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SM/10/109

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April 30, 2010

To: Members of the Executive Board

From: The Secretary

Subject: **Nicaragua—Financial System Stability Assessment—Update**

This paper provides background to the staff report on the 2010 Article IV consultation discussions with Nicaragua and the fourth review under the Extended Credit Facility (EBS/10/68, 4/22/10), which is tentatively scheduled for discussion on **Wednesday, May 5, 2010.** At the time of circulation of this paper to the Board, the authorities of Nicaragua have indicated that they need more time to consider whether they will consent to the Fund's publication of this paper. Any requests for modifications for publication must be received two days before the Board concludes its consideration.

Questions may be referred to Mr. Zandamela (ext. 34328), MCM.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat forthwith; and to the European Commission, the European Investment Bank, and the Inter-American Development Bank, following its consideration by the Executive Board.

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NICARAGUA

Financial System Stability Assessment—Update

Prepared by the Monetary and Capital Markets and Western Hemisphere Departments

Approved by José Viñals and Nicolas Eyzaguirre

April 30, 2010

Mission: The Financial System Stability Assessment (FSSA) is based on the work of a joint IMF-World Bank mission to Nicaragua during October 5–21, 2009 as part of the Financial Sector Assessment Program (FSAP). The mission was led by Rogerio Zandamela (Head, IMF) and Eva Gutierrez (Deputy Head, WB) and included Ivan de Oliveira Lima, Torsten Wezel, David Parker, Pablo Druck, and Adriana Rota (all IMF); Carlo Corazza, Mike Goldberg, Ilias Skammelos, Rafael Pardo, Henri Fortin, and Kit Cutler (all World Bank); and Walter Zunic (former Federal Bank of New York); and Socorro Heysen (former Superintendent of Banks in Peru and IMF). An AML/CFT assessment was conducted separately by the Financial Action Task Force of Central America (CFAT) in October 2008.

Key findings: The Nicaraguan banking system has a comfortable liquidity position and high reported capital adequacy ratios, but underlying risk factors call for substantial buffers. The authorities have also been proactive in implementing the recommendations of the 2003-04 FSAP. However, vulnerabilities stem from: (i) difficulties in conducting a comprehensive assessment of the financial condition of the Nicaraguan regional banking groups operating abroad, due to information shortcomings; (ii) contagion risks from foreign banks belonging to regional groups with a majority of assets in Nicaragua, but now consolidating their operations in Panama; (iii) legal uncertainty about the enforceability of loan terms; (iv) the rapid deterioration in credit quality, particularly for banks specializing in microfinance and consumer credit; (v) large dollar-denominated loans to unhedged borrowers; (vi) the failure to apply international standards of accounting to the government bonds restructured in mid-2008; (vii) large sovereign bond exposures in the two largest banks in the system. Outside the banking sector, accounting and auditing practices are still at an incipient stage of development. The quality of SME financial reporting tends to be quite low overall, and financial information in the real sector is insufficiently standardized.

Key recommendations: Priority recommendations include further strengthening consolidated supervision, improving banks' risk management and governance, taking measures to bolster soundness of the regional banks, and establish a regulatory framework for the microfinance sector.

FSAP assessments are designed to assess the stability of the financial system as a whole and not that of individual institutions. They have been developed to help countries identify and remedy weaknesses in their financial sector structure, thereby enhancing their resilience to macroeconomic shocks and cross-border contagion. FSAPs do not cover risks that are specific to individual institutions such as asset quality, operational or legal risks, or fraud.

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GLOSSARY

ACH	Automatic Clearing House
AML/CFT	Anti-Money Laundering/Combating the Financing of Terrorism
BCN	Central Bank of Nicaragua (Banco Central de Nicaragua)
CAR	Capital Adequacy Ratio
CABEI	Central American Bank for Economic Integration
CENIVAL	Central Securities Depository (Central Nicaragüense de Valores)
CGR	Comptroller General's Office
CMC	Central American Monetary Council (Consejo Monetario Centroamericano)
CPA	College of Public Accountants (Colegio de Contadores Públicos)
COMA	Open Market Operations Committee
CP	Core Principle
CPSS	Committee on Payment and Settlement Systems
EFT	Electronic Fund Transfer
FNI	Investment Finance Company of Nicaragua (Financiera Nicaragüense de Inversiones)
FOGADE	Deposit Insurance Fund (Fondo de Garantía de Depósitos)
FSA	Financial Sector Assessment
FSAP	Financial Sector Assessment Program
FSN	Financial Safety Net
FSSA	Financial System Stability Assessment
GAAP	Generally Accepted Accounting Principles
GDP	Gross Domestic Product
IADI	International Association of Deposit Insurers
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
INSS	Nicaraguan Social Security Institute (Instituto Nicaragüense de Seguridad Social)
ISA	International Standards on Auditing
LOLR	Lender of Last Resort
LICs	Low Income Countries
NPL	National Law of Payments (Ley Nacional de Pagos)
MFIs	Microfinance Institutions
MHCP	Ministry of Finance and Public Credit (Ministerio de Hacienda y Crédito Público)
MIFIC	Ministry of Promotion, Industry and Trade (Ministerio de Fomento, Industria y Comercio)
MUC	Unified Accounting Manual
RFG	Regional Financial Groups
ROA	Return on Assets
ROE	Return on Equity
ROSC	Report on Standards and Codes
RTGS	Real Time Gross Settlement
SIBOIF	Superintendency of Banks and Other Financial Institutions (Superintendencia de Bancos y de Otras Instituciones Financieras)
SMEs	Small and Medium-Size Enterprises
TU	Termination Unit
UNCTAD	United Nations Conference on Trade and Development

EXECUTIVE SUMMARY

The global economic and financial crisis, as well as political tensions, have negatively affected the Nicaraguan economy starting in late 2008. The direct impact of the crisis in the banking system was minimal, as Nicaraguan banks did not have exposures to toxic assets and relied less on foreign credit lines.[1] However, as uncertainty increased, banks retrenched credit to build liquidity buffers. As economic activity decelerated, a decline in credit quality prompted a further tightening of the banks' lending criteria. The slowdown in credit helped to exacerbate the negative effect of the external shocks on the economy, particularly on consumption.

The Nicaraguan banking system has a comfortable liquidity position and high reported capital adequacy ratios (CAR), but the underlying risk factors call for substantial buffers. For the system as a whole, liquid assets amounted to 29½ percent of total assets by end-2009, and all banks reported CARs above 10 percent. However, by applying international standards for accounting rules to the "bonos bancarios" restructured in mid-2008, the average CAR for the system would be 1¾ percentage points lower. Large sovereign bond exposures in the two largest banks in the system and dollar-denominated loans to unhedged borrowers are other sources of concern. There are also difficulties in conducting a comprehensive assessment of the financial condition of the Nicaraguan regional groups operating abroad due to information shortcomings. In addition, credit quality has deteriorated rapidly, particularly for microcredit and consumer loans. Finally, higher liquidity and increased delinquency rates have negatively affected banks' profits and the ability to absorb future losses.

Going forward, the key risks to the financial system are the deterioration in the credit culture and legal uncertainty about the enforceability of loan terms, and contagion risks from Honduran banks belonging to Nicaraguan-owned regional banking groups. Stress tests show that banks' equity positions are generally adequate to cope with medium-sized credit risk shocks affecting the entire domestic loan portfolio as well as large borrowers. However, under the most severe shocks considered, some individual banks would likely become undercapitalized. In addition, exchange-rate-induced credit risk is high due to the large share of dollar borrowers who do not earn foreign currency. Liquidity stress tests indicate that banks are resilient to large liquidity shocks.

The regulatory and supervisory framework for banks has been significantly strengthened since the last FSAP, but challenges remain. New laws have strengthened the powers of the Superintendency of Banks and Other Financial Institutions (SIBOIF) with regard to authorizing new bank licenses and conducting consolidated supervision. New regulations stressed the responsibilities of directors and managers with respect to risk management and the internal control environment. The main challenge going forward will be to improve risk management and corporate governance of banks and banking groups. Additionally, efforts to achieve effective consolidated supervision of cross-border banking groups must continue. To this end, the SIBOIF should devote more resources to bank supervision and an amendment to its charter is

[1] Total bank external liabilities declined from US$483 million at end-2008 to US$410 million by end-2009.

recommended to ensure that contributions from financial institutions to the SIBOIF are adequate. Legal protection of supervisors also needs to be enhanced.

Nicaragua has made good progress in developing its financial safety net (FSN) arrangements, but a formal contingency plan for crisis management is needed. The Ministry of Finance should lead the effort to build on the 2006 ad-hoc crisis committee, and create and chair a Crisis Prevention and Management Committee.

Amendments to the central bank law should ensure the independence of the deposit insurance agency (FOGADE). The proposal to replace FOGADE's Board of Directors with the Board of the Central Bank of Nicaragua (BCN) does not conform to international sound practices. If FOGADE is to be put under BCN, then it should have only a narrow mandate, or a paybox function, with bank intervention, resolution, and liquidation transferred elsewhere, preferably to SIBOIF.

A strengthening of the interbank and public debt markets would help reduce interest rate volatility and support financial stability and development. A more active short-term liquidity management by the BCN may promote higher turnover in the interbank market by encouraging banks to reduce their cash holdings, which would increase the chance of complementary positions appearing in the market. Measures to enhance communication with the private sector and to increase the share of standardized instruments in total public debt could help increase market trading of those securities.

The concentration of the Nicaraguan financial sector appears to be restricting competition and efficiency. The authorities could facilitate market entry by revising the entry policy through the creation of two types of license for regulated microfinance institutions (MFIs), with stricter requirements for deposit-taking institutions than for finance companies. In addition, the authorities could strengthen consumer protection and promote (i) better disclosure and greater transparency in pricing, (ii) consumer education and financial literacy, and (iii) non-traditional financial instruments and other sources of finance.

The rapid growth of the microfinance industry in the current unregulated environment in recent years is threatening its sustainable development. The adoption of a law on microfinance institutions that would regulate the sector should be a priority. In response to social and financial problems caused by the combination of drought, poor client selection by MFIs, and the local effects of the global financial crisis, the Assembly approved last February (with broad consensus) a "Moratorium Law," mandating the restructuring of past due microcredit loans at below market conditions (the law went into effect mid-April 2010). The compulsory rescheduling of debt would undermine creditors' rights, hurt MFIs, further undermine investor confidence, and adversely affect credit availability rural producers. If it spreads to core areas of the financial system, the deterioration in the credit culture in the microfinance segment could pose a systemic risk for the overall financial system.

The Nicaraguan legal framework for payments and securities settlement requires improvement. Authorities should actively remove relevant systemic risks, such as the use of checks for systemically important payments and the lack of interlinkages between the RTGS and the Securities Settlement System.

Outside of the banking sector, accounting and audit practices are still at an incipient stage of development. The quality of SME financial reporting tends to be quite low overall. In addition, financial information in the real sector is insufficiently standardized, and Nicaragua is one of the few countries in Latin America and the Caribbean not requiring listed companies to apply International Financial Reporting Standards (IFRS). In parallel, the accounting and audit profession is under-developed, which undermines the effectiveness of the SIBOIF, the Comptroller General's Office (CGR), and others who rely on audited financial information of public-interest entities.

The authorities have been proactive in implementing the recommendations of the 2003-04 FSAP. Many of the recommendations made in the FSAP have been or are in the process of being implemented (Table 2). Progress was particularly significant in areas such as the legal framework, banking regulation and supervision, macroeconomic policies, and public debt management and markets. However, the pension reform recommendation has not been implemented because of the high fiscal costs associated with the move from a pay-as-you-go scheme to a fully-funded scheme.[2]

The key recommendations of this FSAP update focus on both stability issues and structural reforms in the Nicaraguan financial system. These recommendations are outlined in Table 1.

[2] The pension reform currently under consideration does not envisage moving to a capitalization scheme, but rather it proposes parametric changes to the existing pay-as-you-go system.

I. The Macroeconomic Impact of the Global Economic and Financial Crisis

1. **The global economic and financial crisis, as well as political tensions, negatively affected the Nicaraguan economy starting in late 2008**. The Nicaraguan economy grew by an average of about 3½ percent per year during 2005–08 (Table 3). However, during the second semester of 2008 economic conditions started to deteriorate on account of both domestic factors and the global financial crisis. Real GDP is estimated to have fallen by about 1½ percent in 2009. Monetary policy remains geared at protecting the international reserve position, and the crawling peg, in place since 1993, has helped to anchor expectations and preserve competiveness.

2. **The Nicaraguan financial system, as was the case in other Central American countries, contributed to the transmission of the global economic turmoil to the local economy through a sharp reduction in credit (Figure 1).** The direct impact of the crisis in the banking system was minimal, as Nicaraguan banks did not have exposures to toxic assets nor did they rely much on foreign credit lines. After several years of strong growth, private sector credit started to decline in mid-2008, contracting by 7½ percent y-o-y by end-2009. The slowdown in credit helped exacerbate the negative effect of the external shocks on the economy, particularly on consumption. Similar effects have been observed in other countries of the region (Figure 2).

3. **The authorities took a few measures to shield the banking system from the global crisis.** In March 2009, the central bank increased the size and flexibility of its credit lines to banks. Later, in August 2009, the central bank signed a one-year contingent credit line of about US$200 million with the Central American Bank for Economic Integration (CABEI) to shield the banking system from liquidity and solvency shocks.

4. **Lending rates in dollars have increased, while deposit interest rates have remained stable**. Reacting to higher risks due to sluggish economic activity and political uncertainties, lending interest rates rose quickly from an average of about 11 percent during the first three quarters of 2008 to about 13½ percent in 2009 (Figure 3). In real terms, the increase was much sharper as inflation fell from about 14 percent in 2008 to just under 1 percent by end-2009. Meanwhile, deposit interest rates have fallen to around 3–4 percent (in US$ terms) due to the high levels of liquidity in the banking system, dampening bank profits.

5. **The fiscal deficit increased sharply in 2009 owing mainly to declines in tax revenues.** Since the higher deficit is estimated to have been financed mainly from external funds, financing from the private domestic financial sector has been modest (about US$40 million) with the Nicaraguan Social Security Institute (INSS) buying a large share of the new standardized government securities (Figure 4).

II. Structure of the Financial System

6. **Nicaragua's financial system is dominated by regional banking groups and is highly concentrated.** The banking sector comprises seven private commercial banks (including two microfinance banks) and a public second-tier bank (Table 4). The three largest banks control

about 71 percent of assets, 67 percent of loans, and 75 percent of deposits in the financial system, while the combined market share of the five largest banks reaches 89 percent (the second highest in the region). Regional financial groups control approximately 83 percent of the banking sector assets; the rest are dominated by other foreign banks. Three of the regional banking groups, Lafise, BAC, and Banpro, have the majority of their assets in Nicaragua, although the group holding companies are domiciled in Panama. In addition, there is a vibrant microfinance sector (see Section IV.B). The securities market in Nicaragua is shallow, and virtually all securities (approximately 95 percent) are issued by the government.

7. **Although financial sector growth has been modest in recent years, banks' portfolio reallocation funded a credit boom.** Domestic credit to the private sector increased from 18 percent of GDP in 2001 to about 34½ percent in 2009. However, total credit is still 4 to 5 percentage points of GDP below the average of Central American peers. Total assets of other financial institutions (securities brokers, insurance companies and storage agents) account for 2 ¾ percent of GDP, and together have increased by only ¾ percent compared to 2003.

III. Financial System Strengths and Vulnerabilities

A. Financial System Condition

8. **Nicaraguan Banks have comfortable liquidity buffers.** For the system as a whole, liquid assets amount to 26½ percent of total assets (Table 5). Liquidity ratios ranged from 24 percent to 78 percent across banks at end-2009, an indication of the challenges many banks face in identifying sound credit opportunities. Deposit concentration is relatively modest, with the largest 20 depositors in the system accounting for about 20 percent of total system deposits. The largest depositor is the social security system, which accounts for 4½ percent of total banking system deposits.

9. **Although reported capital adequacy indicators for the system are high, these are justified by underlying risk factors.** As banks moved to more liquid assets and retained part of 2008 profits, capital adequacy ratios (CARs) improved and amounted to 16½ percent at end-2009. All banks reported CARs comfortably above 10 percent.[3] Banks' capital has good loss-absorbing capacity as virtually all Tier 2 capital consists of retained profits reserves. However, by applying international standards for accounting rules to the "bonos bancarios" restructured in mid-2008, the CAR for the system declines to 14¾ percent (capital may be overstated by international standards). In addition, a substantial number of loans have been restructured or reprogrammed, and the new stricter regulation on provisions for these types of loans were only fully applied in March 2010. Moreover, while banks have generally reduced their exposure to sovereign risk in recent years, the two largest banks in the system still hold a large proportion of government bonds, which carry zero risk weight for the purposes of the calculation of the CAR. Additionally, while the financial system is highly dollarized (see Table 3), not all borrowers are

[3] Regulatory capital charges in Nicaragua cover credit risk as well as market risk arising from currency mismatches.

dollar earners. Finally, information shortcomings hamper the assessment of the financial condition of the Nicaraguan regional groups operating abroad.

10. **Following a period of credit expansion, credit quality has deteriorated rapidly in the last quarter of 2008, particularly for microfinance banks and consumer credit**. The current total portfolio at risk of Nicaraguan banks amounted to about 11 percent of total loans by end-2009,[4] while provisions cover less than 40 percent of the portfolio at risk (the same indicators stood at 6 percent and 66 percent, respectively, in September 2008). For some microfinance banks, the deterioration in credit quality has been particularly severe, with the portfolio at risk exceeding 20 percent of total loans. The deterioration in the quality of the portfolio has been particularly sharp in the consumer segment, which had experienced a credit boom in the past few years. Moreover, the construction sector and car dealers have also been affected by the crisis. The agriculture sector, which accounts for about 10 percent of banks' loan portfolio, is currently experiencing a drought.

11. **Higher liquidity and increased delinquency rates have negatively affected banks' ability to absorb future losses.** Return on assets (ROA) has declined from almost 2 percent in 2008, to under 1 percent by end-2009, while return on equity (ROE) has dropped from about 18 percent to under 5 percent over the same period. The two microfinance banks, accounting for 10 percent of banking assets, are already experiencing pre-tax losses. Both banks have had to increase capital in the face of rising credit losses.

12. **The deterioration in the credit and payment culture and legal uncertainty about the enforceability of loan terms could threaten financial stability.** In response to the social and financial problems caused by the combination of the economic downturn and weather-related shocks, as well pressures from the grass-roots *non-payment* movement, the Legislative Assembly close to unanimously approved in late-February 2010 a law mandating the restructuring of past-due microcredit loans at below market terms. The so-called "Moratorium Law," which went into effect in mid-April, would be valid for 120 days and apply to the roughly 5,000 loans overdue as of June 2009 (see Section IV.B). In addition, several initiatives have emerged in the Assembly that would amend or replace the existing Credit Card Law and cap interest rates on credit card loans at below market terms. The approval of any of the initiatives regulating interest rates on credit cards could pose a systemic risk for the financial system, and add to the deterioration in the payment culture resulting from the new Moratorium Law (Appendix VIII).

13. **Vulnerabilities related to three large cross-border banking groups also pose substantial risks to the financial system.** These entities are incorporated in Panama, but are largely Nicaraguan owned and have the bulk of their assets in Nicaragua in the form of subsidiary operations. These groups also maintain Honduran subsidiary banks that are facing

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[4] Portfolio at risk, monitored by SIBIOF as an indicator of credit risk, includes non-performing, restructured and reprogrammed loans. The indicator is conservative as restructured loans that have been performing for several quarters continue to be included in this category.

financial pressures owing to the macroeconomic and political situation in that country. As of August 2009, the CAR of these subsidiaries had dropped to 11-13 percent, and coverage rates for nonperforming loans had also deteriorated (all banks in Honduras have been granted regulatory forbearance to allow time to improve provisioning). These Honduran subsidiaries represent a significant share of the consolidated assets of these regional groups and a further deterioration in these subsidiaries would adversely affect the financial position of the groups but would also pose risks of contagion to the rest of Nicaraguan banking system. It is recommended that SIBOIF coordinate with the Panamanian and Honduran authorities regarding the necessary measures to bolster the capitalization of these groups, and to work more closely with the Panamanian authorities that have responsibility for consolidated supervision of these entities (Appendices IV and VIII).

B. Stress Testing[5]

14. **Stress tests show that the banking system as a whole holds sufficient capital to withstand a further deterioration in credit quality.** First, in a scenario assuming a continued erosion of loan quality (rising non-performing loans and provisions) and a further decline in net profits, banks' CARs remained above the regulatory minimum of 10 percent of risk-weighted assets, except for one bank (see Table 6). Another set of credit risk shocks involved direct downgrades of the entire loan portfolio by one and two notches. As most loans are classified as A loans, the one category downgrade has a minor impact. However, a more severe scenario, in which all loans are downgraded by two notches and become non-performing (e.g., from A to C) would deplete the capital of most banks. Risks related to credit concentration can be regarded as moderate, with only one bank failing capital requirements after an assumed default of the ten largest private debtors in the system. The downgrade of exposures to the 100 largest debtors by as much as two notches also showed a relatively minor impact.

15. **The impact of the two aforementioned legal initiatives (Moratorium Law and Credit Card Law) would have a considerable impact on bank capitalization in some cases.** In scenarios that account for the implied reduction in interest income, none of the banks would become undercapitalized, but the CAR of individual banks would drop by as much as 6½ percentage points. In addition to those initiatives, a reform of bank taxation (involving a flat tax on bank assets) would have a noticeable impact on bank profits, but all banks remain adequately capitalized in the stress tests.[6]

16. **As a combined scenario illustrates, a further decline in profits and the adoption of all legal initiatives would have systemic effects.** If such a situation were to materialize, the average capitalization ratio would decline by 3 percentage points, with three banks failing the capital requirement.

[5] See Appendix III for methodology discussion.
[6] The tax reform approved in December 2009 eliminated the tax-exempt status of government bonds.

17. **Market risk is low, as interest rates are generally variable for both banks' assets and liabilities and banks do not have significant mismatches.** Imposing a shock of a change in dollar interest rates of 1.1 percent percentage points (99th percentile of the historical distribution) on banks' net open positions (re-pricing risk) and their trading portfolio of government bonds (duration-based analysis) did not lower banks' capitalization ratios significantly.

18. **The indirect credit risk implied by a possible one-step devaluation is considerable.** The majority of borrowers with dollar loans do not earn foreign currency. This currency mismatch exposes them to the risk of sharply rising debt service should the Córdoba be devalued. In the absence of survey data on the coverage of businesses and households against exchange rate risk, anecdotal evidence suggests that the large majority of households with dollar or inflation-indexed loans—predominant in the consumer and mortgage loan segment—would be affected, as would about half of Nicaraguan enterprises.[7] The stress test used a devaluation of 25 percent, causing the capital charge on banks' net open positions to rise correspondingly. In addition to this effect, a certain fraction of unhedged borrowers (assumed to be 5 percent, 10 percent, or 20 percent) would default on their loans within the next year, causing the banking sector as a whole to enter into distress, with up to seven banks suffering a considerable shortfall in capital. In the most extreme scenario, the average capital adequacy ratio is projected to drop to well below the regulatory minimum.

19. **Liquidity stress tests indicate that banks are resilient to large liquidity shocks**. Banks can withstand very large deposit withdrawals (up to 30 percent of total deposits), even if it is assumed that all securities in the portfolio are illiquid in the event of a systemic liquidity shock. Banks are even more liquid in dollars than in domestic currency.

20. **The SIBOIF should upgrade data collection and dissemination, and also develop its own stress testing capabilities.** Additional information needed includes the classification of debtors by different banks, the degree to which debtors in foreign currency are unhedged, as well as consolidated balance sheets and income statements at the group level. As regards stress testing, projections of the impact of the entire range of intermediation risks should be made on a regular basis, ideally based on a credit risk model. Stress tests should also assess the regional exposures of financial groups.

IV. Competitiveness, Efficiency, and Access to Finance

A. Competition and Efficiency

21. **The Nicaraguan financial sector shows high concentration that appears to be restricting competition and efficiency.** The high concentration appears to have had an impact

[7] For purposes of stress testing, it was assumed that all household loans, i.e., personal, mortgage and credit card loans, are exposed to exchange rate risk. As suggested by the 2004 FSSA, for corporates this rate is assumed to be 40 percent for loans to the agricultural and farming sector, and 60 percent for industrial and commercial loans.

on competition and efficiency, as reflected in high spreads, interest rates and administrative costs compared to the region (see Figure 5).

22. **Bank profitability, after improving over the last five years, has been strained as a result of the global financial crisis and country specific factors (Tables 7 and 8).** The banks' recent efforts to decrease administrative costs have not been sufficient to offset either the lower financial margins or the higher estimates for loan losses, resulting in lower net income over assets (see Tables 5, 9, and 10 and Figure 3).

23. **The profitability pressures, combined with other factors, could have significant implications for competitiveness and stability.** The Moratorium Law, Credit Card Law, and fiscal reform affecting bank taxation, as well as the start of operations of the newly created bank *Banco Produzcamos*, could reinforce these tendencies by impacting the profitability of the sector, in turn prompting further consolidation.

24. **Although the small scale of the system and the high country risk premium impede greater competition, certain measures could promote efficiency without undermining financial stability.** The authorities could facilitate entry by revising the entry policy through the creation of two types of license for regulated microfinance institutions (MFIs), with stricter requirements for deposit-taking institutions than for finance companies. In addition, the authorities could strengthen consumer protection, promote better disclosure and greater transparency in pricing, promote programs of consumer education and financial literacy, and promote non-traditional financial instruments and other sources of finance.

B. Access to Finance

25. **The rapid growth of the microfinance industry in the current largely unregulated environment is threatening its sustainable development (Tables 11 and 12).** Lack of effective supervision has led to lax credit analysis and poor client selection practices in the industry, and lending to over-indebted borrowers appears to be widespread. The legal limits on lending rates for microfinance loans have resulted in a lack of transparency in the industry as MFIs charge a variety of commissions and fees to cover their high operational costs (10 of the 25 MFIs reporting in 2007 had operational and financial expenses adding up to more than 30 percent of total loans). Interest rates of unregulated MFIs are high (between 2.5 percent and 3.5 percent per month, without including fees and commissions), especially in urban markets, and significant penalties are applied to late payments.[8] Expansion of the NGO MFIs has also revealed weaknesses in governance. One of the largest of such MFIs, ACODEP, suffered a fraud of at least US$2 million that prompted the reconsideration of investment strategies by several leading institutional investors.

[8] Preliminary evidence suggest that average interest rate charged by microfinance institutions in Nicaragua are not significantly different than those charged by similar institutions in Central America and the Caribbean. Higher rates (of up to 60 percent) apply to smaller loans of shorter maturity.

26. **In this environment, the adoption of regulatory framework for the microfinance sector should be a priority.** The failure of a large microfinance institution could severely hamper access to credit in certain regions/sectors and could have contagion effects for other institutions in the sector (including regulated ones). Thus, the current Law on Microfinance Institutions, stalled in Parliament since 2002, should be amended to introduce a two-tier regulatory system for MFIs (including financial cooperatives), as well as stronger provisions on transparency and consumer protection.[9] All MFIs should be subject to regulations, and clear rules established by which certain entities that have grown beyond specific thresholds (e.g., in terms of assets or net worth) are converted into commercial entities supervised by the SIBOIF.

27. **Looking forward, solutions to the problem of over-indebted borrowers should involve voluntary restructurings.** The Government could play a facilitator role in the process, sponsoring a dialogue between the creditor and debtors with the mediation of social actors to agree on the parameters of restructuring. If fiscal space allows for it, a public partial credit guarantee for restructured loans could act as an incentive for restructuring (such as the Chilean FOGAPE scheme). On the judicial side, the *Escuela Judicial* could provide specialized training to judges in financial contract enforcement, with a focus on microfinance.[10] Mandatory restructurings should be avoided as they discourage institutional investors and damage credit for rural producers.

28. **The newly-created public bank should have a clearly defined role aimed at crowding in the private sector and competing on a level playing field.** To allow time to put proper credit-risk management systems in place, *Banco Produzcamos* should concentrate for the first three years on second tier operations, building on the important work of the Investment Finance Company of Nicaragua (FNI) and the Rural Credit Fund (FCR). Only after developing a proven record with second tier lending should *Banco Produzcamos* consider expanding to first tier operations, targeting geographic areas and sectors not well covered by other lenders. SIBOIF should closely monitor and supervise the activities of this new state bank (which initiated operations in April 2010), using the special norms in place.

V. Supervision and Regulation

29. **The regulatory and supervisory framework for banks has been significantly strengthened since the last FSAP.** During 2005–06 a new banking law was issued and amendments to the Law of SIBOIF were passed. The new laws strengthened the authorization of SIBOIF for ownership transfers and new bank licenses, and tightened fit and proper requirements for shareholders and directors. Limits on exposures to related parties were reduced. The SIBOIF was granted powers to conduct consolidated supervision and access to information on financial

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[9] While the current Microfinance Law was approved in 2002, the Assembly did not grant the necessary article by article approval.

[10] Available figures indicate that from late 2008 through February 2009 microfinance loans amounting to US$25 million were voluntarily restructured. Many more loans (some estimates point to US$50 million) may require restructuring as well.

groups. The responsibility of bank directors and managers for adequately running their banks and complying with laws and regulations was stressed. The SIBOIF has issued nearly 40 new regulations, including norms on comprehensive risk management, credit, liquidity and interest rate risks, consolidated supervision, anti-money laundering, internal controls, and a new chart of accounts. The bank supervisory framework is in the process of being revamped and emphasis on risk assessment is improving. These actions have been a major factor in SIBOIF's significantly improved compliance with the Basel Core Principles (Appendix I) and in the AML/CFT regimen (Appendix II).

30. **The improvement of risk management and corporate governance of banks and banking groups will be the main challenge in the years to come.** Supervisory efforts should focus on ensuring that banks and banking groups effectively comply with the new norms on risk management and internal controls. To this end, SIBOIF needs to implement supervisory processes to assess the risk profile and risk management framework of banks and banking groups, and improve processes to supervise credit, liquidity, interest rate, and operational risks.[11] SIBOIF also needs to establish norms regarding country and transfer risks and market risks. The added processes will require that SIBOIF devote more resources to bank supervision, with the Risk Department needing additional staff to develop and conduct these processes. Specialized training is also needed to prepare supervisors for the assessment of risks and risk management. However, this will be a challenge given existing limitations on raising resources. Furthermore, the lack of adequate legal protection for supervisors could stymie enforcement.

VI. Financial Safety Net Arrangements

31. **Nicaragua has made good progress in developing its Financial Safety Net (FSN) arrangements; however, there is room for improvement.** The lender of last resort (LOLR) facilities are untested and are not subject to intensified supervision. Although deposit insurance meets most international standards, there is no provision for a target reserve fund. The special bank insolvency regime provides for effective bank resolution, but there are legal problems with the timing of resolutions and some receivership activities. Finally, there is no contingency plan for crisis management.

Lender of last resort

32. **Liquidity credit is provided by BCN on a short-term basis, but the interest rate is punitive and too volatile.**[12] Credit can be granted to an illiquid, but solvent, bank. These resources have not been used in years, if at all. The regulations do not address cross-border

[11] To support these efforts, since May 2008 the Fund has been providing technical assistance on risk-based supervision to Nicaragua.

[12] The rate is 200 basis points over the average weighted yield rate of BCN securities traded in competitive bidding in the week prior to the credit request. Due to the limited market, this rate is excessively volatile for LOLR purposes. The authorities may want to consider adjusting the reference rate as discussed in Section VII of this report.

liquidity assistance; but this issue could be better addressed via regional MOUs. Liquidity assistance is supported by CABEI's US$200 million one-year contingent credit line contracted in August 2009, US$100 million of which can be used for liquidity assistance. Moreover, there is no LOLR facility in dollars (Appendix I, paragraph 6).

33. **Because the LOLR facilities have rarely been used, BCN should conduct simulation exercises to provide an assurance that emergency liquidity assistance can be granted on a timely basis.** Additionally, provision is needed for intensified supervision of banks accessing the LOLR facilities.

Deposit insurance

34. **The Deposit Insurance Fund (Fondo de Garantía de Depósitos, FOGADE) is a broad mandate scheme, with bank intervention, resolution, and liquidation authority.** FOGADE's reserve fund currently stands at approximately US$85 million, or about 3 percent of total deposits, but there is no legislative target for the fund. FOGADE should establish a target for its reserve fund, expressed as a range, in order to provide a financial buffer in case of a bank failure.

35. **Emergency funding mechanisms for FOGADE should be expanded to allow for increased flexibility.** There is no provision for increased premiums from member banks or other borrowing. Swifter borrowing arrangements, such as a "fast track" credit line with the Ministry of Finance, should be established.[13] Additionally, FOGADE should be able to charge emergency premiums to member banks (limited to a maximum of two times the bank's regular premium and for a one-year period).

Bank resolution

36. **SIBOIF has an adequate and effective authority for progressive enforcement actions, when a bank is facing financial difficulties or operating in an unsafe and unsound manner.** However, there is no provision for the appointment of a conservator or temporary administrator, which may help facilitate bank resolution. This is a tool the authorities may want to consider.

37. **The FOGADE law should be improved to allow for better timing in order to assure prompt access to insured depositors' funds**. The law provides that, within five days after the intervention order, FOGADE`s Board has to approve the least cost resolution alternative. The restitution of deposits must start immediately after intervention and must be completed in 30 days. There is a problem with the timing of these acts, because ideally resolution preparation,

[13] The US$200 million CABEI line of credit includes US$100 million for FOGADE's use in repaying insured deposits; however, it has never been tested and so it is unclear how quickly the funds could be disbursed. Additionally, the authorities should make their own funding arrangements, independently, under their own legislative system.

including steps such as FOGADE’s Board approval of the least cost resolution alternative, should be taken before the intervention.

38. **The Government, led by the Ministry of Finance, should be responsible for providing funds to address systemic situations.** However, Article 50 of Law 551 calls for FOGADE to guarantee liabilities other than deposits, and recapitalize and run a bank for up to three years. A deposit insurance scheme is not designed to prevent or resolve a systemic crisis. Guaranteeing other liabilities is beyond a deposit insurer’s mandate; and the three-year period is too long (one year with a possible extension is more appropriate). FOGADE does not have adequate resources to address systemic crises and should not be responsible for providing funds to recapitalize a bank. However, FOGADE’s capacity could be used to restructure and oversee the institution following implementation of these extraordinary measures.

39. **The instructions for the liquidation process contemplated in the FOGADE law could be improved upon.** Chapter VIII of the FOGADE law on the liquidation process confuses the timing and performance of various functions. Most of the functions itemized in this chapter are the duties of the Receiver, not the Liquidator. The mission recommends that the FOGADE law, and especially this chapter, be analyzed and rewritten as necessary to better comply with international standards.[14]

40. **Amendments to the central bank law should ensure the independence of the deposit insurance agency.** A proposed amendment to the central bank law to replace FOGADE’s Board of Directors with the central bank’s Board of Directors does not conform to international sound practices; it would compromise FOGADE’s independence, and perhaps most importantly, negatively affect public confidence in the Nicaraguan Deposit Insurance Scheme. The authorities should either leave FOGADE independent as it is, or, if it is taken under the wing of the central bank, amend the laws to put the responsibility for bank intervention, resolution, and most likely liquidation, under SIBOIF. Under such a scenario, SIBOIF would need access to additional funding since, as noted earlier in the report, budgetary constraints already challenge its bank supervision capacity.

[14] For example, FOGADE should have the right to both have a role in approving membership as well as to terminate deposit insurance for member institutions in order to provide better checks and balances regarding timely corrective and intervention measures.

Contingency planning for crisis management

41. **There is currently no formal contingency plan for crisis management in Nicaragua.** Building on the 2006 ad-hoc crisis committee, the Ministry of Finance should lead the effort to create and chair a Crisis Prevention and Management Committee (CPMC). The CPMC should develop a Crisis Prevention and Management Plan as described in Appendix V. Given cross-border contagion risks (see paragraph 13), this plan should address timely coordination with other regional supervisors, ring-fencing measures, and possible legal bottlenecks.

VII. Money and Debt Markets and Liquidity Management

42. **Trading liquidity in money and public debt markets plays a key role in promoting financial stability and development.** But in Nicaragua, in spite of the progress made with the standardization and dematerialization of central bank and government bonds, securities markets and the interbank market are still thin (see Figures 6–8).

Central bank liquidity management and the interbank market

43. **The low level of trading liquidity in the interbank market is in part a consequence of the way BCN is conducting its monetary operations.** It induces banks to hoard liquidity, thereby reducing the chances of complementary positions appearing in the interbank market (Appendices VI-VII and Figures 9-14).[15]

44. **To overcome these constraints, the BCN should review its monetary operations framework, focusing on the following measures:**

- BCN should actively manage short-term liquidity to help maintain greater stability in bank reserves. This could be achieved via auctions of either repos or reverse repos.

- Auctions of reverse repos (to absorb excess liquidity) would have a ceiling rate set by the central bank that could function, at the same time, as the floor rate of repo auctions (to inject liquidity) and serve as a reference to market transactions.[16] This would drive money market rates toward the reference rate, thus reducing volatility.

- A standard overnight lending standing facility should be introduced, and access to it would be automatic based on available collateral. It would be implemented through repos of public sector securities at a fixed punitive rate (say, 100 basis points above the reference rate, and less than the LOLR rates); indexation to the weekly auction rates (which is currently practiced) creates uncertainty as to the cost of borrowing from the central bank.

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[15] All BCN credit facilities charge interest rates of 200 basis point above the benchmark yield rate.

[16] However, given the crawling peg exchange arrangement, this rate should be set subject to the intermediate target of international reserves accumulation, not as a direct function of inflation developments or expectations.

- To improve market determination of the rest of the yield curve, pre-announced amounts in BCN weekly auctions should be made binding. Collusion behavior should be addressed on a case-by-case basis. To increase competition and its own room for maneuver, the BCN could undertake auctions for different tenors on separate days.

45. **A change in the central bank law may be needed to allow central bank repos to be fully effective**. Currently, BCN law and financial regulations only allow the central bank to trade government securities with up to one year to maturity in the secondary market. This not only restricts BCN's repos—as repos are normally considered secondary market transactions— but also constrains the market for longer-term government securities, and therefore hinders the lengthening of the maturity profile of the public debt.

The public debt market

46. **In spite of the progress in standardization and dematerialization, and the introduction of computer-based auctions, demand for the new MHCP bills and bonds is coming mainly from the INSS.** From discussions with market participants, it appears that previous unfriendly market episodes, where payments were delayed—because of budget cuts by the Assembly—or restructured, are still affecting the demand for government securities. While regaining confidence is essentially a matter of time, some shorter-term measures could help develop the public debt market. For example, (i) enhancing communication with the private sector would allow the debt manager to have a better understanding of market needs and perceptions; (ii) accepting part of the outstanding non-standardized public sector securities as payment in auctions of government bonds would increase the share of standardized securities in total debt; and (iii) using marketable government securities in the process of recapitalization of the central bank would allow the central bank to use these securities for monetary policy implementation, hence promoting a greater market concentration in these instruments.

VIII. Financial Infrastructure

A. Payment Systems

Legal, regulatory, and oversight framework

47. **The Nicaraguan legal framework for settlement needs to be improved as the payment, remittance, and securities settlement systems remain vulnerable to relevant risks (Appendix VIII).** Nicaragua urgently needs to adopt an adequate legislative or regulatory measure to implement and complete the Treaty on the Payment and Securities Settlement Systems for Central America and the Dominican Republic (the Treaty). This provides a general framework of rules already applicable in the country, but leaves to the national authorities the decision about how to integrate several specific and relevant aspects of the national payment system. Nicaragua should act promptly on these issues, in particular taking care of both systemically important and retail payment systems. The Treaty does not cover the regulations of the payment services, and therefore the authorities should adopt a specific law to cover this gap.

Systems

48. **Although Nicaragua has made progress in modernizing its national payment system in recent years, systemically important payment systems remain exposed to risks.** A real time gross settlement (RTGS) system (Electronic Funds Transfer, *Transferencia Electrónica de Fondos,* EFT) was launched in 2008 for large value payments. However, 40 percent of the large value payments are still settled in the check clearinghouse, which does not observe most of the CPSS Core Principles for Systemically Important Payment Systems.

49. **The EFT does not meet all the relevant standards and procedures that are essential to prevent systemic risks.** The EFT has no specific rules and procedures for liquidity management such as queuing mechanisms and collateralized intraday liquidity facilities. The possibility of mobilizing reserves during the day exists, but they would not be sufficient in case of major liquidity shortages. Moreover, specific measures such as the legal or regulatory prohibition against the use of checks for large value payments and the introduction of pricing schemes discouraging the use of checks should be enforced in order to settle all large value payments exclusively through the EFT. More specifically, appropriate interlinkages between the Securities Settlement System (CENIVAL System) and the EFT should be established.

B. Credit Information Systems

50. **Credit reporting systems have improved enormously in recent years, although information is still somewhat fragmented.** Cross-border cooperation with other countries in the region, in the exchange of relevant information among the public and private credit bureaus, would greatly improve the quality and the quantity of the information available and allow smoother access to credit for individuals and companies. The Data Protection Law, which was submitted to the Assembly several years ago, should be approved to prevent information misuse and protect the privacy of financial consumers.

C. Accounting and Auditing

51. **Overall, current accounting and auditing rules for SIBOIF-regulated entities in Nicaragua are adequate for supervisory purposes, although improvements are desirable in the medium term, as SIBOIF moves toward a risk-based approach.** The new Unified Accounting Manual (MUC), introduced in 2008, incorporates important changes, further aligning Nicaraguan banks' financial reporting with International Financial Reporting Standards (IFRS). Significant differences remain between the MUC and IFRS regarding presentation, valuation, and disclosure of certain transactions. Such differences relate in particular to loan loss provisioning, valuation of securities, tax accounting, derivatives, revenue recognition for commissions on loan origination, and disclosure of risk management policies. Moreover, an ad-hoc, special accounting treatment was granted for the restructured "Bonos Bancarios" in 2008, held by two of the country's largest banks. This treatment does not provide a fair presentation of this asymmetrical transaction under IFRS or any internationally recognized accounting standard.

52. **Although SIBOIF staff members are aware of accounting and auditing issues, they lack in-depth knowledge of IFRS, notwithstanding that SIBOIF rules require such knowledge (to apply IFRS in case of lacunae in the MUC).** SIBOIF needs a group of staff members with significant IFRS expertise, and comprehensive IFRS training among all technical staff. In addition, and given that the local financial system is gradually moving toward IFRS, SIBOIF should consider a medium-term IFRS convergence plan, with a view toward a statutory IFRS requirement for all public-interest entities (including large companies), with due consideration to prudential objectives.

53. **The quality of the financial reporting of small and medium-size enterprises (SMEs) tends to be quite low overall; in addition, financial information in the real sector is insufficiently standardized, with Nicaragua being one of the few countries in Latin America and the Caribbean not requiring listed companies to apply IFRS.** Nicaragua should officially adopt (i) IFRS for all public-interest entities, and for SMEs and all mid-sized companies required by statute or regulation to present audited financial statements, and (ii) International Standards on Auditing (ISA).

54. **Nicaragua's accounting and audit profession is under-developed, a worrisome fact for SIBOIF, the Comptroller General's Office (CGR), and others who rely on audited financial information from public-interest entities.** In the intermediate-to-long term, the authorities should seek to address the critical shortage of international-level accounting and auditing expertise in Nicaragua. A certification mechanism should be required for all statutory auditors, along the lines of Mexico's *Certified Public Accountant (Contador Público Certificado*) credential. Such a major change will require time, the involvement of all stakeholders in the financial reporting process, and proper coordination with other Central American countries (a similar proposal is under discussion in the Dominican Republic).

Table 1. Main FSAP Recommendations

Principal Recommendations (by Area)	
A. Banking Regulation and Supervision	
Negotiate a bilateral MOU with the Panamanian Bank Supervisor and establish contact with the supervisory authorities of Ecuador and the U.S. Office of Comptroller of Currency to obtain information on the operations of the unconsolidated parts of the regional financial groups	ST
Require Nicaraguan bank subsidiaries of regional financial groups (RFGs) to provide information about the risk profile of the overall banking groups directly, especially information that is not disclosed by the Panama Bank Supervisor, and if deemed necessary, request an increase in capital and/or provisions to mitigate cross-border risks of the overall banking group.	ST
Implement supervisory processes to assess the risk profile and risk management framework of banks and banking groups.	MT
B. Access to Finance	
Approve a Law on Microfinance Institutions introducing a two-tier regulatory system for microfinance institutions (including financial cooperatives) where the largest institutions are prudentially regulated by SIBOIF.	ST
C. Safety Nets, Crisis Management and Banking Resolution	
Reconsider the central bank law amendment to replace FOGADE’s Board of Directors with BCN’s Board of Directors; or at least carefully consider all the implications and do it in accordance with international sound practices (convert FOGADE to a narrow mandate and transfer bank intervention, resolution and liquidation responsibilities to SIBOIF).	ST
D. Money and Debt Markets, and Liquidity Management	
Take advantage of the recapitalization process of the BCN to provide it with a portfolio of tradable government securities that can be used in monetary operations (BCN and MHCP).	ST
Actively manage short-term liquidity through daily interventions to level bank reserves via auctions of either repos or reverse repos with a reference—respectively a ceiling or a floor—rate. (BCN)	MT
E. Payment and Remittance Systems	
Exclude checks as a means of payment for securities settlement and link the CENIVAL system with an electronic payment system like the EFT.	ST
Adopt a National Payments Law, including sound, predictable, non-discriminatory and proportionate regulation for remittance services.	MT
F. Accounting and Auditing Systems	
SIBOIF should take the lead in developing proposals to improve Nicaragua’s accounting and auditing through a formal process involving all key in-country stakeholders.	MT

ST = short term (up to 12 months); MT = medium term (1-3 years)

Table 2. Implementation of the 2003–04 FSAP Recommendations

2004 Recommendation	Current Status
Legal Framework	
Approve adequate legal protection for supervisors	PI
Amend the banking law and issue regulations to enable consolidated supervision	FI
Improve banking resolution procedures, including enactment of new legislation	FI
Review composition and tenure of the boards of central bank and superintendency of banks	PI
Eliminate excessive scope for banking secrecy in banking law	FI
Amend provisions in the SBOIF law that compromise the independence and discretion of the superintendent	FI
Implement the reform of the judiciary	FI
Introduce legislation on administrative processes	NI
Clarify jurisdiction of the General Comptroller's Office	PI
Creditor rights and insolvency issues	
Prepare an action plan to address structural problems with land titling	NI
Improve the procedures for registering property rights, licensing of rights and secured interests on movable, fixed and intangible assets	PI
Revamp, in a comprehensive way, the legislation for insolvency reorganization and liquidation proceedings	FI
Build institutional capacity in the judiciary to support the modernization and independence of judicial institutions	FI
Review securities legislation, to enact a new and comprehensive law on secured transactions	FI
Establish favorable conditions to create a functional environment for out-of-court reorganization plans	FI
Microfinance development	
Eliminate lending interest rate ceiling and the provisions in the Microfinance Association Law that bring MFIs under the surveillance of the SBOIF in exchange for some privileges	NI
Make provisions for the establishment of ratings services, information management technology providers and more effective auditing	NI
Promote a private credit bureau (involving banks, finance companies, financial cooperatives, telephone and electricity service providers, and large retail businesses)	FI
Pension reform	
Design the compensation bond and the reforms to the minimum pension, to the minimum pension guaranteed, social security contributions, age of retirement, etc., to ensure fiscal sustainability	NI
The compensation bond, as well as the bonds eventually issued to finance the social security deficit, should not be denominated in, or indexed to, the US dollar	NI
Impose a limit on public debt holdings by pension funds	NI
Public debt management	
BCN should focus on liquidity management and the Ministry of Finance on debt management.	FI
Implement a proactive and prudent national public debt strategy	FI
Payments and settlements systems	
Settle large-value payments exclusively through a designated gross settlement system to reduce credit risk	PI
Settle low-value payments through a system focused more on cost efficiency than on safety (e.g., reducing the use of checks)	PI
Increase the number of payment instruments and services offered by the automated clearinghouse	NI
Make collections and disbursements for the public sector through electronic means	PI
Improve CENIVAL procedures by establishing single-settlement cycles for the same type of securities and by completing the automation between the system of CENIVAL and that of the stock exchange	NI
Link the CENIVAL system with an electronic payments system, like the one envisaged by the BCN	NI
Establish effectively the payment systems oversight function at the BCN	PI
Promote the introduction of new means of payments (such as electronic transfers, direct debits, etc.)	PI

Table 2. Implementation of the 2003–04 FSAP Recommendations (concluded)

Promote agreements among banks to increase interoperability of the current infrastructure	PI
Monetary operations	
Increase credibility of the safety net by improving design of facilities	FI
Revise the reserve requirement regime in the central bank law	PI
Encourage the development of money markets by improving design of instruments	PI
Recapitalize the central bank and improve fiscal-monetary coordination	PI
Banking regulation and supervision	
Strengthen "ring-fencing" of operations of the local banks involved in cross-border activities, e.g., require prior authorization before entering into outsourcing arrangements	PI
Incorporate predetermined triggers for the application of corrective measures where a bank's capital ratio falls below a certain level	FI
Amend the chart of accounts of the SBOIF to ensure that banks follow the IAS	PI
Approve regulations on fit and proper attributes to be furnished by all persons interested in purchasing shares of a financial institution, and extend it to directors and officers of all financial institutions	FI
Increase role of the SBOIF on the surveillance of major acquisitions of financial institutions	PI
Request that banks include an analysis of repayment capabilities of unhedged borrowers when preparing and classifying loans	FI
Set exposure thresholds for government security holdings consistent with the public debt strategy	NI
Enhancing sound financial intermediation	
Reduce regulatory costs by reducing deposit insurance coverage and premium	FI
Allow securitization, especially in mortgage lending, and hedging (especially for foreign exchange exposure)	PI
Monitor restructured loan performance	FI
Monitor provisioning based on loans at risk	FI
Implement provisioning for interest rate risk and other market risks	PI
Macroeconomic policies	
To favor de-dollarization over the long run, ensure adequate international liquidity, provide instruments denominated in córdobas (led by government securities), with indexation to references other than the US dollar), undertake prudential measures to induce monitoring of exchange rate risk	FI

FI = fully implemented; PI = partly implemented; NI = not implemented.

Table 3. Selected Economic and Social Indicators

	2007	2008	2009
Real Sector			
GDP growth (percent)	3.1	2.8	-1.5
CPI (eop, in percent)	16.9	13.8	0.9
GDP deflator (percent)	9.5	13.8	4.9
External Sector		(in US$ millions)	
Current account	-992	-1,504	-773
Exports of goods, f.o.b.	2,336	2,538	2,387
Imports of goods, f.o.b.	-4,088	-4,740	-3,904
of which, oil	-777	-963	-538
Capital and Financial Account[1/]	1,082	1,526	1,190
		(in percent of GDP)	
Current account	-17.6	-24.1	-12.6
Exports of goods, f.o.b.	41.7	40.6	38.8
Imports of goods, f.o.b.	-73.0	-75.9	-63.5
of which, oil	-13.9	-15.4	-10.4
Capital and Financial Account[1/]	19.3	24.4	19.3
Fiscal Sector			
Central government overall balance after grants	0.4	-1.2	-2.3
Revenues	19.9	19.0	17.9
of which, Taxes	18.0	17.6	19.1
Expenditure	23.3	23.6	23.9
of which, Interest	1.5	1.2	1.4
Grants	3.9	2.9	2.5
Primary balance after grants	1.9	-0.1	-2.1
Rest of NFPS overall balance	0.9	0.4	0.0
Central bank balance	-0.3	-0.7	-1.2
Combined public sector (CPS) overall balance	1.0	-1.5	-3.5
Financing	-0.9	1.5	3.5
External	2.9	1.9	3.8
Domestic	-3.8	-0.3	-0.3
Financing Gap	0.0	0.0	0.8
WB/IDB budget support[2/]	0.0	0.0	0.0
Gross debt of CPS	79.3	72.5	77.4
Domestic debt	19.8	17.1	17.3
External debt[3/]	59.5	55.4	60.1
Memorandum items:			
GDP (US$ m)	5,599	6,248	6,149
Gross reserves[4/]	1,103	1,141	1,573
(in months of imports)	3.2	2.9	5.0
Net international reserves[4/]	1,019	1,030	1,423
Net international reserves (adjusted)[5/]	737	710	811
SDR allocation	…	…	165
Reserve requirements of foreign deposits	282	320	447
Short term liabilities	84	111	150
Oil price (average, US$/bbl)	71.1	97.0	58.0

Sources: Central Bank of Nicaragua; Ministry of Finance; and Fund staff estimates/projections.

1/ The 2008 outcome includes budget support that covers the financing gap.

2/ Projections assumes WB financing for US$20 million in 2009 and US$30 million in 2010.

3/ Observed values up to 2008 correspond to the legal situation. The projections assumes "no" restructuring of the outstanding debt to non-Paris Club Bilaterals, currently under negotiations.

4/ Includes new SDR allocation for SDR 105.1 million (US$165 million).

5/ Program definition. Includes FOGADE and excludes new SDR allocation and reserve requirements of commercial banks in foreign currency.

Table 4. Financial System Structure

(Regulated Institutions, as of August 2009)

	Banks	Finance Companies	Securities Brokers	Insurance Companies	Storage Agents
# of institutions	7	2	6	5	4
			(in millions of córdobas)		
Total Assets	75,261.7	1,206.0	90.6	3,338.9	186.6
Total Capital	7,579.0	252.6	78.2	747.4	157.0
Total Loans	41,633.2	993.5	n.a	69.7	32.7
Total Deposits	53,162.9	1.6	n.a	n.a	n.a.
			(in millions of US$)		
Total Assets	3,670.7	58.8	4.4	162.8	9.1
Total Capital	369.6	12.3	3.8	36.5	7.7
Total Loans	2,030.6	48.5	n.a	3.4	1.6
Total Deposits	2,592.9	0.1	n.a	n.a	n.a.
			% of GDP		
Total Assets	58.8	0.9	0.1	2.6	0.1
Total Capital	5.9	0.2	0.1	0.6	0.1
Total Loans	32.5	0.8	n.a.	0.1	0.0
Total Deposits	41.5	0.0	n.a.	n.a.	n.a.
Nominal GDP*	128,092.3	million córdobas			

Source: SIBOIF

Exchage rate: 20.5034

* Estimated

** Includes only institutions regulated by SIBOIF

*** Includes only members of the Microfinance Association (ASOMIF), data as of Dec-08

Table 5. Financial Soundness Indicators
(In percent, unless otherwise indicated)

	2005	2006	2007	2008	2009
I. Core set (deposit taking institutions)					
Capital adequacy					
Regulatory Tier 1 capital to risk-weighted assets 2/	13.4	8.5	8.3	8.4	10.2
Regulatory capital to risk-weighted assets	13.6	14.5	14.2	15.3	16.5
Asset quality					
Nonperforming loans to total gross loans	2.1	2.0	2.5	3.0	3.3
Nonperforming loans to total gross loans 3/	7.2	6.2	5.2	6.7	10.9
Nonperforming loans net of provisions to capital	19.0	16.2	10.2	17.2	33.4
Sectoral distribution of loans					
Commercial	28.4	28.1	27.6	32.8	35.7
Agricultural	11.2	9.5	8.6	9.6	9.5
Consumer	28.3	30.0	31.6	29.6	26.2
Construction	13.0	13.5	13.4	14.1	15.6
Industrial	10.3	10.0	9.0	7.8	9.5
Others	8.8	9.1	9.9	6.2	3.5
Earnings and profitability					
Return on assets	2.6	2.4	2.2	1.8	0.5
Return on equity	29.7	25.1	22.5	18.1	4.8
Interest margin to assets	8.0	8.0	9.1	9.1	8.7
Noninterest expenses to gross income	68.6	68.8	70.1	73.2	81.2
Liquidity					
Liquid assets to total assets	18.9	21.9	19.4	21.2	29.5
Liquid assets to total short-term liabilities	150.5	172.8	137.3	118.0	139.4
Exposure to FX risk					
Net open position in foreign exchange to capital	81.1	75.3	81.7	94.7	81.4
II. Encouraged set (deposit taking institutions)					
Capital to assets	9.8	10.3	10.7	10.8	10.5
Interest margin to total assets	8.0	8.0	9.1	9.1	8.7
Foreign currency-denominated loans to total loans	84.5	83.7	83.1	84.5	87.2
Foreign currency-denominated liabilities to total liabilitie	70.6	70.4	70.3	72.4	74.5
Foreign currency deposits (in percent of GIR)	191.7	152.9	144.4	147.6	125.1
Ratio of real estate loans to total loans	13.2	13.5	13.4	14.1	15.6
Large exposures to capital	59.1	48.0	45.3	n/a	16.5
Personnel expenses to noninterest expenses	39.5	38.9	41.4	41.3	41.0
Spread between reference lending and deposit rates	13.1	13.1	14.1	13.0	13.3
Customer deposits to total (non-interbank) loans	146.7	123.6	110.1	105.4	130.3
III. Structure and performance of the financial sector					
Number of institutions 4/	9	9	10	10	9
Bank concentration					
Number of banks accounting for at least					
25 percent of total assets	1	1	1	1	1
75 percent of total assets	8	8	9	9	8
Total assets (in millions of cordobas)	45,826	54,164	64,484	71,791	79,754
Total assets (in percent of GDP)					
Private commercial	56.2	58.2	61.4	58.2	63.8
Bank deposits (percentage of GDP)					
Private commercial	43.2	41.7	43.3	39.6	63.8
Dollarization and maturity structure					
Assets in foreign currency					
as percentage of banking system assets	61.4	65.2	66.8	69.5	70.2
Contingent and off-balance sheet accounts					
(as percentage of total assets)	11.1	19.3	21.5	18.9	17.7

Sources: Superintendency of Banks; and Central Bank of Nicaragua.

1/ Data through December 2009.
2/ In 2006 a regulatory change narrowed the definition of Tier 1 capital.
3/ NPLs including restructured and reprogrammed loans.
4/ In 2009, HSBC (with deposits less than one percent of total deposits) closed its operations in Nicaragua

Table 6. Stress Test Results

	Capital Adequacy Ratio (CAR)		Number of Banks		Undercapitalized bank(s) > 20% of system assets?
	average	largest drop* (percentage points)	CAR < 10%	CAR < 4%	
Current (as of August 2009)	16.5	…	0	0	…
Actual, adjusted for valuation losses and loan reclassifications**	14.5	…	0	0	…
Baseline Scenario: Stabilization of net profits	17.0	…	0	0	…
Credit risk					
Continuation of decline in net profits (scenario #1)	16.5	8.6	1	0	No
Downgrade of entire loan portfolio by one notch (#2a)	15.8	4.8	1	0	No
Downgrade of entire loan portfolio by two notches (#2b)	1.2	19.8	7	7	Yes
Credit concentration risk					
Downgrade of 100 largest debtors by one notch (#2c)	16.5	1.0	0	0	…
Downgrade of 100 largest debtors by two notches (#2d)	14.3	5.0	1	0	Yes
Default of 10 largest debtors (#2e)	13.6	8.2	1	0	Yes
Impact of proposed laws					
Interest rate cap on impaired microfinance loans (#3a)	16.7	5.2	0	0	……
Interest rate cap on credit card loans (#3b)	16.3	6.8	0	0	…
Increase in taxes on banks (#3c)	15.8	1.5	0	0	
Combined scenario: Decline in profits and legal changes (#4)	14.1	14.7	3	1	Yes
Sovereign risk/Market risk					
Risk weight on government bonds set to 20 percent (#5)	14.2	0.8	1	0	Yes
Change in market interest rates by 1.1 percent (#6)	16.9	0.3	0	0	…
Exchange rate risk					
Default of 5 percent of unhedged dollar debtors (#7a)	14.7	4.1	0	0	…
Default of 10 percent of unhedged dollar debtors (#7b)	12.7	8.7	2	0	Yes
Default of 20 percent of unhedged dollar debtors (#7c)	7.8	19.5	7	2	Yes

* relative to baseline scenario;
** lower net present value of restructured central bank bonds, and reclassifications of certain prolonged and irrecoverable loans.

Table 7. Return on Equity Decomposition

(In percent)

		June 2008	December 2008	June 2009	August 2009
a=b*c	ROE (net income/equity)	21.0	18.0	11.3	9.3
b	Equity multiplier (total assets/equity)	1035.2	1009.4	935.9	944.4
C=d*e	ROA (net income/total assets)	2.0	1.8	1.2	1.0
d	Asset utilization (total revenue/total assets)	14.6	15.5	14.8	14.6
e	Profit margin (net income/total revenue)	13.9	11.5	8.2	6.7
a=b*c*d	ROE (net income/equity)	21.0	18.0	11.3	9.3
b	Net income/net profit margin	65.5	63.5	57.7	53.1
c	Equity multiplier (total assets/equity)	1035.2	1009.4	935.9	944.4
d=e*f	Net profit margin/total assets	3.1	2.8	2.1	1.9
e	Asset utilization (total revenue/total assets)	14.6	15.5	14.8	14.6
f	Net profit margin/total revenue	21.3	18.2	14.2	12.7
	Inflation rate	11.8	13.8	2.0	-0.1
	ROE (net income/real equity)	8.3	3.7	9.2	9.4

Source: Superintendencia de Bancos y de Otras Instituciones Financieras.

Table 8. Return on Assets Decomposition

(All financials are reported over average assets)

		June 2008	December 2008	June 2009	August 2009
a	Financial income	12.3	12.3	12.0	11.8
	o/w from investments	1.3	1.2	1.1	1.1
	o/w from credit portfolio	10.7	10.9	10.8	10.6
b	Financial costs	3.7	3.7	3.7	3.6
	o/w obligations with the public	2.5	2.5	2.4	2.4
	o/w obligations with financial institutions	1.1	1.1	1.2	1.1
c=a-b	Financial margin before exchange rate adjustments	8.6	8.6	8.4	8.2
d	Exchange rate adjustments	1.1	0.4	0.5	0.5
e=c-d	Gross financial margin	9.7	9.1	8.9	8.7
f	Estimate for loan losses	2.2	2.5	3.2	3.3
G=e-f	Net financial margin	7.5	6.6	5.7	5.3
h	Operating income (net)	1.7	2.4	2.0	2.0
i=g+h	Gross operating profit	9.1	9.0	7.6	7.3
j	Administrative costs	6.0	6.2	5.6	5.4
k=i-j	Profit before tax and other fees	3.1	2.8	2.1	1.9
l	Contributions to SIBOIF	0.1	0.1	0.1	0.1
m	Contributions to FOGADE	0.2	0.2	0.2	0.2
n	Income tax	0.8	0.8	0.6	0.6
o=k-(l+m+n)	Net income	2.0	1.8	1.2	1.0

Source: Superintendencia de Bancos y de otras instituciones financieras.

Table 9. Implicit Intermediation Margin Decomposition

(In percent)

		June 2008	December 2008	June 2009	August 2009
a	Financial income	15.8	16.0	15.8	15.6
	Liquid assets	2.0	1.9	0.4	0.4
	Investments	11.6	10.9	8.7	8.7
	Loans	17.0	17.0	17.5	17.5
	o/w commercial	11.6	11.9	13.3	13.4
	o/w consumption	25.5	25.4	26.1	25.8
	o/w mortgage	10.8	10.9	10.8	10.8
	o/w financial leasing	10.1	10.6	11.0	11.1
	o/w microcredit	31.1	31.5	31.4	32.1
b	Financial cost	4.9	4.9	4.9	4.8
	Obligations with the public	4.2	4.2	4.2	4.2
	o/w demand deposits	1.1	1.2	2.6	2.7
	o/w saving deposits	2.2	2.3	2.2	2.2
	o/w time deposits	7.4	7.4	7.3	7.2
	Obligations with financial institutions	7.0	6.9	6.7	6.5
	o/w with FNI	6.9	6.9	7.0	7.0
	o/w with foreign institutions	6.1	6.1	5.7	5.2
	Obligations with BCN	5.0	5.9	9.5	9.4
c=a-b	Implicit intermediation margin	10.9	11.1	10.9	10.8
f=b-d	Narrow implicit intermediation margin	12.7	12.8	13.3	13.3

Source: Superintendencia de Bancos y de otras instituciones financieras.

Table 10. Interest Rate Spreads

	June 2008	December 2008	June 2009	August 2009
Weighted lending rates				
Cordoba, short-term	12.5	13.6	14.1	13.4
Córdoba, long-term	20.4	23.1	16.5	19.6
Córdoba	14.3	13.9	14.4	13.9
Dollar, short-term	10.9	12.6	13.1	12.7
Dollar, long term	12.2	14.0	14.5	14.6
Dollar	11.5	13.0	13.4	13.0
Córdoba and dollar	11.8	13.1	13.6	13.1
Weighted deposit rates				
Córdoba	7.3	6.1	6.9	7.1
Dollar	5.8	6.1	4.9	5.7
Córdoba and dollar	6.2	6.1		
Interest rate spreads				
Córdobas	7.0	7.9	7.4	6.7
Dollars	5.6	7.0	8.6	7.3
Córdobas and dollars	5.6	7.0	8.4	7.0

Source: Superintendencia de Bancos y de otras instituciones financieras.

Table 11. Microfinance Sector

(By type of institution, 2003 and 2008)

Institutions	Number of Accounts		Loan Portfolio (US$ million)		Percent of Total Loan Portfolio		Average Loan Balance (US$)	
	2003	2008	2003	2008	2003	2008	2003	2008
Regulated and Supervised by SIBIOF								
Finance companies and Microfinance banks	42,000	102,886	52.7	288.4	43	41	1,255	1,148
Unregulated sector								
NGO MFIs (19, ASOMIF network)	157,300	354,974	61.0	234.2	50	33	388	660
Coop networks	34,000	299,980	8.5	183.7	7	26	250	612
Total	**235,303**	**757,840**	**122.2**	**709.9**	**100**	**100**	**631.0**	**806.9**

Sources: Redcamif 2003 and 2008, WOCCU, CARUNA estimates for 2008 from public sources; SIBOIF website provided regulated financial institution data; Blidjenstein 2003; 2003 and 2009 FSAP interviews.

Note: Figures are for end of December of each year. Cooperatives' figures are understated, due to a lack of 2008 data for more than 150 small rural cooperatives.

Table 12. Comparison of Nicaragua Outreach
(Average Loan Size with Region)

Country	Gross Portfolio	Number of Active Borrowers	Average Loan Balance per Borrower (in US$)	Coverage Of Population (in percent)	Average Loan Balance in Percent of GNP Capital
Nicaragua	**506.5**	**531,219**	**710**	**9.4**	**61**
Guatemala	132.2	251,901	367	1.8	13
El Salvador	305.4	188,725	958	3.1	27
Ecuador	1,002	614,497	1,111	4.6	28
Peru	2,976.7	2,513,574	1,145	8.7	26
Bolivia	1,159.8	771,786	1,104	8.0	64
Colombia	3,433.4	1,829,701	917	4.1	17

Source: www.themix.org database using audited financial statements from MFIs that report to system, September 2009. Population and GNP per capita information from World Bank Development Indicators database.

Figure 1. Credit Growth

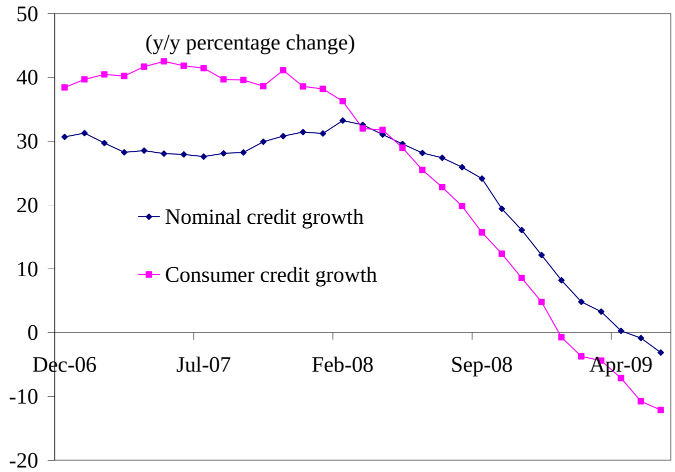
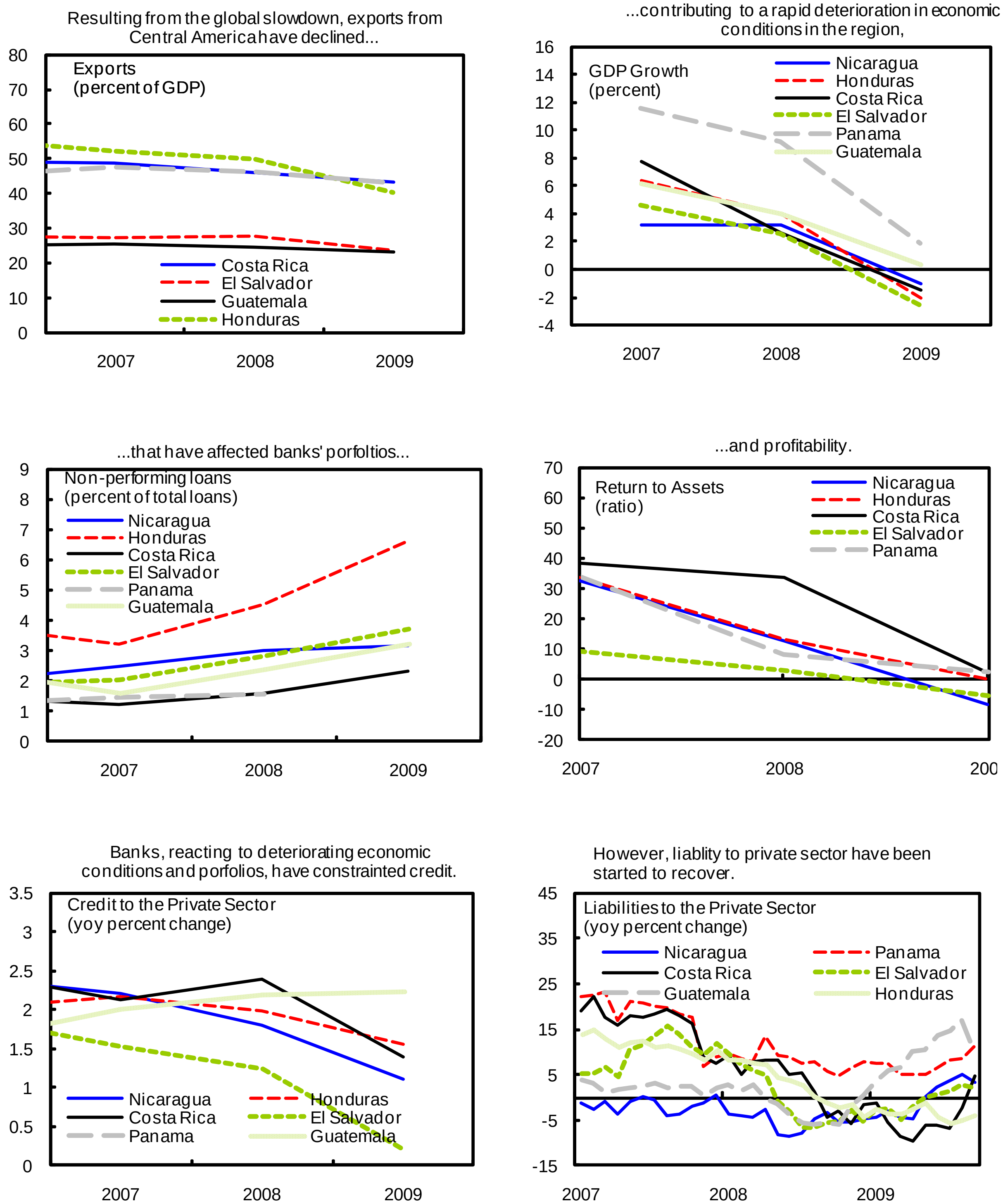


Figure 2. Central America: Recent Economic Developments



Source: Superintendency of Banks from respective countries and IMF estimates.

Figure 3. Dollar Lending and Deposit Rates

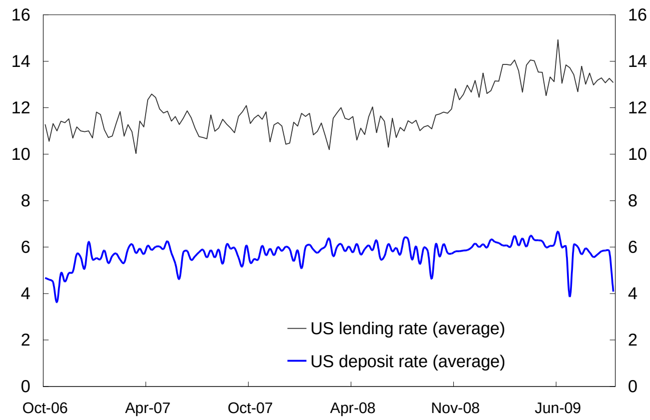
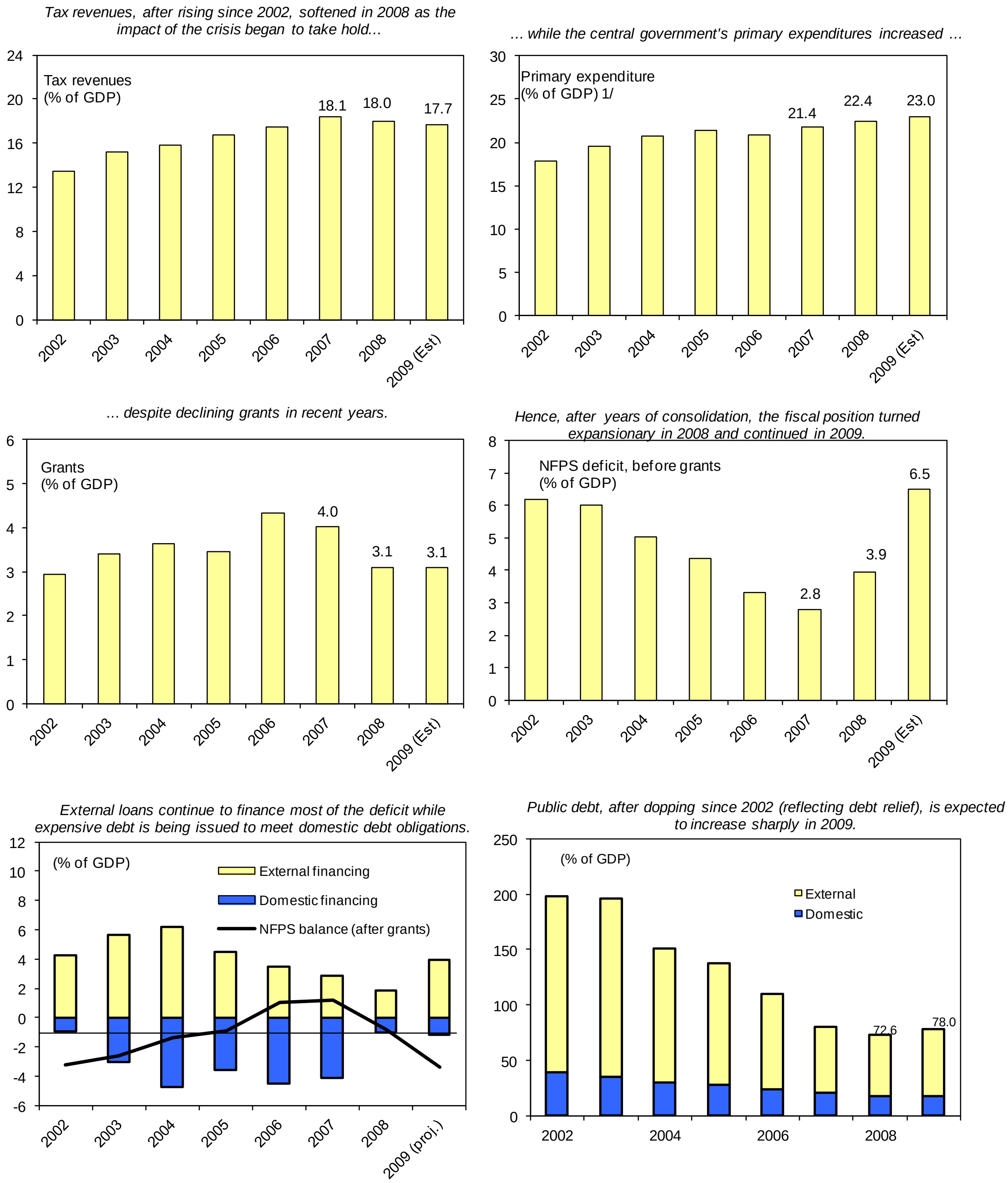


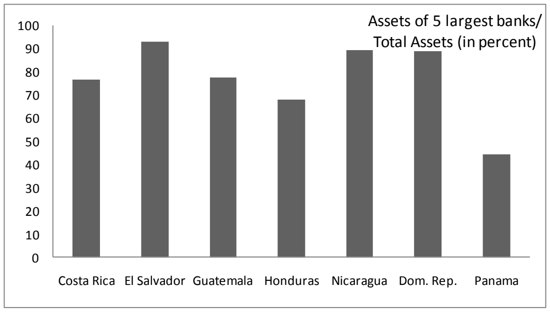
Figure 4. Nicaragua Fiscal Developments



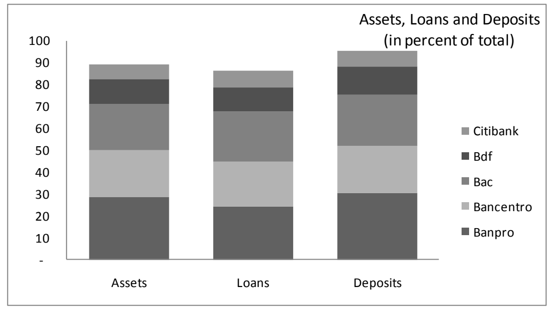
Source: Ministry of Finance, Nicaragua; and IMF estimates.

Figure 5. Competition and Efficiency

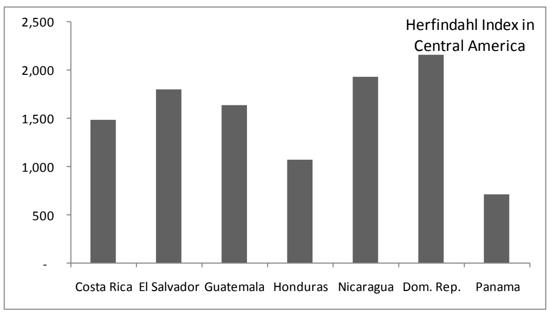
(a) NI has the second highest concentration of assets among the 5 largest bank in the region



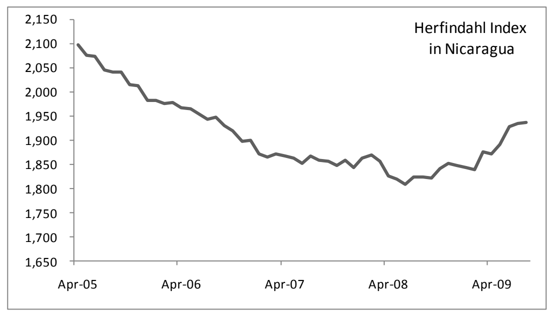
(b) while the largest bank in the system accounts for nearly 1/3 of banking assets and deposits.



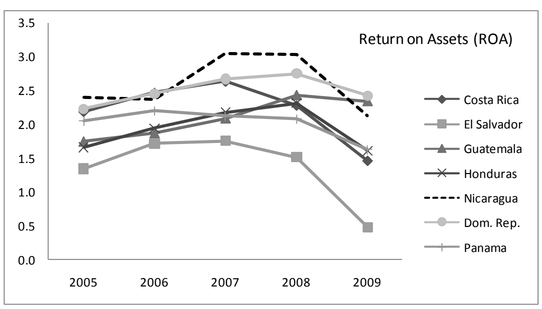
(c) The Herfindahl index is only second to the Dominican Republic



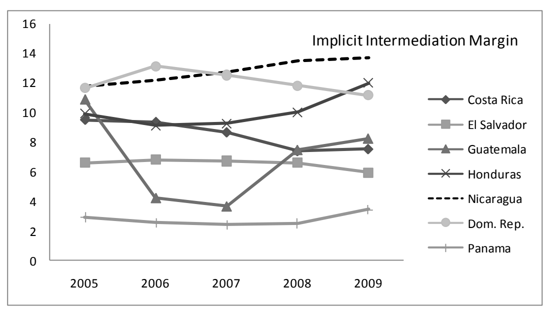
(d) and has been growing since June 2008.



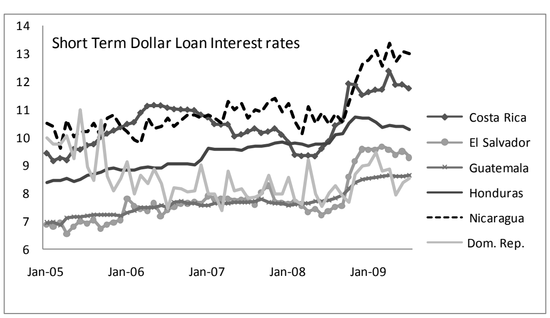
(e) The system also exhibits one of the highest ROA in the region (despite the recent decrease)



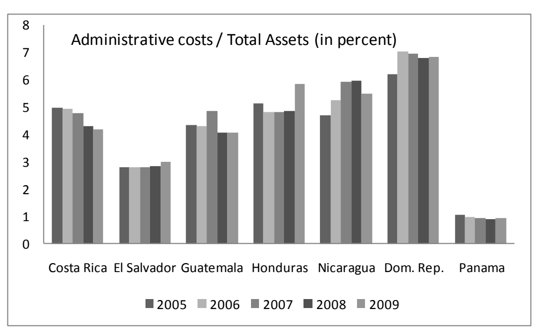
(f) and leads other countries in terms of the implicit intermediation margin.



(g) NI accounts for the highest lending rate for dollar loans after an increase in mid 2008

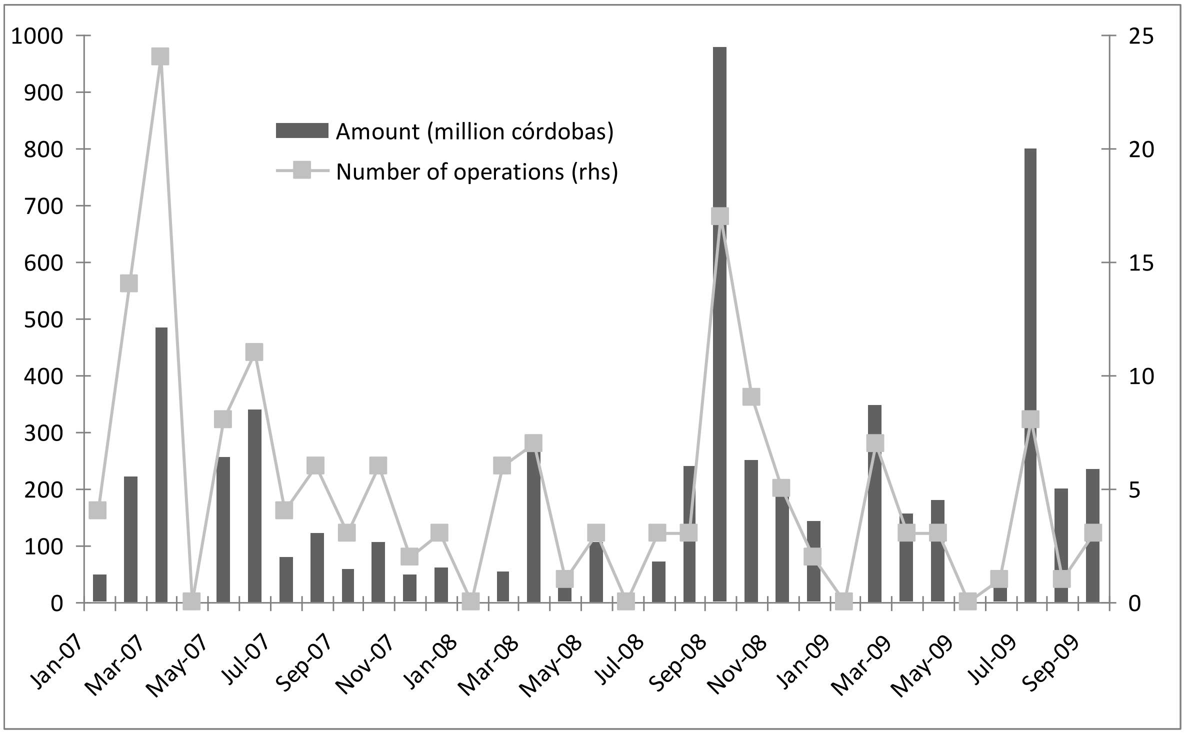


(h) with the second highest administrative costs as a percentage of assets in the region.



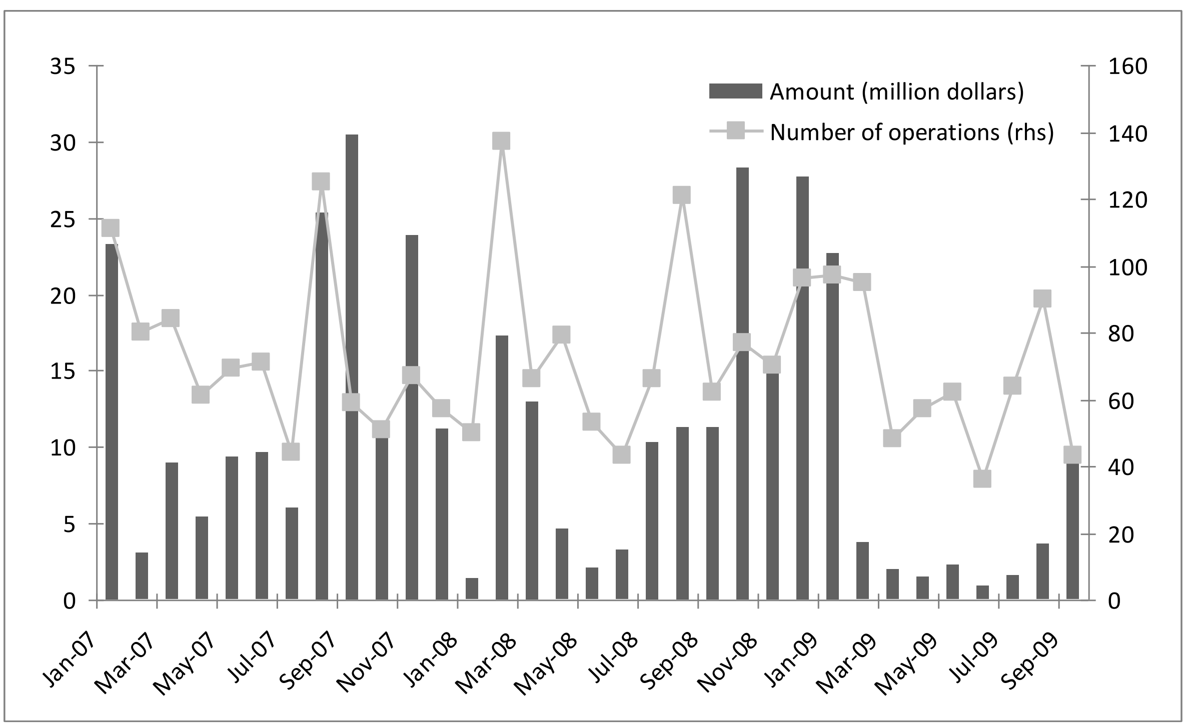
Sources: Consejo Monetario Centroamericano, Central Bank of Nicaragua; and Superintendencia de Bancos y de Otras Instituciones Financieras.

Figure 6. One- to Seven-Day Repos in Córdobas



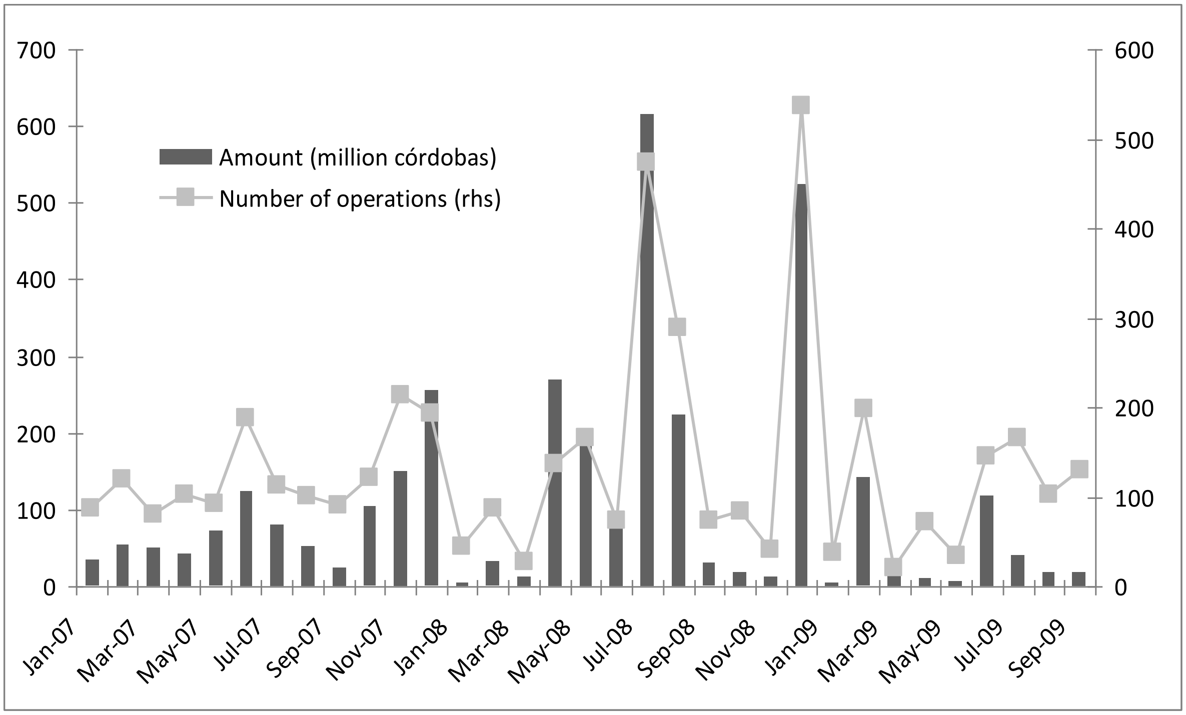
Source: BVN

Figure 7. One- to Seven-Day Repos in Dollars



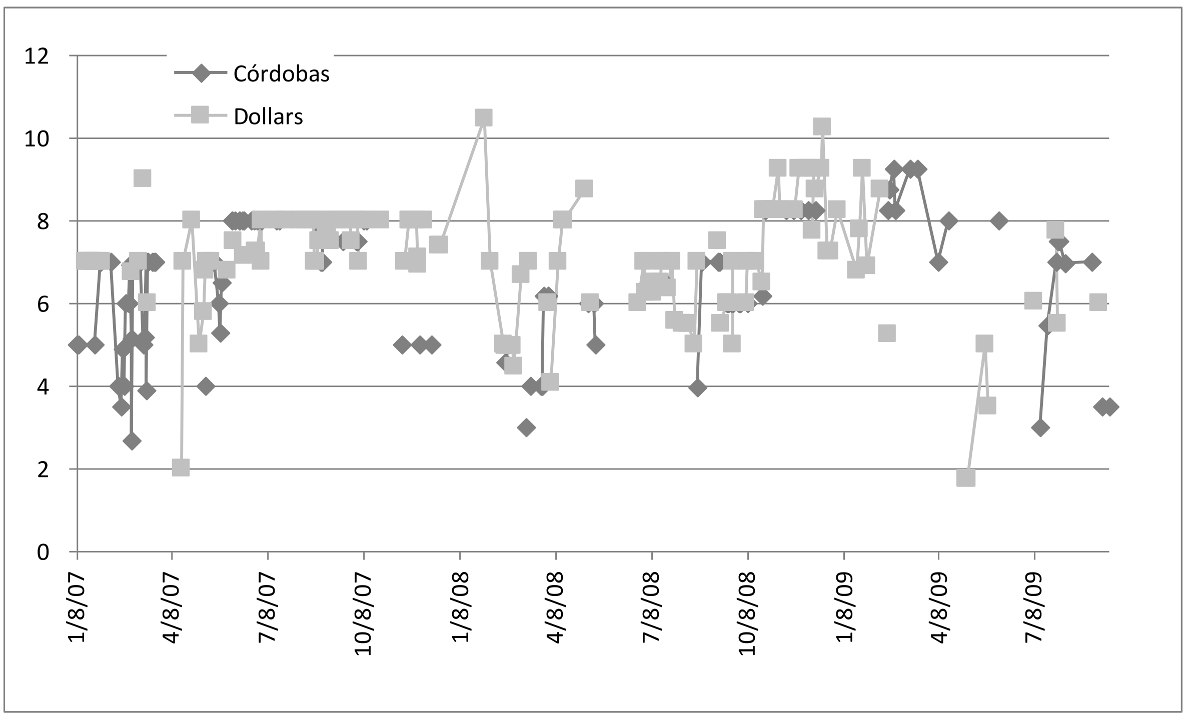
Source: BVN

Figure 8. Secondary Market Trades



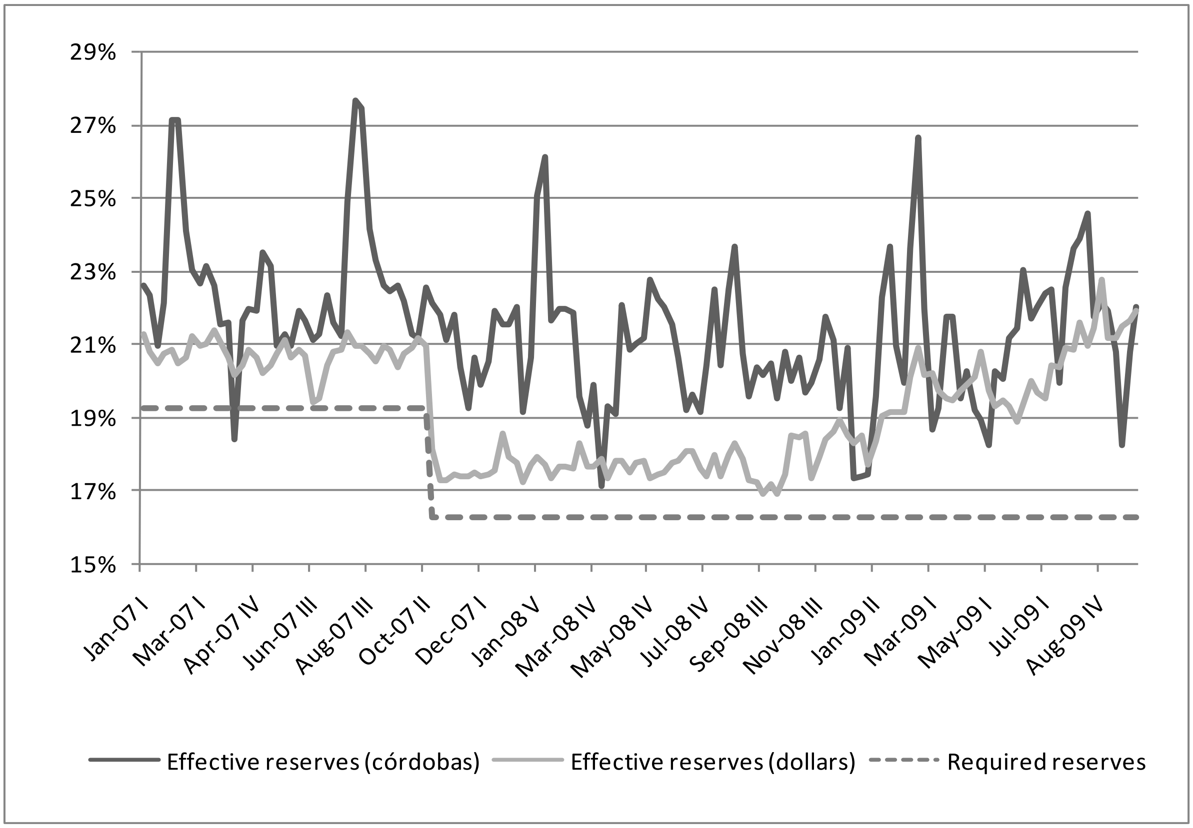
Source: BVN

Figure 9. Average Interest Rate of One- to Seven-Day Repos at BVN



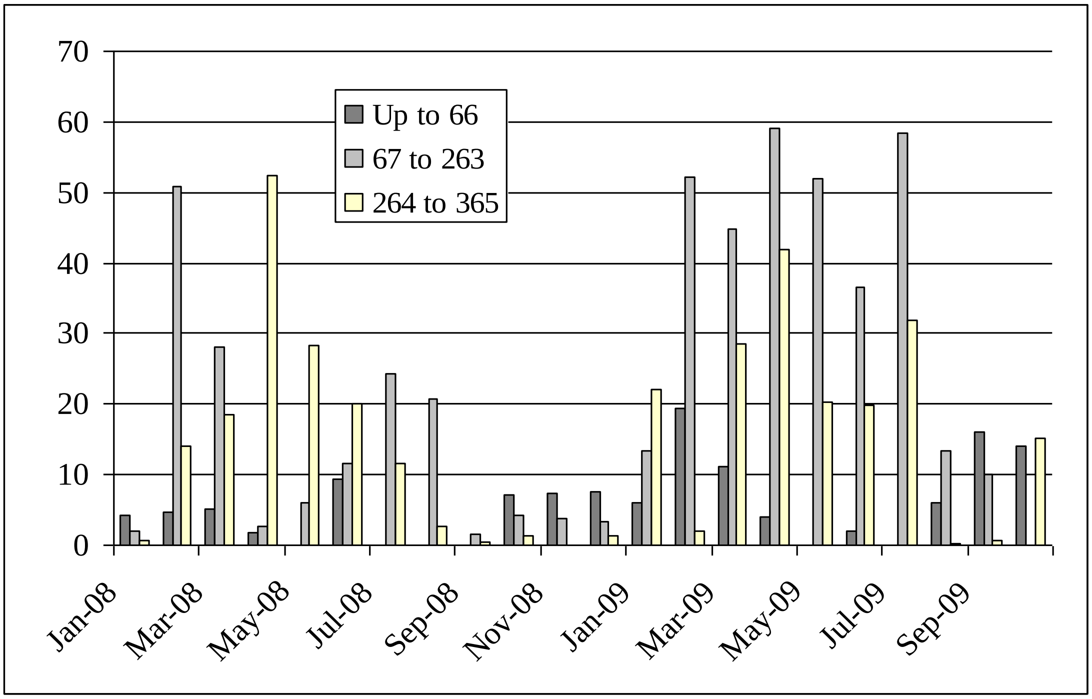
Source: BCN

Figure 10. Total Bank Reserves per Maintenance Period (1 Week)



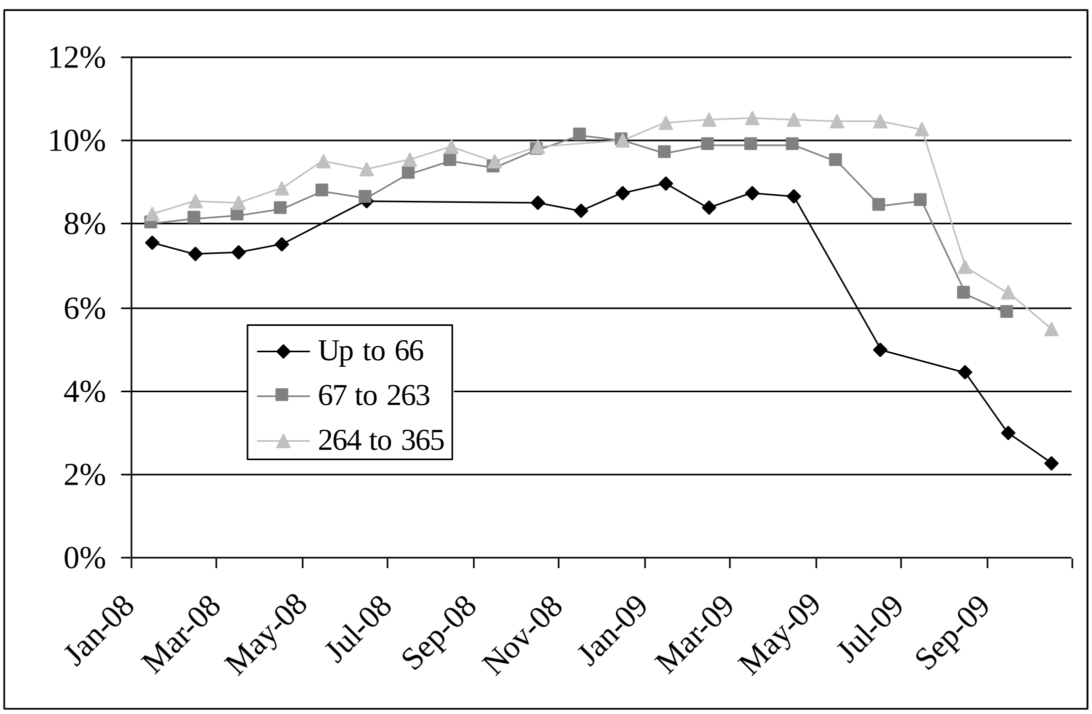
Source: BCN

Figure 11. BCN Auction Placements by Number of Days to Maturity (million dollars)



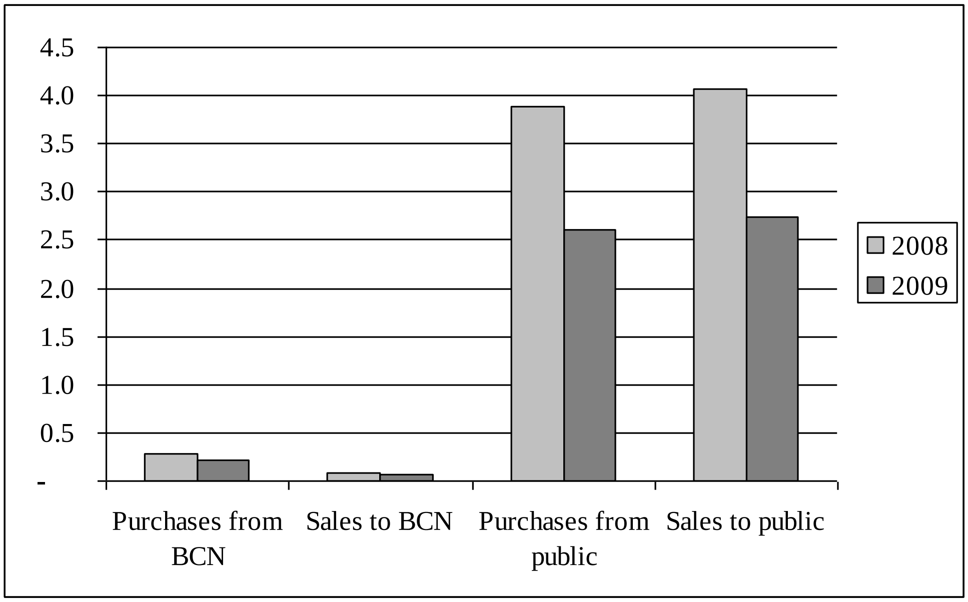
Source: BCN

Figure 12. BCN Auction Rates by Number of Days to Maturity



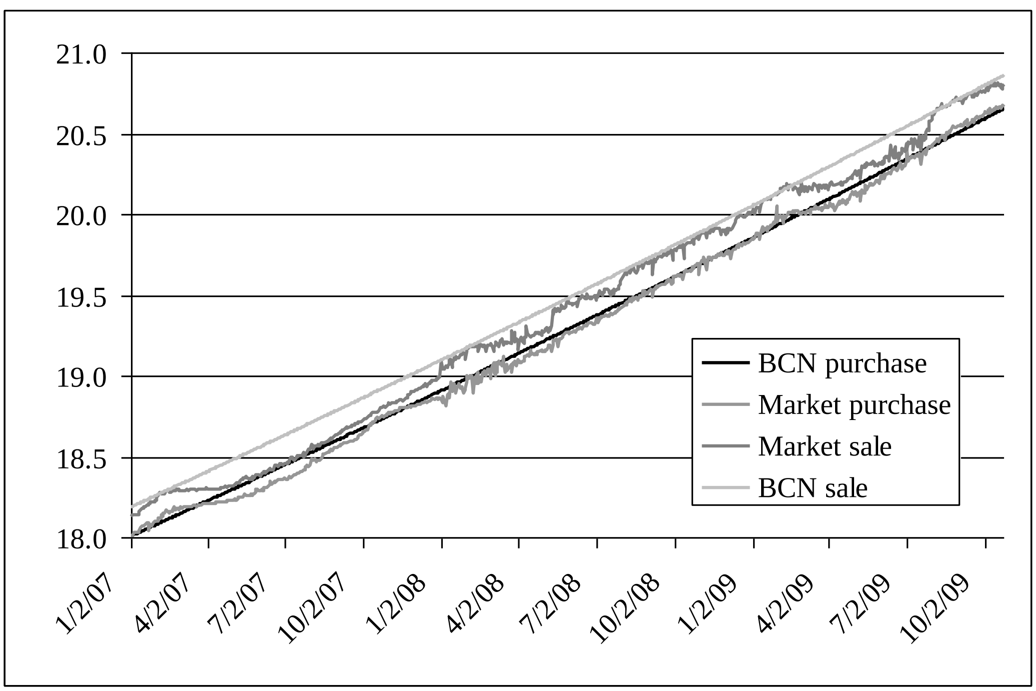
Source: BCN

Figure 13. Banks and Financial Corporations Trades in the Foreign Exchange Market
(in U.S. dollar billion)



Source: BCN

Figure 14. Exchange Rates (córdobas/U.S. dollar)



Source: BCN

ANNEX—OBSERVANCE OF FINANCIAL SECTOR STANDARDS AND CODES—ASSESSMENT OF COMPLIANCE WITH THE BASEL CORE PRINCIPLES

General

55. **This assessment of the current state of implementation of the Basel Core Principles (BCPs) has been completed as part of an FSAP Update undertaken jointly by the International Monetary Fund and the World Bank**. The assessment mission, from October 5 to October 21 2009, follows up on an earlier BCP assessment performed in the context of the 2003–2004 FSAP of Nicaragua, and reflects banking supervision practices in place as of end-September 2009. The assessors were Socorro Heysen and Walter Zunic (both banking supervision experts).

Information and methodology used for assessment

56. **The assessment is based on: (i) the SIBOIF's self-assessment supplemented by detailed interviews with SIBOIF's staff;** (ii) scrutiny of laws, regulations and other documentation on the financial sector, the bank regulation framework, and bank supervision practices and processes; (iii) examination of supervisory files and documentation for purposes of validation of certain material assertions; and (iv) meetings with the banking association and independent auditors of banks.

57. **The assessment was performed in accordance with the Basel Core Principles Methodology (October 2006)**. It involved, as agreed with the authorities, a qualitative assessment of compliance with only the "essential" criteria therein. The assessors had full cooperation from the authorities and received, in principle, the information necessary for the assessment.

Institutional and macro-prudential setting, market structure—overview

58. **The global economic and financial crisis, as well as political tensions, have negatively affected the Nicaraguan economy starting in late 2008**. The direct impact of the crisis on the banking system was minimal, as Nicaraguan banks did not have exposures to toxic assets and relied less on foreign credit lines. However, as uncertainty increased, banks retrenched credit to build liquidity buffers. As banks moved to more liquid assets and retained part of 2008 profits, capital adequacy ratios (CARs) improved, reaching 16½ percent by end-2009.

59. **Nicaragua's financial system is dominated by regional banking groups and is highly concentrated**. The banking sector comprises seven private commercial banks (including two microfinance banks) and a public second-tier bank. The three largest banks control about 71 percent of assets, 67 percent of loans, and 75 percent of deposits in the financial system, while the combined market share of the five largest banks reaches 89 percent (the second highest in the region). Regional financial groups control approximately 83 percent of the banking sector assets;

the rest are dominated by other foreign banks. Three of the regional banking groups have the majority of their assets in Nicaragua, although the group holding companies are domiciled in Panama. In addition, there is a vibrant microfinance sector. The securities market in Nicaragua is shallow, and virtually all securities (approximately 95 percent) are issued by the government.

60. **Although reported capital adequacy indicators for the system are high, these are justified by underlying risks**. All banks reported CARs comfortably above 10 percent. Banks' capital has good loss-absorbing capacity as virtually all Tier 2 capital consists of retained profits reserves. However, by applying international standards for accounting rules to the "bonos bancarios" restructured in mid-2008, the CAR for the system declines to 14¾ percent (i.e., capital may be overstated by international standards). In addition, a substantial number of loans have been restructured or reprogrammed, and stricter regulations on provisions for these types of loans were only fully applied in March 2010.

Preconditions for effective banking supervision

61. **The regulatory and supervisory framework for banks has been significantly strengthened since the last FSAP assessment**. During 2005–06 a new banking law was issued and amendments to the Law of SIBOIF were passed. The new laws strengthened the authorization of SIBOIF for ownership transfers and new bank licenses, and tightened fit and proper requirements for shareholders and directors. Limits on exposures to related parties were reduced. The SIBOIF was granted powers to conduct consolidated supervision and access to information on financial groups. These actions have been a major factor in SIBOIF's significantly improved compliance with the Basel Core Principles and the AML/CFT Guidelines.

Main findings

62. **The Nicaraguan banking system has a comfortable liquidity position and high reported capital adequacy ratios, but underlying risks call for substantial buffers**. The authorities have also been proactive in implementing the recommendations of the 2003-04 FSAP. However, vulnerabilities stem from: (i) difficulties in conducting a comprehensive assessment of the financial condition of the Nicaraguan regional groups operating abroad, due to information shortcomings; (ii) contagion risks from foreign banks belonging to regional groups that consolidate their operations in Panama but have a majority of assets in Nicaragua ; (iii) legal uncertainty about the enforceability of loan terms; (iv) the rapid deterioration in credit quality, particularly for banks specializing in microfinance and consumer credit; and (v) large dollar-denominated loans to unhedged borrowers. Outside the banking sector, accounting and auditing practices are still at an incipient stage of development. The quality of SME financial reporting tends to be quite low overall, and financial information of the real sector is insufficiently standardized.

Recommendations

63. **Priority recommendations include further strengthening consolidated supervision**, improving banks' risk management and governance, taking measures to bolster soundness of the regional banks, and establishing a regulatory framework for the microfinance sector.

Basel Core Principles (BCPs)

64. **The BCPs may be grouped into seven major categories**: (i) objectives, independence, transparency, powers and cooperation (CP1); (ii) licensing and structure (CPs 2-5); (iii) prudential regulations and requirements (CP 6-18); (iv) methods of ongoing supervision (CP 19-22); (v) accounting and disclosure (CP 23); (vi) corrective and remedial powers of supervisors (CP 23); and (vii) consolidated and cross-border banking supervision. (CP 24-25).

Objectives, independence, transparency, powers and cooperation (CP 1)

65. **SIBOIF has set Laws in place for banking, and for each of the authorities involved in banking supervision, with clear objectives and responsibilities**. The General Law of Banks, Non Bank Financial Institutions and Financial Groups (GBL), issued in November 2005, established the legal framework for the operation of the banking system, from the authorization of financial institutions to the revocation of banking licenses, and contains the legal basis for the supervision of banks. SIBOIF is the sole supervisor of bank and non bank financial institutions in Nicaragua. Its responsibilities and objectives are clearly stated in the SIBOIF Law (SIBOIFL) issued in 1999 and its modifications issued in 2005 and 2006. According to the SIBOIFL, the SIBOIF is responsible for protecting the depositors of supervised institutions and preserve the public confidence on these institutions, by conducting an adequate supervision to procure their solvency and liquidity.

66. **The legal framework of the banking system was updated in 2005 and 2006, strengthening the powers of the SIBOIF to obtain information of banking groups and conduct consolidated supervision and to establish requirements for the authorization of ownership transfers and new bank licenses; it also emphasized the responsibilities of directors and managers for the proper administration of their banks**. The legal limit of 0.13 percent of assets on the contribution of supervised entities to SIBOIF (amounting to under US$6 million in 2008), is a binding constraint to the budget of the SIBOIF and, in the current context of declining financial assets, it limits the ability of SIBOIF to allocate sufficient resources to ensure that the salaries of qualified staff are competitive, and to fund necessary training and key software acquisitions that would improve the effectiveness of bank supervision. A modification of the SIBOIF Law is needed to (i) ensure that SIBOIF has access to the necessary resources; and (ii) provide legal protection to SIBOIF staff, for matters related to their job, and should be extended also to the Superintendent and Deputy Superintendent after they leave office.

Licensing and Structure (CPs2-5)

67. **The GBL defines a bank as an authorized financial institution engaged habitually in realizing intermediation operations with funds obtained from the public in the form of deposits or any other instrument and provide other financial services**.(CP2) The GBL establishes the criteria and requirements for licensing banks and specifies that SIBOIF is the only agency that can authorize bank licenses in Nicaragua. The SIBOIF assesses the application against compliance with the regulations applicable to operating banks. In that regard, the minimum capital of a bank is C$233 million (equivalent to about US$11.6 million), and regulations have been issued referring to the integrity and competence requirements for directors, CEOs and internal auditors of supervised institutions. SIBOIF should conduct an independent verification of applicants by consulting credit bureaus and police records of the country of origin. (CP3)

68. **The GBL has an implicit definition of significant ownership**. While the GBL does not explicitly define controlling interest, every purchase, no matter how small, for shareholders that have reached the threshold of 5 percent requires prior authorization of SIBOIF and grants the SIBOF the power to review and reject major acquisitions or investments by a bank. In the case of foreign applicants, SIBOIF should conduct an independent verification of applicants by consulting credit bureaus and police records of the country of origin. (CP4)

69. **Banks are prohibited from holding stocks or shares in non financial companies**. Investments in shares of stocks of other banks require prior authorization of the SIBOIF. The deposits in banks that are not first class are limited to 15 percent of capital. Investments in Nicaraguan government and BCN securities are not subject to any limits. (CP5)

Prudential regulations and requirements (CPs 6-18)

70. **According to the GBL, banks are required to have a ratio of capital to risk-weighted assets of at least 10 percent**. The GBL defines the components of capital. SIBOIF has not issued capital requirements for operational risks and market risks, other than foreign exchange exposures. (CP6)

71. **A comprehensive risk management norm is in place, but implementation has not been fully completed by banks, and supervisors conduct only partial assessments of compliance**. The review of SIBOIF supervisors only covers banks. SIBOIF does not have the ability to conduct examinations of the cross-border operations of Nicaraguan banking groups, as these groups have selected Panama as their home country. (CP7)

72. **A comprehensive risk management regulation has a section dedicated to credit risk management that establishes the functions of the Board of Directors and the Comprehensive Risk Unit, with regards to credit risk**. The onsite supervisors conduct a thorough assessment of credit policies, procedures and debtor files. In addition, SIBOIF has recently issued a specific norm on credit risk which contains more specific responsibilities for

the Board regarding the policies, organizational structures, oversight, and reporting systems for credit risk management. SIBOIF supervisors assess the compliance of these regulations during onsite examinations. (CP8)

73. **The SIBOIF has established the minimum standards that banks have to follow to identify, measure, monitor, control, report, and reveal their credit risks**. This norm also establishes minimum guidelines for the classification of debtors and sets the minimum provisioning requirements. The regulation requires that classification and provisioning take into account off-balance sheet exposures. During onsite inspections, supervisors review the policies, procedures and processes that banks use to classify and write-off loans comply with the regulation. (CP9)

74. **The GBL defines explicitly the term "significant relations," which is the basis for the establishment of exposure limits mentioned below**. There are significant relations in any of the following cases: (i) direct or indirect participations or control (through votes or management) of more than 33 percent in any one company, by a person or another company; (ii) two or more companies, directly or indirectly, have common shareholders or common control (through any means) by 33 percent or more; (iii) a person or company, by any means, has a dominant influence over the shareholders meeting, the Board of Directors or management; and (iv) the Superintendent presumes there are significant relationships. The SIBOIF receives a monthly report on exposures higher than 10 percent of capital to the above mentioned groups to verify compliance with these limits. In addition, banks are required to identify in the Credit Registry whether a particular borrower belongs to a group. (CP10)

75. **The GBL contains a clear definition of "related party," which among others includes any shareholder who individually or with other persons with which he/she maintains direct relationship is the owner of more than 5 percent of the paid in capital of a bank**. In addition, the total amount of operations realized by a bank with all its related parties and the "*personas juridicas*" with who the financial group maintains directly or indirectly significant relationships cannot exceed 30 percent of its capital. On a monthly basis all the institutions forward to the SIBOIF the information covering related parties of all its subsidiaries and affiliates. (CP11)

76. **The SIBOIF has not established formal procedures covering country and transfer risk**. Also, it has not issued a Regulation requiring banks to establish limits or guidelines for country and transfer risks. (CP12)

77. **The SIBOIF does not have a benchmark to determine that market risk limits set by the institution are commensurate with the institution' size and complexity. In general, banks do not perform scenario analysis, or stress testing**. Where limits have been established by the Board or senior management of an institution, the SIBOIF reviews compliance with the limits at the onsite examination process. The SIBOIF has not issued the appropriate policies and processes that clearly spell out the roles and responsibilities related to the identification, measuring and monitoring and control of market risk. (CP13)

78. **The SIBOIF has established liquidity guidelines for the banks that are part of the liquidity management process, and which are monitored on a daily, weekly, and monthly basis by the analysts that are responsible for the offsite supervision of the banks**. At the onsite inspections, the SIBOIF examiners have determined that the various financial entities have established their own guidelines for measuring liquidity and determine that banks have a liquidity management strategy, as well as policies and processes for managing liquidity risk, which have been approved by the Board. (CP14)

79. **The regular team of SIBOIF supervisors at an onsite examination includes an IT specialist examiner**. At the onsite examinations, the IT specialist determines whether an institution has established appropriate technology policies and processes that (i) address security and systems development and that suitable policies and processes have been established; (ii) articulate roles and responsibilities related to the identification of operational risk (established by bank management and approved and periodically reviewed by the Board). The regulations covering operational risk are still in the process of being introduced by bank management. The SIBOIF is not yet in the position to adequately analyze the effectiveness of their implementation. The final tranche of the implementation of the complex regulation on Information Technology Risk is not required to be implemented until December 2010. The SIBOIF, through the onsite examination process, ensures prompt compliance by all banks of the implementation of the appropriate tranche of the operational risk policies. (CP15)

80. **The SIBOIF's supervisors are familiar with basic interest rate risk strategy and measuring interest rate risk**. While supervisors review stress test practices at banks where such tests are performed, SIBOIF's management indicated that supervisors require additional training in order to determine if the limits established by bank management are adequate. Senior examiners should receive additional training in this area in order to increase their expertise in the monitoring and measuring process of interest rate risk, and how to assess associate interest risk management practices. (CP16)

81. **The SIBOIF has a group of IT supervisors, hired from external auditing firms, who have the experience to evaluate internal controls**. However, SIBOIF requires specialist staff to cope with the increasing rate of change in and complexity of finance, banking and the banks' activities. (CB17)

82. **The SIBOIF, as part of the onsite examination process, verifies that the banks have in place adequate policies and processes in the AML area**, including strict know-your-customer rules aiming to promote ethical and professional standards in the financial area and prevent the deliberate or non-deliberate use of banks by criminal elements and to determine if financial organizations comply with their own policies, practices and procedures directed to detection of money laundering activity and to report such activities to the appropriate authorities. The perusal of a recent report of inspection of a large bank included detailed description of AML practices and controls. A lengthy separate AML report is prepared by the AML unit of the SIBOIF. (CP18)

Methods of ongoing supervision (CP 19-21)

83. **The Directorates of Banking, Insurance, Securities and Warehouse Receipts that take part in the onsite and offsite examination process have the adequate tools and processes to develop and maintain a thorough understanding of the risk profile of individual banks**. The SIBOIF monitors and assesses trends and developments of key indicators of the banking system. These are utilized for analytical purposes and presented to SIBOIF's Board for their eventual decisions. The SIBOIF reviews continuously the risks incurred by the banking institutions through a number of reports. Also, the SIBOIF counts with a very good Credit Registry (*Central de Riesgos*) which provides bank supervisors with adequate and timely information, particularly in the area of credit risk, and facilitates the processing of prudential information, however the Credit Registry does not identify large exposures of economic groups and other concentrations of credit. (CP19)

84. **The SIBOIF has geared the focus of onsite examination towards more frequent target examinations, when conditions warrant it, as opposed to a full scope annual examination**. A Risk Committee has been established to analyze the results and recommendations of the onsite examinations of the financial institutions and to eventually submit a new rating system for the banks. The latest reports of examination indicate that the on-site examiners are doing a competent job in providing an objective evaluation of the quality of an institution, and identifying areas where corrective action may be required to strengthen a bank. The evaluation of the various components used to analyze the financial institutions is a mix of quantitative and qualitative judgment. At the onsite examination, the SIBOIF reviews the operational risk procedures, assess institutions' information security and system development policies and procedures and reviews the quality of the banks' contingency plans to ensure that the institution can continue to operate in the event of a severe business disruption. In addition, supervisors determine that the appropriate reporting mechanisms are in place to keep senior management and the Board apprised of any problems in the operational risk areas of the bank. The supervisors request information covering the extent of legal risk that the bank could be exposed to.

85. **Where the bank has outsourced some activities, the bank supervisors review and analyze the outsourcing contracts to determine the allocation of responsibilities between the company that provides the outsourcing and the financial institution, and evaluate the risks to the bank emanating from the arrangement**. In the review of reports of examination, the two assessors verified that exceptions noted in the operational risk and internal controls areas well as in other areas, are included in the SIBOIF's report of examination. While the Directorates of Banking, Insurance, Securities, and Warehouse Receipts that take part in the onsite and offsite examination process have the adequate tools and processes in order to develop and maintain a thorough understanding of risk profile of individual banks, the SIBOIF currently does not have the systems in place to assess the trends and risks of the overall banking system.

86. **Assessment of the performance and quality of management in the area of AML should be performed more in depth**. The onsite inspection includes a review of the AML process in place at the bank. (CP20)

87. **The SIBOIF receives periodically financial reports on an individual or consolidated basis from the banks**. The reports include supporting information on management, operations, liquidity and profitability. Additionally, it is empowered to require that bank administrators, employees, agencies, and branches provide complete information regarding the activity and operations performed, as well as risks, including IT and legal risk. (CP21)

Accounting and disclosure (CP22)

88. **SIBOIF's Regulation on External Audits covers the scope of external audits and the standards to be followed at such audits**. The SIBOIF, at onsite examinations reviews the reports prepared by the external accountants. Banks are required to prepare annual financial statements based on accounting principles and rules that are widely accepted internationally, and to have been audited in accordance with accepted auditing standards and practices. In the past, SIBOIF has revoked the permit of two external accounting firms to conduct audits of local financial institutions. However, significant differences remain between the MUC and IFRS regarding presentation, valuation and disclosure of certain transactions. Such differences relate in particular to loan loss provisioning, valuation of securities, tax accounting, derivatives, revenue recognition for commissions on loan origination, and disclosures of risk management policies.

Corrective and remedial powers of supervisors (CP 23)

89. **The SIBOIF is authorized to implement, when warranted, the following significant remedial actions**: (i) issue a warning, (ii) prohibit the granting of new credits, (iii) suspend specific operations, or order to cease those operations that the SIBOIF considers as unsafe, (iv) prohibit distribution of dividends, (v) issue a formal request to cover the losses incurred, (vi) prohibit opening of additional branches, (vii) undertake mandatory investment in securities of the BCN or in other securities as requested by the Superintendent, (viii) request an increase in capital, in which the Superintendent will request the call of an extraordinary meeting of the shareholders, (ix) designate an officer of the SIBOIF to assist to meetings of the Board of Directors, and credit committees, (x) order the bank to immediately capitalize its subordinated debt, or to suspend payment of interest on such debt, and (xi) take any other necessary measures, in accordance with the applicable laws and regulations in order to correct the situation.

Consolidated and cross-border bank supervision (CP24-25)

90. **SIBOIF's supervisors are cognizant of the fact that cross-border consolidated supervision requires cooperation and information exchange between home supervisors and the various other supervisors involved, especially host banking supervisors**. In order to be familiar with the overall structure of the Banking Groups located in Nicaragua, the SIBOIF follows the Multilateral MOU for the exchange of financial information signed by all the

supervisory authorities of Central America, Panama and the Dominican Republic. Through the "*Comite de Enlace*" (CDE) formed under the Multilateral MOU with the above countries, SIBOIF receives information on the activities of the other members of the BG that consolidate their business in another country. In a similar manner, the SIBOIF exchanges information on the Nicaraguan BGs with the CDE.

Summary of Observance of the Basel Core Principles-ROSC

Reference Principle	Recommended Action
1.1 Objectives	Amend the law of BCN to entrust it with preserving financial stability from a macro-prudential standpoint.
1.2 Independence	Amend the SIBOIF Law to increase the contribution of financial institutions to the SIBOIF or additional funding from the BCN. The SIBOIF should devise a human resources policy (recruitment, payment, and training) to ensure it has an adequate pool of specialized supervisors.
1.5 Legal protection	Amend SIFOIF law to grant legal protection to SIBOIF senior staff and extend protection to the Superintendent after the completion of his/her tenure.
1.6 Information sharing	Sign MOU with Ecuador.
3. Licensing Criteria	Conduct an independent verification of applicants by consulting credit bureaus and police records of the country of origin.
4. Ownership	Conduct an independent verification of applicants by consulting credit bureaus and police records of the country of origin.
6. Capital Adequacy	Implement capital requirements for all material risks. Eliminate the regulatory forbearance granted to two banks and, if needed, bolster capitalization.
7. Risk management process	Implement processes to assess the risk profile and risk management framework of banks and banking groups.
8. Credit risk	Strengthen off-site supervision of credit risks by better exploiting the information in the credit registry.
9. Problem assets, provisions, and reserves	Devise an on-site process to verify that banks identify and provision adequately the borrowers exposed to foreign exchange risk.
10. Large exposure limits	Use information of the credit registry to identify large exposures to with economic groups and other concentrations of the credit portfolio.
CP11: Exposures to Related Parties	The domestic financial institutions have no access to information covering cross-border exposure to related parties in affiliates. It is recommended that SIBOIF contact the Home supervisor to obtain this information.
CP 12: Country and transfer risks	Issue a regulation requiring banks to establish adequate policies for measuring, monitoring, and controlling country risk and transfer risk. The regulation should require financial institutions to set country exposure limits and transfer risk limits on their operations.
CP13: Market Risk	Train supervisors on market risks; particularly on risks of foreign currency forwards.
CP14: Liquidity Risk	Implement a minimum liquidity requirement for foreign currency liabilities, by which banks would need to have dollar liquid assets.
CP15: Operational Risk	Include in the Regulation that an appropriate reporting mechanism should be in place to keep the SIBOIF appraised of developments affecting the operational risk of the bank. The SIBOIF's staff should receive appropriate advanced training to identify the various types of operational risks and that it has the knowledge to assess such risks. The SIBOIF should assess, through onsite visits, the quality and reliability of any outsourced functions.
CP16. Interest rate risk in the banking group	The SIBOIF should ensure that its staff attends advanced training course to assess interest risks.

Summary of Observance of the Basel Core Principles-ROSC (Concluded)

CP17: Internal Control and audit	SIBOIF examiners should ensure that the audit function does not only focus on checking compliance. It should also identify high risk areas and how, if at all, these risks are mitigated or controlled. SIBOIF examiners should receive training in market operations to ensure that there is an appropriate balance in the skills and resources of the back office and control functions relative to the front office business origination.
CP 19: Supervisory approach	SIBOIF should be more precise about the recommendations to bank management. Additionally, SIBOIF should implement a methodology to monitor and assess trends, developments and risks for the banking system as a whole and of banking groups. The methodology should cover, among other, the business focus, the risk profile and internal control environment.
CP20: Supervisory techniques	The CAMELS- BCOR classification system should be simplified. The span of time between the exit of the onsite inspection and the delivery of the final report should be further shortened. Also, SIBOIF's follow up system for the implementation of recommendations should be reviewed in order to ensure quicker implementation of any recommendations.
CP21 Supervisory reporting	SIBOIF should ensure that the appropriate knowledge, skills and experience of supervisory staff, who participate at onsite examinations, are further improved by attending specialized advanced training courses in selected disciplines.
CP22: Accounting and disclosure	SIBOIF needs a group of staff members with significant IFRS expertise, and initiate comprehensive IFRS training among all technical staff.
CP23:Corrective and Remedial Powers of Supervisors	SIBOIF should ensure a timelier implementation of corrective actions based on recommendations made to banks at an onsite inspection.
CP24: Consolidated Supervision	The SIBOIF should coordinate with Panama to step up supervision of the two largest groups in the following areas: governance, risk management and controls at the group level; and large exposures at the group level.
CP25: Home-Host Relationships	The SIBOIF should negotiate an enhanced agreement with the Panama Supervisory Authority to access the information pertaining two large Nicaraguan Groups registered in Panama. The SIBOIF should resume contacts to sign an MOU with the banking authorities of Ecuador.

Authorities' Response

The authorities broadly concurred with the assessment and are developing a timetable for implementing the key recommendations.

APPENDIX I. BANKING SUPERVISION AND REGULATION ISSUES

91. **The SIBOIF has made significant strides since the last FSAP in a number of areas** and has carried out a number of actions aimed at improving the safety and soundness of the institutions it supervises, but challenges remain ahead, especially in the context of increased regional financial integration. New laws have been passed and many key regulations issued. Additionally, efforts to achieve consolidated supervision must continue. The main challenge in the years to come is the improvement of risk management and corporate governance of banks and banking groups.

92. **The improvement of risk management and corporate governance of banks and banking groups will be the main challenge in the years to come.** Supervisory efforts should focus on ensuring that banks and banking groups effectively comply with the new norms on risk management and internal controls. To this end, SIBOIF needs to implement supervisory processes to assess the risk profile and risk management framework of banks and banking groups, and improve processes to supervise credit, liquidity, interest rate, and operational risks. SIBOIF also needs to establish norms regarding country and transfer risks and market risks. The added processes will require that SIBOIF devote more resources to bank supervision, with the Risk Department needing additional staff to develop and conduct these processes. Specialized training is also needed to prepare supervisors for the assessment of risks and risk management. Additional licenses of the information audit software need to be made available to supervisors.

93. **The SIBOIF has budget constraints that limit its capacity to have adequate resources for bank supervision.** The law establishes that contributions of supervised institutions will cover 75 percent of the budget of the SIBOIF, up to 0.13 percent of their assets; and that the BCN will cover the remaining 25 percent. As bank assets have been declining, the budget of SIBOIF has fallen in a period in which additional resources are essential. It is recommended that the SIBOIF Law be amended to increase the contribution from financial institutions to the SIBOIF and/or provide additional funding from the BCN. A legal amendment is also necessary to grant legal protection to the SIBOIF staff and to extend the protection granted to the Superintendent after completion of his term of office.

94. **The capital adequacy requirement does not conform to international standards mainly because of (i) the absence of capital requirements for some of the risks, and (ii) a regulatory exception on the accounting treatment of the "bonos bancarios".** Currently, capital is required for credit and foreign exchange risks but not for operational and other market risks. The regulatory exception granted on the accounting treatment of "bonos bancarios," largely held by the two largest banks in the system, should be phased out and the necessary recapitalization moved forward.

95. **The supervision of credit risk has improved, but additional efforts are necessary to ensure that banks properly manage this key risk.** Off-site analysis of credit risk needs to be strengthened by exploiting the vast information available in the credit registry to identify the

various types of concentration risk in the loan portfolio and the misreporting of high-risk loans. It is important to verify that banks identify the borrowers exposed to foreign exchange risk, make adequate provision for such borrowers, and comply with the new requirements introduced in the credit risk norm. To this end, new supervisory processes need to be implemented.[17]

96. **There are no minimum liquidity requirements for prudential purposes.** Banks are subject to 16.25 percent unremunerated reserve requirements against their domestic and foreign currency deposits, established by the BCN for monetary policy purposes. In addition, SIBOIF regulations have established limits covering mismatches in liquidity positions. However, in the context of a highly dollarized banking system with no lender of last resort (LOLR) facility in dollars, banks need a larger cushion of dollar liquid assets. SIBOIF should consider requiring that banks hold dollar liquid assets against their dollar liabilities. As banks are currently highly liquid, the requirement could be implemented in the short term, as it would not be immediately binding. The definition and level of this requirement should be determined carefully to avoid adding excessive costs to financial intermediation.

97. **The three main regional financial groups (RFGs) in the country are not yet subject to effective supervision on a consolidated basis.** The Laws and Regulations are in place and Nicaragua has signed bilateral and multilateral MOUs with most of the foreign supervisors responsible for these groups, including a multilateral MOU with all Central American supervisors. Under this agreement, information is exchanged through the *Comité de Enlace* and home supervisors conduct on-site inspections in the host countries. In the case of the three Nicaraguan cross-border banking groups, Panama, as the home supervisor, has the responsibility for the consolidated supervision. Nicaragua, as the host supervisor is responsible for informing Panama of the three groups' activities and has access to consolidated statements and selected reports on these groups. However, the largest exposure of the three groups is centered in Nicaragua, and problems in the cross-border operations of these groups would clearly affect the Nicaraguan banking system. Panama has made partial progress in establishing consolidated supervision of the three groups, but the operations of these groups in some countries are not subject to consolidation and this precludes an adequate appraisal regarding the risks incurred by these groups on a global basis (see Appendix IV for details on consolidated supervision). It is recommended that:

- SIBOIF initiate discussions with other Central American supervisors to provide the Lead Supervisor with better access to information, a concept already introduced in the multilateral MOU;

[17] This norm stipulates that banks should (i) assess the impact of a depreciation of the currency on their capacity to repay foreign currency debtors, and (ii) downgrade their borrower's rating whenever capacity to repay is significantly affected. It also requires that banks constitute an additional 0.25 percent provision on all dollar loans to debtors that do not have foreign exchange earnings. The norm also allows the SIBOIF to require an additional 0.5 percent provision when supervisors consider that credit-risk management is deficient.

- SIBOIF engage the Panamanian supervisory authorities, as home supervisor, to step up supervision of the cross-border groups regarding governance, risk management and controls; and large exposures at the group level. Considering their significance in the Region, the Consejo Centroamericano de Superintendentes de Bancos, could recommend that the Superintendencia de Bancos de Panama, including external assistance by other Superintendencias de Bancos of the region, analyze, as of year-end 2009, the financial condition of the largest regional groups.

- SIBOIF negotiate a bilateral MOU with the Panama Bank Supervisory Authorities. This MOU should include a provision that will permit (i) disclosure to SIBOIF of the risks incurred by the foreign cross-border subsidiaries of RFGs with a large exposure in Nicaragua; and (ii) the presence of a SIBOIF supervisor at the onsite inspections, performed by the home supervisor of Panama, of the RFGs that have a significant market share in Nicaragua;

- SIBOIF establish contact with the supervisors of Ecuador and the U.S. Office of Comptroller of Currency to obtain information on the operations of the unconsolidated parts of one of these groups.

- In case increased cooperation does not provide SIBOIF with full disclosure of the risks incurred by the foreign cross-border subsidiaries of the RFGs, SIBOIF should request the information directly from the banks' subsidiaries operating in Nicaragua. The provisions of Article 88 of the general banking law could be used to justify a request for an increase in capital and/or provisions of the bank subsidiary operating in Nicaragua that is part of the RFGs in case it is deemed that its group exposures could pose risks to Nicaraguan depositors (see Appendix IV).

- As a measure of last resort, to be considered only after all other avenues have been explored and proved to be ineffective, the SIBOIF could request that an RFG that has not furnished satisfactory information be re-incorporated in Nicaragua. This measure may require an amendment of the Banking Law.[18]

98. **The legal framework does not explicitly assign responsibility for preserving financial stability.** SIBOIF, as the sole supervisor for the financial sector, is entrusted with protecting depositors and preserving confidence in supervised institutions. Currently, the SIBOIF analyzes the impact of selected macroeconomic variables and the performance of economic sectors on banking risks. However, the inter-linkages between the real economy and the financial sector need an integrated analysis from a macro-prudential point of view. Additionally, other aspects that may affect financial stability fall beyond the scope of the SIBOIF mandate. For

[18] It appears that the monthly meeting of the CCS in November 2009 made progress in the area of information sharing with the Panamanian Supervisory Authorities. The Panama Bank Supervisor reported to the CCS that it had reached an agreement with the Bank Supervisor of Ecuador to perform periodic onsite visits to an Ecuadorian bank subsidiary of one of the FGs domiciled in Panama. The information from the inspection will be available to the SIBOIF.

example, if they continue their growing trend, unsupervised or lightly supervised sectors, such as the cooperatives, may have an impact on the supervised financial sector and on financial stability in the future. The mission supports the authorities' efforts to amend the BCN law to entrust the BCN with the responsibility for financial stability from a macro-prudential standpoint.

APPENDIX II. ANTI-MONEY LAUNDERING/COMBATING THE FINANCING OF TERRORISM (AML/CFT)

99. The following is based on information from the last CFATF AML/CFT Mutual Evaluation Report (October 2008) of Nicaragua, and does not constitute a reassessment by the Fund of Nicaragua's AML/CFT regime.

100. **In 2008, Nicaragua introduced legislation criminalizing money laundering (ML) and the financing of terrorism (FT) that is generally adequate except for some key deficiencies.** The report noted serious limitations in the law to require timely measures to be taken in FT cases, and the list of predicate offenses for ML is incomplete.

101. **A new Penal Code, which came into force in July 2008, criminalized ML and FT broadly in line with international standards, except for minor deficiencies.** The report noted that Nicaragua should amend its Criminal Code in order to include counterfeiting and piracy as predicate offences for Money Laundering, and also include a provision to enable the financing of terrorism to be prosecuted in Nicaragua regardless of whether the act occurred inside or outside the country.

102. **Only financial institutions supervised by the Superintendency of Banks and Other Financial Institutions (SIBOIF) in their capacity as legal persons, are subject to criminal sanctions for ML or FT.** For other legal persons, only ancillary sanctions can be imposed and only when the person responsible for the company has been previously convicted.

103. **Four ML investigations were commenced and two indictments issued during the first six months of the new Code coming into force.** However, at the time of the assessment there had been no convictions for money laundering.

104. **Nicaragua does not have a financial intelligence unit (FIU) and generally lacks an adequate AML/CFT institutional framework.** It has not developed a comprehensive AML/CFT strategy and there is no effective policy coordination among the various AML/CFT institutions.

105. **Financial institutions regulated by the SIBOIF, such as banks, finance companies, securities firms, insurance and general bonded warehouses are adequately regulated for AML/ CFT, but associations and cooperatives, key players in the financial system, are not subject to any regulation or supervision for AML/CFT.** Financial institutions regulated by the SIBOIF appear to comply reasonably well with the AML/CFT requirements.

106. **The regulation and implementation of wire transfer requirements in the supervised sector are appropriate.** However, there are many unsupervised money transfer businesses that have no requirements for their establishment, registration or operation.

107. **Except for casinos, none of the designated non-financial businesses and professions (DNFBP) required by the FATF are covered by the AML law**.

108. **The laws and the Public Business Register do not provide the authorities access to adequate information about the beneficiary owners of legal persons**.

109. **Mutual legal assistance to other countries is operational, although it was not possible to assess the response times.** There are significant potential limitations to international cooperation relating to FT investigations. Neither a national AML/CFT policy with priorities nor a national strategy has been formulated**.** Domestic cooperation and coordination work reasonably well at the operational level, but not at the policy level. The lack of a formal FIU severely limits the ability to provide and receive cooperation on financial intelligence.

APPENDIX III. STRESS TEST METHODOLOGY AND SCENARIOS

110. **Types of Risk:** In the FSAP Update, the Nicaraguan banks were subjected to a wide array of shocks. The stress tests dealt primarily with credit risk, but also considered interest rate risk, exchange rate risk, and liquidity risk.

111. **Methodology**: The stress tests were based on end-August 2009 data and involved projections of banks' net profits by imposing shocks on (i) loan loss provisions; (ii) associated write-off of accrued interest; and (iii) generally muted interest income from loans—all other positions of the income statement were set to grow at the rate of the crawling peg or the inflation rate (both assumed at 5 percent). To begin with a realistic state of the banking sector, the capital positions were first adjusted for the net present value loss associated with last year's restructuring of central bank bonds (affecting the two largest banks), and were also made to reflect a downward reclassification of prorogated and unrecoverable loans in line with best practices. The resulting lower capital positions and adequacy ratios were taken as the starting point for the scenario analyses that used a top-down approach. A baseline scenario against which to compare the impact of shocks on capital adequacy assumed that banks' net profits remain unchanged from 2008.

112. **Scenarios**: The stress tests cover a total of six credit risk and credit concentration scenarios; three scenarios assessing the impact of legal initiatives; two market (interest rate) risk scenarios; three exchange rate risk scenarios; and one liquidity risk scenario.

113. **Baseline Scenario:** Provisions and all other positions of the income statement were assumed unchanged from 2008, i.e. before the bulk of the recent loan reclassifications occurred.

114. **Scenario 1—continuation of decline in bank performance.** Additional non-performing loans and write-offs were projected to increase by 50 percent relative to the twelve months ending in August 2009, whereas the associated provisions were made to conform with the current risk profile of the loan portfolio.

115. **Scenario 2a/b—deterioration of loan quality.** Bank loans were reclassified downward by one/two notch(es) across the board (netting the implied value of guarantees), which results in additional provisions and thus lower profits.

116. **Scenario 2c/d/e—deterioration of large corporate loans.** To assess credit concentration risk, the 100 largest debtors were downgraded by one/two notch(es), again resulting in additional provisions (scenarios 2c and 2d). In addition, the 10 largest debtors were assumed to default (scenario 2e).

117. **Scenario 3a/b—interest rate cap on microfinance and on credit card loans.** Pending legal initiatives would retroactively cap rates on microfinance loans at 12 percent (affecting only three microfinance institutions), and on credit card loans at 24 percent, in both cases implying a loss in interest income.

118. **Scenario 3c—reform of bank taxation.** Another law would introduce an annual one percent tax on bank assets as well as the taxation of interest on public sector bonds held by banks, both straining bank profits.

119. **Scenario 4—decline in performance and legal changes.** This scenario represents a combination of the impacts implied by scenarios 1 and 3a through 3c.

120. **Scenario 5—recognizing the risk of public sector bonds.** In this scenario, the risk weight for public sector bonds was set to 20 percent, resulting in higher risk-weighted assets and thus lower capital ratios.

121. **Scenario 6—interest rate risk.** This scenario considers re-pricing risk based on maturity gaps between interest-sensitive assets and liabilities as well as a value loss in banks' trading books.

122. **Scenario 7a/b/c—exchange rate risk.** Notwithstanding the time-tested crawling peg, an assumed one-step devaluation of the exchange rate by 25 percent increases capital charges on banks' net open positions and causes 5/10/20 percent of unhedged households and businesses to default on their loans. At the same time, it is also taken into account that the devaluation causes a one-time valuation gain (loss) at banks whose open position in foreign currency is long (short).

123. **Scenario 8—liquidity risk.** This scenario assesses the coverage that banks' liquid assets provide in case of a withdrawal of 30 percent of total deposits.

APPENDIX IV. CONSOLIDATED SUPERVISION

124. **The complexity of regional financial groups and cross-border operations of financial institutions poses significant challenges for supervision.** The Nicaraguan Banking System is dominated by regional financial groups (RFGs). The three largest Nicaraguan banks, Banpro, Bancentro and BAC, are respectively the largest institutions of three RFGs operating in most countries in the region—Promerica, Lafise and BAC. Banks belonging to Promerica and Lafise used to operate as parallel banks (RPBs), reporting to different supervisors but without consolidating their operations. The 2005 general banking law obliged RFGs to choose a home country in which to base the holding company, and to differentiate this from host countries. As a result, although the majority of their business activities are conducted in Nicaragua, all three RFGs now consolidate their operations in Panama.

125. **BAC** is a regional financial conglomerate with a presence in Nicaragua, Costa Rica, Honduras, Panama, El Salvador, and Guatemala. It also has credit card operations in Mexico. The group's parent company, BAC International Bank, is a licensed financial institution in Panama. The group has its largest presence in Nicaragua with market share as of September 2009, of 20.8 percent. **Promerica** was founded in Nicaragua in 1991. It has a presence in Guatemala, Honduras, Nicaragua, Costa Rica, El Salvador, Dominican Republic, Ecuador, and is headquartered in Panama. BANPRO, the Nicaraguan subsidiary is the largest bank of the group, and has the largest market share in Nicaragua, totaling as of September 2009, 28.9 percent. **Lafise** was created in 1985 to provide financial services in Central America and the Caribbean. In 1991, Lafise established **Bancentro** in Nicaragua, which is now the second largest bank of the country with a market share of 22.6 percent as of September 2009, and is headquartered in Panama.

126. **Supervision of the groups is coordinated in the region under Central American Council of Superintendents of Banks, Insurance and Other Financial Institutions (CCS)**, The CCS was formed under the Multilateral MOU with the Supervisory Authorities of Central America, Panama, and the Dominican Republic. 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. Panama, as the home country, is responsible for the consolidated supervision of the Banking Groups (BG). Based on the periodic reports received from the CCS, and its own bank supervision process, SIBOIF is familiar with the overall structure of the BG based in Nicaragua, and has a very good knowledge and understanding of the activities of the domestic groups, as well as material parts of foreign activities. However, SIBOIF does not have information on the activities conducted in Ecuador and the United States by the groups.

127. **SIBOIF does not receive sufficient information on all the subsidiaries of each group that are not located in Nicaragua and yet are material to the risk exposure of the Nicaraguan entities**. SIBOIF should ensure that for each BG, capital must be adequate both on a group or consolidated level and on a single-entity solo level. The SIBOIF supervisory process should take into consideration the following problems: differences in the definitions and

calculations of both actual and required capital across borders; differences in accounting standards; the lack of proper financial and auditing consolidation; and inappropriate recording of intra-group transactions, including: (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; (d) regulatory requirements may be circumvented; (e) transfers of deposits and loans (including asset dumping offshore) among banks belonging to the same group to boost capital artificially can occur; (f) cross-border transfer of deposits may magnify liquidity risk; (g) 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; and (h) the existence of parallel bank-based groups.

Options for addressing the risks

128. **The SIBOIF could negotiate a bilateral MOU with the Panama Bank Supervisory Authorities.** This MOU should include a provision that will permit: (a) the assistance of a SIBOIF supervisor at the onsite inspections, performed by the home supervisor of Panama, of the BGs that have a significant market share in Nicaragua; and (b) disclosure of the risks incurred by the foreign cross-border subsidiaries of the same BGs that currently are not available to SIBOIF.

129. **If intensified cooperation through a bilateral agreement with the Panama Bank Supervisors is not satisfactory, SIBOIF could use the provisions of Article 88 of the General Banking Law, which indicates that, in the event that the Superintendent detects facts endangering the depositors to a degree that does not require an intervention or a liquidation, SIBOIF can take preventive action.** The provisions of Article 88 appear to justify a request by the Superintendent for an increase in the capital of an entity that is part of a financial group from which the SIBOIF cannot obtain full disclosure of its risks. Article 88 also provides the measures that the Superintendent may apply, that include among others, to prohibit the declaration and issuance of dividends.

130. **A measure of last resort, to be considered only after all other avenues have been explored and proved to be ineffective, could be for the SIBOIF to request that an FG that has not furnished satisfactory information be re-incorporated in Nicaragua**.[19] This measure may require an amendment of the Banking Law.

[19] Director of Consolidated Supervision indicated in a telephone conversation on December 9, 2009 that at the monthly meeting of the CCS in November progress was made in the area of information sharing with the Panamanian Supervisory Authorities. The Panama Bank Supervisor reported to the CCS that it had reached an agreement with the Bank Supervisor of Ecuador to perform periodic onsite visits to an Ecuadorian bank subsidiary of one of the FGs domiciled in Panama. The information from the inspection will be available to the SIBOIF.

APPENDIX V. CONTINGENCY PLANNING FOR CRISIS MANAGEMENT

131. **An effective contingency planning for crisis management program begins with the creation of a high level Crisis Prevention and Management Committee (CPMC).** The CPMC should document the member groups' responsibilities in a Domestic Crisis Cooperation and Information-sharing MOU. The CPMC should develop a formal plan, including strategies on how to deal with potential financial crises that may seem unlikely in stable times. The CPMC should have regular meetings, perhaps monthly to begin with, and more often when a crisis is imminent.

Simulations and functional plans

132. **The CPMC should create a working group(s) comprised of specialists from various functional areas to develop and conduct simulation drills, in conjunction with enhanced stress tests.** These "what if?" scenarios can check the necessary coordination and cooperation procedures. They can also help identify weaknesses in the present crisis arrangements and plan how the procedures can be strengthened. Each member of the group should have clearly defined responsibilities when a crisis situation is detected.

133. **The CPMC should coordinate with the Liaison Committee (Comité de Enlace) of original supervisors to conduct simulation drills and stress tests at the regional level.**

134. **All actions taken by the authorities in a crisis should be legally defensible and well-documented.** The working group should supplement the domestic crisis agreement with checklists of actions, operational manuals, and support documents for staff involved in crisis management. These documents should be held in a secure place in each institution in the event that a crisis situation unfolds rapidly.

Communications

135. **The CPMC should design a communication strategy to ensure that the authorities speak with one, clear voice to inspire public confidence.** Coordinated communications, such as announcing a coherent and comprehensive package of measures can help build and maintain public and political support, which is crucial in successfully dealing with a crisis. To this end, the authorities may want to consider hiring public relations and financial experts to ensure that messages to the market are well targeted.

136. **The authorities should draft, discuss, and agree in advance on proper press releases, so that their response to the events are perceived as efficient, which in turn will help maintain market confidence.** Crisis simulation exercises should include clearly communicating the results of a comprehensive assessment of the crisis' underlying problems.

APPENDIX VI. CENTRAL BANK'S CURRENT MONETARY OPERATIONS FRAMEWORK

137. **BCN's monetary policy implementation framework centers around the exchange regime.** The final policy objective of price stability is to be achieved through the intermediary objective of exchange rate stability under the crawling peg. The need to maintain an adequate level of international reserves—high enough to give credibility to the pre-announced devaluation pace—steers weekly decisions on the target volume of liquidity to be absorbed by open market operations. Those amounts make other changes in central bank assets and liabilities consistent with the desired level of international reserves.

138. **The monetary operations toolkit consists of reserve requirements, credit facilities and open market operations.** Commercial banks are currently required to hold 16.25 percent of the previous week's average level of deposits and other liabilities with the public, in both domestic and foreign currency, in their reserve accounts at the central bank. Reserve requirements have to be fulfilled in the same currency as the bank liabilities they refer to: córdobas, dollars or euros.[20] [21] Some of the elements of the reserve requirement regime, particularly their weekly basis, are currently established in the central bank law, but changes in the law under discussion in the Assembly would make the central bank board the instance that decide on calculation procedures, measurement periods, fines and penalties.

139. **The BCN uses weekly auctions of its own securities as the main instrument for monetary policy implementation.** Central bank bills of 1, 3, 6, 9, and 12 months may be offered, according to the decision of the Open Market Committee (COMA). Open market operations with government securities are permitted by the central bank law, although restricted to bills and bonds maturing in not more than one year. All BCN securities outstanding are denominated in dollars or indexed to the dollar and settled in córdobas—i.e., they are subject to the value maintenance clause provided for in the monetary law. Competitive auctions, to which only financial institutions and broker houses ("puestos de bolsa") have access, take place on Wednesdays; non-competitive auctions are undertaken on Thursdays and open to the public in general but not to financial institutions and broker houses. Both competitive and non-competitive auctions are settled on the following Monday.

140. **Of the current four BCN credit facilities, the overnight and repo facilities are the ones to be considered part of the monetary operations toolkit, rather than the lender of last resort facilities.** The overnight facility can only be used by commercial banks to cover liquidity shortfalls related to check clearing. The repo facility provides credit to banks and financing firms for up to 7 days against collateral in central bank or government securities. All BCN credit facilities charge an interest rate 200 basis points above the weighted average yield rate of

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[20] Fulfillment of reserve requirements is exclusively through the reserve account; cash in vault is not considered.

[21] In the last four years, the reserve requirement coefficient has been kept at 16.25 percent, except for a period of 16 months starting in July 2006, during which it was raised to 19.25 percent.

securities traded in competitive auctions in the previous week. As in the case of BCN securities, they are subject to the value maintenance clause.

141. **There are important shortcomings in the operational framework described above:** (i) it allows for high volatility in short-term interest rates; and (ii) it induces banks to hoard liquidity, reducing the chances that complementary positions appear in the interbank market.

- The main instruments the BCN uses for liquidity management are the weekly auctions of its own securities, which are calibrated with a view to achieving the quarterly targets for net international reserves. This is sufficient from the perspective of the crawling peg exchange rate regime; however, since the central bank is not aiming at balancing the interbank market on a daily basis, there is too much volatility in short-term interest rates, and hence in the cost of financing short positions (Figure 9).

- The lack of a liquidity injection instrument at market rates brings further incentives to liquidity accumulation by banks. Banks have increased their cash holdings recently—probably as a response to the developments of the international financial crisis—but in previous years they also tended to be all on the same side of the market as they maintained liquidity cushions (Figure 10). This may be in part an accommodation to the way the BCN is managing liquidity as the only market instrument it uses —the only instrument operating at market rates— is an absorption instrument. The other instruments—BCN's credit facilities—are only available at punitive rates and have not been used for years.

APPENDIX VII. FOREIGN EXCHANGE MARKET

142. **The crawling peg exchange rate arrangement, which has been in place in Nicaragua for more than 16 years, has helped to anchor expectations and preserve competitiveness.** Nicaragua adopted a crawling peg exchange rate arrangement in 1993, with a depreciation rate of 5 percent a year that was changed to 12 percent in that same year. The depreciation rate started to be reduced in July 1999, and has been back at 5 percent since the beginning of 2004. The depreciation rate for the subsequent year is not formally announced, but it is indicated in the annual budget that is normally sent to the Assembly in mid-October, and announced in the press conference that the central bank governor gives before the end of the year. The formal commitment with the rate of crawl is the announcement of the daily official exchange rate for the following month, made in the last week of each month.

143. **BCN's participation in the foreign exchange market is relatively small; the most active segment in the market is the one between banks and their clients.** Chapter I of BCN's financial regulations covers the foreign exchange market, and applies to the following market participants: BCN, government, banks, financial corporations ("sociedades financieras"), exchange houses ("casas de cambio"), and individual or companies that customarily buy and sell foreign exchange.[22] Following the exchange regime, BCN stands ready to buy or sell any amount of dollars or euros from the government and from banks and financial corporations registered with the BCN. BCN purchases dollars at the official exchange rate, but charges a commission of 1 percent in its sales. Central bank presence in the foreign exchange market is relatively small: trading of banks and financial corporations with the central bank was worth 5 percent of their trading with the public in the last two years (Figure 14). The interbank market is also not very active, with a negotiated amount, in the last three months, of around 8 percent of banks' and financial corporations' trading with the public. Within the same period, no interbank trading was recorded on about 30 percent of the business days.

144. **Central bank purchase and sale rates create a de facto corridor for foreign exchange market transactions.** Market participants are required to provide to the central bank daily information on their transactions with the public, at an aggregate level. Based on this information, the central bank calculates and publishes in its website the weighted average rates of market trades with the public—purchases and sales separately. The exchange market is quite stable (Figure 14), with the average market sale rate bounded by BCN's purchase and sale rates almost all of the time. In periods when liquidity in córdobas increases—for example at the beginning of the year, when there are large redemptions of the Property Settlement Bonds (Bonos de Pago por Indeminización, BPI) and demand for credit is lower—market sale rates tend to remain closer to the BCN sale rate. The central bank open market committee constantly monitors the gap between market rates and the official exchange rate, and takes into account its seasonal behavior by increasing placements of central bank bills in the first months of the year.

[22] Resolución CD-BCN-XXVII-1-07, of July 11, 2007.

APPENDIX VIII. FINANCIAL STABILITY DIAGNOSTIC AND ASSESSMENT MATRIX FOR FSSA

<table>
<tr><th>Nicaragua</th><th colspan="2">Overall Level of Concern</th></tr>
<tr><th>Nature/Source of Main Threats
(ranked in order of overall level of concern)</th><th>Likelihood of Severe Realization of Threat in the Next 1-3 Years</th><th>Expected Impact on Financial Stability if Threat is Realized</th></tr>
<tr><td>Severe solvency or liquidity problems in one (or several) of the foreign banks that are part of the two large Nicaraguan groups registered in Panama causing contagion to the local Nicaraguan banks, affecting their liquidity and/or solvency.</td><td>Assessment: Moderate
• Information shortcomings to assess the condition of all cross-border operations of these groups. These shortcomings affect 37 percent of the assets of one of the groups (Ecuador, US, El Salvador, Guatemala, and Dominican Republic). Additionally, the complex legal structure of these groups makes it difficult to assess their overall risks.
• Political unrest has weakened Honduran banks. The CAR of the operations of the Honduran subsidiary banks, amounted ti 11-13 percent (August 2009). However, both banks have been allowed to defer full loan loss provisioning by their Honduran supervisor. Provisioning cover of past due loan assets is very low, ranging from 33 to 73 percent in July 2009.
• The two local banks appear well capitalized (CAR amounting to 16.3-18.1 percent, respectively, in July 2009), but one of the banks reported capital hides losses of about 6.5 points of CAR from investments (US$39 million), due to an exception in the accounting treatment.
• Reportedly, these local banks do not have direct exposures to the foreign affiliates in their group, but if one of the members of the group has liquidity problems, they will be prompted to support it.
• These local banks are liquid (29-34 percent of assets), but liquidity could be quickly eroded if one of its foreign affiliates experiences a liquidity problem.</td><td>Assessment: High
• The combined assets of the two local banks, represent 51 percent of the Nicaraguan banking system's assets.
• The foreign operations of these groups represent 45-71 percent of total assets.
• The Honduran operations represent 9-18 percent of assets of the Nicaraguan groups.</td></tr>
</table>

Nicaragua	Overall Level of Concern	
Nature/Source of Main Threats *(ranked in order of overall level of concern)*	**Likelihood of Severe Realization of Threat in the Next 1-3 Years**	**Expected Impact on Financial Stability if Threat is Realized**
	• Mitigating factor: SIBOIF has stopped distribution of dividends and bonuses in the Nicaraguan banks, to protect capital at the Nicaraguan banks. • Mitigating factor: One of the local groups plans to strengthen its capital by issuing US$ 10 million of subordinated bonds to capitalize the regional operations (pending until the group concludes consolidation of its operations in Panama).	
Lack of an effective regulatory framework for microcredit institutions (including NGO MFIs and financial cooperatives) with large portfolios threatens to create opportunities for fraud, and could have contagion effects for the larger financial market.	*Assessment: High* • Given the recent fraud in ACODEP (at a cost of at least US$2.0 million) and the lack of timely and appropriate resolution of this case, the likelihood of another large fraud in a microcredit institution should not be ignored. • The terms of microcredit loans limit their use to commercial and consumer loans, but they may be the only formal credit offer for animal producers in some regions. • Recent microcredit loans to animal producers exceeded US$10,000. This does not fit the microcredit standard in the region (with loan size typically not exceeding US$2,000). • Use of formal collateral by microcredit institutions has substituted for more appropriate credit analysis and client selection techniques for microcredit.	*Assessment: High* • In the short term, the impact on microfinance and rural finance markets could be very high, with potential for contagion, since two banks and a finance company are dedicated to microfinance. • International investors, who have placed more than US$200 million in microfinance banks and microcredit institutions, are considering withdrawing their support. • CARUNA’s loan portfolio has grown dramatically under the ALBA oil financing scheme. However, there is no appropriate financial supervision of this or other large financial cooperatives. • The lack of transparency of microcredit rates has contributed to the recent movement against timely repayment of outstanding loans. • Regional examples of regulatory frameworks for non-deposit taking microcredit institutions include El Salvador and Mexico.

Nicaragua	**Overall Level of Concern**	
Nature/Source of Main Threats *(ranked in order of overall level of concern)*	**Likelihood of Severe Realization of Threat in the Next 1-3 Years**	**Expected Impact on Financial Stability if Threat is Realized**
The Moratorium Law threatens the credit culture in rural markets, and is likely to lead to a large drop in access to credit in these markets. Given the agriculture and livestock industry's reliance on foreign markets, restructuring pressure will continue if demand remains weak.	*Assessment: High* • The likelihood of another "movimiento no pago" should not be ignored. • The withdrawal of foreign investors, combined with the more conservative approach of microfinance banks and unregulated entities, could contribute to a large gap in financing for agriculture and livestock. • Two specialized microfinance banks could require large-scale recapitalization to meet minimum equity requirements and overcome the effects of the movement, the drought and the global financial crisis on loan repayment.	*Assessment: High* • With the approval of the Moratorium Law, significant damage has been done by succumbing to pressures of the non-payment movement and the introduction of • the concept of arbitrary rescheduling through legal means, rather than by voluntary renegotiation of credit contracts. • The lack of transparent interest rates for microcredit could provide the impetus for a new non-payment movement. • The lack of large-scale client education campaigns targeting the most vulnerable clients (such as rural producers, credit card users) could provide an opportunity for more misunderstandings and inappropriate lending/borrowing.
Lack of liquidity in the payment and securities settlement systems. Vulnerable legal framework for payment, remittances and securities settlement.	*Assessment: Low/unpredictable* • The system is quite liquid as banks have excess reserves. • In the last few years there have been only isolated and temporary situations in which banks had to ask for specific interventions of the CBN to provide them with liquidity • However, the unpredictability of the events influencing the liquidity of the markets cannot allow a specific and certain assessment in these terms.	*Assessment: High* • The lack of liquidity in one or more banks in the Nicaraguan market can easily and rapidly generate a domino effect with other players and potentially lead to a systemic crisis. Considering the limited number of banks operating in Nicaragua, a prolonged liquidity crisis, exacerbated by irrational reactions and lack of adequate instruments to absorb the shock, could easily lead to a gridlock of the system. • On one hand, the regional integration of the markets and the presence of several banks in multiple countries in Central America, could affect also their payment systems. On the other hand, the presence of specific measures to deal with the liquidity shortage could mitigate the effects of the crisis in those countries.