ABSTRACT
GUATEMALA

PROJECT TO STRENGTHEN BANK SUPERVISION

Project name:	Project to Strengthen Bank Supervision
Project number:	TC-98-02-44-9
Country:	Guatemala
Project team:	Team members: Olver Bernal (RE2/FI2); Enrique Tarud (COF/CGU); Ricardo Posada (MIF); Ana María Linares (LEG); Team leader: William Armstrong (RE2/FI2)
Executing agency:	Superintendency of Banks
Beneficiaries:	The financial sector, consumers of financial services and the Superintendency of Banks
Estimated cost and financing:	MIF: Facility I US$ 900,000 Local counterpart US$ 600,000 TOTAL: US$ 1,500,000
Tentative dates:	Orientation mission January, 2000 Donors' Committee April, 2001

I. FRAME OF REFERENCE

1.1 The Guatemalan banking system is comprised of many small and, for the most part, locally-owned institutions. There are 33 banks in the system with an average size, measured in total assets, of the equivalent of US$170 million. Two of these are foreign banks and there is one government-controlled bank.

1.2 The solvency of the banking sector is threatened by a number of bad practices. Lending to related parties is common, provisions for lending risks are inadequate, and non-performing loans have been increasing. Furthermore, many transactions that occur within the country are booked in off-shore affiliates of the local bank, or in other entities controlled by the same financial group. Although the size of this "informal" activity is not known nor even knowable under the existing laws, it is clear that a significant proportion of total banking business is booked in these entities, out of sight of the tax and supervisory authorities. Some analysts estimate that half of the total assets and liabilities of the banking system are booked in these entities.

1.3 These problems exist because the legal framework for the banking system does not provide the authorities with the powers that are required to ensure that the risk-taking activities of the banks are controlled within prudent limits. The legal framework consists of the Banking Law that was approved in 1940 and a series of other laws, more recently enacted, that were approved in part to compensate for the deficiencies of the out-of-date banking act. The resulting legal framework is excessively permissive and this has contributed to the delicate condition that the banking sector is in.

1.4 During the last two years the Bank, through ATN/SF-6178-GU and administrative resources, has been supporting the work of the Superintendency of Banks (SB) and the Central Bank of Guatemala (Banguat) to modernize the country's financial laws. More recently, the Bank participated in a World Bank/IMF Financial Sector Assessment Program (FSAP). The FSAP analyzed the banking sector in some considerable detail and provided technical assistance to finish the preparation of the new legal framework.

1.5 These efforts have produced three new draft laws -- a banking and financial groups act, a bank supervision act, and an insurance act. In addition, steps are being taken to modify the central bank act in order to give more independence to the central bank. (RE2/FI2 has reviewed the draft laws and determined that, if passed in a form substantially similar to the November 2000 drafts, they would create a legal framework that is strong enough to provide the authorities with the powers that they need to regulate and supervise the sector adequately.)

1.6 The authorities estimate that the three draft laws would be sent to Congress in the first quarter of 2001, and approved during the first half of 2001. The approval and implementation of these laws are urgently required in order to enable the authorities to bring a halt to the abusive practices mentioned above, practices that could threaten the stability of the system.

1.7 The new legal framework requires the SB to prepare new regulations for the financial sector. Additionally, the Superintendency will have to modify its supervisory tools and its work methods in order to perform the more rigorous supervision that the new legal framework requires. The SB is requesting the technical cooperation described in this abstract so that it can draft and issue the regulations and upgrade its tools and practices in order to implement this new legal framework. This would be the MIF's first project with the SB.

1.8 The proposed project is consistent with the Bank's strategy for Guatemala, as expressed in the Country Paper that was approved by the Programming Committee on October 4, 2000. The CP describes the weaknesses in the financial sector, and recommends that the Bank give a high priority to projects and programs designed to stabilize the financial sector. The proposed technical

assistance program for the SB is included in the operative plan that the CP sets out for the year 2001.

II. PROJECT BENEFICIARIES

2.1 The direct benefit of the proposed project is better supervision and regulation of the financial system. As a result of the improved supervision, the overall level of risk in the financial system should be reduced. The beneficiaries of the project are the consumers of financial services, and the SB itself.

III. OBJECTIVES, COMPONENTS AND ACTIVITIES

3.1 The objective of the project is to strengthen the Superintendency so that it will be able to implement and enforce the new legal framework. To achieve this objective, the project will provide support in three areas: i) the drafting of the regulations for the new laws; ii) the upgrading of supervision tools and practices and training of the inspectors and supervisors in consolidated supervision and; iii) strengthening of off-site supervision.

1. Component 1. The emission of regulations under the new laws.

3.2 In the new legal framework the responsibility for approving regulations is divided between the SB and the Monetary Board (MB). (The MB is the governing body of the central bank and of the SB.) In general, the approval of regulations that have a permanent or strategic effect is the responsibility of the MB whereas the SB issues regulations that have a more temporary or tactical nature. In both cases, the technical staff of the SB drafts the regulations and recommends their approval.

3.3 This component has two activities. The first is to draft the regulations and the related prudential norms that are needed to give effect to the new laws and enable the SB to implement the Basle Committee's 25 principles. Because of the growing importance of the financing of microenterprises, and because the regulation and supervision of micro-lending has special requirements, this component will include the drafting of regulations and norms that will enable the financial intermediaries to expand their activities in this area within an appropriate regulatory environment. The second the second activity of this component is to create a program of dialog and divulgation in order to ensure that the new regulatory framework is accepted by the affected parties.

2. Component 2. The upgrading of supervision tools and practices and training in consolidated supervision

3.4 The new legal framework creates the figure of the "financial group", i.e. a group of related companies that offers a variety of banking, insurance and capital markets services through its affiliated companies. This configuration of the financial sector reflects the trend in many countries to permit financial groups to

exist and to allow them to promote their services as a group. In this way, the group and its customers benefit from the resulting economies of scope and scale. However, permitting related companies to offer a range of financial services makes supervision more difficult because it is possible to hide credit risks by moving them around the group companies. To prevent this, it is necessary to supervise the group as a whole or, in other words, to implement "consolidated supervision".

3.5 Lending to micro-enterprises poses challenges to inspection and supervision just as it does to regulation. In order to ensure that the inspection and supervision process does not become an obstacle to lending to micro-enterprises, the modernization of the inspection and supervision tools supported by this component of the program will include special tools that focus on the measurement and management of the risks of micro-enterprise lending.

3.6 Under this component a group of experts will help the SB evaluate the analytical tools (that is, the financial models, charts of account, procedures manuals and work practices) that the SB uses to inspect and supervise financial institutions in order to determine whether these tools can be used in an environment of consolidated supervision. From this analysis, the existing tools will be modified and new ones developed. Additionally, training will be given, both in the use of these analytical tools, and more generally in how to perform consolidated supervision. It is possible that part of this training will be provided through the Bank/MIF Regional Training Program for Bank and Capital Markets Supervision. To complete this component, the inspection manuals will be updated to make them consistent with the focus on consolidated supervision.

3. Component III. Strengthening of off-site supervision

3.6 The third component is to develop and implement a system for the continual analysis of individual financial institutions by establishing computerized links between the SB and the institutions. With this in place the inspectors will be able to follow the institutions closely during the periods between the annual on-site inspections. The link-up will serve as a channel for the financial information of the institutions, as well as for information on the individual debtors of the system. With this latter information, the SB will create borrowers' risk information exchange, whereby the financial institutions that contribute to the system will be able to query the system in order to determine the credit exposure of individual borrowers.

IV. COST ESTIMATES, FINANCING AND EXECUTION TIME

4.1 The project is expected to cost approximately US$1.5 million. This would be funded by a MIF donation from Window I of US$900,000 and local counterpart resources of US$600,000. At least half of the counterpart resources will be

contributed in cash. Preliminary cost estimates are that the individual components would cost between US$400,000 and US$500,000 each. These estimates will be refined during project preparation, and a detailed cost table will be presented in the Donors Memorandum. The project is expected to be executed over a period of 24 months.

V. EXECUTING AGENCY

5.1 The Superintendency of Banks will be the executing agency. The SB is a semi-autonomous agency that is responsible for the supervision and inspection of intermediaries in the banking and insurance sectors. As stated, it is governed by the Monetary Board, in accordance with the constitution of the Republic.

5.2 The SB has a staff of dedicated experts in the areas of regulation, supervision, inspection, financial analysis, management information systems and financial law. Staff turnover has been relatively low, in part because the SB pays salaries that are competitive with the private sector and offers training programs that help staff members to improve their qualifications and their professional status.

VI. EXPECTED PROJECT RESULTS AND JUSTIFICATION

6.1 The approval of the proposed project will be urgently required, when the new laws are passed. Many of the banks and insurance companies have been weakened by a combination of bad banking practices and the weak economy that has existed for the last three years. The SB has not had the authority to take preventative or corrective actions under the existing legal framework. The new framework will correct this deficiency and give the authorities the powers that they will need in order to reduce and control the risks to depositors. However, to enable the SB to exercise their new powers, the laws will need to be regulated and the SB's tools and work practices will have to be modified to reflect the new laws.

6.2 The expected benefits are an improvement in the quality of bank supervision and a lowering of the overall level of risk in the financial system. It is hoped that this will lead to an increase in national savings, as people come to feel that their savings are secure in the system. Benchmarks to monitor the execution of the project and its benefits will be developed during project preparation.

VII. PROJECT RISKS

7.1 The passage of the banking and financial groups act and the bank supervision act presents an important risk to the success of the project. To mitigate this, the Bank, through ATN/SF-6178-GU has been providing resources and experts that are helping Banguat and the SB to develop a consensus in the banking sector and in the Congress regarding the proposed legislation. The project will not be presented to the Donors Committee until the new legislation is passed.

VIII. ESTIMATED PROJECT PREPARATION TIME

8.1 Following the approval of this project abstract, the SB will begin drafting the terms of reference for the consultants and in parallel they will prepare the detailed cost estimate, and the logical framework. The project could be ready for approval in May, 2001.