

MIF Project Abstract

Belize

I. BASIC DATA OF THE PROJECT

Project Title:	Strengthening of Banking and Non-banking Supervision		
Project Number:	TC-03-05-00-1		
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Executing agency:	Central Bank of Belize (CBB)		
Cost and financing:	MIF	US\$	600,000 (70%)
	Local	US\$	<u>260,000 (30%)</u>
	Total	US\$	860,000

II. BACKGROUND

A. Frame of Reference and Justification

- 2.1 Belize is a small and open economy. Its financial system is dominated by commercial banks, branches of foreign banks and offshore banking institutions. There are also offshore financial services companies, building societies (mortgage finance companies), cooperatives and credit unions. Government-owned institutions are the Development Finance Corporation (DFC- state-owned development bank) and the Small Farmers and Business Bank (SFBB) and the Government Savings Bank (GSB).¹ As of December 2002, commercial banks account for 60% of all financial assets and its ratio of domestic bank liabilities to GDP is 61%, which is significantly lower than the Asian NIEs average, while higher than that of the Caribbean average.
- 2.2 In March 2001, the International Monetary Fund (IMF) performed an assessment mission on the area of banking supervision. The main findings indicate that the current regulatory framework for the financial sector, while comparatively developed, does not address all aspects required outlined in the Basle Core Principles. In particular, it is pointed out that independence of the bank regulation and enforcement from the government influence is not clearly established, which may dampen effectiveness of the overall supervisory task.

¹ There are 5 commercial banks (including 2 foreign bank branches), 7 offshore banks, 15 credit unions, 2 building societies, 13 offshore financial service institutions, 1 mortgage institution, 17 insurance companies, 11 foreign exchange houses, 1 state-owned development bank (Development Finance Corporation or DFC), 1 state-owned small farmers bank (the Small Farmers and Business Bank or SFBB), and 1 state-owned savings bank (the Government Savings Bank or GSB). At end-2002 banks' risk-weighted capital adequacy ratio was 15.7% in the aggregate and banks' returns on asset and equity were 3.7% and 35.1%, respectively.

- 2.3 Moreover, the financial sector of Belize has recently become more complex and diversified. Since the Banks and Financial Institutions Act of 1995 incorporated recommendations of the CARICOM regional harmonization project, the favorable environment further enhanced by the Act led to rapid expansion in non-bank institution such as insurance companies, credit unions and building societies.
- 2.4 Domestic commercial banks, foreign branches and offshore banks are regulated and supervised by the Central Bank of Belize (CBB) and licensed with the approval of the Ministry of Finance. Offshore financial services companies are authorized by the International Financial Services Commission Act and supervised by the International Financial Services Commission. These offshore financial services institutions are not directly supervised by the CBB. The Financial Sector Supervision Department (FSSD) of the CBB performs supervision of commercial banks, but non-bank financial institutions, including a number of significant sized credit unions, as well as building societies, and government-owned financial institutions are either regulated under specific but weak regimes and laws, or essentially not regulated at all. (See the following matrix).

Legislation (Supervisor)

Institution	Banking and Financial Institution Act	Building Society Act	Cooperative Society Act	Credit Union Act	DFC Act, SFBB Act, Savings Bank Act	International Banking Act (Formerly Offshore Banking Act)	International Financial Commission Act
Bank	Central Bank						
Building Societies		Attorney General					
Cooperatives			Registrar of Cooperatives and Credit Unions				
Credit Unions				Registrar of Cooperatives and Credit Unions			
Foreign branches	Central Bank						
Government Banks					Ministry of Finance		
Offshore Banks						Central Bank	
Offshore financial serviced companies							International Financial Commission

- 2.5 The above-mentioned IMF assessments of the state of banking regulation point to specific technical weaknesses in the supervision and insufficient enforcement of regulations, citing as targeted areas of technical assistance interests: capacity for the CBB to perform supervision functions; necessity of extending the CBB's authority to cover credit unions, building societies and DFC; necessity to increase supervision of offshore operations.

- 2.6 The government of Belize has recently outlined its basic reform plan for financial supervision along the following areas: 1) development of legal framework to regulate activities not covered by the existing laws and strengthening supervision at all levels; 2) training of bank and non-bank regulators to help technical staff be equipped with proper tools to manage the supervisory process; 3) more financial/market discipline through increased competition and transparency within the banking system; and 4) action plans to streamline the government banks, in particular, Development Finance Corporation and the Savings Bank.
- 2.7 In spite of the recent steps taken by the Central Bank to increase and empower its human resources, FSSD is understaffed and faces difficulties in enforcing the existing banking laws and regulations. The Government intends to strengthen the supervisory capacity and prudential norms in a context of re-engineering the financial authorities structure, but this will require sustained efforts over time, as the international standards and best practices will be also being advanced. Furthermore, it would be recommendable to develop a plan of actions regarding reorganization of the DFC and Government Savings Bank in light of its deteriorating loan portfolio² and weak management, and subjecting them to banking sector supervision.
- 2.8 Furthermore, in the context of deepening the financial system and supporting the diversification of productive activities, a lack of non-banking laws and trained staff for supervision for such segments needs to be addressed promptly, as small and micro-enterprises are suffering from severely limited access to credit. At present, most credit from commercial banks is directed to stable and less risky activities within the traditional agricultural export sector, thereby making it difficult for small farmers and entrepreneurs to have access to production-oriented credit. Small credit suppliers are often organized as NGOs³ but do not meet accepted industry standards and reported overdue rates are substantial, questioning the financial viability of such institutions. In this area, cooperatives and credit unions constitute a strategic engine for stimulating economic development. With its principles of democratic ownership, collective efforts and capital accumulation, the model would offer realistic opportunities for entrepreneurship and employment generation if operated under an appropriate legal and regulatory framework with strengthened monitoring ability of the supervisor.
- 2.9 **Bank's perspective and MIF additionality.** Bank programs for Belize are to be designed in light of the country's rapid debt accumulation, avoiding additional external borrowing outside of the budget, thus maintaining indebtedness at a sustainable level. In last years, the country's non-financial public deficit brought about a sharp increase in the external public and publicly guaranteed debt from 70.6% of GDP in 2000 to 80% in 2002, resulting in a substantial increase of the

² It refers only to DFC, as the Government Savings Bank only accepts deposits from the public and is not allowed to provide loans.

³ Prominent examples of credit suppliers are National Development Foundation of Belize (NDFB) and Belize Enterprise for Sustained Technology (BEST).

public debt service from 6.6% of GDP in 1999 to 12.6% in 2002. Although the structural reforms in the area of tax and public expenditure initiated by the former administration may have a positive impact on Belize's economy in the medium run, the process of indebtedness cast doubts on the efficiency of the government's pattern of spending, which should be carefully monitored.

- 2.10 The financial system plays a key role in the smooth and efficient functioning of the economy. The most fundamental contribution that any financial system makes is to channel resources from individuals and companies with surplus resources to those with resources deficits. In doing so, the financial system not only satisfies the savings needs of the economy, but also facilitates the accumulation of investment capital that is critical to growth and development of the private sector. In a country whose population is only 250,000, one of the major constraints for establishing an efficient banking system is the scarcity of financial regulatory expertise, particularly in the area of consolidated supervision and offshore banking supervision. A modest amount of technical cooperation will add a significant value to correct the vulnerability of the entire banking system, thus protecting it from being exposed to risk inherent in a small and open economy like Belize, helping establish a more conducive and sustainable environment for private sector development.

III. BENEFICIARIES OF THE PROJECT

- 3.1 The direct beneficiary of the project is the Central Bank of Belize, which will thus be able to strengthen its organizational structure, procedures and systems in order to enhance its capacity to supervise the country's financial institutions. Indirectly, the project will benefit all the consumers of financial services -depositors and borrowers of financial institutions.

IV. OBJECTIVES, COMPONENTS AND ACTIVITIES OF THE PROJECT

A. Objective

- 4.1 The general objective (goal) of the project is to improve the safety and soundness of the financial system of Belize, thus supporting the government efforts to promote macroeconomic stability and private-sector-led economic growth, as well as facilitate access to credit without jeopardizing deposits by the public. The specific objective is to strengthen the Financial Sector Supervision Department (FSSD) of Central Bank of Belize (CBB) in its regulatory, supervisory, monitoring and auditing function over commercial banks and non-bank financial intermediaries. The emphasis of the Project will be upgrading of supervision tools and staff development for domestic and offshore banking, and to a lesser extent credit unions and other non-banking institutions. The project will also initiate public government-owned banks' reforms in the context of furthering financial reform.

B. Components and Activities

- 4.2 CBB recognizes its needs to strengthen “core” functions in banking and non-banking supervision and regulation, including accounting and auditing, information technology, internal auditing, and human resource management. These changes will take place within the context of a comprehensive re-engineering of CBB. To this end, the project is divided into the following three different components that should be implemented in an integral manner. Although the project’s goal in the long run is to have new updated laws passed by the congress, a review of the legislative framework coupled with a broader training and educational plan in banking and non-banking supervision will improve staff skills to meet the on-going and immediate needs of the Belizean financial sector, which is the immediate objective of the proposed operation

Component I: Review of financial legislation and regulatory framework, and updating specific prudential norms

- 4.3 Technical upgrading in financial supervision needs to be accompanied by a review of required legal and normative reforms to increase regulation consistency and coverage across the system. This component comprises a number of activities aimed at reducing the risk faced by the system from the deficiencies in the banking regulations, the differences in regulations between different institutions and the lack of regulation of various non-bank financial institutions. Therefore, it would help to design and introduce standards and to develop FSSD’ technical capacity in the consolidated financial supervision of diverse financial groups.
- 4.4 The first specific activity of the component will be related to assistance for regulated banking institutions (including offshore banks) to adapt current regulations to standards under the Basle Core Principles and other international best practices, particularly with respect to portfolio rating, market and operational risks, and preventive measures. The resources will finance assistance in the review and modernization of specific prudential norms and designing the necessary enforcement mechanism, including restriction on related parties lending, and rules for consolidated risk assessment in financial groups, and know your customer rules.
- 4.5 The second activity will be provision of financial and technical support for the review of non-banking financial institutions’ legislation and regulations, particularly for credit union and building societies,⁴ to identify reform needs for

⁴ Credit unions, and building societies are not covered by the Banks and Financial Institutions Act, but subject to separate and specific legislations. The Registrar of Credit Unions, separate from CBB/FSSD, was established by the Credit Union Act, and is responsible for licensing, regulation and supervision of credit unions. If FSSD were to assume ultimate responsibility for credit unions and building societies, the laws have to be amended. However, supervisory function can be delegated to the CBB through executive resolutions. Anyway, the CBB will require specialized training for staff.

harmonization, thus eliminating regulatory arbitrage⁵ in the system, as well as develop regulatory proposals with a potential implementation path. Additional assistance will be financed for conducting exemplary inspections of selected non-banking financial institutions in cooperation with the banking supervision department to determine potential risk.

- 4.6 Moreover, under this component, assistance will be provided for assessing the one large state-owned bank' (DFC) and two small ones' (SFBB and GSB) performance and initiating plans for organizational restructuring, and strengthening of operational skills, credit and loan recovery departments, accounting and internal auditing, and updating information technology.

Component II: Capacity building of Bank and Non-Bank Supervision

- 4.7 This component comprises a number of specific activities aimed at increasing technical know-how of staff, strengthening efficiency of off-site and on-site monitoring to enhance enforcement capacities. The staff of CBB does not have a broad range of experiences, and examiners do not have an enough professional certification process. Specific activities will include: a) assignment of a long-term advisor to the head of the banking supervision department to assist in the review and reform of current procedures, regulations and systems, develop and impart training for department staff and participate in the planning, execution and review of inspection programs; b) assignment of different specialized short-term advisors to impart specific training to supervisory staff, as well as public accountants and commercial banks' staff on a as-needed basis. Special short-term consultants would include international banking inspectors, who would cooperate with their national counterparts in assisted inspections of financial institutions as an on-the-job learning tool.
- 4.8 **Offshore banking.** Offshore banks are regulated and supervised by the CBB, while offshore financial services companies are regulated and supervised by International Financial Services Commission (IFSC). IFSC, created in 1999 to promote offshore services and provide regulation and supervision of such services with the exception of banking, is composed of the members form the CBB, Finance Ministry and the private sector. The legal framework addressing offshore financial services is embodied by the International Financial Services Commission Act, Money Laundering Prevention Act, and Money Laundering Prevention Regulations. Because of the secrecy restrictions, little detail of offshore financial operations is available.⁶ Assistance will be provided to the authorities to reflect international best practices about supervising on the offshore financial institutions.

⁵ Some discrepancies in the legislation are likely to allow non-bank institutions to operate unregulated and financial groups to take advantage of these gaps and incur greater risks.

⁶ The Caribbean Financial Action Task Force (CFATT) recently performed a review of Belize's offshore financial operations. This is beneficial because of information restrictions contained in the International Financial Services Commission Act.

- 4.9 The activity in this component will include development of the on-site and off-site inspection manuals to reflect the steps that will need to be followed in order to conduct supervision on a consolidated basis. Also, the manual of accounting principles will need to be developed to reflect the adoption of the International Standards for financial institutions.
- 4.10 **Small and micro-credit.** Non-bank financial institutions such as credit unions offer loans to small businesses, being an important source for funding to the disadvantaged group. It is known, however, that almost all the micro finance institutions in Belize find it difficult to meet generally accepted industry benchmark, even adjusting for a very challenging environment. Reported overdue/default rates are substantial, seriously questioning financial viability of the institutions. None of these institutions is currently in a position to cover their operational costs and gain sustainability on their own account. Moreover, most of the institutions have a donor-dependent view of micro finance, generally different from the guidelines established in the Bank policy on the subject.⁷
- 4.11 Under this component, training and dissemination on credit technology utilized for micro finance and its industry characteristics will be provided to the bankers and regulators, in view of a growing diversity of financial services for the sector. The Scotia Bank that has had some interesting experience in setting up a specialized operation for attending small and micro clients in Guyana, is currently exploring the possibility of expanding operations into the small and micro enterprise market. The initiative might present an opportunity to support the rapid development of non-conventional micro finance supply model. The proposed activity is expected to generate enough interests to discuss a modernization of the sector through an appropriate legal and regulatory framework, as well as supervisory strengthening.

Component III: Management Information System.

- 4.12 The present capacity of FSSD information system is fairly basic. Expanding its areas of action and moving forward with the process of accelerated obsolescence of technology solutions to start up these activities calls for modernization and expansion of the information systems platform. The technological modernization will help to enhance the release and dissemination of financial information, and FSSD needs to improve the capacity of its network connections with intermediaries to integrate them in the exchange of financial information.
- 4.13 This component will upgrade FSSD's supervisory information system to gather and process data on the financial system. The system is a database that receives financial and economic information from financial entities, and stores the information that is used by the applications that analyze institutions, classify them, and alert the FSSD to problems in the supervised data. Information systems

⁷ Only BEST appeared to take "less subsidy dependent" view on the matter, although the institution also face substantial challenges in its portfolio quality.

solutions will be developed for on-line communication and electronic transmission of financial information between financial institutions and the FSSD, and remote access to the information provided to the general public. The system will contain programs of early warning and risk management, helping at the same time the standardization of applied tools. In addition, under this component, financing will be provided for development of a centralized risk management system to improve the financial debtor database. Additional technical assistance will be provided for developing a manual to help analyze using the centralized risk management system.

V. COST, FINANCING AND EXECUTION PERIOD OF THE PROJECT

- 5.1 The total cost of the Project is US\$860,000. This cost would be funded by non-reimbursable resources from MIF of US\$600,000 and local counterpart resources of US\$260,000. The major part of the financing will be used to hire specialized consulting services.⁸

VI. EXECUTING AGENCY

- 6.1 The project will be executed by the Cenral Bank of Belize (CBB) through its Financial Sector Supervision Department (FSSD). CBB was founded in 1982. As of December 2001, CBB has a total asset of US\$200 million with capital and reserves of US\$11 million. The FSSD has one manager, one secretary and six examiner employees who concurrently perform both off-site and on-site functions. The FSSD has reaffirmed with the Bank its commitment to improving the application processes for domestic and offshore banking licensing, on-site and off-site inspections aimed at ensuring continued soundness of banks.

VII. EXPECTED RESULTS AND JUSTIFICATION OF THE PROJECT

- 7.1 The financial system is critical to the health of the economy because it performs the essential function of channeling funds from savings to those individuals or firms that have productive investment opportunities. If the financial system does not perform this role well, then the economy cannot operate efficiently, and private sector-led economic growth will be severely hampered. Prudential supervision, in which the government establishes regulations to ensure transparency of financial information, and then supervisors monitor banks to see that they are complying with these regulations and not taking excessive risk, is thus needed to ensure the safety and soundness of the banking system. Preventing

⁸ A part of the resources will be used to enable the FSSD to develop computerized system for collecting, validating, analyzing, and disseminating financial data for the institutions and the general public.

excessive risk taking with prudential supervision is even more critical in emerging market countries. Inadequate prudential supervision has led to severe problems in these countries' banking sectors, which have been an important factor triggering the currency and financial crisis in recent years in the Region, and which have created so much economic hardship.

- 7.2 Enhancing supervision remains an important issue to be addressed in Belize in the context of deepening the financial system. This technical cooperation project in cooperation with the IMF, is expected to provide a better on-site and offsite inspections procedures and lead to the effective implementation of other necessary financial reforms. As a long-term goal, the project will contribute to establish a more stable financial sector in terms of improvements in prudential standards, risk profiles and transparency of the sector.
- 7.3 Upon completion of the project execution, the CBB is expected to have a set of standards adapted to the bank and non-bank financial market and the analytical tools for effective prudential and preventing monitoring of financial intermediaries under its supervision. The stability of the system will be gauged against indicators for financial institutions, in so far as is possible by numerical ones such as capital adequacy and term (mis) match, etc.

VIII. ENVIRONMENTAL AND SOCIAL IMPACT

- 8.1 The proposed project is directed at financial sector supervisory practices and regulatory reforms, thus is not expected to have any direct environmental or social impact.

IX. ISSUES

- 9.1 *Full commitment* by the Belizean authorities for strengthening financial sector supervision is important. The Financial Sector Supervision Department (FSSD) should be provided with more trained staff and monetary resources. The Government must also give assurance in the reform for improvements needed in offshore bank and non-bank supervision. Its commitment will be reconfirmed during the project preparation.
- 9.2 *Independence* of the financial supervision and enforcement from the Government is known by international practices to be critical to enhance its effectiveness. The supervisors in their bank examination task should have legal powers for enforcement of the prudential supervision and regulation norms, and should not be hindered by political influences. To this end, required reforms should include strengthening of CCB's autonomy to make timely interventions with penalization tools. The financial authority's commitment for such independence would need to be confirmed as a priority issue during the project preparation.
- 9.3 Close *coordination* between the Monetary and Exchange Affairs Department (MAE) of the IMF and the Bank is necessary. This entails a Fund-Bank financial

sector collaboration accord on measures for a successful implementation of the technical cooperation in the country. The project team will closely coordinate with the IMF team during the project structuring. *Other issues.* During the preparation, the project team will examine carefully the issues of sustainability, effective use of resources (given the budget constraints of local counterpart), and coordinated execution mechanism (CBB and IFSC).

X. RECOMMENDATION OF THE BANK COUNTRY OFFICE IN BELIZE

- 10.1 The Country Office in Belize considers that this project is a national priority, and its request for funding was made with a strong interest expressed by the highest authority of the government of Belize.

XI. ESTIMATED PERIOD OF ANALYSIS AND PREPARATION OF THE PROJECT

- 11.1 It is estimated that after the approval of the Abstract, the analysis will be able to be completed within 4 months approximately.

Approved by: _____ Date:
Jairo Sánchez (RE2/DEP)