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Supplement 1

May 18, 2005

To: Members of the Executive Board

From: The Secretary

Subject: **Central America—Structural Foundations for Regional Financial  
Integration—Background Paper**

Attached for the **information** of Executive Directors is a background paper on Central America—structural foundations for regional financial integration, prepared jointly by the staffs of the Fund and the World Bank. This paper and the main paper (SM/05/175, 5/18/05), together with a companion paper “Central America—Regional Selected Issues” (to be issued), are tentatively scheduled for discussion in an informal Board seminar on **Wednesday, June 8, 2005**. There will be no gray statements and no concluding remarks for this discussion.

The staff does not propose the publication of this paper after the informal Board seminar but intends to issue a revised paper as an Occasional Paper at a later date.

Questions may be referred to Ms. Brenner (ext. 38500), Ms. Moretti (ext. 36027) and Mr. Morales (ext. 38476) in MFD.

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INTERNATIONAL MONETARY FUND

**Central America**  
**Structural Foundations for Regional Financial Integration—Background Paper**

Prepared by Staff of the Monetary and Financial Systems and Legal Departments  
and The World Bank

Approved by the Monetary and Financial Systems Department

May 17, 2005

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## GLOSSARY

ACH	automated clearing house
AML/CFT	anti-money laundering/combating the financing of terrorism
ATM	automated teller machine
BANGUAT	<i>Banco de Guatemala</i>
BCCR	<i>Banco Central de Costa Rica</i>
BCH	<i>Banco Central de Honduras</i>
BCN	<i>Banco Central de Nicaragua</i>
BCR	<i>Banco Central de Reserva de El Salvador</i>
BIS	Bank for International Settlements
BNP	<i>Banco Nacional de Panamá</i>
BVDN	<i>Bolsa de Valores de Nicaragua</i>
BVP	<i>Bolsa de Valores de Panamá</i>
CAMC	Central American Monetary Council
CEMLA	Center for Latin American Monetary Studies
CEO	chief executive officer
CEPROBAN	<i>Centro de Procesamiento Bancario</i> (Honduras)
CEDEVAL	<i>Central de Depósito de Valores</i> (El Salvador)
CENIVAL	<i>Central Nicaragüense de Valores</i>
CEVAL	<i>Central de Valores</i> (Costa Rica)
CHIPS	clearing house interbank payment system
CIASA	<i>Centro de Intercambio Automatizado, S.A.</i> (Panama)
CLC	<i>Cámara de Compensación y Liquidación de Cheques</i> (Costa Rica)
CLS	continuous linked settlement
CNBS	<i>Comisión Nacional de Bancos y Seguros</i> (Honduras)
CNV	<i>Comisión Nacional de Valores</i> (Panama)
CONASSIF	<i>Consejo Nacional de Supervisión del Sistema Financiero</i> (Costa Rica)
CPSIPS	Core Principles for Systemically Important Payment Systems
CPSS	Committee on Payment and Settlement Systems
CSD	central securities depository
CUT	<i>Cuenta Única del Tesoro</i> (Panama)
DPR	diversified payment right
DvP	delivery versus payment
ECB	European Central Bank
EFTPOS	electronic funds transfer at point of sale
FATF	Financial Action Task Force
FDI	foreign direct investment
FED	Federal Reserve (United States)
FSA	Financial Services Authority (United Kingdom)
FSAP	Financial Sector Assessment Program
FSRP	Financial Sector Regional Project
IDB	Inter-American Development Bank

IFI	international financial institution
IOSCO	International Organization of Securities Commissions
ISIN	international securities identification number
MEF	Ministry of Economy and Finance (Panama)
MFD	microfinance institution
MIB	<i>Mecanismo Interbancario de Dinero</i> (Costa Rica)
MIT	<i>Mecanismo Interbancario de Transferencias</i> (Guatemala)
MONED	<i>Mercado Organizado para la Negociación Electrónica de Divisas</i> (Costa Rica)
MTO	Money transfer operator
OTC	over the counter
PvP	payment versus payment
RNVI	<i>Registro Nacional de Valores Inmobiliarios</i> (Costa Rica)
RTGS	real-time gross settlement
SAT	<i>Superintendencia de Administración Tributaria</i> (Guatemala)
SBOIF	<i>Superintendencia de Bancos y otras Instituciones Financieras</i> (Nicaragua)
SICOF	<i>Sistema Contable Financiero</i> (Guatemala)
SINEDI	<i>Sistema de Negociación Electrónico de Divisas</i> (Guatemala)
SINPE	<i>Sistema Interbancario de Negociación y Pagos Electrónicos</i> (Costa Rica)
SIPS	systemically important payment systems
SITE	<i>Sistema Integrado de Transacciones Electrónicas</i> (Costa Rica)
SML	Securities Market Law
SPID	<i>Sistema Interbancario de Divisas</i> (Guatemala)
SPV	special purpose vehicle
SRO	self-regulatory organization
SSS	securities settlement system
STP	straight-through processing
SUGEF	<i>Superintendencia General de Entidades Financieras</i> (Costa Rica)
SUGEVAL	<i>Superintendencia General de Valores</i> (Costa Rica, Panama)
SV	<i>Superintendencia de Valores</i> (El Salvador)
SWIFT	Society for Worldwide Interbank Financial Telecommunications
TEBEL	<i>Transacciones Electrónicas en Línea</i> (Costa Rica)
TEF	<i>Transferencia Electrónica de Fondos</i> (Costa Rica)
TTS	<i>Transferencia Telefonica Segura de Fondos</i> (Nicaragua)
WHF	Western Hemisphere Payments and Securities Settlement Forum
WOCCU	World Council of Credit Unions

## **PREFACE**

This paper provides background to the report on “Central America: Structural Foundations for Regional Financial Integration,” and has been prepared as part of the Central America Financial Sector Regional Project (FSRP). The chapters were prepared by staff of the Fund’s Monetary and Financial Systems and Legal Departments and of the World Bank. The countries covered in the FSRP comprise the six Spanish-speaking countries of Central America: Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and Panama. The chapters provide: a composite picture of financial development and soundness in the six countries; trends in regional financial integration and supervisory responses; development of the insurance sector; development of payment and securities settlement arrangements; and worker remittances.

## I. MEASURING FINANCIAL SECTOR SOUNDNESS AND DEVELOPMENT<sup>1</sup>

### A. Introduction

1. **This chapter provides an overview of the soundness and the development of Central America's financial sectors by examining information from a variety of sources for Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and Panama.** With about 40 million people, Central America's population is as large as Spain's or Argentina's. Besides geographic proximity and a common language, the region shares a dependence on raw material exports, close economic ties to the United States, and vulnerabilities to natural disasters and terms of trade shocks. Several of the countries have also suffered from long periods of civil strife, which slowed economic growth generally, and hampered the development of legal and judicial systems. The country-by-country analysis undertaken here finds similarities and differences in the region, identifies weaknesses in particular countries and in the region as a whole, and suggests potential areas for policy reform.
2. **To present a composite picture of the financial sectors of these six countries, we compute an index measuring their development and soundness.**<sup>2</sup> This index makes use of a broad range of qualitative and quantitative indicators (see Appendix I). These are grouped into seven subsets measuring (a) the development of the monetary sector and monetary policy instruments, (b) banking sector soundness, (c) banking sector development, (d) nonbank financial sector development, (e) regulatory governance, (f) financial openness, and (g) institutional quality. The choice of indicators is often constrained by availability of comparable information across countries.
3. **Financial sector soundness and development promote economic growth by helping to allocate resources efficiently or are at least seen as a necessary condition to achieve high, sustainable growth rates.**<sup>3</sup> This chapter suggests whether the financial sector is "sound" *and* well developed. A country could portray a "stable," but not well-developed financial sector at the same time. It could also be "well-developed" (in the sense that advanced financial instruments are available), but unstable at the same time (e.g., due to inadequate supervision).

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<sup>1</sup> Prepared by Jens Clausen (MFD).

<sup>2</sup> While the construction of the index draws heavily from Creane et al. (2004), who analyze the financial sector of 20 countries from the Middle East and North Africa, the index presented here differs with respect to the number of themes defined (we add a theme on banking soundness) as well as with respect to the composition and specification of the indicators.

<sup>3</sup> While the direction of causality between financial sector development and growth is disputed, most studies find a positive correlation between them (see Box 4.1 in IMF (2005) for an overview).



## B. Methodology and Themes

4. **The index comprises 33 variables grouped under seven subthemes.** The variables are rated on a scale from 0 to 10 (with 10 meaning well-developed, sound). The data have been compiled for a single point in time. If not stated otherwise, all data used are for end-June 2004.<sup>4</sup> Weights are assigned on a subjective basis and tested for sensitivity.

5. **The first theme describes the development of the monetary sector and monetary policy instruments.** Three indicators apply to all countries within this theme: the ratio of M2 to GDP; the involvement of the government in allocating credit; and the presence of secondary markets for government securities. Because El Salvador and Panama are fully dollarized economies and have no independent monetary policy, no values are computed for these countries concerning the use of indirect monetary policy instruments and central bank independence.

6. **The second theme examines banking sector soundness.** The related variables are: the ratio of capital to unweighted assets (for measuring capital adequacy); nonperforming loans (NPLs) to total loans (measuring asset quality); the difference between nonperforming loans and provisions; return-on-assets (ROA) for measuring the profitability of the banking sector; liquid assets to total assets (for liquidity risk)<sup>5</sup>; and sensitivity to exchange rate risk.<sup>6</sup> The information inherent in financial soundness indicators relies on the quality of the underlying data and comparisons across countries are difficult due to different definitions of, for example, capital adequacy ratios and nonperforming loans.<sup>7</sup>

7. **The third theme describes the state of development of the banking sector with respect to size and structure.** The related variables are: the ratio of credit to the private sector to GDP; a measure of concentration; and the extent of privatization. A low degree of government involvement and a high degree of competition have proven to be beneficial for the development of the banking sector.<sup>8</sup> In addition, the third theme takes into account whether there are barriers to entry for foreign banks. Allowing foreign banks to enter the market has been shown to lead to higher efficiency in the banking sector through increased competition and knowledge spillovers.

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<sup>4</sup> Exceptions are the financial soundness indicators for El Salvador and Guatemala, which are based on September and July 2004 data, respectively, as well as annual M2, credit, and GDP data, which are from 2003.

<sup>5</sup> In measuring liquidity risk, a higher ratio of liquid assets to total assets is considered better. However, this indicator does not take into account that a high ratio could indicate a lack of profitable investment opportunities in the economy.

<sup>6</sup> For the dollarized economies El Salvador and Panama, the exchange rate risk is evaluated as being low (and assigned a 10 on the scale). Countries highly, but not fully, dollarized are considered to be sensitive to exchange rate risk (assigned a score of 0 or 2.5).

<sup>7</sup> See IMF (2004) for details on the compilation of financial soundness indicators.

<sup>8</sup> See Creane et al. (2004) for an overview of the relevant literature documenting these relationships.

8. **The fourth theme analyzes the development of the nonbank financial sector.** Variables include the development of microfinance (measured as the proportion of active microfinance clients to the population); housing finance (availability of housing loans); the size of the insurance sector (measured by the ratio of gross premia to GDP); and the presence of other nonbank financial markets, which contribute to the efficient allocation of capital.

9. **The fifth theme tries to capture the regulatory governance of banking supervision, which is important for the development and soundness of the banking sector** (see Das et al. 2004). Measures comprise an evaluation of the independence of the banking supervision authority; availability of financial data; and the effectiveness of consolidated supervision. It proved to be impractical for all countries in the region to use the Basel Core Principles assessments resulting from FSAPs as some of these assessments were outdated.<sup>9</sup>

10. **The sixth theme measures financial sector openness.** It assesses whether the domestic financial sector is able to intermediate funds across borders. This theme comprises whether multiple exchange rates exist, whether there are restrictions on foreign currency purchases by residents, and whether a country has failed to comply with its obligations under Article VIII, Sections 2, 3 and 4 of the IMF's Articles of Agreement.

11. **Finally, the seventh theme examines the institutional environment.** The quality of institutions plays a crucial role for the soundness and development of the financial sector and for growth in general. To assess institutional quality in Central America, we make use of cross-country databases,<sup>10</sup> which have evaluated countries according to their traditions of law and order; their handling of property rights; their bureaucratic quality; the involvement of government in banking; and their susceptibility to corruption. We also try to assess the difficulty of recovering loans through the judicial system.

### C. Results

12. **Based on the indicators described above, Panama has the most developed and sound financial sector in the region.**<sup>11</sup> Rankings for other countries vary significantly, depending on the particular theme. The results of computing the index, which are shown in Table 1 and Figure 1 below, do not seem to be overly sensitive to the choice of weights.<sup>12</sup> To assess the extent to which the subjectively chosen weights influence the results, we also assign a different set of equally distributed weights to the seven themes (Table 2). The

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<sup>9</sup> Five of the six countries have participated in the Financial Sector Assessment Program (FSAP) and Panama is currently participating in an Offshore Financial Center assessment.

<sup>10</sup> The databases used are the "Index of Economic Freedom" published by the Heritage Foundation and the "International Country Risk Guide (ICRG)" published by the PRS Group.

<sup>11</sup> Panama scores the highest, or ties for highest, in five of the seven themes.

<sup>12</sup> Detailed results for the indicators are reported in Appendix II.

second set of weights does not change the overall ranking of countries, which shows that the choice of weights only has a limited impact on the overall scores.

13. **For all countries, two common features emerge: while financial sector openness is high** (on average 8.3 out of possible 10), **overall institutional quality is relatively low** (on average 4.6 out of 10). There is free entry of foreign banks and there are no restrictions on foreign currency purchases by residents in any of the countries. At the same time, in much of the region, corruption reportedly poses a problem and property rights are not well established according to the cross-country databases noted above.

Table 1. Central America: Financial Soundness and Development 1/

	Monetary Sector	Banking Sector Sound- ness	Banking Sector Size & Structure	Nonbank Financial Sector	Regulatory Governance	Financial Sector Openness	Institutional Environ- ment	Total
<b>Average</b>	6.8	5.2	7.3	5.5	5.7	8.3	4.6	6.1
Costa Rica	5.9	5.0	5.0	5.6	3.7	8.0	5.2	5.4
El Salvador 2/	5.8	7.1	8.8	6.3	5.7	8.0	5.3	6.8
Guatemala	6.7	3.8	7.5	4.4	5.8	9.5	3.3	5.5
Honduras	7.0	3.3	8.8	6.3	5.8	8.0	3.6	5.9
Nicaragua	6.2	5.0	5.0	1.3	5.3	8.0	5.6	5.0
Panama 2/ 3/	9.2	7.1	8.8	9.2	7.8	8.0	4.7	7.8

Source: IMF staff calculations

1/ Based on a subjectively weighted index; scale: 0-10, 10 meaning well-developed and sound.

2/ For El Salvador and Panama, the value for the "Monetary Sector" theme is computed based on three instead of five indicators by increasing the weights of these three indicators to 100 percent.

3/ The value for the nonbank financial sector in Panama is based on three instead of four scores due to a lack of microfinance data.

Table 2. Sensitivity Analysis

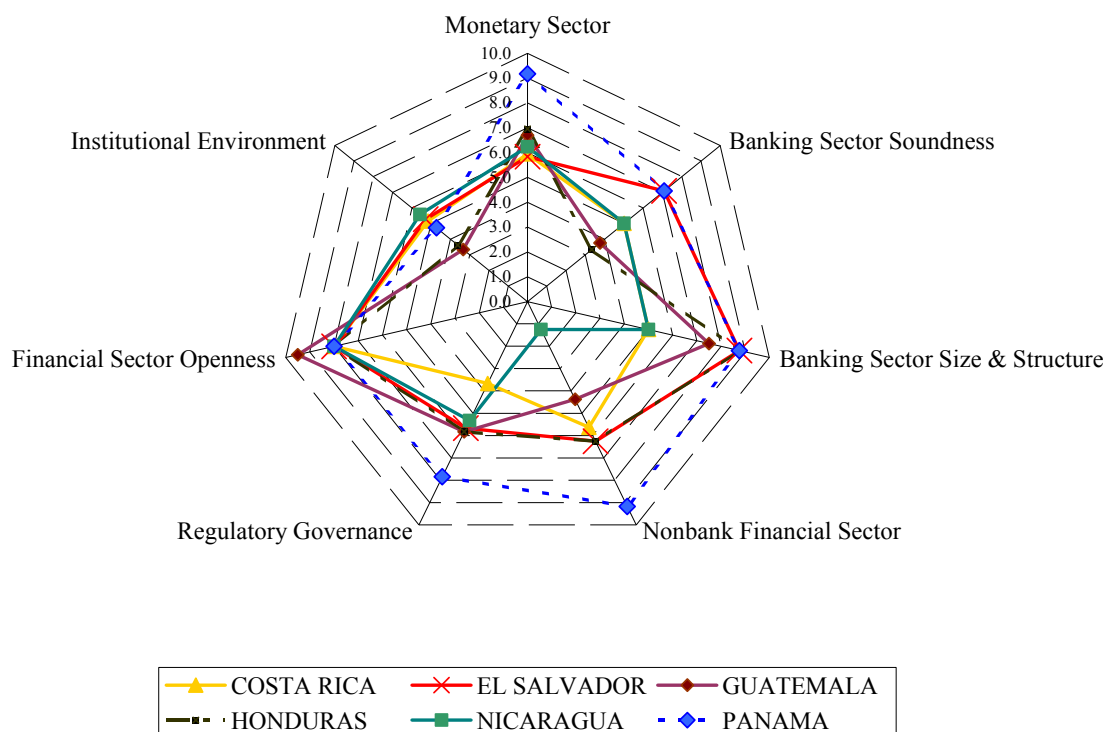
Theme	Subjectively assigned weights	Equally distributed weights 1/	Country	Total (using subjective weights)	Total (using eq. distributed weights)
Monetary Sector	13	14.3			
Banking Sector Soundness	24	14.3	Costa Rica	5.4	5.5
Banking Sector Size & Structure	16	14.3	El Salvador	6.8	6.7
Nonbank Financial Sector	16	14.3	Guatemala	5.5	5.9
Regulatory Governance	9	14.3	Honduras	5.9	6.1
Financial Sector Openness	10	14.3	Nicaragua	5.0	5.2
Institutional Environment	12	14.3	Panama	7.8	7.8
Sum	100	100			

Source: IMF staff calculations.

1/ Rounded.

14. **Central America's monetary sector has grown substantially in the last decade.** The average credit to GDP ratio grew from 26 percent in 1993 to 39 percent in 2003, while average M2 to GDP in Central America rose from 32 percent to 48 percent. Despite this growth, the results suggest that there is room for developing active secondary markets for government securities and for improving the independence of central banks and banking supervisory agencies.

Figure 1. Index of Financial Soundness and Development  
(Scale: 0-10, 10 meaning well-developed and sound)

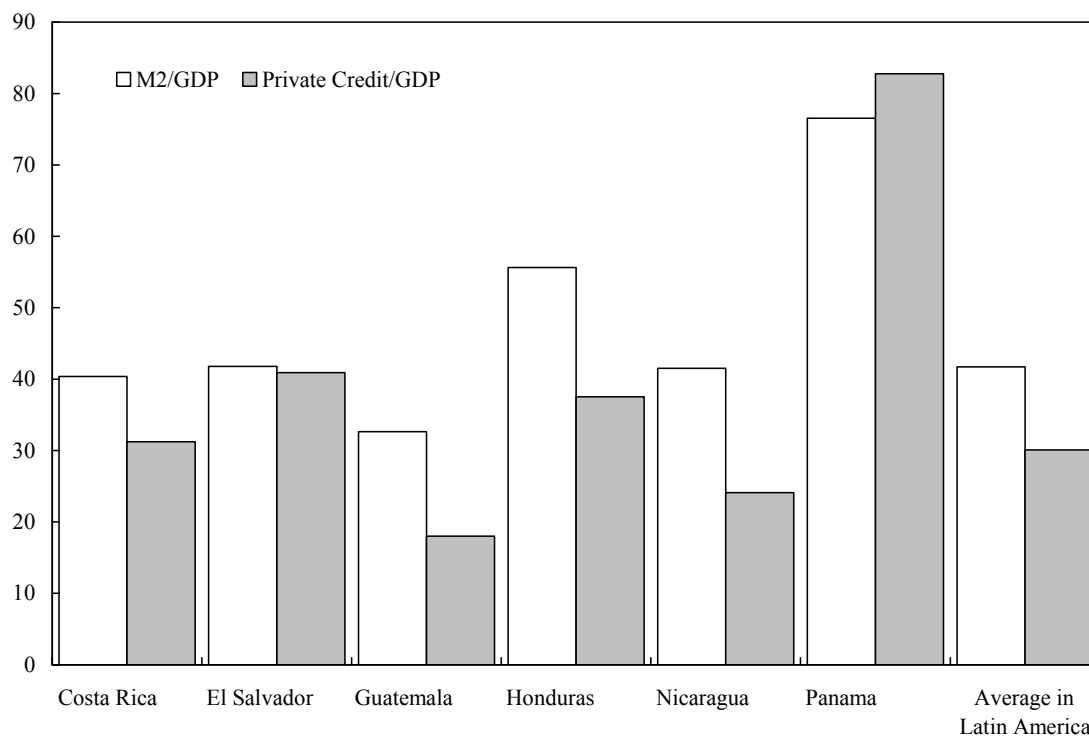


Source: IMF staff calculations.

15. **Financial depth and structure vary significantly from one country to another.** When measuring banking sector size and structure, scores range from 5.0 for Costa Rica and Nicaragua to 8.8 for El Salvador, Honduras, and Panama. Guatemala lies in between (7.5). On average and excluding Panama, financial intermediation in Central America is similar to the average in Latin America (Figure 2). The average ratio of credit to the private sector to GDP for Central American countries (without Panama) is 30 percent for 2003. However, Nicaragua and Guatemala with 24 and 18 percent, respectively, display below average values for Latin America. For the ratio of M2 to GDP, only Guatemala, with 33 percent, exhibits a ratio significantly below the average of 42 percent in Latin America. Panama exhibits ratios

substantially above the average in Latin America, with a credit to GDP ratio of 83 percent and an M2 to GDP ratio of 77 percent.

Figure 2. Central America: Private Credit to GDP and M2 to GDP, 2003  
(In percent)



Sources: IFS, national authorities.

16. **Government-owned banks account for only a small share of total assets in the banking sector in most countries in the region.** In Costa Rica public banks' assets account for around 60 percent of total assets in the banking system; for Panama, the ratio is 15 percent, while in the other four Central American countries the share of government-owned banks is below 5 percent.<sup>13</sup>

17. **Some countries in Central America portray concentrated banking systems.** In Costa Rica and El Salvador, the financial system can be characterized as being moderately concentrated (three banks account for more than 60 percent of total assets), while Nicaragua's banking sector is highly concentrated (three banks account for more than 70 percent of total assets). In Honduras, Guatemala, and Panama, the banking systems is not highly concentrated.

<sup>13</sup> Shares are computed with data from June 2004.

18. **Banking systems exhibit significant cross-country variations** (Table 3). When measuring banking sector soundness, El Salvador and Panama display high scores (both 7.1), followed by Costa Rica and Nicaragua (both 5.0), and Guatemala and Honduras (3.8 and 3.3, respectively). Due to problems with comparability of the data, these scores have to be interpreted with caution. Financial soundness indicators show that the ratios of liquid assets to total assets range from about 14 percent in Costa Rica to 32 percent in El Salvador. The capital to unweighted assets ratios are reported as between 7.3 percent for Honduras and 12.9 percent for Panama. Profitability, measured by return-on-assets, varies between 1 percent in El Salvador and 2.1 percent in Nicaragua and Panama. The ratios of NPLs to total loans range between 1.8 percent for Costa Rica and 9.6 percent for Honduras.

Table 3. Financial Soundness Indicators for the Banking Sector  
(In percent; as of June 2004, if not stated otherwise)

	Costa Rica	El Salvador 2/	Guatemala 3/	Honduras	Nicaragua	Panama
Capital/Assets 1/	9.7	10.1	8.2	7.3	8.1	12.9
NPLs/Total Loans 1/	1.8	2.1	5.3	9.6	2.7	2.0
ROA	1.9	1.0	1.3	1.4	2.1	2.1
Liquid Assets / Total Assets	14.4	31.6	29.1	27.6	23.5	20.5

Sources: Central American Monetary Council, country authorities.

1/ As of June 2004; source: Central American Monetary Council.

2/ Data on ROA, liquid assets to total assets as of September 2004; source: country authorities.

3/ Data on ROA, liquid assets to total assets as of July 2004; source: country authorities.

19. **The nonbank financial sector is moderately developed on average** (5.5) with Nicaragua (1.3) and Panama (9.2) at the least and most developed ends of the scale. In most countries, financial sectors outside banks exist but need further development. There may be economies of scale and scope to be achieved by the development, for example, of a regional stock exchange or regional bundling of insurance against damage to crops and infrastructure from hurricanes, flooding, and earthquakes (see Chapters III and IV below).

20. **All of the countries have strengthened the quality of banking supervision during the past few years, and are in the process of bringing their systems further in line with the Basel Core Principles.** Laws governing the financial sector have been revised, new regulations that strengthen loan classification and provisioning have been issued, and efforts have been undertaken to enforce capital adequacy ratios. Limits on large exposure and related-party lending have also been tightened.

21. **Among other areas, cross-border supervision activities need to be made more effective, and there is room to improve the independence of banking supervisory agencies.** International experience has shown that operational and financial autonomy and adequate legal protection for supervisors are essential if they are to carry out effective

oversight of financial institutions free from intervention by vested interests. In El Salvador, specifying the conditions for dismissal of banking supervisors as well as providing adequate legal protection would be important measures to increase the independence of the supervisory authorities. Increasing legal protection is also an issue in Panama. In Honduras, protecting the budgeting process of the supervisory agency institution from political interference would enhance independence. In Nicaragua, frequent judicial decisions overturning supervisors' actions raise concerns about the banking authorities' autonomy. (For further discussion of ways to improve financial sector supervision, see Chapter II below.)

#### D. Conclusions

22. This chapter provides an overview of Central America's financial sectors by computing an index measuring their development and soundness. Using a broad range of qualitative and quantitative indicators, the above analysis suggests that

- **financial sector openness is high across the region.** Capital controls are absent or negligible and there is free entry of foreign banks.
- **state-owned banks and directed credit are less of a problem** than elsewhere in the world.
- **the nonbank financial sector is moderately advanced and needs further development** with potential for economies of scale and scope to be achieved, for example, by a regional stock exchange or regional bundling of insurance products.
- **overall institutional quality needs considerable development.** Weak governance, connected lending, and uncertain property rights pose problems in much of the region for financial intermediation and economic growth, notwithstanding initiatives to combat these problems.
- **While substantial efforts have been made in all six countries in promoting the quality of banking supervision, bringing regulatory regimes up to the level of best practice is a work in progress.** For ongoing reforms, it is crucial to improve the independence of financial oversight agencies and provide adequate legal protection for supervisors. This is needed to ensure that prudential and supervisory laws and regulations are applied in an even-handed manner, free from interference by vested interests.

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## CONSTRUCTION OF INDEX

This appendix explains the construction of the index. The indicators are rated on a scale from 0 to 10 (with 10 meaning well-developed, sound). One group of indicators use a scale of 0 – 2.5 – 5 – 7.5 – 10, while a second group employs a scale of 0 – 5 – 10. A third group of indicators is rated on a continuous scale from 0 to 10. The weights used to compute the index are provided in brackets.

### 1. **Development of the Monetary Sector and Monetary Policy Instruments** (Weight: 13 percent)<sup>14</sup>

- a. Ratio of M2 to GDP (4 percent)
  - The ratio of M2 to GDP is relatively low when compared to countries in Latin America (below 30 percent) 0
  - The ratio of M2 to GDP is moderate (between 30 and 49 percent) 5
  - The ratio of M2 to GDP is high (50 percent and above) 10
- b. Use of indirect instruments of monetary policy (2 percent)
  - Only direct monetary policy instruments are used 0
  - One indirect policy instrument is used, but not actively 2.5
  - One indirect policy instrument is actively used (e.g. open market operations) 5
  - At least two indirect monetary policy instrument are used and one is actively used 7.5
  - At least two indirect monetary policy instruments are actively and flexibly used 10
- c. Credit controls and directed credits (2 percent)
  - Allocation of credit is closely controlled and/or directed by authorities 0
  - Allocation of credit is controlled and/or directed by authorities 2.5
  - Credit is partly allocated by authorities 5
  - No substantial government involvement in credit allocation 7.5
  - No government involvement in credit allocation 10

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<sup>14</sup> For El Salvador and Panama, the value for the “Monetary Sector” theme is computed based on three (1a, c, d) instead of five indicators by increasing the weights of these three indicators to 100 percent.

d.	Central bank bills/treasury bills (2 percent)	
	- Neither central bank bills nor treasury bills exist	0
	- Central bank bills exist and are auctioned or distributed via market mechanisms, but no treasury bills	2.5
	- Treasury bills exist and are auctioned or distributed via market mechanisms, but there is no active secondary market	5
	- Treasury bills exist and are auctioned or distributed via market mechanisms, but there is only a limited active secondary market	7.5
	- Treasury bills are auctioned or distributed via market mechanisms, and there are active secondary markets	10
e.	Independence of the central bank (3 percent)	
	Scores rely on the ranking in Jácome, Luis, and Francisco Vázquez, 2005, "Is There any Link Between Legal Central Bank Independence and Inflation in Latin America and the Caribbean?", IMF Working Paper No. 05/75 (Washington: International Monetary Fund).	
2.	<b>Banking Sector Soundness (Weight: 24 percent)</b>	
a.	Capital to assets ratio (4 percent)	
	- The banking sector shows a low capital to assets ratio (smaller than 7 percent)	0
	- The banking sector has a capital to assets ratio between 7 and 8.4 percent	2.5
	- The banking sector portrays a capital to assets ratio between 8.5 and 9.9 percent	5
	- The banking sector has a capital to assets ratio between 10 and 11.5 percent	7.5
	- The banking sector shows a high capital to assets ratio (larger than 11.5 percent)	10
b.	Nonperforming loans to total loans (4 percent)	
	- Nonperforming loans to total loans are larger than 7 percent	0
	- Nonperforming loans to total loans are between 7 and 5 percent	2.5
	- Nonperforming loans to total loans are between 4.9 and 3 percent	5
	- Nonperforming loans to total loans are between 2.9 and 1 percent	7.5
	- Nonperforming loans to total loans are lower than 1 percent	10

c. (Nonperforming loans minus provisions) / Tier I Capital (4 percent)	
- Ratio is larger than 10 percent	0
- Ratio is between 10 and 1 percent	2.5
- Ratio is between 0 and -9 percent	5
- Ratio is between -10 and -20 percent	7.5
- Ratio is smaller than -20 percent	10
d. Profitability of the banking sector/earnings (4 percent)	
- The median ROA for the banking system is lower than 1 percent	0
- The median ROA is between 1 percent and 1.9 percent	2.5
- The median ROA is between 2 percent and 2.9 percent	5
- The median ROA is between 3 percent and 4 percent	7.5
- The median ROA is larger than 4 percent	10
e. Liquidity (4 percent)	
- Liquid assets to total assets are smaller than 5 percent	0
- Liquid assets to total assets are between 5 and 14 percent	2.5
- Liquid assets to total assets are between 15 and 24 percent	5
- Liquid assets to total assets are between 25 and 35 percent	7.5
- Liquid assets to total assets are above 35 percent	10
f. Sensitivity to exchange rate risk (4 percent)	
- Financial sector is highly sensitive to exchange rate risk	0
- Financial sector is moderately sensitive to exchange rate risk	5
- Financial sector is weakly sensitive to exchange rate risk (if a country is fully dollarized, the exchange rate risk is assumed to be weak)	10
<b>3. Development in the Banking Sector: Size, Structure (Weight: 16 percent)</b>	
a. Privatization of commercial banking sector (4 percent)	
- Public banks' assets to total assets in banking system are higher than 30 percent	0
- Public banks' assets to total assets are between 30 and 5 percent	5
- Public banks' assets to total assets are lower than 5 percent	10
b. Ratio of credit to the private sector to GDP (4 percent)	
- The ratio of credit to the private sector to GDP is relatively low when compared to countries in Latin America (below 30 percent)	0
- The ratio of credit to GDP is moderate (between 30 and 39 percent)	5
- The ratio of credit to GDP is high (40 percent and above)	10

c.	Concentration in the banking sector (4 percent)	
	- The banking sector is highly concentrated (3 banks account for 70 percent of assets, or 2 banks account for 60 percent, or 1 bank accounts for 40 percent)	0
	- Moderate concentration in the banking sector (5 banks account for 70 percent of assets, or 4 banks for 60 percent, or 3 banks for 50 percent, or 2 banks for 40 percent, or 1 bank for 25 percent)	5
	- Low concentration in the banking sector (the conditions above do not hold)	10
d.	Are there barriers to entry for foreign banks? (4 percent)	
	- Yes	0
	- Not for representational purposes but for accepting deposits	5
	- No	10
4.	<b>Development of the Nonbank Financial Sector (Weight: 16 percent)<sup>15</sup></b>	
a.	Microfinance (4 percent)	
	- The proportion of active clients to the population is lower than one percent	0
	- The proportion of active clients to the population is between one and 2.5 percent	5
	- The proportion of active clients to the population is higher than 2.5 percent	10
b.	Housing Financing (4 percent)	
	- It is difficult to obtain housing finance	0
	- It is possible to obtain housing loans (some specialized housing finance institutions exist)	5
	- There are large and active mortgage markets (size around a quarter of GDP) and it is easy to obtain housing finance	10
c.	Insurance sector (4 percent)	
	- Gross premia to GDP are below 1 percent	0
	- Gross premia to GDP are between 1 and 1.9 percent	2.5
	- Gross premia to GDP are between 2 and 2.9 percent	5
	- Gross premia to GDP are between 3 and 4 percent	7.5
	- Gross premia to GDP are above 4 percent	10

<sup>15</sup> The value for the nonbank financial sector in Panama is based on three instead of four scores due to a lack of microfinance data.

d.	Other nonbank financial markets and instruments (4 percent)	
	- At most one of the following institutions/instruments exist: Pension funds, Mutual Funds, Corporate Bonds, Insurance Companies	0
	- At most three of the following institutions/instruments exist: Pension funds, Mutual Funds, Corporate Bonds, Insurance Companies	5
	- All of the following institutions/instruments exist: Pension funds, Mutual Funds, Corporate Bonds, Insurance Companies	10
5.	<b>Regulatory Governance of Banking Supervision (Weight: 9 percent)</b>	
a.	Independence of the Banking Supervision Institution (3 percent)	
	- Institution not independent	0
	- Institution somewhat independent, but under heavy influence from government	5
	- Institution largely independent	10
b.	Availability of financial data (3 percent)	
	The availability of financial data was tested by searching for recent data on capital, assets, CARs, NPLs, provisions, ROA, and liquid assets on the respective country websites. If all series were directly available and recent (end-January 2005 data were available as of March 30), a score of 10 was given. For each unavailable series a score of 2.5 was subtracted from 10. If data were older than end-January, a score of 1.5 was subtracted, if older than end-December 2004, a score of 3	
c.	Effectiveness of consolidated supervision (percent)	
	- Weakly effective, needs strengthening	0
	- Moderately effective, but still needs strengthening	5
	- Adequately effective	10
6.	<b>Financial Sector Openness (Weight: 10 percent)</b>	
a.	Multiple exchange rates or parallel markets (2 percent)	
	Yes	0
	No	10
b.	Restrictions on foreign currency purchases by residents (2 percent)	
	Yes	0
	No	10

c.	Restrictions on the financial activities of non-residents (2 percent)	
	Yes	0
	No	10
d.	Forward exchange market (2 percent)	
	No	0
	Yes	10
e.	Violation of Article VIII (2 percent)	
	Yes	0
	No	10
7.	<b>Institutional Environment (Weight: 12 percent)</b> (The data from the Heritage Foundation and the PRS Group are normalized to be in a [0, 10] range.)	
a.	Is it easy to recover loans through the judicial system? (2 percent)	
	- Difficult	0
	- Moderately difficult	5
	- Yes, the judicial systems helps the process of loan recovery	10
b.	Law and order tradition (Source: PRS Group) (2 percent)	
c.	Property rights index (Source: Heritage Foundation) (2 percent)	
d.	Bureaucratic quality (Source: PRS Group) (2 percent)	
e.	Government involvement in banking (Source: Heritage Foundation) (2 percent)	
f.	Corruption (Source: PRS Group) (2 percent)	

**DETAILED RESULTS OF THE INDEX**

	<b>Costa Rica</b>	<b>El Salvador</b>	<b>Guatemala</b>	<b>Honduras</b>	<b>Nicaragua</b>	<b>Panama</b>
<i>Monetary Sector</i>						
Ratio of M2 to GDP	5	5	5	10	5	10
Indirect instruments of monetary policy	7.5		7.5	5	5	
Credit controls and directed credits	2.5	7.5	10	5	10	7.5
Government securities	7.5	5	7.5	5	5	10
Independence of central bank	7.4		5.7	6.8	7	
<i>Banking Soundness</i>						
Capital to assets ratio	5	7.5	2.5	2.5	2.5	10
Nonperforming loans	7.5	7.5	2.5	0	7.5	7.5
Provisions	5	7.5	0	0	7.5	5
Profitability of the banking sector	7.5	2.5	5	5	7.5	5
Liquidity	2.5	7.5	7.5	7.5	5	5
Sensitivity to exchange rate risk	2.5	10	5	5	0	10
<i>Banking Sector Size, Structure</i>						
Privatization of commercial banking sector	0	10	10	10	10	5
Ratio of credit to private sector by deposit money banks to GDP	5	10	0	5	0	10
Concentration in the banking sector	5	5	10	10	0	10
Are foreign banks present?	10	10	10	10	10	10
<i>Development of Nonbank Financial Sector</i>						
Microfinance	5	5	0	5	0	
Housing finance	5	5	5	5	2.5	10
Insurance	2.5	5	2.5	5	2.5	7.5
Other nonbank financial markets and instruments	10	10	10	10	0	10

	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua	Panama
<i>Regulatory Governance</i>						
Independence of banking supervision	5	5	5	5	5	7.5
Availability of financial data	6	7	7.5	7.5	8.5	8.5
Effectiveness of consolidated supervision	0	5	5	5	2.5	7.5
<i>Financial Sector Openness</i>						
Multiple exchange rates or parallel markets	10	10	10	10	10	10
Restrictions on foreign currency purchases by residents	10	10	10	10	10	10
Restrictions on the financial activities of non-residents	10	10	10	10	10	10
Forward exchange market	0	0	7.5	0	0	0
Article VIII status	10	10	10	10	10	10
<i>Institutional Environment</i>						
Is it easy to recover loans through the judicial system?	5	5	0	2.5	10	5
Law and order traditions (source: PRS Group)	6.7	5	2.5	2.5	6.7	5.0
Property rights index (source: Heritage Foundation)	5	5	2.5	2.5	2.5	2.5
Bureaucratic quality (source: PRS Group)	5	5	5	5	2.5	5
Government involvement in banking/finance (source: Heritage Foundation)	5	7.5	7.5	5	7.5	7.5
Corruption (source: PRS Group)	4.2	4.2	2.5	4.2	4.2	3.3



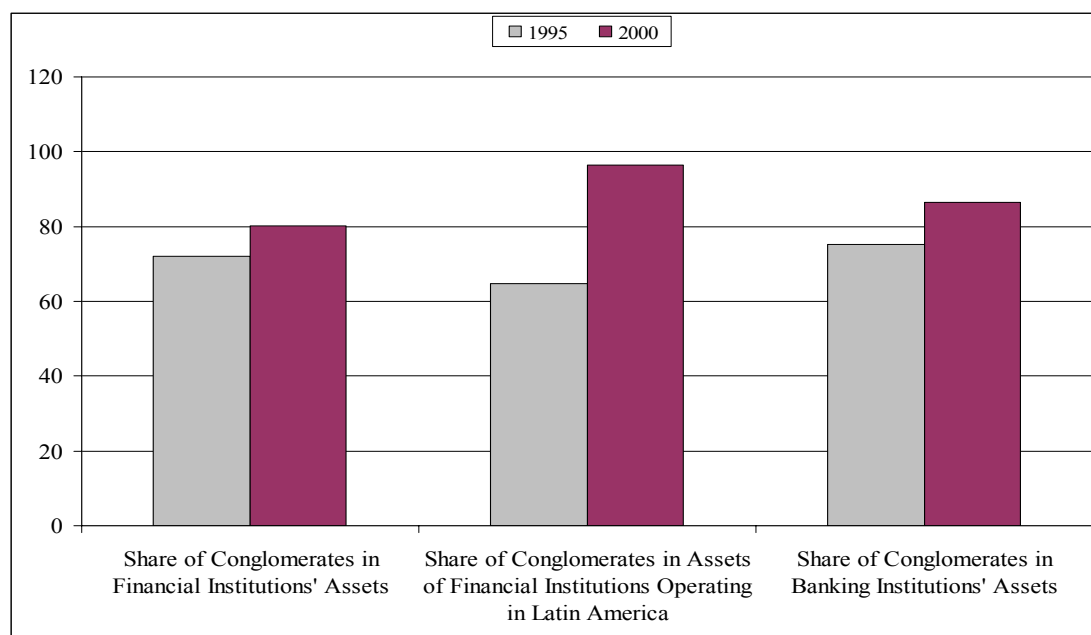
## II. CONSOLIDATED SUPERVISION OF FINANCIAL GROUPS IN CENTRAL AMERICA<sup>16</sup>

### A. Introduction

#### Regional financial integration

23. **Financial groups are becoming the dominant institutional structure in the financial services industry around the world** (Figure 1).<sup>17</sup> Financial globalization and innovation have also stimulated increasing cross-border operations in Central America,<sup>18</sup> particularly by financial groups operating regionally. These operations have benefited from economies of scale and scope as well as from deregulation and international liberalization. The associated consolidation process has favored the emergence of financial groups with complex management and corporate structures offering a range of financial services on a cross-border basis. Meanwhile, products and services offered by banks and other financial institutions have become closer substitutes.

Figure 1. Share of Conglomerates in Assets of Top 500 Financial Institutions Worldwide



Source: De Nicolo et al (2003) and Worldscope.

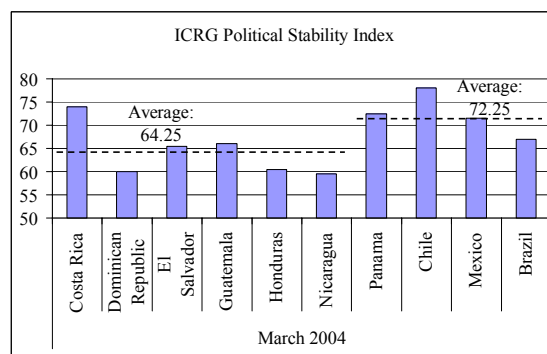
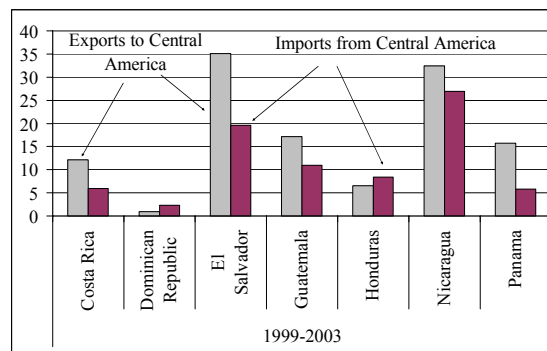
<sup>16</sup> Prepared by Patricia Brenner and R. Armando Morales, with contributions from Luis Cortavarría, Michael Moore, Marina Moretti, and Manuel Vásquez (all MFD).

<sup>17</sup> Baldwin and Kourelis (2002), and De Nicolò and others (2003).

<sup>18</sup> For purposes of this study, the countries of Central America are Costa Rica, El Salvador, Honduras, Guatemala, Nicaragua, and Panama.

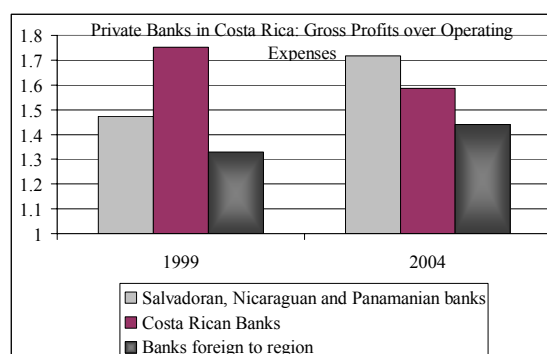
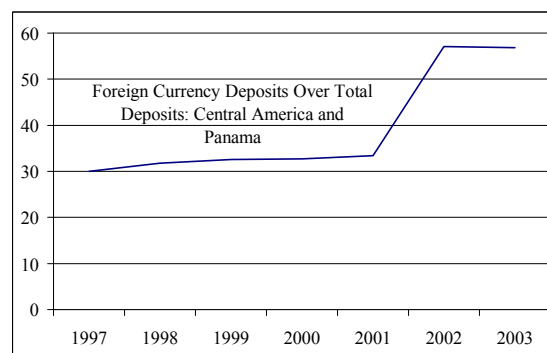
24. **Financial liberalization in Central America has contributed to the growth of large regional financial groups that originated locally.** Thus, financial integration has progressed concurrently with the growth of large regional financial groups under a variety of corporate structures competing successfully with foreign banks for prime customers. Explanations for these developments include:

- Increased cross-border economic linkages.** Trade within the region has expanded gradually, and represents a significant share of total international trade for El Salvador and Nicaragua (where most regional financial conglomerates have emerged). Regional operations of most of the large local corporate groups expanded quickly after the peace process in the region was firmly established in the 1990s. In this period, the Salvadoran Kriet group, owner of TACA airlines, acquired several smaller domestic airlines, while becoming the dominant company in the sector. The Nicaraguan Pellas group absorbed several small domestic competitors in the beer market and established a strategic alliance with other domestic groups. Often, these large corporate groups have ownership participation in financial groups.
- Political uncertainty and a weak rule of law.** In some countries, notably El Salvador and Nicaragua, a long period of social unrest and political uncertainty led major corporate groups to diversify their operations across the region. Concerns over the enforceability of property rights may also explain this diversification (Costa Rica and Panama being the exceptions). These concerns may also have discouraged foreign banks from aggressive entry to the regional markets, creating a vacuum that has been filled by large regional financial groups.<sup>19</sup> Although some of these concerns have been addressed in recent years, the region is still often perceived as less stable than the rest of Latin America.



<sup>19</sup> A review by Fitch concludes among other things that “(because of) de facto barriers of entry (including corruption, poor contract enforcement and weak credit cultures), large international financial players have, up until now, shown little interest in having a larger and/or retail presence in these countries” (Fitch, 2004).

- Improved reputation of large domestic banks.** Depositor confidence in large banks belonging to regional groups improved after these institutions survived crises and, in some cases, absorbed assets and liabilities of failed banks. Also, some groups have been able to obtain credit ratings, which opens access to international capital markets.<sup>20</sup>
- Economies of scale that may arise from dollarization.** Official dollarization in El Salvador and Panama and high dollarization in Nicaragua may have helped to lower operating and intermediation costs regionally. The adoption of official dollarization by El Salvador in 2001 may have helped level the playing field between foreign banks and regional groups that originated locally. Banks have also become more aggressive in implementing cost-cutting strategies, charging fees for their services, and slowing provisioning, to consolidate gains in profitability following the initial boost from dollarization.<sup>21</sup>
- Panama as an international financial center.** Most regional financial groups have active offices in Panama using an international license to conduct operations throughout the region. Easy access from their home countries provides an opportunity to put in place significant managerial capacity in Panama (Table 1). Tax advantages may also be a factor when the tax difference is substantial.<sup>22</sup>



<sup>20</sup> Fitch rates the capacity to meet foreign currency commitments of Panamanian and Salvadoran banks as BB+ (higher than Brazil, Ecuador and Uruguay, lower than Chile and Mexico). Standard & Poor's rates BAC International, a Nicaraguan bank operating in Panama, as BBB-; and BAC San Jose, operating in Costa Rica, and *Banco Agrícola* and *Cuscatlán*, Salvadoran banks, as BB (same as *Banco do Brasil*, the largest South American bank).

<sup>21</sup> Standard & Poor's (2004).

<sup>22</sup> Offshore financial transactions originated in the international banking center are not subject to income tax in Panama. There are also corporate income tax exemptions on interest earned when borrowed funds are used abroad, even when capital and interest are repaid in Panama. The local-source based tax structure in place in Panama treats the distribution of dividends from foreign earnings as not taxable.

Table 1. Central America: Country Distribution of Assets of Regional Financial Groups

Physical presence Country of Origin	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua	Panama	Total
Costa Rica	81.4	0.0	0.0	0.0	0.0	18.6	100.0
El Salvador	4.1	78.4	4.4	1.2	1.3	10.5	100.0
Guatemala	0.0	0.0	77.0	0.0	0.0	23.0	100.0
Honduras	0.0	0.0	0.0	69.5	0.0	30.5	100.0
Nicaragua	17.6	16.1	6.2	11.6	29.4	19.2	100.0
Panama	20.6	0.0	0.0	13.0	0.0	66.3	100.0

Sources: Individual bank data and staff calculations.

25. **Financial integration in Central America is a positive development** since the diversification of operations across activities and markets helps to reduce business risks (those less correlated across markets). However, financial integration may also magnify financial vulnerabilities and requires a consolidated view of regional financial group operations to ensure appropriate supervisory oversight.

#### The need for consolidated supervision

26. **The complexity of regional financial groups and cross-border operations of financial institutions poses challenges for the uniform application of prudential regulation across countries and sectors.** Consolidated supervision shows room for improvement in many jurisdictions worldwide. In particular, consolidation of accounts and consolidated monitoring of compliance with prudential standards, and cooperation between home and host country regulators, are generally inadequate.<sup>23</sup> In Central America, the supervisory authorities have responded in several ways to the challenge of adapting supervisory methods to consolidated supervision. On the whole, however, supervisory arrangements lag behind the development of cross-border operations by financial groups.

27. **Consolidated supervision should aim at a comprehensive assessment of the safety and soundness of financial groups.** Effective consolidated supervision, including on a regional basis, may not be achieved unless supervisory authorities have mechanisms in place to discourage or prevent regulatory arbitrage, encourage collaboration among supervisors within and across borders, respond to emerging problems in individual banks, and anticipate and/or confront systemic crises.<sup>24</sup> In the case of Central America, the agenda for putting in place adequate supervisory and legal tools as well as a political commitment to regulate large financial conglomerates, including harmonization of regulation and supervision of institutions offering similar products, remains to be completed. An

<sup>23</sup> See *Financial Sector Regulation: Issues and Gaps* (SM/04/268) and *Financial Sector Regulation: Issues and Gaps—Background Paper* (SM/04/290), August 2004.

<sup>24</sup> Majaha-Jartby and Olafsson (2004).

overarching requirement would be effective coordination and information sharing among all country regulatory agencies in the region.

28. **The absence of adequate preconditions and infrastructure for effective banking supervision has also hindered the development of consolidated supervision of financial institutions in the region.** Recent progress in achieving sound and sustainable macroeconomic policies still faces uncertainties, and the region generally lacks an environment that fosters the honoring and enforcement of financial contracts. Effective market discipline based on transparency and corporate governance is work in progress. Moreover, problems in terms of operational independence of supervisors and adequate resources affect several countries in the region,<sup>25</sup> and legal protection for supervisors is weak or nonexistent (Box 1). Political difficulties often preclude implementation of laws and regulation, even when the legislation itself is adequate.

### **Box 1. Central America: Status of Legal Protection of Supervisors**

There are some provisions in Central America for the legal protection of supervisors performing their official duties in good faith. Formal procedures for the coverage of legal expenses to staff of the superintendency deriving from lawsuits initiated in connection with actions undertaken in their capacity as financial system supervisors and regulators have been established in Guatemala, Honduras and Nicaragua. Other features of legal protection of supervisors in individual countries are:

**Costa Rica:** Supervisors are subject to the General Law of Public Administrations, by which all public servants are fully accountable in performing their duties. Thus, there are no provisions on legal protection for supervisors' good faith actions. The Central Bank provides for the coverage of legal expenses of supervisors for acts related to the exercise of their duties.

**El Salvador:** The Banking Law (Art. 160) establishes that cases against the directors of the Deposit Guarantee Institute (IGD) must be initiated with the approval of the Supreme Court. It also authorizes the IGD to provide legal assistance to IGD directors and ex-directors facing lawsuits associated with the performance of their duties. The Superintendency of Banks holds an insurance policy to cover legal expenses.

**Guatemala:** The Financial Supervision Law (Art. 15) generally establishes that criminal actions against the Superintendent of Banks and other specified officials may only be initiated with the approval of the Supreme Court. Legal expenses for the defense of legal actions related to the performance of official duties are covered by the Superintendency of Banks.

**Honduras:** Three mechanisms in the banking law provide for legal protection of supervisors: (a) no judicial action can be initiated against superintendents and other officials for decisions adopted according to the law, without the prior ruling of the administrative court; (b) supervisors may request a "pre-trial" hearing as provided in the Law of Organization and Court Attributions; and (c) The National Council of Banking Supervision provides legal defense for its staff, when prosecuted.

**Nicaragua:** The Superintendency of Banks approved procedures for the coverage of legal expenses to staff of the Superintendency deriving from lawsuits initiated in connection with actions undertaken in the performance of their duties. The Law on the Deposit Guarantee Fund (Art. 11) provides that Board members and staff of the Deposit Guarantee Fund shall not be sued for actions taken in the performance of their duties unless an action has been previously brought against the Deposit Guarantee Fund and such action has been decided against the Deposit Guarantee Fund. Recently, the Constitution was modified to grant immunity to the superintendent and the deputy superintendent, by which no action of any nature can be initiated in court while they are in office.

**Panama:** The Banking Law does not provide statutory protections for Superintendency personnel or an indemnity against expenses of litigation. Decree N° 49 of 1998 (issued by the Ministry of Planning and Economic Policy) establishes that "the actions of the supervisory personnel of the Superintendency of Banks undertaken in the discharge of their duties are authoritative" and a veracity presumption in favor of the supervisory personnel as to their declarations, with the burden of the proof falling on whoever challenges the supervisors' decisions. However, it appears unclear if this provision would be upheld should it be reviewed by the courts.

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<sup>25</sup> Basel, 1997.

## B. Financial Conglomerates Operating in Central America

### Definitions

29. **In Central America, financial groups are generally *financial conglomerates dominated by banks*.** A *financial conglomerate* is a group of companies under unified control, primarily engaged in financial services in at least two of the following areas: banking, insurance, and securities.<sup>26</sup> A group is determined by a parent-subsidary relationship, by a relationship based on a participation, or by a horizontal structure.<sup>27</sup> Some of the groups in Central America are parts of larger corporate groups (*mixed financial conglomerates*).

30. **Among groups with cross-border operations, *regional financial conglomerates (RFC)* have significant cross-border activities.** Banks with links to other regional financial institutions (BFIs) have a minor regional presence. For purposes of this paper, RFCs are classified by having physical presence in at least two countries in the region, in addition to the home country of shareholders. RFC and several BFI perform some form of accounting consolidation.

31. **A number of banks with common ownership operate in different countries in the region but do not consolidate their operations and thus operate as *parallel banks (RPB)*.** Each parallel bank reports to a different supervisor in the region. Other banks run *booking offices* that basically conduct booking operations not reported to the home supervisor. *Shell banks* constitute an extreme case (Box 2). Parallel banks report to two or more home supervisors, but neither of them performs consolidated supervision of the entire group.

32. **The Basel Committee on Banking Supervision strongly discourages allowing operations of parallel banks, shell banks, and booking offices.**<sup>28</sup> “Parallel-owned banking structures present greater risk for supervisors who may be unaware of the nature and extent of any relationships and transactions between the banks that may have an impact on its safety and soundness. This opaqueness may also provide an incentive to the controllers to use the banks to provide undisclosed support mechanisms or to mask the true risks within the group.”<sup>29</sup> This makes it difficult for a supervisor to apply prudential norms to the domestic bank operations, while fully understanding the impact on the overall financial position of the group. In the case of shell banks and booking offices, there is uncertainty as to where mind and management are located.<sup>30</sup>

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<sup>26</sup> This paper focuses on financial conglomerates involving at least one bank.

<sup>27</sup> Gruson (2004).

<sup>28</sup> Basel Committee on Banking Supervision (2003a, 2003b).

<sup>29</sup> Basel Committee on Banking Supervision (2003a). “Controllers” refers to the persons in control of the bank.

<sup>30</sup> The Basel Committee defines “meaningful mind and management” located within a jurisdiction as “physical presence.” The existence simply of a local agent or a low-level staff will not constitute physical presence.

33. **Foreign banks operate as branches or subsidiaries in host countries.** A branch is primarily regulated by the home country supervisor responsible for the legal entity overall but also monitored in its local operations by the host country supervisor, while a subsidiary is primarily regulated by the host country but subject to additional home country oversight at the group level. Some of these institutions operate as *banks with an international license* (BILs) based in Panama but intermediating resources within and outside Central America.

**Box 2. Institutions Conducting Cross-border Financial Transactions  
in Central America**

- **Branches of foreign banks** have an identifiable head office located abroad but do not have a separate legal status, and are thus an integral part of the foreign parent bank. Reportedly, some foreign banks operate regionally from branches located in one particular Central American country (Panama, Honduras). These banks are normally institutions with sound reputation (for example, Citibank, HSBC).
- **Subsidiaries of foreign banks** are legally independent institutions that are incorporated under the law of the host country. Operations are consolidated in the corresponding parent company's home country. Three Salvadoran banks and a Nicaraguan bank operate through subsidiaries or affiliates (local banks in which they have purchased a majority share) in other Central American countries.
- **Parallel banks** are banks licensed in different jurisdictions that, while not being recognized as part of the same financial group for regulatory consolidation purposes, have the same beneficial owners and consequently often share commonly managed and interlinked business.
- **Booking offices** normally provide only basic administrative services to a bank or a number of banks in a jurisdiction where the bank has no meaningful mind and management. Usually no local operations are originated in the branch. These branches are normally domiciled in an offshore financial center.
- **Shell banks** are banks that have no physical presence in the country where they are incorporated and licensed, and are not affiliated with any financial services group that is subject to effective consolidated supervision. The mind and management are located in another jurisdiction, often in the offices of an associated entity or sometimes in a private residence.

34. **Domestic financial institutions operate either as stand-alone firms or as part of domestic financial conglomerates.** All countries in the region perform consolidated supervision of domestic financial conglomerates, albeit with different degrees of effectiveness. Public banks are particularly significant in Costa Rica, where they account for 70 percent of bank assets. A particular case is *Banco Nacional de Costa Rica*, which owns 80 percent of BICSA, a bank operating in Panama with a general license.

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Management is used to include administration, i.e. books and records. See Basel Committee on Banking Supervision (2003b).

### **Mapping of financial groups operating in the region<sup>31</sup>**

35. **Four regional financial conglomerates from El Salvador, Nicaragua, and Panama operate in Central America** (Table 2). They all hold an international license to operate from Panama, where they consolidate operations. RFCs operate as a group mostly within the region using holding companies. Nicaraguan and Panamanian groups have significant operations in Panama, while Salvadoran banks have a more limited presence in Panama and have established separate conglomerate structures in various countries. RFCs actively pursue benefits from economies of scale and risk diversification. RFCs exploit economic linkages among countries in the region, and generally conduct financial intermediation in foreign currency, reflecting the fact that their countries of origin are dollarized or quasi-dollarized economies.

36. **Three Nicaraguan groups are parallel-bank based.**<sup>32 33</sup> One group has been in contact with the International Finance Corporation to pursue a capital injection conditional on consolidation of operations of their different units. Another group perceives that operations by individual banks are sufficiently isolated, and that consolidation is not justified. Apparent concerns about political uncertainty in the home country of shareholders of parallel-bank-based regional groups partly explain their reluctance to consolidate despite a relatively well-established reputation as de-facto financial groups in the region. Specifically, these groups argue that ongoing difficulties in the political arena and weaknesses in the institutional and legal framework in Nicaragua entail risks that are difficult to prevent under arrangements involving consolidation.

37. **Seven banks have links with other financial institutions in the region.** Some of these institutions are called “offshore banks”—in practice, booking offices originally created to circumvent limitations to operate with sight deposits and/or foreign currency (Costa Rica and Guatemala). Other booking offices operate abroad to accommodate specific interests of their customers. Supervisory authorities are in the process of gathering information from these institutions when they are part of regional groups.

38. **Banks that do not consolidate can facilitate regulatory arbitrage.** Many booking offices are established outside of the region. Uncertainties about the permanence of financial deregulation policies in their home countries may explain why these structures continue despite such deregulation. In Costa Rica, the continued presence of banks with limited physical operations outside the country appears to be related to the dominance in the

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<sup>31</sup> Only financial institutions owned by shareholders domiciled in the region are considered, i.e., subsidiaries of foreign banks are not included in the analysis in this section.

<sup>32</sup> The Panamanian *Primer Banco del Istmo* recently started to expand operations in the region, and has already obtained a license to operate in Nicaragua.

<sup>33</sup> This study does not deal with fraudulent parallel booking of the type uncovered during the 2001-02 banking crisis in the Dominican Republic.



domestic financial system of public banks benefiting from preferential treatment by the government relative to private financial institutions.<sup>34</sup>

39. **Few foreign banks have operations in Central America.** Citibank and Bank of Nova Scotia (United States and Canada, respectively) operate in different countries in the region. There are thirty other foreign banks and several Panamanian banks operating from Panama with an international license granted by Panama. Some of these Panamanian banks have representation offices in the region (Table 2).

### **Regional financial indicators**

40. **Regional financial groups account for about one third of assets and deposits of the regional banking system,** of which regional financial conglomerates hold about 22 percent of total loans and deposits. Parallel banks and regional financial institutions combined hold about 10–13 percent of the system in terms of assets, loans, deposits and equity (Table 3).<sup>35</sup>

41. **Foreign banks, excluding banks operating from Panama with an international license, represent only about three percent of the system.** The share of banks with an international license not belonging to RFCs is between 10 and 15 percent for different financial aggregates. Many of these banks' operations are with countries outside Central America.<sup>36</sup>

42. **Domestic banks account for about half of the regional financial system.** Private banks hold about one-third of different financial aggregates, similar to the share of regional financial groups. Public banks account for about 18 percent of the assets of the regional financial system, mostly reflecting the predominance of public banks in Costa Rica.

43. **Regional financial conglomerates have higher capitalization than parallel banks and regional financial institutions.** Profitability, as measured by the return on assets, also appears higher for RFCs relative to other groups. Higher capital and profitability of RFCs seems to reflect their success in servicing prime customers. Foreign banks show somewhat lower profitability, which may be partly related to more strict accounting required by parent offices (for example, stricter provisioning) (Table 4).<sup>37</sup>

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<sup>34</sup> Public banks benefit from a blanket government guarantee, monopoly in the attention of government agencies as customers, and exemption from a 17 percent tax on sight deposits.

<sup>35</sup> Financial information was aggregated using individual bank data, since consolidated financial statements are not available for all groups.

<sup>36</sup> As of September 2004, about 21 percent of assets in the international banking center were outside Latin America.

<sup>37</sup> Data processed using the format required for this study was only available for the period above indicated. To that extent, conclusions based on this information are tentative at this stage.

Table 2. Central America: Main Banks Operating in the Region

	Country of Origin 1/	Physical Presence	Group		Country of Origin 1/
<b>Regional Financial Groups</b>				<b>Domestic Banks</b>	
<i>Regional Financial Conglomerates</i>				<i>Private Banks</i>	
Agricola	El Salvador	El Salvador	Agricola	Salvadoreño	El Salvador
Agricola	El Salvador	Panama	Agricola	Industrial	Guatemala
Caley	El Salvador	Nicaragua	Agricola	Comercio	El Salvador
Cuscatlan	El Salvador	El Salvador	Cuscatlan	Del Café	Guatemala
Cuscatlan G	El Salvador	Guatemala	Cuscatlan	De Desarrollo Rural	Guatemala
Cuscatlan CR	El Salvador	Costa Rica	Cuscatlan	Ficohsa	Honduras
Lloyds (Cuscatlan)	El Salvador	Honduras	Cuscatlan	BAMER	Honduras
Cuscatlan P (Lloyds)	El Salvador	Panama	Cuscatlan	Bancredito	Costa Rica
BAC San Jose	Nicaragua	Costa Rica	BAC	Agromercantil	Guatemala
BAC ES	Nicaragua	El Salvador	BAC	BANPAIS	Honduras
BAC G	Nicaragua	Guatemala	BAC	De Occidente	Guatemala
BAC H	Nicaragua	Honduras	BAC	Reformador	Guatemala
BAC N	Nicaragua	Nicaragua	BAC	Credito Hipotecario Nacional	Guatemala
BAC International Bank	Nicaragua	Panama	BAC	De Exportacion	Guatemala
Primer Banco del Istmo	Panama	Nicaragua	Banistmo	Internacional	Guatemala
Primer Banco del Istmo	Panama	Panama	Banistmo	Banco General	Panama
BGA	Panama	Honduras	Banistmo	Banco Continental	Panama
BANEX	Costa Rica	Costa Rica	Banistmo	Improsa	Costa Rica
BANEX	Costa Rica	Guatemala	Banistmo	Del Quetzal	Guatemala
BANEX	Costa Rica	Panama	Banistmo	BANCON	Honduras
				Banhcafe	Honduras
<i>Parallel-Bank Based Groups</i>				De Comercio	Guatemala
BANCENTRO	Nicaragua	Nicaragua	Lafise	Ficensa	Honduras
Lafise	Nicaragua	Costa Rica	Lafise	Procredit	El Salvador
Futuro	Nicaragua	Honduras	Lafise	Bancotrab	Honduras
Promerica ES	Nicaragua	El Salvador	Promerica	Americano	El Salvador
Promerica CR	Nicaragua	El Salvador	Promerica	Inmobiliario	Guatemala
Promerica H	Nicaragua	Honduras	Promerica	Corporativo	Guatemala
Banpro	Nicaragua	Nicaragua	Promerica	De la Republica	Guatemala
St. Georges Bank and Company	Nicaragua	Panama	Promerica	SCI	Guatemala
UNO CR	Nicaragua	Costa Rica	UNO	Promotor	Guatemala
UNO ES	Nicaragua	El Salvador	UNO	de Antigua	Guatemala
UNO H	Nicaragua	Honduras	UNO	Privado para el Desarrollo	Guatemala
UNO N	Nicaragua	Nicaragua	UNO	Vivibanco	Guatemala
UNO P	Nicaragua	Panama	UNO	Americano	Guatemala
UNO G	Nicaragua	Guatemala	UNO	Metropolitano	Guatemala
				Empresarial	Guatemala
<i>Banks with Links to Other Financial Institutions</i>				Comercial	El Salvador
BDF	Nicaragua	Nicaragua	BDF	Bancatlán	Honduras
BDF	Nicaragua	Panama	BDF	Multicredit Bank	Panama
BCT	Costa Rica	Costa Rica		Banco Atlantico	Panama
Cathay	Costa Rica	Costa Rica		Banco Aliado	Panama
Interfin	Costa Rica	Costa Rica	INTERFIN	Towerbank	Panama
G&T Continental	Guatemala	Guatemala	GTC	Banco Aleman Platina	Panama
GTC Bank	Guatemala	Panama		Banco Trasatlantico	Panama
De Occidente (BANCOCCI)	Honduras	Honduras	De Occidente	Banco Panameño de la Vivienda	Panama
De Occidente Panama	Honduras	Panama		Banco Universal	Panama
Popular Bank	Dominican Repub	Panama		Banco del Pacifico	Ecuador
BCT Bank International	Costa Rica	Panama		Metrobank	Panama
Cathay International Bank	China	Panama		Blubank	Panama
				Mibanco	Panama
<i>Foreign Banks</i>				<i>Public Banks</i>	
Scotiabank ES	Canada	El Salvador		Nacional	Costa Rica
Scotiabank CR	Canada	Costa Rica		BICSA	Costa Rica
Nova Scotia	Canada	Panama		BICSA	Panama
Citibank	USA	El Salvador		Costa Rica	Costa Rica
Citibank	USA	Guatemala		Popular y Desarrollo Comunal	Costa Rica
Citibank	USA	Costa Rica		Hipotecario	El Salvador
Unibanca	Venezuela	Panama		Hipotecario de Vivienda	Costa Rica
Banco del Centro	Venezuela	Panama		Banco Nacional de Panama	Panama
Banco de Bogota (general license)	Colombia	Panama		Caja de Ahorros	Panama
Honduras	USA	Honduras	Citibank	De Fomento	El Salvador
				De los Trabajadores	Guatemala

1/ Contry of origin is the one where the principal shareholders' mind and management resides.

Table 3. Central America: Market Share by Bank Categories (June 2004)

	Assets		Loans		Deposits		Equity	
	US\$	percent	US\$	percent	US\$	percent	US\$	percent
	billion		billion		billion		billion	
<i>Regional Financial Groups</i>	22.6	33.0	11.4	32.1	15.3	31.9	2.3	32.2
Regional Financial Conglomerates (RFCs)	14.8	21.6	8.0	22.4	9.2	19.3	1.7	23.8
Regional Parallel-bank based Groups (RPBs)	3.2	4.7	1.6	4.5	2.5	5.2	0.3	3.9
Banks with links to other regional financial institutions (BFIs)	4.6	6.8	1.9	5.2	3.6	7.5	0.3	4.6
<i>Foreign Banks</i>	1.8	2.7	1.0	2.7	1.3	2.6	0.2	3.1
<i>Other Banks with International License</i>	10.3	15.0	5.2	14.5	8.0	16.8	1.0	13.6
<i>Domestic Banks</i>	33.7	49.2	18.1	50.7	23.4	48.7	3.7	51.1
Domestic Private Banks	21.7	31.6	12.6	35.3	14.5	30.2	2.2	30.8
Public Banks	12.1	17.6	5.5	15.4	8.9	18.5	1.5	20.2
	68.5	100.0	35.7	100.0	48.0	100.0	7.2	100.0

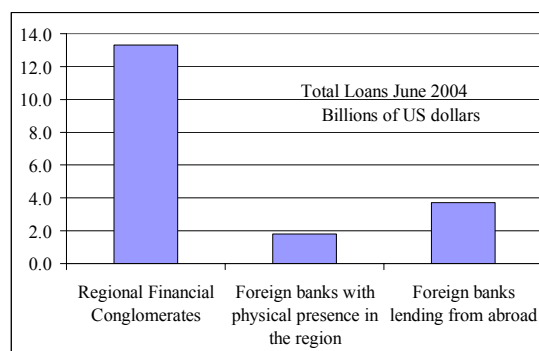
Sources: Individual banks and staff calculations.

Table 4. Central America: Main Financial Ratios (June 2004)  
(In percent)

	Loan/ Assets	Loan/ Deposits	Equity/ Assets	ROE	ROA
<i>Regional Financial Groups</i>	50.5	74.6	10.3	...	...
Regional Financial Conglomerates	54.0	86.5	11.6	19.2	2.2
Parallel-bank based Groups	49.4	64.1	8.7	17.7	1.5
Banks with links to other regional financial institutions	39.9	51.4	7.2	20.9	1.5
				...	...
<i>Foreign Banks</i>	51.8	75.3	12.4	11.1	1.4
<i>Domestic Banks</i>	53.6	77.4	11.0	...	...
Domestic Private Banks	58.1	87.0	10.3	16.9	1.7
Public Banks	45.6	61.8	12.1	15.1	1.8

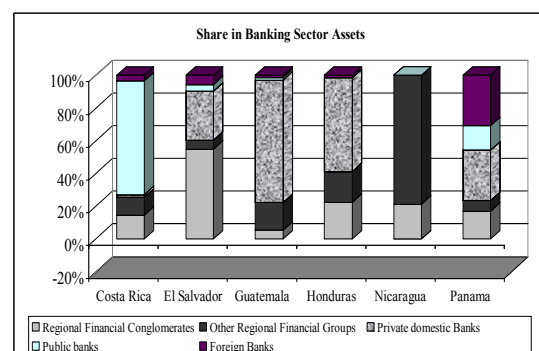
Sources: Individual banks and staff calculations.

44. **Foreign banks' low share of the market is partly offset by offshore operations.** Lending by foreign banks, including entities located in financial hubs outside the region (Miami), has increased by 40 to 100 percent during the period 1998–2003 in each individual country. Loans by foreign banks operating in financial hubs, mostly to prime customers, are equivalent to more than twice the magnitude of loans from foreign bank offices in the region.<sup>38</sup>



45. **A trend toward consolidation is observed in the regional financial system.** Between 1998 and 2003, 24 banks were closed and 31 mergers took place, more than offsetting the number of new banks (8 banks started operations in the region in the same period).<sup>39</sup> Total bank assets expressed in US dollars increased by 38 percent between 1998 and 2002 for Central American countries (excluding Panama, which experienced a slight decline). Concentration in the region, as measured by the share of assets of the five largest banks increased to 73 percent in 2002. At the country level, this phenomenon is observed in all countries except Costa Rica, with Nicaragua showing the highest concentration (96 percent). Banks maintain a dominant position in the region with 90 percent of financial sector assets.

46. **Regional financial groups have increased their share in regional financial markets.**<sup>40</sup> In addition to the expansion of Salvadoran and Nicaraguan groups, *Primer Banco del Istmo* (Panama) has participation in Honduras and Costa Rica, and *Cuscatlán* (El Salvador) acquired the regional banks formerly owned by the British bank, Lloyds. Banks belonging to regional groups acquired selected assets of failed banks, including through cross-border acquisitions: *Banex* (Panama) in Costa Rica absorbed 4 banks between 1998 and 2001; *Lafisse* and *Promerica* (Nicaragua) absorbed assets and liabilities from failed banks in Nicaragua and El Salvador; and *Cuscatlán* and *Agrícola* (both El Salvador) from failed banks in Costa Rica and Guatemala. Banks belonging to regional financial groups are dominant among private banks in Costa Rica, El Salvador and Nicaragua.



<sup>38</sup> “International players have found it advantageous to serve the larger regional corporates from financial hubs outside the region, mainly Miami. Some of the main foreign players providing cross-border lending to Central American corporates are Citibank, Wachovia, International Bank of Miami, Scotiabank, Dresdner Bank Lateinamerika and Barclays Bank.” (Fitch, 2004)

<sup>39</sup> Central American Monetary Council, 2003.

<sup>40</sup> Barraza, 2003.

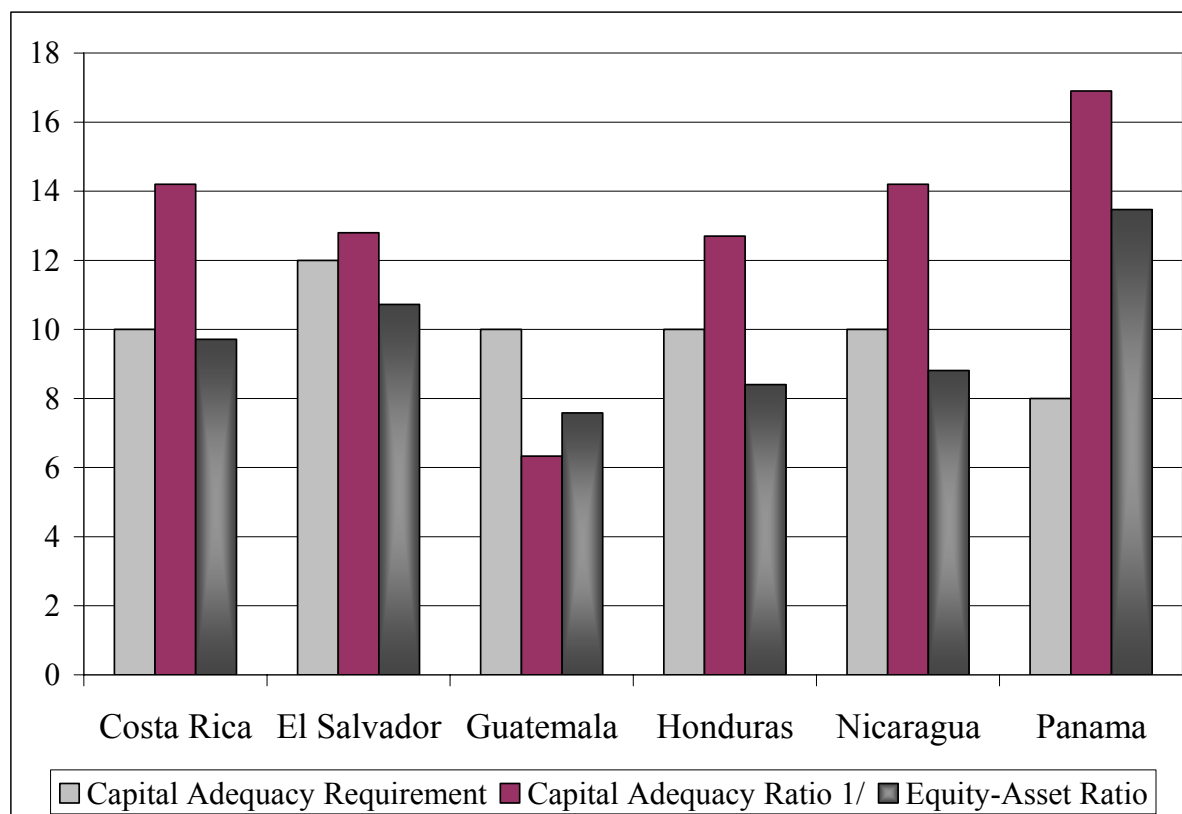
## C. Regional Financial Groups: Risks and Regulatory Responses

### Main risks

#### *Inflated capital*

47. **Capital may be inflated for regional financial groups, despite it being apparently sufficient on a solo basis.** For a financial conglomerate, capital must be adequate both on a group or consolidated level and on a single-entity solo level. Proper monitoring is complicated by differences in the definitions and calculations of both actual and required capital across borders, differences in accounting standards, and lack of proper financial and auditing consolidation. Also, capital adequacy requirements are not comparable because of differences in the measurement of both the numerator (capital) and the denominator (risk-weighted assets) in individual countries. Minimum capital adequacy requirements are set at 10 percent in all countries except El Salvador and Panama (12 percent and 8 percent, respectively), and compliance is generally good. Actual capital-to-asset ratios (i.e., without risk weights) vary, with Guatemala showing a ratio below 8 percent; Costa Rica, Honduras, and Nicaragua between 8 and 10 percent; and El Salvador and Panama above 10 percent (Figure 2).

Figure 2. Central America: Capital Ratios, December 2004



Source: National authorities.

**48. Inappropriate recording of intra-group transactions may also inflate capital.**

These transactions could hide the overall risk exposure of individual entities and/or their corresponding groups. Several problems are associated with intra-group transactions: (a) capital or income may be inappropriately transferred from a regulated entity; (b) the terms of the transfer may be disadvantageous to a regulated entity; (c) there may be a negative impact on solvency, liquidity and/or profitability of individual entities; or (d) regulatory requirements may be circumvented.<sup>41</sup> Transfers of deposits and loans (including asset-dumping offshore) among banks belonging to the same group to boost capital artificially have been particularly problematic. Other areas of concern have been the emergence of outsourcing contracts with related institutions, whose pricing is difficult to test against the market, and the use of credit by shareholders to provide inject capital into related financial institutions, which facilitates double gearing. Double (or multiple) gearing occurs when one entity holds regulatory capital issued by another entity within the same group and the issuer is allowed to count the capital in its own balance sheet.

***Contagion risks***

**49. Cross-border operations may become a vehicle for quick contagion.** The intricate nature of cross-border operations makes the Central American financial system susceptible to contagion (Table 5). Cross-border transfer of deposits may magnify liquidity risk. While the availability of intra-group financing may help overcome temporary liquidity problems, eventual solvency problems of the troubled institution may lead to intra-group contagion to liquidity providers. Contagion may take place within the group (if troubled members of a conglomerate “infect” healthy members of a conglomerate in another jurisdiction), both within and across borders; and among unrelated institutions within a country (if perception of systemic problems is augmented by cross-border risks).

***Opportunities for regulatory arbitrage***

**50. Credit risk concentration, related in part to concentration of wealth, has been a problem in the region.** Cross-border financial intermediation further complicates adequate monitoring of credit risk. Corporate groups may become “too large” relative to domestic financial institutions, making it attractive to both financial institutions and corporate groups to use different regional institutions to conduct business between them.<sup>42</sup>

**51. Regulation of large credit exposures is uneven in Central America.** El Salvador imposes the most stringent regulations overall, with Guatemala and Honduras allowing wider room for lending to groups, presumably because their economies also show the least diversification. On lending to related parties, demand for financing by groups operating as

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<sup>41</sup> Gruson (2004).

<sup>42</sup> “Some of the hurdles to be addressed ... are the existence of corporate/financial groups, where the corporate component may be even more sizeable than the financial portion” (Fitch, 2004).

Table 5. Central America and Dominican Republic: Regional Financial Links

Destination	Costa Rica	Dominican Republic	El Salvador	Guatemala	Honduras	Nicaragua	Panama	USA	Other
Origin									
Costa Rica	BCT Improsa, Interfin								Interfin (Bahamas), Banex (Cayman Islands).
Dominican Republic		8 domestic banks.					Banco Popular		
El Salvador	Cuscatlan		Agricola, Cuscatlan, Salvadoreño	Cuscatlan	Cuscatlan	Caley (Agricola)	Agricola, Cuzcatlán (international license)	Agricola, Cuzcatlán (remittances)	Cuscatlan (through Guatemala): Montserrat, Western Indies
Guatemala				22 domestic banks			GTC		8 offices in Bahamas, Puerto Rico, Belice, Barbados
Honduras					10 domestic banks.		Banco de Occidente		
Nicaragua	BAC share in Banco de San José, UNO, Promerica, Lafise.	Promerica	BAC, UNO, Promerica, Americano	BAC, UNO	BAC, UNO, Promerica	BAC, UNO, Banpro, BDF, Bancentro	BAC, UNO, St Georges (Promerica), BDF	BAC Florida	BAC (Cayman Islands)
Panama	Primer Banco del Istmo (Banex)			BANEX	Primer Banco del Istmo in BGA	Primer Banco del Istmo, share of BDF (Panama)	14 domestic banks (plus 4 with international license)		About 13 percent of assets belong to financial institutions in offshore centers.
State-Owned	Bancredito, Banco de Costa Rica, Banco Nacional, Banco Hipotecario, Banco Popular	Banco de Reservas.	Fomento Agropecuario, Hipotecario				Banco Nacional de Panama	BICSA (Costa Rica) shares owned by Bancredito, Banco de Costa Rica and Banco Nacional	Banco Hipotecario (Costa Rica) shares in Biete (Venezuela)
USA	Citibank	Citibank, Scotiabank	Citibank, First Com. Bank	Citibank	Banco de Honduras (Citibank)		International Financial Center		
Other	Cathay (Taiwan), Scotia Bank (Canada)	Republic Bank (Trinidad & Tobago) owns Banco Mercantil Sabadel (Spain) and Popular (Puerto Rico) own shares of BHD.	Nova Scotia from Canada (acquiring Comercio Procredit (ONG owned).	Internacional (Spain)		Procredit (ONG owned)	International Financial Center. BLADEX (shares from BAC San Jose, Interfin, and BCT)		

mixed conglomerates tends to be attended first by the group, as lack of capital market development encourages reinvestment as a source of financing. Regulations on related party lending also vary widely across the region, with El Salvador and Panama showing far more strict requirements than neighboring countries. At the other end of the spectrum, Guatemala and Honduras lack an aggregate limit for overall lending to related parties (Table 6).

52. Bad loans from a stricter jurisdiction could be sold to a less strict jurisdiction before recovery problems are detected, increasing the underlying gap between reported and actual credit risk for the group. Risks may be compounded as Central American countries have different requirements in place for the sale of loan portfolio bundles.

Table 6. Central America: Regulation on Loan Concentration and Related Lending

	Limits on Loan Concentration and Related Lending		
	One borrower	Groups	Related lending
Costa Rica	20 percent of capital	20 percent of capital	20 percent of capital for financial groups. Aggregate limit of 80 percent of capital according to banking law.
El Salvador	15 percent of capital (additional 10 percent with real guarantees).	15 percent of capital (additional 10 percent with real guarantees).	Aggregate limit: 5 percent.
Guatemala	15 percent of capital	30 percent of capital	Individual and group limit applies. No aggregate limit.
Honduras	20 percent of capital (50 percent with real guarantees)	20 percent of capital (50 percent with real guarantees)	30 percent of capital
Nicaragua	30 percent of capital	30 percent of capital	15 percent for individual, 25 percent for group, 60 percent aggregate limit.
Panama (regulations apply to banks with general license)	25 percent of capital	25 percent of capital	5 percent of capital (10 percent with real guarantees). Aggregate limit: 50 percent (25 percent in 2005)

Sources: Central America Monetary Council and National Superintendencies



53. **Differences in loan classification and provisioning could also lead to regulatory arbitrage.** A financial group may take advantage of differences in the treatment of collateral for loan classification purposes, and record loans in a location where more favorable treatment is available. Costa Rica, El Salvador, and Nicaragua link loan classification to the quality of collateral. Also, differences in the minimum arrears period to reclassify a loan may provide incentives for regulatory arbitrage. Provisioning requirements also vary: for example, El Salvador and Nicaragua require more severe provisioning adjustments in the transition between the first and the second loan categories relative to other countries in the region.

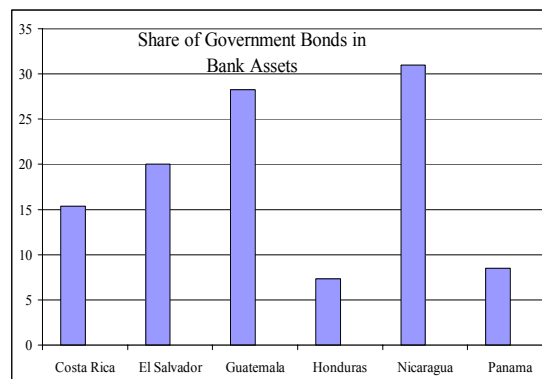
Table 7. Central America: Regulation on Loan Classification and Provisioning

	Length of arrears for intermediate loan category	Provisioning for second best and second worst loan category	Treatment of collateral on provisioning
Costa Rica	90-120	1, 60 (30 for mortgage loans)	Collateral helps classification in some categories.
El Salvador	90-180 (60-90 for consumer loans)	5, 60	Collateral helps classification in some categories.
Guatemala	90-180 (60-120 for microlending)	5, 50	Provision net of collateral
Honduras	61-90 (91-120 for consumer loans)	1.6, 36 (gradual increase)	Collateral not used for classification or deducted for provisioning.
Nicaragua	60-90 (91-180 for mortgage loans, 31-60 for microlending).	5, 50	Collateral helps classification in some categories.
Panama	60-90 (90-120 for mortgage loans)	2, 50	Provision of loans net of "expected recovery"

Source: National Superintendencies.

### *Compound unregulated risks*

54. **Regional financial groups are exposed to compound sovereign risk.** In all jurisdictions within the region, government bonds are subject to zero risk-weight, based on the argument that sovereign risk constitutes the benchmark for local securities. Clearly, capital adequacy is overestimated since not all countries are exposed to the same degree of government default risk. However, setting differential risk weights across countries would not be easy, since any official validation of a differential risk may result in volatility in the market for government bonds, especially for less developed and illiquid markets. For groups that are not subject to consolidated supervision, dependency of the government budget on bank financing may create pressure to maintain the status quo not only on regulation of sovereign risk but also on other areas (including consolidated supervision). For financial conglomerates that are subject to consolidated supervision, the question to be addressed is the appropriate valuation of a regional government bond portfolio.



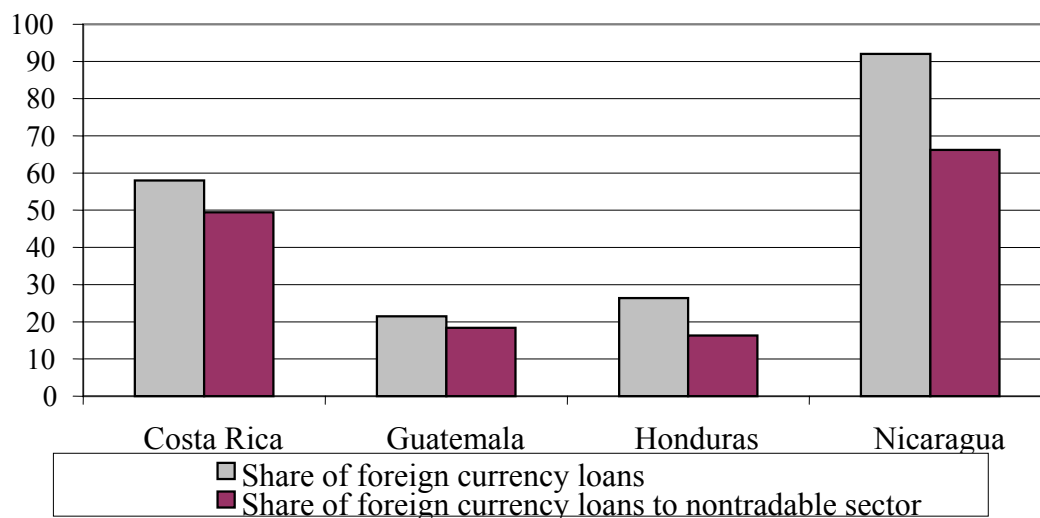
55. **Currency mismatches could be compounded by cross-border operations.** Banks operating in fully dollarized economies have no alternative to lending in foreign currency to the nontradable sector. They offer the same lending alternatives to foreign customers. Moreover, preliminary information shows that most loans in foreign currency are to the nontradable sector, even in economies that are not fully dollarized (Figure 3). In the case of regional financial groups, transfer of loans and deposits across borders may lead to imbalances in the foreign currency position of individual banks. Financial groups may have an even higher incentive than domestic financial institutions to lend to unhedged borrowers as a less costly way to keep a balanced foreign exchange position. Competition to retain prime customers may also drive domestic financial institutions to offer similar alternatives to those offered by regional groups and foreign banks.

### **Regulatory responses**

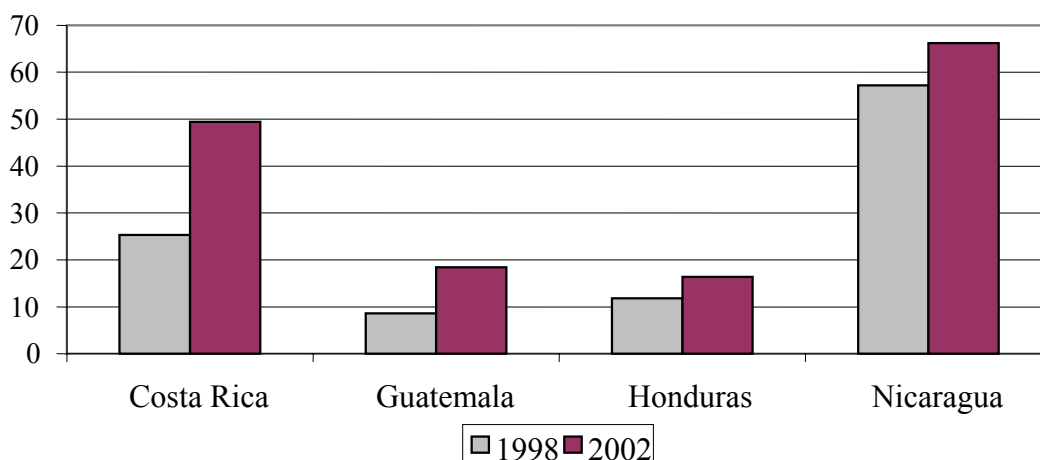
56. **Supervisory authorities have put in practice regulatory responses at the individual and at the regional country levels, with mixed results.** They have attempted to combine the supervision of domestic conglomerates and of cross-border financial intermediation, and in several countries financial legislation has been modified recently to that effect. For countries dealing with parallel banks (notably, Nicaragua), ring fences are being used (more strict prudential regulation for entities belonging to a group and not submitting consolidated financial statements to supervisory authorities). At the regional level, memoranda of understanding and regional plans within the Central American Council of Superintendents of Banks and Other Financial Institutions have been the main instruments utilized by country supervisory authorities in the region.

Figure 3. Central America: Foreign Currency Lending to Non-tradable Sector

Share of foreign currency loans to total loans (2002)



Share of foreign currency loans to the nontradable sector



Sources: Central American Monetary Council (2004), Alvarez (2003) and staff calculations.

### *Individual country initiatives*

#### *Combining supervision of Domestic Financial Conglomerates and of Cross-Border Financial Intermediation*

57. **Attempts to incorporate institutions operating abroad into the same supervisory platform as domestic financial conglomerates have proven difficult.** The first hurdle to overcome has been adapting the legal framework for financial activities to allow for consolidated supervision. Legislation in **Costa Rica and Panama** includes long-standing

provisions for consolidated supervision, but only Panama has been able to effectively implement to some extent supervision of domestic financial conglomerates and of cross-border intermediation (Box 3). **El Salvador** approved amendments to its banking law in 2002, defining “financial conglomerates” and providing for their supervision on a consolidated basis. However the Salvadoran Superintendency has not conducted supervision of cross-border financial activities because the two Salvadoran regional financial conglomerates decided to consolidate their international operations in Panama. **Guatemala and Honduras** recently approved modifications to the legal framework, and the process of implementation is under way. Changes in the legal framework for financial activities are still pending approval by congress in **Nicaragua**, where the supervisory authority has relied on miscellaneous legal provisions and ring fences to control cross-border transactions within financial groups (Box 4 and Appendix II).<sup>43</sup>

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<sup>43</sup> Although nonbank financial institutions are generally of no systemic importance, there is experience in the region of crises episodes associated with them. In Costa Rica, inappropriate recording of security transactions masked the failure of *Banco Anglo* in 1994.

### **Box 3. Consolidated Supervision of Regional Financial Conglomerates in Panama**

**Several of Central America's largest regional financial groups have elected to consolidate their banking activities in Panama, which has presented challenges for implementation of consolidated supervision.** The attraction to consolidate operations in Panama largely results from the advantages of operating in an international banking center and market factors. The prospect of more favorable international recognition and Panama's fully dollarized economy and open capital account have attracted foreign-owned banks that offer integrated domestic and international financial services, which may be convenient for cross-border transactions of regional financial groups. Moreover, several of the domestic banks are recognized as among the strongest in Central America, for which three of the banks have achieved an investment grade rating from global rating agencies.

**Legal and regulatory factors also explain consolidation of activities in Panama.** New banking legislation in 1998 established the Superintendency of Banks as an autonomous regulator, independent from the government and with sufficient resources to finance its activities. Key features of the legal and regulatory framework that support consolidated supervision are requirements for (i) consolidated supervision in law and regulation; and (ii) accounting and auditing standard and financial reporting. However, it must be noted that according to Panamanian legislation, banks with an international banking license are not subject to several prudential requirements applicable to banks with a general banking license.

**The Superintendent of Banks is able to supervise economic groups and their bank and nonbank affiliates on a consolidated basis, though with some limitations.** There is robust authority for the supervision of domestic banks and their subsidiaries (both domestic and foreign), which include the power to carry out direct onsite inspections. However, for holding companies and other non-bank entities, the Superintendent's powers are limited to requiring audited financial statements and other reporting information from nonbank affiliates of economic groups. The Superintendent has carried out inspections of the domestic non-banking subsidiaries and some foreign subsidiaries of Panamanian banks.

**Other powers of the Superintendent of Banks include the ability to impose restrictions on the transactions between the domestic bank and the holding company and other affiliates.** To facilitate the cross-border supervision, the Superintendent of Banks has in place numerous memorandums of understanding (MOU) for cooperation with foreign supervisors, establishing the working arrangements on the use of shared information.

**Accounting requirements apply to both the general and international license banks and their economic groups.** For financial reporting purposes, the Superintendency of Banks requires that economic groups file financial information using International Accounting Standards (IAS) as issued by the International Accounting Standards Committee or Generally Accepted Accounting Principles (GAAP) as issued by the US Financial Accounting Standards Board. Financial statements are to be prepared on a consolidated basis requiring the combination of balance sheet and income statement accounts for subsidiaries and the holding company, with the elimination of inter-company balances and transactions. Consolidated accounting is necessary to provide a true and fair view of risk concentrations, transactions with affiliates, and capital adequacy. Most importantly, the IAS/GAAP accounting requirement serves investors and other market participants, which is important factor recognized by regional financial groups for consolidating their operations in Panama.

#### **Box 4. Comparison of Legislation on Consolidated Supervision in Central America**

In **Costa Rica**, the National Council for Financial System Supervision (NCFSS) regulates the transfer, registration, and functioning of financial groups, including limits on lending or borrowing operations between institutions belonging to the same group. The NCFSS oversees the General Superintendency of Financial Institutions (SUGEF), an arm of the central bank that supervises banks, nonbank financial institutions, savings and loan mutual associations, savings and credit cooperatives and solidarity associations. Financial groups are defined as entities subject to joint control or joint management. They comprise holding companies and firms engaging in the provision of financial services such as banks, nonbank financial institutions, bonded warehouses, stockbrokers, investment companies, financial leasing firms and banks or financial companies domiciled abroad. The Superintendent may determine the existence of a de-facto financial group and must be notified of significant changes in “ownership interest.” While there is no explicit instruction for consolidated supervision, provision is made for consolidated reporting by financial groups. For the purposes of large exposure and related-party lending limits, operations of group members are consolidated. The requirement for external audits includes audits on a consolidated basis. For banks or financial firms operating abroad, SUGEF must assess whether there is sufficient supervision exercised by the host country supervisor. There are no provisions for on-site inspections by SUGEF of entities domiciled abroad.

In **El Salvador**, financial conglomerates are expressly subject to approval and consolidated supervision by the Superintendency of Banking (SB). Financial conglomerates consist of companies where more than 50 percent of the respective stock is held by a holding company. They must include one bank and may incorporate insurance companies, pension fund management institutions, brokerage firms, companies specialized in the deposit and custody of securities, credit card issuers, foreign exchange houses, financial leasing companies and bonded warehouses. Financial conglomerates can also include foreign banks, where at least 45 percent of the stock is owned by the holding company and it exercises control of the bank. There is a presumption of a financial conglomerate based on a determination of common control, but this presumption can be contested. The SB has access to all information of all members of the financial conglomerate needed to effectuate consolidated supervision. Financial conglomerates must satisfy total capital requirements on a consolidated basis, but there is no explicit requirement to apply large exposure and related-party lending limits on a consolidated basis. For banks that are not part of a financial conglomerate, consolidated supervision is applied to banking subsidiaries, including requiring consolidated financial statements and adherence with prudential requirements. Banks may conduct financial operations abroad through branches and subsidiaries, provided there is prudent regulation and supervision in the host country and the SB has given prior authorization. Foreign subsidiaries of a financial conglomerate are subject to the supervision of the SB and examination by independent auditors of the parent bank, without prejudice to the powers of foreign authorities.

In **Guatemala**, the Superintendency of Banks (SB) is granted broad powers for the exercise of supervision over banks and other financial service providers, including on a consolidated basis. A financial group is defined broadly as “two or more legal entities engaging in activities of a financial nature, one of which shall be a bank, when there is common control of such entities based on ownership, management, or use of corporate image.” A holding company or a bank may head the financial group. Only specified entities such as banks, finance companies, exchange brokerages, bonded warehouses, insurance companies, surety companies, credit card companies, financial leasing companies, factoring companies, securities brokerages, local or off-shore entities and other entities determined by the Monetary Board as well as support service providers such as automated tellers or electronic data processing providers are eligible to form part of a financial group. The SB may presume common control, but its presumptions may be challenged. The financial statements of the companies comprising the financial group must be prepared on a consolidated basis. The law explicitly states that companies comprising the financial group shall maintain required capital on solo and consolidated basis, and prudential requirements may be applied to such entities on a solo and consolidated basis. The SB is empowered to request information from entities in a financial group as needed and to carry out on-site examinations while safeguarding the identity of depositors. Banks may establish branches abroad, provided that the host country exercises supervision in a manner that allows for the exercise of consolidated supervision by the home country supervisor in line with international standards.

In **Honduras**, the Financial System Law of September 2004 introduces consolidated supervision, to be carried out by the National Commission of Banks and Insurance (NCBI), entity “in service” to the central bank, reporting directly to the President of the Republic. Financial groups consist of two or more companies engaged in activities of a financial nature under common control and may include banks, savings and loans associations,

finance companies, subsidiaries, and branches and offices of foreign financial institutions. The NCBI may determine that the relationships or transactions with non-financial members of the same financial group may endanger the financial stability of the group, in which case it shall have the right to conduct all inspections necessary to evaluate risks and require the implementation of necessary measures. The NCBI may not authorize the existence of a financial group without being able to exercise consolidated supervision of the financial activities undertaken. Financial groups must supply the NCBI consolidated financial statements including its subsidiaries and branches abroad. Consolidated capital of the financial group must be at least equal to the sum of the capital requirements of the companies in the group and inter-company investments among group members are subtracted from the paid-in capital of the investing company. The NCBI authorizes the opening of branches or subsidiaries abroad of a Honduran financial system institution and may supervise them directly or through auditors hired abroad. For a foreign financial institution to operate a branch in Honduras, the NCBI must have executed a memorandum of understanding with the home country supervisor.

In **Nicaragua**, the Superintendent of Banks is empowered to exercise consolidated supervision over financial groups. A financial group is defined as banks and nonbank financial institutions (including domiciled abroad) and affiliates that are directly or indirectly controlled by a majority of shares. The Superintendent may specify cases where setting up holding companies may be necessary. All banks or nonbank financial institutions must inform the Superintendent of whether they belong to a financial group. The coordinator of a financial group is the member established in Nicaragua with the largest asset value. The coordinator must consolidate the statements of the financial group, and submit them together with individual financial statements of its members. The Superintendent may set general prudential standards as deemed necessary to supervise financial groups on a consolidated basis. The Superintendent may apply a range of preventive measures “when the situation so warrants it” to members of a financial group. Prior authorization of the Superintendent is required to open branches abroad. However, there is no explicit authority to limit the range of activities a financial group may conduct in foreign locations, or for the Superintendency to conduct onsite inspections, but the Superintendent has broad authority to cooperate with foreign supervisors as necessary for consolidated supervision. Branches of foreign banks must apply for authorization to operate in Nicaragua.

In **Panama**, the Superintendency of Banks (SB) is authorized to supervise Panamanian banks (both with general and international banking licenses) on a consolidated basis, and is responsible for the supervision of Economic Groups (EG) of which Panamanian banks form part. An EG is defined as a group of natural or juridical persons whose interests are interrelated in such a way that the SB shall consider them as a single person. Descriptions of what constitutes an EG including ownership and control criteria are specified in legislation. The financial consolidation of subsidiaries for regulatory and financial reporting purposes is required. EG of banks with a general banking license must maintain at all times a global index of capital adequacy equal to the sum of the capital requirements for all the companies comprising the group. The SB may set prudential requirements on banks and members of the EG on an individual basis and on the entire EG of which a bank is a member. However, powers of the SB concerning capital adequacy and other prudential requirements appear more limited with regard to banks with an international banking license. The Superintendency has the power to supervise operations on a consolidated basis of branches and subsidiaries of Panamanian banks established in foreign jurisdictions. For the opening of branches and bank subsidiaries in Panama, the SB may require certification issued by the home country supervisor indicating its assurance that consolidated cross-border supervision of the applicant would occur, and the frequency and extent of the onsite examinations in Panama. It appears that this requirement is applied at the discretion of the Superintendency on a case-by-case basis.

58. Main problems with the legal framework for effective consolidated supervision include the lack of a clear definition of a financial group in some countries and the lack of enforcement of legal powers to regulate financial groups to the extent necessary to ensure effective monitoring. Heterogeneous and unclear definitions across countries often lack a structure that would allow for clear parameters to conduct consolidated supervision. Weak legal powers of supervisors to regulate financial groups prevent imposing effective limits on intra-group operations or requiring corrective actions when dubious transactions are observed. Implementation of legal requirements is also made difficult by the limited exchange of information, with critical sensitive information not being shared among supervisors in the region. In some cases, secrecy laws pose obstacles to an effective exchange of information between supervisors.

59. El Salvador has attempted to incorporate non-bank financial institutions and cross-border activities into the scope of consolidated supervision. However, Salvadoran conglomerates decided to consolidate in Panama, partly a response to the upgrade in the capabilities of the superintendency. Therefore, it was not possible to test the effectiveness of the legal framework providing for consolidation of cross-border activities. Other difficulties faced by Salvadoran supervisors were the evolving organization structures of current financial conglomerates and the exclusion of companies such as instrumental companies and fiduciary trusts from the scope of supervision.

### *Ring fences*

60. In light of the importance of cross-border operations by parallel-bank-based groups of Nicaraguan origin, the Nicaraguan Superintendency has put in place ring fences to limit opportunities to circumvent regulation. This is consistent with Basel criteria. According to the Basel Committee, “where the supervisor of a parallel bank concludes that there is inadequate access to information about material parts of the parallel-owned banking structure, and cooperation with the foreign supervisor will not sufficiently mitigate the risk of the parallel bank structure, it should seek to ring-fence the operations of the domestic bank.”<sup>44</sup> Consistent with this, the Nicaraguan Superintendency issued regulations including limits to investment in financial institutions and special accounting rules; adaptation to the regulation on capital adequacy (for example, higher risk weights for some investment categories); regulation on deposits and investments; 100 percent provisioning on sales of loan-portfolio bundles; and restrictions in the use of a common name. However, implementation of ring-fence type measures has faced difficulties in practice, and does not provide an adequate alternative to consolidated supervision, since it does not allow an overall assessment of vulnerabilities. Recent attempts to expand powers of the superintendency based on ring fences have been subject to injunctions in the courts. While the efforts of the superintendency are commendable in the adverse circumstances they face, prospects for further progress using this strategy appear limited. “It is not feasible or practical to require any supervisor acting alone to gather the necessary supervisory information on all related foreign parallel banks in the group, especially if parts of the organization structure in foreign countries are opaque.”<sup>45</sup>

### *Gradual absorption of DBB into the scope of consolidated supervision*

61. There has been some progress in the provision of information from booking offices operating abroad that are part of regional financial groups. In Costa Rica, some information is available for the 7 (out of 14) private financial groups that have offices abroad. However, financial groups have been unwilling to allow full access to their subsidiaries’ accounts. The Memoranda of Understanding signed with supervisory authorities where these subsidiaries operate have not allowed the verification of consolidated information. Reluctance to report continues despite higher capital adequacy requirements (20 percent for non-reporting groups and 10 percent for groups allowing full access). Private financial groups allege that their behavior aims at mitigating the significant dominance of public banks, which results from the lack of a level playing field. While public banks benefit from a blanket guarantee by the

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<sup>44</sup> Basel, 2003a.

<sup>45</sup> Basel, 2003a.



state, there is no deposit insurance for private banks. In Guatemala, the process of integrating information from booking offices is still ongoing. Eleven out of 18 financial groups have offices abroad (3 of which are foreign), and the superintendency has completed a first round of onsite inspections of all offshore entities. However, reporting deficiencies result in the unreliability of financial statements of banks and groups. So far, only nine financial groups have completed the process of registration as financial groups.

### ***Regional initiatives***

#### *Cooperation through Memoranda of Understanding*

62. The implementation of arrangements between different supervisory authorities in the region shows limited progress. A general arrangement sponsored by the CCS was signed in 1998. Subsequently, specific memoranda of understanding were signed between 2000 and 2003 to motivate bilateral cooperation, especially on exchange of information. However, the lack of a central authority, legal restrictions in some cases (in particular, secrecy provisions), unclear focus on what information is to be exchanged, and reported reluctance of supervisors to provide timely and detailed information have conspired against a smooth exchange of information. Sharing of findings or offsite analysis is incomplete, and joint inspections have been rare.

#### *Coordination in Council of Superintendents of Banks, Insurance, and Other Financial Institutions (CCS)*

63. The CCS has been instrumental in promoting an exchange of views among regional supervisors on the need for cross-border consolidated supervision. The CCS was founded in 1976, with the goal of encouraging cooperation and exchanging of information between regional superintendencies, and facilitating the implementation of regional agreements. Discussions on plans to harmonize regulation across countries in the region have taken place with the Inter-American Development Bank (IDB), with the main goal of identifying the gaps for the application of international standards for banking supervision. Coordination to implement international financial reporting system criteria was assisted by the Central American Bank for Economic Integration (CABEI). Steps to improve regional banking supervision include the preparation of assessments and action plans to be implemented in the second half of 2005. The CCS is at a crucial juncture in defining a roadmap and priorities to show effective progress in improving consolidated supervision of regional financial institutions.

## **D. Conclusions and Elements of an Action Plan**

### **Minimum standards**

64. **International experience (e.g., the European Union, the East Caribbean Currency Union, WAEMU, CEMAC, and NORDEA) can be used as a reference for consolidated supervision in Central America only to a limited extent.** The experience of NORDEA would seem most applicable to Central America, because both operate outside the framework of a currency union. In most cases, financial integration has progressed in parallel with political integration at least to the extent necessary to have a common supervisory

authority.<sup>46</sup> Central America not only lacks the political integration to establish a common supervisory authority, but there is limited experience with minimum standards in the face of enforcement difficulties. The exchange of information through a memorandum of understanding (MoU) is less than what would be necessary to compensate for the lack of a common authority. Moreover, the choice of a home supervisor for a group is left to the group, providing for opportunities to seek out a weak supervisory regime in the context of a quite heterogeneous supervisory framework.

65. **The minimum standards for the supervision of international banking groups established by the Basel Committee** stipulate that (a) all international banks should be supervised by a home country authority that capably performs consolidated supervision; (b) the creation of a cross-border banking establishment should receive the prior consent of both the host country and the home country authority; (c) home country authorities should possess the right to gather information from cross-border banking establishments subject to their supervision; and (d) if the host country authority determines that any of these three standards is not being met, it could impose restrictive measures or prohibit the establishment of banking offices.

66. **In Central America, the performance of consolidated supervision is most advanced in Panama.** An assessment of how capably supervision is performed is beyond the scope of this note.<sup>47</sup> Strengths of Panama's supervisory framework include experience in dealing with financial groups, sufficient resources and the requirement of international accounting standards. However, the presence of banks that do not consolidate financial statements and the likely substantial mind and management in the home country of shareholders of RFCs are areas to be addressed within the framework of a regional approach.

67. **Prior consent to authorize operations of banks in different jurisdictions was made without paying attention to the lack of consolidated supervision.** Most institutions were established in different countries as domestic banks, and therefore primarily subject to supervision only of the individual entity.

68. **Provision of information to the home country supervisor (Panama) seems to be generally adequate.** However, supervisors in other countries feel that the substantial presence of mind and management in their jurisdictions justifies the provision of information from the home to the host country supervisor.

69. **Standards do not call for a specific supervisory technique.**<sup>48</sup> In Central America, more than one approach seems necessary because different problems need to be addressed: (a) regional financial conglomerates with mind and management outside Panama consolidating in Panama; (b) parallel banks being supervised on a non-consolidated basis taking advantage of the absence of a common enforcement of consolidation; and, (c) offshore activities of DBB that are not being reported to any supervisory authority are being phased out too slowly.

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<sup>46</sup> For summaries of the experience with regional financial supervisory bodies, see Appendix II.

<sup>47</sup> An Offshore Assessment of Panama, including assessments of performance under four international financial standards and codes will take place in the coming months.

<sup>48</sup> Bank for International Settlements, 1996.

## **Regional initiative to improve consolidated supervision**

70. **In the context of discussions within the CCS, Panama has prepared a regional initiative for consolidated and cross-border supervision.** The main objectives are: (a) eliminate opportunities to elude supervision; (b) use adequate prudential standards; (c) define the structure, ownership and management of conglomerates; (d) establish adequate capital requirements on a consolidated basis; (e) assess asset and liability management, including credit management; (f) identify global risks of conglomerates; (g) ensure transparency of information; (h) establish links to transmit risks; (i) determine contagion risks; and (j) verify compliance with the legal framework.

71. **The proposed regulation would be implemented through a series of bilateral arrangements between the supervisory authorities in Panama and other superintendencies.** The chosen mechanism would operate as an umbrella memorandum of understanding. In addition, the proposal includes a standardized questionnaire to be used in inspections of a conglomerate. Moreover, the proposal discusses other elements that are pertinent for improving the effectiveness of consolidated supervision, such as allowing for a major role for the home country when the host country does not have adequate resources, ensuring adequate flow of information, uniform criteria for on-site inspections, and adequacy of the legal framework. The proposed agreement has the following main features:

- The host supervisor would notify the home supervisor of requests to obtain licenses, and the home country would report on compliance with laws and regulations in the home country of the requesting financial group.
- Information exchange would be open, with the exception of the identification of depositors.
- Supervisors commit to provide assistance to on-site inspections of other country supervisors.
- Cooperation would be promoted, especially on AML/CFT issues.

72. **Additional actions that could be considered to strengthen Panama's initiative are that:** (a) a no-objection letter from the home regulator be required prior to the granting of licenses in another country in the region; (b) information on depositors be made available to the home supervisors on an exceptional basis, for example to identify group exposures and concentration; (c) cooperation on AML/CFT issues be specified to allow for specific gateways, such as for testing compliance with the applicable group requirements and in relation to suspicious activity reports.

## **Strategy to improve consolidated cross-border supervision**

73. **The strategy to be adopted should take as a starting point the endogenous response of financial groups to consolidate in Panama.** To be most effective, the strategy should aim at maximizing the potential benefits that consolidating in a jurisdiction within the region may bring, while reinforcing the mechanisms that would allow more effective identification, monitoring and mitigation of risks in each country.

74. **As a first step, all countries should commit to a plan to effectively integrate operations of parallel banks and booking offices into their financial groups with a common deadline to be enforced by regional ring fences.** This will reinforce the capability of supervisors to integrate information from offices operating offshore without adequate supervision. More generally, for the Basel Committee, “there is a presumption that in principle (parallel banks) should not be permitted.”<sup>49</sup> A reasonable period of regularization would be considered, after which a lead supervisor might be appointed in the context of coordination within the CCS to act under the presumption of the existence of a conglomerate in the absence of a formal arrangement, which will be applicable in all jurisdictions. According to Basel (2003a) “if a bank exhibits **one or more** of these characteristics, the supervisors should conduct additional inquiries to ascertain whether a parallel-owned banking structure is in fact in place:

- An individual or group of individuals acting in concert that controls a foreign bank also controls any class of voting shares of a domestic bank; or financing for persons owning or controlling the shares is received from, or arranged by, a foreign bank, especially if the shares of the domestic bank are collateral for the stock purchase loan.
- A domestic bank has adopted particular or unique policies or strategies similar to those of a foreign bank, such as common or joint marketing strategies, sharing of customer information, cross-selling of products, or linked websites.
- An officer or director of a domestic bank either serves as an officer or director of a foreign bank, controls a foreign bank, or is a member of a group of individuals acting in concert or with common ties that control a foreign bank.
- There is an unusually high level of reciprocal correspondent banking and other facilities between a domestic bank and a foreign bank.
- The name of a domestic bank is the same as or is similar to that of a foreign bank. A lead supervisor could be appointed to supervise parallel structures on a quasi-consolidated basis (in accordance with the legal framework).”

75. **The role of host supervisors in the process of consolidated supervision should be strengthened.** The strategy to be followed should be mindful of the strong “mind and management” presence in the country of origin of RFC shareholders. Consideration should be given to a two-way exchange of information, with the home country providing feedback to host supervisors on selected risks that require careful cross-border monitoring. A system based on a principle of “host country conditional deference” could be put in place, which would operate like the “home country rule” system in the European Union, but host country supervisors, while deferring to home country supervisors, would reserve the right, when warranted by the circumstances, to resume a more active role.<sup>50</sup> In principle, there are three types of information to be provided by the home supervisor to the host authority. These are (a) information specific to the local office supervised by the host supervisor; (b) information on the overall framework of supervision in which its banking group operates; and

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<sup>49</sup> Basel 2003(a).

<sup>50</sup> Uhlick, 1999.

(c) significant problems that arise in the head office of the group as a whole. The most sensitive issue normally is material adverse changes in the global condition of banking groups operating in the host supervisors' jurisdictions.<sup>51</sup>

76. **A minimum set of risks considered priority issues should be addressed in a first stage.** Risks associated with related-party lending and loan concentrations, loan classification and provisioning and capital requirements seem to be candidates to be addressed in the first instance, establishing minimum standards and a timetable to make them more stringent. This could be accompanied by an effort to start promptly work on the formation of a regional credit risk bureau. Risks associated with AML/CFT and country risk could also be targeted as priorities. There may be a case to allow for differential limits for large exposures in countries where economic diversification is limited (Box 5).

77. **On unregulated risks, monitoring currency mismatches and exposure to sovereign risk should be intensified.** An effort should be made in gathering information and detecting promptly cases where individual institutions or groups take excessive risk relative to the average. On lending to unhedged borrowers, all countries could implement a policy of incorporating information on foreign currency hedging by borrowers as an element to decide on loan classification.

#### **Box 5. Harmonization of Supervision of AML/CFT Requirements**

Supervisory systems and practices for AML/CFT vary widely across the region. As for prudential supervision, such systems have not kept pace with the increasing development of financial groups operating across the region, particularly given the divergence in prudential requirements applied to banks and non-bank financial institutions, resulting in an uneven application of AML/CFT risk management practices and supervision across countries and within financial groups. The evolving financial landscape therefore calls for a refocusing of AML/CFT risk supervision in a way that: (a) requires the application of AML/CFT policies, procedures and practices on a group-wide basis. For banks, this would be consistent with the Basel paper on consolidated AML/CFT risk management and supervision and with the applicable FATF recommendations; (b) harmonizes the AML/CFT supervisory procedures across the region for both off- and on-site supervision; and, (c) applies a risk-based approach to AML/CFT supervision consistent with the FATF recommendations. Development of enhanced AML/CFT risk supervision should be consistent with the broader effort to implement region-wide consolidated supervision in other areas.

More stringent enforcement and implementation of AML/CFT requirements and, in particular, in the offshore financial centers in the region may contribute to encouraging regional financial groups to reorganize or conduct their offshore business in a manner that allows for effective supervision. Over time, this may lead to a reduction in the number of parallel banks as offshore operations are either discontinued or converted to subsidiaries.

78. **It is difficult to find alternative schemes for deposit insurance protection that minimize the transfer of obligations in the event of a crisis.** Alternatives such as differential protection or deposit insurance premia for financial institutions or groups based on compliance with a schedule for consolidation might be considered.

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<sup>51</sup> Basel, 1996.

79. **Cross-border cooperation needs enhancement.** Central America has a history of formal MOU that lack effective follow up. An assessment of comparative experiences would be useful to ensure that MOU could produce better results, noted in the context of the umbrella MOU proposed in the CCS. National authorities could consider making public information on contacts and gateways to exchange information.<sup>52</sup> A clear sequencing and prioritization should start with the sharing of inspection and offsite reports. Thereafter, risks regarded as priority should be the focus of more intensive use of joint inspections at the beginning, while joint global inspections should only be considered once inspections of specific risks have been successfully concluded. While Basel recommends to allow hosts the option but not the duty to accompany the home supervisor during the inspections, the need to overcome deficiencies in Central America would justify a more proactive approach<sup>53</sup>

80. **Transitional arrangements appear to be necessary.** More stringent requirements for opening new offices in the region while consolidation of large groups is completed could be considered. Also, a common understanding about the choices of organizational structures seems necessary. A clear common definition of financial group should be a priority.

81. **Finally, to promote the contribution of financial integration to economic growth, fundamental improvements of the institutional framework are required.** Political stability, enforcement of property rights, an overhaul of preconditions for effective banking supervision, and effective legal protection of supervisors when performing their duties in good faith are all basic requirements.

#### **Addressing systemic risks in Central America**

82. **The growth of cross-border banking activities poses significant challenges for banking resolution.** In the event of failure, regional financial groups may be split into their national legal entities, each subject to different bankruptcy proceedings.<sup>54</sup> As a result, fair treatment of creditors may be hampered if creditors in one jurisdiction receive higher compensation than similar creditors in other locations. In addition, lack of harmonization in key resolution procedures and poor communication between regulators are obstacles to coordinated intervention and resolution of different entities within the same failed international group.

83. **Ring fences can affect regulators' ability to resolve cross-border banks in a manner that is fair to all creditors.** In jurisdictions where ring fencing is allowed, branches of foreign banks are treated as separate legal entities and, if necessary, are wound-up as such (separate-entity approach). The purpose of ring fencing is to ensure that local creditors receive preferential treatment over foreign creditors, and under this approach the various parts of the financial institution located in different jurisdictions will be subject to separate legal proceedings. In contrast, in jurisdictions following a single-entity approach, there is only one set of insolvency proceedings in which the financial institution is treated as one entity, and its assets, no matter where they are located, will be included in a single liquidation or reorganization process. Under this approach, all creditors, no matter where situated, are

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<sup>52</sup> IMF Conference on Cross-Border Cooperation and Information Exchange, Washington DC, July 7-8, 2004.

<sup>53</sup> See Basel, 1996.

<sup>54</sup> Lastra (2003).

entitled to lodge their claims in the single set of proceedings and receive the same treatment as all other creditors within their class. There is no “best practice” as to which approach should be followed in the legislation governing bank insolvencies.

84. **While progress has been substantial in upgrading the legal framework for banking resolution, differences in approach remain that hamper coordinated resolution of cross-border entities within the same failed group.** For instance, supervisors in different jurisdictions may not be able to intervene branches and subsidiaries of a failed group in a coordinated fashion due to differences in the legal definition of bank insolvency or in the legally-mandated minimum period before liquidation. Different treatment of shareholders also prevents consistency in dealing with the same class of stakeholders across borders, and in some cases can prevent orderly resolution.

85. **Continuous coordination and communication between regulators is also critical to ensure orderly resolution.** A decision to intervene or close a domestic bank with operations abroad or a subsidiary of a foreign bank could have unintended, but significant consequences for other countries.<sup>55</sup> Thus, bank supervisors should coordinate their actions with a view to containing cross-border contagion as a result of problems in an international financial group.

#### *Regional initiatives*

86. **Although the six Central American countries are signatories to a regional convention on cross-border bankruptcy proceedings, further efforts are needed.** The 1928 Convention on International Private Law (the “Bustamante Code” or “Havana Convention”) only sets certain principles applicable to cross-border bankruptcy proceedings as to the extra-territoriality of a bankruptcy order. In the absence of an international agreement specifically governing cross-border bank insolvency, the authorities may want to consider entering into a regional treaty which would set specific rules and procedures applicable to cross-border bank insolvency proceedings, particularly aimed at dealing with regional banking problems to help ensure fair, timely, and transparent treatment of claims from depositors and other creditors.

87. **Specifically, international experience on cross-border bank insolvency and the analysis of current legislation points to the following key areas requiring further strengthening:**<sup>56</sup>

- **Specific procedures applicable to cross-border bank bankruptcy proceedings.** The objective is to avoid that different approaches to, for instance, ring fencing, result in inconsistent and unfair treatment of creditors of the same financial group based on their location. Such procedures would also need to address the issue of seniority of claims of deposit insurance agencies over foreign creditors and inter-company

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<sup>55</sup> For instance, in certain circumstances, the intervention and closure of a small subsidiary of a foreign bank by a host bank supervisor may have no major impact on the stability of the local banking system, but it may create severe consequences for the parent bank’s credibility and ultimately create a banking crisis in that location.

<sup>56</sup> For details, see Appendix I.

accounts, which is common in Central American countries and may play against the fair treatment of depositors in other locations.

- **Explicit agreement on coordination and information sharing between national regulators and liquidators** to facilitate orderly cross-border resolutions. For instance, agreement of regulators from a number of locations may be needed to finalize the restructuring of an international financial conglomerate.
- **Measures to reduce the risk that assets and liabilities be shifted across bank subsidiaries in the event of problems.** A particular concern in the region relates to the possibility that prior to a bank failure insider or other deposits be moved to locations with higher deposit insurance coverage.<sup>57</sup> While only harmonization of deposit insurance regimes across the region would eliminate this risk, relevant regulators in the region should initiate discussions as a matter of urgency on how to better prevent these transactions and mitigate their risks in the short term.

### *Upgrading national legal frameworks*

88. **In recent years, the legal framework for banking resolution in most countries within the region have been strengthened significantly** (Table 8). Among other measures, many countries have: (a) introduced prompt corrective actions to address banking problems at an early stage, including the requirement that shareholders of weak, but viable, banks submit rehabilitation plans; (b) approved triggers to induce bank intervention in case of insolvency; (c) introduced bank resolution tools, including merger and purchase & assumption schemes (P&A); and (d) enhanced and clarified the role of deposit insurance agencies in bank resolution.

89. **Further coordination and harmonization of treatment is needed in a number of areas, however, to ensure equitable treatment of all parties in banking resolution:**

- **Triggers for bank intervention:** A uniform definition of insolvency—currently ranging from 2 to 8 percent of risk-weighted assets—would allow the authorities to coordinate the timing of intervention of members of a financial group across countries, thereby minimizing the risk of contagion and asset stripping.<sup>58</sup>
- **Duration of bank intervention:** Consistency regarding the length of time a bank may be subject to official administration would facilitate orderly resolution of cross-border entities when a single-entity approach is followed. Intervention can vary in duration, however. It can range from 30–90 days in Nicaragua and Panama to up to one year in Costa Rica. The time limit is not well defined in Nicaragua, Honduras, and El Salvador, and does not exist in Guatemala.
- **Rights of shareholders.** Shareholders' rights should be suspended as part of bank intervention. In Costa Rica, El Salvador, Honduras, and Panama the law is ambiguous

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<sup>57</sup> All six Central American countries except Panama have explicit deposit insurance, but the coverage varies.

<sup>58</sup> Generally, the banking authorities may put a bank under official administration in the event of insolvency, suspension of payments, and/or failure to submit or comply with a rehabilitation plan.



with respect to the shareholders' rights during a bank intervention, which could be a serious obstacle for bank resolution. In the case of Costa Rica, the law not only is silent with respect to the status of shareholders' rights during bank intervention (suggesting that they maintain ownership rights during such period), but also it specifically establishes that the bank's shareholders may be part of a bankruptcy committee together with the authorities and creditors;

- **Treatment of bank managers.** If a single-entity approach is followed, managers in all subsidiaries and branches of a failed group should be prevented from participating in key bank resolutions decisions to ensure fairness. That is not always the case in Central American countries, however. In Guatemala and Nicaragua bank managers are dismissed when the authorities declare a bank under official administration. In the other countries, it is unclear whether the authorities can keep incumbent bank managers from participating in key decisions as to the bank resolution. For instance in Honduras, the supervisor has only limited powers to reverse bank management decisions during the regularization phase.
- **Asset valuation rules.** If a single-entity approach is followed, different rules on the valuation of assets could undermine the use of purchase and assumption (P&A) transactions. Assets must usually be valued according to local rules before they are transferred to another institution or trust fund. The valuation of claims against nonresidents and assets abroad could create difficulty in bank restructuring.

90. **Weaknesses hampering quick bank resolutions should also be addressed since speed in the adoption of resolution measures is key to containing losses.** Three major issues may play against the early identification of problem banks and proper implementation of the legal framework for banking resolution:

- **Lack of independence and discretionary powers of bank supervisors to act at an early stage.** In some jurisdictions, as a result of legal limitations or the political process, bank supervisors cannot act independently and may hesitate to impose early remedial actions on weak banks.
- **Weak legal protection for bank supervisors.** The risk of legal challenges from former bank shareholders in court, together with weak protection from recourse against individual bank supervisors, may discourage early bank resolution measures by banking supervisors.
- **Limitations to detecting bank insolvency.** Despite the progress made in strengthening bank supervision, in some cases, bank insolvency may remain undetected as a result of: (i) lack of effective monitoring of credit to insiders (the bank's capital may have already been diluted through credit to related parties or affiliated entities); and (ii) the use of inaccurate asset valuation rules. Failure to correctly assess the borrower's future repayment capacity, over reliance on loan collateral, and excessive regulatory forbearance could in some cases postpone the recognition of bank losses.

Table 8. Overview of Legal Framework for Banking Resolution in Central America

Countries	Triggers for official administration	Restructuring powers	Opening of liquidation proceedings	Priority of depositors' claims	Deposit insurance scheme
Costa Rica	Bank intervention is triggered, among other causes, by the total or partial cessation or suspension of payments or in cases where more than half of the bank's equity is lost.	During official administration the intervenor appointed by the National Council shall implement the regularization plan. The National Council may (i) ban any new credit transaction or extension of grace periods for the payment of debts with past due dates; (ii) call for a shareholders' meeting to recommend capital increases; (iii) suspend or limit the payment of bank's liabilities; (iv) ban or limit the distribution of dividends unless authorized by SUGEF; and (v) order the "reorganization of the bank". The law does not specify however, what are the specific techniques that could be implemented by SUGEF or the intervenors in order to restructure a failing bank, which may cause that such actions could be challenged on legal or constitutional grounds.	Judicially-supervised proceedings. Liquidation proceedings initiated by the competent judge at the request of the National Council in case of failure of the restructuring, at the request of the Superintendent when such petition is "justified", or by a petition filed by the bank itself or by one of its creditors in case of cessation of at least one payment.	No priority for depositors' claims. Based on the general bankruptcy legislation the priority is as follows: (i) secured creditors; (ii) privileged creditors (labor and fiscal claims); (iii) bankruptcy's costs; and (iv) other unsecured creditor's claims, including "depositors' claims."	Blanket guarantee for public banks. None for private banks.
El Salvador	A bank may be restructured if the bank fails to submit a regularization plan when due, (ii) does not correct its irregularities within the regularization period, (iii) fails to comply with any of its obligations arising from the regularization proceedings, or (iv) the Superintendent finds that the regularization plan would not be sufficient to address the bank's problems.	The restructuring modalities are: (i) a mandatory reduction or increase of the bank's capital; (ii) the exclusion of some of the bank's assets and liabilities (the "excluded estate"); (iii) the judicial intervention of the bank (official intervention); or (iv) the adoption of any other measure deemed technically necessary in accordance with the nature of the problem (although the law does not to specify these other measures).	Judicially-supervised proceedings. Upon transfer of the excluded estate's assets or if the Superintendent determines that the solvency or non-solvency problems that gave rise to a situation of irregularity of the bank cannot be corrected through a regularization plan. The bank's creditors are not in a position to petition for bankruptcy. The law does not recognize the "cessation of payments" as one of the grounds for initiating a bank's liquidation.	Depositors are privileged as they are guaranteed to be paid with the proceeds of the transfer of the excluded estate's assets, or directly from the IDG. The priority of claims is as follows: (i) liabilities arising from labor, pensions and child support claims; (ii) liabilities from deposits up to the amount of the deposit guarantee; (iii) claims of foreign banks arising from foreign trade transactions duly registered before the Central Bank; (iv) liabilities for deposits in excess of the deposit guarantee;	The deposit insurance scheme (IDG) guarantees the deposits of the general public in banks and participates in bank restructurings through the acquisition of assets of excluded estates, or by participating in the <i>Fideicomiso</i> established with such assets. The deposit guarantee is currently set in an amount equivalent to \$7,060 per depositor per bank, and covers both sight and time deposits.

Countries	Triggers for official administration	Restructuring powers	Opening of liquidation proceedings	Priority of depositors' claims	Deposit insurance scheme
				(v) other privileged claims; (vi) claims represented in credit instruments; (vii) unsecured claims of the Multisectoral Investment Bank; (viii) claims of the State and the local governments; (ix) other unsecured claims; and (x) the balance of the time subordinated debt.	
Guatemala	The bank's operations must be suspended when the bank ceases the payment of its obligations or incurs a capital deficiency that exceeds 50 percent of the required capital. In addition, events that allow (but not require) a suspension of operations are the non-presentation of a regularization plan, its rejection by the Superintendent or the non-compliance with such plan, or other grounds duly justified by the Superintendent.	The restructuring powers are: (i) to determine losses and charge them against reserves or capital; (ii) to select assets and transfer them to a trust administered by a bank appointed by the SB; (iii) to select deposits for up to the amount covered by the deposit insurance and employee liabilities and transfer them to other banks; deposits exceeding the amounts guaranteed by the deposit insurance can be transferred if it is estimated that there are sufficient assets to transfer to the trust. Banks assuming the payment of deposit and employee liabilities receive a participation in the trust for the same value of the liabilities they assume; (iv) to request the deposit insurance fund to make grants to the trust formed with the assets of the failed bank.	Judicially-supervised proceedings. Bankruptcy proceedings are initiated by the competent judge at the request of the Superintendent. The law provides that the petition is made once the procedures for the spin off and transfer of assets and liabilities are concluded but fails to explicitly state whether bankruptcy may be requested in the absence of such procedures. It is unclear whether the bank's creditors may make such petition to the courts upon verification of the grounds set forth under the general bankruptcy law.	No preference for depositors' claims over other creditors in the bankruptcy proceedings. Under the general bankruptcy law, the liquidation proceeds are paid in the following order of preference: (i) bankruptcy expenses; (ii) alimony, funeral and estate expenses; (iii) expenses documented in public deeds, in the order they were documented; (iv) other expenses.	The deposit insurance scheme (FOPA) insures deposits under the terms specified in the law but has no restructuring powers (with some exceptions). The deposit insurance scheme covers deposits of up to 20,000 quetzales or its equivalent in foreign currency (to be adjusted as necessary to ensure that at least 90 percent of the deposits are protected).

Countries	Triggers for official administration	Restructuring powers	Opening of liquidation proceedings	Priority of depositors' claims	Deposit insurance scheme
Honduras	The law puts emphasis on corrective actions rather than provide for official administration of a bank in distress. In the event of deficiencies not yet triggering compulsory liquidation, such as liquidity and solvency problems, operational losses during three straight months, or capital inadequacy for at least 60 days, among others, financial institutions are required to submit a regularization plan to the Commission.	The Commission may appoint a delegate to the board of the financial institution with the aim of overseeing the operations and safeguarding the interests of the customers and the public during the execution of the regularization plan. The Commission is also authorized to reverse any transaction in breach of the regularization plan.	Mainly administrative process. The Commission shall order the compulsory liquidation of a financial institution for non-submission of the regularization plan, its contravention, or the non-rectification of the deficiencies at the origin of the plan. Other mandatory grounds for ordering the compulsory liquidation are, among others: (i) the capital is lower than the minimum initial capital required; (ii) inability to pay outstanding obligations with the public when due; and (iii) the regularization plan is unworkable or cannot be implemented. Compulsory liquidation cannot be triggered by third party creditors.	The priority of claims is as follows: (i) labor-related claims; (ii) all deposits; (iii) loans granted by the Central Bank due to liquidity problems and other banking obligations; (iv) funds collected for payments to third parties; (v) payments to FOSEDE; and (vi) the remaining claims in keeping with the priority established in the Commerce Code.	The deposit insurance scheme (FOSEDE) is responsible for the payment of the deposits in financial institutions that have been liquidated and making non-reimbursable contributions or loans in relation to compulsory liquidation processes, as requested by the Commission. The maximum amount insured is 150,000.00 lempiras per each depositor and financial institution.
Nicaragua	The bank must be placed under official administration if the bank's capital is less than one fourth of the minimum required capital or if the bank is in cessation of payments. There are several discretionary triggers, such as violations to the law and regulations, an evident non-compliance of the regularization plan, losses that exceed one third of the capital, indications of a possible cessation of payments or illiquidity or insolvency problems less severe than those requiring the forced liquidation.	Under the Law on Banks, Financial Institutions and Financial Groups, the official administrator may: (i) terminate the employment relationships and reduce the bank's expenses; (ii) sell any of the banks' assets in the interest of depositors; and (iii) sell or merge the bank with another bank. If FOGADE is appointed as official administrator, in the process for the restitution of deposits, it may transfer deposits and corresponding amounts of assets to acquiring banks.	Mainly administrative, with some court involvement. Upon specified events, such as severe illiquidity, insolvency, or an unsuccessful recovery of the bank in the context of an official administration, the Superintendent shall request the courts to place a bank in forced liquidation. The role of the courts is limited to declare the mandatory liquidation, with the Superintendent in charge of appointing the liquidator and monitoring the liquidator's performance. The declaration of liquidation and any decisions adopted by the liquidator can be appealed before the Courts.	Depositors that are individuals have a special preference on the liquidation proceeds over all other creditors for up to a specific amount. The priority of claims is as follows: (i) employees claims; (ii) all deposits, including for the amounts not covered under the special preference; (iii) claims of the Central Bank of Nicaragua; (iv) taxes; (v) other claims in accordance with their preferences and modalities established in the civil code.	The deposit insurance scheme (FOGADE) has broad powers to undertake restructurings under the procedures for the restitution of deposits. FOGADE covers deposits of up to 20,000 dollars.

Countries	Triggers for official administration	Restructuring powers	Opening of liquidation proceedings	Priority of depositors' claims	Deposit insurance scheme
Panama	Intervention is triggered on the following grounds: (i) a request from a bank; (ii) the reduction of the capital by the bank so it corresponds to less than 8 percent of its total assets and off-balance sheet operations; (iii) the decline of the capital adequacy ratio below 8 percent; (iv) business is conducted in an illegal, negligent or fraudulent manner; (v) payments are suspended; (vi) repeated infraction of the liquidity requirements; (vii) threat to the interest of the depositors if the bank continues to operate; (viii) assets are insufficient to cover the sum of its liabilities; (ix) unjustified delay of the voluntary liquidation; and (x) failure to comply with the reorganization plan.	In a reorganization, the Superintendent is authorized to execute any of the following actions: (i) amortize the losses against the paid-in capital stock and reserves; (ii) appoint new managers; (iii) authorize the issuance of new shares of the bank, as well as their sale to third parties at a price determined by the Superintendent; (iv) promote the merger or the consolidation of the bank with one or more banks, acquire loans, the sale or partial liquidation of its non-productive assets or the imposition of liens upon them; or (v) initiate the process of liquidation. During intervention, the intervenor is authorized to suspend or limit the payment of the bank's obligations for the duration of the intervention.	Administrative proceedings without the involvement of the courts. The Superintendent has discretionary powers to order the compulsory liquidation of a bank that has been intervened or is in the process of reorganization. Compulsory liquidation may also be decided by the Superintendent at the conclusion of the reorganization, if the process has not been completed satisfactorily, or at any other moment before the conclusion of the reorganization due to insolvency or any other reason that prevents the recovery of the bank. Insolvency proceedings cannot be initiated at the request of third party creditors.	The priority of claims is as follows: (i) labor-related claims; (ii) claims by the Social Security agency concerning contributions owed by the bank's employees; (iii) tax-related claims of the National Treasury or the Municipalities, as well as levies for public services rendered by the State; (iv) deposit accounts for US\$5000 or less belonging to natural persons; and (v) all other deposits and claims.	None.

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## **LEGAL FRAMEWORK FOR CONSOLIDATED SUPERVISION OF BANKS AND BANK INSOLVENCY**

This note has been prepared by the Legal Department of the International Monetary Fund and describes selected features of the legal frameworks of Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and Panama in the areas of consolidated supervision of banks and bank insolvency.<sup>59</sup> The first part of the note analyzes the extent to which the law requires banks and banking groups to be supervised on a consolidated basis in the domestic and cross-border settings. The second part of the note outlines the bank insolvency framework for each country.

The description is based primarily on a review of English translations of legislation made available to Fund staff as described in each country section. As a starting point, it should be noted that additional provisions may be embedded in legislation and regulations that were not made available to Fund staff; moreover, Fund staff did not have the opportunity to discuss with the relevant authorities the manner in which various provisions of national legislation are interpreted or applied. Accordingly, the analysis set out below should not be regarded as either comprehensive or complete.

### **I. Consolidated Supervision of Banks**

#### **A. Costa Rica<sup>60</sup>**

##### **Domestic supervision on a consolidated basis**

In Costa Rica, consolidated supervision at the domestic level is carried out by the National Council for Financial System Supervision (the “National Council”).<sup>61</sup> The National Council oversees the General Superintendency of Financial Institutions (SUGEF) (the “Superintendency”) in charge of the supervision of banks, nonbank financial institutions, savings and loan mutual associations, savings and credit cooperatives and solidarity

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<sup>59</sup> This note has been prepared under the guidance of Ross Leckow (Assistant General Counsel) and Maike B. Luedersen (Counsel) with country sections prepared by Debbie Siegel (Senior Counsel) and Katharine Christopherson, Antonio Hyman-Bouchereau, Gabriela Rosenberg, and Moni SenGupta (Counsels).

<sup>60</sup> The analysis is based on a review of: the *Organic Law of the Central Bank of Costa Rica*, Law 7558, (as amended through Nov. 25, 2004), (the “Central Bank Law”); *Ley Reguladora del Mercado de Valores*, Law No. 7732 (as amended through July, 1, 2003) (the “Securities Law”); Regulations Governing the Establishment, Transfer, Registration, and Operations of Financial Groups (Nov. 4, 1998) (“FG Regulation”); and Regulation of Financial Information of Financial Entities, Group, and Conglomerates (January 20, 2004) (“Reporting Regulation”). Unless otherwise specified, citations are to the *Organic Law of the Central Bank of Costa Rica*.

<sup>61</sup> The National Council oversees various subsidiary supervisory agencies (Art. 171 of the Securities Law). It replaced the Board of Directors of the Central Bank in this role and appears to operate within the Central Bank but its legal status is unclear in the law (Art. 117; Arts. 169-171 of the Securities Law). The General Superintendency of Financial Institutions is an arm of the Central Bank (Art. 115).



associations, as well as entities that are authorized by law to engage in financial intermediation (Art. 117).

The National Council establishes rules on such issues as the establishment, transfer, registration, and functioning of “financial groups.”<sup>62</sup> Financial groups are comprised of a holding company and firms engaging in the provision of financial services organized as business corporations.<sup>63</sup> Entities intending to operate as a financial group must apply to be registered with the National Council, which will designate the appropriate supervisor (Art. 6 of the FG Regulation), i.e., the Superintendency when one of the entities is a bank. The Superintendency may determine the existence of a de facto financial group (Art. 8 of the FG Regulation).<sup>64</sup> Shareholders with an equity interest of more than five percent in a holding company of a financial group must be reported to the authorities and such information must be “constantly updated” (Art. 117). While there is no explicit approval requirement for the transfer of shares, significant changes in a financial group such as a merger or the addition of a member require the prior approval of the Superintendency (Art. 29 of the FG Regulation). The legal framework also provides for coordination among supervisors (Art. 31 of the FG Regulation).

The law does not explicitly require the Superintendency to conduct supervision on a consolidated basis but does provide for consolidated reporting by financial groups. The holding company of a financial group must provide the Superintendency with consolidated financial statements of the group, including those entities “which are not subject to monitoring by any of the supervisory agencies” (Art. 145; Art. 14 of the FG Regulation). Banks or firms that are members of the group and located abroad must, through the holding company, provide the Superintendency with audited reports (Art. 147). External audits must be conducted on a consolidated basis (Art. 3 of the FG Regulation).

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<sup>62</sup> Financial groups are defined in Art. 2 of the FG Regulation as those entities subject to joint control (holding directly or indirectly a majority of the shares or controlling the appointment of most of the directors in the decision making process) or joint management (“whenever two or more financial enterprises come under one management or governing body, use the same or similar names, act jointly or offer complementary services to enterprises connected with the financial group”). Requirements for a holding company include that it shall at all times be the owner of at least 25 percent of the paid-up capital of each of the institutions in the group (Art. 142).

<sup>63</sup> Such as banks, nonbank financial enterprises, bonded warehouses, stockbrokers, investment companies, financial leasing firms, as well as banks or financial companies domiciled abroad, duly accredited in this capacity by the pertinent foreign authority (Art. 141).

<sup>64</sup> Despite establishment as business corporations (with some exceptions), there is broad liability that “pierces the corporate veil” in that holding companies shall be liable—on a subsidiary basis, and without limit—for the fulfillment of the obligations incumbent upon each of the institutions belonging to the group, including in respect of obligations incurred prior to the formation of the group (Art. 142).

The Central Bank Law establishes individual large exposure limits amounting to 20 percent of paid-up capital and non-redeemable capital reserves (Art. 135).<sup>65</sup> These limits apply on a solo basis to supervised entities and on a consolidated basis to the financial group as a whole (Art. 148). While Art. 135 permits an exposure of up to 80 percent of paid-up capital and non-redeemable capital reserves to related parties, Art. 25(b) of the FG Regulation sets a 20 percent limit on the extension of credit by a financial group to entities connected with the group, with an aggregate limit of 80 percent for all such related-party exposures. All direct and indirect operations of each group member are to be consolidated for purposes of these limits, which apply against the consolidated paid-up capital and non-redeemable capital reserves. Moreover, Art. 131 provides for the issuance of rules by the National Council on capital adequacy. For certain types of banks, “fit-and-proper” requirements applicable to bank directors are set out in Arts. 21 and 22 of the *Organic Law of the National Banking System*.

### **Cross-border aspects**

The Central Bank Law requires that “banks or financial firms domiciled abroad and belonging to a financial group” must, *inter alia*, “be domiciled in a banking market acceptable to the Central Bank” (Art. 147).<sup>66</sup> Moreover, relevant information about the supervisory system in the host country (financial center) must be provided to the National Council (Art. 17 of the FG Regulation).<sup>67</sup> The Costa Rican supervisory authorities are required to periodically assess prevailing conditions in relevant banking centers (Art. 19 of the FG Regulation).

Before a foreign entity may join a Costa Rican financial group, it must obtain, *inter alia*, written authorization from its supervisor to provide “such financial information on the operations of the bank or financial enterprise ... as is permitted under the laws of that country.” (Art. 17 of the FG Regulation). The Superintendency is authorized to enter into cooperation agreements with other supervisors in banking centers authorized by the National Council (Art. 19 of the FG Regulation). However, this provision does not address the treatment of information that is confidential or pertains to individual accounts.<sup>68</sup>

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<sup>65</sup> There are more specific limits in the Central Bank Law on mortgage transactions and rural credit departments, although the interaction between the limits in the Central Bank Law and similar provisions found in the *Organic Law of the National Banking System* (for example, Arts. 128(2), 61(5) and 97(2)) is unclear.

<sup>66</sup> While this provision contains useful guidance, it should be clearer as to whether it deals with operations by Costa Rican banks abroad or applies to foreign financial firms entering the Costa Rican market.

<sup>67</sup> “To be considered, the center must be supervised by a counterpart of the Costa Rican supervisory agency, and the Superintendency or supervisory agency of the respective center must at least comply with and implement the provisions issued by the Offshore Group of Banking Supervisors.” (Art. 19 of the FG Regulation). Banking centers where the banking supervisors belong to the Basel Committee on Banking Supervision are authorized automatically, and for others, the applicant must provide information to assess whether the supervisors comply with these standards.

<sup>68</sup> It is not clear whether the blanket prohibition (with limited exceptions) on the disclosure of information by supervisors in the Central Bank Law may restrict information sharing with foreign supervisors (Art. 132).

The Superintendency has the power to inspect and seek judicial authority for the closure of entities—“irrespective of their corporate headquarters or place of operation”—that engage in impermissible activities. This power extends to entities within a de facto financial group that “ought to form part of a financial group, [but] do business without registering as members of the group” (Art. 156). In the Central Bank Law, there are no specific provisions on the establishment of branches by foreign banks in Costa Rica.

## **B. El Salvador<sup>69</sup>**

### **Domestic supervision on a consolidated basis**

In El Salvador, “financial conglomerates” are expressly subject to consolidated supervision by the Superintendency of Banking (the “Superintendency”) (Art. 113(a)). A financial conglomerate consists of those companies (including at least one bank) in which more than fifty percent of the respective stock is held by the holding company,<sup>70</sup> provided that companies in the financial conglomerate must be financial sector entities (Arts. 113 and 114).<sup>71</sup>

Financial statements of all companies of a financial conglomerate, including the consolidated financial statements of the holding company, must be audited by the same independent auditor (Art. 119). Financial conglomerates must satisfy total capital requirements on a consolidated basis, and such consolidated total capital must not be less than the sum of the total capital required by rules applicable to each of the companies (Art. 127). Moreover, the Superintendency may access information on each company within a financial conglomerate for the purpose of exercising consolidated supervision (Art. 136), and has express audit and supervisory authority over companies within a conglomerate that are not supervised by other

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<sup>69</sup> The analysis is based on a review of Decree No. 697, *The Law of Banking* (September 1999, as amended September 2002) and the *Organic Law of the Superintendency of the Financial System of El Salvador* (Decree No. 628, as amended February 1996). Unless otherwise specified all citations are to the *Law of Banking*. While the FSSA Update of December 23, 2004, refers to guidelines and regulations in place to regulate financial conglomerates, Fund staff has not received these documents for the purpose of this review.

<sup>70</sup> A Salvadoran bank may constitute the holding company (Art. 113). Financial conglomerates may include foreign banks, where at least 45 percent of the stock is owned by the holding company and the holding company exercises control of the bank (Art. 113). The Superintendency may also find a group of companies to be a financial conglomerate where there is “common control.” Common control includes the ability to secure the majority of votes at shareholders’ meetings or to elect a majority of directors, control at least ten percent of voting stock in the absence of a group that controls a percentage equal to or larger than this amount, or two or more common directors between two or more companies (Art. 115). This presumption can be contested and the Superintendency is obliged to provide a hearing on such objections (Art. 115).

<sup>71</sup> Such as insurance companies, pension fund management institutions, brokerage firms, companies specialized in the deposit and custody of securities, credit card issuers, foreign exchange houses, financial leasing companies and bonded warehouses.

superintendencies (Art. 136).<sup>72</sup> It may request information from foreign banks or other companies in which members of the financial conglomerate hold over 50 percent of the voting stock (Art. 147). For banks that are not part of a financial conglomerate, consolidated supervision is applied to bank subsidiaries (Art. 23).

The law applies “fit and proper” criteria to shareholders owning more than one percent of the shares of a bank and to directors and managers of a bank (Arts. 11 and 33). The law explicitly requires that capital requirements be applied on a consolidated basis, but is silent as to the application of large exposure or related-party lending limits on a consolidated basis (Art. 127). With regard to a general limit on related-party lending of 5 percent (Art. 203), the language in the law is unclear as to whether it constitutes an aggregate or individual limit for each group of related-parties to which the limit is applied.<sup>73</sup>

### **Cross-border aspects**

Where the holding company of a financial conglomerate in El Salvador holds more than 45 percent of the shares of a foreign bank and exercises control over that bank, the bank is subject to consolidated supervision by the Superintendency. The approval for a holding company of a financial conglomerate to include a foreign bank will not be granted by the Superintendency unless the supervisory regime applicable to the foreign bank meets international standards and the Superintendency has entered into a memorandum of understanding for cross-border supervision with the relevant supervisor (Art. 113).<sup>74</sup> The prudential requirements for determining the solvency of a financial conglomerate (including capital requirements) require inclusion of the foreign bank for the purposes of the calculations (Arts. 113, and 127-129). Companies within a financial conglomerate based outside El Salvador should preferably be audited by the same independent audit firm or an associate or corresponding firm (Art. 119).

A bank in El Salvador may conduct financial operations abroad through branches and subsidiaries in which it holds at least 50 percent of the stock, provided that there is an acceptable level of supervision in the host country and the bank has received the prior approval of the Superintendency (Art. 23). Subsidiaries abroad are subject to the supervision of the Superintendency<sup>75</sup> and examination by independent auditors of the parent bank,

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<sup>72</sup> The Superintendency also has audit authority with regard to companies in which there is common control with one or more of the companies that are members of the conglomerate, although the reach of this provision outside of the conglomerate is not clear (Art. 136).

<sup>73</sup> It is understood that the Salvadoran authorities apply this limit as an aggregate limit.

<sup>74</sup> Although the legal authority for the Superintendency to enter into memoranda of understanding is not explicitly specified in the *Organic Law of the Superintendency of the Financial System of El Salvador*, such authority may be presumed from the requirements of *The Law on Banking*.

<sup>75</sup> If the subsidiary is not fully-owned, shareholders owning ten percent or more of the stock of the foreign subsidiary are required to adhere to the requirements for major shareholders of Salvadoran banks, to file annual financial statements and to meet “fit and proper” criteria and solvency criteria (Arts. 11, 12, and 23).

without prejudice to the powers of foreign supervisory authorities (Art. 23(e)). The Superintendency is authorized to order the closing or sale of subsidiaries or offices abroad that are operated in contravention to law, or have serious deficiencies in their operating and internal control systems that threaten the interests of the public (Art. 23).

A foreign bank may only establish a branch in El Salvador with the prior approval of the Superintendency (Arts. 26-29). Before granting such approval, the Superintendency must execute a memorandum of cooperation with the supervisor in “the country of the parent company of the bank in question” (Art. 29). It must also be shown that the “parent company” of the foreign bank is legally established in its home country, and is subject to “careful regulation and supervision, according to applicable international standards, and that it is rated as first-tier by an internationally-recognized credit rating agency” (Art. 27). The foreign bank must have had at least five years of satisfactory operation, according to reports by the home country supervisor. It must also be demonstrated that the home country law authorizes the establishment of branches abroad and that any necessary approval has been received from the home country supervisor. Foreign branches are required to maintain in El Salvador the amount of capital and capital reserves at the same level as Salvadoran banks (Art. 27).

Foreign banks may acquire a majority interest in a Salvadoran bank with the approval of the Superintendency. Approval will only be granted if the foreign bank’s home country supervisor exercises supervision in accordance with applicable international standards. As a precondition for approval, the Superintendency must execute a memorandum of understanding with the home country supervisor for the exchange of information (Art. 10).

### **C. Guatemala<sup>76</sup>**

#### **Domestic supervision on a consolidated basis**

In Guatemala, the Banking Superintendency (the “Superintendency”) is granted extensive powers to exercise supervision over banks and other financial service providers, including on a consolidated basis (Arts. 1; 3(g) and (h) of the Financial Supervision Law). The Superintendency exercises its powers under the general direction of the Monetary Board of the central bank, the Bank of Guatemala.

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Enforcement of the “fit and proper” requirements regarding foreign subsidiaries would appear problematic in the absence of relevant understandings specifically covering the enforcement abroad of this Salvadoran requirement. The value of the share capital of foreign subsidiaries is deducted from the sum of Tier 1, Tier 2 and Additional Capital in determining the total capital of the bank.

<sup>76</sup> The analysis is based on a review of the *Law on Banks and Financial Groups*, Decree Number 19-2002 (May 13, 2002); the *Law on Financial Supervision*, Decree Number 18-2002 (May 10, 2002); and the Banking Superintendency Agreement No. 13-2004 (February 18, 2004). Unless otherwise specified, all references are to the provisions of the *Law on Banks and Financial Groups*.

All entities comprising a “financial group”<sup>77</sup> are subject to consolidated supervision exercised by the Superintendency. Unless a separate holding company is formed to exercise common control and head the financial group, the law requires that the group be headed by a bank and that the group structure be approved by the Monetary Board. The Monetary Board is empowered to determine which entities are considered part of the group (Art. 27(4)).<sup>78</sup> Only specified entities may form part of a financial group.<sup>79</sup>

In the licensing process, the Superintendency must review whether the group structure may present an obstacle to effective supervisory oversight (Art. 7(e)). The “solvency, reliability, honesty, and responsibility” of the bank’s founders (Arts. 7(c); 13) must also be established.<sup>80</sup> Subsequent transfers of “substantial” shares are subject to approval by the Monetary Board, on the recommendation of the Superintendency (Art. 11). In addition, Art. 19 requires approval by the Superintendency for the transfer of shareholdings of 5 percent or more of the paid-in capital of a bank.

Pursuant to Art. 28, the Superintendency is empowered to request information from entities in a financial group as needed and to carry out on-site examinations while “safeguarding the identity of depositors.” According to Art. 62(2), individual and consolidated information on the companies comprising the financial group must be provided to the Superintendency, and made available to the public as required. The Superintendency may exchange information with other domestic supervisors for the purpose of supervision (Art. 3(s) of the Financial Supervision Law).<sup>81</sup>

The financial statements of the companies comprising the financial group must be prepared on a consolidated basis (Art. 60).<sup>82</sup> Prudential requirements may be applied to entities in a financial group on a solo and consolidated basis (Art. 28). While the single exposure limit

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<sup>77</sup> A financial group is defined broadly as “two or more legal entities engaging in activities of a financial nature, one of which shall be a bank, when there is common control of such entities based on ownership, management, or use of corporate image, or even if no such relationship exists if the entities agree to common control” (Art. 27).

<sup>78</sup> Art. 30 mentions several elements for the presumption of common control; however, these may be challenged. While Art. 35 envisages a controlling stake of more than 50 percent of the relevant entity’s capital, it is not clear how situations involving a lower shareholding – together with the exercise of common control – will be addressed.

<sup>79</sup> Such as banks, finance companies, exchange brokerages, bonded warehouses, insurance companies, surety companies, credit card companies, financial leasing companies, factoring companies, securities brokerages, local or off-shore entities and other entities determined by the Monetary Board (Art. 27(4)), as well as support service providers such as automated tellers or electronic data processing providers (Art. 38.)

<sup>80</sup> For founders in the form of legal entities, this requirement applies to the ultimate beneficial owner (Art. 8(3)).

<sup>81</sup> It is not clear whether the explicit mandate for a court order for the disclosure of individual depositor information applies to such exchanges of information among domestic supervisors (Art. 63).

<sup>82</sup> Further details, including on the treatment of intra group transactions, are set out in the Agreement No. 13-2004.

(15 percent of computable equity) is consistent with international best practice, the limit for large exposures to a group of individuals forming a risk unit appears high (30 percent of computable equity) (Art. 47). The law explicitly states that companies comprising the financial group shall maintain required capital on a consolidated as well as individual basis (Art. 68).<sup>83</sup>

### **Cross-border aspects**

Banks may establish branches abroad, provided that the host country exercises its supervision in a manner that allows for the exercise of consolidated supervision by the home country supervisor in accordance with international standards. In addition, the law requires that the host country supervisor consent to the exchange of information (Art. 14). The Superintendency is authorized to exchange information with foreign supervisory bodies (Art. 3(s) of the Financial Supervision Law).<sup>84</sup>

Foreign banks seeking to establish a branch in Guatemala must allocate assigned capital to be maintained in Guatemala (Art. 18). Prior to the Monetary Board authorizing the establishment of a branch of a foreign bank (Art. 7), the Superintendency must issue an opinion, considering whether: (i) the level of home country supervision in the country where the bank's head office is located is in accordance with international standards; (ii) the home country supervisor has consented to the establishment of the branch; and (iii) information between the relevant supervisors may be exchanged. Recognizing that a branch is legally part of the foreign entity, and in an attempt to counteract any "ring-fencing", the law states that a foreign bank incurs "unlimited liability exposing all their assets for operations carried out at such branches" (Art. 18(2)). Representative offices may not only engage in business promotion but they are also permitted to engage in the extension of financing (Art. 6).

A separate framework applies to foreign offshore financial intermediaries, including offshore banks, seeking to operate in Guatemala. Art. 113 requires that such entities "declare that they are part of a Guatemalan financial group" and accept supervisory oversight by the Superintendency.<sup>85</sup>

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<sup>83</sup> The minimum capital adequacy requirement is set at 10 percent for banks, and investments in financial companies are taken into account as reductions in the calculation of the bank's computable equity (Arts. 64(2) and 65).

<sup>84</sup> However, Art. 63 explicitly requires a court order for the disclosure of individual depositor information, thereby severely undermining the ability of the Superintendency to exchange certain types of data. As indicated in the FSSA (SM/01/119, p. 43), there are additional restraints on the exchange of information based on a bank secrecy article in the Guatemalan Constitution.

<sup>85</sup> Art. 113(b) gives rise to concern as it specifically excludes the submission of individual customer information to the Superintendency.

## D. Honduras<sup>86</sup>

### Domestic supervision on a consolidated basis

Consolidated supervision in Honduras has only been recently established through the enactment of the *Financial System Law* in September, 2004. Consolidated supervision is carried out by the National Banking and Insurance Commission (the “Commission”), a decentralized agency of the office of the President, which is “in service” to the Banco Central de Honduras (the “Central Bank”) and reports directly to the President. The Superintendencia de Bancos, Seguros y Instituciones Financieras (the “Superintendency”) carries out the operational functions of the Commission.

The *Financial System Law* regulates “financial groups,” which are comprised of two or more companies engaged in activities of a financial nature and are deemed to be under common control with at least one a “financial system institution” (Art. 77).<sup>87</sup> The Commission may not authorize the existence of a financial group without being able to exercise consolidated supervision of the financial activities undertaken (Art. 81).<sup>88</sup> Authorization by the Commission is required for all transfers of ten percent or more of bank capital (Art. 22).<sup>89</sup>

The Financial System Law requires financial groups to submit to the Commission and publish consolidated financial statements that include subsidiaries and branches abroad, at least annually. Financial statements of all companies in the financial group must be audited by the same external auditing firm, including the consolidated financial statements (Art. 82). Moreover, upon request by the Superintendency, data must be filed in consolidated form, including on the companies holding the capital of supervised institutions (Art. 27 of the Banking Law).<sup>90</sup> With respect to capital adequacy requirements, the consolidated capital of

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<sup>86</sup> The analysis is based on the review of the two laws primarily addressing consolidated supervision of financial institutions and cross-border banking supervision: *The Financial System Law* (September 2004) and *Honduran Banks and Insurance Commission Law* (La Ley de Comision Nacional de Bancos y Seguros) (the “Banking Law”) (November 1995). It appears that a 1995 *Financial System Institutions Act* has been overridden in its entirety by the *Financial System Law* and that contradictory provisions on licensing in the Banking Law are overridden by the *Financial System Law*. All references in this analysis are to the *Financial System Law*, unless otherwise noted.

<sup>87</sup> “Financial system institutions” include banks, savings and loans associations, finance companies, and their respective subsidiaries, including subsidiaries abroad (Arts. 16 and 17), and branches and offices of foreign financial institutions (Art. 18).

<sup>88</sup> Should the relationships or transactions with non-financial members of the same financial group endanger the financial stability of the group, the Commission is empowered to conduct inspections and require the implementation of measures necessary for maintaining the group’s solvency (Art. 81).

<sup>89</sup> In addition, the Banking Law authorizes the Commission to inspect and verify the functioning of companies holding controlling interests in supervised institutions, but does not specifically require banks to consolidate operations of their subsidiaries (Art. 14(9) of the Banking Law).

<sup>90</sup> This provision appears to apply to banks with a holding company even when there is no determination of a “financial group.”



the financial group must be at least equal to the sum of the capital requirements of the companies in the group (Art. 81).<sup>91</sup>

Financial system institutions are required to adhere to minimum initial capital requirements, which must be fully paid in before operations commence (Art. 36), and to adhere to minimum capital adequacy requirements established by the Commission. “Fit and proper” requirements apply to the organization of, and the transfer of shares of ten percent of capital of, financial system institutions, but not to the transfer of control of financial groups (Art. 8 and 22). Some powers appear to remain with the Central Bank, such as setting limits on loans to one borrower (Art. 61).

While the Financial System Law calls for the Commission to supervise financial groups on an individual and consolidated basis, the law does not specifically refer to the application of prudential requirements (i.e., capital ratios, large exposures, related-party lending, etc.) on a consolidated basis (Art. 36-38). Moreover, in the absence of an established financial group, the Banking Law does not specify that banks should consolidate prudential requirements with their parent holding companies. However, as a general matter, the Commission is empowered to ensure strict compliance, including on-site supervision, with the requirements of the weighting of risk assets and the capital ratios for supervised institutions (Art. 14(2) of the Banking Law).

### **Cross-border aspects**

Under the newly established framework, a Honduran financial system institution may only open a branch or subsidiary abroad with the permission of the Commission; the Commission must issue such authorization if it receives a favorable opinion from the Central Bank. The capital of subsidiaries or assigned capital of branches opened abroad must be deducted from capital (Art. 17). The Superintendency may directly, or through auditors hired abroad, supervise the foreign branches of Honduran banks (Art. 13(12) of the Banking Law). A domestic financial system institution may only open a foreign branch if the Commission has entered into a convention for exchange of information with the host country supervisor allowing for consolidated supervision (Art. 17).

Permission from the Commission, supported by a favorable opinion from the Central Bank, is required for foreign financial institutions to establish a branch in Honduras (Arts. 18 and 20). Moreover, the law requires institutions with foreign investment to provide the Commission with consolidated information under standards similar to those of their home country (Art. 82).<sup>92</sup> For a foreign financial institution to open and operate a branch or office

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<sup>91</sup> Intercompany investments among the group members must be subtracted from the paid-in capital of the investing company.

<sup>92</sup> They must also provide, *inter alia*, information on the structure of the financial group and the identity of controlling shareholders, along with a certification of their home country supervisor of the accuracy of such information provided to the Commission (Art. 82).

within Honduras, the Commission must have signed a convention for the exchange of information with the foreign institution's home country supervisor allowing for cross-border supervision (Art. 18).<sup>93</sup> However, the law does not require the Commission to determine whether adequate home country supervision is in place as a condition for the opening of a branch of a foreign bank.

## E. Nicaragua<sup>94</sup>

### Domestic supervision on a consolidated basis

In Nicaragua, the Superintendent of Banks (the "Superintendent") is *empowered* but not required to exercise consolidated supervision over financial groups and their members, including foreign members (Art. 132).<sup>95</sup> A "financial group" is defined to comprise banks and nonbank financial institutions (including if domiciled abroad) and affiliates that are directly or indirectly controlled by a majority of shares (Art. 130).<sup>96</sup> All banks or nonbank financial institutions must inform the Superintendent whether they belong to a financial group, and the Superintendent may require the setting up of holding companies (Art. 131).<sup>97</sup>

The law establishes a regime for the provision of information on a consolidated basis. More specifically, the "coordinator of a financial group" must consolidate the statements of the financial group in accordance with regulations of the Superintendent and submit them together with individual financial statements for each of its members (Art. 135).<sup>98</sup> However, the provisions on internal and external audit do not refer to consolidated reporting (Arts. 38 and 39). The Superintendent coordinates supervision of the members of the financial group, and other supervisory bodies must provide any necessary information (Art. 132).

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<sup>93</sup> The Commission may deny the opening of branches of foreign financial system institutions where there is no reciprocity in the home country (Art. 18). Although the authority of the Commission to enter into memoranda of understanding is not specifically included in the Financial System Law or the Banking Law, such authority may be presumed based on the specific requirement in the Financial System Law for the execution of such memoranda of understanding by the Commission as a precondition for approval.

<sup>94</sup> The analysis is based on a review of: the *General Law on Banks, Nonbank Financial Institutions, and Financial Groups* (Law No. 314, 1999); and the *Law on the Superintendency of Banks and Other Financial Institutions* (October 11, 1999) ("Supervisory Law"). Unless otherwise specified, citations are to the *General Law on Banks, Nonbank Financial Institutions, and Financial Groups*.

<sup>95</sup> Note also that the Supervisory Law includes a function of the Superintendent to supervise financial groups but does not explicitly stipulate its oversight on a consolidated basis (Art. 19.5 of the Supervisory Law). This power should be mandatory, and indeed the FSAP report stated it was not exercised in practice.

<sup>96</sup> The definition of indirect control is cross-referenced to Art. 50, i.e., shareholdings of 33 percent or more of the capital, but this is not entirely clear.

<sup>97</sup> There are no specific provisions on the transfer of bank shares or regarding "fit and proper" criteria for controlling shareholders (as there are for managers of branches of foreign banks) other than a limitation on family ties as a disqualification for employment (Art. 113).

<sup>98</sup> The role of financial group coordinator is assigned to the member established in Nicaragua that has the largest asset value as reflected in the financial statements of the group (Art. 134).

The Superintendent has a broad range of powers to be applied in consolidated supervision; for example, it may set “general prudential standards as it deems necessary ... to supervise financial groups on a consolidated basis” (Art. 133). The law itself provides for a minimum capital adequacy ratio of 10 percent and allows the Superintendent to raise (but not lower) this level through regulation (Art. 19). The limit for related-party lending is set at 15 percent on an individual basis (Art. 50.4) and a 25 percent limit for groups including “connected parties” (Art. 50.5). The large exposure limit for a single “interest unit” is set at 30 percent (Art. 50.5). The Superintendent may also apply a range of preventative measures (Art. 86) to the members of a financial group “when the situation so warrants” (Art. 136).

### **Cross-border aspects**

The law requires Nicaraguan banks to obtain the prior authorization of the Superintendent before opening a branch abroad (Art. 125). The applicant must provide such information as the Superintendent shall require by regulation (Art. 125). There would appear to be no requirement in Nicaraguan law that branches only be permitted in countries whose host country supervisors permit the exercise of consolidated supervision. There is no explicit authority to limit the range of activities a banking group may conduct in foreign locations, or for the Superintendent to conduct on site visits.

The Superintendent has broad authority to enter into cooperation/information exchange agreements as necessary for consolidated supervision (Art. 139; Art. 16 of the Supervisory Law). The law does not detail the kind of information that must be covered by the agreements, but requires them to call for appropriate confidentiality. Bank secrecy is generally subordinated to these agreements, but this does not appear to be the case regarding client identify information (Art. 109).<sup>99</sup>

Nicaraguan law does not specify whether a foreign bank wishing to establish a subsidiary in Nicaragua must demonstrate that it has the approval of its home country supervisor or that adequate home country supervision is applied to such subsidiaries on a consolidated basis. With respect to the establishment of a branch of a foreign bank in Nicaragua (Art. 9), the application for authorization must include verification that the applicant bank is “legally authorized to establish branches” but it is unclear whether this provision requires the Superintendent to verify that the home country supervisor has approved such establishment or that the home country supervisor conducts banking supervision on a consolidated basis. Banks constituted abroad that obtain permission to operate in Nicaragua are explicitly subject to all local laws (Art. 13). Local managers are subject to “fit and proper” requirements (Arts. 29 and 31). Branches of foreign banks must state the capital/reserves assigned to the branch in Nicaragua along with any capital/reserves of their head office (Art. 18). Representative

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<sup>99</sup> Information on individual accounts may only be provided by the Superintendent “in response to an express request from the competent judge, or if the account holder expressly gives consent” (Art. 139).

offices of foreign banks may not accept deposits, but may grant loans, engage in investments, and operate information centers (Art. 14).

## **F. Panama<sup>100</sup>**

### **Domestic supervision on a consolidated basis**

The Superintendency of Banks (the “Superintendency”) is generally authorized to supervise Panamanian<sup>101</sup> banks (both General and International Banking Licenses<sup>102</sup>) on a consolidated basis (Art. 30). Art. 17.14 states that the Superintendency is responsible for the supervision of the “economic groups”<sup>103</sup> of which Panamanian banks form part, including by means of onsite examinations of the companies comprising the group. The transfer of shares of banks and entities controlling a bank requires the prior authorization of the Superintendency (Art. 17.6).

Art. 16.14 authorizes the Superintendency to request financial statements from economic groups, including a bank’s parent company. Additionally, Art. 54 authorizes the Superintendency to request and obtain from any bank or any company belonging to the economic group of which the bank is a member any documents and reports related to their operations, including non-financial companies. Audited financial statements must be submitted (Art. 55) and Agreement 4-98 requires the consolidation of information on subsidiaries for regulatory and financial reporting purposes.

Art. 16.32 authorizes the Superintendency to set prudential requirements on banks and members of the economic group on an individual basis, and on the entire economic group of which a bank is a member on a consolidated basis. Art. 69 authorizes the Superintendency to establish limits on the concentration of risks by a bank in any given economic sector. The limit on credit exposure to a single person or legal entity and its particular economic group is

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<sup>100</sup> The analysis is based on a review of: *Decree-Law 9* of 26 February 1998, “By means of which the banking regime is reformed and the Superintendency of Banks is established”; and Superintendency of Banks’ Agreements 4-98, 1-99, 2-99, 3-99, 8-99, 10-99, 3-2001, 2-2002 and 4-2002. Unless specified otherwise, all references are to Articles of the *Decree-Law 9 of 1998*.

<sup>101</sup> Generally, a bank is considered “Panamanian” if it has been incorporated pursuant to Panamanian company legislation.

<sup>102</sup> The General Banking License authorizes the bank to engage in business activities with both residents and non-residents, while the International Banking License is exclusively limited to business with non-residents.

<sup>103</sup> An “economic group” is defined in Art. 3.13 as a group of natural or juridical persons whose interests are interrelated in such way that the Superintendency shall consider them as a single person, which includes the bank’s owners, despite the lack of a legal definition of “bank holding company”. Guidance on which persons constitute the economic group of a bank is provided in Art. 2 of Agreement 3-99, and includes: companies that have the majority of their directors/officers in common with the bank, companies that have the majority of their shareholders with the bank, companies where the bank owns over 50 percent of their shares in circulation; companies that own over 50 percent of the bank’s shares that are in circulation, companies that exercise control over the voting rights in the bank, among others.

25 percent (Art. 2 of Agreement 1-99) and the limit on direct or indirect credit exposure to related parties is 5 percent for individual related parties (with an aggregate limitation of 50 percent for all related parties) (Art. 64 and Agreements 2-99).<sup>104</sup> With regard to “limits on concentrations of risks”, Art. 73 provides for an exemption for banks with an International Banking License. This could in effect undermine the application of prudential requirements on large exposures and related-party lending for effective consolidated supervision.<sup>105</sup> Banks with a General Banking License are forbidden to hold at any time, on their own behalf, shares or any kind of participation in companies carrying out non-financial activities when the cumulative value of the participation exceeds 25 percent of the bank’s capital (Art. 67).<sup>106</sup>

Economic groups of banks with a General Banking License must maintain at all times a Global Index of Capital Adequacy, expressed in relation to the capital of the economic group of the bank, which shall be equal to the sum of the capital requirements for all the companies comprising the group (Art. 3 of Agreement 3-99). This Global Index of Capital Adequacy does not apply to economic groups including banks with an International Banking License.

Although not specified in the law as such, the Superintendency has broad powers under Art. 17.33 to coordinate and share information with other domestic authorities responsible for supervision of specific entities within the group, such as the Superintendency of Insurance, the National Securities Commission and the Ministry of Commerce and Industry.<sup>107</sup>

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<sup>104</sup> Pursuant to the phased reduction of these limits provided by Art. 4 of Agreement 2-99, the aggregate limit on exposures to related parties will be 25 percent from May 2005. Agreement 8-99 stipulates an identical limitation for exposures through investments in securities issued directly or indirectly by related parties.

<sup>105</sup> Preferably, the law should be clear that prudential limits are applied to both banks with a General Banking License and International Banking License in an uniform manner in the context of consolidated supervision.

<sup>106</sup> Art. 73 appears to exempt banks with an International Banking License from this investment restriction.

<sup>107</sup> There are no specific provisions that establish mechanisms for the designation of a lead supervisor to coordinate the supervision of groups involving significant operations in the banking and another financial sector.

## Cross-border aspects

The power of the Superintendency to supervise operations on a consolidated basis under Art. 30 extends to branches and subsidiaries of Panamanian banks (both General and International Banking Licenses) established in foreign jurisdictions. In accordance with Art. 40, the opening of branches and subsidiaries by Panamanian banks abroad requires the prior approval of the Superintendency. Pursuant to Art. 1(d) of Agreement 4-2002, a request shall not be approved unless the legislation of the host jurisdiction allows for cross-border consolidated supervision by the Superintendency.<sup>108</sup>

Art. 17.29 requires the Superintendency to establish cooperative arrangements with foreign supervisors for the purpose of strengthening control mechanisms and information sharing. Pursuant to Art. 31, the Superintendency shall reach agreements or understandings with foreign supervisors in order to facilitate such consolidated supervision. Agreement 4-98 establishes the general criteria for the signing of memoranda of understanding by the Superintendency with foreign counterparts to facilitate cross-border consolidated supervision.<sup>109</sup>

The establishment of branches and bank subsidiaries of foreign banks or banking groups in Panama requires the prior approval of the Superintendency, under the conditions established by Agreement 3-2001.<sup>110</sup> Such approval will only be granted if the laws applicable to the applicant's main office require consolidated supervision of the Panamanian branch or subsidiary, and the applicant provides an express authorization or a declaration of "no objection" from the home country supervisor and an assurance from this supervisor that it will sign a memorandum of understanding with the Superintendency. In addition, the Superintendency may require assurances from the home country supervisor regarding the performance of consolidated cross-border supervision, and the frequency and scope of onsite examinations carried out by the home country supervisor in Panama (Agreement 3-2001).<sup>111</sup>

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<sup>108</sup> Art. 4 of Agreement 4-2002 provides that approval may not be granted when cooperation between home and host country supervisors is not possible.

<sup>109</sup> The criteria are reciprocity, pertinence of the information requested to supervisory matters, national treatment of foreign examiners during onsite inspections in Panama and confidentiality of the information obtained. Such memoranda of understanding shall provide for the possibility of onsite examinations in the host country by the Superintendency.

<sup>110</sup> Agreement 3-2001 requires, *inter alia*, that the controlling shareholders of foreign banks demonstrate moral and financial solvency, and have an adequate corporate governance structure in place.

<sup>111</sup> It appears that such assurances would be required only at the discretion of the Superintendency. Preferably, the law should require the Superintendency to always require such assurances and to assess the adequacy of home country supervision of the applicant.

## II. Bank Insolvency Framework

This section examines selected features of the legal and institutional frameworks governing bank insolvency in each of the countries under review. In particular, it examines provisions governing the official administration and liquidation of banks. In this regard, the laws of many countries provide for a system of “official administration” in which, although the precise modalities may differ from country to country, an official authority assumes direct managerial control of a bank with a view to protecting its assets, assessing its true financial condition and, either conducting restructuring operations, or placing the bank in liquidation. Liquidation proceedings normally lead to the legal dissolution of a bank and the distribution of the proceeds of liquidation to creditors.

### A. Costa Rica<sup>112</sup>

The Costa Rican bank insolvency system provides for the “intervention” (official administration) of an insolvent bank by an “intervenor” appointed by the National Council for Financial System Supervision (the “National Council”). Bank liquidation is a judicially-supervised proceeding.

#### Corrective action

The legal framework confers upon the General Superintendency of Financial Institutions (SUGEF) (the “Superintendency”) a broad range of powers with which to deal with banking institutions found to be in a position of “financial instability” (Art. 139). The legal framework distinguishes between three levels of financial instability and, more specifically, those which: (i) may be remedied by the adoption of short-term corrective actions by the bank’s management (Level 1); (ii) require the adoption of a “restructuring or rehabilitation plan” (*plan de saneamiento*) by the bank’s management (Level 2); and (iii) in more serious cases, trigger “bank intervention” or official administration of the bank by the Superintendency (Level 3) arising from the “total or partial cessation or suspension of payments,” a case of “losses originating a reduction of more than half of the bank’s equity,” the failure to implement the regularization plan, or the engagement by the bank in unsound or illegal practices (cases of “regulatory insolvency”) (Art. 136(d)).

#### Official administration

Upon a finding by the Superintendency of a Level 3 situation, the National Council issues a resolution ordering the commencement of official administration or “intervention” of the

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<sup>112</sup> The analysis is based on a review of the following legislation: (i) financial system’s legislation: the *Organic Law of the National Banking System* (OLNBS, Law No. 1644); the *Organic Law of the Central Bank of Costa Rica* (Law No. 7558, as amended through October 5, 2004); and the *Securities Market Regulatory Law* (SMRL, Law No. 7732); and (ii) general bankruptcy legislation: *Commercial Code* (Arts. 851-967) and *Civil Procedures Code*. All citations are to the *Organic Law of the Central Bank of Costa Rica*, unless otherwise specified.

bank, designating the “intervenor” (who may be members of the Superintendency’s staff) and setting the period of intervention, which should not exceed one year (Art. 140(d)). The intervenors temporarily assume the powers of the bank’s management and board of directors, including the immediate administration of all bank assets.<sup>113</sup> The intervenors are required to submit a “restructuring plan” and, once it has been approved by the National Council, it must be implemented by the bank. The Superintendent of Banks and Financial Institutions (the “Superintendent”) supervises the intervention, and the National Council may remove and replace the intervenors if they are not properly carrying out their functions (Art. 140(f)). All expenses arising from the intervention are to be borne by the bank (Art. 140(e)).

Under an intervention, the National Council may: (i) prohibit the extension of new credits by the bank; (ii) call for a shareholders’ meeting to recommend capital increases; (iii) suspend or limit the payment of the intervened bank’s liabilities; (iv) prohibit or limit the distribution of dividends unless authorized by the Superintendency; and (v) order the “reorganization of the bank,” including the temporary or definitive separation of any personnel (Art. 139(c)). The law, during the period of intervention, prohibits: (i) the seizure of the bank’s assets, including those that may guarantee liabilities whose payments have been suspended or limited; and (ii) the initiation of liquidation or bankruptcy proceedings against the bank (by parties other than the National Council (Arts. 139(c) and 140(c)). Thirty calendar days before the expiration of the period of the intervention, the National Council must decide, after consulting with the intervenors, whether to allow the bank to continue its operations or to request the competent judge to commence proceedings for the liquidation or bankruptcy of the bank (Art. 140(d)). A major weakness of the restructuring framework is the law’s failure to specify the techniques that may be used to restructure a bank, which may expose the actions taken by Superintendency or the intervenors to court challenges on legal or constitutional grounds.

## **Liquidation**

The liquidation of banks is subject to judicially-supervised proceedings based on the general rules for bankruptcy as set forth in civil and commercial legislation, and complemented by some “special provisions” set forth in the OLNBS (Title VI, Chapter IV of the OLNBS). In the case of public banks, however, since they are established by special laws, their liquidation is also subject to procedures set forth in a special law, and, therefore, the procedures explained below are not applicable to them.

A bank liquidation is initiated by the competent judge at the request of the National Council, when the attempt to restructure a bank fails (Art. 140(d)), or at the request of the

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<sup>113</sup> However, the law does not specifically provide for the removal of the bank’s management and board of directors. Moreover, the law is also silent with respect to shareholders’ rights, so it is understood that they maintain such powers and may exercise them during this process.



Superintendent in cases in which such a petition is justified<sup>114</sup> (Art. 162 of the OLNBS), or by a petition filed by the bank itself or by one of its creditors (Art. 161 of the OLNBS).<sup>115</sup>

Upon the initiation of the proceedings, the judge will appoint a tripartite Bankruptcy Committee (Arts. 162 and 164 of the OLNBS) comprising the Superintendent, a representative of the bank's shareholders and a representative of the bank's creditors. Art. 172 of the OLNBS establishes that any proceeds from the realization of the bank's assets are distributed on the basis of specified priorities. No priority is given to the claims of depositors who are treated as any other unsecured creditors. Accordingly, based on the general bankruptcy legislation, the priority rules are as follows: (i) secured creditors; (ii) privileged creditors (labor and fiscal claims); (iii) the costs of the liquidation proceedings; and (iv) other unsecured creditor's claims, including "depositors' claims".

According to Art. 175 of the OLNBS, the "dissolution" of a bank as a legal entity takes place after all the proceeds of liquidation have been distributed and a one-year period following the expiration of the date established for the collection of creditors' claims has elapsed. The bank's license, however, can be suspended or revoked by the National Council prior to the declaration of the bank's dissolution (Art. 171(d) of the SMRL).

### **Other issues**

The legislation Fund staff has reviewed does not contain specific rules providing for a comprehensive strategy to address the problem of troubled banks that may have systemic implications, or special provisions dealing with cross-border insolvency of banks or the resolution of entities that are part of a conglomerate. There are no special rules providing for the set-off of financial transactions that mature after the commencement of insolvency proceedings.

### **Deposit insurance**

Except for the "blanket guarantee" provided by the State to the public banks (Art. 4 of the OLNBS), there is no other deposit guarantee fund or scheme applicable to private banks.

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<sup>114</sup> The problem with this provision is that the law empowers the Superintendent to petition for a declaration of bankruptcy when it finds that a bank is in a "situation that justifies" such declaration, but it does not specify what are the circumstances that may trigger the need to request a declaration of bankruptcy of a private bank.

<sup>115</sup> The OLNBS, however, does not establish the grounds under which this petition can be filed by "any creditor" or the bank itself (Art. 161 of the OLNBS). Based on the general rules, one of the grounds for a petition of bankruptcy is the debtor's cessation of at least one payment due and payable with respect to the creditor filing the petition, or the cessation of payments of any liabilities due to other creditors.

## B. El Salvador<sup>116</sup>

The Salvadoran bank insolvency system provides for bank restructuring by the Superintendency and official administration by an intervenor appointed by the commercial court. Bank liquidation is a judicially-supervised proceeding.

### Corrective action

A bank is obliged to submit a “regularization plan” (*plan de regularización*) to the Superintendency of Banking (“Superintendency”) for approval, when it is found to be in a position of “irregularity” due to a case of “regulatory insolvency” or other “non-solvency” related problems (Art. 75).<sup>117</sup> The regularization plan must specify all the actions and measures to be undertaken by the bank to restore its “good standing” (Art. 77). The Superintendency may designate a “special supervisor” to oversee the bank’s operations with the right to veto any decision of the bank that could undermine even further the bank’s situation or that may not correct the irregularities (Art. 87). The Superintendency may also request the removal of members of the bank’s executive board and administration and their replacement in accordance with the bank’s articles of incorporation (Art. 88). If the Superintendency finds, however, that the situation of regulatory insolvency or the non-solvency related problems of the bank creates a risk to the recovery of bank deposits, it may order that the bank be put under any of the restructuring mechanisms described below (Art. 82).

### Official administration/bank restructuring

Moreover, the Superintendency, on its own initiative or at the bank’s request, may order the restructuring of a bank that: (i) fails to submit a regularization plan when due, (ii) does not correct its irregularities within the regularization period, (iii) fails to comply with any of its obligations arising from the regularization proceedings, or (iv) submits a regularization plan that, in the opinion of the Superintendency, would not be sufficient to address the bank’s problems (Art. 91). In restructuring the bank, the Superintendency may order: (i) a mandatory reduction or increase in the bank’s capital; (ii) the exclusion of some of the bank’s assets and liabilities (the “excluded estate”)<sup>118</sup>; (iii) the judicial intervention of the bank

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<sup>116</sup> The analysis is based on a review of the following legislation: (i) financial legislation: the *Law of Banking*, Decree 697 (Articles 75-112-C, and 153-183); the *Organic Law of the Superintendency of the Financial System* (OLSFS), Decree 628 (Chapter IX), and (ii) commercial legislation: *Commercial Code* (CC, Articles 498-552), *Commercial Proceedings Law* (CPL, Articles 77-119) and *Civil Procedures Code* (CPC, Articles 659-777). All citations are to *Law of Banking*, unless otherwise specified

<sup>117</sup> For this purpose, regulatory insolvency means any shortfall relative to the required capital-to-risk-weighted ratio, while the non-insolvency related problems include repeated non-compliance with legal or prudential norms, contagion risks arising from conglomerate structures and chronic illiquidity (Art. 76).

<sup>118</sup> Under the mechanism involving the bank’s “excluded estate”, the Superintendency is authorized to exclude the bank’s assets in an amount necessary to cover the bank’s liabilities arising from deposits and labor claims (Art. 94). The excluded estate can be transferred directly to other banks (Arts. 95-96) or be used to establish a

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(official intervention); or (iv) the adoption of any other measure deemed technically necessary to deal with the problem (although the law does not specify what are these other measures that can be adopted) (Art. 93). Generally, these measures are followed by the initiation of liquidation proceedings.

If any of the above-mentioned mechanisms requires the participation of the Institute of Deposit Guarantee (the “IDG”), the latter’s prior authorization is required to proceed with the implementation of that mechanism (Art. 92). This is because the IDG is also authorized by law (Art. 174) to provide financial assistance to its members during a restructuring proceeding, if so requested by the Superintendency. It may extend loans or provide capital contributions, and assume losses and restructuring costs. In such cases, the IDG is obliged by law (Art. 175) to conduct a “least cost-benefit analysis” prior to determining whether or not to participate in any modality of assistance under a bank restructuring scenario.<sup>119</sup>

The Superintendency may also, at any time, apply to the commercial court for the initiation of official administration or “judicial intervention”<sup>120</sup> of the bank. The Court will appoint one or more “intervenor(s)” from a list proposed by the Superintendency. The intervenor may represent the bank during the restructuring proceedings and effect all the necessary actions in order to directly transfer the assets of the bank’s excluded estate to other parties. The bank’s executive board and management will continue to conduct the bank’s ordinary operations not related to these assets (Art. 104).

The Superintendency is also authorized by law (Art. 105) to order the temporary suspension, totally or partially, of the bank’s operations. During the period of temporary suspension, no precautionary measure may be adopted against the bank’s assets or any type of foreclosure executed against the suspended bank. Also, during this same period, claims against bank and the accrual of interest are suspended.

## Liquidation

Under Salvadoran law, the Superintendency must revoke a bank’s license, *inter alia*, where the excluded estate of a bank has been transferred to another party or where the

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*Fideicomiso* (trust fund) (Art. 97), which will issue “certificates of participation” of different categories (representing the different priorities of the claims that must be satisfied in the restructuring process) that may be acquired by other financial institutions or the IDG. In the latter case, the IDG shall determine what assets are necessary to be transferred to the *Fideicomiso* (Art. 102). During the restructuring period under the “excluded estate” modality, no precautionary measure can be ordered against the assets of the excluded estate nor any summary proceeding, seizures or foreclosure proceedings initiated or continued against such assets, unless directed at paying secured creditor’s claims, or a liability arising from labor or child support claims (Art. 101).

<sup>119</sup> Only if the study proves that the cost of assistance by the IDG is lower than the estimated amount of deposit guarantee to be paid out, then it will issue a favorable opinion to the Superintendency to proceed with the bank’s restructuring.

<sup>120</sup> The OLSFS has a chapter containing specific provisions on bank intervention that seems to be conflicting with the provisions of the *Law of Banking*.

Superintendency, with the prior concurrence of the central bank, determines that the problems that gave rise to a situation of irregularity of the bank cannot be corrected through a regularization plan (Art. 106).<sup>121</sup> Upon revocation of the license, the bank must be liquidated.<sup>122</sup> The liquidation is a judicially-supervised proceeding governed principally by commercial legislation of general application and complemented with certain special rules for banks, under which a “liquidator” is appointed by the competent commercial judge from a list of persons proposed by the Superintendency (Art. 110). Among the special rules, the law prohibits a bank or its creditors from requesting judicial authorization to suspend payments, and does not allow the bank’s creditors to file petitions requesting that the bank be declared bankrupt (Art. 111).

In a liquidation proceeding, depositors enjoy a privileged position as their claims are guaranteed to be paid with the proceeds of the transfer of the excluded estate’s assets, or directly from the IDG through the deposit guarantee (Art. 112). In the latter case, the IDG is subrogated to the depositors’ claims and the IDG is authorized to supervise the liquidation proceedings to oversee the recovery of its claims (Arts. 110 and 173). The law establishes the following priority of claims: (i) liabilities arising from labor, pensions and child support claims; (ii) liabilities from deposits up to the amount of the deposit guarantee; (iii) claims of foreign banks arising from foreign trade transactions duly registered before the Central Bank; (iv) liabilities for deposits in excess of the deposit guarantee; (v) other privileged claims; (vi) claims represented in credit instruments; (vii) unsecured claims of the Multisectoral Investment Bank; (viii) claims of the state and the local governments; (ix) other unsecured claims; and (x) the balance of subordinated debt. Secured creditors are paid with the proceeds of the realization of the relevant collateral and, in case the proceeds are insufficient to pay the debt, the remaining amount will be paid in the order of priority into which such claims fall. If a creditor is also a debtor of the bank, such creditor will be paid only in the amount the claim exceeds liabilities to the bank (Art. 112-A).

### **Other issues**

When the problems encountered in a bank may give rise to systemic risk, the IDG’s participation in any of the mechanisms to assist in the regularization or restructuring of such bank shall require the prior favorable opinion of a “Special Committee” comprised of the Superintendent, the Minister of Finance and the President of the Central Bank who will act as the coordinator of the Special Committee (Art. 176).

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<sup>121</sup> The law does not include specifically the “cessation of payments” as one of the grounds for initiating a bank closure or liquidation.

<sup>122</sup> At the bank’s request the liquidation can be voluntary if the bank has paid all its liabilities arising from deposits, provided that the Superintendency has determined that it is not in a situation of irregularity and it is capable of paying all its other financial obligations.

## Deposit insurance

The IDG, which is under the supervision of the Superintendency (Art. 181), has a dual function, namely, to guarantee the deposits of the general public in banks and to participate in bank restructurings through the acquisition of assets of excluded estates, or by participating in the *Fideicomiso* established with such assets (Art. 154). The deposit guarantee scheme is mandatory for all banks subject to the *Law of Banking* except for branches of foreign banks, if the Superintendency determines that coverage is provided by a deposit insurance mechanism in the home country (Art. 156). The deposit guarantee is set in an amount equivalent to \$7,060 per depositor per bank (Art. 167).

### C. Guatemala<sup>123</sup>

The bank insolvency system in Guatemala provides for official administration of a bank by a committee appointed by the Monetary Board of the central bank. Bank liquidation is a judicially-supervised proceeding.

## Corrective action

A bank is required to submit a regularization plan where there are (i) capital deficiencies, (ii) repeated infringements of the law, regulations or instructions, (iii) deficiencies in reserve requirements, (iv) problems in management that are deemed by the Banking Superintendency of Banks (the “Superintendency”) to pose serious risks to the bank’s liquidity and solvency, or (v) where the bank has submitted information or documentation deemed false by the Superintendency (Arts. 70 and 73). The Superintendency, to supervise the implementation of the regularization plan, may appoint an officer who may veto the decisions adopted by the bank that may undermine the implementation of the plan, and may remove one or more of the bank’s directors or managers (requiring the shareholders to call an extraordinary meeting to appoint new management) (Art. 74). The law provides for various measures that may be part of a regularization plan, which include an increase in the bank’s equity or the capitalization of reserves or dividends as necessary to cover capital deficiencies, the issuance of subordinated debt, and the sale of assets and/or liabilities. (Art. 70).

## Official administration

The official administration of a bank takes place once a decision is taken by the Monetary Board of the Bank of Guatemala (the “Monetary Board”) to suspend the operations of a

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<sup>123</sup> The analysis is based on the review of the following legislation: (i) Financial system legislation: the *Law on Banks and Financial Groups* (Decree No. 19-2002), the *Law on Financial Supervision* (LFS, Decree No. 18-2002), and the *Organic Law on the Central Bank* (OLCB, Decree No. 16-2002), and (ii) General Legislation: *Bankruptcy Law* (Articles 379-397 of the Civil and Commercial Procedures Code) and the *Commercial Code*. All references to the law in this section correspond to the Law on Banks and Financial Groups unless otherwise specified.

bank.<sup>124</sup> The Monetary Board must suspend a bank's operations when the bank is no longer paying its obligations as they fall due or the bank has incurred a capital deficiency that exceeds 50 percent of the required capital (capital adequacy ratio is at least 10 percent according to Art. 64).<sup>125</sup> In addition, the Monetary Board may suspend operations, *inter alia*, when the bank fails to submit a regularization plan, the plan is rejected by the Superintendency, or the bank fails to implement the plan (Art. 75). The Monetary Board, at the proposal of the Superintendency, will then appoint a three-member committee for the transfer of assets and liabilities (the "Committee") (Art. 78).<sup>126</sup>

Upon the suspension of operations, all legal actions taken by creditors against the bank are stayed, interest no longer accrues on the bank's liabilities, and the bank is prohibited from contracting new indebtedness.<sup>127</sup> Upon the appointment of the Committee, the rights of shareholders are suspended, and the bank's management is removed. The Committee is authorized to: (i) determine losses and charge them against reserves or capital; (ii) select assets and transfer them to a trust administered by a bank designated by the Superintendency; (iii) select deposits up to the amount covered by deposit insurance and employee liabilities and transfer them to other banks;<sup>128</sup> and (iv) request the deposit insurance fund to make grants to the trust formed with the assets of the failed bank.<sup>129</sup> Within five days of the conclusion of the transfer of assets and liabilities, the Monetary Board, at the request of the Superintendency, must revoke the license of the bank (Art. 82).

## Liquidation

The liquidation of banks is subject to judicially-supervised proceedings, subject to the general rules for bankruptcy as set forth in the civil and commercial code of procedures. Proceedings are initiated by the competent judge at the request of the Superintendency (following prior instructions issued by the Monetary Board).<sup>130</sup> Within five days following the bankruptcy petition, the judge must declare bankruptcy based on the bank's balance sheet

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<sup>124</sup> The Guatemalan approach appears to preclude the rehabilitation of a bank once it is subject to official administration.

<sup>125</sup> There is no timeframe specified in the law regarding the official administration.

<sup>126</sup> The Committee is functionally dependent on the Superintendency and is accountable to the Monetary Board through the Superintendency.

<sup>127</sup> Upon the suspension of operations, checks drawn against the bank are not included in the clearing system (Art. 77).

<sup>128</sup> Deposits exceeding the amounts guaranteed by the deposit insurance can be transferred if it is estimated that there are sufficient assets to transfer to the trust. Banks assuming the payment of deposit and employee liabilities receive a participation in the trust for the same value of the liabilities they assume.

<sup>129</sup> The deposit insurance fund can also purchase from the acquiring banks their participation rights in the trust. The use of deposit insurance funds must follow least-cost-criteria (Arts. 78 and 81).

<sup>130</sup> The law is explicit in granting the Superintendency the power to commence liquidation proceedings against a bank (Art. 3 of the LFS), but does not specify whether the creditors can do so as well.

submitted by the Superintendency to the Court, reflecting the situation of the bank following the transfer of assets and liabilities (Art. 83).<sup>131</sup>

There is no special priority granted to depositors in the distribution of the proceeds of liquidation. Under the general bankruptcy law, the liquidation proceeds are paid in the following order of preference: (i) bankruptcy expenses; (ii) alimony, funeral and estate expenses; (iii) expenses documented in public deeds, in the order they were documented; and (iv) other expenses (Art. 392 of the Civil and Commercial Procedures Code).

### **Other issues**

Legislation in Guatemala does not establish an extensive framework of rules governing cross-border insolvency or the resolution of entities that are part of a conglomerate. The law provides that foreign banks that are granted a license to open a branch in Guatemala shall have, and shall demonstrate that they have, unlimited liability for their operations in Guatemala (Art. 18). The law also provides that a branch of a foreign bank will be subject to suspension of operations and a “spin-off” if the foreign bank fails, within a 30-day period after receiving a request by the Superintendency, to address the branch’s capital deficiency (Art. 70, last paragraph).

The general commercial law provides that, upon a declaration of bankruptcy of a foreign corporation in the country of its incorporation, the Commercial Registry of Guatemala must be notified so that it can “adopt any measures that are necessary to protect the national public interest” (Art. 219 of the Commercial Code). There is no further specification of the type of measures that are to be adopted. Such declaration of bankruptcy must also be published in Guatemala’s official gazette and newspapers (Art. 219 of the Commercial Code).<sup>132</sup> Concerning conglomerates, the law provides that a holding company is responsible for addressing capital deficiencies at the conglomerate level. If this deficiency is not addressed, and there are grounds under the law for the dissolution of the relevant company, the Superintendency will request its dissolution before the courts. The Superintendency is required to inform the Monetary Board of capital deficiencies (Art. 72).

### **Deposit insurance**

The law establishes a Fund for the Protection of Savings (the “FOPA”). FOPA is set up for the purpose of insuring deposits and has no restructuring powers (other than making

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<sup>131</sup> The law provides that bankruptcy is to be petitioned once the procedures for the transfer of assets and liabilities are concluded but fails to explicitly state whether bankruptcy may be requested in the absence of such procedures (i.e., where the transfer of assets and liabilities has been unsuccessful or deemed not consistent with the least cost criterion). Moreover, it is also uncertain whether FOPA is able to directly pay off the deposit insurance amounts in the absence of a transfer of assets and liabilities.

<sup>132</sup> The general commercial law conditions the opening of branches by foreign entities in Guatemala on their express undertaking to cover, either with assets in Guatemala or abroad, the obligations contracted in Guatemala (Art. 215 (5) of the Commercial Code).

contributions to the trust as mentioned above) (Art. 85). Deposit insurance is mandatory for banks (Art. 86(a)). The fund covers deposits of up to 20,000 quetzales or its equivalent in foreign currency.<sup>133</sup> Deposits in branches of foreign banks are also covered (Art. 87). Only in situations where the deposit insurance resources are used to make grants to the trust, does the law provide that any remaining proceeds of the trust must be used to reimburse FOPA prior to the bank being sent to liquidation (Art. 84).

#### **D. Honduras<sup>134</sup>**

The Honduran bank insolvency system emphasizes a regime of corrective actions imposed by the National Banking and Insurance Commission (the “Commission”) rather than providing for official administration of a bank. Bank liquidation is mainly conducted in an administrative process by the Commission.

##### **Corrective action**

Corrective actions in the event that a bank is in difficulty are decided by the Commission (Art. 103). Where a bank experiences specific difficulties such as liquidity and solvency problems, operational losses for three straight months, or capital inadequacy for at least 60 days, the bank is required to submit a regularization plan to the Commission (Arts. 104 and 105). The regularization plan must provide for certain measures, that may include the capitalization of reserves and/or earnings, an increase in authorized capital, restrictions on lending operations, the transfer of loan or investment portfolios or the transfer or merger of the institution (Art. 106). The Commission may appoint a delegate to the board of the bank with the aim of overseeing the operations and safeguarding the interests of customers and the public during the execution of the regularization plan (Art. 103). The delegate of the Commission may reverse any transaction that is not consistent with the regularization plan (Art. 110).<sup>135</sup>

##### **Official Administration**

Unlike other bank insolvency systems in the region, the Honduran framework makes no provision for the imposition of official administration over a bank in difficulty.

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<sup>133</sup> The Monetary Board must adjust this amount as necessary to ensure that it would protect at least 90 percent of the deposits.

<sup>134</sup> The analysis is based on a review of the Financial System Law, Decree No. 129-2004 of September 22, 2004; and the Deposit Insurance Law (the “DIL”), Decree No. 53-2001 of May 28, 2001, as amended. Unless specified otherwise, all reference to Articles are to provisions of the Financial System Law.

<sup>135</sup> The task of this delegate may give rise to conflicts of interests, since this official becomes directly involved in the administration of the bank without having assumed full control of its operations.



## Liquidation

Banks are not subject to the general bankruptcy provisions of the Commercial Code but rather to a special regime governing bank insolvency set out in the Financial System Law and supplemented by provisions of the Commercial Code (Art. 139). The compulsory liquidation of a bank is conducted by the Commission (Art. 118).<sup>136</sup> The Commission must commence liquidation proceedings against a financial institution that has failed to submit a regularization plan, has failed to implement it, or has failed to correct deficiencies in the plan (Art. 113). Other mandatory grounds for ordering the compulsory liquidation are, *inter alia*: (i) capital that is lower than the minimum initial capital required; and (ii) the inability to pay outstanding obligations to the public when due. Upon the initiation of liquidation proceedings, interest on deposits, debts and any other obligations owed by the financial institution will be suspended (Art. 120.5).<sup>137</sup>

Honduran law establishes priorities for the distribution of the proceeds of the bank's estate as follows: (i) labor-related claims; (ii) all deposits; (iii) loans granted by the Central Bank due to liquidity problems and other banking obligations; (iv) funds collected for payments to third parties; (v) payments to the Deposit Insurance Fund (FOSEDE); and (vi) the remaining claims in keeping with the priority established in the Commerce Code (Art. 131).<sup>138</sup> Pursuant to Art. 51 of the DIL, either the State or FOSEDE has the right to recover all sums paid in relation to the liquidation of a financial institution from whoever is responsible for the insolvency of the institution.

For the purpose of protecting the depositors of a financial institution under compulsory liquidation, the Commission is authorized to exclude a portion of the financial institution's assets and deposits so they may be transferred to one or more financial institutions in good standing in the Honduran financial system (Art. 140). Should there be a shortfall between the insured deposits and the value of the assets transferred, FOSEDE must cover such difference not exceeding the maximum insured amount (Art. 35 of the DIL).

## Systemic issues

Pursuant to Art. 148, when one or more financial institutions under compulsory liquidation holds 20 percent or more of the deposits, or the loans, or the payments in the system, the

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<sup>136</sup> Compulsory liquidation cannot be triggered by third party creditors.

<sup>137</sup> Pursuant to Art. 121, the statute of limitations for all claims on the financial institution as well as the terms in the proceedings where the institution is a party are suspended for up to 6 months following the declaration of compulsory liquidation.

<sup>138</sup> In the case of remaining assets, the liquidator shall make provision for the payment of claims under litigation (Arts. 131 and 132 of the FSL). If additional assets remain, the liquidator shall pay, wholly or partially, the interest on liabilities of the institution that had been suspended due to the liquidation. The provision does not explicitly establish priority concerning the costs of the liquidation. Such inclusion would be useful to ensure that the costs of the liquidation are covered.

Commission and the Central Bank may exceptionally propose the capitalization of the institutions in distress, upon approval by the President of the Republic. The State, as sole shareholder, shall transfer the shares within the following 3 years (Art. 151), provided that the previous shareholders are forbidden from acquiring these shares (Art. 152).

### **Deposit insurance**

The administration of the deposit insurance fund is assigned to FOSEDE, an entity attached to the Central Bank but with technical, administrative and budgetary independence. FOSEDE is responsible for the payment of the deposits in financial institutions that have been liquidated and making non-reimbursable contributions or loans in relation to compulsory liquidation processes, as requested by the Commission (Art. 15 of the DIL). Participation in the deposit insurance fund is compulsory for all financial institutions (Art. 5 of the DIL), including the branches of foreign banks (Art. 3 of the DIL). The maximum amount insured is 150,000.00 lempiras per each depositor and institution (Art. 30 of the DIL).<sup>139</sup>

Art. 145 of the DIL allows the Commission to submit a request to FOSEDE for a non-reimbursable contribution to the financial institutions participating in the restitution of deposits scheme, as an alternative to the payment of the insured deposits, provided the amount to be contributed by FOSEDE is less than the aggregate payment of the insured deposits. The Commission may also request FOSEDE to grant a loan to the liquidator to facilitate the return of the deposits to the depositors whose accounts have been transferred to other financial institutions under the restitution process.<sup>140</sup>

### **E. Nicaragua<sup>141</sup>**

The Nicaraguan bank insolvency system provides for official administration under separate laws by the Superintendent of Banks (the “Superintendent”) or the Deposit Insurance Agency. Bank liquidation is a mainly administrative process with some court involvement.

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<sup>139</sup> The deposits of legal entities belonging to the same economic group as the financial institution in liquidation, its related parties, and those of persons who have contributed to the financial decline of the institution are excluded from deposit insurance (Art. 29 of the DIL).

<sup>140</sup> Pursuant to Art. 7 of DIL, whenever FOSEDE’s resources equal 5 percent of the aggregate amount of the deposits in the financial system, the requirement to pay the contribution will be suspended, rather than reduced, until this percentage diminishes. This provision can potentially lead to the weakening of FOSEDE’s resources. In accordance with Art. 24 of the DIL, the Central Bank is required to maintain a contingency line of credit on behalf of FOSEDE, which can only be used in the event the resources of FOSEDE become insufficient.

<sup>141</sup> The analysis is based on a review of the following legislation: the *General Law on Banks, Nonbank Financial Institutions and Financial Groups* (Law No. 314 of October 12, 1999), the *Law on the Superintendency of Banks and Other Financial Institutions* (the “LSB”, Law No. 316 of October 11, 1999), the *Organic Law on the Central Bank* (the “OLCB”, Law No. 317 of October 11 of 1999), and the *Law on Deposit Insurance* (the “LDI”, Law No. 371 of July 27, 2001). All references to the Law in this section correspond to the *General Law on Banks, Nonbank Financial Institutions and Financial Groups* unless otherwise specified.

### **Corrective action**

The Superintendent is authorized to order various corrective actions to be taken by a bank that is experiencing certain specified problems such as (i) deficiencies in reserve requirements or other illiquidity indicators; (ii) actual or imminent losses in the bank's capital; (iii) administrative or managerial irregularities; (iv) deficiencies in the bank's minimum capital; or (v) other infringements to the applicable laws, regulations or instructions or situations deemed by the Superintendent as posing risks to depositors or other creditors, or to the bank's solvency or liquidity that are less severe than those that warrant the imposition of official administration (Art. 82). The corrective actions that may be ordered include a prohibition against granting new loans or entering into other transactions, cease and desist orders, a prohibition against the distribution of dividends, orders to restore adequate capital, the submission of a regularization plan, and the appointment of an officer with veto powers over decisions of the board of directors or loan committee (Art. 82).

### **Official administration**

The official administration of banks is governed by parallel legal proceedings (described separately below), as follows: (i) proceedings under the *General Law on Banks, Nonbank Financial Institutions and Financial Groups*; (ii) the procedures for the restitution of deposits under the LDI, and (iii) the extraordinary procedures for the restitution of deposits, governed by the LDI. These are all administrative proceedings conducted by the Superintendent.

The Superintendent must place a bank under official administration if the bank's capital is less than one fourth of the minimum required capital (banks' capital adequacy ratio is 10 percent, Art. 19) or if the bank is no longer paying its obligations as they fall due (Art. 84, last paragraph). The Superintendent may place a bank under official administration under other specified circumstances, such as violations of the law and regulations, an evident non-compliance with the regularization plan, and the incurrence of losses that exceed one third of the capital as well as indications of a possible cessation of payments or illiquidity or insolvency problems less severe<sup>142</sup> than those requiring the compulsory liquidation (Art. 84).<sup>143</sup> The Superintendent may decide to act as official administrator, or may appoint others to act in this capacity under the Superintendent's supervision (Arts. 84-86).

The effects of an official administration are (i) the displacement of management; and (ii) if decided by the Superintendent, a standstill on payments while the official administration is in effect. It is not clear from the law whether new enforcement actions against the bank can be

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<sup>142</sup> It is not clear how the liquidity or insolvency problems that may trigger a discretionary intervention can be distinguished from the "more severe" liquidity or insolvency problems that trigger compulsory liquidation.

<sup>143</sup> In addition, the Board of the Superintendency of Banks may also decide a bank's official administration if the Superintendent fails to do so despite the existence of mandatory grounds for intervention (Art. 10.12 of the LSB).

initiated or not. Concerning already existing enforcement actions, the law allows their continuation before the courts, but prohibits foreclosure of the bank's assets (Art. 87).<sup>144</sup>

### **Proceedings under the General Law on Banks, Nonbank Financial Institutions, and Financial Groups**

The official administrator must determine, within 30 days following the placement of the bank under official administration, whether the bank can continue its operations, a merger or acquisition with/by another bank would be viable, or the bank must be liquidated (Art. 86, first and second paragraphs). Although the law is not explicit in stating the maximum duration of an administration, it appears that an official administration for a 60-day maximum period is envisaged. The restructuring powers of an official administrator under this law are: (i) to terminate the employment relationships and reduce bank's expenses; (ii) to sell any of the banks' assets in the interest of depositors; and (iii) to sell or merge the bank with another bank (Art. 86, fourth paragraph). The Superintendent must issue a resolution to terminate an official administration. If upon the conclusion of the official administration there are grounds for the banks' liquidation, the Superintendent shall request the courts to place the bank under compulsory liquidation (Art. 86, fifth paragraph).

### **Procedures for the restitution of deposits under the LDI**

The Superintendent may decide to appoint the Deposit Insurance Agency (FOGADE) to act as official administrator if the bank's capital is less than 50 percent, and is required to appoint FOGADE as administrator, if the bank's capital is less than one fourth of the required capital or if there are legal grounds to request a court declaration of compulsory liquidation.

If FOGADE is appointed as official administrator, it has to undertake the procedures for the restitution of deposits. These procedures allow for the transfer of deposits and corresponding amounts of assets to acquiring banks. Deposits should be transferred for up to the insured amounts. They can be transferred in amounts exceeding the insured amounts if there are sufficient assets available. Amounts from the deposit insurance fund can be used to cover shortfalls between the available assets and insured deposits (Art. 39). The transfer of assets and deposits has to be conducted under the detailed rules set forth in the LDI, with the least-cost-principle being one of the various principles guiding the use of deposit insurance funds (Arts. 37 and 40). The law does not provide for a maximum term for the completion of the procedures for the restitution of deposits. Upon the conclusion of these proceedings, the Superintendent must request the courts to declare the compulsory liquidation (Art. 46).

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<sup>144</sup> The LDI provides that during official administration the banks shareholders' rights are displaced and exercised by the official administrator who can act "in accordance with the *Law on Banks, Financial Institutions and Financial Groups*" or "exercising shareholder's rights under the general law" (Art. 48 of the LDI). However, it is unclear whether this explicit provision on the displacement of shareholders' rights also applies to cases where FOGADE has been appointed as official administrator to undertake the procedures for the restitution of deposits.

### **Extraordinary procedures for the restitution of deposits**

Separate bank resolution procedures, referred to as extraordinary procedures for the restitution of deposits, are available under the LDI. The law fails to specify objective grounds for their application, which can take place whenever the majority of each of the boards of FOGADE, the BCN, and the Superintendent determine that other resolution proceedings “are not the most adequate” to protect the interest of depositors. These proceedings provide for (i) the capitalization of certain bank liabilities, (ii) a reduction in the bank’s capital and writing down the shareholders’ equity; (iii) the delivery of assets of the bank to the bank’s shareholders in payment for their shares (such payment is to be made before the courts); (iv) the subscription by FOGADE of shares in the bank using resources as necessary to meet the capital adequacy requirements; and (v) the appointment of new management. The law provides FOGADE with a maximum term of five years to sell the shares of bank, an excessively long time period (Art. 47 of the LDI).

### **Liquidation**

The liquidation of a bank is governed by the *General Law on Banks, Nonbank Financial Institutions and Financial Groups*. Upon the occurrence of specified events, including severe illiquidity, insolvency, an unsuccessful recovery of the bank in the context of an official administration, the Superintendent must request the courts to place a bank in compulsory liquidation (Art. 88). If FOGADE has been appointed to carry out the procedures for the restitution of deposits under the LDI, these procedures must be completed before the request for the bank’s liquidation.

The liquidation proceedings are mainly administrative, with some court involvement. The intervention of the courts is limited to declaring, at the Superintendent’s request, the mandatory liquidation of the bank, which has the effect, by virtue of the law, of revoking the bank’s license. It is the Superintendent who appoints the liquidator and monitors the liquidator’s performance. The declaration of liquidation and any decisions adopted by the liquidator can be appealed before the courts. The law provides that any appeals filed against the liquidator’s decisions shall not suspend the decisions’ effectiveness (Arts. 92 and 94).

The effects of a compulsory liquidation are: (i) the revocation of the bank’s license; (ii) the displacement of management (Art. 92); and (iii) the suspension of the accrual of interest on the bank’s liabilities (Art. 93). There are no specific provisions on shareholders’ rights, except for a general provision on the displacement of the authorities charged with the “direction and management” of the bank (Art. 92). Moreover, the law provides banks’ shareholders with the right to any proceeds of the liquidation that remain after the payment of all of the banks’ liabilities (Art. 104).

Depositors that are individuals enjoy a special preferential position in the distribution of the liquidation proceeds up to a specified amount (Art. 100). Depositors must be reimbursed for these amounts even if the liquidation proceeds are insufficient for this purpose, and the law

requires the liquidator to obtain loans from other banks as necessary for the payment, which appears impracticable. The remainder of the proceeds of liquidation are to be distributed as follows: (i) employees' claims; (ii) all deposits, including for the amounts not covered under the special preference; (iii) claims of the Central Bank of Nicaragua (the "BCN"); (iv) taxes; (v) other claims in accordance with their preferences and modalities established in the civil code (Art. 101). The law provides that the liquidation expenses must be paid from the bank's assets but fails to specify a preference for this category. FOGADE is subrogated to the position of depositors with respect to amounts it paid under the procedures for the restitution of deposits. There are no specific rules for the netting and settlement of financial contracts. The liquidation must be completed within six months, but the Superintendent can extend this term for an additional six months. The liquidator must submit a final report for the approval of the Superintendent.

### **Other issues**

No specific provisions on cross-border insolvency are included in the law. Concerning conglomerates, the law provides that any of the members of a conglomerate can be subject to official administration and liquidation as provided for under the law. The Superintendent may decide to adopt these procedures to protect the interests of depositors and creditors, and must seek a solution for the conglomerate viewed as a whole (Art. 138). It is unclear whether this approach is consistent with the resolution procedures under the specific laws governing the entities that are members of a conglomerate.

### **Deposit insurance**

FOGADE has been established as a public entity (Art. 2 of the LDI), with broad powers to undertake restructurings under the procedures for the restitution of deposits. FOGADE's decision-making body consists of a board comprised of: (i) a person proposed by the banking association and appointed by the President of the Republic as chairman; (ii) the president of the BCN; (iii) the Superintendent; (iv) a representative from the Ministry of Finance; and (v) another person proposed by the banking association and appointed by the President of the Republic (Art. 8 of the LDI). FOGADE's funding includes contributions by banks; FOGADE may also issue bonds guaranteed by the Republic. Moreover, at FOGADE's request, the BCN is required to acquire these bonds (Art. 23 of the LDI). The fund covers deposits of up to 20,000 dollars (Art. 31 of the LDI). Deposits in branches of foreign banks are also insured (Art. 4 of the LDI).<sup>145</sup>

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<sup>145</sup> The limit was recently lowered to 10,000 dollars.

## F. Panama<sup>146</sup>

The Panamanian bank insolvency system provides for the official administration of an insolvent bank by the Superintendency of Banks (the “Superintendency”). Bank liquidation is conducted in administrative proceedings, without the involvement of the courts. The responsibility for deciding on the intervention, reorganization and compulsory liquidation of a bank (both General and International License) rests with the Superintendency (Art. 17.6).

### Corrective action

In accordance with Art. 17.27, the Superintendency has discretionary powers to call for corrective measures to prevent or address deficiencies in the bank’s operations that may jeopardize the interests of its depositors, the stability of the bank or the soundness of the banking system. Without prejudice to any other corrective measure required of a bank, Art. 76 establishes that, if the Superintendency has grounds to consider that a bank’s capital has suffered losses or that the bank is insolvent (liabilities exceed assets), the Superintendency may appoint an advisor at the bank’s expense to advise it on the measures it must undertake to correct the deficiency.<sup>147</sup> The advisor is required to submit regular reports to the Superintendency during of his appointment (Art. 78) and must submit a final report at the end of the appointment. The advisor may recommend in the final report the intervention, reorganization or compulsory liquidation of the bank (Art. 79). On the basis of the advisor’s report, the Superintendency may order the reorganization of a bank whenever it deems it necessary, in the interests of the depositors and to ensure the solvency and survival of the bank (Art. 108).

In the event of reorganization, Art. 109 authorizes the Superintendency to require the bank’s shareholders to provide additional capital. If the shareholders fail to do so, the Superintendency is authorized to: (i) amortize the bank’s losses against its paid-in capital stock and reserves; (ii) appoint new managers; (iii) authorize the issuance of new shares of the bank, as well as their sale to third parties at a price determined by the Superintendency; (iv) “promote the merger or the consolidation of the bank with one or more banks, the obtaining of loans, the sale or partial liquidation of its non-productive assets or the imposition of liens upon them”; or (v) initiate the process of liquidation. Pursuant to Art. 107, the shareholders are forbidden to adopt decisions that may obstruct the reorganization process for its duration. The management and control of the bank shall be returned to its directors, at the satisfactory conclusion of the reorganization (Art. 112).

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<sup>146</sup> The analysis is based on a review of *Decree-Law 9* of 26 February 1998, “By means of which the banking regime is reformed and the Superintendency of Banks is established.” Unless specified otherwise, all references are to Articles of the *Decree-Law 9 of 1998*.

<sup>147</sup> For instances of balance sheet insolvency, the appointment of an advisor to restore the bank’s solvency seems inadequate given the gravity of the situation. The provision in Art. 76 regarding balance sheet insolvency is also inconsistent with Art. 95.8, which sets up insolvency as grounds for intervention.

## Official administration

The Superintendency shall order the “intervention” (official administration) of a bank on the following grounds: (i) a request from the bank itself; (ii) the reduction of the bank’s capital for a period where it is less than 8 percent of its total assets and off-balance sheet operations; (iii) a decline of the capital adequacy ratio below 8 percent<sup>148</sup>; (iv) the conduct of business in an illegal, negligent or fraudulent manner; (v) the suspension of payments; (vi) the repeated violation of the liquidity requirements; (vii) the existence of a threat to the interests of the depositors if the bank continues to operate; (viii) a situation where the bank’s assets are insufficient to cover the total of its liabilities; (ix) an unjustified delay in the voluntary liquidation of the bank; and (x) the failure to comply with the reorganization plan (Art. 95).

The intervention proceedings are designed to afford time for the “intervenor” to assess the situation of the bank and prepare an opinion for the Superintendency concerning the measures to be imposed following the end of the intervention. The term of the intervention is set at 30 calendar days, which can be extended once for up to additional 30 calendar days (Art. 102). The intervenor is authorized to suspend or limit the payment of the bank’s obligations for the duration of the intervention (Art. 100.1). At the end of the intervention, the intervenor shall submit a final report to the Superintendency with a recommendation for the return of the administration and control of the bank to its directors, its reorganization or its compulsory liquidation (Arts. 100 and 102). During the term of the intervention, the bank’s assets shall not be attached or be subjected to any other preventive measure (Art. 105). In addition, the statute of limitations on the credits and debts of the bank is suspended from the date of the notice of the intervention.

## Liquidation

The provisions concerning bankruptcy contained in the Commerce and Judicial Codes are not applicable to banks (Art. 135). The applicable legal framework is set out in *Decree-Law 9 of 1998*, supplemented by the relevant provisions of the Civil, Commerce and Judicial Codes insofar as these are not incompatible. Art. 115 grants discretionary power to the Superintendency to order the compulsory liquidation of a bank that has been intervened or is in the process of reorganization.<sup>149</sup> The Superintendency is not required to endorse a recommendation of compulsory liquidation by the intervenor. Compulsory liquidation may also be initiated by the Superintendency at the conclusion of the reorganization, if the process has not been completed satisfactorily, or at any other moment prior to the conclusion of the reorganization due to insolvency or any other reason that hinders the recovery of the bank (Art. 111). The banking license must be revoked whenever a bank ceases to carry out its business (Art. 38.1).

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<sup>148</sup> Mandatory intervention due to a decline in the bank’s capital adequacy ratio below 8 percent appears to provide for an early trigger at a time where it may still be possible to rectify such deficiency by instructing the bank to increase its capital or by implementing other measures, with or without the assistance of an advisor.

<sup>149</sup> Proceedings cannot be initiated at the request of third party creditors.



In compulsory liquidation, interest on the unsecured claims on the bank will cease to accrue, in which case the creditors may demand the current interest due, up to the value of the proceeds of the encumbered assets (Art. 117).<sup>150</sup> In addition, all statutes of limitation relative to any of the bank's privileges or causes of action, as well as the terms for filing lawsuits or proceedings involving the bank, shall be considered suspended for up to six months (Art. 119).

The proceeds of liquidation of the bank's estate will be distributed in the following order: (i) labor-related claims; (ii) claims by the Social Security agency concerning contributions owed by the bank's employees; (iii) tax-related claims of the National Treasury or the Municipalities, as well as levies for public services rendered by the State; (iv) deposit accounts for US\$5000 or less belonging to natural persons; and (v) all other deposits and unsecured claims (Art. 127). Secured claims have preference over any other claims regarding encumbered assets.<sup>151</sup> The costs of the liquidation, including the fees of the liquidator and salaries of the staff hired to assist in the liquidation are considered unsecured claims (Art. 126.1).<sup>152</sup> There are no specific provisions regarding the restitution of the assets remaining after liquidation, if any, to the shareholders.

### **Other issues**

Assets of the bank located in a foreign jurisdiction are considered to be subjected to the compulsory liquidation proceedings, without prejudice to the requirements of the applicable laws where such assets are located. The bank's depositors and creditors domiciled in a foreign jurisdiction have the same rights as those domiciled in Panama. There are no specific provisions concerning the insolvency of systemically relevant banks. There is no deposit insurance system in Panama.

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<sup>150</sup> The suspension of interest does not affect such credits secured via pledge or mortgage.

<sup>151</sup> Amounts owed to the national treasury for property taxes take precedence over claims secured by pledge or mortgage on such assets (Art. 128).

<sup>152</sup> It would be advisable to include the cost of the liquidation as a preferred claim, to ensure that the costs of the liquidation are covered by the proceeds of the liquidation.

## INTERNATIONAL EXPERIENCE WITH CONSOLIDATED SUPERVISION OF REGIONAL FINANCIAL CONGLOMERATES<sup>153</sup>

### European Union

Regulation and supervision of cross-border banking groups in the EU takes place in the context of a regional market for financial services that has to a significant extent been unified, but where—despite increasing harmonization—licensing, regulation and supervision of financial institutions remain essentially organized at the national level.

The single European market for banking services is based on the principle of a single banking license or “passport.” This principle implies that any financial institution licensed to provide certain financial services in one EU country, and actually providing those services in that country, can provide the same services throughout the EU, by means of cross-border transactions or foreign branches. To prevent regulatory arbitrage, minimum licensing standards have been set at the European level, using the same procedures as those for minimum regulatory standards (see below). However, licensing itself is done by the relevant national authorities, which may opt to apply stricter licensing criteria than the minimum standards. Banking subsidiaries set up by EU banks in other EU countries need to be licensed separately by the host country.

National authorities remain in charge of setting bank regulation, be it subject to increasingly specific minimum standards agreed at the European level. For banks that operate cross-border, the principle of home country control applies, i.e., banks are subject to the regulations of their home country, even when operating in other EU countries.

Until recently, EU-wide minimum regulatory standards were established as regular EU legislation, on the basis of proposals made by the European Commission that had to be approved by the Council and the European Parliament. In preparing such legislation, the Commission was advised by the Banking Advisory Committee, which comprised representatives of the national supervisory agencies and ministries of finance in the different member states. In certain technical areas, the Committee was able to amend EU banking legislation without having to go through the above-described legislative procedure.

In part to avoid excessive delays in adapting the regulatory framework to a rapidly changing financial environment, and in order to further streamline and harmonize regulations, the European Union decided in December 2002 to extend the Lamfalussy approach to the area of bank regulation.<sup>154</sup> Under the Lamfalussy approach, regulatory framework principles are

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<sup>153</sup> Prepared by Jens Clausen, Marco Espinosa (both MFD), and Wim Fonteyne (EUR).

<sup>154</sup> The Lamfalussy approach was originally proposed in 2001 for the regulation of securities markets, by a Committee of Wise Men led by Baron Alexandre Lamfalussy. A discussion of the Lamfalussy approach in bank regulation can be found in the November 2004 issue of the ECB’s Monthly Bulletin, and in Schüler, Martin, (continued)

established in the form of formal Directives or Regulations (“primary legislation”) through the normal EU legislative procedures (Level 1). On the basis of these framework principles, more detailed technical implementing rules (“secondary legislation”) are prepared by the European Commission, on the basis of consultations with sectoral committees consisting of the relevant authorities, and subject to the approval of a regulatory committee (the European Banking Committee or EBC) comprising representatives of the member states (Level 2). The consistent implementation of harmonized regulations throughout the EU is the objective of another committee (the Committee of European Banking Supervisors or CEBS), which brings together high-level representatives of European banking supervisory agencies and central banks (Level 3).

To ensure effective and harmonious supervision in the context of an EU-wide single market in which responsibility for supervision remains with national agencies, a number of basic principles have been established. These are (i) mutual recognition of the way supervision is conducted in the different member states, (ii) an obligation for supervisors to cooperate with each other, (iii) harmonization of supervisory practices and (iv) home country control as the basic approach in consolidated supervision.

In this context, responsibilities for the supervision of cross-border bank activities have been allocated as follows: (i) the home country supervisor is responsible for consolidated supervision of a banking group as a whole; (ii) branches of EU banks in other EU countries are supervised by the home country supervisor; and (iii) subsidiaries of EU banks in other EU countries are supervised by host country supervisors as separate entities, and as part of the consolidated banking group by the home country supervisor.

Cooperation between the different national supervisors is essential to make this framework function smoothly. Nevertheless, individual agencies have been left with a significant degree of freedom in organizing this cooperation (in particular, the exchange of information), through the conclusion of bilateral Memoranda of Understanding (MoUs). Such MoUs specify the modalities for information exchange (including confidentiality issues) and other forms of cooperation and outline the commitments agencies take vis-à-vis each other. These bilateral MoUs are supplemented by a number of multilateral MoUs, often dealing with specific multinational banking institutions. Cooperation has been strengthened further with the establishment of the CEBS, which has among its objectives to serve as a forum for the exchange of information, a role which was previously fulfilled to a lesser extent by the “Groupe de Contact” and the ESCB’s Banking Supervision Committee.

Within the Lamfalussy framework, harmonization/convergence of supervisory practices is a role allocated to the CEBS and, to a lesser extent, to the EBC.

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“How do Banking Supervisors Deal with Europe-Wide Systemic Risk?,” Paper prepared for the CESinfo-Delphi Conference “Designing the new EU.”

## NORDEA

There is a long-standing tradition of cooperation among Nordic<sup>155</sup> central banks as well as among Nordic banking supervisory authorities.<sup>156</sup> In 2003, the Governors of the Nordic central banks agreed on an MoU, which outlines the procedures followed in the event of a banking crisis with cross-border implications. It specifies the details of crisis management and possible emergency liquidity support. They regarded a non-legally binding MoU as the appropriate tool for organizing cooperation between the central banks. An MoU among the banking supervisory authorities was first been signed in 1989, and was renewed in 1994 and 2000. The Swedish Financial Supervisory Authority acts as the secretariat of the group. The Memorandum specifies the cooperation related to cross-border supervisory activities. It defines the home and host country responsibilities, information sharing, and cooperation on conducting on-site examination, consolidated supervision and cross-border financial services. Special attention is given in a separate MoU to the supervision of the NORDEA Group, a financial conglomerate active in four of the five Nordic countries. The establishment of a joint supervisory group for NORDEA was a “major step toward ensuring effective consolidated supervision” (2002 FSSA for Sweden, p. 28).

## ECCU

In 1981, eight Eastern Caribbean countries established the Organization of Eastern Caribbean States (OECS). The eight member countries and territories of the ECCB are Antigua and Barbuda, Dominica, Grenada, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines, which are independent states and members of the IMF, and Anguilla and Montserrat, which are territories of the United Kingdom. In 1983 they created the Eastern Caribbean Central Bank (ECCB) and adopted the ECCB Agreement Act. The financial system in the Eastern Caribbean Currency Union (ECCU) comprises domestic banks, offshore banks, credit unions, insurance companies, national development foundations, development finance institutions, building and loan associations and finance companies.

The regulatory framework of the domestic banking system includes the ECCB Agreement Act of 1983 and its amendments as well as the Banking Acts of the various member states. The Agreement Act gives the bank the power to “regulate banking business on behalf of and in collaboration with participating Governments.” Between 1988 and 1992 new banking legislation, referred to as the Uniform Banking Act, was enacted in each of the member states. This legislation sets the stage for the harmonization of financial intermediaries within the ECCB area and the standardization of the ECCB’s supervisory and regulatory framework.

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<sup>155</sup> Nordic countries comprise Denmark, Finland, Iceland, Norway, and Sweden.

<sup>156</sup> This section draws from the 2002 FSSA for Sweden (SM/02/212) and “Regional Financial Conglomerates: The Case for Improved Supervision” by Julia Majaha-Jartby and Thordur Olafsson, IMF Working Paper, forthcoming.

The Uniform Banking Act (UBA) reaffirms the ECCB as the region's central bank with responsibility for the supervision of the financial system. The ultimate authority in the application of the Act is vested in the minister of finance of the individual countries, who are required to act in consultation with, and on the recommendation of the ECCB. All commercial banks and other banking business institutions are required to be licensed under the Uniform Banking Act. As part of the continuing supervision, licensed financial institutions are required to submit monthly, quarterly and annual reports to the ECCB.

Some deficiencies of the UBA are being partly addressed as a result of the recent ECCU FSAP, including the lack of sufficient central bank authority to sufficiently enforce the banking requirements. This would be particularly relevant where key supervisory decisions lie outside of the supervisory authorities, and where such decisions can be politically influenced.

The offshore financial services sector regulated by the Offshore Banking Acts in the respective countries, is primarily the responsibility of the national regulators. In the case of Dominica, Nevis and St. Vincent and the Grenadines, the Offshore Banking Acts have been amended to allow for varying degrees of participation in the regulation and supervision of the offshore sector by the ECCB. The ECCB provides support to the national regulators in the other territories in supervising the sector.

## **WAMU and CEMAC**

The West African Monetary Union (WAMU) and the Central African Economic and Monetary Union (CEMAC) are monetary unions with a single currency, the CFA franc. The WAMU treaty established a single currency and a regional central bank (*Banque Centrale des États de l'Afrique de l'Ouest*—BCEAO) in 1962.<sup>157</sup> The eight countries that belong to WAMU are Benin, Burkina Faso, Côte d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal, and Togo. The Governor of the BCEAO is the President of the Banking Commission (*Commission Bancaire de l'UMOA*), which was created in 1990 to strengthen regional banking supervision and authorize uniform licensing. The Banking Commission is responsible for the organization and supervision of banks and financial institutions in the eight member states. The 1995 PARMEC law (*Projet d'Appui à la Réglementation sur les Mutuelles d'Épargne et de Crédit*) for savings and credit institutions laid the basis for a regulatory framework for cooperative financial institutions in the region. Both government authorities and the BCEAO are responsible for supervising microfinance institutions. Pensions funds, the stock market and insurance companies are supervised by separate regional institutions. There are reforms underway to expand the Banking Commission's authority to also regulate these markets as well as to be able to withdraw banking licenses, which until now has been subject to the approval of the minister of finance of each country.

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<sup>157</sup> This section draws from the report "West African Economic and Monetary Union—Recent Economic Developments and Regional Policy Issues," SM/04/202.

The Central African Economic and Monetary Union (CEMAC) encompasses six countries (Cameroon, Central African Republic, Chad, the Republic of Congo, Equatorial Guinea, and Gabon). The *Commission Bancaire de l'Afrique Centrale* (COBAC) has been assigned nearly the full range of powers that national supervisory countries have in other countries.<sup>158</sup> It conducts off-site and on-site supervision and issues prudential regulations. It shares responsibility with the national ministries of finance for the licensing of new banks. It also has the authority to sanction credit institutions, to revoke banking licenses, and to decide on the liquidation of banks. Although legally independent, COBAC is closely related to the Bank of Central African States (BEAC). The Governor of BEAC is also the chairman of COBAC. COBAC also depends on the BEAC for its financial and human resources. The 1992 Convention provides joint responsibility for issuing banking licenses between national authorities and COBAC. While the latter has de jure overriding responsibility, in practice COBAC has to rely on the respective national authorities' cooperation to implement and enforce its decisions. The 2000 FSAP for Cameroon found that through good handling of a number of crises, COBAC has become a well-respected institution. Regional initiatives, such as the harmonization of the commercial code and regional payment systems are expected to promote cross-border financial intermediation, trade, and investment, and thus generate higher economic growth.

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<sup>158</sup> This description draws from the 2000 Cameroon FSAP.

### III. DEVELOPMENT OF THE INSURANCE SECTOR<sup>159</sup>

#### A. Introduction

91. The insurance sector remains small in most of Central America. The scarcity of insurance affects welfare directly, because households and companies must bear most risks themselves, leading to undesired volatility of intertemporal consumption. Moreover, lack of insurance may reduce the availability of financing or increase its costs, because lenders are discouraged when they must bear both the economic risks associated with a project to be financed and also insurable risks such as that for work accidents or property damage. In addition, the limited assets of insurance companies implies that they cannot be major players in domestic financial markets and in particular in securities markets, so these markets are thinner than they would otherwise be. Hence, measures to promote the insurance industry could yield multiple benefits if well targeted.

92. Many of these measures, such as those related to the modernization of the regulatory framework, can be undertaken by individual countries. In some cases, joint regional initiatives or mere coordination may make the measures more effective, for example, by exploiting economies of scale or scope in the provision of innovation or diversifying risks. Despite their differences, the countries covered in this study—Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and Panama—are sufficiently similar that cross-country comparisons are meaningful, and that worthwhile joint action in certain areas might be identifiable.

93. These considerations motivate the material of this chapter. However, due account must be taken of the limits of a regional study. Information is sometimes not available for all countries, and data are often not fully comparable.<sup>160</sup> More fundamentally, the countries differ in level of development, the structure of their economies, and other aspects of the framework within which insurance markets operate. Panama and Costa Rica are substantially more well-to-do than the other countries, and have generally displayed greater economic and political stability in recent decades. Costa Rica is unique in having a state-owned monopoly provider of insurance. Guatemala, El Salvador, Honduras, and Nicaragua are more similar to one another, although Nicaragua is still transitioning from a long period of state monopoly in the sector, which extended until 1996.

94. The prevalence of non-term life insurance, that is, life insurance with an important savings element, depends on whether or not other savings vehicles are available and whether

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<sup>159</sup> Prepared by Daniel Hardy (MFD) and Miguel Palomino (MFD consultant).

<sup>160</sup> The main sources of information include responses by national supervisory authorities to a questionnaire; self-assessments by those authorities of observance of the International Association of Insurance Supervisors' Core Principles; the websites of those authorities and the Association of Latin American Insurance Supervisors; FSAPs for those countries; and discussions with the supervisory authorities and market participants. The authors benefited from discussions with staff at the World Bank and the Inter-American Development Bank.

or not public or private pension schemes are in operation. Given the multitude of fiscal, distributional, and demographic factors affecting non-term life insurance; their heterogeneity across the region; and the fact that important policy decisions are currently under debate in some countries, this study concentrates on non-life insurance.

95. The next section describes the structure of the insurance markets of these countries, the availability of insurance products, and the recent performance of insurance companies. The subsequent section looks at the legal, regulatory and supervisory framework. The final section addresses a number of cross-country issues and recommendations.

## **B. Structure and Performance**

### **Insurance penetration**

96. The market volume for insurance products in most Central American countries is modest in absolute terms and relative to those countries' GDP (Table 1 and Figures 1 and 2).<sup>161</sup> However, the level of insurance penetration as measured by the ratio of premium income to GDP is roughly in line with the relationships that are seen around the world: demand for insurance is strongly correlated with average income, and with the presence of a substantial middle class, that is, with a relatively even distribution of wealth. Central America contains some of the poorest countries in the Western Hemisphere, and is characterized by uneven distribution of wealth, so one would expect relatively low demand for insurance. For many Central American countries, their past history of macroeconomic instability and at times severe political conflict may have hindered the supply of, and demand for insurance products, as well as the creation of an insurance culture. Furthermore, most of Central America also faces large risks, for example, of natural catastrophes, that are not diversifiable domestically, and therefore expensive to insure against.<sup>162</sup>

97. The insurance sector is also small relative to banks and the market for government debt. Insurance company assets are just a small fraction of broad money, which can be taken as a metric for the size of the banking system (Table 2). In addition, many insurance companies tend to be relatively small affiliates of banks. Hence, insurance companies cannot play a major role in counter-balancing banks in the market for deposits or in that for securities. By the same token, insurance companies are not generally of systemic importance.

98. The insurance sector in the region has shown trend growth in absolute terms in the past several years, but rather less when measured by gross premia relative to GDP. However, growth in insurance services is sometimes underestimated by measuring the service in terms

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<sup>161</sup> Available information pertains to companies operating in the domestic market. The volume of insurance may be underestimated because much insurance for trade, international transport and the activities of multinationals companies may be provided by insurance companies abroad.

<sup>162</sup> The same factors that constrain development of the formal insurance sector also constrain the availability of informal insurance, which, moreover, is generally more difficult to organize than informal credit.



of premiums paid when there is a reduction in unit prices; total premiums may fall even if the risks being insured are growing. As can be seen in Table 3, the number of policies is generally rising.

99. Nonetheless, insurance penetration is still low not only in value terms, but also in terms of the number of policies. In addition to low income levels, this is a reflection of the uneven distribution of income, as most households and production units cannot access insurance services. The available data on the number of policies, because one policy can comprise a large number of end users, complicate comparisons, but market participants agreed that low penetration is a characteristic of all regional markets.

100. The poor are especially lacking in insurance services throughout the region. The relatively high administrative costs of offering small amounts of insurance coverage to low income households and to small firms, where risk assessment, record keeping, and handling claims generate fixed costs, tends to make the services either prohibitively expensive or unprofitable. Hence, the expansion of insurance services to the mass of the poor population is essentially an issue of developing a low-cost technology for the production of the service (Boxes 1 and 2). Past administrative control of insurance premia and the importation of insurance practices and models from more developed countries likely hindered the development of insurance schemes that would make the service accessible to lower income groups.

### **Product range**

101. Insurance companies receive most of their non-life premia for coverage of automobile and other property risks; property insurance typically covers damage from earthquake, fire, flooding, other natural catastrophes, and similar risks. Health insurance is usually the third most important category.<sup>163</sup> Life insurance generates between one-tenth and one-third of total premium income.

102. Mandatory insurance coverage exists in some countries. This is the case of third-party liability (TPL) automobile insurance in Costa Rica and Nicaragua and, for commercial vehicles, in Panama. Other coverage is sometimes also mandatory (for example, worker compensation insurance in Costa Rica). Mandatory insurance policies are the source of significant premium income and various schemes, especially automobile TPL are being debated in some countries. However, insurance requirements seem often to go unenforced.<sup>164</sup>

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<sup>163</sup> Most of the countries have some form of Social Security and also a state-funded health service, but the provision of services is limited.

<sup>164</sup> For example, in Nicaragua, third party motor insurance is compulsory, yet as of 2004 there were only about 100,000 motor policies in force, while some 250,000 cars were registered.

### **Box 1. Mass Insurance Products**

To assure low costs, mass insurance products rely on simple and standardized policies that require little verification (and are therefore cheap and easy to sell), and also on cheap collection arrangements. One of the ways in which this has been achieved in some countries in the region is through “bancassurance.” Bancassurance relies on the use of banks’ branch networks as a sales platform and the banks’ established payments system as a collection mechanism with low marginal costs. Bancassurance has been quite successful in several countries in the region. In El Salvador, perhaps the most successful country in this regard, a large insurance company led the effort to sell mass insurance products through a bank with which it was affiliated. The first program was one for traditional individual life insurance policies (which can be made simpler than property insurance policies): in the five years to 2004, close to 300,000 individual life insurance policies were sold. Of these, some 120,000 were in existence at end of 2004, compared to a total of 3,000 policies in existence before the program was launched. Reportedly, the number of policies sold by this company in the five year period was more than the number of individual life insurance policies sold in all of Central America in the previous 20 years.

However, bank networks may not be entirely well suited to the distribution of mass insurance products. Banks may offer cost advantages mainly in collecting pre-determined amounts from established clients, rather than more generally. Alternative distribution network with low cost collection arrangements could be available to sell a product whose crucial ingredient is its simplicity. Indeed, various insurance companies in the region are developing mass insurance products that need not be distributed via bank branches. One independent insurance company that had successfully developed an mass product reported technical difficulties in using banks as a collection mechanism; it proved difficult, for example, to keep track of payments from policyholders who were not depositors at the collecting bank. It appears that a major reason that mass insurance products are often sold through banks is that banks are often affiliated with insurance companies.

Bancassurance, as well as any mass insurance distribution system, may raise regulatory concerns regarding the appropriateness of the information and advice provided to end users. The absence of a qualified salesperson (be it a broker or a trained insurance company employee) in a bank sales point may reduce the scope for informed choice by consumers. Yet the success of mass insurance products depends on low costs, and if more expensive conditions are imposed on the point of sale, they may effectively block the product. (This issue has a parallel with the question of when to allow sale of over-the-counter medicines rather than prescription drugs.) The question is whether the potential costs of “mistaken” choices by consumers is offset by the gains from making the service more cheaply available to larger number of consumers. In any case, regulations should consider new and future developments in order to determine the responsibilities and the scope for action of agents in activities related to insurance.

### **Box 2. Product Bundling**

In addition to bancassurance, understood as banks being used for the mass marketing of unbundled insurance products, banks throughout the region also sell bundled financial and insurance products. This is often the case of insurance tied to mortgage loans or automobile credits. The sale of bundled insurance products through banks may generate concerns over consumer protection, as it may lead to confusion on the part of the public with regard to both product pricing, and which entity is responsible for the insurance liabilities. This is especially problematic in the sale of insurance products tied to banking products offered by affiliated firms, which creates stronger incentives for uncompetitive practices that are hard to regulate. However, these kinds of uncompetitive practices generally depend on a pre-existing lack of competition in loan services, rather than being attributable to the offering of insurance services themselves. Informing the public and requiring the unbundling of the prices for the different services offered would likely improve consumer choices. This appears to be another area for regulatory improvement in some countries, in addition to the issues mentioned in Box 1 above.

Nonetheless, experience in the region suggests that it is not always easy to exploit “captive clients”: One insurance company reported that an attempt to integrate its customer base and that of an affiliated bank so as to sell both products to all clients was abandoned because the preferred customers for each product line were rather different. Hence, attempting to force bundled products on them threatened to alienate the better clients of both product lines.

Another issue that may be associated with product bundling and bancassurance is cross-subsidization between affiliated firms of a financial/business group. There appears to be evidence of this in some countries, with premia for affiliated firms apparently being higher than those for non-affiliated firms (this may be motivated by tax arbitrage). In one country, for example, an insurance company’s premia for mortgage-related policies sold through an affiliated bank more than doubled when authorities determined that insurance taxes were being avoided by setting artificially low insurance premia, which were compensated by high (untaxed) insurance sales commissions for the bank. However, the concern in these cases is not bancassurance itself but rather the broader issue of adequate regulation of business-financial groups.

103. In most countries, some type of coverage is available for a wide range of risks. Larger firms and better-off households reportedly can obtain most standard forms of insurance at competitive rates. Insurers are able to tailor contracts to special needs when the client is willing to pay a sufficiently high premium. However, total premium income from such business is small. From the available statistics, it appears that insurance of plant and equipment as opposed to buildings is still very limited. This reflects the weak industrial base of the region.

104. Public sector institutions often take out insurance for certain risks (for example, affecting government cars), but rarely for health coverage for government workers. In all countries, substantial public sector assets, such as roads and bridges, are not insured. Coupled with the lack of insurance of most of the private sector capital stock, this exposes the country to significant macroeconomic risks from large scale disasters, such as major hurricanes or earthquakes. The government’s implicit liabilities regarding disaster relief and reconstruction in the case of widespread destruction can also have serious fiscal consequences.

105. Crop insurance and other forms of agricultural insurance are rare and mostly newly introduced, despite the importance of the agricultural sector in the region and in particular in El Salvador, Guatemala, Honduras, and Nicaragua (Box 3). This deficiency has several causes. First, crop insurance is relatively complex and expensive to administer (even in industrialized countries) because: policies must be tailored to the product concerned and to such factors as projected weather and local geographical conditions; high monitoring costs result from the above and from large exposure to moral hazard;<sup>165</sup> and high loss rates are prevalent in the sector. These complications apply *a fortiori* in developing countries. Second, many farmers in the region are poor and undercapitalized, so transaction costs are high relative to potentially insured amounts. Note also that agricultural risk in undercapitalized countries tends to be higher because of the absence of agricultural infrastructure (such as dams and irrigation networks) which is largely aimed at reducing risks to agricultural output. Finally, in small countries, premia may have to be high because it is difficult for companies to diversify risk (for example, a drought may affect farming throughout the country).

### **Market structure**

106. Most insurance companies are locally owned, but subsidiaries of foreign companies operate throughout the region with the exception of Costa Rica (Table 4). The foreign parents are typically located outside the region and in particular in the United States, but there also exist a few local insurance groups active in several countries. Foreign entry is undertaken through subsidiaries rather than branches, with the latter forbidden in several countries. In all countries of the region, cross-border selling of insurance is prohibited under the insurance law, with exemptions only for products not offered locally. Another reason for opening a local subsidiary, as opposed to a branch, is that it can be difficult to enforce insurance contracts and effect dispute resolution between entities in different jurisdictions.<sup>166</sup>

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<sup>165</sup> It is difficult to distinguish whether a low harvest is due to exogenous growing conditions or due to the farmer's neglect.

<sup>166</sup> This chapter does not look further into differences among non-insurance legislation and judicial systems. Analogous differences exist in other regions: reportedly, large European insurance groups generally find it easier to operate through separate subsidiaries in European Union member countries rather than sell insurance products across borders or through branches abroad.

### **Box 3. Crop Insurance Initiatives**

Existing crop insurance schemes in almost all cases are derived from insurance requirements tied to bank loans, with the loan funding typically offered by state development banks. Hence, most crop insurance schemes are not wholly voluntary and appear to have some element of subsidy in the financing conditions, although no subsidy is provided directly to the insurance premia.

In El Salvador, the crop insurance scheme promoted by the Banco Multilateral de Inversiones (BMI) resulted in the insurance of 3,000 hectares of cotton in 2004, with premia of 5 to 6 percent of the loan amount. This appears affordable in the context of scarce and/or expensive agricultural credit, and the premia appear roughly in line with the overall cost of subsidized crop insurance in Mexico. The program expects to increase coverage to 8,000 hectares of cotton in 2005, under similar conditions as before. Some farmers with other crops have begun to require the service directly, without being tied to a specific financing scheme. The insurance is calculated to cover the equivalent of 70 percent of normal crop yields. Approximately 75 percent of the risk is reinsured abroad. The program required extensive research and preparatory work by the insurance company which was chosen to manage the program as a result of a contest (among local insurers) organized by the BMI. The program benefited from the experience in crop insurance in other countries, including expert assistance for the supervisor for the approval of the novel policy, and the BMI provided partial financing of the international consulting services needed for the preparation of the program. Note, however, that the insurance covers only weather-related losses in crop yields and not losses related to pests or other causes.

Other private sector crop insurance schemes are currently being pursued in most countries in the region, with varying degrees of success. The experience so far in the region indicates that the service takes some time to be developed on a sound basis and to be understood by farmers: a crop insurance program that was admittedly rushed into beginning operations two years ago in another country has had serious difficulties, with a substantial decrease in the amount of crop land covered and with losses for the insurance company that initiated the program. A number of private insurance companies (including at least one with extensive related experience in a country neighboring the region) appear to be planning to develop the product line.

107. The insurance sector in most of the region is highly fragmented, and therefore the average company is of small size. As of 2003, the average company in El Salvador received the equivalent of just US\$17 million per year in gross premia. Costa Rica, with its monopoly provider, is an exception. The insurance sector in Nicaragua is also relatively concentrated because a state monopoly existed there until 1997; the former monopolist has been slowly losing market share but still makes up about one half of the sector.

108. The fragmentation is conducive to competition. It appears that most property product lines are offered under reasonably competitive conditions in most of the region. This thesis is supported by data on falling premia and high loss-rates. Nonetheless, premia tend to be somewhat high in international comparisons, but this may be due mainly to higher non-diversifiable risks associated with the region as well as the higher average costs of operating on a smaller scale and with smaller insured amounts. However, markets are sufficiently flexible that fire premia (which include earthquake risks) are lower in Honduras, where there is no substantial earthquake risk, and auto premia are lower in Nicaragua, where auto theft risk is relatively low.

109. These numerous small companies almost certainly operate at well below efficient size, especially since most if not all of them operate as a traditional insurance company with traditional procedures.<sup>167</sup> In many cases their revenues are insufficient to support the employment of their own actuary or the development of a fully computerized system of record keeping, data analysis, and claims processing. Their investment portfolios may also be too small to achieve full diversification.

110. The concentration ratio has remained fairly stable in most countries over the past years and, on average, the top six firms account for about 70 percent of the market. While high in absolute terms, this concentration ratio is not unusual in international comparisons. The number of insurance companies has been relatively stable (except for growth in Nicaragua since the market was opened to the private sector in 1996); some companies have exited, but others have entered.

111. The available statistics may overstate the fragmentation problem to an extent because, in most countries, many insurance companies form groups with each other and perhaps with banks (for example, a bank might have one life insurance subsidiary and one non-life insurance subsidiary), and the group as a whole might provide certain “back-office” functions. Some companies, for example in Nicaragua, are subsidiaries of larger foreign insurers from the region or from industrialized countries.

112. Insofar as insurance companies are attached to financial groups that have a strategy of offering a full range of products, the lack of consolidation is not surprising. Some insurance companies may be linked to broader industrial-financial conglomerates, which prefer to keep insurance in-house and which may be able to benefit from regulatory or fiscal arbitrage.<sup>168</sup> In addition, it is widely believed that consolidation is being held up also by the desire of managers and major shareholders to preserve their independence. Industrial-financial groups will have to decide to break up for there to be significant additional consolidation in the insurance sector of several of the countries.<sup>169</sup>

113. The close and in some cases growing links between insurance companies and banks presents a number of regulatory concerns. Another chapter in the FSRP addresses the regulation and supervision of financial conglomerates. Nevertheless, it is worthwhile to note that affiliated insurance companies are generally smaller than their related banks, and that

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<sup>167</sup> Academic studies suggest that for American insurance companies, economies of scale prevail in companies with premium income up to at least US\$500 million per year.

<sup>168</sup> For example, if marginal tax rates differ by sector and level of profits, a conglomerate can adjust transfer pricing in order to minimize taxation. Operating as a conglomerate might also be advantageous because that structure might effectively loosen constraints on connected lending.

<sup>169</sup> Possible obstacles to the breakup of industrial-financial groups include: (i) the lack of liquid capital markets that make it hard to price assets, and hence difficult to agree on terms of sale for companies (and may induce non-market diversification of wealth); and (ii) the relatively small scale (by international standards) of the industrial-financial groups themselves, which allows economies of scale in top management to offset the costs of centralized control of disparate businesses.

often the insurance company has had significant exposure to the bank's risk (largely from assets placed with the bank).<sup>170</sup> The opposite is typically not true, as affiliated insurance companies typically account for only a small part of bank deposits. However, the growth of bancassurance may lead to increased exposure of banks to the activities of their affiliated insurance companies, to the extent that their profitability may in time depend increasingly on insurance.

114. Insurance companies use a variety of means to distribute their products. Besides using their own offices, a network of independent agents operates in all countries. Independent agents take the form of both individual brokers and brokerage firms and in all countries they intermediate a substantial percentage of policies. The importance of brokers in distribution varies significantly across countries, although exact figures are not available: in Panama brokers reportedly generate over 90 percent of premia, while in El Salvador they generate less than half of all premia. Bancassurance is growing in importance in most countries (Box 1 above). In some countries, such as El Salvador and Honduras a significant part of bank profits are reportedly derived from their sale of insurance products.

115. Specialized reinsurance companies are found only in Panama. Companies in other countries are too small to achieve the risk diversification inherent in reinsurance. Instead, heavy use is made of reinsurance from the large international reinsurers, although the relatively small Panamanian re-insurers (both specialized reinsurance companies and insurance companies authorized to also perform reinsurance services) also accept risks in the region. The incentive to cede premia to reinsurers is greater for companies with low capitalization, and is reinforced by certain regulatory provisions (see below). Reinsurance is especially favored for product lines for which it is difficult to diversify risks domestically and for which monitoring costs are lower. Thus, companies retain a higher proportion of premia for auto insurance, where the large number of policies, their smaller value and the nature of the risks ensure that loss rates are relatively stable and administrative expenses high, than for other property insurance and especially catastrophe risk. At the other end of the spectrum are specialized high value products such as airline insurance, where there is essentially no local retention and reinsurance is handled through a small number of specialized foreign companies.

### **Recent performance**

116. Most indicators for the soundness and performance of insurance companies in Central America display stability and do not raise immediate, systemic concerns. There have been no major failures in recent years, despite the occasional failure of small companies. In at least one case, the failure of an insurance company was the direct result of substandard reinsurance contracts, and in another case, an insurance company failed because of the

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<sup>170</sup> Regulations regarding insurance company portfolio diversification vary greatly within the region. Some countries have in some regards strong diversification requirements, especially with respect to affiliated firms, while others do not.

collapse of its affiliated bank. In cases of failures, insurance policies have typically been transferred to other insurance companies along with associated assets to constitute reserves.<sup>171</sup> However, the last decade has witnessed a few cases of more disorderly closure, where policies have not been honored, for example, because of delays in court resolution of disputes or because the affected company did not have enough remaining assets.

117. Soundness indicators such as profitability rates, leverage and liquidity ratios appear generally adequate for sectors as a whole, although in most countries there are some firms that appear less healthy (Table 2). The absolute level of capitalization of most firms is low and tends to be proportional to the size of the market. Average loss ratios (the ratio of payouts on claims to premium income) are in line with, or sometimes above, those found in other comparable markets. Since loss ratios are considered to be indicative of the degree of market competition, these indicators support the reported high level of competition in most product lines.

118. Recent experience with heavy losses from both Hurricane Mitch in several countries (especially Honduras) and two earthquakes in El Salvador in 2001 indicates that, in the affected countries, the insurance sector as a whole was prepared to cover its liabilities, largely because it was extensively reinsured.<sup>172</sup> In the case of the Salvadoran earthquakes, some \$300 million in losses were paid for by local insurers, but the net cost for the local companies was less than \$5 million. All market participants agreed that most claims were settled rapidly, which helped reduce the overall cost of the earthquake damages. However, as is discussed further below, the low penetration of insurance services also resulted in substantial losses being absorbed by producers and families, with some of those losses transferred to governments.

119. Companies' investment portfolios are typically not very diversified, at least by type of investment. This appears to be largely the result of underdeveloped capital markets with few investment options; diversification by asset type is greater in Panama, where the capital market is most developed, although portfolio concentration with related parties is in some cases significant. Honduras applies stringent portfolio diversification regulations with regard to both asset types and private sector issuers (especially for related parties and for foreign investments), but there is no limit to portfolio concentration in government securities. Most companies place most assets in bank accounts or, in some cases, in securities issued by their respective national governments. Real estate, direct lending, and equity are also significant investments for companies in some countries. Investment abroad is modest and in all countries is severely constrained by regulations. Partly due to regulatory reasons, investments related to non-life business, which has a short time horizon, are held mostly in relatively liquid assets to match companies' liabilities (i.e., their reserves against potential insurance

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<sup>171</sup> Insurance legislation generally includes various provisions for intervening in and winding up companies in distress.

<sup>172</sup> Note, however, that, in Honduras, Hurricane Mitch led to the failure of an insurance company which had substandard reinsurance contracts.



claims and other risks). In this case, the available investments may be broadly adequate, although real returns may be fairly low, especially for small companies that lack the volume and sophistication to engage in active portfolio management or bargain with banks to obtain a good return on deposits. The latter is especially true when dealing with banks that are affiliated with (smaller) insurance companies. For non-term life business, companies are often severely constrained by the lack of securities with a maturity approaching that of liabilities to policy-holders.

120. Until at least the 1990s, the majority of the insurance sector in all countries had antiquated back offices that led to slow service both in issuing policies and paying claims. Information for adequate management decisions was poor, leading to poorly-managed risk taking. Administrative costs and issuing costs were high. Largely due to the deficiencies of insurance companies, brokers established a very strong position in most insurance markets, often taking over some functions that were typically performed by the insurance companies.

121. In all countries, to varying degrees, the past few years have seen a significant improvement in the operations of at least the leading companies, largely as a result of the use of more modern information systems. In the case of Nicaragua, the elimination of the state monopoly in 1997 allowed private companies to start from scratch and build up relatively modern systems, despite operating in the smallest market in the region. Improved operations and information should lower costs and improve products, allowing for greater market penetration. As an example, a company in El Salvador used its improved information system to track and control costs in such a way that it could introduce a new automobile insurance product that attracted new clients by offering no deductible at no additional cost.

122. Several caveats must be made with relation to these indicators of performance. On the one hand, insurance companies have significant scope (perhaps more than banks) to smooth results from year to year.<sup>173</sup> On the other, the insurance business is inherently vulnerable to rare but large risks; performance can be satisfactory for many years, but the true soundness of the system is often apparent only when a major event such as an earthquake tests the capital adequacy of the sector. While some countries in the region have weathered “stress tests” rather successfully, not all have. As mentioned above, the stress test of Hurricane Mitch in Honduras revealed that regulatory standards for reinsurance contracts were inadequate, and that it was the sound business practices of most insurers (and not regulatory controls) that allowed them to cope with the event. It is also interesting to note that El Salvador and Honduras, the two countries that in the recent past have suffered the greatest losses from natural disasters, were motivated to update their regulatory frameworks. These considerations reinforce the importance of reviewing the regulatory framework.

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<sup>173</sup> Insurance companies typically have some discretion in determining the appropriate level of reserves against various risk factors and allocating losses across reserves and capital.

### **C. The Legal and Regulatory Framework**

123. No detailed assessments of observance of the International Association of Insurance Supervisors' Core Principles were available, but several countries in the region have performed self-assessments. Most supervisory institutions publish extensive material on their activities and the regulations in force. These materials were the basis for the summary contained here (Table 5).

124. In El Salvador, Guatemala, Honduras, and Nicaragua, supervision is carried out by a section of the financial sector supervisor. In some cases, insurance supervision is not integrated as a unit, and some insurance specific responsibilities (in one case including the review and approval of insurance policies) are assigned to non-specialized units within the overall financial sector supervisor. This may lead to significant coordination issues. In addition, in some cases, reorganization and reassignment of responsibilities for insurance regulation and supervision has affected effectiveness. Panama has a separate insurance superintendency that reports to the Ministry of Commerce and Industry. In Costa Rica, the state monopoly insurance company reports directly to the executive and is not subject to formalized prudential or other regulation and supervision beyond provisions of the insurance law and general legal principles.

125. The supervisors generally monitor the condition of their insurance industries closely, and are aware of regulatory developments elsewhere. However, in several countries the supervisors acknowledge that they lack the budgetary resources to retain as many well-trained staff as they would prefer. In addition, in some countries, detailed and inflexible laws that may be outdated limit the supervisor's ability to respond to perceived problems (see below). Insurance supervisors have available several venues for international cooperation, such as bilateral contacts, the Central American Council of Financial Sector Supervisors, and the Latin American Association of Insurance Supervisors. In some countries, international cooperation is a very important source of resources for training.

126. All countries have a law on insurance. The Honduran law was substantially amended in 2001 and the supervisor is currently working on some minor legislative revisions. The supervisor in El Salvador is planning changes aimed at establishing risk based reserve regulations and some other modest revisions to the 1997 law. Panama and Guatemala are preparing substantially new insurance laws that are expected to be discussed in their respective Congresses during the course of 2005. It appears that the proposed legislation would only partially move in the direction of risk based regulation. In Nicaragua, the regulator expects significant revisions to the 1997 legislation, also aimed at establishing risk-based reserve regulations, but only in the medium term.

127. Existing laws sometimes specify prudential and other provisions in detail, which can be problematic when they have not been amended to keep up with developments in insurance practice. Supervisors and market participants are generally aware that certain legal provisions are inappropriate, but enacting the necessary amendments is not high on the legislative

agenda.<sup>174</sup> Many firms choose to establish internal financial policies that are much stricter required by regulations.

128. Largely because of the provisions in insurance laws, certain common features can be identified in the regulations of many (if not always all) of the countries of the region:

- Minimum required technical reserves (also called provisions) for non-life policies are defined as a proportion of premia net of the amount ceded to reinsurers, rather than related to the actuarial value of expected losses. This approach may be administratively convenient, and would not be problematic if premia were always set as a known proportion of risks borne. Indeed, in most countries, a company must receive approval from the supervisor for the terms attached to any new product; approval is contingent on proof that (initial) premia are set at or above an actuarially appropriate level. However, this condition need not obtain over time because required reserves are related to a company's pricing policy, which may vary depending on such factors as the degree of competition in various product lines, administrative expenses, the current return on assets, and level of the company's capitalization. Furthermore, the factor of proportionality linking net premia to minimum reserves is defined in law and is often the same across a broad range of products, yet the risk characteristics of products may differ; thorough studies are not available on the determinants of appropriate proportionality factors; and the various countries use different factors for no apparent reason. Furthermore, this specification of minimum reserves may create an incentive for companies to increase risk by competing via lower premia, because that way they both gain market share and reduce the expense of holding reserves.<sup>175</sup> If the proportionality factor is too high, the affected products will be needlessly expensive.
- On a related point, the treatment of insurance premia ceded to reinsurers does not differentiate sufficiently depending on the specifics of the reinsurance contract. Reinsurance might be ceded on more or less tight conditions, so that the reinsurer has more or less scope to limit or contest reinsurance payouts to the primary insurer in case of loss. If the regulations do not allow for this possibility yet required reserves are related to net premia or retained risks, primary insurers have a short term incentive to reinsure as cheaply as possible while also reducing the expense of holding reserves. Hence, the effective level of reserves against true retained risk

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<sup>174</sup> The legislatures in some Central American countries are characterized by weak party discipline, so on occasion it has proven difficult to pass even technical laws without delay or substantial amendment.

<sup>175</sup> To illustrate the issues, suppose that a company underwrites a risk on a project; losses are normally distributed with mean 100 and a standard deviation of 10. If the authorities wish to ensure that the company can meet payouts without resorting to its capital 95 percent of the time, the company should be required to hold premia and reserves of 120. If required reserves are set at 20 percent of premia and premia are 100, the objective is achieved. However, the company would under-provision if it set the premium at 90 (when reserves would be only 18), or if the minimum reserve to premium ratio is fixed at 10 percent.

might be less than the supervisor intended. The regulation of reinsurance risk (that is, the risk that, for whatever reason, the reinsurer will not cover all the ceded risk) is especially important given companies' heavy reliance on reinsurance.

- Most countries also require companies to establish reserves against a standard range of risk factors, such as those connected with non-accrued premia, unpaid or unreported claims, uncertainty over the actuarial model used in setting policy rates, and the possibility of unusually large correlated losses (“outliers” in statistical parlance or “catastrophe risk” in insurance parlance). Some countries have slightly less comprehensive regulations in these areas and, as in the case of technical provisions, the reserve requirements vary across countries, often without thorough studies to establish the appropriate level of required reserves.
- All countries establish solvency requirements (“solvency margins”), which set a minimum level of overall reserves and capital, based on complex calculations that depend, among other things, on gross and retained premia, current and past gross and retained claims and the composition of the insurance portfolio. Numerical parameters, presumably based on international and historical experience with event risks, are also part of the calculations and were uniform in some countries. No supervisor had a study that supported the parameters used nor the specific calculations, although they indicated that similar practices appear to exist in other countries outside of the region. A few supervisors indicated that the minimum solvency requirements appeared to be too low. In some countries, (private) insurance firms have capital and reserve levels that are a multiple of regulatory requirements. In Panama and Guatemala, the insurance sectors have five times and three times the required level of capital and reserves. This would indicate that required capital and reserves are too low.
- Insurance laws also set an absolute minimum capital requirement, which is somewhat low in some countries and for some business lines.<sup>176</sup> The requirement is set in local currency, which erodes in real terms over time due to inflation, although some countries have a mechanism for regularly revising and maintaining the capital requirement level in real terms. A low minimum capital requirement permits very small firms to survive, but also facilitates entry. It can be argued that higher capital requirements would help consolidation of the insurance sector, but it is not clear what the costs would be in terms of barriers to entry, especially if one considers the potential for the development of small scale insurance schemes aimed at the lower income population.
- Investment by insurance companies is restricted in various ways. While many of these restrictions are motivated mainly by concern to preserve the solvency and

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<sup>176</sup> In the United States, where insurance is regulated by the states, the typical minimum absolute capital requirements for property insurance companies are about the same as in Central America, but minimum requirements for certain products and in particular for life business tend to be somewhat higher.

liquidity of the companies, some may be counter-productive or inefficient. Certain restrictions strongly favor investment in securities issued by the national government, rather than a full range of domestic investments. In all countries, regulations specify authorized investments, and most countries establish maximum exposure limits to specific issuers and to specific securities, while others have no such requirements. Typically, when specifying exposure limits to issuers, no differentiation is made according to differences in the riskiness of issuers or of investments within one category. In some countries, this can result in measures aimed at diversification forcing insurers into poor quality investments. Given the prevalence of insurance companies affiliated with financial-business groups, most (but not all) countries also have regulations on exposure to related parties.

- Additionally, in all countries, investment abroad is severely limited and in some countries returns on foreign investment are taxed much more heavily than returns on domestic investments. In at least one country, limits on exposure to a single issuer are applied separately to domestic and foreign investments, creating a further restriction for foreign investment.<sup>177</sup> Given the limited size and development of regional capital markets, restrictions on foreign investment seriously limit investment choices and significantly increase risk by limiting diversification. While developmental/nationalistic arguments are made to support restrictions on foreign investment by insurance firms, all the countries in the region have reasonably open capital accounts. Hence, any restriction on insurance sector investment has scant macro impact since the local recipients of said investment can normally invest the funds abroad with few if any restrictions. The only result is that policy holders bear additional risk and potentially lower returns.
- Investments related to non-life reserves typically have significant liquidity requirements in order to assure that funds are available to pay claims without insurers having to resort to potentially high costs of selling illiquid assets. However, an adequately capitalized and solvent insurer should be able to access liquidity in the market without incurring these liquidation costs. Since liquidity requirements can significantly erode returns on investments, regulators should be careful not to overemphasize the importance of liquidity when setting investment regulations.
- The interaction of underdeveloped capital markets and investment regulations limits the investment options available to insurance firms. Hence, it may be expensive for companies to diversify their portfolios, obtain adequate risk adjusted returns and match their portfolios to their underwriting risks to the degree that would be desirable.

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<sup>177</sup> Suppose that regulations state that at most 25 percent of the total portfolio can be invested abroad, and at most 10 percent of investments can be placed with any one issuer. If the large exposure limit is applied just to the foreign component, effectively only 2.5 percent of investments can be placed with any one foreign issuer.

- Entry by foreign firms is generally permitted, subject to standard licensing procedures (except in Costa Rica). However, there are restrictions on the form in which a company can be incorporated, and in particular in several countries a foreign entrant must establish a locally-incorporated subsidiary, rather than open a branch. All countries prohibit the purchase of insurance from abroad, with some countries making exceptions for the case of products that cannot be offered by local insurers. The requirement to insure through domestic authorized firms leads to the widespread practice of “fronting,” whereby local firms will nominally carry insurance that is in reality offered by a foreign insurer. This is most common in the case of multinational firms.<sup>178</sup>
- Premia and other contract conditions are generally free of restrictions, except that they must be approved by the supervisor when a new product is introduced. Some regulators may enforce compliance with minimum premium levels determined on an actuarial basis when policies are originally authorized, but other regulators have no mechanism to assure compliance once policies are authorized. Laws relating to free competition and pricing may limit any attempts to enforce actuarially sound premium levels. In most countries minimum (or minimum average) premium levels are often imposed by reinsurers as part of proportional reinsurance contracts. To the extent that proportional reinsurance is replaced by excess loss contracts, reinsurers do not impose minimum premia; in some cases this has led to increased price competition among insurers.
- In most countries, presumably because of the recent nature of the service, specific regulations regarding bancassurance are weak. As discussed above, when banks sell insurance products through their branches, the scope for bundling financial products—such as a loan with an insurance requirement—gives rise to potential issues of consumer protection and the definition of fiduciary responsibilities.<sup>179</sup>
- Regulations in all countries cover the licensing and authorized activities of insurance agents and brokers, although the specific regulations vary significantly. In some countries, regulators have encountered significant problems when trying to impose qualifications for broker licenses.
- Few countries have extensive requirements on companies to prepare and publish regular reports on their actuarial situation (Nicaragua is an exception), although some countries require an actuarial review of reserves as part of an annual external audit of financial statements. Regulations and supervision of information management systems, computer systems, and other forms of operational risk are very limited. The

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<sup>178</sup> The countries of the region have subscribed to the Central American Free Trade Agreement with the United States. When this comes into force, entry and the availability of insurance from abroad will be liberalized.

<sup>179</sup> Another chapter in the FSRP addresses the regulation and supervision of financial conglomerates.

lack of requirements in these areas, where effective systems are characterized by high fixed cost, helps smaller companies to survive.

- Domestic reinsurers exist only in Panama, which has a reinsurance law, but throughout the region companies are heavy users of foreign reinsurance. In most countries, reinsurance contracts can be established only with reinsurers that meet minimum ratings set by international ratings agencies, and in some cases reinsurers must also provide the supervisor with basic and updated information in order to be authorized to sell reinsurance to local companies. Supervisors often establish contact with the regulators of the home countries of the reinsurers to assure their good standing. In most countries, reinsurance plans must be presented to and approved by the supervisor.
- The tax treatment of insurance differs across countries. In some, but not all countries, premia for life insurance and certain other categories of insurance are deductible from income tax. Sometimes certain insurance expenses are exempt from sales tax or value added taxes. The tax treatment of insurance payouts also varies.

#### **D. Insurance Sector Development and Regional Issues**

129. The insurance sector in Central America is developing, and the private sector is taking the lead. Some important initiatives are under way, for example, in the mass marketing of products and the provision of crop insurance. Nonetheless, the authorities, in individual countries and in the region as a whole, have scope to accelerate the process.

##### **Fostering insurance sector development**

130. Modernizing the regulatory framework and supervisory practices will contribute to the sound development of the insurance sector. The authorities hope to move towards a more risk-based approach to regulation and supervision, with a greater role played by actuarial calculation of risks. In particular, technical reserves need to be related to expected value of losses, their variance and covariances, and other risks (such as reinsurance risk and “catastrophe” risk). Also, companies need more scope to manage their portfolios to match underwriting risks. Many measures needed for prudential purposes, such as introducing more risk-based reserve requirements, and mandating the production of actuarial reports and the introduction of modern information management systems, would likely impact more on smaller companies, and could spur consolidation.

131. While the regulatory and supervisory framework can be improved, it will be important to allow room for less sophisticated products aimed at providing basic coverage at low cost. Regulatory principles that by and large have been developed for more sophisticated markets may limit some potential avenues for growth in countries where insurance markets are at an early stage of development.

132. Besides these regulatory issues, the authorities may have a role in providing other supporting services. For example, direct subsidies or administrative support for crop

insurance could be worthwhile.<sup>180</sup> Any subsidy would have to be made transparent in the budget and consistent with fiscal sustainability, perhaps by being offset by a reduction in other agricultural subsidies. Furthermore, the cost-benefit ratio would probably be most advantageous if any subsidies were temporary and directed to covering start-up costs. Administrative support might take the form of some type of centralized information processing and provision, possibly government organized, to reduce the substantial start-up costs of crop insurance services.<sup>181</sup> Financing the dissemination of international experience in agricultural insurance can also help reduce the costs of developing agricultural insurance schemes. Insofar as farmers are poor, there may be distributional reasons for these types of support. Moreover, the availability of crop insurance may yield a payoff in terms of greater provision of credit to the agricultural sector (helping to break the vicious cycle that limits the capitalization of the sector), yet be held back by fixed costs that are high relative to the capitalization of the sector; government action may be needed to overcome this threshold to establishing a market and achieving critical mass.<sup>182</sup>

133. Governments could also contribute to the development of the insurance sector by insuring more of their own risks instead of relying on implicit self-insurance.<sup>183</sup> Greater insurance volumes by the government could help in creating critical mass and economies of scale for the sector. Note that increased demand for insurance by the government is unlikely to pressure prices (in part because the products would be specialized), nor would it necessarily lead to crowding out. Adequately insuring important assets such as roads and bridges, among other infrastructure, could add to explicit planned expenses, but would also allow for an improved budgetary process and less need for costly last minute reallocations of budget revenues to attend unforeseen reconstruction expenses and other losses.

134. Another potential area for government action is catastrophe insurance; action in this area could be linked to efforts to stabilize government expenses as described in the previous paragraph. A large number of private sector assets are uninsured and the potential losses from a large event, such as an earthquake, can create a negative macro shock that significantly disrupts economic activity and multiplies the direct losses from the event. To the extent that governments typically assume some responsibility for disaster recovery and

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<sup>180</sup> Mexico, among other countries has a program of direct subsidy to agricultural insurance, by which between 30 percent and 45 percent of insurance premia for a wide number of crops are paid by the government.

<sup>181</sup> The firm in El Salvador that launched agricultural insurance reported that collecting existing but unpublished data mostly from public sector institutions constituted one of the more complicated and time consuming tasks in the preparation of its program.

<sup>182</sup> Many factors, including land titling and a history of political interference, contribute to agricultural under-capitalization and the scarcity of agricultural credit. However, crop insurance services themselves are relatively simple contracts in terms of legal principles and ownership, as they apply to a single crop cycle and tend to be paid in advance.

<sup>183</sup> Governments in other some countries take out insurance for major installations. In Bahrain, for example, premiums on government-owned infrastructure such as petroleum facilities accounts for about half of all non-motor property insurance.



reconstruction in the case of catastrophes, there is an implicit public sector liability exists. Recognizing these potential liabilities and dealing with them through appropriate insurance contracts is likely to reduce the associated costs.<sup>184</sup> Given international experience and the size of the Central America economies relative to the world insurance and reinsurance industry, a variety of approaches would be feasible. Hence, a number of issues must be considered when designing these insurance contracts.

- Given the social desirability of providing for catastrophes through insurance, should the costs of the insurance be financed through mandatory insurance, as is the case with similar programs such as pension schemes, or should financing come out of general government revenue?<sup>185</sup> In this connection, should operations be managed by one or more private companies, with the government acting as regulator, or should the government play a more direct role?
- Given that high administrative costs constitute a major reason why insurance coverage is currently low, any insurance scheme (mandatory or not) must focus on minimizing the costs of implementation.<sup>186</sup> This would likely entail the use of existing mechanisms and non-insurance distribution systems for identification of potential program clients as well as for access, collection (if necessary) and potential payments.
- The insurance scheme should aim to provide for rapid relief, to minimize both the direct macro shock occasioned by a catastrophe as well as the added costs of delaying relief and reconstruction. There will generally be a trade-off between precise targeting of the relief and the speed and administrative expense of providing the relief; assessing and verifying individuals' losses is time consuming and often relatively expensive.
- The insurance scheme should aim to create incentives for economic agents to reduce risk through individual decision making, for example, on where and how to build housing. Again, there will generally be a trade-off between how sophisticated the insurance scheme is and the expense of administering it.

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<sup>184</sup> There are initiatives to develop catastrophe insurance under way in several individual countries of the region, with the assistance of the World Bank, the Inter-American Development Bank, and the International Finance Corporation.

<sup>185</sup> Turkey has introduced mandatory earthquake insurance where premia are paid by home owners. Iceland imposes a special levy to pay for a reserve fund dedicated to meeting costs associated with natural disasters.

<sup>186</sup> Traditional insurance services typically cost several times the underlying "technical" cost of the risk because of the costs associated with marketing, identifying and valuing the insured asset, processing the policy, monitoring the risk, placing the reinsurance, identifying and valuing losses, processing claims, and paying out the proceeds.

135. Governments could also reduce the losses from various risks, including catastrophes, by enacting and/or enforcing appropriate regulations, such as building codes or zoning restrictions. Reducing losses would lead to lower insurance and reinsurance costs and hence help expand insurance services. In addition existing insurance schemes in some countries, such as those for automobile TLP, could be better enforced to further expand the market.

### **Regional issues**

136. It is likely that economies of scale in insurance activity could be better exploited on a regional basis, and that the countries could learn from each others' experience. One set of measures available to the authorities would be directed at the harmonization and mutual recognition of regulations, in line with international best practice. The authorities could coordinate the introduction of risk-based regulations, and eventually there could be a presumption that a company satisfying the regulatory requirements of one jurisdiction would be free to offer insurance products and to open a branch or subsidiary in another country of the region.<sup>187</sup> In this way, competition could be preserved even as the sector consolidates within individual countries. This type of effort appears particularly relevant given the expected results of the Central America Free Trade Agreement (CAFTA) with the US and other possible trade liberalization negotiations.<sup>188</sup>

137. Regional efforts could be worthwhile in other areas, including: (a) the collection and dissemination of demographic, meteorological, agronomic, and other statistics needed for actuarial calculations that underlie insurance pricing, notably but not exclusively in relation to crop insurance; and (b) joint development of catastrophe insurance programs, especially where geographic or climatic regions with similar risk characteristics extend across border.

### **E. Conclusions**

138. The insurance sector is small and fragmented in most of Central America, and much of the population has scarcely any insurance cover despite their exposure a range of natural and other risks. Yet, the sector has the potential to contribute much more to financial deepening and economic development. Some recent initiatives, for example in the areas of crop insurance and the mass marketing of certain products, are promising. The financial situation of the insurance companies is generally satisfactory, the macroeconomic environment is relatively benign, and countries of the region have committed themselves to

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<sup>187</sup> Foreign (extra-regional) reinsurers currently operate under similar conditions to that proposed here for regional insurers. In effect, regulation by their home country supervisor, plus some simple registration and information requirements (and minimum risk classification), are deemed sufficient for them to offer (re)insurance services in the region.

<sup>188</sup> CAFTA contains provisions requiring home-country treatment of insurers from all signatory countries, so that entry will be restricted only by non-discriminatory prudential requirements. Therefore, the insurance monopoly in Costa Rica will be dismantled after a phase-in period. Insurance companies in all countries may face more competition from larger US companies.

intensified regional integration, for example, through free trade agreements. Hence, conditions are favorable for measures to promote the sector.

139. The regulatory and supervisory regime governing the insurance sector needs to be modernized, primarily by moving towards a risk-based approach. For example, the provisions that a company must make need to be related to a fair valuation of the risks that it retains, and companies need to improve risk management techniques by developing the requisite systems for information collection and analysis. The relaxation of non-prudential limitations on the allocation of companies' investments could enhance both the functioning of regional capital markets and the soundness of the companies. Liberalization of trade in insurance products could ensure that competition remains effective even if national industries consolidate.

140. Governments can play a more direct role in expanding the availability of insurance coverage. Crop insurance schemes may yield a range of benefits, including improved access to credit for the agricultural sector. Governments could insure more of their own assets, which would not increase the scale of the insurance market but also contribute to fiscal management. In recognition of the region's vulnerability to natural disasters, consideration could also be given to introducing compulsory catastrophe insurance, with premia paid by private parties.

Table 1. Central America: Financial Situation of the Insurance Sector

	Costa Rica		El Salvador		Guatemala		Honduras		Nicaragua		Panama	
	2000	2003	2000	2003	2000	2003	2000	2003	2000	2003	2000	2003
	(In millions of US dollars)											
Gross premia	314	318	230	350	274	344	157	185	50	57	368	393
of which: non-life premia	277	290	182	303	233	295	125	151	...	50	254	267
Net retained premia	235	...	96	140	129	163	69	65	34	33	258	251
Gross damages payments	171	...	122	133	100	89	71	64	21	22	191	138
Profits (after tax)	...	...	17	27	11	21	6	21	3	2	...	30
Total assets	776	...	249	347	228	306	203	263	67	77	689	704
Investments	...	...	159	227	141	201	85	162	38	40	423	479
Technical reserves	422	...	91	123	155	134	101	131	39	48	261	305
Capital and general reserves	208	...	78	129	56	90	41	83	17	15	0	261
Paid-in equity	...	...	54	70	24	32	...	40	9	10	...	...
	(In percent of GDP)											
Gross premia	2.0	1.9	1.8	2.3	1.4	1.4	2.7	2.7	1.3	1.4	3.2	3.1
of which: non-life premia	1.8	1.7	1.4	2.0	1.2	1.2	2.1	2.2	...	1.3	2.2	2.1
Net retained premia	1.5	...	0.7	0.9	0.7	0.7	1.2	1.0	0.9	0.8	2.2	1.9
Gross damages payments	1.1	...	0.9	0.9	0.5	0.4	1.2	0.9	0.5	0.6	1.6	1.1
Profits (after tax)	...	...	0.1	0.2	0.1	0.1	0.1	0.3	0.1	0.1	...	0.2
Total assets	5.0	...	1.9	2.3	1.2	1.3	3.4	3.9	1.8	1.9	5.9	5.5
Investments	...	...	1.2	1.5	0.7	0.8	1.4	2.4	1.0	1.0	3.6	3.7
Technical reserves	2.7	...	0.7	0.8	0.8	0.5	1.7	1.9	1.0	1.2	2.2	2.4
Capital and general reserves	1.3	...	0.6	0.9	0.3	0.4	0.7	1.2	0.4	0.4	0.0	2.0
Paid-in equity	...	...	0.4	0.5	0.1	0.1	...	0.6	0.2	0.2	...	...
Assets/M2 (in percent)	13.7	...	4.1	5.6	4.2	3.8	7.1	7.0	4.5	4.6	8.0	7.2

Sources: National authorities, and staff estimates.

Table 2. Central America: Insurance Sector Indicators  
(In percent)

	Costa Rica		El Salvador		Guatemala		Honduras		Nicaragua		Panama	
	2000	2003	2000	2003	2000	2003	2000	2003	2000	2003	2000	2003
Non-life premia/total premia	88.2	91.2	79.4	86.5	85.0	85.6	79.3	82.0	...	87.8	69.1	67.8
Automobile/total non-life premia	...	...	25.9	18.3	43.3	35.6	23.7	22.2	...	29.9	36.4	26.4
Property/total non-life premia	69.1	...	22.2	29.8	19.9	27.8	21.4	27.8	...	25.7	13.8	17.6
Health/total non-life premia	...	...	13.8	11.6	13.6	15.6	13.5	17.1	...	10.9	21.2	22.2
Retained premia/gross premia	74.7	...	41.8	39.9	47.0	47.3	44.0	35.0	67.7	56.9	70.0	63.8
Damages payments/premia	54.5	...	53.2	37.9	36.6	25.8	45.3	34.6	41.8	38.6	51.9	35.2
Damages payments/reserves	40.5	...	134.0	107.4	64.8	66.2	70.5	48.6	53.6	46.0	73.2	45.3
Reserves/retained premia	179.9	...	94.8	88.4	120.1	82.5	146.1	203.3	115.0	147.6	101.3	121.7
Investments/reserves	...	...	174.5	183.9	91.1	150.0	84.0	123.6	98.6	83.6	162.0	156.9
Share of investments												
Claims on government	...	...	10.1	13.5	43.1	38.1	...	...	...	...	...	22.3
Claims on banks	...	...	36.8	37.6	9.9	22.8	...	...	40.0	47.8	...	32.7
Total capital/total assets	26.8	...	31.5	37.2	24.7	29.5	20.4	31.5	25.3	19.3	...	37.0
Total capital/reserves	49.2	...	85.9	104.8	36.4	67.3	41.0	63.0	43.7	30.9	...	85.4
Equity/total capital	...	...	68.9	53.9	42.9	34.9	...	48.4	53.7	66.5	...	...
Profits/retained premia	...	...	1.8	1.9	0.9	1.3	0.9	3.2	1.0	0.7	...	1.2
Profits/assets	...	...	6.9	7.7	4.9	6.9	3.2	7.9	5.0	2.8	...	4.3
Profits/capital	...	...	21.8	20.6	19.9	23.4	15.6	24.9	19.8	14.3	...	11.5
Profits/equity	...	...	31.7	38.1	46.5	67.1	...	51.6	36.8	21.5	...	...
Annual growth rates, 2000-2003												
Gross premia	...	0.4	...	15.0	...	7.9	...	5.5	...	4.7	...	2.2
Gross non-life premia	...	1.5	...	18.4	...	8.2	...	6.6	...	...	...	1.6

Source: National authorities, and staff estimates.

Table 3. Central America: Insurance Contract 1/

	Costa Rica		El Salvador		Guatemala		Honduras		Nicaragua		Panama	
	2000	2003	2000	2003	2000	2003	2000	2003	June 2001	2003	2000	2003
	(Number of policies)											
Life	...	...	...	81,231	...	174,688	117,826	134,678	...	...	108,770	105,250
Health and accidents	...	...	...	5,842	...	106,026	...	...	...	...	57,496	58,118
Property	...	...	...	60,981	...	...	64,937	68,678	...	...	78,857	105,501
Automobile	...	...	...	123,605	...	...	...	...	...	...	129,095	104,175
	(Value of coverage; In millions of US dollars)											
Life	...	...	8,082	...	...	41,195	...	...	1,495	4,314	...	...
Health and accidents	...	...	4,579	8,364	...	...	...	...	4,029	3,788	...	...
Property	...	...	11,666	13,129	...	...	11,370	15,564	2,716	4,157	...	...
Automobile	...	...	1,764	2,853	...	...	2,836	3,538	1,012	583	...	...

Source: National authorities, and staff estimates.

1/ Statistics cover the number of contracts outstanding, and the value of coverage. The number of insured parties may differ because parties hold more than one policy each, or because policies cover multiple parties.

Table 4. Central America: Structure of the Insurance Sector

	Costa Rica		El Salvador		Guatemala		Honduras		Nicaragua		Panama	
	2000	2003	2000	2003	2000	2003	2000	2003	2000	2003	2000	2003
Number of companies of which: domestic	1	1	18	21	18	16	11	11	5	5	20	19
	1	1	17	20	18	16	8	8	5	5	14	14
	(Share in gross premia; in percent)											
Share of largest company	100.0	100.0	18.5	12.7	23.8	18.8	18.5	21.2	57.1	42.0	...	19.1
Share of largest 5 companies	100.0	100.0	54.7	54.2	70.3	63.9	70.8	61.4	100.0	100.0	...	72.9
	(Average per company, in millions of US dollars)											
Gross premia	314.1	318.0	12.8	16.7	15.2	21.5	14.3	16.8	10.0	11.5	18.4	20.7
Profits	...	...	0.9	1.3	0.6	1.3	0.6	1.9	0.7	0.4	...	1.6
Assets	776.2	...	13.8	16.5	12.7	19.1	18.4	23.9	13.5	15.4	34.4	37.1

Sources: National authorities, and staff estimates.

Table 5. Central America FSRP: Summary of Main Insurance Sector Regulation 1/

Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua	Panama
<b>Location of supervisor</b>					
Self regulating	Integrated supervisor	Integrated supervisor	Integrated supervisor	Integrated supervisor	Separate; bureau of the Ministry of Commerce and Industry
<b>Licensing requirements</b>					
Company established by law	Yes. Life and non-life must be separate companies.	Life and non-life activities must each be licensed.	Life and non-life licensing not separated	Life and non-life licensing not separated	Separate authorization for life and non-life
<b>Ownership forms</b>					
State monopoly	Joint stock company	Share company	Anonymous company or mutual	No restriction	No restriction
<b>Foreign entry</b>					
Forbidden	Foreign subsidiaries and joint ventures but not branches	Foreign subsidiaries and joint ventures but not branches	Foreign subsidiaries and joint ventures but not branches	Foreign subsidiaries, joint ventures, and branches with own capital	No restriction
<b>Minimum capital</b>					
None	US\$0.67 million for non-life companies and US\$1 million for life companies. Updated periodically.	Equivalent to about US\$0.5 million for either life or non-life companies, and US\$1 million for mixed companies.	Equivalent to about US\$1.3 million for personal or property companies, and US\$2.6 million for mixed companies	Minimum equivalent to US\$0.7 million for life or property companies, US\$1.4 million for mixed companies	Equivalent to US\$2 million



## Technical provisions and reserves

Required to hold reserves on premium, claims and contingencies.	Technical reserves on nonlife products proportional to retained premium. Mathematical reserves for life products on actuarial basis. Also reserves for unearned premium, statistical risk, unpaid claims and unreported claims. Catastrophe reserve based on PML of highest risk concentration area.	Technical reserves on nonlife products proportional to retained premium (10% to 25%). Mathematical reserves for life products on actuarial basis. Also reserves for unearned premium and unpaid claims. Catastrophe reserves from accumulated earthquake policy reserves.	Technical reserves on nonlife products proportional to retained premium and to loss history. Mathematical reserves for life products on actuarial basis. Also reserves for unearned premium, statistical risk, unpaid claims and unreported claims. Catastrophe reserve based on PML of highest risk concentration area.	Technical reserves on nonlife products proportional to retained premium (40% to 50%). Mathematical reserves for life products on actuarial basis. Also reserves for unearned premium, statistical risk, unpaid claims and unreported claims. Catastrophe reserve based on PML of highest risk concentration area.	Technical reserves on nonlife products proportional to retained premium (35%). Mathematical reserves for life products on actuarial basis. Also reserves for unearned premium, statistical risk, catastrophe, unpaid claims and unreported claims.
Solvency requirements	Determined by law on the basis of product specific premium and losses as well as fixed parameters.	Determined by regulation on the basis of product specific premium and losses as well as fixed parameters.	Determined by regulation on the basis of product specific premium and losses as well as fixed parameters.	Determined by regulation on the basis of product specific premium and losses as well as fixed parameters.	Determined by regulation on the basis of product specific premium and losses as well as fixed parameters. General reserve accumulated from 10% to 20% of net earnings..

## Solvency requirements

None

### **Restrictions on investment portfolio**

Only government securities, real estate and mortgages	Direct lending limited. Maximum limits on various categories of investment.	At least 40 percent in government securities; at least 1 percent in demand deposits; at most 59 percent in other investments.	Ceilings on share in banks, government bonds, corporate bonds, shares, loans, real estate. Exposure to one risk<10% of capital.	Supervisor sets limits on categories of investment. No limit on exposure to government. Equity limited to 10 percent of portfolio.	Admissible investments specified for 75 percent of technical reserves: government and private securities, real estate. No large exposure limits.
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### **Restriction on investment abroad**

Forbidden, although local U.S. dollar assets are available	Maximum of 20 percent of technical reserves and required capital. Excess capital freely investable.	Forbidden for required reserves and capital. Excess capital freely investable.	Maximum 20 percent of capital and reserves from local currency dominated policies can be invested abroad. Reserves from dollar denominated policies can be freely invested abroad.	Maximum of 20 percent of technical reserves and required capital. Excess capital freely investable.	Maximum of 25 percent of required capital and reserves; at most 50 percent of excess capital.
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### **Pricing restrictions**

None. Policies dominated in local currency and US\$	Supervisor reviews premia so that they cover future claims but enforcement only through suspension of product.	Supervisor reviews and can enforces premia so that they cover future claims.	Supervisor reviews and can enforces premia so that they cover future claims.	Supervisor reviews and can enforces premia so that they cover future claims. Supervisor may set ceiling on rates for compulsory insurance	Supervisor reviews premia so that they cover future claims but enforcement only through suspension of product.
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### **Compulsory insurance**

Auto TPL, civil liability, and labor risks	None	None	Government demands bond from contractors	Auto TPL	TPL for commercial vehicles.
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## Reinsurance regulations

Law exists. No companies operate. Reinsurance abroad available	No companies operate. Companies specify maximum and minimum retention limits. Reinsurers must register and meet minimum qualifications from rating agencies. Retention and cession requirement for catastrophe insurance	No companies operate. Companies specify maximum and minimum retention limits. Reinsurers must register and meet minimum qualifications from rating agencies. Maximum retention limits specified.	No companies operate. Companies specify maximum and minimum retention limits. Reinsurers must register and meet minimum qualifications from rating agencies. Maximum retention limits specified.	Re-insurance specialists have to be licensed
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## Regulation of brokers and agents

Various agents including bancassurance are used	Brokers must be licensed.	Brokers and agents must be licensed.	Brokers and agents must be licensed.	Only licensed brokers can offer insurance products.
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## Tax treatment

Premia on life, worker safety, and a few other products except from sales tax. Property and catastrophe premia deductible from income tax	Life products over ten years exempt from sales tax. Life premia deductible from income tax. and payments exempt.	(Term) life premia deductible from income tax	Payments exempt from income tax.	Special levy (2 to 5 percent of net premia) to pay for supervisor. No tax on earnings from life-savings products
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## Accounting conventions

GAAP	Set by supervisor: IAS with insurance adjustments.	Set by supervisor: IAS with insurance adjustments. Life and non life P&L.	Set by supervisor: IAS with insurance adjustments. Life and non life P&L.	GAAP
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<b>Auditing</b> Auditor General, internal, and external firm	Internal and external auditor mandatory. Annual external audit of financial statements.	Annual external audit of financial statements.	Internal and external auditor mandatory. Annual external audit of financial statements and actuarial audit of reserves.	Internal and external auditor mandatory. Annual external audit of financial statements.	Internal and external auditor mandatory. Annual external audit of financial statements.
	All new products. Quarterly actuarial review of technical reserves. Annual external actuarial audit of technical reserves.	All new products. Supervisor does actuarial audit.	All new products. Annual external actuarial audit of technical reserves.	All new products. Annual actuarial financial statements audit.	All new products. Supervisor does actuarial audit.
<b>Actuarial report</b> Not obligatory					
<b>Centralization of claims data</b> Yes, but not publicly available	Yes.	No.	Yes.	Yes.	Yes.
<b>Remarks</b> State monopoly will end under CAFTA	Revisions to law under consideration.	New law in preparation	New law 2001. Implementation not fully completed.	New law in early stages of preparation	New law in preparation

Figure 1. Central America: Relative Insurance Indicators, by Indicator

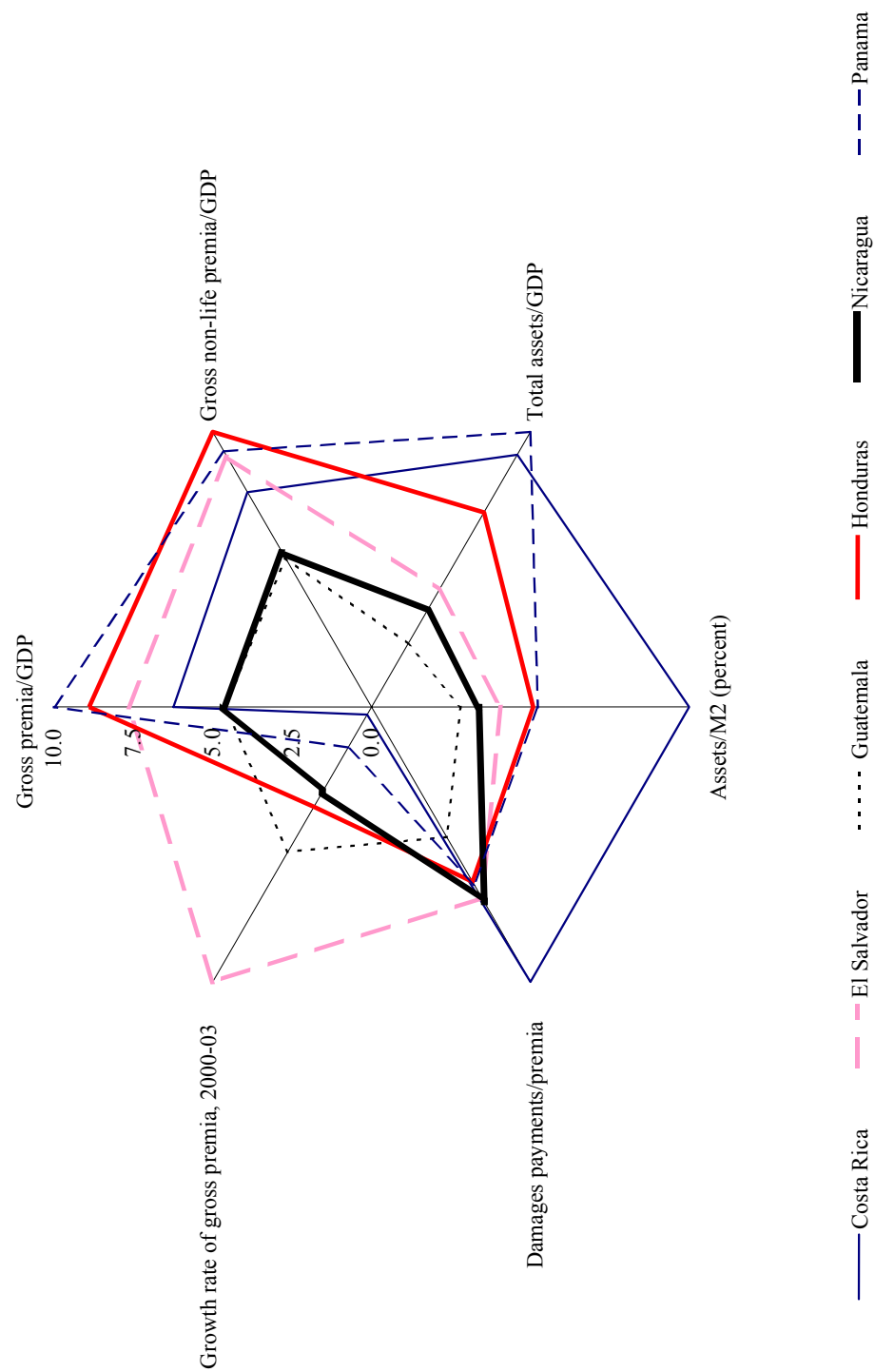
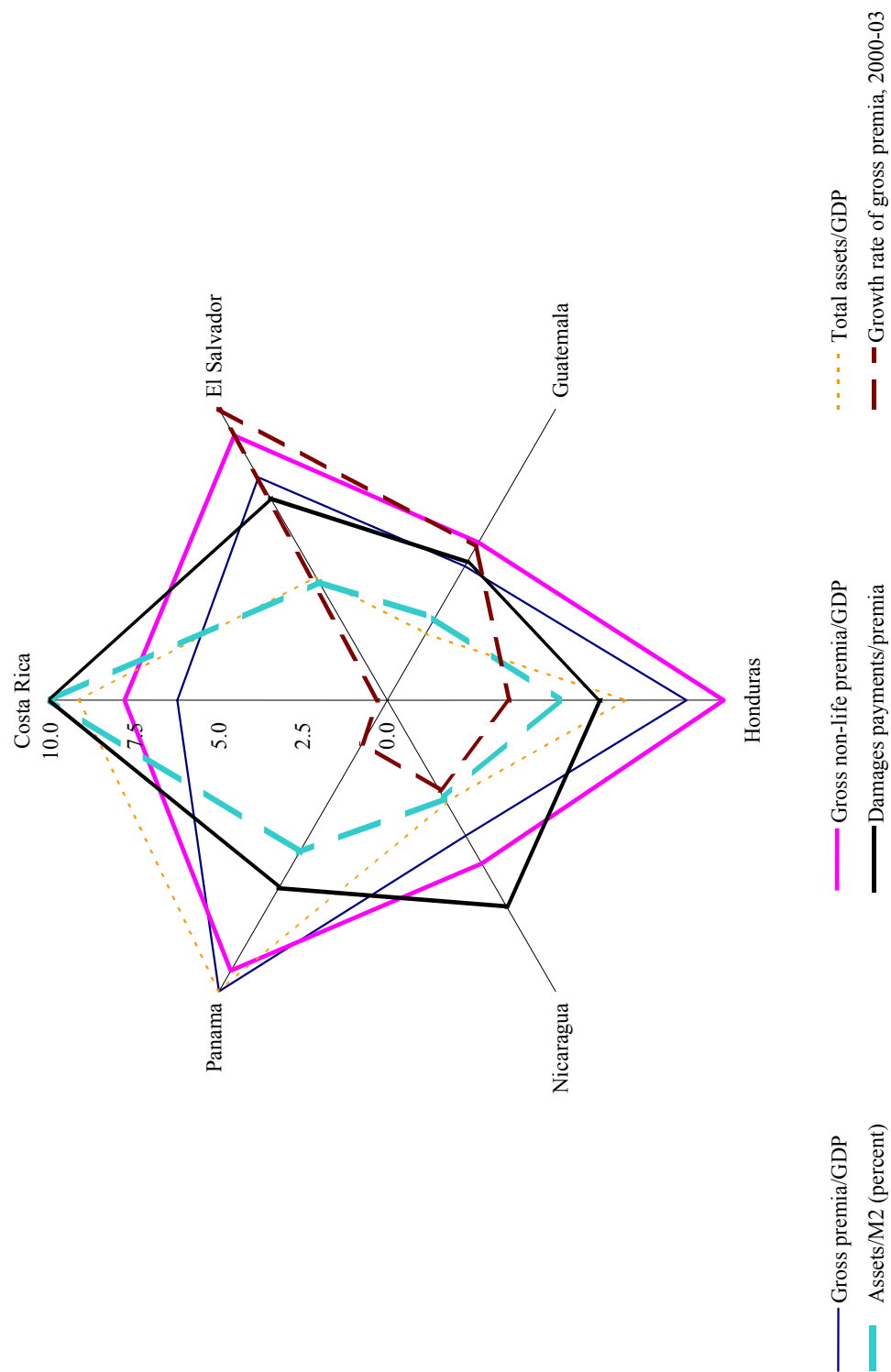


Figure 2. Central America: Normalized Insurance Indicators, by Country



## IV. PAYMENT AND SECURITIES SETTLEMENT SYSTEMS

### A. Introduction<sup>189</sup>

141. **There is growing interest in Central America and elsewhere in the possible efficiency gains to be achieved from the adoption of integrated frameworks for regional payments and securities settlement.** Individual Central American countries are already undertaking payment system reform with assistance from the international financial institutions (IFIs). In addition, projects on regional clearance and settlement of large value financial transactions and on integrated regional large value real-time gross settlement (RTGS) payment system have been launched by Central American governments, the Central American Monetary Council (CAMC), and the Inter-American Development Bank (IDB).

142. **This chapter has been prepared as part of the Financial Sector Regional Project (FSRP) for Central America.**<sup>190</sup> It draws from country assessments undertaken as part of ongoing efforts to upgrade the payment and securities settlement systems in several countries in Central America.<sup>191</sup> Assessment dates for each FSRP country are reported below.

Country	Date of WHF Assessment	Date of FSAP Assessment
Costa Rica	June 2001	October 2001
El Salvador	February 2000	February 2000
Guatemala	February 2004	September 2000
Honduras	October 2002	October 2002
Nicaragua	December 2003	December 2003
Panama	-	January 2005 1/

1/ A payments expert visited Panama for the purpose of the FSRP in January 2005.

143. This chapter is organized by topic, covering (a) issues related to the legal framework; (b) interbank exchange settlement circuits, including proposals for the reform of these systems; (c) retail payment systems; (d) government payments; (e) foreign exchange and cross-border settlement mechanisms; (f) interbank money market; (g) securities markets and settlement, including clearing and settlement processes, settlement risks, custody risk, regulatory and oversight issues, central securities depositories' (CSDs) organizational arrangements, and cross-border settlement; and (h) payment system oversight and cooperation. Each of these sections include, first, a brief *context* which generally identifies international standards and best practices; second, a *status* box describing the current status

<sup>189</sup> Prepared by Mario Guadamillas and Massimo Cirasino, The World Bank.

<sup>190</sup> The project covers the six Spanish-speaking Central American countries (Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and Panama).

<sup>191</sup> The IFIs have helped to conduct these assessments as part of the joint IMF-World Bank Financial Sector Assessment Program (FSAP) or as part of the Western Hemisphere Payments and Securities Settlement Forum (WHF), a joint effort by the Center for Latin American Monetary Studies (CEMLA) and the World Bank. On the latter, see <http://www.forodepagos.org/>.

of the specific issue covered; and third, an *observations* subsection summarizing the overall findings. A section on proposals for reform concludes the document.

## **B. Legal Framework**

### **Context**

144. **An appropriate legal framework is needed to underpin a sound and efficient payment system.** The legal environment should include the following: (a) laws and regulations of broad applicability that address issues such as insolvency and contractual relations between parties; (b) laws and regulations that have specific applicability to payment systems (such as legislation on electronic signature, validation of netting, settlement finality); and (c) the rules, standards, and procedures agreed to by the participants of a payment system. The legal infrastructure should also cover other activities carried out by both public and private sector entities. For example, the legislative framework may establish clear responsibilities for the central bank or other regulatory bodies such as oversight of the payment systems or the provision of liquidity to participants in these systems. Finally, relevant pieces of legislation that have impact on the soundness of the legal framework on the payment system include: law on transparency and security of payment instruments, terms, and conditions; antitrust legislation for the supply of payment services; and legislation on privacy. While laws are normally the appropriate means to enforce a general objective in the payments field, in some cases regulations by the overseers may be an efficient way to react to a rapidly changing environment. In other cases, specific agreements among participants may be adequate; in this cases, a professional assessment of the enforceability of these arrangements is usually required. Finally, since the payment system typically includes participants incorporated in foreign jurisdictions or it might operate with multiple currencies or across borders, it may be necessary to address issues associated with foreign jurisdictions.

145. **The operation of a securities settlement system (SSS) must be reliable and predictable.** This depends on the laws, rules, and procedures that support the holding, transfer, pledging, and lending of securities and related payments, and how these work in practice—that is, whether system operators, participants, and their customers can enforce their rights. If the legal framework is inadequate or its application uncertain, it can give rise to credit or liquidity risks for system participants and their customers or to systemic risks for financial markets as a whole.

146. **A variety of laws and legal concepts can affect the performance of clearing and settlement systems.** Weaknesses in contract laws, company laws, bankruptcy and insolvency laws, custody laws, and property laws may impede the performance of a clearing system. The general need is to have an adequate legal basis that is able to accommodate technological advances. Key aspects of the settlement process that the legal framework should support include: enforceability of transactions, protection of customer assets (particularly against insolvency of custodians), immobilization or dematerialization of securities, netting arrangements, securities lending (including repos and other economically equivalent transactions), finality of settlement, arrangements for achieving delivery versus payment,



default rules, liquidation of assets pledged or transferred as collateral, and protection of the interests of beneficial owners. The rules and contracts related to the operation of the SSS should be enforceable in the event of insolvency of a system participant, whether the participant is located in the jurisdiction whose laws govern the SSS or in another jurisdiction.

147. **An important emerging issue is the legal status of digital signatures.** If digital signatures are to substitute for handwritten signatures, they must be legally binding. A critical need is to ensure that laws are both enforced and are enforceable in all relevant jurisdictions. In addition, disputes should become the subject of court proceedings only as a last resort. This can be achieved through the specification and acceptance of clear, comprehensive, and fair arbitration processes.

### Status in the region

Country	Legal Basis	Finality and Irrevocability	Netting	Oversight Empowerment	Custody Arrangements
Costa Rica	Organic Law of <i>Banco Central de Costa Rica</i> (BCCR) (Law 7558 of 1995) The Securities Market Law (SML), Law 7732 of 1998	No explicit zero hour rule but no complete finality certainty	No explicit legal recognition of netting arrangements	Article 2 of the BCCR Law, but no clarity on power to regulate and oversee payment systems provided outside the central bank	Adequate
El Salvador	<i>Ley de Integración Monetaria</i> (LIM) introduced dollarization effective January 2001 For securities, Legislative Decrees 806 (Organic Law of the Securities Superintendency) and 809 (Stock Exchange Law)	No provision regarding acceptance and irrevocability	No explicit legal recognition of netting arrangements	No legal clarity on the authority empowered to regulate and oversee payment systems	No protection of custody arrangements
Guatemala	Organic Law of Banco de Guatemala (BANGUAT) of May 2002 Securities Markets Law ( <i>Ley del Mercado</i>	No provision regarding acceptance and irrevocability	No explicit legal recognition of netting arrangements	Article 4 of BANGUAT Law, but no regulation developing the oversight function	Protection of custody arrangements only included for the securities depository but not for other custodians

Country	Legal Basis	Finality and Irrevocability	Netting	Oversight Empowerment	Custody Arrangements
	<i>de Valores y Mercancías</i> ) of 1996				
Honduras	Banco Central de Honduras (BCH) Law 2001 SML; its regulation is under development	No provision regarding acceptance and irrevocability	No explicit legal recognition of netting arrangements	Article 2 of BCH Law Recent reform of the BCH Law (in 2004), Article 54	No clear legal basis for ownership transfer of dematerialized securities
Nicaragua	Organic Law of Banco Central de Nicaragua (BCN) No legal framework for the securities market	No provision regarding acceptance and irrevocability	No explicit legal recognition of netting arrangements	Article 3 of the BCN Law	No due to lack of specific legal framework for securities
Panama	Banking Law (Decree-Law 9 of 1998) SML (Decree-Law 1 of 1999)	No provision regarding acceptance and irrevocability	No explicit legal recognition of netting arrangements	No central bank	Adequate

## Observations

148. **There is no regulation in the six countries specifying how oversight is to be conducted**, although central bank laws usually recognize that payment systems oversight is among the central bank's functions (the exceptions being El Salvador and Panama).

149. **There is a lack of provisions regarding acceptance, irrevocability, or settlement finality of an order to be processed by the system.** These concepts are especially important in the event of an insolvency and their definition could limit potential problems. In netting systems, the legal definition of these concepts would reduce uncertainties and limit systemic liquidity risk from unwinding procedures. Similarly, although in general there are no explicit zero hour rules, it is not clear if the countries' courts could revoke pending or already executed operations made by the defaulting institution. Many legal frameworks fail to define specific triggers for the intervention of a financial institution, creating uncertainty about the system's or central bank's credit risk exposure (the latter in the case the central bank grants overdrafts to the system's participants).

150. **In some of the countries, the central bank law provisions have not translated into a specific regulation dealing with the operation of settlement systems.** Not all the systems have detailed rules. Thus, participants may not be aware of the risks they incur.

There is also a lack of clarity regarding penalties and the conditions and procedures for removing a participant from the system.

151. **There is no explicit legal recognition in the six countries of multilateral netting arrangements, creating legal uncertainty in the event of an insolvency.** Since netting is used on a broad scale for the settlement of stock exchange transactions and cheque and retail payments, this constitutes a serious legal risk. It might also hamper further development of financial instruments such as derivatives. It is important to protect netting schemes from potentially disruptive insolvency laws so that, even if a system participant fails during the day, a liquidator cannot unwind settlement occurring on a net basis at a later time in the day (see for instance the Finality Directive of the European Commission).

152. **Most countries have recently approved laws for electronic documents and signatures.** These need to be complemented by changes in relevant rules and regulations to ensure that the legal basis is effective and clarify that the laws also apply to the electronic exchange of messages within the payment systems operated by the central bank.

153. **In general, there is no public or private body responsible for the resolution of potential conflicts arising from the operation of the systems.** There is no provision regarding the responsibility of the operator in case of malfunctioning of the system, and therefore there is no rule dealing with a possible compensation for those cases.

154. **The judiciary in the six countries lacks familiarity with the specific legal needs of the financial sector and the systemic implications of the application of certain laws.** Focused training programs should be put in place as soon as an overall assessment of the legal framework for the payment system is completed.

155. **Although securities markets legislation usually includes the legal basis for immobilization and dematerialization, in some cases (e.g., Guatemala) this law only applies to private securities.** The legal framework for public debt securities is separate and does not include a definition of dematerialization and immobilization.

156. **A sound legal basis requires the legal definition of the depository function that the central bank is often undertaking for public debt securities.** However, the depository function is normally defined in securities markets legislation for joint stock companies, while central bank laws only cover the custody function. That is, central banks maintain the registry of the primary market but have not developed the ownership transfer functionality for the secondary market, even when another depository does not exist. This is a clear impediment to the development of the secondary market as its settlement rests on the exchange of physical certificates.

157. **Transactions linked to securities settlement systems are not legally final,** creating a potential for counterparty risk. Finality must be integrated in the legal framework. This is an important issue in all existing net settlement systems, especially those that have longer settlement cycles. Without this legal basis, it is uncertain whether in case of bankruptcy the transfer of securities to the counterparty or his custodian could take place, even if the

counterparty has already paid for the securities (in some systems there is a time lag between the settlement of the cash leg and the settlement of the securities leg). Due to this uncertainty, an unwinding of the net settlement might be the only solution if the cash settlement process did not take place. If the cash settlement already took place it might bring forward principal risk if the court did not grant the request to transfer the securities.

158. **Even systems with more advanced legal frameworks are vulnerable to settlement finality risk** because of bankruptcy procedures that cancel fraudulent transactions effective several days before the participant is declared failed. However, the impact in case of RTGS systems is likely to be negligible due to the gross nature of the system. Problems of interpretation might also arise since settlement finality is subject to regulations that have a lower hierarchy than the bankruptcy law. Initiatives to engage the judicial system in this debate are worth pursuing.

159. **In general, protection of customer assets under custodian arrangements is not clearly established.** Therefore, assets pledged as collateral by clearing members are not adequately covered by the law, thereby compromising the capacity to execute collateral. Sometimes, the protection of custody arrangements is included for the depository and brokers-dealers but not for other custodians, or vice versa. This limitation could bar potential settlement arrangements.<sup>192</sup> In the case of public securities, this could limit retail market development as beneficial owners are usually not identified in the accounts of the depository.

160. **Custodian arrangements for government securities (which are often issued in physical form) do not have secure legal support as primary dealers keep the ownership in the registry of the ministry of finance or central bank.** Thus, it is uncertain whether the certificate endorsements in subsequent repo operations can be legally considered a proof of ownership. In some cases, participants agree that the transferred certificate will be kept but not used to transfer ownership in the ministry of finance or central bank registry.

161. **Although repo operations are legally defined, there is uncertainty with regard to their use as guarantees for transactions to be processed into a system.** The legal basis for the pledge is typically included in the civil code but the pledge, as a tool for collateralized operations, is not regulated. Furthermore, there are no rules on the execution of those guarantees in case of a default. This creates an important impediment to the granting of collateralized intraday credit by the central bank for the purpose of payment settlement.

162. **The definition of repos only covers sell and buy-back transactions, although the scope of a repo is much wider internationally.** Repos are especially used to collateralize cash or securities loans. If during the collateralization period, due to market developments, the collateral offered no longer covers in full the obligation to pay back the loan or the value of the securities borrowed, additional collateral can normally be requested through a margin

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<sup>192</sup> For example, markets with a high volume of transactions sometimes do not maintain subaccounts with beneficial owner information but only accounts at the participant level. Such settlement systems should be accompanied by a strong legal protection of custody arrangements and supervisory framework.

call. The definition used in the six countries leaves no room for this market practice and makes it difficult to use international standard contracts. Margin calls during the contract period might also give rise to legal risk if the court re-characterizes a repo agreement with interim margin calls as an improper pledge. It might be worth studying if there should be an explicit distinction between a repo in the form of a collateralized cash or securities loan and an explicit sell and buy-back transaction.

163. **Laws are clear in terms of the segregation of accounts by the depository but not by the custodians** (e.g., banks, broker-dealers), although this is often done in practice. This makes it unclear whether the customer assets will be protected against the insolvency of custodians. This issue is relevant in circumstances when the bulk of the market is represented by government securities (a common situation in Central America) that are issued in physical form and basically held by custodians.

164. **Legal basis for securities lending does not exist in many cases or no detailed regulations have been developed.** The current low volume of market trading is an opportunity to develop the legal and regulatory framework in preparation for an eventual recovery of past market volumes.

165. **The fragmentation of laws and regulations related to securities and capital markets is common in the region.** This creates uncertainty and confusion in the legal framework and may ultimately influence both the functioning of the markets and the activities of market participants. A unified payment systems law might help resolving the potential conflicts of interpretation on issues such as finality and oversight.

166. **Legal frameworks often do not contain explicit conflict of law rules.** This could hamper the development of intraregional financial markets and international cooperation in the area of trading, custody, and clearing and settlement.

167. **Lack of the legal framework enforceability is hampering the development of securities settlement systems.** Many countries have introduced an adequate legal and regulatory framework for the processing of electronic operations but poor enforcement is preventing a further development of financial markets.

168. **To sum up, country authorities need to review the legal framework with particular attention to irrevocability of final settlement, adequate protection against bankruptcy effects, the legal basis for custody arrangements, legal definition of a repo operation, legal recognition of multilateral netting arrangements, legal definition of immobilization and dematerialization of securities (especially public securities), and legal definition and regulation of oversight powers of the central bank.** Other legal issues considered from a developmental point of view include the legal basis for collateral pledge and securities lending. Due to the variety and importance of these legal aspects, some of the countries should consider if the level of legal changes required could justify a payment systems law.

## C. Interbank Exchange and Settlement Circuits

### Context

169. **Large-value systems are the most significant component of the national payment system.** This is because they can generate and transmit systemic disturbances to the financial sector. Several measures can be adopted to minimize these systemic risks. If the system is characterized by a deferred net settlement of payment transactions, risk control measures include the introduction of bilateral and multilateral caps, the implementation of loss-sharing agreements, and the pledging of collateral. On the other hand, the development of real-time gross settlement (RTGS) systems is one response to the growing awareness of the need for sound risk management in large-value funds transfer systems. RTGS systems can offer a powerful mechanism for limiting settlement and systemic risks in the interbank settlement process, because they can effect final settlement of individual fund transfers on a continuous basis during the processing day. In addition, RTGS can contribute to the reduction of settlement risk in securities and foreign exchange transactions by facilitating delivery-versus-payment (DvP) and payment-versus-payment (PvP) mechanisms. Variants of the basic RTGS system—the so-called hybrid systems—that take into account liquidity saving features in net settlement systems are being introduced in some countries.

### Status in the region

170. The table below presents some data about the amount of cash and transferable (sight) deposits as a proxy for the use of cash and cashless payment instruments.

Country	Population (In millions)/ GDP per capita (In US dollars) 1/	Bank Notes and Coins in Circulation (In millions of US dollars)	Transferable Deposits in Domestic Currency (In millions of US dollars)	Transferable Deposits in Foreign Currency (In millions of US dollars)	Systemically Important Payment Systems (SIPS)	Yearly Value Settled to GDP (In percent)
Costa Rica	4.0/4,280	449	1,074	898	SINPE	312
					Cheque system (CLC)	125
El Salvador	6.5/2,200	36	1,167	1,167	Cheque system	N/A
Guatemala	12.3/1,910	1,266	1,903	406	Cheque system	187
					MIT	31
Honduras	7.0/970	408	531	--	Cheque system (CEPROBAN)	173
					Funds Transfer	125
Nicaragua	5.5/730	190	147	279	Cheque system	135
					Phone transfer system (TTS)	32
Panama	3.0/4,250	...	...	...	Cheque system	220
					BNP-CIASA	984

1/ Population and GDP per capita are 2003 data. The rest of data is end-2004.

Sources: Central American central banks

171. The table below presents the main characteristics of the interbank settlement systems identified as SIPS. Clearinghouses are included as they are systemically important, although they are also relevant retail payments (see next section).

Country	System	Owner/ Operator	Type of Settlement, Closing Time	Settlement Asset	Credit and Liquidity Risk Mechanisms
Costa Rica	SINPE	Central bank	Real-time	Central bank money	Use of Reserve Requirements for Settlement No intraday credit No queuing mechanism
	CLC	Central bank	Multilateral net basis next day 2:00 p.m.	Central bank money	Guarantee Scheme based on defaulter's pay principle (amount of guarantee recalculated based on net debit position)
El Salvador	Cheque clearinghouse	Central bank	Multilateral net basis next day 5:00 p.m.	Central bank money	None
Guatemala	SICOF	Central bank	Deferred gross basis (manual procedures)	Central bank money	Use of Reserve Requirements for Settlement
	Cheque clearinghouse	Private banks	Multilateral net basis next day 3:00 pm	Central bank money	None
Honduras	Funds transfer system	Central bank	Deferred gross basis (manual procedures)	Central bank money	Use of Reserve Requirements for Settlement
	CEPROBAN	Private banks	Multilateral net basis same day 7:00 pm	Central bank money	None
Nicaragua	TTS	Central bank	Deferred gross basis (manual procedures)	Central bank money	Use of Reserve Requirements for Settlement
	Cheque clearinghouse	Central bank	Multilateral net basis same day 4:30 pm	Central bank money	None
Panama	Corresponding banks in the US	Network of correspondent banks	Gross through SWIFT network	Asset of the foreign correspondent banks	None
	Clearinghouse	BNP	Multilateral net basis next day 12:00 pm	Asset of BNP	None

## Observations

172. **Large-value and systemically important payment systems in Central America do not fully observe several of the CPSS CPSIPS.** A number of Central American central banks (El Salvador, Guatemala, Honduras) have initiated payment systems reforms to improve the safety and efficiency of large-value systems, launch RTGS systems, and reduce

the use of cheques for large-value settlement. These efforts should be carried out as part of the overall strategy to reform the national payment system, of which large systems represent the backbone.

**173. The high value of cheques settled in the cheque clearinghouses throughout the region and their use in interbank payments confirm that cheques should be viewed as a SIPS.** Strengthening payment system stability requires that the discharge of obligations among financial intermediaries be executed through electronic payments settled in the RTGS system (when this is operational). The movement from cheques to electronic payments is crucial to increase the efficiency of the payment system as a whole. Consequently, central banks should evaluate ways to provide intermediaries with incentives to use the RTGS system instead of cheques for interbank transfers. Pricing policy should be used as an incentive for this transition.

**174. There has been progress in launching RTGS systems in the region.** Costa Rica already has a safe and efficient RTGS system, and new systems in line with the CPSIPS are being launched in El Salvador, Honduras, and Guatemala. In Nicaragua, an overhaul of the gross settlement system (*Transferencia Telefónica Segura de Fondos*, TTS) is underway. All countries in the region should count with an appropriately designed RTGS system. To this end, central banks should evaluate and discuss with market participants all aspects of the new system. In particular, central banks should prepare rules and procedures relating to the use of the system, including tools for managing legal, financial, and operational risks. Tools to handle liquidity risks should include queuing and optimization mechanisms; efficient throughput mechanisms and adequate interconnections among the systems; routines for channeling government payments early in the operating day; the flexible use of reserve requirements; intraday liquidity provision through repos with application of haircuts. Moreover, the design of the system should include: (a) a robust and efficient communications network between the bank and system participants, which should reduce and eventually eliminate the use of manual and paper-based procedures; (b) strict security measures for physical and electronic access to the system; (c) contingency plans and disaster recovery mechanisms, including the setting-up of a secondary site; and (d) measures for business continuity and resilience. The design should include elements that could affect the system's efficiency and practicality such as full integration of available systems, strictly enforced operating hours, and reduction and elimination of manual procedures. Pricing policies should be consistent with the overall objectives. Some form of cost recovery should be evaluated vis-à-vis other externalities stemming from a robust and efficient payment system (i.e., cost reduction). Access criteria (including exit and exclusion) should be defined more clearly and tiered arrangements should be reviewed and eventually favored to allow the reduction of manual procedures. In some cases, some institutions (such as the stock exchange and retail system operators) might be allowed to hold settlement-only accounts within the system. The governance of the system inside the central bank should be streamlined and rationalized. User groups (i.e., groups of system participants to discuss system development issues) should be introduced.



**175. The smooth functioning of the RTGS system requires sufficient reserves and the efficient distribution of liquidity among intermediaries during the operational hours of the day.** To facilitate the optimum use of available liquidity, intermediaries should have complete and timely information on incoming and outgoing payments. It is the central bank's responsibility to remove obstacles to the efficient use of liquidity and to facilitate cash management by intermediaries. To this end, the central bank should collect reliable statistics to be used to analyze the functioning of the RTGS system. This supports the decision to improve the functionality of the system. In determining how to improve the efficiency of the system, it is important that open discussion takes place among all parties involved. In particular, some central banks have found it useful to review the time schedule of settlement of payments in the RTGS system during the day and the critical times at which relevant sources of liquidity are injected into the system. In this regard, the evaluation of the Treasury time schedule for settling its payments—one of the most important sources of liquidity for the financial system—is critical in order to avoid unforeseen injections or withdrawals of reserves that increase volatility in the availability of intraday liquidity.

**176. The implementation of RTGS systems in Central America will not only serve the needs of domestic payment systems but also create conditions for future regional integration.** The integration of payment systems should be based on the existence of common features in all relevant areas (including legal, risk control mechanisms, liquidity provision, access policies, governance, organizational arrangements, operational aspects, reliability, and business continuity).

#### **D. Retail Settlement Systems**

##### **Context**

**177. A wide range of payment instruments is essential for supporting customer needs.** A less than optimal supply of payment instruments may ultimately have an impact on economic development and growth. The safe and efficient use of money as a medium of exchange in retail transactions is particularly important for the stability of the currency and a foundation of the trust people have in it. As CPSS publications have shown, the use of retail payment instruments differs both within and among developed countries.<sup>193</sup> This is due to a variety of reasons including cultural, historical, economic, and legal factors. Common trends can be observed, however, namely the continued primacy of cash (in volume terms) for face-to-face payments; growth in payment cards use; increased use of direct funds transfers, especially debit transfers, for remote payments; and changes in market arrangements for providing and pricing the retail payment instruments and services delivered to end-users. This evolution is likely to continue in the future and is expected to influence traditional (especially paper-based) instruments. Over the long term, some of the observed market

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<sup>193</sup> See Bank for International Settlements, *Clearing and Settlement Arrangements for Retail Payments in Selected Countries* (CPSS publication No. 40, September 2000); and *Retail Payment Systems in Selected Countries: a Comparative Study* (CPSS publication No. 33, September 1999).

developments may well alter traditional payment practices and contribute to increased efficiency and convenience in retail payment systems. In an increasing number of countries more and more attention is devoted by authorities and market participants to the efficiency and efficacy of production and distribution of payment instruments (including cash).

**178. Central banks are involved in retail payments in an operational capacity, as payment system overseers and/or as facilitators of market and regulatory evolution.**

Even though the involvement of central banks in retail payments varies from country to country, a recent CPSS report argues that each central bank should examine market developments periodically with a focus on clearly identified policy issues (Box 1).<sup>194</sup> Where such issues are judged to arise, relevant public authorities (including central banks) may decide to take action aimed at establishing or re-establishing an acceptable balance of the various aspects of safety and efficiency. The public policy goals, central bank minimum actions, and the range of possible additional actions identified in the CPSS report are summarized in Box 1. The CPSS report has been prepared in light of the trends in retail payment markets in the G-10 countries and Australia. It is likely that, in developing countries, central banks and other private and public entities need to take a proactive role and carefully explore the possibility of using the additional actions.

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<sup>194</sup> See Bank for International Settlements, *Policy Issues for Central Banks in Retail Payments* (CPSS publication No. 52, March 2003).

**Box 1. Public Policy Goals, Central Bank Minimum Actions and Range of Possible Additional Actions for Retail Payment Systems**

**Legal and regulatory framework**

**Public Policy Goal A.** Policies relating to the efficiency and safety of retail payments should be designed, where appropriate, **to address legal and regulatory impediments to market development and innovation.**

The central bank should, at a minimum:

- Review the legal and regulatory framework to identify any barriers to improvements in efficiency and/or safety;
- Cooperate with relevant public and private entities so that the legal and regulatory framework keeps pace with the changing circumstances and barriers to improvements in efficiency and/or safety are removed, where appropriate.

**The range of possible additional actions** could include, depending on the individual central bank's responsibilities, powers, and priorities:

- Altering regulations that currently present barriers to improving efficiency and safety, where this is within the central bank's remit and where other public interest arguments do not militate against such action;
- Introducing or proposing new regulations, as the central bank's remit allows, where the legal or regulatory framework is insufficient to support increased efficiency and/or safety;
- Offering expert advice to other responsible authorities, for example in the preparation of relevant legislation.

**Market structure and performance**

**Public Policy Goal B.** Policies relating to the efficiency and safety of the retail payments should be designed, where appropriate, **to foster market conditions and behaviors.**

The central bank should, at a minimum:

- Monitor developments in market conditions and behaviors relating to retail payment instruments and services and assess their significance;
- Cooperate with other public or private entities, as appropriate, to foster competitive market conditions and to address any significant public policy issues arising from market structures and performance.

**The range of possible additional actions** could include, depending on the individual central bank's responsibilities, powers, and priorities:

- Promoting appropriate standards or guidelines for transparency, in cooperation with relevant public and private sector entities;
- Reviewing conditions in the market for cross-border retail payments, with a view to promoting improvements, if such action is warranted;
- Considering and, if appropriate, performing regulatory and/or operational intervention in cases where market forces are judged not to have achieved or not to be likely to achieve an efficient and safe solution.

**Standards and Infrastructure**

**Public Policy Goal C:** Policies relating to the efficiency and safety of retail payments should be designed, where appropriate, **to support the development of effective standards and infrastructure arrangements.**

The central bank should, at a minimum:

- Monitor developments in security standards, operating standards, and infrastructure arrangements for retail payments that the central bank judges to be important for the public interest, and assess their significance;
- Cooperate with relevant public and private entities to encourage market improvements in such standards and infrastructure arrangements, where appropriate.

**The range of possible additional actions** could include, depending on the individual central bank's responsibilities, powers, and priorities:

- Participating actively in reviewing and developing appropriate standards and arrangements, in cooperation with relevant public and private entities, where the central bank judges its more intensive involvement to be necessary to furthering the goal;
- Considering and, if appropriate, performing regulatory and/or operational intervention in cases where market forces are judged not to have achieved or not to be likely to achieve an efficient and safe solution.

#### **Central bank services**

**Public Policy Goal D.** Policies relating to the efficiency and safety of retail payments should be designed, where appropriate, **to provide central bank services in the manner most effective for the particular market.**

The central bank should, at a minimum:

- Review and, if appropriate, adapt its provisions of settlement services to contribute to efficient and safe outcomes;
- Be transparent in its provision of services.

**The range of possible additional actions** could include, depending on the individual central bank's responsibilities, powers, and priorities:

- Reviewing the relevant non-settlement services it provides and considering their adaptation to changing market conditions;
- Reviewing policies on access to central bank services and on pricing.

### **Status in the region**

179. The table below includes some data about the use of cashless instruments for retail payments. However, many countries still use the cheque as a payment mean for large value transactions, though with a diminishing trend. The main features of the clearinghouses have been presented in the previous section.

<b>Country</b>	<b>Cheques in domestic currency</b> (In millions of US dollars)	<b>Cheques in foreign currency</b> (In millions of US dollars)	<b>Number/ payments by cards</b> (In millions/ millions of US dollars)	<b>Credit transfers</b> (In millions of US dollars)	<b>Direct debits</b> (In millions of US dollars)	<b>ATM operations</b> (In millions of US dollars)
Costa Rica	14,045	6,464	1.5/740	39,662	37	1,900
El Salvador	--	24,591	... /202	6,818	...	...
Guatemala	45,108	1,211	4.3/125	10,318	...	564
Honduras	11,179	--	...	...	...	...
Nicaragua	5,300	1,882	4.3/32	1,114	...	...
Panama	--	28,800	120	...	...	...

Data for cheques are for to 2003. Data related to cards, credit, direct debits and ATM operations are for 2001.  
Sources: Central American central banks, and WHF.

### **Observations**

180. **In many cases, new applications to process retail electronic credit and debit instruments have been a major element of efforts to modernize national payment**

**systems.** Automated clearinghouses (ACHs) have been launched in some countries (Costa Rica, El Salvador, Guatemala, and Honduras). In most Central American countries, however, ACH projects are either too slow to keep pace with customer needs, or too limited in scope (e.g., the project only focuses on improving cheque clearing procedures). Central banks actively support the full deployment of efficient applications to process electronic retail payment instruments. Specifically, central banks should take a leadership role to ensure that banks and other participants reach the necessary agreements. They should also coordinate efforts to achieve a single system encompassing all banks and other major participants and processing as many payment and collection services as possible (see Section D), so as to avoid duplications and misuse of infrastructure.

**181. Central banks and commercial banks should consider extending payment instruments and services offered by the ACHs.** The introduction of new means of payments (such as electronic transfers and direct debits) has good potential for cost reduction. Strategies for modernizing the payment system based solely on improvements in the cheque clearing system are inadequate and counterproductive. Improvements in cheques clearing produces efficiency gains in the short term as it is the main cashless payments media used in all countries. However, a strategy that includes the development of other means of payments could have a major impact in the medium and long term. New instruments such as electronic transfers and direct debits will benefit directly the urban and major rural areas, and indirectly remote rural areas through the reduction of operational costs in financial institutions and, therefore, less expensive financing.

**182. The region is characterized by a heavy use of cheques, which is far from optimal from the point of view of efficiency and risk control.** Central American central banks and all stakeholders in the retail arena must work together in a clear strategy to promote the intensive use of retail electronic payment instruments and reduce the importance of cheques. Customers change their choice of payment service as a response to the price and convenience of the services provided. Thus, central banks might use moral suasion to persuade participants to make alternative retail payment instruments relatively more attractive at the end-user level, including a relative higher cost for cheques than that for electronic payment services. It should be noted that such a pricing strategy must be agreed and applied at the system level (e.g., binding interbank agreements), as individual competitive strategies may derail efforts in this direction. To avoid oligopolistic practices, the interbank agreements would be based on an analysis of processing costs for the different payment instruments. Also, a minimum fee structure could be set in such a way that there will still be incentives for banks to reduce costs and promote efficiency, for instance, by basing the minimum fee for the different payment instruments on the processing costs of the bank with the lowest internal processing costs.

**183. In all countries, cheques are used for large value payments and cheque clearinghouses are systemically important payment systems.** Central banks should be proactively pursuing the removal of all large-value items from the check clearinghouse. In parallel, the introduction of some risk control measures (such as guarantee funds and loss-sharing agreements) should be considered.

184. **Some efficiency gains could also be implemented in the cheque clearing system, such as full or partial truncation** (for cheques under a given value). Investments required for these efficiency gains should not create an obstacle for the development of modern payment instruments (e.g., electronic transfers, direct debits), by giving system participants the false illusion that cheque processing can be less costly than that of other instruments.

185. **Retail circuits are characterized by very low interoperability (e.g., ATMs and EFTPOS), resulting in the inefficient use of the current infrastructure.** Many of the positive effects of a payment cards system for increased efficiency are not being captured due to the lack of electronic payment instruments for retail transactions. For example, ATMs of any network can only be used by the customers of the banks belonging to that network. As a result, the volume of transactions needed to amortize the investment in the ATM is slow to achieve, creating disincentives to the deployment of more ATMs. Although ATMs are not payment instruments on their own, they are an effective means to reduce the use of “on us” cheques and are a useful infrastructure through which electronic payments and other services may be channeled. In the case of EFTPOS, lack of interoperability translates in merchants having three terminals (one for each card processor) on their premises, which increases overall costs and may translate into merchants giving customers incentives to pay in cash or cheques. Finally, the lack of retail electronic payment instruments makes the card system more cumbersome and costly as card processors pay merchants with cheques, or merchants need to have an account at many banks in order to receive credits from every card processor they work with.

186. **Some banks are starting to offer retail payment instruments and services in multiple countries in the region.** These efforts should be monitored and supported by central banks and banking supervisors. However, there is no project to develop a common regional infrastructure in the retail sector. Consideration should be given to fostering the standardization and harmonization in this area to allow for the creation of some form of regional ACH in the future.

187. **In sum, central banks and commercial banks have a role to play to ensure that retail circuits support customer needs and that such arrangements are safe, convenient, and efficient for the economy as a whole.** The central bank, as the entity leading the efforts to improve the country’s financial infrastructure, should promote agreements among banks to facilitate increased interoperability. Central banks should examine developments in the market periodically in the light of public policy goals and take action as necessary. In particular, the central bank should: (a) review the legal and regulatory framework to identify barriers to efficiency and/or safety, and cooperate with relevant public and private entities to ensure that such a framework keeps pace with market developments; (b) monitor market conditions and behaviors and ensure they are competitive; and (c) support the development of effective standards and infrastructure arrangements. Central banks could engage participants in a dialogue on national payment systems with a view to agreeing on necessary improvements. Once conditions are ready (e.g., when agreements on interoperability are reached and/or when an ACH is deployed that would produce interbank obligations that need to be cleared and settled somewhere), central banks could adapt their provision of settlement

services for systems operated by other entities to contribute to efficient and safe outcomes, allowing all such systems to settle in central bank money.

## E. Government Payments

### Context

188. **The public sector is a heavy user of the payment system.** The government receives and remits many payments (tax collection, salaries, purchase of goods and services, and so on). In several countries, the public sector has lagged behind the private sector in terms of efficient use of payment instruments and has failed to make effective use of the banking sector. In recent years, more and more attention has been devoted to this issue and, in some countries, the government has been able to use efficiently the options offered by new technologies (ACHs, smart cards, etc.), significantly reducing its processing costs.

### Status in the region

Country	Government Payments
Costa Rica	<p>Significant progress has been achieved in recent years in government payments. The launch of SINPE and the extension of its services to the treasury has generated a remarkable result in terms of efficiency and cost reduction for treasury operations. Payments of the central Treasury are channeled exclusively through SINPE. They include payment of payrolls and public sector providers. Tax collection is done through the banking sector, which transfers funds to the treasury the day after receiving the payments. The reform has introduced important savings for the treasury in fees and reduction of costs (in the order of about six million dollars since its introduction) and is perceived as highly successful by the treasury. Currently a relatively high fee is charged by the banks for tax collection (0.25 percent of the value). An intended and beneficial side effect of government use of direct credit was the increase in bank customers. The same effects were and will be reached through the implementation of direct credit payments for social services.</p> <p>Several projects are underway to further improve the efficiency of public sector payments. They include the introduction of a centralized account, the connection of all local treasuries to the central account, and the reform of procedures for the collection of customs duties. These reforms will be key in reducing the public deficit since the current practice to assign budget to local treasuries in advance, and the consequent investment of positive balances by local treasuries in government securities, generates the paradox of having a relatively high portion of the public debt in the hands of the public sector. The reform of customs procedures should, on the other hand, reduce corruption and guarantee a smooth functioning of import-export operations. These projects have a high level of support from the government.</p>
El Salvador	<p>The BCR serves as the government bank, issuing and receiving payments on behalf of the government. By law, overdrafts of government accounts at BCR are not permitted.</p>
Guatemala	<p>The central government Treasury and the Social Security Institute have made some progress to reduce the use of cash or cheques in their payments. Until recently, the treasury was using the ACH-like system offered by Bancared, but it decided to develop an alternative system for cost and efficiency reasons, as the system of Bancared entailed a relatively high use of paper and several manual procedures. At present, both institutions use credit transfers through the “<i>Oficios</i>” system of the BANGUAT. Paper instructions (“<i>oficios</i>”) are received by the BANGUAT from 8:00 a.m. to 2:00 p.m. The latter distributes the funds among commercial banks on the same day according to</p>

	<p>what established in the <i>oficios</i>. Once the banks have received the funds and a fax confirmation of the transfer, which happens on T+1, they can access the website of the paying institutions to download the payment details. The final beneficiaries are credited on T+3.</p> <p>Nearly 70 percent of the total volume of payments of these institutions is channeled through the system explained in the previous paragraph. The rest is made by cheques. In the case of local governments, payments are made mainly by cash or cheques drawn on commercial banks. On the other hand, central government collections are managed by a different institution, the <i>Superintendencia de Administración Tributaria</i> (SAT). Taxes and other payments to the government are collected through the commercial banking network. The banks gather the amounts collected in a single account each of them hold for the Treasury. Then, in T+1, through an <i>oficio</i> they request the BANGUAT to make a transfer from their reserve account to the single account the treasury holds at the BANGUAT. Finally, banks access the system of the SAT to send the details of payments they received.</p>
Honduras	<p>Currently the <i>Secretaría de Finanzas</i> makes payments to suppliers and government staff by means of cheques. Tax collection takes place through the banking system through an electronic system (FENIX) or through manual procedures. The BCH makes payments associated to government securities through its accounts.</p>
Nicaragua	<p>At present the ministry of finance and the Social Security Institute, two of the major users of the country's payments system, handle collections and make payments mainly with cash or cheques. Every month, the ministry of finance draws nearly 50,000 cheques on its BCN account that are paid to the final beneficiaries through the commercial bank network on behalf of the BCN. It also makes recurrent payments through the TTS system of the BCN to other government entities, particularly autonomous schools. However, this system does not handle third-party information and payments may take from several days to some weeks to arrive to the beneficiary's account. Recently, the ministry of finance has also been using direct credits to the account of the beneficiaries, basically for payments associated with its payroll, but these represent only 2 percent of the total volume of payments it made.</p> <p>Collections related to income taxes are operated mainly through the ministry's own premises, while customs taxes and other collections are operated basically through the banking network. For this latter purpose, the ministry of finance holds approximately 300 different current accounts at commercial banks.</p>
Panama	<p>Government payments and receipts follow a complex and lengthy process characterized by manual procedures and lacking automation. The BNP serves as the government bank, collecting taxes through the banking network and placing them in government accounts at BNP, receiving payments on behalf of the government and acting as its paying agent. Overdrafts of government accounts at BNP are not permitted. The national treasury (part of the Ministry of Economy and Finance--MEF) instructs BNP to execute payments to providers on its behalf. For payroll (wage) payments, the national treasury authorizes and prepares checks with a facsimile of the minister's signature, while these checks are handed physically to recipients by the Office of the Comptroller.</p> <p>For servicing the domestic public debt, MEF-General Directorate of Public Credit authorizes the gross budgetary allocation and informs Latinclear and MEF-General Directorate for the treasury. Latinclear is the CSD in charge of the custody of public debt securities and in such capacity has detailed information on the custodians of the securities who are the beneficiaries of the payments. In order to fund Latinclear accounts for it to serve the debt, MEF-treasury instructs BNP (which acts as paying agent) to credit Latinclear's account (currently CIASA account acting on behalf of Latinclear). When the CSD has confirmed reception of funds in its accounts, it credits custodians' accounts through an ACH order (using the services of CIASA for this purpose).</p> <p>The treasury has been working on alternatives to streamline procedures. Two projects developed with the financial support of the IADB are particularly worth mentioning:</p>



	<ul style="list-style-type: none"> <li>• The “revenues module of the CUT project” which will make possible an automatic register (financial, budgetary and for accounting posting) of all current and public debt revenue at a single treasury account (<i>cuenta única del Tesoro</i>, CUT), by interacting with other currently existing systems and in close coordination with BNP, the Directorates of Income, Customs and Public Debt, the “institutional treasuries,” the Office of the General Comptroller, and banks that collect taxes;</li> <li>• The centralization and concentration of revenues and expenditures at the CUT with a view to improving the efficiency of public finances management and reducing the fragmentation of public sector liquidity in different accounts of public entities. For this purpose, a secure electronic link between BNP and the treasury is expected to be developed to allow remote access on balance status, posting of recent transactions, sending electronic orders, and so on. Additionally, to make it possible to execute electronic transfers, i.e., direct credits (initially to providers, later on the payroll) through the ACH, the BNP has installed an electronic system at the Directorate of Treasury. Operations are expected to commence in 2005 (pending on approval of a Manual of Operations).</li> </ul>
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## Observations

189. **Costa Rica, Guatemala, and Panama have implemented or are in the process of implementing projects to integrate the public sector in the national payment system.** In one case (Costa Rica), the integration has been particularly successful. In others, these projects are stand-alone and are not fully consistent with a long-term strategic vision of the payment system.

190. **Central banks and relevant government agencies should foster coordination and communication to ensure that collections and disbursements of public institutions that are major players in the payment system be processed electronically and timely** through an appropriate system, such as an ACH for retail electronic payment instruments. In many cases, gains in efficiency and cost reduction for government payments have resulted from the reform effort. Such a strategy can also ensure that all sectors can benefit from new payment alternatives, for example, by increasing the banking services used by the public. On the other hand, government payments provide an opportunity to channel a high volume of transactions, thereby making the ACH project for electronic payment instruments more attractive for potential investors.

191. **Government payments are also a major source of liquidity for the banking system.** If coordinated effectively, they can facilitate the smooth functioning of the RTGS system being implemented in the region and increase its appeal to participants.

## F. Foreign Exchange and Cross-Border Settlement Mechanisms

### Context

192. **Foreign exchange markets present relevant risks.** The foreign exchange settlement risk clearly has a credit risk dimension. If (as is usually the case under current market practices) a bank cannot make the payment of the currency it sold conditional upon its final receipt of the currency it bought, it faces the possibility of losing the full principal value of

the transaction. Foreign exchange settlement risk also has an important liquidity risk dimension. Even temporary delays in settlement can expose a receiving bank to liquidity pressures if unsettled funds are needed to meet obligations to other parties. Foreign exchange settlement risk has other dimensions as well, for example legal risk. In the case of foreign exchange deals, legal risk can be complicated by the fact that settlement normally takes place in more than one jurisdiction. In a 1996 CPSS report, the G-10 central banks agreed to a three-track strategy providing for:<sup>195</sup>

- action by individual banks to control foreign exchange settlement exposures;
- action by industry groups to provide risk-reducing multi-currency services; and
- action by central banks to induce rapid private sector progress.

193. The report also states that the “G-10 central banks encourage existing and prospective industry groups to develop and offer services that would contribute to the risk-reducing efforts of individual banks.”<sup>196</sup>

194. **Also as a result of the recommendations included in the 1996 CPSS report, the Continuous Linked Settlement (CLS) service was launched in September 2002.** The CLS (provided by CLS Bank International) settles foreign exchange transactions in seven currencies (Australian dollar, Canadian dollar, US dollar, Euro, Swiss franc, Japanese yen, and British pound) on a payment versus payment (PvP) basis on the books of the seven respective central banks. At the time of its launch, CLS had 66 of the world’s financial institutions participating as shareholders and represented over 80 percent of the world’s foreign exchange business by value. Transactions in other currencies are likely to be settled by the CLS Bank in the future. The CLS Bank is subject to the cooperative oversight of central banks involved and it is under the direct oversight of the U.S. Federal Reserve.

### Status in the region

Country	Foreign Exchange and Cross-Border Mechanisms
Costa Rica	Since 1992 residents in Costa Rica are allowed to hold deposits in the financial sector in dollars and make payments in dollars. Nowadays around half of the deposits held by residents in the financial sector are dollar denominated but only about a fourth of cheques cleared at the clearinghouse are denominated in foreign currency. Authorized financial institutions can hold deposits denominated in foreign currency at the central bank for the settlement of their foreign exchange operations. However, the BCCR does not remunerate them. These accounts have the same characteristics as the reserve accounts in Colones and the clearing and settlement of domestic transactions in foreign currency are concomitant with those in Colones. The value of interbank transfer of funds through TEF in dollars is around two-thirds of transfer in Colones.

<sup>195</sup> See BIS, *Settlement Risk in Foreign Exchange Transactions* (CPSS publication No. 17, March 1996).

<sup>196</sup> See also BIS, *Supervisory Guidance for Managing Settlement Risk in Foreign Exchange Transactions* (Basel Committee on Banking Supervision, September 2000).

	<p>The foreign exchange market is predominantly in US dollars and the value of interbank transactions is around US\$90 million per month, without considering BCCR interventions. The central bank conducts a crawling peg policy and intervenes accordingly. The domestic foreign exchange market trades in MONED, which is administered by the stock exchange. The market operates on an anonymous basis. All operations are settled gross on a real-time PvP basis on the reserve accounts of the central bank. Since only a few large banks (around five) are connected to the international SWIFT network, the BCCR performs a correspondent function for domestic financial institutions that have to settle trade and foreign exchange obligations or that are receiving payments from abroad. Orders are received and sent via TEF. BCCR is connected to SWIFT.</p>
El Salvador	<p>BCR and six large banks are members of SWIFT, which is used to process cross-border payments. As such, they have access to SWIFT hardware and software that permits the electronic transmission of payment instructions on a worldwide basis. These payment instructions can then be settled through the use of correspondent bank balances in the country of settlement. SWIFT access in El Salvador occurred in recent years and replaced the telex for international transfers. Banks that do not have SWIFT still resort to the telex for their payment instructions.</p> <p>The central bank has three types of clients for international payments. These are the government, commercial banks and near-government agencies. The BCR serves as the government bank, issuing and receiving payments on behalf of the government. In order to facilitate international payments, the BCR will also provide international payment services for commercial banks in El Salvador. Banks continue to use the central bank to move their funds abroad, especially to transfer their excess reserves. As with government agencies, transfers will be made to and from the commercial bank's US dollar holdings in their reserve account. The BCR will effect such transfers via SWIFT. Finally, there are a number of government or near-government agencies that receive funds from foreign donor institutions. Such agencies may receive the payments via SWIFT through the BCR.</p>
Guatemala	<p>The foreign exchange market in Guatemala is very active when compared to the overall size of the financial system, trading an average of US\$70 million per day. There are two formal trading platforms in the country, the <i>Sistema de Negociación Electrónico de Divisas</i> (SINEDI), which is managed by the stock exchange, and the <i>Sistema Interbancario de Divisas</i> (SPID). However, both systems combined account for less than 6 percent of the total traded value, as most of the trades are made bilaterally in the over-the-counter (OTC) market. For settlement, participants in the SINEDI and the SPID, which include banks, finance companies, and <i>casas de cambio</i>, may choose from three settlement alternatives (cheque vs. cheque, reserve account transfer vs. cheques, international transfer vs. cheque), none of which guarantees that the two legs of a foreign exchange transaction are settled on a payment-versus-payment (PvP) basis. Furthermore, participants know who their trading counterparties are only in the case of the SPID. These problems have apparently led to the current fragmentation of the market. Participants have largely recurred to bilateral OTC transactions as a less costly and apparently safer alternative as it is based on mutual trust. However, not even in this latter case are PvP conditions met since payments are also made with cheques</p> <p>Cross-border retail payments are relevant for Guatemala as there is increasing commercial and financial integration among Central American countries and because of the importance of remittances. A total of 13 commercial banks (nearly half of the country's total) and the BANGUAT are connected to the global SWIFT network. The BANGUAT only makes cross-border payments on behalf of the government, mainly those associated with servicing the external debt and the diplomatic service. In recent years, several commercial banks in the country are developing proprietary mechanisms to facilitate wholesale as well as retail cross-border payments through their banking subsidiaries in Central American countries or through joint ventures with other banks in this region.</p>

Honduras	<p>Accounts at the central bank are in domestic currency (<i>lempiras</i>) and foreign currency (US dollars). The reserve ratio is 12 percent for domestic currency and 50 percent for foreign currency. The entities that have current accounts at the central bank are banks, savings and loans associations, finance companies, foreign exchange dealers (<i>casas de cambio</i>), stock exchanges and the government. The 12 percent reserve ratio for domestic currency is calculated as an average every 14 days and balances can be used for making daily payments. Furthermore, the BCH Law specifically mentions that they should be used as the base for the functioning of the checks clearinghouse (see Article 54.) In the case of foreign currency, 12 percent has to be maintained in the accounts at the central bank and the remaining 38 percent can be held in a foreign bank in liquid assets. However, in this case, 12 percent has to be maintained as a minimum at all times and account holders can only make a transfer in US dollars if after the transaction they still have more than 12 percent in the account. Foreign currency transactions can only be operated through the funds transfer “system” as the cheques clearinghouse only operates in domestic currency.</p> <p>The foreign exchange market is intervened by the central bank, which operates a crawling peg system. Only banks and authorized foreign exchange dealers (<i>casas de cambio</i>) can trade in foreign currency in Honduras (BCH Law Article 29). They must convert foreign currency incoming to the country to domestic currency at the central bank (see BCH Law Article 29).<sup>197</sup> They have to make a transfer to one of the central bank’s accounts in a foreign correspondent bank. Then, the central bank credits the equivalent amount in domestic currency in the accounts of these institutions at the central bank.<sup>198</sup> The purchase of foreign currency is done through the central bank auction. The central bank has to receive the funds payment by means of bank cheque or funds transfer in order for an intermediary to participate in the auction two days in advance. The central bank debits the domestic currency account two days before the auction and once the auction is finished credits the foreign currency account of the buyer.</p>
Nicaragua	<p>Regarding foreign exchange trading and settlement, the BCN operates a wholesale foreign exchange market (local currency into US dollars and vice versa) for banks, the <i>financieras</i> and the government. In this market the BCN is the seller for every buyer and the buyer for every seller, and PVP is achieved through the use of the current accounts in both currencies at the central bank. However, this is not necessarily the case for other important participants in this market like foreign exchange dealers (e.g., <i>casas de cambio</i>) or for trades among the banks and financieras themselves.</p> <p>Cross-border retail payments are very relevant for Nicaragua as there is an increasing commercial and financial integration among Central American countries particularly because of remittances, which are a major source of external income for the country. Only two commercial banks in the country are connected to the global SWIFT network. Furthermore, several commercial banks in the country are developing proprietary mechanisms to facilitate wholesale as well as retail cross-border payments, mainly throughout Central America.</p>
Panama	<p>Since the US dollar is legal tender in Panama and bank assets and interbank operations are in US dollar, FX transactions are very occasional and limited to transactions between the US dollar and other currencies, especially the euro. At least 20 large banks are connected to the international SWIFT network, and Panama is an important hub for SWIFT services in the region. In 2003 BNP entered into an agreement with the FED to receive international ACH direct credits from the United State , which are directed to American residents. BNP can not</p>

<sup>197</sup> The public can hold foreign currency but can only trade it with the central bank or authorized institutions.

<sup>198</sup> Other institutions operating with foreign currencies (such as remittances companies) must convert incoming foreign exchange into domestic currency in one of the authorized intermediaries (banks and foreign exchange dealers).

	send ACH payments to the United States. Cross-border retail payments and remittances with Central American countries are small.
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## Observations

195. **Foreign exchange transactions are not settled on a payment versus payment (PvP) basis.** Central banks should investigate the possibility of introducing measures to mitigate the risks associated to these operations when PvP is not possible. Risks in this market can be evaluated taking as a reference the reports and questionnaires published by the CPSS. For domestic foreign exchange transactions (those that involve only domestic counterparties), those central banks that allow holding reserve accounts both in local currency and U.S. dollars need to ensure, as matter of urgency, that wholesale foreign exchange trades are settled in central bank money on a PvP basis (not necessarily RTGS, but always maintaining PvP). In this direction, these central banks could eventually consider the provision of a settlement-only account to other major players in the foreign exchange market like the *casas de cambio*.

196. **Central banks and banking supervisors should introduce measures to mitigate the associated risks.** Attention should also be given to correspondent arrangements abroad of domestic banks to ensure that risk profiles and operating procedures of correspondents are constantly reviewed and do not generate any relevant risks in the country.

197. **Proprietary mechanisms of commercial banks for cross-border payments can turn into a less costly and convenient alternative for customers.** Another possible benefit is that remittances from other Central American countries can now be channeled all the way through banks instead of unregulated specialized companies, so that among other things, remittances need not be paid in cash. Central banks in cooperation with banking supervisors and among themselves should carefully monitor these mechanisms and other developments in this area and decide whether regulations are necessary to ensure that they do not increase risks for the domestic banks involved.

198. **On the other hand, a large share of remittances are still channeled through unregulated specialized institutions, for which there are no standards for aspects such as transparency of fees and other charges or the timing of accreditation of funds to end beneficiaries.** In this last regard, the regulatory perspective should be widened from the traditional areas of balance of payments and money laundering to include payment system issues, in particular issues related to efficiency, transparency, and risks.

199. **In sum, Central American central banks should monitor carefully trading and settlement platforms and procedures for foreign exchange and cross-border transactions,** especially remittances, to ensure they can apply the principles of safety and efficiency to the clearance and settlement.

## **G. Interbank Money Market**

### **Context**

200. **The adequate functioning of an interbank money market goes beyond clearance and settlement considerations.** An efficient mechanism for trading and settlement of these transactions will allow for improved liquidity management and, thus, for an increased safety and stability of the financial system. In addition it will help securities settlement through lower interest rates that will be in the benefit of broker-dealers in the credit lines they negotiate with banks. Another important concern for the authorities is the smooth and effective functioning of the monetary policy as the interbank money market is normally the market that central banks use to give a clear signal to banks that then is extended to the rest of the financial sector. If the operational procedures or the organizational and regulatory arrangements do not provide for an efficient system, the central bank can have difficulties in providing clear monetary policy signals.

201. **Key elements for the development of interbank money markets are a special purpose system for large-value payments to provide secure electronic interbank transfers with immediate settlement, interconnected to an electronic book-entry securities system to register and record changes in ownership of securities.** Discussions on the development of the depository function need to involve responsible authorities and all market participants. An adequate strategy that takes into account the national interest and leaves aside any particular interest should be defined and agreed.

### **Observations**

202. **The future evolution of securities markets needs to be discussed among responsible authorities and market participants.** An adequate strategy that takes into account the national interest, leaving private interest aside, should be defined. Once the strategy has been agreed, a neutral securities clearance and settlement system can be implemented to allow fair competition in the financial sector. Authorities and market participants should openly discuss what will be the likely future of securities markets and agree on organizational and regulatory arrangements that allow for an adequate development of the interbank money market, on the one hand, and the securities market, on the other. This will be a difficult process because several private interests will be affected, but it is the only alternative to develop safe and efficient securities markets than can take a lead in a potential regionalization process.

203. **In sum, the adequate functioning of an interbank money market is crucial for the smooth functioning of payments and securities settlement.** An efficient mechanism for trading and settlement will improve the system's liquidity management. Another important concern for the authorities is smooth and effective functioning of monetary policy as the interbank money market is the backbone of monetary transmission. Two key elements for the development of interbank money markets are a special purpose system for large-value payments to provide secure electronic interbank transfers with immediate settlement

interconnected to an electronic book entry securities system to register and record changes in ownership of securities.

### Status in the region

Country	Interbank Money Market
Costa Rica	<p>For historical reasons, in Costa Rica brokerage houses are the main players in the money markets and trading systems are operated by the stock exchange. The current trading and settlement systems in order to avoid defaults on the securities leg of a settlement transaction have introduced fragmentation in the liquidity market due to operational difficulties to arbitrate between different trading systems. This is basically a consequence of the need to block securities before trading to assure the security delivery in a non standardized securities market.</p> <p>However, as the banking system has evolved and banks have been more active in the money markets new trading mechanisms have been required to attend the need for an interbank money market. In this sense, the MIB was launched in 1997 by the stock exchange in order to facilitate interbank trading in this market.</p> <p>The current organizational and regulatory arrangements is not conducive to the development of an efficient interbank market. Legal impediments to directly executing a pledge in a bankruptcy case (without the intervention of a judge), unless the ownership is transferred to a trust, has led to the practice of collateralized interbank loans by means of repos.<sup>199</sup> However, the SML (Article 23) states that any repo transaction is considered a “securities transaction” and, thus, subject to trading by brokerage houses in the stock exchange. This situation could force banks to trade and settle in the systems operated by the stock exchange even if it is not the best solution in terms of cost and efficiency.</p>
El Salvador	<p>The treasury of El Salvador plays a relatively minor role in securities issuance. The secondary market is dominated by repo trading on the stock exchange (70 percent of stock exchange operations were repos in 2000). It is basically a money market as the bulk of repo transactions have a maturity of less than seven days (91 percent of repos in 2000).</p>
Guatemala	<p>The interbank money market is not very active. Banks exchange liquidity among themselves through the MIT and the cheques system, but the central bank does not have the information to differentiate between interbank money market operations and other type of transactions carried out through this system. Interbank money market operations are normally outright loans, as collateralized interbank loans would require the exchange of physical certificates.</p> <p>Interbank money market transactions take place by means of an interbank cheque or a transfer through the funds transfer system, but the central bank does not capture the reason for the operation. This market is mostly uncollateralized as there is not an effective way to collateralize securities and, thus, it would mean the exchange of physical certificates. The other active money market is repos through the stock exchange but it is not a banking market but a brokers-dealers one.</p>
Honduras	<p>The interbank money market is not very active. Banks exchange liquidity among themselves through the funds transfer and the cheques system, but the central bank does not have the information to differentiate between interbank money market operations and other type of transactions carried out through this system.</p>

<sup>199</sup> This is not the case for dematerialized securities (see Article 123 of the SML). However, for the time being, there are not dematerialized securities in Costa Rica and, thus, in practice it is not being applied. The issuance of dematerialized securities will be possible with the SAC system.

Nicaragua	<p>The interbank money market is almost non-existent at the moment. Participants with liquidity shortages may resort to some facilities: (i) they can arrange an uncollateralized loan bilaterally, as there is not an effective way to collateralize interbank loans and, thus, it would mean the exchange of physical certificates; (ii) get liquidity through a repo transaction at the stock exchange; (iii) obtain liquidity from the BCN.</p> <p>The combination of relatively high reserve requirements (16.25 percent) and the abundance of liquidity under normal circumstances ensure that the system does not experience liquidity shortages as a whole. However, the management of the liquidity in the system is far from efficient in part due to deficiencies in the financial infrastructure and the interbank market. This contributes substantially to the high levels of interest rates in the country.</p> <p>The market is very narrow at present due to several reasons. First, there is a lack of confidence among financial institutions which stemmed from the period of financial distress. Furthermore, investors face a lack of investment alternatives as there are not enough instruments in the market. The public debt market is not yet very well organized and the government of Nicaragua does not issue securities on a regular basis. Additionally, banks, the <i>financieras</i> and brokerage houses (the latter are currently regulated by the banking law as there is no designated law for the securities market) are not allowed to invest freely in private sector securities, but only after the SBOIF gives them specific authorization, which occurs on a case by case basis and may take several days.</p> <p>However, an additional contributing factor is the lack of an adequate financial infrastructure. For example, in Nicaragua securities settlement systems are risky due to the lack in many cases of DvP. In this context, the emergence of a collateralized interbank money market, an important alternative in situations where the level of confidence is low, will face substantial difficulties.</p>
Panama	<p>There is not much information on the interbank money market in Panama since no public or private institution receives and collects system-wide statistics. It is noteworthy that most interbank money market operations in Panama are executed through correspondent banks in the United States (either Fedwire or CHIPS) and are non-collateralized. It is not possible to perform same-day domestic operations in BNP funds. When trading securities, banks recur mostly to their own broker-dealers (for tax reasons) and rarely perform OTC transactions.</p>

## H. Securities Settlement Systems

204. **This section covers issues related to securities settlement other than legal issues,** which are covered in Section B. Included in this section are issues related to clearing and settlement processes, settlement risk, operational issues, custody risk, regulatory and oversight issues, depositories organizational arrangements, and cross-border settlement.

### Clearing and settlement processes

#### *Context*

205. **The clearance and settlement process includes capturing trade information, trade matching, confirming and affirming institutional investor's trades, clearing, and settlement.** Various international organizations have attempted to set standards for prompt, efficient, and effective trade processing, including its cost-effectiveness (in terms of both system operation and fees paid by participants) and ease and convenience of use. One of the most widely recognized concepts is that the longer it takes to settle a securities trade, the greater the risk that settlement may not take place. In this regard, the CPSS/IOSCO



recommends that trade settlement occur by T+3 or less. However, T+3 often is no longer regarded as best practice. The shortest possible elapsed time between trade date and settlement date reduces settlement risks (especially market risk) and promotes liquidity in the maturity. Nevertheless, the practical impact of shortening this time must be assessed, especially if it affects the number of trades that fail to settle.<sup>200</sup> Same-day settlement could be considered as the final goal, although it is generally recognized that this may not be achievable in the short or medium term, particularly for cross-border transactions. The magnitude of the changes required to achieve a particular standard must also be carefully considered. For example, whereas it might be relatively easy to move from T+5 to T+3 by simply imposing more discipline on system participants, more fundamental changes (i.e., process re-engineering) in all aspects of the system are likely to be necessary to move to T+2 or T+1. Regardless of the settlement cycle, the frequency and duration of settlement failures should be monitored closely.

**206. The profile of market investors (retail vs. wholesale, domestic vs. foreign) and their intermediaries should be taken into account as this can influence the practicality of the targeted clearing and settlement cycle.** Appropriate trade-off between risk, cost, and convenience must be made, else the system will not satisfy user requirements at an affordable and acceptable cost and thus might constrain market development.

**207. Another widely recognized concept is that trade matching should occur as soon after the trade as possible so that errors and discrepancies can be discovered early in the settlement process.** The CPSS/IOSCO recommends that trade comparison be accomplished by T+0 and in any case no later than T+1. In addition, indirect market participants—institutional investors and custodians—should be members of a trade comparison system that achieves positive affirmation of trade details. Moreover, there should be an integration system for trade matching, comparison, and book-entry settlement of securities and funds. An automated link between the exchange/OTC and the CSD is generally considered to be desirable and is a prerequisite for broker-dealer straight-through processing from execution to settlement. Likewise, when clearing and depository services are provided by different entities, it is recommended that these two functions be closely tied together, otherwise finality of settlement is difficult to achieve. Fortunately, the cost of implementing automated systems is decreasing. However, care should be taken to ensure that sufficient transaction volume exists and that users are willing to pay for the automated services based on tangible benefits in terms of efficiency or risk reduction.

**208. Mature and liquid securities lending markets (including markets for repos and economically equivalent transactions) generally improve the functioning of securities markets** by allowing sellers ready access to securities needed to settle transactions where those securities are not held in inventory, by offering an efficient means of financing

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<sup>200</sup> Currently, there is a debate about the adequacy of moving the settlement cycle to T+2. Given globalization of financial markets, there is an increasing necessity to standardize this process at an international level, even if this implies increasing the settlement cycle for some countries.

securities portfolios, and by supporting participants' trading strategies. The existence of liquid markets for securities lending reduces the risk of failed settlements because market participants with an obligation to deliver securities that they have failed to receive and do not hold in inventory can borrow these securities and complete delivery. Securities lending markets also enable market participants to cover transactions that have already failed, thereby curing the failure sooner. Intraday finality is crucial for these operations. In cross-border transactions, particularly back-to-back transactions, it is often more efficient and cost-effective for a market participant to borrow a security for the delivery rather than to deal with the risk and costs associated with a settlement failure.

**209. Because of increased automation and globalization of securities markets, it is beneficial for domestic systems to use internationally recognized securities identification numbering standards.** With this in mind, the G30 recommended that all markets should adopt a numbering system that meets the International Securities Identification Number (ISIN) standards. The CPSS/IOSCO recommendations insist on this point through recommendation 16.

*Status in the region*

Country	Securities settlement system	Trade confirmation	Settlement cycles	Securities lending	International numbering
Costa Rica	Stock exchange-CEVAL	Lock-in (securities blocked before matching)	T (Mercado de Liquidez) T+1 (TEBEL) T+1 (SITE international securities) T+2 (Primary auction) T+3 (SITE equities) For all the systems only one multilateral net debit position is calculated every day for the cash settlement	No	A standardization process is underway for both private and public securities and all issues in CEVAL have been assigned an ISIN number
El Salvador	Stock exchange-CEDEVAL	T	T	No	No
Guatemala	Stock exchange	T	T	No	No
Honduras	Stock exchanges	No confirmation	No standardized settlement cycle	No	No
Nicaragua	Stock exchange-CENIVAL	T	T (market practice, no official settlement cycle)	No	No
Panama	Stock exchange-Latinclear	T	T+3	No	No

### *Observations*

210. **There is significant manual handling in the confirmation process, which increases the probability of errors and, thus, settlement failures.** Manual handling of securities results in inefficiencies and risks that limit the development of the markets. Indeed the bulk of the market sometimes is settled in-house in order to minimize these risks.

211. **Some systems (e.g., Costa Rica, Panama) have close links between trading and settlement such as blocking of transactions prior to matching.** This procedure ensures the availability of securities but hampers back-to-back transactions and the effective arbitrage between trading and settlement platforms. In order to arbitrate, an investor might wish to sell securities bought in one system in another during the same day. This is not possible if securities have to be blocked in advance. This blockage also makes the rollover of repos difficult. More orthodox risk management tools should be used in order to avoid the rigidity introduced by this mechanism. The development of a new system that allows for the separation of trading and settlement is crucial for the efficient operation of stock exchanges as well as observance of international standards for settlement risk. In addition, as long as no robust risk management procedures are implemented, cash settlement on a multilateral net basis should be done separately for each trading system in order to minimize systemic risk even if it raises costs due to higher liquidity needs of broker-dealers.

212. **The standardized settlement cycle must be fixed and identified for all the trades executed in the securities markets.** This is particularly relevant in the stock exchanges where a T+3 settlement cycle would be appropriate. Shorter settlement cycles for securities traded in the stock exchanges should be taken into consideration, especially those related to bilateral trades between market participants.

213. **Some stock exchanges (e.g., Costa Rica) play a crucial role in money markets and have difficulties in accommodating different settlement needs.** Should these stock exchanges evolve into a more traditional role of secondary market transactions, the introduction of a standardized settlement cycle will be needed.

214. **Shorter settlement cycles can reduce risk in line with international standards.** However, the costs and benefits of a shorter settlement cycle should be assessed, in particular the impact on retail customers. Retail customers may be required to keep funds with broker-dealers or deposit funds with a broker before a broker can execute a buy order. In general, STP will help the reduction of settlement cycles without increasing settlement risks.

215. **Some SSSs allow for the extension of the standardized settlement cycle should a failure occur in the settlement process.** It is essential to count with appropriate risk management tools to guarantee settlement in the case of failures on settlement date. Settlement procedures on a DvP basis help to avoid settlement extensions. Given a failure in the delivery of securities on settlement date (and counting on a guarantee regime and a settlement system on a DvP basis), it is recommended that SSSs can execute buy-in procedures in the securities markets in order to reduce the risk in the system.

**216. Automatic securities lending and borrowing facilities are not available in Central American markets mainly due to the low level of activity.** Such mechanisms provide the SSS with an effective risk management tool for the securities leg of market transactions. Prior to its establishment, securities lending must be recognized and encouraged by law. The finalization of the standardization process is essential for this mechanism to be effective. All barriers (e.g., lack of standardization, legal, tax) should be removed. Securities lending could be implemented in two different ways:

- Bilaterally between market participants. In this case the CSD will act as loan register.
- Multilaterally or centralized. This implies the creation of a group of entities (mostly banking and financial institutions) capable of lending securities against an interest rate. The administration of the pool of potential available securities and the allocation process normally is delegated to the securities depository or another entity acting on a not-taking-risk policy. The efficiency of existing ways to cope with securities shortages should be evaluated vis-à-vis standardized forms of securities lending.

In addition:

- All securities lending operations must be collateralized and backed by private contracts subject to international standards.
- Fiscal treatment of securities lending contracts must be neutral and objective.
- If short-selling is permitted, for example as a way to increase the liquidity of the markets, it should be linked to securities lending operations in order to cover the oversold positions. Regardless, securities regulators must be alert against unhealthy market practices relating to short-selling that could lead to market manipulation.

**217. With the exception of Costa Rica, communication networks do not follow international standards.** Although the local communication networks work correctly, if cross-border transactions are relevant the network should be consistent with international communication procedures. Securities depositories and investment firms with a relevant foreign business share should adopt in the short term international standardized communications procedures in order to facilitate cross-border transactions both free or against payments. Local firms should adapt their communication procedures to the international communications networks using the same standards.

**218. In sum, improved clearing and settlement processes in SSSs are necessary** to reduce market fragmentation, increase standardization of settlement cycles, accommodate different settlement needs, operate with shorter settlement cycles, avoid extension of settlement cycles due to inadequate risk management tools, improve market liquidity through automatic securities lending, and introduce international communication standards.

## Settlement risks

### *Context*

219. **The settlement process exposes market participants to different risks.** The system should be designed to minimize these risks. The immobilization or dematerialization of securities reduces or eliminates certain risks, such as destruction or theft of certificates. The transfer of securities by book-entry is a precondition for the shortening of the settlement cycle for securities trades, which reduces replacement cost risks.

220. **The main settlement risk is counterparty risk (credit or principal risk).** DvP is one of the primary means by which a market can reduce the risk inherent in securities transactions. The DvP concept seeks to eliminate principal risk from securities transactions by ensuring that sellers give up their securities if, and only if, they receive full payment and vice versa. There are three essential elements in a DvP transaction: (a) good and irrevocable delivery of securities, (b) final and irrevocable funds, and (c) simultaneous exchange. The CPSS has identified three different models of DvP.<sup>201</sup> Although these models vary in their approach to achieving DvP, they all meet the concept of real DvP.

221. **The use of a central counterparty that interposes itself between the counterparties to securities trades is becoming more common.** It is an especially effective tool for reducing risks vis-à-vis active market participants. Use of a central counterparty concentrates risk and reallocates it among participants. The ability of the system as a whole to withstand the default of individual participants depends crucially on the risk management procedures of the central counterparty and its access to resources to absorb financial losses.

222. **There are a variety of risk management procedures to reduce market risk and strengthen a DvP mechanism.** Those procedures include admission standards, member's creditworthiness monitoring, novation, participation funds, collateral, margins, buy-ins and sell-outs, net debit caps, bilateral credit limits, and loss-sharing arrangements. Most settlement systems use more than one procedure to minimize market risk. In addition, there are a number of mechanisms designed to improve the settlement process. Among them are central lending facilities, pledge recording facilities, and prompt re-registration procedures. Properly regulated securities lending and borrowing can bring significant benefits to a market and its users, leading to more liquid markets. Short-selling could be a useful mechanism to add liquidity, but regulation must be in place against manipulative practices, including those associated with significant short positions.

223. **Systems that are considering whether to implement RTGS or a netting scheme should examine market volume and participation to determine if these mechanisms are appropriate.** Historically, netting was introduced to reduce the amount of physical

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<sup>201</sup> See Bank for International Settlements, *Delivery versus Payment in Securities Settlement Systems* (CPSS publication No. 6, September 1992).

documents passing between market members. Later, with the introduction of early computer systems, it was used to reduce the number of electronic settlements. Today efficiency advantages are less important due to the high speed introduced by powerful computers and RTGS systems. Thus, the debate is focused on the trade-off between liquidity requirements and risk mitigation as discussed previously in this paper.

**224. Settling in same-day funds is essential when operating in an RTGS environment and is useful in achieving real intra-day DvP.**<sup>202</sup> In order to achieve timely and risk-free settlement in same-day funds, efficient banking arrangements will need to be developed that enable funds to be moved quickly and relatively inexpensively.

**225. Finality of both payments and securities' ownership transfer is a crucial factor in the development of a securities market.** Otherwise, only local investors will operate in the market based on well-established client relationships and the confidence that these provide. In emerging markets, this factor is critical if there is a desire to attract foreign investment. Foreign investors will be reluctant to participate in a market that is not considered to be safe and sound. Payments finality is equally important.

**226. The failure of a bank providing cash accounts to settle payment obligations for CSD members could disrupt settlement and result in significant losses and liquidity pressures.** Use of the central bank as the single settlement bank may not, always be possible, however. In such cases, a private bank sometimes is used as the single settlement bank and steps must be taken to protect CSD members from potential losses and liquidity pressures that would arise from its failure.

### *Status in the region*

Country	Securities settlement system	Risk management tools	DvP	Cash settlement asset
Costa Rica	Stock exchange CEVAL	Securities block prior to trading; credit line; guarantee fund (defaulters pay)	Model 2 (1.5 hours difference between cash settlement and securities leg)	Central bank
El Salvador	Stock exchange CEDEVAL	None	No	Central bank
Guatemala	Stock exchange	None	No	Central bank or cheques
Honduras	Stock exchanges	None	No	Cash or cheques
Nicaragua	Stock exchange CENIVAL	None	No	Cheques
Panama	Stock exchange Latinclear	Securities blocking prior to selling; guarantee scheme (a defaulters pay)	Model 2	Private Settlement Agent (CIASA)

<sup>202</sup> A payment is made in same-day funds when payment of such funds is made on an irrevocable basis to the counterparty on the day of settlement such that they are available for use on the day of settlement.

### ***Observations***

227. **A modern securities market needs to have a securities depository and fungible securities.** All physical securities kept in custody by participants of the securities depositories should be immobilized or dematerialized in a securities depository.

228. **Additional efforts are necessary in order to achieve full dematerialization and immobilization of securities.** Central banks and ministries of finance are making efforts to achieve the complete dematerialization of government securities. Similar efforts are being undertaken by the private sector. Lack of securities standardization is an important obstacle, mainly in the case of public securities. Regular meetings with issuers and both institutional and non-institutional investors are practical measures in order to promote dematerialization and immobilization and the movement of securities on a book-entry basis.

229. **Some systems (El Salvador, Guatemala, Honduras and Nicaragua) still do not settle on a DvP basis.** Consequently, payments are not necessarily linked to securities transfers and vice versa. Therefore, principal risk exists and no measures have been taken to eliminate principal risk and to reduce and mitigate replacement risk (i.e., a guarantee regime). Coordination and links between securities and monetary flow transfers on a DvP basis model are essential. Replacement risk must be reduced or mitigated with the implementation of a strict guarantee regime.

230. **Most systems have imperfect DvP procedures.** Due to the time differences between the clearing of the cash leg and that of the securities leg, principal risk could occur if a broker goes bankrupt in this period. In that case it might be difficult to transfer the securities from the account of the depository in which they are blocked at the beginning of the trading day to the defaulters counterparty, even if the counterparty has already paid for these securities. In addition, principal risk in these systems is sometimes substantially enlarged by the decision to release securities in the second leg of a repo transaction before cash settlement in order to allow for rollover. The securities might already be transferred to a third party by the original owner while no money might be available in order to fulfill the obligation to its counterparty. One reason behind this kind of settlement arrangements is lack of standardization.

231. **In general, there is an absence of risk management tools used to cover settlement failures.** Some systems do not count with any, while others count with some clearly insufficient tools. Authorities should analyze if current risk management tools are enough to cover potential failures, especially taking into account that existing guarantee funds can be used for failures other than those associated with settlement. A specific guarantee fund for settlement failures could be separated from a more general guarantee fund. In some cases, operations are unwound prior to the use of the guarantee funds and no risk management tool is established for failures on the settlement side, except to compensate the broker-dealer for the fee. In order to avoid potential systemic risk the guarantee funds should be used prior to the unwinding and a buy-in or similar mechanism could be established to cover securities

failures. In some cases, the total value of the guarantees seems insufficient to cover failures for both securities and funds, at the current levels of market volume and value.

**232. Relating to the funds side, the common use of checks on the settlement process implies that the same-day-fund principle could not be fulfilled.** Central bank money is often used in transactions. However, settlement in central bank money is not normally mandatory and payments by cheques are commonly used in many systems. The use of central bank money to settle transactions relating to securities markets should be encouraged (this is especially important for developing markets although not required by the standards). Existing funds settlement systems in the region already allow for the use of other type of fund transfer that would eliminate this risk. Due to the nature of securities transaction, funds settlement should take place with an instrument that allows for finality at the end of settlement day.

**233. Normally, nonbank clearing members and broker-dealers do not have access to central bank money, which imposes a liquidity constraint on their operations.** If there is a lack of liquidity in the financial system or inefficient liquidity management and market practices of broker-dealer and their clients, the shortage of liquidity could be exacerbated by settlement without DvP. In some cases, broker-dealers have difficulties accessing intra-day liquidity facilities from commercial banks. Banking innovation in payments mechanisms might bring some reduction of liquidity pressures at the broker and customer levels. Provision of funds from the final investor to the broker-dealer in order to execute the transactions would also ease liquidity pressures. The reliability of the system as a whole, and of clearing and settlement procedures on a DvP basis, are essential to bringing confidence to the system and, thus, allowing final investors to provide broker-dealers with liquidity for operations carried out on their behalf.

**234. In the case where settlement of funds is made at a private settlement bank (not common but present in the region), assets used to settle the cash leg of securities transactions between SSS members should carry little or no credit or liquidity risk.** If central bank money is not used, steps must be taken to protect participants from potential losses and liquidity pressures arising from the failure of a settlement bank. Often, when a private settlement bank is used, there is no supervision of its settlement function. Lack of coordination between regulators on this raises additional concerns. Authorities should explore alternatives in terms of the assets used to settle the cash leg of securities transactions and, if a private settlement bank is used, adequate regulatory and supervisory mechanisms should be in place.

**235. Plans for the development of new securities depository in the region are not always realistic in terms of timing and are driven by a specific technological solution, not by a strategy agreed by all stakeholders.** Some stock exchanges are developing technological solutions based on other countries' experiences in the region. The launch of a securities depository is a desirable and necessary element, but it implies much more than the establishment of an operational system. The launch of the securities depository should be considered in the context of a comprehensive reform of the payment and securities settlement systems. Some crucial elements should be agreed by regulators and other stakeholders before



any implementation takes place, such as the role of the central bank; what kind of securities will the securities depository immobilize or dematerialize; who will be the settlement bank and what implications does the legal framework have in this regard; what are the most appropriate settlement cycles; should the depository identify the beneficial owner or should this be done only at the custodian level (this decision depending on the strength of the supervisory function); what model of DvP will be implemented; what risk management tools will be in place to mitigate settlement risks in case of a multilateral net system; operational security requirements and supervision; what ownership structure should the depository have, will the system allow for fair and open access to all participants; and what will be the governance arrangements. It is important that the reform focuses on all elements of SSSs and not only on the operational system for a securities depository. It is also important that the new SSS observes the *Recommendations for Securities Settlement Systems* issued by CPSS-IOSCO in November 2001, which include legal and custody issues, clearance and settlement procedures, settlement risk, cash settlement asset, operational risk, regulation and oversight, transparency, efficiency, access and governance. Finally, formal coordination among regulators and cooperation with the private sector is crucial in developing this piece of financial infrastructure.

**236. Where public authorities have not taken a leadership role in the development of securities settlement arrangements, private institutions have introduced solutions that are not integrated in a comprehensive payments and securities settlement reform.** Due to public interest on the development of an SSS infrastructure (implications to fiscal and monetary policy, liquidity management and development of the capital markets), public authorities (central bank, securities regulator, pension funds regulator, and ministry of finance) should take the lead in defining how such a system should be designed and implemented, and cooperating with the private sector in doing so. The public nature and neutral position of regulators can help overcome the conflict among private interests.

**237. Some markets are exposed to concentration risk in settlement activity.** Broker-dealers have a central function in some trading and securities settlement systems. In some cases, they have the monopoly on trading in the stock exchange. They are also the only participants in the depository with operational rights (pension funds and banks have non-operational custody accounts) and for that reason have a monopoly on custody services for immobilized securities. In some cases, all money market transactions have to be done via broker-dealers. Broker-dealers also provide services to the public by attracting deposits and invest in capital or money market instruments. This full range of services includes substantial liabilities of the broker-dealers to banks, other financial institutions, and the public. However, capital requirements for broker-dealers houses are relative low.

**238. The settlement of securities and funds should be linked to stock exchange transactions settled on a DvP basis in order to eliminate principal risk.** The main improvements needed are: achievement of full dematerialization and immobilization of securities, establishment and completion of DvP procedures, upgrade of current risk management tools, mitigation of credit and liquidity risk in the cash leg settlement (including elimination of cheques as a cash asset), better access to liquidity for SSS participants, and

comprehensive strategic approach for the reform of SSSs versus technology-driven and exclusively operational reform projects.

## **Operational issues**

### ***Context***

239. **Operational risk is the risk that deficiencies in information systems or internal controls, human errors, or management failures result in unexpected losses.** As clearing and settlement systems become increasingly dependent on information technology systems, the reliability of these systems is a key element of operational risk. Operational risk can arise from inadequate control of systems and processes; inadequate management more generally (lack of expertise, poor supervision or training, inadequate resources); inadequate identification or understanding of risks and the controls and procedures needed to limit them; and inadequate attention paid to ensure that procedures are understood and complied with.

240. **In order to minimize operational risk, system operators should identify the sources of this risk.** All key systems should be secure (i.e., have access controls, adequate safeguards to prevent external intrusions, and provide audit trails), reliable, scaleable, able to handle stress volume, and with contingency plans in case of system interruption. The system should maintain an adequate capacity to process current and anticipated future transaction volume, including projected peak day and peak hour volume demands. To achieve this, the operator must: (a) establish formal current and future capacity estimates for their automated trade comparison systems; (b) conduct periodic capacity stress tests to determine the behavior of systems under a variety of simulated conditions; and (c) conduct independent annual reviews to assess whether these systems can adequately perform at their current and estimated future capacity levels.

241. **Operational capacity must also be demonstrated to exist at the mandatory disaster-recovery site.** Operators must have in place a well-designed and adequately tested mechanism for transferring system control to the back-up site in an acceptable time frame without loss of data or unacceptable reduction in service levels.

242. **In assessing the efficiency of settlement systems, the needs of users and the costs imposed on them must be carefully balanced with the requirement that the system meet appropriate standards of safety and security.**

### ***Status in the region***

Country	Securities settlement system	Operational reliability
Costa Rica	CEVAL	In the present systems for clearing and settlement and for central custody services, attention is paid to operational reliability. Every year an analysis of potential threats is made and the existing emergency plan is adapted accordingly. A contingency committee is installed. Protection

		<p>measures against unauthorized access are tested periodically by an external expert. There is an own power supply in case of an electricity cut off. Communication with the brokers is based on a client-server infrastructure. Every participant is connected with the server via two dedicated optical fiber lines. Capacity of the systems can handle two times the peak hours demand. Procedures are in place concerning procurement, development and modification of the systems and modifications are adequately tested before becoming operational. The systems have separate environments for production, developing and testing. A changeover committee is installed with participants of the IT department who designed and implemented the modification, the internal audit department and the person responsible for testing. The committee is chaired by the CEO himself. However disaster recovery facilities are not up to standard. There is no back-up server in hot standby mode and there is no second contingency site.</p> <p>Efficiency of the systems needs to be improved. There are too many systems for different segments which leads to fragmentation. Integration of trading and settlement and the blocking of securities at the moment the participants enter the trading platforms is inefficient and costly.</p>
El Salvador	Stock exchange CEDEVAL	Contingency plans are based on manual procedures.
Guatemala	Stock exchange	The BVN reports that all their systems, including the securities depository, count with safe operational features, back-up sites and contingency plans. However, there is no regulation or supervision of these issues by any regulatory authority, as the stock exchange operates as a full SRO.
Honduras	Stock exchange	Manual procedures.
Nicaragua	CENIVAL	Neither the BVDN nor the CENIVAL have contingency facilities and/or back-up sites. The only contingency plan at present is the possibility to hold outcry floor sessions for trading purposes in case there is a malfunctioning of the electronic trading system.
Panama	Latinclear	Latinclear claims to pay special attention to operational reliability. Periodical analyses of potential threats are made. Communications with the brokers are made through dedicated lines. There is no back-up server in hot standby mode, but there is an alternative contingency site located in Panama City, about 6 km away from the primary site. A tape containing a back-up copy of operations is sent daily to the back-up site.

### ***Observations***

243. **The physical handling of securities is still common in many SSSs.** The clearing and settlement of securities transactions with physical certificates instead of a transfer via a book-entry system is not only risky, but also cumbersome and costly and hampers development of capital markets. It is absolutely not in line with the international code and standards. Thus, an important target should be to eliminate physical handling of securities. General laws on securities or capital markets must recognize the immobilization, dematerialization and the transfer of securities on a book-entry basis. Depositories should encourage the dematerialization and immobilization of all securities as a matter of urgency.

244. **Straight-through processing (STP) is not the rule in SSSs in the region.** Many procedures imply physical handling of securities. This makes some clearance and settlement procedures cumbersome, for example, dividends payments and corporate actions in general that require a substantial amount of manual intervention. Gradual implementation of STP procedures would be desirable for all kinds of securities in order to reduce operational risk. STP processing for securities transactions will mean a fully automated transactional link for trade matching, comparison, and book-entry settlement of securities and funds. Such an integrated system would not only reduce the possibility of errors, but also make the clearing and settlement process more efficient by, for example, eliminating duplicate processes and giving the participants immediate information for effective liquidity management.

245. **In many cases, back-up facilities are missing or in the process of being implemented.** They should be in place as early as possible to cover any contingency in the system. Alternate sites and disaster recovery facilities must enable operations to be recovered in a manner that does not disrupt settlement.

246. **External auditing of operational systems should be considered in order to assess the security and cost-efficiency of all systems.** Authorities and the private sector have made very important efforts in the development of technological platforms for the operation of the SSSs. In some cases, an in-house solution has been adopted versus the acquisition of standard systems. In these cases, an external audit of the systems developed should be considered to ensure that all required features (i.e., security, contingency, back-ups, capacity) are in place for a safe and efficient operation of the new systems. This is even more important when supervision of operational risk is not well developed.

247. **In sum, there is room for important efficiency gains in the securities settlement infrastructure.** In particular, physical handling of securities should be eliminated to increase the safety and efficiency of SSSs. In addition, there is room for improvement in the clearing and settlement process as STP is not the common rule. Various plans for back-up sites and disaster recovery facilities should be accelerated or established when non-existent. Finally, external audit of the systems should be undertaken, especially when systems have been developed in-house. The latter is especially important when supervision of operational risk is weak.

## **Custody risk**

### ***Context***

248. **Custody risk is the risk of losses on securities held in custody due to the custodian's (or subcustodian's) insolvency, negligence, misuse of assets, fraud, poor administration, or inadequate record keeping.** A custodian should employ procedures ensuring that all customer assets are appropriately accounted for and kept safe. Customer securities must also be protected against claims of the custodian's creditors, and typically client assets are given preferential treatment under insolvency law.

**249. Custodians must have a demonstrated capacity to safeguard securities and funds in their custody or control, or for which they are responsible, and to protect against reasonably anticipated internal or external threats to the integrity of their operations.**

In many markets, settlement is carried out and controlled through automatic data processing systems. In these cases, the system should have appropriate procedures to back-up data and a contingency plan to minimize disruptions.

**250. Electronic technologies such as the use of Internet for initiating financial transactions increase consumer choices but provide means for abuse and illegal activity.**

Safeguards should anticipate, and be designed to provide protection against the possibility of theft, accidental or malicious destruction or loss of securities or funds and the possibility of accidental or intentional but unauthorized modification, disclosure, or destruction of data.

**251. Custodians should have an adequately staffed internal audit department,** which has the authority to review, monitor, and evaluate the organization's system of internal controls and the integrity of operational procedures.

**252. In summary, special attention is required to reduce fraud.** Some of the issues to be addressed are: (a) the operational security of systems including identification systems, message authentication and protection measures in safeguarding access to the system; (b) protection against insider fraud; (c) a regular independent audit of the systems to ensure continued integrity; and (d) the determination of liability for loss or technical failure.

### ***Status in the region***

<b>Country</b>	<b>Depository</b>	<b>Custody arrangements</b>
Costa Rica	CEVAL	Segregation of accounts in CEVAL exists at the clients' level. Ownership rights of an investor are clearly defined. An investor who has given his securities in custody is protected by law against the claims of the creditor or his custodians (Article 142). Independent of the form and the location, securities of clients form no part of custodian assets, stay outside the available assets after bankruptcy and cannot be claimed by its creditors. This is also the case if securities had been deposited for third parties. This article protects securities issued in Costa Rica and foreign securities kept in custody by a local custodian. The law protects Costa Ricans, foreign investors, and foreign custodians using a Costa Rican local agent.
El Salvador	CEDEVAL	Security settlement occurs through CEDEVAL, which is the nation's security depository. Securities settlement occurs by transferring the ownership records at CEDEVAL. Since not all securities are immobilized, sellers must deliver physical securities to CEDEVAL 24 hours before the sale is made.  A draft law for the dematerialization of securities has been presented for its approval in the Parliament. The draft law gives the possibility to the BCR to be the depository and maintain the registry for public securities. Considering that 80 percent of all transactions in the securities market are of official securities (Treasury and BCR paper), mainly in the form of short-term repos, the proposed dematerialization will have an important

		impact in the securities settlement.
Guatemala	Stock exchange	<p>In principle, all public securities are issued in physical form, however if the investor decides to keep them under the custody of the central bank they are issued as book-entry notes at the central bank Registry. The central bank only performs the custody function and not the ownership transfer, that is, they only register the ownership of the investor in the primary market. Subsequent ownership transfers are done by means of delivery (if bearer securities) or endorsement (if order securities) or book-entry note in the stock exchanges' securities depository, once previously deposited.</p> <p>For stock exchange transactions, securities must be deposited in the correspondent securities depository (<i>Caja de Valores</i>). The securities depository of the BVN started operating in 1994. Physical custody of securities deposited in the <i>Caja de Valores</i> has been outsourced to a private bank, owner of broker-dealers members of the stock exchange. Custody of securities is formalized by means of a deposit contract, regulated in the SML (Art. 79). Each participant in the depository must open an own account and an account on behalf of final beneficiaries, of which the depository keeps a record. Broker-dealers must send periodic information to their customers about their account statements. The depository also administers economic rights associated to the securities deposited.</p>

## Settlement risks

### Context

253. **The settlement process exposes market participants to different risks.** The system should be designed to minimize these risks. The immobilization or dematerialization of securities reduces or eliminates certain risks, such as destruction or theft of certificates. The transfer of securities by book-entry is a precondition for the shortening of the settlement cycle for securities trades, which reduces replacement cost risks.

254. **The main settlement risk is counterparty risk (credit or principal risk).** DvP is one of the primary means by which a market can reduce the risk inherent in securities transactions. The DvP concept seeks to eliminate principal risk from securities transactions by ensuring that sellers give up their securities if, and only if, they receive full payment and vice versa. There are three essential elements in a DvP transaction: (a) good and irrevocable delivery of securities, (b) final and irrevocable funds, and (c) simultaneous exchange. The CPSS has identified three different models of DvP.<sup>203</sup> Although these models vary in their approach to achieving DvP, they all meet the concept of real DvP.

255. **The use of a central counterparty that interposes itself between the counterparties to securities trades is becoming more common.** It is an especially effective

<sup>203</sup> See Bank for International Settlements, *Delivery versus Payment in Securities Settlement Systems* (CPSS publication No. 6, September 1992).

tool for reducing risks vis-à-vis active market participants. Use of a central counterparty concentrates risk and reallocates it among participants. The ability of the system as a whole to withstand the default of individual participants depends crucially on the risk management procedures of the central counterparty and its access to resources to absorb financial losses.

**256. There are a variety of risk management procedures to reduce market risk and strengthen a DvP mechanism.** Those procedures include admission standards, member's creditworthiness monitoring, novation, participation funds, collateral, margins, buy-ins and sell-outs, net debit caps, bilateral credit limits, and loss-sharing arrangements. Most settlement systems use more than one procedure to minimize market risk. In addition, there are a number of mechanisms designed to improve the settlement process. Among them are central lending facilities, pledge recording facilities, and prompt re-registration procedures. Properly regulated securities lending and borrowing can bring significant benefits to a market and its users, leading to more liquid markets. Short-selling could be a useful mechanism to add liquidity, but regulation must be in place against manipulative practices, including those associated with significant short positions.

**257. Systems that are considering whether to implement RTGS or a netting scheme should examine market volume and participation to determine if these mechanisms are appropriate.** Historically, netting was introduced to reduce the amount of physical documents passing between market members. Later, with the introduction of early computer systems, it was used to reduce the number of electronic settlements. Today efficiency advantages are less important due to the high speed introduced by powerful computers and RTGS systems. Thus, the debate is focused on the trade-off between liquidity requirements and risk mitigation as discussed previously in this paper.

**258. Settling in same-day funds is essential when operating in an RTGS environment and is useful in achieving real intra-day DvP.**<sup>204</sup> In order to achieve timely and risk-free settlement in same-day funds, efficient banking arrangements will need to be developed that enable funds to be moved quickly and relatively inexpensively.

**259. Finality of both payments and securities' ownership transfer is a crucial factor in the development of a securities market.** Otherwise, only local investors will operate in the market based on well-established client relationships and the confidence that these provide. In emerging markets, this factor is critical if there is a desire to attract foreign investment. Foreign investors will be reluctant to participate in a market that is not considered to be safe and sound. Payments finality is equally important.

**260. The failure of a bank providing cash accounts to settle payment obligations for CSD members could disrupt settlement and result in significant losses and liquidity pressures.** Use of the central bank as the single settlement bank may not always be possible,

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<sup>204</sup> A payment is made in same-day funds when payment of such funds is made on an irrevocable basis to the counterparty on the day of settlement such that they are available for use on the day of settlement.

however. In such cases, a private bank sometimes is used as the single settlement bank and steps must be taken to protect CSD members from potential losses and liquidity pressures that would arise from its failure.

### *Status in the region*

Country	Securities settlement system	Risk management tools	DvP	Cash settlement asset
Costa Rica	Stock exchange CEVAL	Securities block prior to trading; credit line; guarantee fund (defaulters pay)	Model 2 (1.5 hours difference between cash settlement and securities leg)	Central bank
El Salvador	Stock exchange CEDEVAL	None	No	Central bank
Guatemala	Stock exchange	None	No	Central bank or cheques
Honduras	Stock exchanges	None	No	Cash or cheques
Nicaragua	Stock exchange CENIVAL	None	No	Cheques
Panama	Stock exchange Latinclear	Securities blocking prior to selling; guarantee scheme (a defaulters pay)	Model 2	Private Settlement Agent (CIASA)

### *Observations*

261. **A modern securities market needs to have a securities depository and fungible securities.** All physical securities kept in custody by participants of the securities depositories should be immobilized or dematerialized in a securities depository.

262. **Additional efforts are necessary in order to achieve full dematerialization and immobilization of securities.** Central banks and ministries of finance are making efforts to achieve the complete dematerialization of government securities. Similar efforts are being undertaken by the private sector. Lack of securities standardization is an important obstacle, mainly in the case of public securities. Regular meetings with issuers and both institutional and non-institutional investors are practical measures in order to promote dematerialization and immobilization and the movement of securities on a book-entry basis.

263. **Some systems (El Salvador, Guatemala, Honduras, and Nicaragua) still do not settle on a DvP basis.** Consequently, payments are not necessarily linked to securities transfers and vice versa. Therefore, principal risk exists and no measures have been taken to eliminate principal risk and to reduce and mitigate replacement risk (i.e., a guarantee regime). Coordination and links between securities and monetary flow transfers on a DvP basis are essential. Replacement risk must be reduced or mitigated with the implementation of a strict guarantee regime.



264. **Most systems have imperfect DvP procedures.** Due to the time differences between the clearing of the cash leg and that of the securities leg, principal risk could occur if a broker goes bankrupt in this period. In that case it might be difficult to transfer the securities from the account of the depository in which they are blocked at the beginning of the trading day to the defaulters counterparty, even if the counterparty has already paid for these securities. In addition, principal risk in these systems is sometimes substantially enlarged by the decision to release securities in the second leg of a repo transaction before cash settlement in order to allow for rollover. The securities might already be transferred to a third party by the original owner while no money might be available in order to fulfill the obligation to its counterparty. One reason behind this kind of settlement arrangements is lack of standardization.

265. **In general, there is an absence of risk management tools used to cover settlement failures.** Some systems do not count with any, while others count with insufficient tools. Authorities should analyze if current risk management tools are enough to cover potential failures, especially taking into account that existing guarantee funds can be used for failures other than those associated with settlement. A specific guarantee fund for settlement failures could be separated from a more general guarantee fund. In some cases, operations are unwound prior to the use of the guarantee funds and no risk management tool is established for failures on the settlement side, except to compensate the broker-dealer for the fee. In order to avoid potential systemic risk the guarantee funds should be used prior to the unwinding and a buy-in or similar mechanism could be established to cover securities failures. In some cases, the total value of the guarantees seems insufficient to cover failures for both securities and funds, at the current levels of market volume and value.

266. **Relating to the funds side, the common use of cheques on the settlement process implies that the same-day-fund principle could not be fulfilled.** Central bank money is often used in transactions. However, settlement in central bank money is not normally mandatory and payments by cheques are commonly used in many systems. The use of central bank money to settle transactions relating to securities markets should be encouraged (this is especially important for developing markets although not required by the standards). Existing funds settlement systems in the region already allow for the use of other type of fund transfer that would eliminate this risk. Due to the nature of a securities transaction, funds settlement should take place with an instrument that allows for finality at the end of settlement day.

267. **Normally, nonbank clearing members and broker-dealers do not have access to central bank money, which imposes a liquidity constraint on their operations.** If there is a lack of liquidity in the financial system or inefficient liquidity management and market practices of broker-dealer and their clients, the shortage of liquidity could be exacerbated by settlement without DvP. In some cases, broker-dealers have difficulties accessing intra-day liquidity facilities from commercial banks. Banking innovation in payment mechanisms might bring some reduction of liquidity pressures at the broker and customer levels. Provision of funds from the final investor to the broker-dealer in order to execute the transactions would also ease liquidity pressures. The reliability of the system as a whole, and of clearing and settlement procedures on a DvP basis, are essential to bringing confidence to

the system and, thus, allowing final investors to provide broker-dealers with liquidity for operations carried out on their behalf.

**268. In the case where settlement of funds is made at a private settlement bank (not common but present in the region), assets used to settle the cash leg of securities transactions between SSS members should carry little or no credit or liquidity risk.** If central bank money is not used, steps must be taken to protect participants from potential losses and liquidity pressures arising from the failure of a settlement bank. Often, when a private settlement bank is used, there is no supervision of its settlement function. Lack of coordination between regulators on this raises additional concerns. Authorities should explore alternatives in terms of the assets used to settle the cash leg of securities transactions and, if a private settlement bank is used, adequate regulatory and supervisory mechanisms should be in place.

**269. Plans for the development of new securities depositories in the region are not always realistic in terms of timing and are driven by a specific technological solution, not by a strategy agreed by all stakeholders.** Some stock exchanges are developing technological solutions based on other countries' experiences in the region. The launch of a securities depository is a desirable and necessary element, but it implies much more than the establishment of an operational system. The launch of the securities depository should be considered in the context of a comprehensive reform of the payment and securities settlement systems. Some crucial elements should be agreed by regulators and other stakeholders before any implementation takes place, such as the role of the central bank; what kind of securities will the securities depository immobilize or dematerialize; who will be the settlement bank and what implications does the legal framework have in this regard; what are the most appropriate settlement cycles; should the depository identify the beneficial owner or should this be done only at the custodian level (this decision depending on the strength of the supervisory function); what model of DvP will be implemented; what risk management tools will be in place to mitigate settlement risks in case of a multilateral net system; operational security requirements and supervision; what ownership structure should the depository have, will the system allow for fair and open access to all participants; and what will be the governance arrangements. It is important that the reform focuses on all elements of SSSs and not only on the operational system for a securities depository. It is also important that the new SSS observes the *Recommendations for Securities Settlement Systems* issued by CPSS-IOSCO in November 2001, which include legal and custody issues, clearance and settlement procedures, settlement risk, cash settlement asset, operational risk, regulation and oversight, transparency, efficiency, access, and governance. Finally, formal coordination among regulators and cooperation with the private sector is crucial in developing this piece of financial infrastructure.

**270. Where public authorities have not taken a leadership role in the development of securities settlement arrangements, private institutions have introduced solutions that are not integrated in a comprehensive payments and securities settlement reform.** Due to public interest on the development of an SSS infrastructure (implications for fiscal and monetary policy, liquidity management, and development of capital markets), public

authorities (central bank, securities regulator, pension funds regulator, and ministry of finance) should take the lead in defining how such a system should be designed and implemented, and cooperating with the private sector in doing so. The public nature and neutral position of regulators can help overcome the conflict among private interests.

**271. Some markets are exposed to concentration risk in settlement activity.** Broker-dealers have a central function in some trading and securities settlement systems. In some cases, they have the monopoly on trading in the stock exchange. They are also the only participants in the depository with operational rights (pension funds and banks have non-operational custody accounts) and for that reason have a monopoly on custody services for immobilized securities. In some cases, all money market transactions have to be done via broker-dealers. Broker-dealers also provide services to the public by attracting deposits and investing in capital or money market instruments. This full range of services includes substantial liabilities of the broker-dealers to banks, other financial institutions, and the public. However, capital requirements for broker-dealers are relatively low.

**272. The settlement of securities and funds should be linked to stock exchange transactions settled on a DvP basis in order to eliminate principal risk.** The main improvements needed are: achievement of full dematerialization and immobilization of securities, establishment and completion of DvP procedures, upgrading of current risk management tools, mitigation of credit and liquidity risk in the cash leg settlement (including elimination of cheques as a cash asset), better access to liquidity for SSS participants, and comprehensive strategic approach for the reform of SSSs versus technology-driven and exclusively operational reform projects.

## **Operational issues**

### ***Context***

**273. Operational risk is the risk that deficiencies in information systems or internal controls, human errors, or management failures result in unexpected losses.** As clearing and settlement systems become increasingly dependent on information technology systems, the reliability of these systems is a key element of operational risk. Operational risk can arise from inadequate control of systems and processes; inadequate management more generally (lack of expertise, poor supervision or training, inadequate resources); inadequate identification or understanding of risks and the controls and procedures needed to limit them; and inadequate attention paid to ensure that procedures are understood and complied with.

**274. In order to minimize operational risk, system operators should identify the sources of this risk.** All key systems should be secure (i.e., have access controls, adequate safeguards to prevent external intrusions, and provide audit trails), reliable, scaleable, able to handle stress volume, and with contingency plans in case of system interruption. The system should maintain an adequate capacity to process current and anticipated future transaction volume, including projected peak-day and peak-hour volume demands. To achieve this, the operator must: (a) establish formal current and future capacity estimates for their automated

trade comparison systems; (b) conduct periodic capacity stress tests to determine the behavior of systems under a variety of simulated conditions; and (c) conduct independent annual reviews to assess whether these systems can adequately perform at their current and estimated future capacity levels.

**275. Operational capacity must also be demonstrated to exist at the mandatory disaster-recovery site.** Operators must have in place a well-designed and adequately tested mechanism for transferring system control to the back-up site in an acceptable time frame without loss of data or unacceptable reduction in service levels.

**276. In assessing the efficiency of settlement systems, the needs of users and the costs imposed on them must be carefully balanced with the requirement that the system meet appropriate standards of safety and security.**

*Status in the region*

Country	Securities settlement system	Operational reliability
Costa Rica	CEVAL	In the present systems for clearing and settlement and for central custody services, attention is paid to operational reliability. Every year an analysis of potential threats is made and the existing emergency plan is adapted accordingly. A contingency committee is in place. Protection measures against unauthorized access are tested periodically by an external expert. There is an own power supply in case of electricity cut off. Communication with the brokers is based on a client-server infrastructure. Every participant is connected with the server via two dedicated optical fiber lines. Capacity of the systems can handle two times the peak-hour demand. Procedures are in place concerning procurement, development and modification of the systems and modifications are adequately tested before becoming operational. The systems have separate environments for production, developing and testing. A changeover committee is in place with participants from the IT department (which designed and implemented the modification), the internal audit department, and the person responsible for testing. The committee is chaired by the CEO himself. However disaster recovery facilities are not up to standards. There is no back-up server in hot standby mode and there is no second contingency site.  Efficiency of the systems needs to be improved. There are too many systems for different segments, which leads to fragmentation. Integration of trading and settlement and the blocking of securities at the moment the participants enter the trading platforms is inefficient and costly.
El Salvador	Stock exchange CEDEVAL	Contingency plans are based on manual procedures.
Guatemala	Stock exchange	The BVN reports that all their systems, including the securities depository, count with safe operational features, back-up sites, and contingency plans. However, there is no regulation or supervision of these issues by any regulatory authority, as the stock exchange operates as a full SRO.

Honduras	Stock exchange	Manual procedures.
Nicaragua	CENIVAL	Neither the BVDN nor the CENIVAL have contingency facilities and/or back-up sites. The only contingency plan at present is the possibility to hold outcry floor sessions for trading purposes in case there is a malfunctioning of the electronic trading system.
Panama	Latinclear	Latinclear claims to pay special attention to operational reliability. Periodical analyses of potential threats are made. Communications with the brokers are made through dedicated lines. There is no back-up server in hot standby mode, but there is an alternative contingency site located in Panama City, about 6 km away from the primary site. A tape containing a back-up copy of operations is sent daily to the back-up site.

### **Observations**

277. **The physical handling of securities is still common in many SSSs.** The clearing and settlement of securities transactions with physical certificates instead of a transfer via a book-entry system is not only risky, but also cumbersome and costly and hampers development of capital markets. It is not in line with international standards. Thus, an important target should be to eliminate physical handling of securities. General laws on securities or capital markets must recognize the immobilization, dematerialization, and transfer of securities on a book-entry basis. Depositories should encourage the dematerialization and immobilization of all securities as a matter of urgency.

278. **Straight-through processing (STP) is not the rule in SSSs in the region.** Many procedures imply physical handling of securities. This makes some clearance and settlement procedures cumbersome, for example, dividends payments and corporate actions in general that require a substantial amount of manual intervention. Gradual implementation of STP procedures would be desirable for all kinds of securities in order to reduce operational risk. STP processing for securities transactions will mean a fully automated transactional link for trade matching, comparison, and book-entry settlement of securities and funds. Such an integrated system would not only reduce the possibility of errors, but also make the clearing and settlement process more efficient by, for example, eliminating duplicate processes and giving the participants immediate information for effective liquidity management.

279. **In many cases, back-up facilities are missing or in the process of being implemented.** They should be in place as early as possible to cover any contingency in the system. Alternate sites and disaster recovery facilities must enable operations to be recovered in a manner that does not disrupt settlement.

280. **External auditing of operational systems should be considered in order to assess the security and cost-efficiency of all systems.** Authorities and the private sector have made very important efforts in the development of technological platforms for the operation of the SSSs. In some cases, an in-house solution has been adopted versus the acquisition of standard systems. In these cases, an external audit of the systems developed should be considered to ensure that all required features (i.e., security, contingency, back-ups, capacity) are in place

for a safe and efficient operation of the new systems. This is even more important when supervision of operational risk is not well developed.

281. **In sum, there is room for important efficiency gains in the securities settlement infrastructure.** In particular, physical handling of securities should be eliminated to increase the safety and efficiency of SSSs. In addition, there is room for improvement in the clearing and settlement process as STP is not the common rule. Various plans for back-up sites and disaster recovery facilities should be accelerated or established when non-existent. Finally, external audit of the systems should be undertaken, especially when systems have been developed in-house. The latter is especially important when supervision of operational risk is weak.

## **Custody risk**

### *Context*

282. **Custody risk is the risk of losses on securities held in custody due to the custodian's (or subcustodian's) insolvency, negligence, misuse of assets, fraud, poor administration, or inadequate record keeping.** A custodian should employ procedures ensuring that all customer assets are appropriately accounted for and kept safe. Customer securities must also be protected against claims of the custodian's creditors, and typically client assets are given preferential treatment under insolvency law.

283. **Custodians must have a demonstrated capacity to safeguard securities and funds in their custody or control, or for which they are responsible, and to protect against reasonably anticipated internal or external threats to the integrity of their operations.** In many markets, settlement is carried out and controlled through automatic data processing systems. In these cases, the system should have appropriate procedures to back-up data and a contingency plan to minimize disruptions.

284. **Use of electronic technologies such as the Internet for initiating financial transactions increase consumer choices but provide means for abuse and illegal activity.** Safeguards should anticipate, and be designed to provide protection against the possibility of theft, accidental or malicious destruction or loss of securities or funds, and the possibility of accidental or intentional but unauthorized modification, disclosure, or destruction of data.

285. **Custodians should have an adequately staffed internal audit department,** which has the authority to review, monitor, and evaluate the organization's system of internal controls and the integrity of operational procedures.

286. **In summary, special attention is required to reduce fraud.** Some of the issues to be addressed are: (a) the operational security of systems including identification systems, message authentication, and protection measures in safeguarding access to the system; (b) protection against insider fraud; (c) a regular independent audit of the systems to ensure continued integrity; and (d) the determination of liability for loss or technical failure.

***Status in the region***

Country	Depository	Custody arrangements
Costa Rica	CEVAL	Segregation of accounts in CEVAL exists at the client level. Ownership rights of an investor are clearly defined. An investor who has given his securities in custody is protected by law against the claims of the creditor or his custodians (Article 142). Independent of the form and the location, securities of clients form no part of custodian assets, stay outside the available assets after bankruptcy and cannot be claimed by its creditors. This is also the case if securities had been deposited for third parties. This article protects securities issued in Costa Rica and foreign securities kept in custody by a local custodian. The law protects Costa Ricans, foreign investors, and foreign custodians using a Costa Rican local agent.
El Salvador	CEDEVAL	Security settlement occurs through CEDEVAL, which is the nation's security depository. Securities settlement occurs by transferring the ownership records at CEDEVAL. Since not all securities are immobilized, sellers must deliver physical securities to CEDEVAL 24 hours before the sale is made.  A draft law for the dematerialization of securities has been presented for Parliament approval. The draft law gives the possibility to the BCR to be the depository and maintain the registry for public securities. Considering that 80 percent of all transactions in the securities market are of official securities (Treasury and BCR paper), mainly in the form of short-term repos, the proposed dematerialization will have an important impact on securities settlement.
Guatemala	Stock exchange	In principle, all public securities are issued in physical form, however if the investor decides to keep them under the custody of the central bank they are issued as book-entry notes at the central bank Registry. The central bank performs only the custody function, not the ownership transfer, that is, it only registers the ownership of the investor in the primary market. Subsequent ownership transfers are done by means of delivery (if bearer securities) or endorsement (if order securities) or book-entry note in the stock exchange's securities depository, once deposited.  For stock exchange transactions, securities must be deposited in the correspondent securities depository ( <i>Caja de Valores</i> ). The securities depository of the BVN started operating in 1994. Physical custody of securities deposited in the <i>Caja de Valores</i> has been outsourced to a private bank, owner of broker-dealers members of the stock exchange. Custody of securities is formalized by means of a deposit contract, regulated in the SML (Article 79). Each participant in the depository must open an own account and an account on behalf of final beneficiaries, of which the depository keeps a record. Broker-dealers must send periodic information to their customers about their accounts statements. The depository also offers the services of administering economic rights associated to the securities deposited.
Honduras	Stock exchanges	Public securities are issued in dematerialized form and can be under the custody of the BCH or the stock exchange. In the rare occasion that those securities are traded in the secondary market, it is done through the physical exchange of custody certificates or at the custodian service of the stock exchange. In any case, there is no legal basis for this custody

		arrangement as the Commercial Law only recognizes securities issued in physical form. The SML provides the legal support for a CSD and ownership transfer of securities by book entry notes through it but it has not yet been established.
Nicaragua	CENIVAL	<p>All public securities are issued in physical form. Subsequent ownership transfers are done by means of delivery (if bearer securities) or endorsement (if order securities) or book-entry note in the CENIVAL.</p> <p>In order to be traded at the stock exchange in a secondary market, securities must be deposited in the CENIVAL. Physical custody of securities is formalized by means of a deposit contract. Participants endorse their securities to CENIVAL in order for the latter to make the necessary securities transfers through book-entries. The depository also offers the services of administering economic rights associated to the securities deposited.</p> <p>Regarding the protection of customer assets in the event of bankruptcy or insolvency of the custodian, each participant in the depository must open an own account and an account on behalf of final beneficiaries, of which the depository keeps a record. In turn, the CENIVAL keeps the deposited securities in so-called memorandum accounts. However, there is no specific legal protection for assets under custody for the securities market.</p>
Panama	Latinclear	The SML mandates segregation of accounts of clients. The ownership rights of an investor are clearly defined. An investor who has given his/her securities in custody is protected by law against the claims of creditors. Independent of the form and location, the securities of the clients are no part of the assets of the custodian, stay outside the available assets after bankruptcy and cannot be claimed by its creditors (SML, articles 27, 37, 122, 177 and 179). 99 percent of securities are either dematerialized or immobilized, so that 100 percent of transfers are book-entry.

### **Observations**

287. **There is a need for additional legal developments in order to guarantee the protection of customer assets in the event of bankruptcy of the depository or insolvency of the custodian.** Country authorities should make sure that the segregation of accounts for securities and funds under custody have a clear legal basis. They must also ensure that all customer assets are appropriately accounted for under the beneficial owners in the depository or in the custodian's omnibus accounts. Specifically, they must ensure that customer assets are protected against the insolvency of custodians, whatever the nature of the custodian.

### **Regulatory and oversight issues**

#### **Context**

288. **A specific allocation of responsibilities for securities clearance and settlement supervision is important.** In most cases, this function is performed together with the general supervision function of participant entities without any special attention being given to clearance and settlement issues. There is a trend towards regulatory oversight policy being



implemented at two levels, substituting for traditional direct supervisory activity. The regulator conducts the oversight of self-regulatory organizations' (SROs) (CSDs, exchanges) activities, while these institutions perform the same function with regard to participants.

**289. A securities regulator should have the authority to license central clearinghouses and CSDs (system operators) as SROs and review and approve their rules.** As an SRO, a system operator should have the authority to make and enforce rules on its participants. The securities regulator should have the power to issue guidelines for system operators. In addition, the securities regulator should assure that rules and procedures issued by SROs permit a sound and effective operation of the system and provide fair access to all market participants. The securities regulator should also have the authority to conduct periodic inspections, require the production of periodic reports, and enforce securities laws and regulations.

**290. Mutual cooperation between the securities regulator and the central bank as well as their cooperation with other relevant authorities is important** in achieving their respective policy goals.

### *Status in the region*

Country	Regulatory and oversight issues
Costa Rica	<p>CONASSIF is responsible for issuing all regulations for the financial system as well as the overall policies that govern the three supervisory agencies of the financial system. In this regard, Article 169 of the SML states that the SUGEF, the SUGEVAL, and the SUPEN will all function under the direction of the CONASSIF. The members of CONASSIF are the Minister of Finance, the President or General Manager of the BCCR, and five representatives not holding public sector positions. The SUGEVAL was created by the SML (Law 7732 of 1998) and replaced the former National Securities Commission which had been created by the previous SML (Law 7201 of 1990). The SUGEVAL is responsible for supervising brokers-dealers, investment funds managing companies, financial groups, and financial and non-financial securities issuers. SUGEVAL is charged with the regulation, supervision, and control of the securities markets. However, its powers are limited by the SML, which confers to the CONASSIF the power to dictate the rules for authorization, regulation, supervision, control, and surveillance that SUGEVAL and the other supervisory agencies must execute.</p> <p>Regarding securities clearance and settlement, the SUGEVAL sets and supervises the rules regarding the functioning of CSDs, clearance systems, centralized transaction and information systems for securities transactions. Article 6 of the SML specifically entitles SUGEVAL to regulate the organization and the functioning of the RNVI, including the necessary information and updates, to which all individuals and firms participating either directly or indirectly in the securities market (except for investors) must subscribe. All actions and contracts associated with this market as well as all public offerings of securities must also be registered in the RNVI.</p> <p>Depositories must be authorized by SUGEVAL. Article 134 of the SML gives them also the possibility, together with brokers-dealers and entities subject to SUGEF control, to offer custody services, including the administration of economic rights associated with the securities under custody. Articles 119 and 134 to 143 regulate different aspects of the central depository and custody functions such as the constitution of a deposit, proof issuance, restitution of securities, bonds or documents, and depositor protection in case of bankruptcy or insolvency of</p>

	a custodian.
El Salvador	The Superintendencia de Valores (SV) is the entity in charge of supervising and overseeing the stock market and its participants. This institution began its operations on January 1, 1997, with the stock exchange, brokerage firms, deposit and securities custody firms, and risk rating firms falling within its limits of supervision. Securities depositories must be approved by the SV, but apart from this there is no specific oversight function over securities settlement.
Guatemala	According to the Securities Market Law (SML), the stock exchanges are self-regulatory organizations (SRO) with regulatory and supervisory power over their members. There is neither a securities regulator nor any other public agency that performs this role. This function is completely assumed by the stock exchanges in their SRO capacity. Article 18e of the SML specifies as a function of the stock exchange to oversee and ensure that the activity of the brokers-dealers and issuers comply with the regulation. Title V of the Internal Rules of the Stock Exchange develops the supervisory role of the stock exchange over the registered entities and broker-dealers. Penalties are included in Chapter III of Title II.
Honduras	The CNBS Law ( <i>Ley de la Comisión Nacional de Bancos y Seguros</i> , 1995) states the institutions under the supervision of the CNBS (see Article 6) including entities involved in securities markets. There is no formal oversight over the securities settlement.
Nicaragua	The stock exchange, the depository(ies) and brokers-dealers are all regulated by the SBOIF but only on the basis of the banking law. The SML draft gives self-regulatory powers to the stock exchange (Articles 39 and 123). In this draft, depository(ies) are to be authorized by the SBOIF according to some of the requirements set forth in the banking law. Depository(ies) are not considered self-regulatory organizations (SROs) in the SML draft.
Panama	CNV is an autonomous entity, responsible for issuing all regulations for the securities market based on the principles of the Decree-Law 1, 1999. BVP and Latinclear are SROs with capacity to issue regulations and enforce them on their participants. CNV is responsible for supervising market participants (brokers-dealers, investment societies, securities issuers, and SROs). Broker-dealer, investment societies and SROs must be authorized by SUGEVAL. Articles 27, 56, and 122 of the SML regulate the conditions for the provision of custody services, including the administration of economic rights associated with the securities under custody. Title XI, Chapters I, II, and III regulate different aspects of the central depository and custody functions such as the constitution of a deposit, proof issuance, restitution of securities, bonds or documents, and depositor protection in case of bankruptcy or insolvency of a custodian.

### **Observations**

291. **Most countries do not count with an oversight role over securities settlement other than the SRO role of the stock exchange.** This undermines trust in the system, especially from a foreign investor perspective, and constitutes an obstacle to securities markets development. This will become a clear bottleneck as envisaged reforms in the payment systems will make liquidity management important through the collateralized money market.

292. **In general, the capacity of securities regulators in the area of securities settlement should be strengthened.** Some securities regulators are recent institutions whose capacity for securities settlement is yet to be developed. The securities regulator must have

the appropriate human and material resources to supervise participating institutions and the SSS as a whole. If the skills cannot be found in-house external assistance should be sought.

293. **The oversight empowerment for securities settlement systems is missing in some cases.** The securities supervisor's oversight responsibilities on SSSs must be strengthened by law. This law must regulate the powers of the securities regulator and authorize it in cooperation with the central bank to issue regulations relating to securities clearing and settlement activities. The oversight of a SSS and its participants is normally shared among regulators (central bank, securities regulator, pension funds regulator), hence cooperation is crucial. Potential conflicts between the roles of the central bank as operator and overseer of SSSs should be addressed by appropriate internal organizational arrangements. Cooperation could be done through formal agreement among the parties (e.g., a memorandum of understanding).

294. **In sum, securities settlement oversight should be institutionally strengthened** by devoting adequate resources and establishing an effective cooperative framework with other regulators, SROs and the private sector.

### **Central securities depositories organizational arrangements**

#### ***Context***

295. **It is widely accepted that a securities market should be supported by the CSD with the broadest possible industry participation.** Admission should be open to all qualified market participants needing access to the CSD.<sup>205</sup>

296. **Membership standards for system operators should be established in order to minimize risk.** Certain minimum standards of financial responsibility, operational capacity (including system security and integrity), experience, and competence should be required for participation in the systems. Mandatory capital requirements for participants are the first safety net against a participant's failure. However, these requirements are frequently established for reasons other than clearance and settlement and a system operator should have the authority to impose higher financial standards on its members/participants if the general requirements do not adequately cover the perceived risks.

297. **The rules for clearing and depository organizations should avoid discrimination among potential and actual participants.** The rules should provide fair procedures for review of decisions concerning denials of access. In addition, the system should provide participants with a meaningful opportunity to participate in the administration of the organization's affairs.

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<sup>205</sup> The cost is an important element to consider in order to avoid an unfair situation for the minority investor. In any case, transactions costs per unit should be clearly identified.

298. **The above applies to CSDs and central counterparties, which are at the heart of the settlement process.** Many are sole providers of services to the markets they serve, and their performance is a critical determinant of the safety and efficiency of those markets. Therefore, their performance is a matter of public as well as private interest. In addition, there may be other providers of services (for example trade comparison or messaging services) whose performance is also critical to the functioning of some markets. The governance arrangements of any critical service providers should also be consistent with the above recommendation.

299. **No single set of governance arrangements is appropriate for all institutions in the securities markets.** However, an effectively governed institution should meet certain basic requirements. Governance arrangements should be clearly articulated, coherent, comprehensible, and fully transparent. Governance arrangements should therefore seek to minimize the conflicts between the objectives of owners, users, and other interested parties, and as far as possible to resolve any remaining conflicts.

300. **Financial markets operate most efficiently when participants have access to information on the risks they are exposed to and can take action to manage those risks.** The need for transparency applies to the entities that form the clearing, settlement, and custodial infrastructure of the securities markets. Informed market participants are better able to evaluate the costs and risks to which they are exposed as a result of participation in the system. Relevant information should be accessible to market participants. Information should be current and available in formats that meet the needs of users.

### *Status in the region*

Country	CSD	CSDs' organizational arrangements
Costa Rica	CEVAL	Currently, only brokerage houses, with the exception indicated below, can open an account in CEVAL and have for this reason a monopoly on custodial services. Also, banks and pension funds have their own accounts at CEVAL, however securities in these accounts can only be traded if they are transferred to a broker's account or to the MIB account in the case of the interbank market. In the present governance structure, brokers, as owners of the stock exchange, dominate the policy with respect to trading, custody, clearing, and settlement. It is sometimes difficult to change the situation separating money market and capital markets. The CEVAL is a private institution fully owned by the exchange and governed by the members of the Exchange Board of Directors (brokerage houses and the stock exchange).
El Salvador	CEDEVAL	Currently, the <i>Central de Depósito de Valores</i> (CEDEVAL)—an association specialized in the deposit and custody of securities that began operations in 1998—is the central securities depository. Companies specialized in the deposit and custody of securities are constituted as corporations and are subject to the commercial laws. The deposit and custody services can only be offered through stock exchanges, banks, financial or specialized institutions. The CEDEVAL has the stock

		<p>exchange and brokerage firms as its principal shareholders. Presently, the stock market has 80 percent of CEDEVAL's capital, shares five of the same directors, and the stock exchange's general manager is proprietary director of CEDEVAL.</p> <p>Institutions holding an account at CEDEVAL are the pension funds (AFPs), the stock exchange, and foreign trustees. At present, brokerage firms are not connected online with CEDEVAL; nevertheless, this institution works so that the AFPs and the brokerage firms can directly access the trustee's information from their terminals.</p>
Guatemala	Stock exchange	<p>The creation of the <i>Cajas de Valores</i> is regulated in the SML (Article 79). They were created as a department of the respective stock exchanges. Thus, governance arrangements of the securities depositories in Guatemala are the same as those for the stock exchanges. The stock exchanges are equally owned by each member. As of December 2003, there were 33 registered broker-dealer of which 20 remain active, 14 of the latter being linked to a banking group. Some banking groups own more than one broker-dealer. In order to use the services of the <i>Cajas de Valores</i>, an entity must be an agent or broker-dealer of the respective stock exchange. The <i>Cajas de Valores</i> also allow for institutional participants to use the services of the depository for its own operations but not on behalf of others.</p>
Honduras	--	There is no CSD.
Nicaragua	CENIVAL	<p>The CENIVAL is a subsidiary of the stock exchange, which owns 90 percent of the former's equity. The CENIVAL started operating in December of 1997 and current arrangements and practices are based on bilateral agreements and contract law as in Nicaragua there is no legal basis for the operation of a CSD. Governance arrangements of the securities depository are, in general, the same as those of the stock exchange, the two institutions and share the same board of directors and some managing directors. Access to the CENIVAL is broad. According to Article 8 of its Internal Regulation, all types of financial institutions duly authorized by the SBOIF, foreign banks and other non-financial institutional investors, may open a deposit account.</p>
Panama	Latinclear	<p>Brokerage houses accounts are segregated in own accounts and client accounts. Also, banks and corporations have their own accounts at BVP but securities can only be traded if they are transferred to a broker's account. <i>Acuerdo 7, 2003</i> of CNV explicitly encourages SROs' internal regulation to create conditions for fair and open access and prevents any discriminatory practice.</p>

### Observations

301. **While in general governance arrangements are adequate, it is unclear whether they prevent conflicts of interest.** These aspects should be carefully evaluated by the overseers especially in light of possible expansion of the stock exchanges in the clearing and settlement industry. Also, the stock exchanges might want to form a user group to ensure that the needs of all participants are represented and all parties have the opportunity to participate in the decision-making process.

302. **Some legal and governance arrangements introduce monopolistic situations that impede the adequate development of some markets (e.g., the money market).** This could lead to the development of settlement infrastructures that are not adequate for market needs. These include high entrance fees, inadequate facilities, and lack of facilities to process intraday repos used by the central bank to provide intraday liquidity.

303. **Unsolved conflicts of interest are the main reason for the underdevelopment of basic SSS infrastructures such as depositories.** In these cases, under the leadership of the securities regulator and the central bank, in coordination with the ministry of finance, a legally sound solution should be agreed with stakeholders in order to establish the depository function as soon as possible. Depending on the solution adopted for the immobilization/dematerialization of securities and establishment of the depository function, careful attention should be given to the ownership structure of the depository in order to make sure that the system is efficient and fair in terms of access, and that it counts with appropriate governance arrangements. The depository should provide participants with a meaningful opportunity to participate in the organization's decision making process for system design and settlement procedures, among others.

304. **A strong, capitalized, and autonomous securities depository, with reliable and flexible systems to expedite settlement of transactions and accessory rights, is crucial for the development of the securities markets.** When important conflicts of interest emerge, the authorities should take the lead in their resolution.

### **Cross-border settlement**

305. **Settlement of cross-border securities transactions is more complicated and involves more risk than that of domestic transactions.** Links between CSDs permit participants in either CSD to settle trades in securities from multiple jurisdictions through a simple gateway operated by its domestic CSD or by an international CSD. However, CSDs need to design links carefully to ensure that risks are reduced. They must address legal and operational complexities. If links are not properly designed, risks can be exacerbated. Inefficiencies may arise because of variations in operating hours. Links may create significant credit and liquidity interdependencies between systems. A CSD should evaluate the financial integrity and operational reliability of any CSD with which it intends to establish a link. Any credit extensions between CSDs should be fully secured by securities, letters of credit, or other high-quality collateral, and should be subject to limits.

### ***Status in the region***

<b>Country</b>	<b>CSDs</b>	<b>CSDs' Links</b>
Costa Rica	CEVAL	Regional links (see information for Guatemala and Nicaragua).
El Salvador	CEDEVAL	Regional links (see information for Guatemala and Nicaragua).
Guatemala	Stock exchange	The securities depository ( <i>Caja de Valores</i> ) also offers the custody of securities, both in physical or book-entry form, for securities issued outside Guatemala. To this purpose, the depository has links with Clearstream

		Banking, <i>Central de Depósito de Valores, S.A.</i> (El Salvador), <i>Bolsa Hondureña de Valores, S.A.</i> , <i>Central Nicaragüense de Valores, S.A.</i> , <i>Central para el Depósito de Valores en la Bolsa Nacional de Valores, S.A.</i> (Costa Rica) and <i>Central Latinoamericana de Valores, S.A.</i> (Panama). These operations are settled through an omnibus account open at the name of <i>Bolsa de Valores Nacional, S.A.</i> in each of these entities. The BVN keeps a detailed registry of the securities deposited in each of the omnibus accounts.
Honduras	Stock exchange	Regional links (see information for Guatemala and Nicaragua)
Nicaragua	CENIVAL	Currently, the CENIVAL holds accounts for other CSDs in the Central America region: <i>Central de Depósito de Valores, S.A.</i> (El Salvador), <i>Caja de Valores</i> (Guatemala), <i>Bolsa Hondureña de Valores</i> , <i>Central para el Depósito de Valores en la Bolsa Nacional de Valores, S.A.</i> (Costa Rica) and <i>Central Latinoamericana de Valores, S.A.</i> (Panama). Foreign investors may buy securities deposited in the CENIVAL through the omnibus account these other CSDs hold with the former.  The CENIVAL also offers the custody of securities, both in physical or book-entry form, for securities issued outside Nicaragua through the same group of Central American securities depositories. These operations are settled through an omnibus account open at the name of the CENIVAL in each of this entities.
Panama	Latinclear	Latinclear also offers custody services for securities issued outside Panama. It has depository links with Clearstream, CEDEVAL (El Salvador) and CEVAL (Costa Rica). These operations are settled through omnibus accounts.

## Observations

306. **Most securities depositories include cross-border links.** Authorities should analyze in detail the risks associated with these links as settlement of cross-border transactions typically involves more risk than settlement of domestic transactions. Particular attention should be devoted to the multiple jurisdiction profile of these transactions, especially from a legal and operational perspective. At the international level, the main improvement in this area is related to the international law governing the cross-border pledge of securities as collateral. Some depositories have been participating in the Hague Convention efforts to build an internationally accepted principle on this issue, but believe that market participants and clearing and settlement systems were not sufficiently involved. Some securities regulators are already involved in this discussion.

## I. Transparency, Oversight, and Cooperation in Payment Systems

### Context

307. **Smooth and reliable money transfer mechanisms affect the efficiency of financial markets and the real economy; they also have an impact on the central bank lender-of-last-resort function, the conduct of monetary policy, and liquidity management.** Market forces alone may not be able to achieve the objectives of efficiency and reliability of the payments system since participants and operators may not have adequate incentives to

minimize the risk of their own failure, or the costs their failure may impose on other participants. In addition, the institutional structure of the payment system may not provide incentives or mechanisms for efficient design and operation.

**308. For these reasons, central bank involvement in the payments system is an integral component of their overall mandate to ensure financial system stability and maintain confidence in the domestic currency.** In this context, central banks perform a number of functions in their national clearance, settlement, and payment arrangements. These functions may include direct involvement in managing clearing and settlement systems and in overseeing the payments system by developing rules, principles, and best practices under which private payment arrangements operate. The oversight role of the central bank is at the heart of the current international debate and the function is emerging as a key facet of central bank activity.<sup>206</sup>

**309. The role of the central bank is particularly relevant when the country is engaged in a comprehensive reform of its payments system.** In this case, the central bank has a leading role to play in developing a vision for the reformed system, in coordinating with all stakeholders, and in carrying out the reform plan. Direct involvement of the central bank in managing clearing and settlement systems has been the first step toward governing the overall structure and operation of a country's payments system and ensuring that the desire to limit systemic risk, especially in the area of large-value payment systems, is adequately taken into account. In many cases, this role stems from the need to ensure a widespread adoption of more advanced technology in the fund transfer mechanisms and to avoid possible discriminations in access to payment services. In all cases, in order to pursue the public interest in the payments system, central banks should ensure that the systems they operate comply with the principles and guidelines they establish and, as overseers, ensure the (financial and operational) reliability and efficiency of the clearing and settlement systems they do not operate. The central bank's oversight role is more likely to emerge in its relevance when payments reform is complete and the central bank is called upon to ensure the ongoing monitoring of the reliability and efficiency of the domestic system.

**310. In an increasing number of countries, payments system oversight is entrusted to the central bank by law.** Specifying objectives in the law may be the most direct way of providing a well-founded legal basis for the central bank to implement its policies and make it accountable in pursuing its goal and mandate in the payment system. For countries that are reforming their payment systems, it is important for the central bank to have a well-founded legal framework that clearly defines its payment system role and objectives.

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<sup>206</sup> Recent examples are the focus on central bank's responsibilities in the CPSS Core Principles, the CPSS/IOSCO recommendations for securities settlement systems, and the *Payments System Oversight* reports of the Bank of England. See also Bossone and Cirasino, 2001, "The oversight of the payments system – A framework for the development and governance of payment systems in emerging economies", Western Hemisphere Payments and Securities Clearance and Settlement Initiative Research Series, CEMLA-World Bank, Mexico City.



311. **As for the scope of the oversight function, at the international level there is consensus that systems posing systemic risks should fall under the direct control of the overseer.** Typical examples of these systems are those that handle transactions of a high value at both the individual and aggregate level. For example, the CPSS Task Force on Core Principles identified four responsibilities of the central bank in applying the Core Principles for Systemically Important Payment Systems (Box 2).

### **Box 2. Oversight Role of the Central Bank**

Responsibilities of the central bank in applying the Core Principles:

- The central bank should define clearly its payment system objectives and should disclose publicly its role and major policies with respect to systemically important payment systems.
- The central bank should ensure that the systems it operates comply with the Core Principles.
- The central bank should oversee compliance with the Core Principles by systems it does not operate and it should have the ability to carry out this oversight.
- The central bank, in promoting payment system safety and efficiency through the Core Principles, should cooperate with other central banks and with any other relevant domestic or foreign authorities.

312. **Increasing attention is being paid to securities clearance and settlement systems as relevant components of the overall payments system.** The oversight of these systems might well be a cooperative efforts of two or more regulatory agencies. In some countries, retail (low value) systems also fall under control of the oversight agency because of their importance in the overall efficiency of the payments system, their potential impact on the public trust of money, and their relevance to the ultimate objective of economic growth.<sup>207</sup>

313. **The evolution towards a new central bank role in payment systems calls for a careful consideration of at least three issues:**

- The adequacy of legal enforcement of central bank actions in the payments system should be evaluated. The central bank role in payment systems stems from its responsibility for financial market stability and monetary policy. In many countries, a clearly stated legal enforcement for the central bank's activity as overseer of the payments system has facilitated the fulfillment of the central bank's objectives.
- The internal organization of the central bank may also be worth evaluating. Experience in many central banks indicates that significant improvements can be derived by setting up a unit specifically devoted to payments policy issues. Typically, such a unit could develop a policy framework and tools (e.g., data collection, periodical inspections, etc.) for use in assessing the appropriateness of individual

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<sup>207</sup> There are many examples of how an inefficient retail system can affect economic activity, for example by failing to accommodate the needs of customers and merchants in a transaction that as a result cannot take place.

payments systems. This function could be undertaken in close coordination with the banking supervisor. The staff of this unit should have adequate skills. Typical aspects to be analyzed in administering the oversight functions include, *inter alia*, potential risks emerging from the clearing houses, the adequacy of risk control measures, the potential implications of unwinding procedures, and efficiency issues.

- Effective cooperation must be in place between the overseer and market players, among domestic regulators, and among international oversight agencies. In particular, central banks without bank supervisory powers may face considerable information limitations, especially in crisis management situations.<sup>208</sup> An effective way to overcome this problem is to stipulate formal rules for granting the overseer adequate access to supervisory information. The institutionalization of information-sharing arrangements may reduce the risk that the exchange of information might be hampered by frictions in cooperation between different institutions. Various solutions can be adopted for this purpose, from signing a memorandum of understanding that specifies the framework for cooperation, to assuring contacts between institutions through joint board membership, or the establishment of a comprehensive market regulatory/supervisory body where all the institutions with oversight responsibilities are represented and mandated to cooperate.<sup>209</sup> Cooperation must also be pursued between the overseer and the securities markets regulators, as securities settlement is an integral part of the payments system, and problems in securities markets clearing and settlement may easily spill over to the payments system and vice versa.

**314. Effective cooperation among market participants, between regulators and market participants, and among regulators is essential for the development of a sound and efficient payments system.** In particular, the systemic nature of the underlying operating procedures for the transfer of money makes the payments system an “institution” whose existence and smooth functioning requires effective cooperation between all participants. On the one hand, the use of payment instruments generates significant externalities on the demand side, since the usefulness of an instrument is strictly linked to the degree of its acceptance and use for transactions purposes. Consequently, widespread use of new payment instruments and services relies heavily on public confidence in them. On the

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<sup>208</sup> The overseer would have to rely on information from the supervisory authorities, or should develop its own independent access to information on payment system participants. While the first option transfers *de facto* the responsibility for triggering oversight action to the supervisory authority, the second one raises risks of duplication in information collection, inconsistent public action, and additional costs to participants.

<sup>209</sup> See Banca d'Italia, 1999, *White Paper on Payments System Oversight* for a description of the institutional arrangements adopted in some leading industrial countries. In the United Kingdom, the Bank of England and the Financial Services Authority (FSA) have signed a memorandum of understanding requiring that “the FSA and the Bank [of England] will establish information sharing arrangements, to ensure that all information which is or may be relevant to the discharge of their respective responsibilities will be shared fully and freely. Each will seek to provide the other with relevant information as requested” (see Bank of England, 2000, *Oversight of Payment Systems*). In the European Union, the European Central Bank (ECB) has issued a protocol for payment system oversight to be adopted by the euro-area national central banks and the ECB.

other hand, within the payments system, the supply of services can be affected by coordination failures due to the existence of conflicts of interests (and information costs) as well as the intermediaries' unwillingness to cooperate. This can lead to sub-optimal equilibria in the organizational arrangements in terms of reliability and efficiency. The payments system overseer is therefore entrusted with making up for coordination failure in the market for payment services. Cooperation problems may be especially relevant within interbank clearing and settlement systems. In these systems, risk profiles—both at the system level and at the level of the individual intermediary—may not be fully assessed by participants. In addition, the concern with having to support less reliable intermediaries may lead larger participants to discriminate against smaller ones, even when these are technically eligible to participate in the system. Finally, the payment system industry also depends on agreements between producers to ensure that different components of the system are compatible. Most recently, the emergence of new types of nonbank intermediaries and payment instruments has strengthened the need for a comprehensive level of cooperation in payment systems.

**315. The safety and efficiency objectives of payment and securities settlement systems may be pursued by other public sector authorities in addition to the central bank and the securities commission.** Examples include legislative authorities, ministries of finance, and competition authorities. There are also complementary relationships between oversight, banking supervision, and market surveillance. Appropriate cooperation among supervisors can be achieved in a variety of ways, for example, exchanges of views and information between relevant authorities may be conducted by holding regular or *ad hoc* meetings. Agreements on the sharing of information may be useful for such exchanges.

## J. Status in the Region

Country	Legal foundations of the function	Transparency of the oversight and dissemination of information	Objectives, scope, instruments, pricing, and access	Organizational arrangements and cooperation
Costa Rica	Law 7558 of 1995 (Organic Law of the <i>Banco Central de Costa Rica</i> - BCCR). Article 2	The operation of systemically important payment systems detailed in a set of documents known as the “Blue Book”  The BCCR does not have any regular publications covering payment system developments.  Statistical information on the	The BCCR has significant role in payment system reform  The BCCR’s objectives in the payment system have not been publicly disclosed  Instruments of oversight can be summarized as the operational involvement, its specific regulations and moral suasion.  Explicit provision exists to regulate the pricing of payment services in both the central bank law and the SINPE regulation.	Several departments under the <i>Dirección de Servicios Financieros</i> deal with payments system issues. Some aspects related to foreign exchange and cross border payments are dealt with by another department.  No formal unit is in charge of monitoring the payment system.  At the top level, coordination exists through CONASSIF. At

		payments system is not available on a regular and structured basis	The BCCR determines access requirements to the systems it manages. As of yet, there is no general provision to regulate access to payment systems managed by the private sector.	the working level, no formal framework exists to enhance cooperation on a continuous basis. No Payment System Council
El Salvador	No legal clarity on the authority empowered to regulate and oversee payment systems	Oversight function not formally performed	Oversight function not formally performed	Oversight function not formally performed. No Payment System Council.
Guatemala	The Legal Statute of the BANGUAT ( <i>Ley Orgánica del Banco de Guatemala</i> ) of May 2002. Article 4	The BANGUAT does not have any regular publications covering payment system developments. Statistical information on the payments system is not available on a regular and structured basis	The BANGUAT is playing a leading role in the reform of payment arrangements in the country, in particular, through the launch of the new RTGS system. The objectives and scope of the oversight function are not clearly defined. In absence of secondary legislation and/or any central bank document on payments system oversight, the available instruments are regulation and moral suasion in the context of central bank's activities. The BANGUAT has not defined as yet a coherent pricing policy for the payment systems it operates and/or guidelines for the payment systems it does not operate. There is no statement that clarifies BANGUAT objectives and policies related to access.	Oversight function not formally performed. No formal cooperation exists between the BANGUAT and other regulators on payment system issues. Only recently, the BANGUAT has become more active in international and regional fora on payments and securities settlement issues. No Payment System Council.
Honduras	Banco Central de Honduras (BCH) Law. Article 2.	Oversight function not formally performed	The BCH is playing a leading role in the reform of payment arrangements in the country, in particular, through the launch of the new RTGS system. Oversight function not formally performed.	Oversight function not formally performed. Payments System Council recently established. Only recently, the BCH has become more active in international and

				regional fora on payments and securities settlement issues.
Nicaragua	Banco Central de Nicaragua (BCN) Organic law. Article 3.	Oversight function not formally performed.	Oversight function not formally performed.	Oversight function not formally performed. No Payments System Council.
Panama	No central bank	Oversight function not formally performed.	BNP performs some regulatory and administrative responsibilities related to cheques and other payments instruments and settlement.	Oversight function not formally performed. No formal cooperative arrangements are in place but banks have reached important agreements in relevant areas.

## Observations

316. **In most Central American countries (except El Salvador and Panama), the law gives some authority to the central bank over the payment system.** However, the legal foundation of oversight of clearance and settlement systems is not always solid. For example, the law is often not clear about the scope of application of the function and the relative roles of the central bank and other authorities. To overcome these problems, it is important that central banks prepare and encourage approval of primary or secondary legislation to complete the legal framework and ensure the secure foundation of payment mechanisms that effectively contributes to the integrity, efficiency, and safety of all financial markets and the operation of monetary policy, especially in the area of securities settlement systems. Legislation should clarify in detail the empowerment and enforcement of the central bank as payment system overseer.

317. **In the context of establishing the oversight function, central banks should disclose publicly their objectives and implementation strategies relating to payment system matters.** To this end, central banks should develop a comprehensive policy statement providing guidance to the private sector on matters relating to payment system governance, day-to-day management, risk mitigation, and on the policies that must be satisfied by all transactions that are ultimately settled on its books.

318. **Central banks should broaden the set of policy objectives, from efficiency and reliability of payment systems, to include competition in the payment services market and consumer protection.** These objectives might be pursued by central banks especially where they are not included in other regulators' mandates. With regard to their oversight role, central banks should apply their authority over all payments and securities settlement systems in the country, both systemically important and retail systems, since the latter have a role in supporting economic activity and the public trust in money.

**319. Central American central banks should be able to carry out their oversight role effectively.** To this end, central banks should: (a) establish appropriate organizational arrangements and staffing;<sup>210</sup> (b) ensure that an adequate degree of participant cooperation exists and is sufficient to promote and realize the desired organizational and operational arrangements (see below); (c) verify that individual payment systems satisfy user needs as well as risk and efficiency requirements through appropriate interventions both at the development stage and during the ongoing system implementation and operational phases; (d) define and implement appropriate actions should participants not comply with published rules and regulations (e.g., the application of pre-determined penalties and sanctions for compliance failures); and (e) collect and distribute relevant statistical information to demonstrate the use being made of each system and the extent to which the systems are satisfying end-user and other market needs. Information on substantial payment system matters should be disclosed in a manner that assures wide dissemination among payment system stakeholders and the general public.

**320. Central American central banks should move towards compliance of their systemically important payment systems with international standards.** In particular, central banks will continue to be direct providers—owners and operators—of clearing and settlement services. In this regard, care should be taken to ensure that appropriate service and performance levels are routinely achieved and adequately cover all critical safety and efficiency requirements. To this end, central banks should continuously review and seek to improve the design and operation of the systems they operate (e.g., along the lines that the CPSS Core Principles envisage for payment systems operated by private entities).

**321. In performing the oversight function, central banks should ensure that policies and conditions for payment services offered are transparent.** In each country, the central bank, banks, and other financial institutions should be encouraged to provide information to the public on the services they offer in the payments system. Moreover, arrangements for the resolution of conflicts should be disclosed and understood by providers, users, and regulators of payment systems and services. The general public should be able to resort to consumer protection agencies (e.g., a bank Ombudsman) for resolution of conflicts related to payment services. The central bank should cooperate with the banking supervisor and other relevant authorities to ensure that payment services and instruments are appropriately covered by the new arrangements.

**322. Cooperation among regulators is weak in Central America.** The payments system overseer (central bank), the ministry of finance, the banking supervisor, the securities commission, and other relevant authorities should identify and implement procedure and process changes to address any weaknesses or inconsistencies in the regulatory arrangements

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<sup>210</sup> This includes forming a small unit in charge of payments system oversight to be separated to the extent possible from the units in charge of operating the systems offered by the central bank. Skills of human resources involved in the function should be as wide as possible and include legal, operational, and technical expertise as well as policy and economics.

and assure a high level of cooperation in the way that policies are implemented. Consideration should be given to establishing joint task forces to address problems of common interest and/or the preparation of appropriate memoranda of understanding. At the international level, central banks should get involved in the efforts of harmonization at the sub-regional level in Central America, and in the activities of the WHF Working Group on Payment System Issues of Latin America and the Caribbean.

**323. Cooperation among regulators and stakeholders should also be strengthened.** No formal cooperative arrangement for the payment system as a whole exist in Central America. In each country, the central bank should establish a formal National Payment System Council. The new body should include representatives from all major stakeholders with an interest in payments and securities clearance and settlement systems improvements and should be used as the main tool also to secure a constructive dialogue between regulators and market participants. The central bank should provide strong leadership and the secretariat. Payment System Councils in Central American countries could establish forms of interaction with a view to moving forward the harmonization and integration agenda.

**324. Binding interbank agreements are equally important to enhance cooperation within the banking sector.** Cooperation at the interbank level has not always been satisfactory in Central America. Evidence can be seen in the area of retail payment circuits, the development of the interbank market, and the slowness to reduce dependency on cheques. In light of possible market concerns about the potential loss of competitive advantages, which are however lower than the social benefit of taking these actions, the central bank and the banks are urged to work together toward the implementation of some agreements in the area of payment systems, which could enhance efficiency for the banking sector as a whole.

**325. In sum, there is a need to establish the oversight function over the payments system.** Regarding the oversight function and its transparency, Central American central banks should strive to achieve fully observe Responsibilities A, B, C, & D of the CPSIPS. Cooperative arrangements in payment systems among all stakeholders should also be enhanced.

## **K. Conclusions**

**326. In recent years, Central American central banks have played a very active role in the reform of national payments systems.** Important efforts have been completed and others are ongoing. Reform programs have allowed for a better integration between the central bank and the banks and have given the banks a means to send and reduce settlement lags and settle their payments more efficiently on the accounts they hold at the central bank. In some countries, these results have been achieved despite instability in the financial sector. Acknowledging these important achievements, central banks need to undertake an exercise to finalize the reform effort. Elements such as improvements in the legal framework, compliance with international standards, full integration of all systems, introduction of new and efficient payment instruments, and establishment of the oversight function for payments and securities settlement systems have not been fully included in the reform projects. The

degree of coordination and communication with other stakeholders and government treasurers has been on some occasions informal and asymmetrical, resulting in a technology-driven approach with strong emphasis on some components of the operational aspects of the payments system (e.g., the automation of the check clearing house), and less emphasis on others. In general, this has not permitted Central American countries to catch up rapidly with the experience of other Latin American countries.

327. **As a result, Central American central banks should broaden the scope of reform** to include additional elements (e.g., electronic retail payments, securities settlement) and incorporate improvements not only in the systems but also in the legal, regulatory, and oversight environments.

328. **Central banks should develop a long-term, comprehensive strategy for the payments system as a whole**, and discuss it with stakeholders. In conducting a reform, the logical sequencing process would be: (a) diagnostic, stocktaking, situational analysis; (b) vision development; (c) conceptual design and implementation planning; (d) user requirement specifications; and (e) acquisition, procurement, development, testing, and implementation. Furthermore, important issues to be decided when launching a payments and securities settlement reform are scope (holistic versus specific); approach (gradualist versus leap-frogging); degree of sophistication (e.g., innovative products); number of systems; system operator (central bank, external provider, private provider); ownership of the system (central bank, private, joint); and timeframe.

329. **In some countries, important projects such as an RTGS system have already been launched or are in the pipeline.** Indeed, the definition of formal cooperative arrangements with all stakeholders is very important to avoid different positions and opinions of participants once the reform has been launched.

330. **Countries should reform their payments systems as a matter of urgency.** By adopting a broad approach based on international standards and best practices, and with support from international organizations, other central banks, and payment system experts, each Central American country will count on a set of payment arrangements, services, and circuits able to serve the needs of all users in the economy. Appropriately reforming each national payments system in the region will also create the conditions for further harmonization and integration among the different payment systems. Central banks should, therefore, work in parallel in reforming as a first priority their national payments systems and, at the same time, work towards closer integration within the region by discussing and preparing minimum common features and a realistic timetable.

331. Specifically, assessments of national payment and securities settlement systems in Central America point to the following key findings:

- **There is a need to improve the legal framework**, notably as regards the irrevocability of final settlement, adequate protection of the systems against the effects of bankruptcy procedures, legal basis for custody arrangements, legal



definition of a repurchase (repo) operation, legal recognition of multilateral netting arrangements, legal definition of immobilization and dematerialization of securities (especially public securities), and legal definition and regulation of central bank oversight powers. From a developmental viewpoint, improvements are also needed on the legal basis for collateral pledge and securities lending in all countries except El Salvador and Costa Rica where the laws contain specific provisions for the creation, regulation, and enforcement of pledges. Due to the variety and importance of these legal issues, passage of a separate payments system law might be advisable in some countries.

- **Upgrading RTGS systems as recommended will modernize the national payment systems and create the conditions for future regional integration** through the interlinking of the different systems. Such recommendations would create common features in all relevant areas of the payments systems (such as legal, risk control mechanisms, liquidity provision, access policies, governance, organizational arrangements, operational aspects, reliability, and business continuity), which would facilitate their integration.
- **Central and commercial banks have a role to play in ensuring that the existing retail circuits support customers' needs and are safe, convenient, and efficient** for the economy as a whole. Central banks should monitor market developments and take action as appropriate, in consultation with other relevant authorities (e.g., consumer protection agencies), to restore safety and efficiency. In particular, the central bank should: (i) ensure that the legal and regulatory framework keeps pace with market developments;<sup>211</sup> (ii) monitor competitive market conditions and behaviors and take appropriate actions to foster such conditions; (iii) support the development of effective standards and infrastructure arrangements;<sup>212</sup> and (iv) adapt as necessary its provisions of settlement services for systems operated by other entities to contribute to efficient and safe outcomes, allowing all such systems to settle in central bank money.<sup>213</sup>
- **Central banks and relevant government agencies should foster coordination** to ensure that collection and disbursements of public sector institutions that are major players in the payments system be processed electronically through an appropriate system, such as an ACH for retail electronic payment instruments. Government payments are also a major source of liquidity for the banking system and, if

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<sup>211</sup> Particular issues in this regard would be for central banks to assess whether the current legal framework effectively supports the use of modern (i.e., electronic) payments and related arrangements.

<sup>212</sup> The central bank, possibly building on the already existing groups that in most countries are engaged in the discussion to improve the cheque clearing house or other retail systems, could engage participants in a dialogue to analyze all payment systems in the country and come to agreements on necessary improvements.

<sup>213</sup> This would become necessary when agreements on interoperability are reached and/or when an automated clearing house (ACH) is deployed producing interbank obligations that need to be cleared and settled.

coordinated effectively, can facilitate the smooth functioning of the RTGS system being implemented by Central American central banks and increase its appeal to participants.

- **Central banks should monitor trading and settlement platforms and procedures for foreign currency and cross-border transactions**, notably remittances, to ensure that the principles of safety and efficiency can be applied to clearance and settlement.
- **An adequate interbank money market is key to the smooth functioning of a country's payments and securities settlement system.** An efficient mechanism for trading and settling these transactions will improve systemic liquidity management. Key elements for the development of interbank money markets are a special purpose system for large-value payments providing secure electronic interbank transfers with immediate settlement, interconnected to an electronic book entry securities system registering and recording changes in securities' ownership.
- **Improved clearing and settlement processes in securities settlement systems (SSSs) are necessary** in order to reduce market fragmentation, increase standardization of settlement cycles, accommodate different settlement needs, operate with shorter settlement cycles, avoid extension of settlement cycles due to inadequate risk management tools, improve markets' liquidity through automatic securities lending, and introduce international communication standards.
- **Linking the settlement of securities and funds would allow stock exchange transactions to be settled on a DvP basis** so as to eliminate principal risk. The main aspects to be improved are: achieving of full dematerialization and immobilization of securities; establishing DvP procedures; upgrading risk management tools; mitigating credit and liquidity risk in the cash leg settlement (including eliminating the use of cheques as a cash asset); providing better access to liquidity for SSS participants; and developing a comprehensive strategic approach to the reform of SSSs, as opposed to technology-driven and purely operational reform projects.
- **There is room for efficiency gains in the securities settlement infrastructure.** Physical handling of securities should be eliminated to increase the safety and efficiency of SSSs. In addition, clearing and settlement should aim at achieving straight-through processing (STP). The various plans for back-up sites and disaster recovery facilities should be accelerated or established when non-existent. External audits of the systems should be undertaken, especially when the systems have been developed in-house and/or the oversight framework is weak.
- **The legal framework needs to be strengthened to reduce custody risk**—that is, to guarantee the protection of customers' assets in the event of bankruptcy of the depository holding their titles or insolvency of the custodian. The country authorities should ensure that the segregation of accounts for securities and funds under custody has a clear legal basis; that all customer assets are appropriately accounted for as

beneficial owners in the depository or in the custodian's omnibus accounts; and that customer assets are protected against the insolvency of custodians, whatever the nature of the custodian.

- **The securities depository should be well capitalized, autonomous, and capable of expediting settlement of transactions and accessory rights.** This would be crucial for the development of the securities markets. The authorities should take the lead in the resolution of conflicts of interest in the event they emerge.
- **The authorities should analyze the risks associated with cross-border links among securities depositories,** as settlement of cross-border transactions typically involves more risk than settlement of domestic transactions. Particular attention should be devoted to the multiple-jurisdiction profile of these transactions, especially from a legal and operational perspective. At the international level, the legal framework governing the cross-border pledge of securities as collateral should be improved. In this respect, some depositories and securities regulators participate in the Hague Convention efforts to develop internationally accepted principles in this area, but believe that market participants have not been sufficiently involved.
- **There is scope for improving the oversight of payment and securities settlement systems.** Central American central banks do not fully observe Responsibilities A, B, C, and D of the Core Principles for Systemically Important Payment Systems (CPSIPS) regarding payment system oversight. In addition, securities settlement oversight should be strengthened by devoting adequate resources to regulators and establishing an effective cooperative framework with other agencies, SROs, and the private sector. In performing the oversight function and as system operators, central banks and securities regulators should ensure transparency in their policies and conditions for payment services offered. The general public should be able to resort to a bank's ombudsman and to the central bank or another appropriate supervisor and the consumers' protection agencies for resolution of conflicts related to payment services. Cooperative arrangements in payment systems should be enhanced in Central America as a matter of urgency.
- **Central American central banks should work in parallel** in reforming as a first priority their national payments systems and, at the same time, work towards closer harmonization and integration within the region by discussing and preparing minimum common features and a realistic timetable to achieve this objective.

## **V. MIGRANT REMITTANCES IN CENTRAL AMERICA<sup>214</sup>**

### **A. Introduction**

332. This chapter highlights the importance of international migrant remittances in six Central American countries—Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and Panama.<sup>215</sup> Migrant remittances are the largest source of external financing in four out of these six countries. From a financial sector point of view, these large remittance flows raise two sets of issues.<sup>216</sup>

- The cost of sending remittances is very high, especially for small transfers undertaken by poor migrants. High remittance fees are a reflection of market failure and inefficiencies in the retail payment system. Remittance costs can be reduced by strengthening the financial infrastructure supporting remittances. But these efforts to reduce costs would also have to be carefully balanced with those to fight money laundering and the financing of terrorism.
- The second issue relates to increasing the impact of these remittances on financial development without directly affecting these personal flows. This would require encouraging more flows through formal channels, and linking remittances to consumer and housing loans and insurance products for remittance recipients. Financial institutions can also use remittances as collateral for raising external bond financing.

333. The next section describes the size of remittances and their importance in the retail payment systems of each of these six countries. Section III discusses possible measures to reform the retail payment system and reduce high remittance fees. Section IV briefly describes the complementarities between financial institutions and remittances. Section V is devoted to securitization of remittances as a tool for raising private external bond finance. The last section contains a summary of recommendations.

### **B. Remittances and Retail Payment Systems**

334. A retail payment transaction may be defined as a transaction originated by or payable to an individual, the other counterparty being an individual, a firm, or a government agency. A retail payment may be defined to include frequent, small-value business-to-business

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<sup>214</sup> Prepared by Dilip Ratha, The World Bank.

<sup>215</sup> Migrant remittances are defined as the sum of workers' remittances and compensation of employees—see Ratha (2003).

<sup>216</sup> This paper does not discuss the development impact of remittances in the receiving countries. At the household level, these impacts could be to reduce poverty, act as an insurance against adverse shocks, and increase household spending. At the macroeconomic level, remittances could increase financial deepening and lead to exchange rate appreciation. See Mishra (2005), Yang (2004), Adams (2004), and Cox Edwards and Ureta (2003) for discussion of some of these issues.

payments.<sup>217</sup> Thus, retail payments would include pure transfers such as migrant remittances or transfers from public and private institutions to individual beneficiaries. They would also include small-value payments in exchange for goods and services, or for acquisition of assets, or for debt servicing. In more developed countries, migrant remittances would form only a small share of retail payments which, in turn, are only a tiny fraction of wholesale payments. But in developing countries, especially in Central America, remittances form a significant source of funding in relation to the size of the economy, and, therefore, of the retail payment system. Furthermore, any evaluation or reform of the retail payment system from the point of view of facilitating remittances is equally likely to benefit other (not easily quantifiable) components of retail payments as well.

335. Officially recorded international remittance receipts by Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and Panama amounted to US\$6 billion, or about 7.4 percent of their combined GDP, in 2003 (Table 1 and Figure 1). Remittance receipts ranged from US\$85 million in Panama to over US\$2.1 billion each in El Salvador and Guatemala. While larger countries in general received larger amounts of remittance flows, the poorer countries (Nicaragua, Honduras, Guatemala and El Salvador) received relatively larger amounts than the richer countries (Panama and Costa Rica).<sup>218</sup> In El Salvador, remittance receipts in 2003 were as high as 14.7 percent of GDP, over 30 percent of imports of goods and services, nearly 12 times the size of net official inflows, and nearly 24 times the size of foreign direct investment (FDI). In general, in the poorer Central American countries remittances are larger than earnings from the single largest export item, or official and private capital flows.<sup>219</sup>

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<sup>217</sup> Bank for International Settlements (1999).

<sup>218</sup> Remittances tended to be more stable than export receipts or private capital flows in El Salvador, Guatemala, Honduras, and Nicaragua (Figure 1). The cyclical stability of remittances owes in part to the fact that they are largely altruistic transfers by the existing migrant stock. Indeed, remittances may also behave counter-cyclically as existing migrants may increase remittances, and new migration may take place, during a period of economic slowdown in the remittance recipient economy (Ratha, 2003).

<sup>219</sup> In contrast, the richer neighbors, Costa Rica and Panama, have significant remittance *outflows* to the region. The exact amount of flows from various source countries is not available as bilateral flow data do not exist for most countries.

Table 1. Remittance Flows, 2003

	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua	Panama
Remittance receipts (in millions of US dollars)	321	2,122	2,147	867	439	85
As a share of (in percent):						
GDP	1.8	14.7	8.7	12.4	10.0	10.7
Trade deficit	37	284	153	224	40	15
Imports of goods & services	3.4	30.4	27.5	21.9	21.0	0.9
FDI	56	2,384	1,851	438	204	11
Official flows <sup>1</sup>	272	1,172	2,440	387	101	266
Outward remittances (in millions of US dollars)	192	25	82	1	...	53
<i>Memorandum items:</i>						
Per capita GNI (in US dollars)	4,280	2,200	1,910	970	730	4,250
No. of migrants in the USA ('000) <sup>2</sup>	109	1074	591	354	302	178
As share of own population (percent)	2.9	17	5.2	5.5	6	6.2

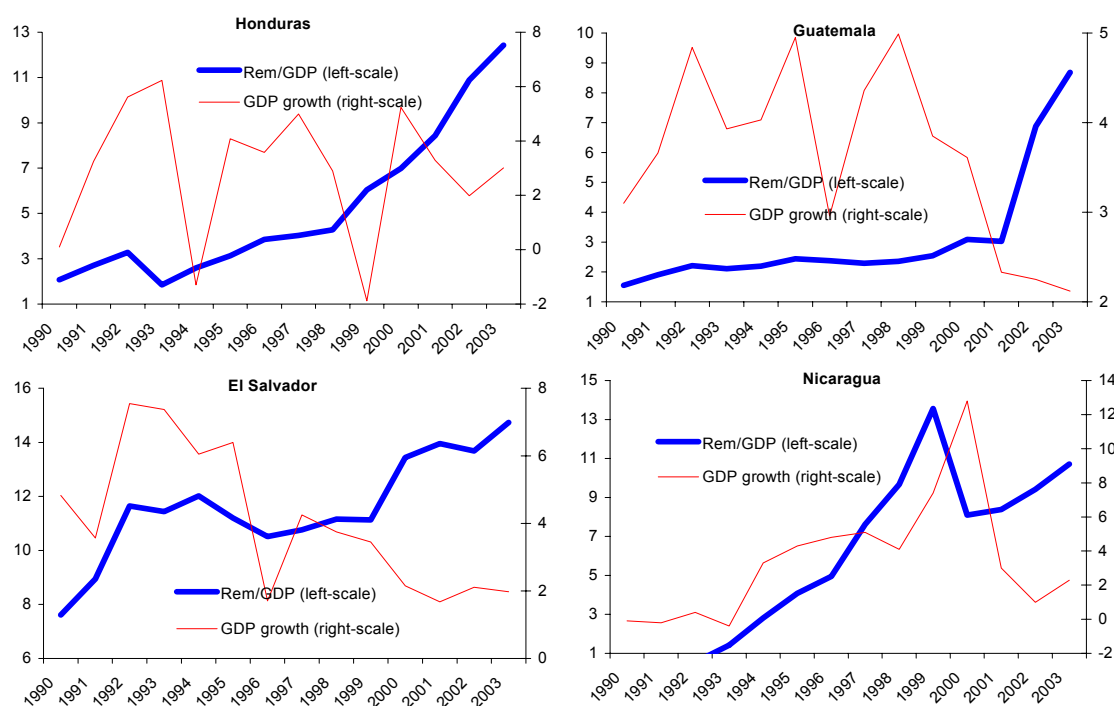
Note: Remittances defined as the sum of workers' remittances and compensation of employees.

<sup>1</sup> Data for Nicaragua is for 2002.

<sup>2</sup> 2001 round of US Census 2000 Supplementary Survey as calculated in Yang (2004).

Sources: Global Development Finance (2005), IMF Balance of Payments Statistics Yearbook (2004).

Figure 1. Cyclical Stability of Remittances  
in Honduras, El Salvador, Guatemala, and Nicaragua



Source: Global Development Finance (2005), IMF Balance of Payments Statistics Yearbook (2004).

336. These data are likely to be underestimated.<sup>220</sup> Official data do not include remittance flows through informal (unregulated) channels. They do not even fully capture flows through the formal channels. Most countries do not require reporting of “small” remittance transactions.<sup>221</sup> Also, remittances paid by post offices, exchange bureaus, and other agents of money transfer companies in Central America are often not reflected in the official statistics. Finally, a large amount of remittances are misclassified under export revenue, tourism receipts, non-resident deposits, or even FDI.<sup>222</sup>

337. The United States is by far the largest source of remittances to the Central American countries. The remittance pattern is closely linked with the migration pattern. It is worth noting, however, that the Central American countries also have significant intra-regional migration and remittance flows. Nicaragua, for example, has nearly half as many migrants in Costa Rica as it has in the United States; it also has significant number of migrants in Canada, El Salvador, and Guatemala. Honduras has a sizeable migrant stock in Mexico, besides the United States. Costa Rican migrants are also significantly present in El Salvador and Honduras, besides the United States and Canada. The sizeable intraregional remittance flows are a factor worth including in discussions about regional retail payment systems.

338. Formal remittances to these Central American countries are largely originated by money transfer operators (MTOs) and banks in the source countries, channeled using mostly private proprietary payment systems, and distributed through banks and agents of the MTOs.<sup>223</sup> Most remittances from the United States to these countries are in the form of electronic transfers, but some are in the form of money orders and drafts, especially in Honduras.<sup>224</sup> Nicaraguan migrants seem to rely heavily on the MTOs, which often have partnership with local bank and postal networks. Honduras and Nicaragua also have partnership between their post offices to provide remittance services. In El Salvador and Guatemala, banks are the dominant remittance service provider. Except for a small presence in Guatemala, credit unions and microfinance institutions do not play any significant role in distributing remittances.

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<sup>220</sup> The 2004 estimates of remittance flows produced by the Multilateral Investment Fund of the Inter-American Development Bank, for example, exceed the figures presented in Table 1 by 20 percent in El Salvador, 25 percent in Guatemala, and 31 percent in Honduras.

<sup>221</sup> For example, the reporting threshold is US\$10,000 in the United States, €12,500 in Western Europe, and ¥3 million in Japan. Data on remittances rely on reports from recipient countries.

<sup>222</sup> The International Working Group to Improve Remittance Statistics was set up in 2004 at the behest of the G8. The World Bank has been requested to lead the working group in close collaboration with the IMF, the European Central Bank, the Inter-American Development Bank, the OECD, and the United Nations; representation is also sought from key sending and recipient countries. This working group is expected to prepare a draft for consultation in September 2005 and a final report in March 2006.

<sup>223</sup> See Appendix I for an explanation of a remittance transaction structure.

<sup>224</sup> De Luna Martinez (2005).

339. A significant part of flows also goes through informal channels, especially traveling friends and relatives.<sup>225</sup> The choice of the channel is affected by, among other things, remittance costs, trust in the intermediary, and convenience factors such as location, hours of operation, language, and identification requirements. Among these, high remittance costs stand out as the most important factor affecting the channel, the instrument (check, money order, electronic wire, pre-paid card, debit card, and hand carry), the frequency, and possibly the amount of remittance flows.

### **C. Remittance Costs**

340. The fee structure for sending cross-border remittances is rarely transparent. Remittance fees, typically paid by senders to the remittance agent at the time of sending, range from a fixed US\$3-5 per transaction to as high as 20 percent in the case of some MTOs. The average remittance fee (excluding foreign exchange commission) according to some reports is around 4-6 percent in Honduras, 5-7 percent in El Salvador, 6-8 percent in Guatemala and 6-9 percent in Nicaragua for money transfers below US\$300 dollars, which is the average amount that migrants send home every month. In the case of Western Union and Money Gram, the fee for sending US\$300 from New York to any of these Central American countries was 9.7 percent and 8.3 percent, respectively. All remittance agencies charge an additional foreign exchange commission when the remittance is delivered in local currency. In El Salvador, Nicaragua, and Panama, major remittance agencies deliver remittances in US dollars. On top of the remittance fee and foreign exchange commission, remittance agents (especially banks) often take advantage of the “float” by delaying remittance delivery and investing the funds in the overnight money market.

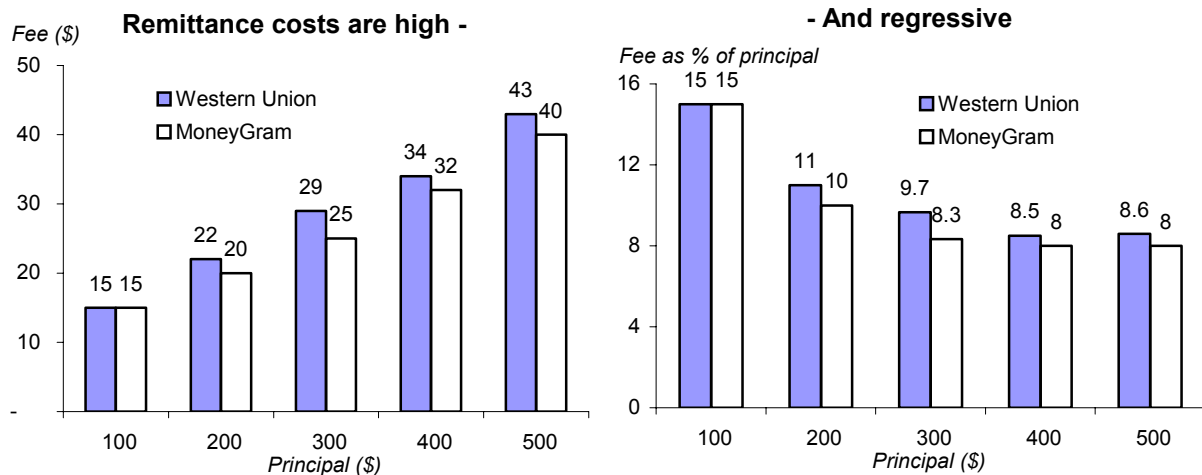
341. Remittance costs are significantly higher for smaller remittance transactions used by poorer migrants. In the case of Western Union and MoneyGram, for example, sending \$100 costs 15 percent; however, sending \$500 costs 8.6 at Western Union and 8 percent at MoneyGram (Figure 2). The remittance cost structure, thus, represents a greater burden for small transactions. It is very likely that remittance flows would increase, especially through formal recorded channels, if remittance costs were lowered.

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<sup>225</sup> For instance, the results of the 2004 survey on *State-By-State Data on Remittances Sent by Migrants in United States to Latin America*, conducted by the Multilateral Investment Fund of the Inter-American Development Bank, indicate that approximately 12 percent of remittances are sent through people traveling or by mail (<http://www.iadb.org/exr/remittances/>).



Figure 2: Remittance Costs



Source: [www.westernunion.com](http://www.westernunion.com), [www.moneygram.com](http://www.moneygram.com), on April 1, 2005.

Note: Fees shown are for remittances from New York to Central America. The same fee structure applies to all six Central American countries.

342. Conservative estimates based on market analysis suggest that the true cost of transactions—labor, technology, setting up networks, and rent—add up to only about US\$5 (or less) per transaction, significantly below the fees charged to customers.<sup>226</sup> The marginal cost of effecting transfers using sophisticated payment system infrastructure can be very low. The FedACH International service, offered by the Federal Reserve Banks to process cross-border transactions, for example, charges only 67 cents per remittance transaction, irrespective of the principal amount.<sup>227</sup> However, this service may enjoy cost advantages in terms of volume and infrastructure.

343. Further analysis is necessary to determine various components of remittance costs. Recent research points to absence of competition in this market as a major contributor to high transaction costs. Remittance costs are low, and have fallen in recent years, in corridors (the United States-Mexico corridor, for example) where competition has increased.<sup>228</sup> Entry of new remittance service providers, however, has been sluggish in most corridors. High fixed costs required to build extensive agent networks is a major entry barrier.

344. Improving transparency in remittance transactions would raise consumer awareness, reduce unfair remittance practices, and may have a significant effect on costs. The World Bank and the BIS Committee on Payment and Settlement Systems (CPSS) have set up a task

<sup>226</sup> Ratha and Riedberg (2005).

<sup>227</sup> FedACH International services are currently available to Canada, Mexico, Austria, Germany, the Netherlands, Switzerland, and the United Kingdom.

<sup>228</sup> Hernandez-Coss (2004).

force, with IMF participation, to develop voluntary principles for remittance service providers, regulators and supervisors for improving transparency in the market. It is also possible that simply publicizing information on costs, as Mexican authorities do through the PROFECO initiative will contribute to strengthening competition.<sup>229</sup>

345. Other measures to reduce remittance costs include introducing new remittance instruments that take advantage of new technology, especially internet-based technology. Card-based instruments such as stored value cards (similar to phone cards), credit cards, and debit cards, are frequently used for sending remittances to urban locations that have access to card processing machines.<sup>230</sup> These instruments, however, represent a challenge from an anti-money laundering and combating the financing of terrorism (AML/CFT) standpoint to properly identify the customer behind a transaction.

346. Regulatory and policy decisions also affect the level of transactions costs. Since the terrorist attacks of September 11, 2001, authorities in many countries have adopted more stringent regulations and stepped up enforcement of existing rules governing the transfer of foreign exchange. In particular, the introduction of the Patriot Act in the United States in late 2001 tightened know-your-client requirements for fund transfers.<sup>231</sup> In addition, financial institutions are also required to comply with the AML/CFT recommendations of the Financial Action Task Force (FATF), which are transposed in national regulations, as well as with the Office of Foreign Assets Control (OFAC) sanctions list.<sup>232</sup> An increasing number of countries are requiring MTOs to register and report transactions on a regular basis. These regulatory requirements have raised the cost of fund transfers to the remittance service providers who tend to pass on the cost increase to customers.

347. The regulatory regime governing remittances has to strike a balance between curbing money laundering, terrorist financing, and general financial abuse, and facilitating the flow of funds through formal channels. While, for instance, documentation requirements can add to the cost of remittances and restrict access to formal channels, they are necessary to prevent the abuse of remittance services for money laundering or terrorist financing purposes. Strengthening the formal remittance infrastructure by offering the advantages of low cost,

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<sup>229</sup> The International Remittance Protection Act proposed by Senator Paul Sarbanes of Maryland in September 2004 marks an effort to improve disclosure of fees and exchange rate commissions in remittance transactions.

<sup>230</sup> Cellular phone-based technologies, such as the Smart Padala system in the Philippines, are not yet popular in the region, but it is a matter of time before such instruments become available. These systems combine the advantages of phone banking with the unique ID and security features of cellular technology. See Ratha and Riedberg (2005), and DFID (2005).

<sup>231</sup> Section 326 of the Patriot Act requires banks to verify the identity of customers. The law does not bar non-US citizens from opening bank accounts in the United States. A non-US customer who does not already have a social security number could use a government-issued identity document (e.g., the national passport) to open a non-interest bearing checking account, and apply for an income taxpayer identification number (ITIN) to open an interest-bearing savings account.

<sup>232</sup> The FATF has issued special AML/CFT recommendations for registering/licensing remittance service providers. See IMF (2005).

flexible hours, expanded reach, and language, and increasing efforts to identify and regulate the unregulated sector, would be effective ways to facilitate remittance flows while preserving their integrity.

348. Harmonizing electronic fund transfer systems could reduce the cost of remittances. Currently, major transfer agents use their own (costly) proprietary systems for effecting cross-border remittances. Also, domestic payment systems have evolved independently, although efforts are underway for their harmonization.

349. Even with the prevailing cost structure, there may be scope to reduce average remittance costs by “bundling,” that is, by enabling senders to remit more money but less frequently, perhaps by improving access to savings accounts or credit. Banks and other financial institutions could play a role in facilitating this. In addition, improving migrant workers’ access to banking in the remittance-source countries could reduce transactions costs as well as encourage financial deepening in the countries receiving remittances.

#### **D. Remittances and Financial Institutions**

350. Financial institutions, including smaller ones such as credit unions and microfinance institutions (MFIs), can play a major role in delivering low-cost and convenient remittance services.<sup>233</sup> If remittances are channeled through financial institutions, they might encourage more savings and also enable better matching of saving and investment in the economy.<sup>234</sup> Among the products that financial institutions are starting to offer to families receiving remittances are consumer loans, mortgages, and life insurance. Banks from countries in the region have been active in this market for some time, including through branch networks in sender countries. Larger international banks have more recently shown some interest in tapping this market.<sup>235</sup>

351. Credit unions in El Salvador, Guatemala, Honduras, Nicaragua, Mexico, and Jamaica that are members of the World Council of Credit Unions (WOCCU) encouraged WOCCU to establish the International Remittance Network (IRnet) in July 1999, to facilitate remittance flows from the United States to Latin America. This initiative has successfully lowered remittance costs by raising customer awareness of remittance fees and by generating, to some extent, competition in the remittance market. The remittance fee through IRnet is a flat US\$10 for sending up to US\$1,000, much lower than the fees charged by major MTOs (see

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<sup>233</sup> Microfinance can be particularly important for channeling remittances to in rural areas, where nearly 40 percent of recipients reportedly live—see Yang (2004) based on the 2002 round of the *Encuesta de Hogares Propósitos Múltiples*.

<sup>234</sup> A bank account offers security and convenience for saving. Thus, a remittance recipient with a bank account is more likely to save a part of the remittance income than an unbanked person.

<sup>235</sup> For instance, in 2004 Banco Bilbao Vizcaya Argentaria (BBVA) of Spain reached agreement to acquire Laredo National Bancshares of the United States with a view to tapping the Hispanic market in the Texas-Mexico Border area.

Figure 2). Besides fee income, these institutions are interested in using remittances for relationship building with existing and new customers. It is reported that 14–28 percent of nonmembers who came to WOCCU-affiliated credit unions to transfer funds eventually opened an account, and 37 percent of credit-union members saved some part of their remittance receipts.<sup>236</sup>

352. Financial institutions are exploring new products such as car and housing loans to remittance recipients. The idea of using remittance receipts as a way to evaluate credit history for lending to micro enterprises is also being explored. Some institutions are also exploring ways to target remittances to specific uses such as paying school fees or medical bills. Others are exploring insurance products, for example, ensuring a stable flow of income to the remittance beneficiary in the event that the sender suffers an income shock.

353. In entering the remittance market, smaller nonbank financial institutions such as MFIs have often entered into corresponding banking relationships with local commercial banks and with international remittance providers (such as the IRnet or the major MTOs).<sup>237</sup> Such tie ups may be a reason behind high remittance fees charged by some MFIs in Central America, although their services may still be considered convenient by customers.<sup>238</sup>

### **E. Securitization of Remittances**

354. Taking advantage of the large size and stability of remittance flows, financial institutions in El Salvador followed the example of Mexican banks and raised US\$650 million from the international capital markets between 1998 and 2004 by securitizing future flows of remittances and, more recently, other diversified payment rights (DPRs), such as export revenue and FDI (Table 2).

355. Securitization of future remittances (as well as tourism receipts and export receipts) can enable developing country borrowers (typically, financial institutions) to access international capital markets during hard times. By mitigating currency convertibility risk, a key component of sovereign risk, the securitization of future remittances allows securities to be better rated than the sovereign. These securities are typically structured to obtain an investment grade rating. In the case of El Salvador, for example, the remittance-backed securities were rated investment grade, two to four notches above the sub-investment grade sovereign rating. Investment grade rating makes these transactions attractive to a wider range of “buy-and-hold” investors (for example, insurance companies that face limitations on buying sub-investment grade securities). As a result, the issuer can access international capital markets at a lower interest rate and longer maturity.

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<sup>236</sup> Grace (2005) based on data from the FEDECACES in El Salvador and the FENACOAC in Guatemala.

<sup>237</sup> In Guatemala, Bancafe, Banrural, and FENACOAC have partnerships with respectively MoneyGram, Western Union, and Vigo. In El Salvador, FEDECACES has partnered with Vigo, and Procredit with Western Union, and several others with MiPueblo (see Orozco 2005).

<sup>238</sup> See Orozco and Hamilton (2005), Isern, Deshpande, and van Doorn (2004), and Sanders (2004).

Table 2: Securitization of Future Remittances in El Salvador

Year	Issuer	Amount (In millions of US dollars)	Flow type	Transaction rating	Sovereign rating
1998	Banco Cuscatlan	50	Remittances	BBB	BB
1999	Banco Cuscatlan	25	Remittances	BBB	BB+
2002	Banco Cuscatlan	100	DPR	AAA	BB+
2002	Banco Agricola	100	DPR	AAA	BB+
2002	Banco Agricola	40	DPR	AAA	BB+
2003	Banco Cuscatlan	125	DPR	AAA	BB+
2003	Banco Agricola	60	DPR	AAA	BB+
2004	Banco Salvadoreño	25	DPR	BBB	BB+
2004	Banco Salvadoreño	75	DPR	BBB	BB+
2004	Banco Cuscatlan	50	DPR	BBB	BB+
Total		650			

Source: Ketkar and Ratha (2004), Fitch Ratings, Standard and Poors.

356. Perhaps the most important incentive for governments to promote this asset class lies in the externalities associated with it. Such deals involve a much closer scrutiny of the legal and institutional environment—the existence as well as the implementation of laws relating to property rights and bankruptcy procedures—than unsecured transactions. A remittance securitization transaction backed by the government can also help usher in reforms of the legal and institutional environment.

357. Remittance securitization typically involves the borrowing entity such as a bank pledging its future remittance receivables to an offshore special purpose vehicle (SPV) that issues the debt (for an example, see Appendix II). Designated correspondent banks are directed to channel all remittance flows of the borrowing bank directly to an offshore collection account managed by a trustee. The collection agent makes principal and interest payments to the investors and sends excess collections to the borrowing bank. Since remittances do not enter the issuer's home country, the rating agencies believe that the structure mitigates the usual sovereign transfer and convertibility risks. Such transactions also often resort to excess coverage to mitigate the risk of volatility and seasonality in remittances.

358. The first major securitization deal involving international migrant remittances occurred in 1994 in Mexico. Since then, the volume of remittance securitization has grown rapidly. Using this instrument, Mexico, Turkey, and El Salvador raised about US\$2.3 billion during 1994–2000. As electronic transfers became more prevalent and made it easier to track complex transactions, remittances securitization gave way to securitization of diversified payment rights (DPRs) including mainly migrant remittances, but also payments related to exports and FDI. Between 2000 and 2004, a total of US\$10.4 billion was raised through

securitization of DPRs by Brazil (US\$5.3 billion),<sup>239</sup> Turkey (US\$4.1 billion), El Salvador, Kazakhstan, Mexico, and Peru (although remittances remain dominant).

359. As experience with this instrument broadens and investors become more comfortable with its characteristics, it is possible that it could be used by a wider range of countries (including poor countries) and for a broader range of external flows (remittances, tourism receipts, commodity earnings). Financial institutions in the Central American countries that receive significant amounts of remittances can potentially raise financing from international capital markets using the future remittances-backed securitization structure. However, to the extent remittances finance consumption and imports, they will not be available as collateral.

360. One of the main problems with future flow securitization is that it increases the level of inflexible debt of the issuer, usually private financial institutions.<sup>240</sup> Although the current level of debt pledged to future flows is not alarming, such debt reduces the flexibility and ability to service other non-preferred debt. Securitization of future remittances (and other future flows) can potentially conflict with the negative pledge provision included in the IBRD loan and guarantee agreements. While this clause does not prevent a borrower from pledging assets to other lenders, it prohibits the establishment of a priority for other lenders over the IBRD.<sup>241</sup>

361. Several policy hurdles need to be surmounted before securitization deals can proceed. High fixed costs of legal, investment banking, and credit rating services and long lead times can pose difficulties for developing countries with few large entities and high borrowing needs. A master trust arrangement can permit issuers to structure a large deal but tap the market in several tranches. Pooling receivables of several branches (or even several borrowers) could also help to increase the deal size to justify large fixed costs. Absence of an appropriate legal infrastructure is yet another constraint on issuance. Overcoming this constraint need not call for a grand overhaul of the entire legal system—a more focused approach that concentrates on bankruptcy law may suffice, by making sure that pledged assets remain pledged in the event of default.<sup>242</sup>

## **F. Conclusions**

362. Migrant remittances are the largest source of external financing and a large source of funding in relation to the size of the Central American economy. Remittances are, therefore,

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<sup>239</sup> These bonds resulted in a spread saving of over 700 basis points compared to Brazil's sovereign spread.

<sup>240</sup> See IMF (2003) and Chalk (2002).

<sup>241</sup> The Fund does not have any formal negative pledge provision, but it could take into account collateralized future receipts agreements in making financing decisions under Article V (IMF 2003, p. 14).

<sup>242</sup> Tran and Roldos (2003) outline a broader set of policy actions and reforms for securitization. Although these recommendations are for securitization of existing (and local currency) assets such as mortgage loans, they also apply for securitization of future flow (and hard currency) assets.

a significant part of the retail payment system covering small-value transfers or transactions where one of the counterparty is an individual.

363. From a financial sector point of view, large remittance flows raise two sets of issues: how to reduce cross-border remittance costs; and how to leverage remittances for improving financial deepening in the recipient countries. A related and somewhat under-researched issue is the use of remittances as collateral for raising external financing.

364. Measures to reduce remittance costs and strengthen the financial infrastructure include encouraging competition among remittance service providers, harmonizing regulation, introducing electronic remittance instruments, harmonizing payment systems, and extending banking access of remittance recipients at home and migrants overseas.

365. Improving data on remittances, especially bilateral flows and corridor-specific data, would help to encourage competition in the larger corridors. Officially recorded remittance data are believed to significantly underestimate the true size of remittance flows. An International Working Group headed by the World Bank, in close collaboration with the IMF, the European Central Bank, the Inter-American Development Bank, the OECD, and the United Nations is currently looking into improving data on remittances. Another task force jointly set up by the World Bank and the CPSS, including IMF participation, is currently developing voluntary principles for remittance service providers and regulators to improve transparency in the remittance market.

366. Many of these efforts to facilitate cross-border remittances would require bilateral cooperation between the Central American countries and the US government, since the United States is the most important source of remittance flows to Central America. These efforts would also require regional cooperation as intra-regional remittance flows are sizeable.

367. Efforts to reduce costs have to be carefully balanced with those to fight money laundering and the financing of terrorism. While, for instance, documentation requirements can add to the cost of remittances and restrict access to formal channels, they are necessary to prevent the abuse of remittance services for money laundering or terrorist financing purposes. Strengthening the formal remittance infrastructure by offering the advantages of low cost, flexible hours, expanded reach, and language, and increasing efforts to identify and regulate the unregulated sector, would be effective ways to facilitate remittance flows while preserving their integrity.

368. Banks and smaller financial institutions such as credit unions and microfinance institutions (MFIs), can play a role in delivering low-cost and convenient remittance services. Remittances, in turn, may bring new customers and business, such as consumer loans, mortgages, and life insurance, to these institutions. Banks from countries in the region have been active in this market for some time, including through branch networks in sender countries. Larger international banks have more recently shown interest in tapping this market.

369. There is potential for mobilizing financing from international bond markets by securitizing future remittance flows in Central America, especially during times of low liquidity and heightened perception of country risk. Future flow securitization, however, increases the level of inflexible debt of the issuer (usually, financial institutions). This activity may also be constrained because remittances tend to feed directly into consumption and imports and thus do not constitute increased financial saving.



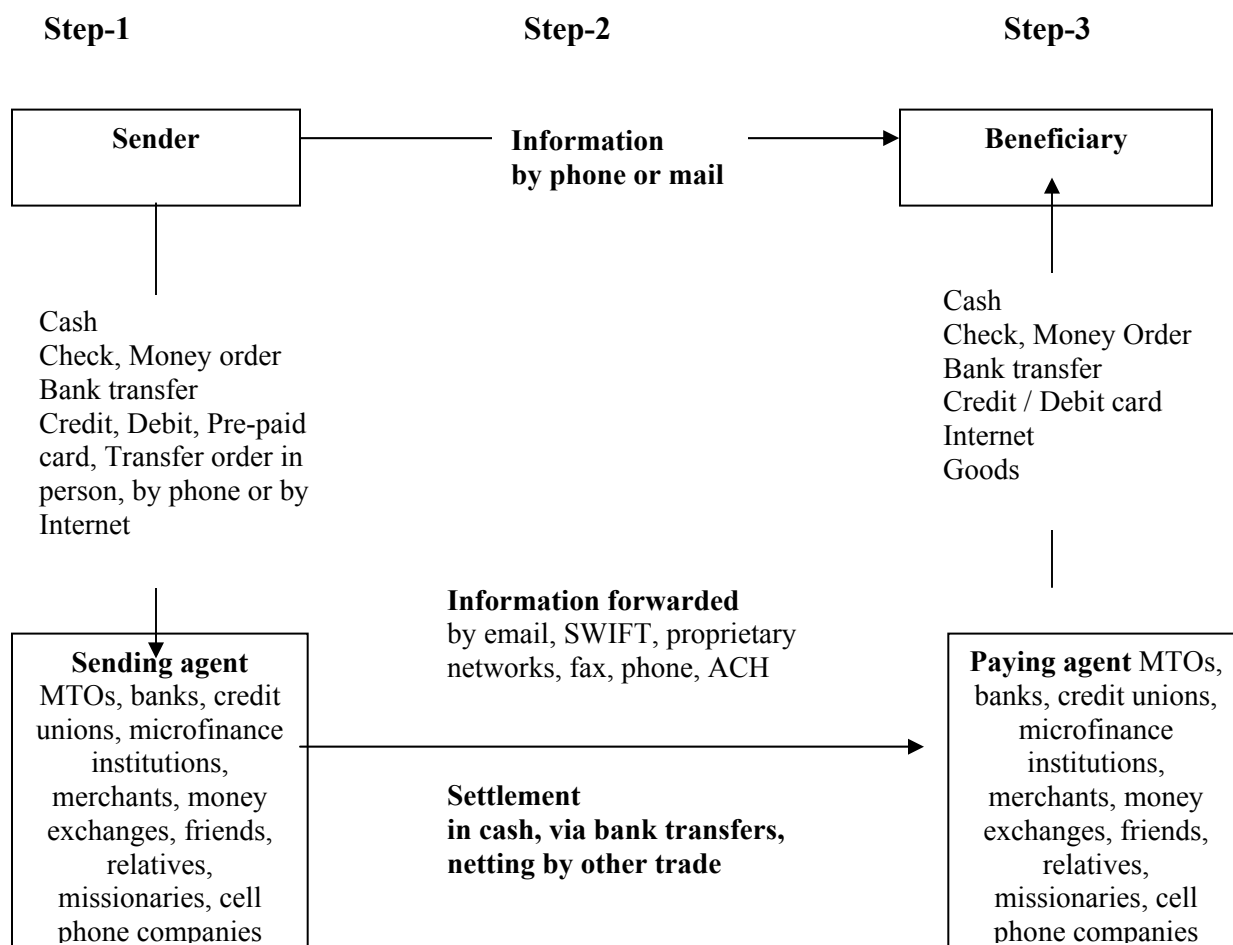
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### REMITTANCE TRANSACTION STRUCTURE

A typical remittance transaction takes place in three steps: (1) initiation of remittances by a migrant sender using a sending agent; (2) exchange of information and settlement of funds; and (3) delivery of remittances to the beneficiary. In step 1, the migrant sender pays the principal amount of remittance to the sending agent using cash, check, money order, credit card, debit card, or a debit instruction sent through email, telephone, or internet banking. In step 2, the sending agency—a MTO, a bank or another financial institution, a money changer, or a merchant (e.g., a gas station, grocery store) then instructs its agent in the recipient country to deliver the remittance to the beneficiary. In step 3, the paying agent makes the payment to the beneficiary. In most cases, there is no real-time fund transfer; instead, the balance owed by the sending agent to the paying agent is settled periodically according to a mutually agreed schedule. The settlement is mostly carried out using commercial banks through the national clearing and settlement systems. Informal remittances are sometimes settled through goods trade.



### **BANCO DO BRASIL'S NIKKEI REMITTANCE TRUST SECURITIZATION<sup>243</sup>**

Amount: US\$250 million.  
 Collateral: U.S. dollar- or Japanese yen-denominated worker remittances.  
 Transaction Rating: BBB+ versus Banco do Brasil's and Republic of Brazil's foreign currency rating of BB-/Stable.

This deal involved Banco do Brasil (BdB) selling its future remittance receivables from Brazilian workers in Japan directly or indirectly to a Cayman Island-based offshore special purpose vehicle (SPV) named Nikkei Remittance Rights Finance Company. A New York City-based SPV issued and sold the debt instrument to investors, receiving US\$250 million. BdB Japan was directed to transfer remittances directly to the collection account managed by the New York-based trust. The collection agent was to make principal and interest payments to the investors. Excess collections were to be directed to the originator BdB via the SPV.

Since remittances did not enter Brazil, the rating agencies believed that the structure mitigated the usual sovereign transfer and convertibility risks. The structure also mitigated the bankruptcy risk because the SPV had no other creditors, and risk of bankruptcy was minimum given the government-owned BdB's dominant position in Brazil. Furthermore, legal opinion held that creditors would continue to have access to the pledged security (i.e., remittances) even if BdB were to file for bankruptcy.

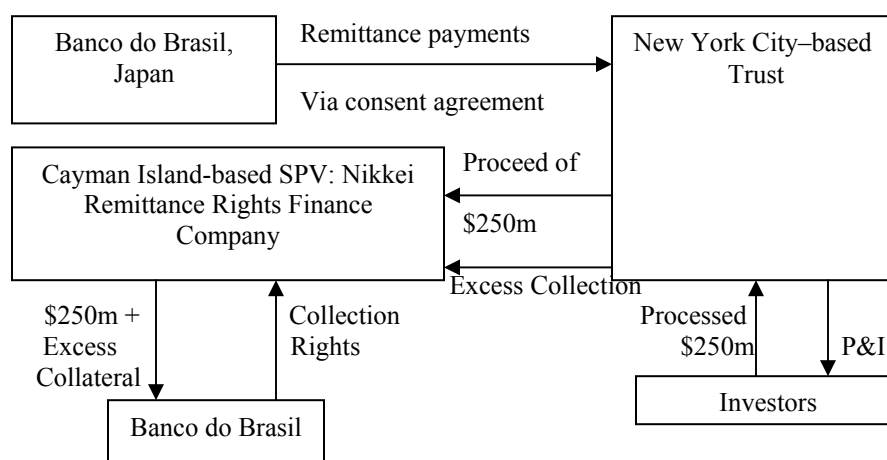
A number of residual risks remained that were difficult to structure away. These included performance risk—the ability and willingness of BdB to garner remittances and deliver them to the collection account managed by the New York-based trustee; the product risk—the ability and willingness of Japan to generate remittances; and the diversion risk—the possibility of BdB selling the remittance rights to another party. The performance risk is generally captured in the issuer's local currency rating. For entities such as banks, Fitch uses the going concern and S&P the "survival" assessment of the originating entity in rating an asset-backed transaction higher than the issuer's local currency rating. This was the case for the BdB's Nikkei Remittance Trust transaction, which was rated BBB+ versus BdB's BB+ local rating. In reaching this decision, S&P took into account BdB's position as the largest financial institution in Brazil (with a 2,900 strong branch network) that makes it a natural conduit for funds transfers, the long-established presence of BdB in Japan since 1972, and the importance of worker remittances in generating foreign exchange for the Brazilian government. The product risk from volatility and seasonal fluctuations in remittances was mitigated via over-collateralization or excess coverage, with a debt service coverage ratio of 7.64.<sup>244</sup> Another element of product risk was partially mitigated by recognizing Japan's need for workers to supplement the native workforce, and the availability of Brazilians of Japanese

<sup>243</sup> This appendix draws on Ketkar and Ratha (2004).

<sup>244</sup> While excess coverage helps to mitigate elements of product risk, it also reduces the total amount of funds that can be raised with future flow receivables.

descent to fill this demand. S&P, however, recognized as constraints on the rating the possibilities of Japan obtaining workers from countries other than Brazil and BdB selling remittance rights to another party. It expressly identified the latter as an event of default, triggering early amortization.

Figure 1: Structure of Banco do Brasil's Remittance Securitization



Source: Standard and Poors (S&P)

Some elements of sovereign risk cannot be totally eliminated. For example, the Central Bank of Brazil can compel BdB to pay remittances directly to the central bank instead of the trust. A degree of protection against this risk is provided by the fact that BdB is majority owned by the government of Brazil. In other instances, remittance securitized transactions have made designated correspondent banks sign a Notice and Acknowledgement, binding under the U.S. law (or the law of a highly rated country), that they will make payments to the offshore trust. That would make the sovereign reluctant to take the drastic step of requiring payments into the central bank. Currency devaluation is yet another element of sovereign risk that cannot be totally eliminated even in structured transactions. For instance, currency devaluation may impact the size and timing of remittances, particularly through formal channels.