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## **PANAMA**

# **STRENGTHENING MACROFINANCIAL AND FISCAL MANAGEMENT**

**(PN-L1086)**

## **GUARANTEE PROPOSAL**

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<b>REQUIRED</b>	
1.	Policy letter <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=37247418">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=37247418</a>
2.	Means of verification matrix <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=36935758">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=36935758</a>
3.	Results matrix <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=36935759">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=36935759</a>
<b>OPTIONAL</b>	
1.	Panama – 2012 (April). Article IV Consultation, IMF Country Report 12/83 <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=36935761">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=36935761</a>
2.	Cost-benefit analysis <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=36935771">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=36935771</a>
3.	Financial sector monitoring and evaluation plan <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=36935773">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=36935773</a>
4.	Terms and conditions sheet <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=36935774">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=36935774</a>
5.	Guarantee arrangement <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=36935775">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=36935775</a>
6.	Economist Intelligence Unit. Country Finance. Panama <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=36935763">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=36935763</a>
7.	Macro-prudential Policy: What Instruments and How to Use Them? IMF working paper 2011 <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=36935764">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=36935764</a>
8.	Social and Fiscal Responsibility Law of Panama <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=36935765">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=36935765</a>
9.	Banking Law of Panama. Consolidated text <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=36935766">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=36935766</a>
10.	2010-2014 Strategic Government Plan. Republic of Panama <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=36935768">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=36935768</a>
11.	The Bank's Country Strategy with Panama. 2010-2014 <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=36935770">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=36935770</a>

## **ABBREVIATIONS**

FAP	Fondo de Ahorro de Panamá [Panama Savings Fund]
GDL	Guarantee disbursement loan
GDP	Gross domestic product
IDB	Inter-American Development Bank
IFRS	International Financial Reporting Standards
IMA	Independent Macroeconomic Assessment
IMF	International Monetary Fund
MEF	Ministry of Economy and Finance
NFPS	Nonfinancial public sector
SBP	Superintendencia de Bancos de Panamá [Superintendency of Banks of Panama]

## PROJECT SUMMARY

### PANAMA STRENGTHENING MACROFINANCIAL AND FISCAL MANAGEMENT (PN-L1086)

Financial Terms and Conditions			
<b>Guarantor:</b> Inter-American Development Bank <b>Guaranteed borrower:</b> The Bank of Nova Scotia, acting as trustee of a trust fund in Panama. <b>Counterguarantor:</b> Republic of Panama <b>Executing agency:</b> Ministry of Economy and Finance (MEF)		<b>Financial terms of the Guarantee</b>	
		<b>Availability period:</b>	Until 31 July 2016 + 75 days
		<b>Disbursement period:</b>	N.A.
		<b>Grace period:</b>	N.A.
		<b>Guarantee fee:</b>	Spread applicable to sovereign loans from the Ordinary Capital at the time of signature of the guarantee
		<b>Inspection and supervision fee:</b>	N.A.
<b>Source</b>	<b>Amount</b>	<b>Interest rate:*</b>	LIBOR-based sovereign lending rate at the Bank + 2%
<b>IDB (OC)</b>	US\$350 million	<b>Credit fee:</b>	N.A.
<b>Local</b>	0	<b>Currency:</b>	U.S. dollars from the Ordinary Capital of the Bank
<b>Total</b>	US\$350 million		
Project at a Glance			
<b>Objectives:</b> The general objective of the program is to reduce the fiscal risk of macroeconomic and financial shocks by strengthening the macrofinancial and fiscal management framework. The specific objectives are: (i) to reduce sovereign risk; and (ii) to reduce systemic risk in the financial system. To this end, the program will strengthen the country's macrofinancial and fiscal management framework through four basic components: (i) macroeconomic stability; (ii) development of government asset and liability management tools; (iii) development of macroprudential regulations, supervision, and instruments; and (iv) strengthening of risk-based supervision (see paragraphs 1.25 to 1.31). The Republic of Panama has asked the Bank to process the first operation of the program in the form of a guarantee.			
<b>Special contractual conditions:</b> The entry into force of the guarantee will be subject to fulfillment of the following conditions: (i) the Republic of Panama has met the conditions of the policy matrix; (ii) the Republic of Panama has paid the guarantee fee in full; (iii) the Republic of Panama is not in arrears with any payment obligations under contracts signed with the Bank; (iv) an audit satisfactory to the Bank and its advisers has been performed with respect to the loan contract, the lender, and the trustee; (v) legal opinions have been presented verifying the validity and legality of the operation and the enforceability of all contracts associated therewith; and (vi) the loan contract, the guarantee contract, and the counterguarantee contract have been signed (see paragraphs 2.3 to 2.7).			
<b>Exceptions to Bank policies:</b> None			
<b>Project consistent with country strategy:</b> Yes [ <input checked="" type="checkbox"/> ]      No [ <input type="checkbox"/> ]			
<b>Project qualifies as:</b> SEQ [ <input type="checkbox"/> ]      PTI [ <input type="checkbox"/> ]      Sector [ <input type="checkbox"/> ]      Geographic [ <input type="checkbox"/> ]      Headcount [ <input type="checkbox"/> ]			

\* If the guarantee is activated, any disbursement by the Bank under the guarantee will be converted into a loan to the Republic of Panama, subject to the prevailing interest rate for Ordinary Capital loans plus 2% per annum on the total amount disbursed. The Republic of Panama will repay the loan to the Bank within 180 days.

## I. DESCRIPTION AND RESULTS MONITORING

### A. Context and objectives<sup>1</sup>

- 1.1 **Macroeconomic context.** Between 2007 and 2011, the country's real GDP grew by 9%, spurred by a strategic program of investments to promote the country's competitiveness, in particular the expansion of the Panama Canal.<sup>2,3</sup> This growth took place in a framework of fiscal and macroeconomic sustainability. External debt as a proportion of GDP fell, thanks to the solid expansion of nominal GDP. The external debt to GDP ratio stood at 41.8% in 2011, almost 10 percentage points lower than the average between 2006 and 2010. The growth of Panama's economy has gone hand in hand with strong needs for financing,<sup>4</sup> a significant share of which (7.7% of GDP) has come in the form of foreign direct investment between 2007 and 2011.
- 1.2 In this context, the Panamanian government considers it very important to develop a comprehensive strategy to control macrofinancial and fiscal risk, understood as the expected fiscal impact of a macroeconomic or financial shock, weighted by the probability of occurrence. This comprehensive strategy is based on strengthening the country's financial and fiscal management framework, in line with international best practices. This initiative is fully consistent with studies and recommendations by international organizations (IMF, IDB).<sup>5</sup> A stronger financial and fiscal management framework would directly benefit Panama's public sector<sup>6</sup> and financial agencies, and indirectly benefit the country's population as a whole.
- 1.3 The recent international financial crisis has shown that a financial and fiscal management framework intended to prevent macrofinancial and fiscal risks should be based on two dimensions:<sup>7</sup> (i) control of the country's balance sheet risk, that is, sovereign risk, defined as a risk that the country cannot meet its financial obligations; and (ii) management of system-wide financial risk, in other words, systemic risk, defined as "a risk of disruptions to financial services that is caused by an impairment of all or parts of the financial system and has the potential to have

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<sup>1</sup> Based on Article IV of the IMF (2012) and the 2012 Independent Macroeconomic Assessment (IMA) by the IDB.

<sup>2</sup> All direct and indirect activities associated with the Panama Canal represent around one fifth of the country's GDP; the Canal expansion is expected to increase annual GDP growth by approximately 3.5%.

<sup>3</sup> In 2011, public investment represented 15.2% of GDP, and private investment 13.8%. Between 2000 and 2010, average public and private investment levels stood at 9.8% and 16.6% of GDP, respectively.

<sup>4</sup> Gross financing needs for the 2012–2014 period are estimated at US\$4 billion dollars. This operation will meet 8.75% of those needs. External public debt is expected to fall from 35.5% of GDP in 2011 to 26.6% in 2014, while domestic debt is expected to double from 6.2% of GDP in 2011 to 12.6% in 2014.

<sup>5</sup> For an analysis of the current sovereign risk of Panama, see: Moody's Panama Risk Appraisal, December 2011.

<sup>6</sup> Specifically, on the income side, the functions of the Ministry of Economy and Finance (MEF) would be specially strengthened; on the expenditure side, the public sector as a whole would be strengthened.

<sup>7</sup> International Monetary Fund: Stability Report, 2012 (April).

serious negative consequences for the real economy.”<sup>8</sup> An effective financial and fiscal management framework should develop the instruments needed for controlling both types of risk so as to reduce the fiscal cost of a macroeconomic and financial crisis.<sup>9</sup> Logically, the two types of risks are related in various ways; the purpose of separating them is to facilitate analysis and explanation.

- 1.4 **Sovereign risk.** Instruments to mitigate sovereign risk aim to maintain a robust public sector balance sheet with sustainable debt and deficit levels.<sup>10</sup> These instruments include fiscal rules, which play a key role as institutional mechanisms for strengthening fiscal credibility and discipline.<sup>11</sup> The public sector balance sheet should be robust both on the assets side and on the liabilities side, especially those that are strategic for the country. Panama’s most important assets include the strategic resources associated with the expansion of the Panama Canal, and its most important liabilities are its debt. In developing the financial and fiscal management framework, tools for managing government assets and liabilities must be strengthened and aligned with fiscal rules to improve the country’s solvency and, thus, its resilience in a macroeconomic and financial crisis.
- 1.5 **Systemic risk.** There are two major dimensions of systemic risk and the instruments used to mitigate it:<sup>12</sup> (a) the time dimension, which refers to the tendency of financial and nonfinancial economic agents to increase their exposure to risk during expansionary phases of the financial cycle, and to reduce excessive exposure during recessionary phases. Instruments designed to mitigate this dimension of systemic risk are macroprudential regulation and supervision, which include the institutions and rules on prudential risk control throughout the financial system; and (b) the cross-sectional dimension, which refers to risk distribution in the financial system. The instrument used to mitigate this dimension is microprudential regulation, which includes risk-based regulation and supervision, corporate governance, accounting standards, and mechanisms governing the settling and bankruptcy of financial entities.<sup>13</sup> The development of an effective financial and fiscal management framework should take into account both components of systemic risk.

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<sup>8</sup> International Monetary Fund: “Macroprudential Policy: an Organizing Framework.” Monetary and Capital Markets Department. 2011

<sup>9</sup> The fiscal cost of a systemic and sovereign debt crisis in the region ranges between 4% and 12% of GDP. See Laeven, Luc and Valencia, Fabian. Systemic Banking Crisis: A New Database. WP/08/224.

<sup>10</sup> International Monetary Fund: Stability Report, 2011 (April).

<sup>11</sup> International Monetary Fund: Fiscal Rules—Anchoring Expectations for Sustainable Public Finances. IMF Fiscal Affairs Department. 2009

<sup>12</sup> Op. cit. 7.

<sup>13</sup> Logically, there is a connection between the temporal dimension and the crosscutting dimension of systemic risk. While the first triggers the destabilization mechanism, the second can amplify the impact of financial stress on the system and the real economy.

## **B. Analysis of government asset and liability management in Panama**

- 1.6 **Macrofiscal situation.** Panama's nonfinancial public sector (NFPS) had a primary surplus of 0.8% of GDP in 2010, and 0.1% in 2011. The total NFPS deficit in 2011 was 2.3% of GDP. This situation is consistent with the strong surge in public investment by the Panamanian government,<sup>14</sup> especially related to the expansion of the Panama Canal. Having peaked in 2011, planned public investments are expected to gradually decline, reaching 2008 levels by 2015.
- 1.7 **Fiscal sustainability.** Sustainability assessments by the IMF (Article IV, 2012) and the IDB (IMA, 2012) show that Panama's debt levels are sustainable under different risk scenarios. Accordingly, the country is in a sound fiscal position to pursue the ambitious investment program under conditions of fiscal sustainability. IMF projections estimate that the NFPS will move into surplus in 2016.<sup>15</sup> Recently, Law 38 of 2012 created the Panama Savings Fund (FAP), the purpose of which is to save part of the revenues generated by the Canal to serve as a buffer against emergencies or economic downturns in the future.
- 1.8 **Regulatory framework.** Panama's Social and Fiscal Responsibility Law is the cornerstone of the country's macrofiscal system. It mandates that the NFPS deficit remain below 1% of GDP and that once the public debt to GDP ratio falls below 40%, it may not exceed that threshold again. Because of the natural disasters in 2010, the Panamanian government made use of the exceptions provided for under the Law to request an increase in the deficit above 1% between 2011 and 2013. In June 2012 the Law was amended to increase the allowable fiscal deficit to 2.9% of GDP in 2012, 2.8% in 2013, and 2.7% in 2014, gradually decreasing it thereafter until reaching 1% of GDP in 2017.
- 1.9 **Pending business.** As noted in the assessments of the international organizations (IMF, Article IV; IDB, IMA), government asset and liability management has gained strategic importance for the Panamanian government due to its ambitious public investment program and the importance of continuing to anchor fiscal policy within the framework of the Social and Fiscal Responsibility Law. This is why the public sector balance sheet should be strengthened on the government asset and liability side, in order to reduce sovereign risk due to possible economic downturns.
- 1.10 **Government assets.** The investments in the Panama Canal will begin to generate a permanent and relatively stable income stream (tolls, rates, dividends) in 2015. Management of this government asset is of strategic importance for the country. Since the income is not tied to domestic economic activity, it could generate spending pressures if applied exclusively to public expenditure, creating long-term

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<sup>14</sup> The government has been promoting a plan that has increased public investment from 8.2% of GDP in 2008 to 15.2% of GDP in 2011. During those years, aggregate investment rose from 27.6% to 29% of GDP (IMA, 2012).

<sup>15</sup> For an analysis of Panama's current sovereign risk status, see Standard & Poor's Panama Rating Report. July 2012.



fiscal sustainability problems. According to IMF estimates (Article IV, 2012), cumulative income in the FAP will be on the order of 8% of GDP by 2025. As explained later in the description of the proposed program, in order to control public spending pressure, an intergenerational approach should frame the development of the FAP and the management of government revenues from the Panama Canal, in order to reduce net public debt and accumulate savings for periods of economic slowdown or states of emergency.

- 1.11 **Government liabilities.** In 2011, domestic public debt stood at 6% of GDP, representing 15% of total public debt. Domestic public debt instruments in the local primary (secondary) capital market amounted to US\$0.9 (0.27) billion, 3% (1%) of GDP, which is comparatively low.<sup>16</sup> Deepening the domestic public debt market and making it more efficient are key aspects of risk diversification and mitigation for the country, since they act as a buffer against external shocks. This market is still not liquid or deep enough to attract private investors. Therefore, it is of key importance to improve public debt scheduling and incentives to consolidate market-making agents that provide liquidity and stimulate private investment (in the primary and secondary markets) in order to develop a domestic rate curve and increase the share of domestic debt in total debt.

**C. Analysis of the framework for macroprudential regulation, supervision, and intervention in Panama**

- 1.12 **Context.** Panama is a regional banking center with considerable financial depth, and adequate levels of capitalization and profitability, comparatively speaking.<sup>17</sup> Total banking sector assets exceed 266% of GDP, and the National Banking System, which excludes internationally licensed banks, has an 81% share of the market (with total assets, credits, and deposits standing at US\$66 billion, US\$40 billion, and US\$50 billion, respectively).<sup>18</sup> The insurance and credit union sectors are small compared with the banking sector (total assets of 5% and 4.5% of GDP, respectively). In 2010, private sector loans began to grow again following a contraction induced by the international crisis, recovering from negative growth of 0.13% in 2009 to positive growth of 13.3% in 2010 and 17.3% in 2011. Loans account for 60% of the assets of the National Banking System, and 132% of GDP.

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<sup>16</sup> These levels are in contrast to those of countries with less financial depth such as Chile, Colombia, and Peru, and in those in which the share of sovereign debt securities quoted on the capital market is significantly greater, specifically 11%, 24%, and 15% of GDP, respectively. For a comparative analysis of debt markets in the region see: Shah, Hemant, Andreas Jobst, Laura Valderrama, and Ivan Guerra. 2007. Public Debt Markets in Central America, Panama, and the Dominican Republic. IMF Working Paper 07/147.

<sup>17</sup> For a detailed analysis, see Economist Intelligence Unit. Country Finance. Panama. 2012.

<sup>18</sup> As of end-2011, Panama had 49 general license banks, including 2 State-owned banks; 28 international license banks; and 14 branch offices. In total, 56 foreign banks were operating in Panama, of which 28 had general banking licenses and therefore were part of the National Banking System. State-owned banks' share of the market, by total assets, is 10.8% (US\$8.4 billion, 28% of GDP).

One third of loans are issued to nonresidents. Loans are geared mainly toward the business (29%), mortgage (27%), and consumption (20%) sectors.<sup>19</sup>

- 1.13 **Institutional and regulatory framework.** Panama's regulatory framework is based on the 1998 Banking Law, which consolidated supervision of the banking sector in the Superintendency of Banks (SBP). Although the country does not have a deposit insurance fund, it does have prudential regulations on liquidity requirements, which require 30% liquidity ratios for short-term obligations. Other supervisory institutions in the financial sector are: the Instituto Panameño Autónomo Cooperativo [Autonomous Panamanian Cooperative Institute], which supervises cooperatives, including credit unions; the Superintendency of Insurance and Reinsurance, which oversees the insurance sector; the National Securities Commission, for capital markets, pension and investment funds, and financial intermediaries; and the Financial Enterprises Department of the Ministry of Commerce and Industry, which oversees lending and leasing companies.
- 1.14 **Pending business.** The disjointed nature of the regulatory system increases the cost of information and of implementing measures for the financial system. Therefore, an institution responsible for macroprudential supervision is needed. In addition, there are no dynamic and countercyclical macroprudential regulations in place whose regulatory parameters change in accordance with the macrofinancial situation,<sup>20</sup> as recommended by the Basel Committee.<sup>21</sup> This makes it hard to mitigate systemic risk and, accordingly, does not reduce the economy's vulnerability to macrofinancial shocks.
- 1.15 **Macroprudential institutional framework.** Coordination between the financial system's supervisory bodies requires an institutional structure that systematizes the exchange of information and has a clear mandate for macroprudential supervision. To this end, the proposal is to create a Financial Coordination Council as the foundation of the macroprudential regulation system. The council should have a mandate for macroprudential regulation and involve the participation of the country's main supervisory bodies.
- 1.16 **Countercyclical dynamic provisioning.** The financial crisis showed that reducing procyclical trends in the banking system mitigates the effects of macroeconomic shocks.<sup>22</sup> The idea behind countercyclical dynamic provisioning is to build up a buffer in good economic times that can be used in times of economic stress to cover

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<sup>19</sup> The remaining assets are primarily securities and deposits in other banks, which represent 19% and 15% of assets, respectively.

<sup>20</sup> For a complete discussion, see: Macroprudential Policy: What Instruments and How to Use Them? C. Lim, F. Columba, A. Costa, P. Kongsamut, A. Otani, M. Saiyid, T. Wezel, and X. Wu. IMF working paper. 2011.

<sup>21</sup> See Basel III. A global regulatory framework for more resilient banks and banking systems, revised version. June 2011.

<sup>22</sup> Basel Committee. The policy implications of transmission channels between the financial system and the real economy. Working Paper No. 20. May 2012.

credit losses in loan portfolios, thereby boosting the system's resilience in periods of recession or instability. An effective countercyclical dynamic provisioning system must be able to obtain and calibrate information, and analyze it in detail.<sup>23</sup>

#### **D. Analysis of risk-based supervision and regulation in Panama**

- 1.17 **Condition of the banking system.** Panama's financial system is solid and profitable, adequately capitalized, and has conservative loan practices that mitigate market, operational, and credit risks.<sup>24</sup> Both the national and international banking sectors are highly capitalized (16.5% average capital adequacy ratio since 2008), show low levels of arrears in both the domestic and external portfolios (2.7% and 0.6%, respectively, in 2011), and adequate profitability (1.7% return on assets and 15% return on equity in 2011). The National Banking System is also characterized by high liquidity, at double the current legally required rate of 30%.<sup>25</sup>
- 1.18 **Regulatory framework.** The regulations of Panama's financial system are aligned with key international standards and consistent with the principles of Basel I (IMF, 2012 Article IV; IDB, IMA 2012). Specifically, progress has been made in the areas of regulation and supervision, based on the main recommendations of earlier assessments by the international organizations.<sup>26</sup>
- 1.19 **Pending business.** Two aspects of Panama's financial regulations need to be developed to strengthen their effectiveness in mitigating systemic risk: (i) the country lacks a complete risk-based supervision framework that meets all the core principles of the Basel Committee. It does, however, have the legal foundation for developing this framework, which includes the Banking Law and an accounting framework aligned with international standards (based on International Financial Reporting Standards); and (ii) the regulatory framework does not cover cooperatives, so they are not subject to prudential regulation or supervision, thereby increasing systemic risk in the sector.
- 1.20 **Risk-based regulation and supervision.** The Superintendency of Banks (SBP) is developing a comprehensive risk-management system for the banking system that will make it possible to identify, assess, monitor, and control or mitigate all materially important risks, in accordance with the size and complexity of the operations of the financial entity. In this connection, it is important to develop new standards for defining the different types of risks (mainly market, credit,

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<sup>23</sup> Wezel, T; Chan-Lau, A; Columba, F. 2012. Dynamic Loan Loss Provisioning: Simulations on Effectiveness and Guide to Implementation. IMF Working Paper. WP/12/110.

<sup>24</sup> Op. cit. 13.

<sup>25</sup> Data from the Superintendency of Banks (SBP), 2011.

<sup>26</sup> The main recommendations included formulating policies to regulate market risk in accordance with the requirements of Basel II, and amending the Banking Law to clarify the SBP's authority with regard to financial conglomerates and bankruptcy processes. Executive Decree 52 of 2008 amended the 1998 Banking Law in order to consolidate supervision. This recommendation was made by the IMF. Panama: Assessment of Financial Sector Supervision and Regulation. 2007.

operational, and liquidity risks), as well as the processes, responsibilities, and organizational structure needed for financial entities to perform effective comprehensive risk management. Good practices include supporting this process with the preparation of manuals and guidelines to facilitate and systematize application, and providing training for the SBP's inspectors and analysts.

- 1.21 **Regulation of credit unions.** In Panama, there are 166 credit unions and 25 multipurpose cooperatives that offer loan products, with assets totaling US\$1.3 billion. The four largest credit unions account for 53% of assets and 60% of deposits, showing the importance of bringing them under supervision and regulation to mitigate systemic risk.

#### **E. Summary of pending business**

- 1.22 **Sovereign risk.** The core areas of pending business related to sovereign risk have to do with both the assets and the liabilities of the public sector balance sheet. On the assets side, the country faces the challenge of managing the revenues generated by the Canal expansion so as to prevent spending pressures and ensure firm compliance with the Social and Fiscal Responsibility Law. On the liabilities side, it must increase the efficiency and depth of the public debt market in order to improve the public sector financing strategy.

- 1.23 **Systemic risk.** There are four areas of pending business related to systemic risk: (i) development of an institutional structure for macroprudential supervision; (ii) analysis of the bases for regulations on countercyclical dynamic provisioning; (iii) strengthening of risk-based supervision; and (iv) development of regulations for the credit union sector.<sup>27</sup>

#### **F. Government priorities and recent progress**

- 1.24 **Government commitment.** Given the economic implications of macroeconomic and financial shocks for the country, which could have a fiscal impact of between 5% and 10% of GDP according to the recently compared experience (see the operation's [cost-benefit analysis](#)),<sup>28</sup> the Panamanian government is actively involved in strengthening the country's financial and fiscal management, as evidenced in the 2010-2014 Strategic Government Plan, the technical dialogue between its authorities and the IMF, and its request for the Bank's technical and financial support. In addition, the actions to develop risk-based regulations or create mechanisms for managing government assets in accordance with international best practices show that the government is committed to implementing a series of measures to strengthen fiscal and financial administration in the country.

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<sup>27</sup> An assessment of similar interventions in the financial sector can be found in: Basel Committee on Banking Supervision. August 2010. "An Assessment of the Long-Term Economic Impact of Stronger Capital and Liquidity Requirements."

<sup>28</sup> The economic analysis of the program yielded a significant return for the operation (based on conservative assumptions, net present value is US\$3.1 billion).

## **G. Proposed program**

- 1.25 **Objectives.** The general objective of the program is to reduce the fiscal risk of macroeconomic and financial shocks by strengthening the macrofinancial and fiscal management framework. The specific objectives are: (i) to reduce sovereign risk; and (ii) to reduce systemic risk in the financial system.
- 1.26 **Structure of the program.** The program is proposed as a programmatic loan involving two sequential operations, in accordance with the guidelines for preparation and implementation of policy-based loans (document CS-3633). The total cost of the first operation will be US\$350 million, which, at the request of the Panamanian government, will be in the form of a guarantee (see paragraph 2.1).
- 1.27 The first operation, as well as the program as a whole, will have four components. Components I and II aim to reduce sovereign risk, and Components III and IV aim to prevent systemic risk.
- 1.28 **Component I. Macroeconomic stability.** As provided in document CS-3633, maintaining a stable macroeconomic framework consistent with program objectives will be a condition of the guarantee. This consistency will be established by the policy letter and evaluated by means of the independent macroeconomic assessment (IMA).
- 1.29 **Component II. Development of government asset and liability management tools.** This component has two subcomponents. **Subcomponent II.1. Creation of a sovereign savings fund for macroeconomic stabilization.** The fund will function as a countercyclical mechanism based on international best practices established by the IMF,<sup>29</sup> which include investing its resources abroad, operating as a financing fund that cannot be used for expenditures or automatic transfers, and has a governance structure that guarantees that investment decisions are functionally and operationally independent of political power. **Subcomponent II.2. Development of the domestic segment of the public debt market** by strengthening the Market Maker Program and improving trading infrastructure so as to increase the depth of domestic debt markets. The Market Maker Program will stimulate competition between market makers and clearly and transparently regulate the mechanisms for access to the program, participant responsibilities, measurement of program performance, and the spreads and fees of market operations. The Market Maker Program will be supplemented by actions to improve publicity for and the programming of public auctions. The second operation will further the institutionalization and key functional elements of the FAP and the Market Maker Program.

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<sup>29</sup> International best practices include the recommendations of the International Working Group of Sovereign Wealth Funds, as set out in the “Santiago Principles.” For a review of best practices, see: IMF. 2008. Sovereign Wealth Funds—A Work Agenda. Prepared by the Monetary and Capital Markets and Policy Development and Review Departments.

- 1.30 **Component III. Development of macroprudential regulations, supervision, and instruments.** This component has two subcomponents. **Subcomponent III.1. Creation of the Financial Coordination Council** as the coordinating hub for the different supervisory agencies of Panama's financial system. All agencies responsible for financial supervision (see paragraph 1.15) will be included in the Council, which will establish mechanisms for the exchange of information between them, especially regarding financial groups. The Financial Coordination Council will be led by the SBP, and its functions will include the capacity to propose supervisory and regulatory improvements. In addition, actions will be pursued to progressively strengthen the council's technical and regulatory capabilities, by establishing a methodology for macroprudential supervision and training staff on the supervision of macroprudential risk. **Subcomponent III.2. Analysis and development of a countercyclical dynamic provisioning system** to be adopted by the financial entities. A study will be conducted to establish regulations for a countercyclical dynamic provisioning arrangement, to include evaluation of countercyclical dynamic provisioning systems, information requirements, alternative calculation and calibration methodologies, and the guidelines and key functional and operational elements required for implementing it. The second operation will strengthen the Financial Coordination Council's technical and human capabilities, and make further progress on developing and approving regulations on countercyclical dynamic provisioning.
- 1.31 **Component IV. Strengthening of risk-based supervision.** This component has three subcomponents. **Subcomponent IV.1. Development of risk-based supervision.** The purpose of this subcomponent is to improve the regulation of comprehensive risk management in line with the principles of the Basel Committee and its management framework, including: operational risk (definition of types, and strategy for identification, control, mitigation, and reporting); credit and market risk (including mechanisms for managing and setting interest rates and the exchange rate); and technological risk. **Subcomponent IV.2. Institutional strengthening for risk-based supervision,** which includes adapting the organizational structure of the SBP to the new regulations and supervision, and improving human resources policies, especially relative to the training of supervision officials. **Subcomponent IV.3. Analysis and development of a regulatory system for the credit union sector** and for the loan departments of multipurpose cooperatives. The focus will be on defining responsibilities for regulation of the cooperatives sector, and the regulatory needs of the largest operators. The second operation calls for further development of the regulations for **risk-based supervision**, accounting and financial audit training, and regulation of the credit union sector.
- H. Results indicators**
- 1.32 The reason for developing a financial and fiscal management framework is to minimize the fiscal risk of macroeconomic and financial shocks. The key indicator for measuring this objective will be the evolution of public debt, such that the

debt-to-GDP ratio will fall below 40% of GDP in accordance with the Social and Fiscal Responsibility Law. The objective of reducing sovereign risk will be measured by the sovereign debt rating, while reduction of systemic risk will be monitored by credit growth (macroprudential component) and the legal liquidity ratio (microprudential component). Specifically, credit growth is to be less than one standard deviation above the average of the last five years. In this regard, see the work of Schularick, Moritz, and Alan M. Taylor. 2012. “Credit Booms Gone Bust: Monetary Policy, Leverage Cycles, and Financial Crises, 1870-2008.” *American Economic Review*, 102(2): 1029–61. For further details, see the program results matrix and the monitoring and evaluation plan. Lastly, program outputs will be measured using various indicators (see the [results matrix](#)).

## **I. The Bank’s country strategy with Panama**

- 1.33 **Strategy of the programmatic series.** Under the first operation, the program will focus on defining and approving the content and structure of the policies and reforms needed for strengthening macrofinancial and fiscal management in each area, laying the foundation for the rest of the program. The focus of the second operation will be to implement the regulations and institutional arrangements defined in the first operation.
- 1.34 The program is consistent with the Bank’s country strategy with Panama (document GN-2596). The program objectives to reduce the country’s fiscal vulnerabilities by mitigating macrofiscal risk will have a positive impact on the country’s public finances. Therefore, it is consistent with the strategic objective to “improve the management and efficiency of public expenditure.”
- 1.35 The Ninth General Capital Increase spells out the Bank’s strategic objectives for the coming years. This program is consistent with the purpose of “lending to small and vulnerable countries.” In addition, given the importance of Panama as a regional financial hub for Central America and the Caribbean, improvements in financial regulations and supervision will also contribute to the objective of strengthening financial integration in the region.

## **II. FINANCING STRUCTURE AND MAIN RISKS**

### **A. Financing instruments**

- 2.1 **Guarantee in support of policy reform.** At the request of the Panamanian government, this first operation of the programmatic series will be in the form of a guarantee (the guarantee). As expressly stated in the Agreement Establishing the Bank,<sup>30</sup> the Bank is authorized to issue guarantees to any member country. The Board of Executive Directors has approved different forms of public sector guarantees, as presented in document GN-1858-2 on the use of Bank guarantees,

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<sup>30</sup> Section 4 of Article III of the Agreement Establishing the Bank states, “the Bank may make or guarantee loans to any member [...]”

which establishes guidelines for using partial risk and partial credit guarantees in investment projects,<sup>31</sup> and document GN-2106-6,<sup>32</sup> on the pilot program to provide the option of disbursing loans in the form of guarantees, guarantee disbursement loans (GDL) with sovereign guarantee, which gives borrowers the option of disbursing policy-based loans and investment loans in the form of a guarantee. This first operation of the programmatic series is a guarantee in support of policy reform. Although this instrument is not expressly provided in the policies approved by the Board of Executive Directors, this operation is being presented for the consideration of the Board for the following reasons: (i) it is an instrument that is already in use by other multilateral development banks, such as the World Bank,<sup>33</sup> and for which there is demand on the part of the borrowing member countries; (ii) it is a high impact operation for Panama that contributes significantly to the development of the country's financial and fiscal sector; and (iii) the experience gained in the preparation and execution of this operation will be an important source of lessons learned for the platform of public sector guarantees on which the Bank's Management is working with participation by the Finance Department, the Legal Department, the Vice Presidency for Countries, the Vice Presidency for Sectors and Knowledge, the Research Department, and the Office of Strategic Planning and Development Effectiveness.

- 2.2 **Additionality of the operation.** First, the reforms of the policy-based program will benefit the Republic of Panama by reducing the fiscal risks associated with macroeconomic or financial shocks. Second, the guarantee will enable the Republic of Panama to reschedule a series of obligations derived from investment loans for road rehabilitation. In this connection, the guarantee will: (i) reduce the cost of the rescheduling; (ii) facilitate compliance with current fiscal and public expenditure legislation, extending the term of the loans; and (iii) preclude the need for the Republic of Panama to incur additional external debt, which would have potentially negative effects on its sovereign debt rating.
- 2.3 **The guarantee operation.** The Bank will guarantee the borrower's obligations for the repayment of principal and payment of interest under a loan contract (the loan) with a lending syndicate (the beneficiary of the guarantee). The borrower (see next paragraph) will use the proceeds of the loan to acquire a series of irrevocable payment obligations from the Republic of Panama related to the construction of public works (partial payment vouchers). The partial payment vouchers document

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<sup>31</sup> The two precedent public sector guarantee operations approved by the Board of Executive Directors were approved under document GN-1858-2: Peru loan 1717/OC-PE (PE-L1010) and Guyana loans 1730/SF-GY and 1731/SR-GY (GY0055).

<sup>32</sup> This document established the terms for a two-year pilot program. Document GN-2106-11 extended the term of the pilot program for another two years, under more flexible terms. The GDL program expired on 31 December 2004 without ever having been used by the Bank.

<sup>33</sup> On 20 April 1999, the World Bank approved a policy-based guarantee instrument (PBG) within the context of a pilot program for a maximum amount of US\$2 billion. It recently approved PBGs in Macedonia (US\$140 million), in 2012, and in Serbia (US\$400 million), in 2011.



the progress of a work or advance payments agreed upon with the contractors for the aforementioned construction of the public work. The borrower will come to an agreement with the Government of Panama on extending the maturity of the partial payment vouchers (see [guarantee agreement](#)). The Bank-issued guarantee will be backed by a counterguarantee issued by the Republic of Panama in favor of the Bank (the counterguarantee).

- 2.4 **Terms and conditions of the guarantee. General.** The terms and conditions of the guarantee agreed upon with the Government of Panama are presented on the [terms and conditions sheet](#). The guarantee will cover the risk of the loan principal and interest payable on the maturity date of the loan (31 July 2016), for up to a maximum amount of US\$350 million. The Bank's guarantee will be unconditional and irrevocable once the conditions have been met for it to enter into force (described below). The Bank's guarantee will not cover early termination of the loan prior to the final maturity date. **Beneficiary of the guarantee.** The beneficiary of the guarantee is a syndicate of lenders made up of The Bank of Nova Scotia, Bank of Tokio Mitsubishi, Sumitomo Mitsui Banking Corporation, and Banco Nacional de Panamá. The Agreement Establishing the Inter-American Development Bank<sup>34</sup> establishes that it may use Ordinary Capital resources to partially or fully guarantee loans made, barring exceptional cases, by private investors. Management understands the composition of the syndicate to be consistent with that provision of the Bank's Charter. **Guaranteed borrower.** The borrower covered by the guarantee will be The Bank of Nova Scotia's subsidiary in Panama, which will act as the trustee of a Panamanian trust fund. According to Panamanian law, the trust fund is not a legally constituted entity and acts through the representation of its trustee. The beneficiary of the trust fund will be the syndicate of lenders. **Guarantee fee:** For issuing the guarantee, the Republic of Panama will pay the Bank a guarantee fee equivalent to the spread applicable to Ordinary Capital sovereign loans at the time of signature of the guarantee, on the amount of the guarantee (the guarantee fee).
- 2.5 **Conditions precedent to the guarantee's entry into force.** The entry into force of the guarantee will be subject to fulfillment of the following conditions: (i) the Republic of Panama has met the conditions of the policy matrix; (ii) the Republic of Panama has paid the guarantee fee; (iii) the Republic of Panama is not in arrears with any payment obligations under contracts already signed with the Bank; (iv) due diligence satisfactory to the Bank and its advisers has been performed with respect to the loan, the syndicate of lenders, and the trustee; (v) legal opinions have been presented verifying the validity and legality of the operation and the enforceability of all contracts associated therewith, in form and substance satisfactory to the Bank; and (vi) the following have been signed: (a) the loan contract between the syndicate of lenders and the trustee, acting on behalf of the trust fund; (b) the guarantee contract between the syndicate of lenders, the Bank,

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<sup>34</sup> See Section 4 (iii) of Article III of the Agreement Establishing the IDB.

and the trustee, acting on behalf of the trust fund; and (c) the counterguarantee contract between the Republic of Panama and the Bank. **Calling the guarantee.** The borrower is under the obligation to repay the entire loan on the final maturity date (31 July 2016). If the borrower fails to meet all or part of its obligation to repay the principal and interest on the final maturity date, the syndicate of lenders may call the guarantee.

- 2.6 **Irrevocable and unconditional nature of the guarantee.** The Bank's standards and procedures on arrears (document CF-3-3), approved by Management in May 1990, establish that if a borrower is more than 30 days behind in any payment under a loan contract, the Bank may suspend the disbursements of that loan or any other loan between the Bank and that borrower. Because the Bank-issued guarantee is irrevocable once it enters into force, Management has approved that the standards and procedures on arrears will not apply to the guarantee.
- 2.7 **Counterguarantee of the Republic of Panama.** The Bank's guarantee will be backed by a counterguarantee contract with the Republic of Panama. Any disbursement made by the Bank under the guarantee will be understood as a loan to the Republic of Panama subject to the LIBOR-based interest rate in effect for sovereign loans from the Bank's Ordinary Capital plus 2% per annum on the disbursed amount. The Republic of Panama will repay the amount disbursed by the Bank within 180 days following the disbursement. If the Republic of Panama fails to meet this repayment obligation to the Bank, the Bank's standards and procedures on arrears will apply to the Republic of Panama. Panama will register the counterguarantee with the Bank and the rest of the obligations of the structure in accordance with the country's public accounting laws, taking into account the recommendations and technical cooperation of the IMF.

**B. Environmental and social safeguards**

- 2.8 According to directive B.13 of the Bank's Environment and Safeguards Compliance Policy (document GN-2208-20 and manual OP-703), this operation does not require classification because it is a programmatic policy-based loan. Moreover, the policy changes made within the framework of this operation will not have direct or significant social effects, or effects on the country's environment or natural resources.

**C. Risks and key issues**

- 2.9 **Coordination between donors.** The Bank has worked in close coordination with the IMF on the design of the program to ensure consistency and complementarity. The program takes into account the 2012 Article IV recommendations made by the IMF.
- 2.10 **Program risks. (i) Development risks.** Development risks are low due to the considerable progress that has been made with regard to the legislation and regulations considered in the program. (ii) **Macroeconomic and fiscal risks.** Public

accounts can deteriorate because of a downturn in the global economy, changes in the government investment plan, or financial shocks. Nonetheless, the country and the Panamanian government have pursued prudent management of economic growth, and the program itself aims to mitigate fiscal and financial risks. Thus, macroeconomic and fiscal risks are low and are not expected to impact program objectives. (iii) **Governance and public sector management risks.** Poor coordination between government agencies or lack of technical and financial resources could delay approval of the legislation and regulations covered by the program. This risk is considered low given the country's technical and financial capabilities, as well as the vigorous public-private dialogue facilitated by the authorities on the topics addressed by the program. In addition, no strong opposition has been expressed by interest groups. (iv) **Reputational risks.** The risk of not achieving the regulatory reform objectives for the programmatic operation is low and is mitigated by the collaboration between the IMF and the Panamanian government in developing the parameters for the operation.

### **III. IMPLEMENTATION AND MANAGEMENT PLAN**

#### **A. Summary of execution arrangements**

- 3.1 The Ministry of Economy and Finance (MEF) of Panama will be the executing agency. The MEF will designate the Public Credit Department as program coordinator, and as such it will be responsible for: (i) supporting the entities involved in implementing the program; (ii) coordinating technical execution; (iii) submitting work plans and monitoring reports to the MEF; (iv) monitoring compliance in due form and time with the Policy Matrix agreed upon between the Panamanian government and the Bank (see Annex II); and (v) compiling evidence of fulfillment of the program objectives identified in the results matrix.

#### **B. Summary of monitoring and evaluation plan**

- 3.2 Program implementation will be monitored by the Panamanian government through the MEF. The borrower and the Bank will hold quarterly meetings to review the program's progress and fulfillment of the conditions required for the subsequent operation. At the conclusion of the programmatic series, the Bank will prepare a project completion report in order to evaluate the outcomes.

#### **C. Supplementary Bank interventions and technical assistance**

- 3.3 The activities for obtaining the commitment for the first operation will be completed by the date of approval, as applicable, of the loan. Some of the activities for the second operation will receive the support of technical cooperation programs. These activities supplement the Bank's technical cooperation operation with the SBP on risk-based supervision and training, valued at US\$1.8 million, as part of loan 1757/OC-PN (PN-L1009).

Development Effectiveness Matrix				
		Summary		
I. Strategic Alignment				
1. IDB Strategic Development Objectives		Aligned		
Lending Program	The intervention contributes to the lending program for small and vulnerable countries, and to support regional cooperation and integration.			
Regional Development Goals	The intervention contributes to the regional development goals: i) Percentage of firms using Banks to finance investments, and ii) Ratio of actual to potencial tax revenue.			
Bank Output Contribution (as defined in Results Framework of IDB-9)				
2. Country Strategy Development Objectives		Aligned		
Country Strategy Results Matrix	GN-2596	The program's objectives of reducing fiscal vulnerabilities through macro-fiscal risk mitigation would impact positively on the country's public finances. This is therefore consistent with the strategic objective of "improving management and efficiency of public spending".		
Country Program Results Matrix	GN-2661-4	The intervention is not included in the 2012 Country Program Document.		
Relevance of this project to country development challenges (If not aligned to country strategy or country program)				
II. Development Outcomes - Evaluability		Highly Evaluable	Weight	Maximum Score
		8.5		10
3. Evidence-based Assessment & Solution		8.2	25%	10
4. Ex ante Economic Analysis		10.0	25%	10
5. Monitoring and Evaluation		5.7	25%	10
6. Risks & Mitigation Monitoring Matrix		10.0	25%	10
Overall risks rate = magnitude of risks*likelihood		Low		
Environmental & social risk classification		c		
III. IDB's Role - Additionality				
The project relies on the use of country systems (VPC/PDP criteria)	Yes	The project relies on the use of all Financial Management Sub-systems. Also Procurement Sub-systems will be used (Information System and Shopping Method).		
The project uses another country system different from the ones above for implementing the program				
The IDB's involvement promotes improvements of the intended beneficiaries and/or public sector entity in the following dimensions:				
Gender Equality				
Labor				
Environment				
Additional (to project preparation) technical assistance was provided to the public sector entity prior to approval to increase the likelihood of success of the project	Yes	Non Reimbursable resources included in the operation 1757/OC-PN PN-L1009 aimed at technically supporting the development of the risk based regulation and technical capabilities.		
The ex-post impact evaluation of the project will produce evidence to close knowledge gaps in the sector that were identified in the project document and/or in the evaluation plan.				

This is the first operation of two consecutive policy-based loans (PBL) for the government of Panama. It will be entirely financed with resources from the Bank's ordinary capital by US\$ 350 millions. The general objective of the program is to minimize fiscal risk due to macroeconomic and financial shocks. The specific objectives include minimizing (i) the balance sheet sovereign risk, and (ii) the financial systemic risk.

The project has a reasonable diagnosis that identifies the main deficiencies and clearly quantifies them. The justification for the effectiveness of the intervention in other or similar contexts is less clear. Results are correctly defined and all indicators are SMART. In most cases the objectives are realistic and outputs are also defined in a clear way. General mechanisms of monitoring have been defined and there is a budget for this activity.

The program has a before-after analysis to evaluate results with an evaluation plan and the main activities to perform. There is an economic analysis for some of its components with costs and benefits correctly quantified. Assumptions are clearly spelled out and are reasonable. The program has identified risks, as well as all the required mitigation measures. Furthermore, there are indicators for all of the mitigation measures identified.

## POLICY MATRIX

POLICY OBJECTIVES	AGREEMENTS 1ST LOAN	AGREEMENTS 2ND LOAN
<b>Component I - Macroeconomic stability</b>		
To maintain a stable macroeconomic environment consistent with program objectives	Macroeconomic policy framework consistent with the guidelines of the sector policy letter.	Macroeconomic policy framework consistent with the guidelines of the sector Policy Letter.
<b>Component II—Development of government asset and liability management tools</b>		
To improve government asset management: to develop a savings fund for macro stabilization.	<p>Creation of the Panama Savings Fund (FAP), based on international best practices:</p> <ul style="list-style-type: none"> <li>• Macroeconomic stability mandate.</li> <li>• Investment of assets abroad.</li> <li>• No systematic or automatic financing of expenditures, and funds transferred only to the Treasury.</li> <li>• Governance based on best practices.</li> </ul>	<p>Entry into effect of the regulations for the FAP Law, following international best practices, establishing conditions for investment, security, performance, liquidity, risk diversification, and limitations.</p> <p>Entry into effect of FAP investment guidelines, including benchmark indices and placement limits by asset class, implemented by the MEF.</p> <p>Approval of the FAP internal regulations and operating budget by its Board of Directors.</p> <p>Presentation of annual reports on FAP operations to the MEF.</p>
To improve government liability management: to develop and regulate the domestic debt market in the capital market.	<p>Entry into effect of the Market Makers Program, to include:</p> <ul style="list-style-type: none"> <li>• Incentives for market-making agents</li> <li>• Publicity mechanisms in public debt auctions</li> </ul>	<p>Strengthening of the Market Makers Program approval of the program by Presidential Decree, and its expansion in order to:</p> <ul style="list-style-type: none"> <li>• Develop a domestic rate curve.</li> <li>• Increase market depth and efficiency.</li> <li>• Improve competition between market makers.</li> </ul>

POLICY OBJECTIVES	AGREEMENTS 1ST LOAN	AGREEMENTS 2ND LOAN
<b>Component III–Development of macroprudential regulation, supervision, and instruments</b>		
<b>To develop macroprudential instruments and regulations</b> to mitigate the probability of a financial crisis.	Development of guidelines and identification of the scope of a study to establish the principles for regulation of a countercyclical dynamic provisioning system.	Draft regulations on countercyclical dynamic provisioning that adapt international best practices to the country's situation, agreed upon by the governing board of the Superintendency of Banks (SBP) and the IMF.
<b>To develop the institutional and organizational framework</b> for macroprudential supervision.	Creation of a Financial Coordination Council with the mandate to: <ul style="list-style-type: none"> <li>• Bring together all entities responsible for financial supervision.</li> <li>• Establish mechanisms for the exchange of information between responsible entities, especially with regard to financial groups.</li> <li>• Propose improvements in supervision and regulation.</li> </ul>	Development of the Financial Coordination Council's technical and regulatory capabilities: <ul style="list-style-type: none"> <li>• Design, approval, and entry into force of a methodology or manual on macroprudential supervision.</li> <li>• Design and launch of a training plan on macroprudential supervision.</li> </ul> Design, approval, and entry into force of the Financial Coordination Council's operating regulations.
<b>Component IV–Strengthening of risk-based supervision</b>		
<b>Subcomponent IV.1 – Development of regulations for risk-based supervision</b>		
To improve the comprehensive regulation of risks of financial entities regulated by the SBP, in accordance with international best practices, including operational, credit, market, and technological risk.	<p>Entry into force of regulations on operational risk. Definition of types of operational risk, and strategies for identification, monitoring, control, mitigation, and reporting.</p> <p>Entry into force of regulations on credit risk. Qualitative framework.</p> <p>Entry into force of regulations on technological risk.</p> <p>Entry into force of regulations on electronic banking and management of related risks.</p>	<p>Application of approved risk-management regulations, operational, technological, and credit risk (qualitative framework).</p> <p>Entry into force of regulations on the following risks:</p> <ul style="list-style-type: none"> <li>• Credit risk. Quantitative framework.</li> <li>• Market risk (including interest rate, exchange rate, and other risks).</li> <li>• Liquidity risk.</li> <li>• Financial conglomerates and exposure thresholds in economic groups and related parties.</li> </ul>

POLICY OBJECTIVES	AGREEMENTS 1ST LOAN	AGREEMENTS 2ND LOAN
<p>To consolidate the risk-based supervision framework.</p>	<p>Entry into force of the Consolidated Manual on Risk-Based Supervision, approved by the SBP, to include:</p> <ul style="list-style-type: none"> <li>• Policies, processes, and procedural guidelines</li> <li>• Bank rating and risk assessment system.</li> <li>• Early warning system, to include: “red flag” prudential indicators, stress tests, position of net financial assets, and value at risk (for determining market and credit risk).</li> </ul> <p>Launch of pilot testing of in situ inspections, based on the new manual (Consolidated Manual on Risk-Based Supervision), and used in one nationally licensed bank and one internationally licensed bank.</p> <p>Installation of software to automate and support the administration of supervisory functions, including the new processes covered in the Consolidated Manual on Risk-Based Supervision.</p>	<p>Use of Consolidated Manual on Risk-Based Supervision by at least 3 financial groups, 3 national banks, and 2 international banks, including recommendations.</p> <p>Design of curriculum, launch, and implementation of e-learning courses to provide new supervisors with timely training on the methodology.</p>
<p>To improve corporate governance and transparency.</p>	<p>Entry into force of the regulations on corporate governance in the banking system, specifically:</p> <ul style="list-style-type: none"> <li>• Require banks to have a clear framework for internal control and the basic mechanisms for implementing it.</li> <li>• Specify responsibilities and regulate the governing boards and senior management. Establish risk management as a responsibility of the governing boards.</li> </ul> <p>Entry into force of regulations on content and dissemination of information on interest rates and product and service fees.</p> <p>Entry into force of regulations on the collection of certain fees and surcharges by banking entities.</p>	<p>Effective implementation of the regulations on corporate governance and transparency.</p> <p>Presentation of draft legislation to update the regulatory framework for the accounting profession in Panama, based on SBP best practices.</p> <p>Preparation and approval, by the appropriate professional association, of the code of ethics for the accounting profession.</p>

POLICY OBJECTIVES	AGREEMENTS 1ST LOAN	AGREEMENTS 2ND LOAN
<b>Subcomponent IV.2 Institutional strengthening of the Banking Authority of Panama (SBP)</b>		
To adapt the organizational structure to the new regulations and risk-based supervision.	Modification and application of the new organizational structure of the SBP in order to adapt it to the changes in the supervision process.	<p>Creation of an External Auditor Control Department.</p> <p>Development of policies, procedures, and guidelines for the work of the department.</p> <p>Preparation of a quality control plan for external audit firms.</p>
To improve training for SBP personnel and its human resources policy.	<p>Launch of training workshops on the new supervision process (Consolidated Manual on Risk-Based Supervision) for all supervisors.</p> <p>Approval and implementation of a comprehensive training plan.</p> <p>Approval and implementation of a code of ethics and professional conduct for the SBP.</p> <p>Approval and implementation of a professional advancement plan to include a competencies manual and plans for promoting and retaining talent.</p> <p>Approval and implementation of new wage policy.</p> <p>Launch of training on International Financial Reporting Standards (IFRS) for 100 IFRS-certified staff of the SBP.</p>	<p>Application of training plans, the code of ethics, the professional advancement plan, and the wage policy.</p> <p>Preparation and approval of the SBP's Strategic Communications Plan.</p> <p>Completion of the review and reformulation of the job description manual and the organization and functions manual, and approval of the modifications to the SBP.</p> <p>Launch of the certificate program in IFRS and International Standards on Auditing.</p>
<b>Subcomponent IV.3 Analysis and development of a regulatory system for the credit union sector</b>		
To develop a regulatory system for the credit union sector.	Agreement on the defining principles of guidelines for regulation in the credit union sector, based on a study conducted for that purpose.	Presentation to the Legislative Assembly of a law to regulate the credit union sector in Panama.