, reflected in system-wide improvements in return on assets (ROA) from -0.14% to -0.04%, and return on equity (ROE) from -1.04% to -0.31%. Aggregate bank capital rose by $26.1mn (7.8%) during the year as improvements in retained earnings by some banks more than offset losses sustained by the others. The capital adequacy ratio (CAR) consequently increased to 24.4%, the highest level in five years.

Five Largest Credit Unions

Chart 3.4: Loans, Cash and Balances Due from Banks and Assets



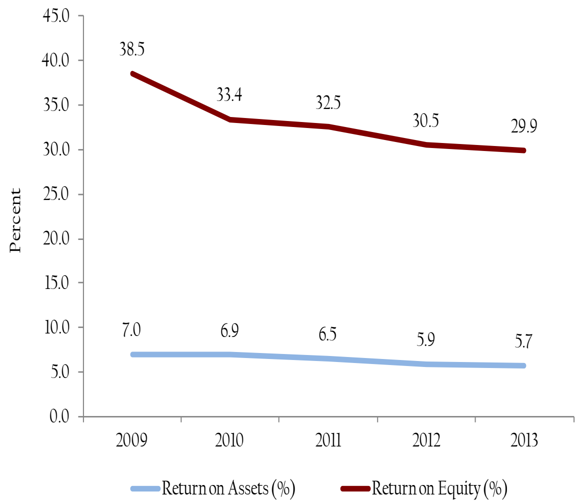
Credit Unions

Credit union activity continued to increase with membership rising by 3.6% and the assets of the five largest credit unions (the Group) climbing by 10.3%, almost on par with the previous year's growth of 10.8%.

The Group's aggregate capital continued the steady growth evident since 2009, rising by 9.7% to $127.0mn during the year. The ratio of institutional capital to total assets remained relatively stable at 11.8%,

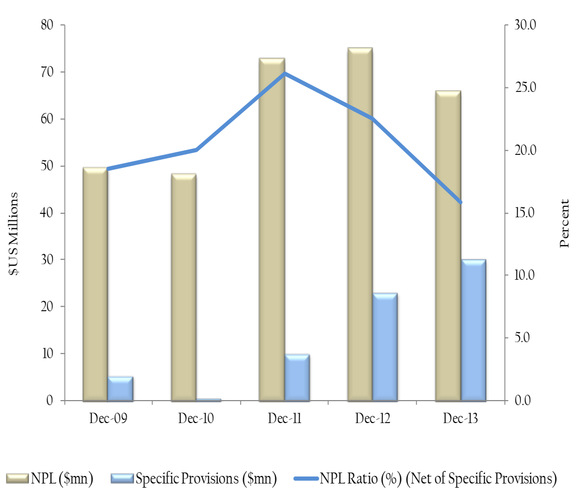
The Financial System *continued*

Chart 3.5: Profitability



International Banks

Chart 3.6: Asset Quality



comparing favourably with the international benchmark of 10.0%.

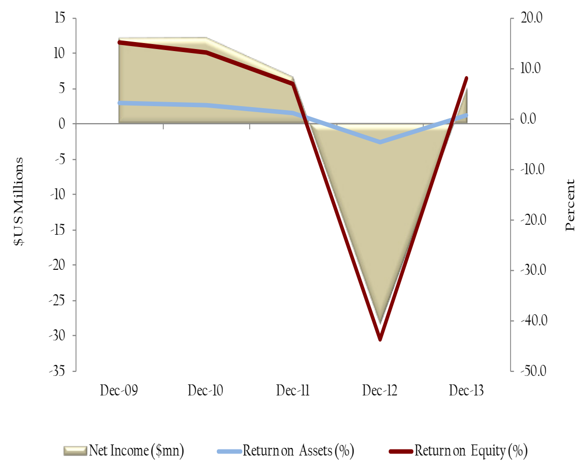
With interest income up by 6.5% and interest expenses down by 2.1%, the Group's net profits grew by 6.4% to $37.7mn, outpacing the 1.3% growth of 2012. The marginal decline in their ROE from 30.5% in 2012 to 29.9% was consequently mainly a reflection of the growth in capital. ROA also fell marginally to 5.7%, as the expansion in assets slightly outpaced the growth in net income.

International Banks

Because of the substantial amount of NPL on their books, the international banks continued to struggle during the year. These banks sustained the hardest hits as a result of the negative effect of the global financial crisis on the local real estate market, and the need for loan loss provisions mounted with the rise in NPL. Recognizing the need to ameliorate some of the adverse effects on their balance sheets, the Central Bank proposed that the necessary provisions be gradually phased in over a three year period beginning in November 2011. In consonance with this decision, loan write-offs and liquidation of collateral by two banks resulted in NPL declining by US$9.0mn in 2013. Their specific provisions were simultaneously increased by US$7.1mn and as a result, the NPL ratio (net of specific provisions) fell from 22.6% to 15.9%.

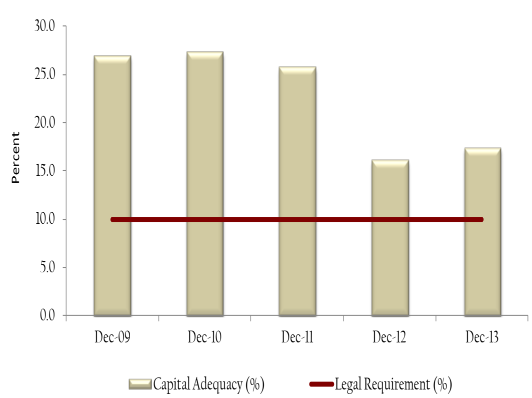
The Financial System *continued*

Chart 3.7: Profitability



The deposit liabilities of the banks rose by 9.0% during the year, however, their assets increased by only 2.4% mainly due to a reduction in lending. A profit of US$5.3mn was nevertheless recorded as the banks took steps to reduce their cost of funds by increasing the share of demand deposits relative to time and savings deposits. The consolidated ROA and ROE consequently improved from -4.6% to 0.8% and from -43.7% to 8.0%, respectively, and the return to profitability enabled capital to be augmented by 6.0% to US$55.9mn. This raised the consolidated CAR from 16.1% to 17.4%, relative to the 10.0% legal requirement.

Chart 3.8: Capital Adequacy Ratio

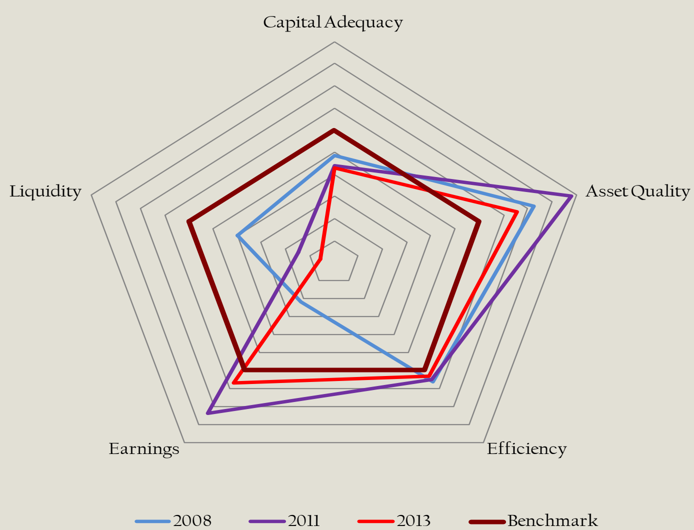


The Financial System *continued*

Box 1: Resiliency of the Domestic Banking System: A Medium Term Perspective

Despite strong growth in credit union assets, commercial banks remained dominant, accounting for 54.0% of assets and 76.8% of loans in the domestic financial system. Reflecting its relative underdevelopment and thinness, the financial system was notable for a high degree of interconnectedness as credit unions and insurance companies held a significant portion of their assets in the form of bank deposits. In most cases these balances were far in excess of their mandated liquid reserves. Other institutional investors also depended on these traditional financial products to provide a stable source of income despite the recent decline in time deposit rates. With domestic banks continuing to play a key role in the financial system, their resilience underpins financial sector stability.

Chart A: Cobweb Model for Domestic System



In Chart A, the analysis of the domestic banking system is depicted in a cobweb diagram that uses the CAMELS approach in tracking five main areas of bank performance from the onset of the financial crisis in 2008 up to the present (Capital Adequacy, Asset Quality, Management (measured by Efficiency), Earnings and Liquidity) . In the instances where the measured values move progressively outwards to the edge of the chart, this is indicative of a deterioration in performance, and conversely, the system's performance is seen to be improving when data points move inwards to the centre of the chart.

As shown in the chart, asset quality is an area of concern for the banking system. Due to poor lending practices in earlier years, the consolidated NPL ratio (net of specific provisions) of the commercial banks stood at 10.7% on the eve of the 2008 downturn (compared to the benchmark maximum of 5.0%), and loan ever-greening (i.e. lending money to facilitate interest payments) was found to be practiced at some institutions.

The Financial System *continued*

Box 1: Resiliency of the Domestic Banking System: A Medium Term Perspective *continued*

Non-performing loans spiked from $221.1mn in 2008 to $332.6mn by December 2011 and the commercial banks, which relied heavily on collateral-based lending, could not easily liquidate non-performing assets at originally appraised values during the downturn in the property market. Since the banks had not been required to set aside provisions for loans that were fully secured by marketable collateral, they continued to hold these non-performing assets on their books and avoided an immediate write-down that would have translated into a sizeable reduction in profits. This contributed to the elevation in the NPL ratio to 14.4% by December 2011.

Recognizing the need to recalibrate the incentives that had led to the over emphasis on collateral-based lending, the Central Bank mandated commercial banks to begin setting aside loan loss provisions for collateralised NPL. Set at 70.0% in December 2011, this requirement was revised downwards to 50.0% in April 2013. In the two years since its promulgation, the new practice directions resulted in a $30.8mn increase in provisioning and $90.4mn in write-offs that has brought the NPL ratio (net of specific provisions) down to 8.8%.

Commercial bank earnings have also been volatile during the period under review due to the high level of NPL, which necessitated increased provisioning expenses. Net losses were declared in 2011, yielding negative ROE of -5.58% and ROA of -0.83%. In the subsequent periods, the banks have boosted their operating income by increasing fees and simultaneously lowering their cost of funds. Although an improvement, 2013's consolidated ROA and ROE of -0.04% and -0.31%, respectively, continue to be below the minimum 1.0% benchmark for earnings.

Since 2008, the sector's efficiency levels have been gradually improving. Despite the persistently high level of NPL, the system as a whole was able to remain liquid and adequately capitalised. Beyond meeting the 9.0% legal requirement, CAR improved from 19.3% in 2008 to 24.4% in 2013 partially due to the sizeable NPL write-offs. High levels of liquidity continue to be prevalent with the excess holdings of the banks rising from 20.6% in 2008 to 56.3% partly due to a slowdown in lending in recent years. However, once the process of balance sheet strengthening is completed and this is reflected in loan repricing, it would be expected that liquidity levels will commence a gradual downward slide that will reduce the sizeable overhang that now exists.