FINANCIAL SECTOR REFORM PROGRAM III

(NI-0104)

EXECUTIVE SUMMARY

BORROWER AND GUARANTOR:	Republic of Nicaragua	
EXECUTING AGENCY:	Central Bank of Nicaragua	
AMOUNT AND SOURCE:	IDB Fast-disbursing resources (FSO)	US$65 million
	Technical Cooperation (NI-0106)	
	BID (FSO)	US$ 765,000
	Counterpart:	US$ 85,000
	TOTAL:	US$ 850,000
FINANCIAL TERMS AND CONDITIONS:	Amortization period:	40 years
	Grace period:	10 years
	Disbursement period:	24 months
	Interest rate:	1% for first 10 years; 2% thereafter
	Inspection and supervision:	1%
	Credit fee:	0.5%

OBJECTIVES:

The objective of the proposed reform program is to liquidate or privatize Nicaragua's state-owned banks, and foment the stability and efficiency of the private banking sector through the strengthening of the legal and regulatory framework of the financial system.

DESCRIPTION:

The proposed operation is designed to support the structural reform program of the financial sector and provide financing within the context of the Government's ESAF agreement with the IMF.

The program is structured as a fast-disbursing operation with three tranches: the first tranche for US$15 million, the second for US$25 million, and the third tranche for US$25 million.

The program embodies a medium term vision for the Nicaraguan financial system based on the principles of a competitive and efficient market. Direct government intervention in the delivery of financial

services, and the accompanying distortions it causes, shall cease. Foreign capital and direct competition should contribute to a deepening of the finance and capital markets, characterized by financial service innovation and a broadening of the client base. The legal framework of the financial sector will provide a foundation for this deepening process, as well as appropriate regulatory mechanisms that conform to international standards of safety and soundness. The institutional structure of the central bank and the banking and securities market regulator will provide the necessary autonomy and professional leadership to ensure macroeconomic and regulatory stability in the emerging sector. And the regulatory and supervision regime will maintain a level of discipline in the Nicaraguan market that conforms to international standards of safety and soundness.

This medium term vision of the sector is reflected in the three principal areas of reform proposed in the program: (1) liquidation or privatization of the state banks, (2) modernization of the legal and regulatory structure of the financial system, and (3) modernization of the institutional and normative framework for prudential regulation and supervision. Specific conditions are presented in the Policy Matrix of Annex I.

RELATIONSHIP OF PROJECT IN BANK'S COUNTRY AND SECTOR STRATEGY

The proposed operation is consistent with the Bank's strategy for development of the private sector as the basis for sustainable economic growth. The program provides continuity to the comprehensive program of sectoral loans, global loan and technical cooperation operations financed by the Bank since 1991 as parts of a systematic program of support to the development of the legal and regulatory framework of the financial system, management of the deterioration of the state banks, and expansion of financial services through the growth of the private banks.

ENVIRONMENTAL/ SOCIAL REVIEW:

The Environmental Management Committee approved the operation with no specific recommendations. The operation is not expected to have significant negative social or environmental impact.

BENEFITS:

Successful completion of the program should produce two principal benefits for the country. First, the fast disbursing resources will provide external financing in support of the IMF ESAF program, which is expected to provide macroeconomic stability. This

benefit has far reaching and immediate positive effects for all sectors. Successful completion of the state bank reform program will also eliminate the reoccurring costs associated with the state banks, thereby facilitating a more rational allocation of budget resources. Secondly, the financial sector reform will also establish the legal and regulatory framework required for the development of safe and efficient financial markets, a prerequisite for sustained economic growth.

RISKS:

The success of the proposed sectoral reforms is subject to maintenance of stability in an extremely delicate macroeconomic environment. Given the severity of the imbalances in Nicaragua's internal accounts, failure to meet the ESAF targets for expenditure reductions, tax revenue increases, tariff adjustments in the public enterprises, or disbursement schedules of future loans and grants will likely result in an abrupt expansion of domestic credit , requiring emergency measures that will be politically difficult to implement. The ESAF agreement relies on significant flows of external financing from policy-based loans and grants in 1998 to cover existing deficits, and assumes that the necessary reforms will be enacted in time to drastically improve fiscal performance in the latter part of the three-year program. In this respect, the ESAF program assumptions are ambitious, and the Government will have to accelerate the current pace of the reform program in order to meet the programmed targets.

The proposed program is the result of an intensive effort to define critical financial sector policy reforms within a time frame consistent with the ESAF's proposed schedule for disbursement of external resources from bilateral and multi-lateral donors. The specific objectives of the individual reforms are defined by concrete actions that are achievable, and represent definitive completion of the respective initiatives. In addition, the President and his economic cabinet have made clear declarations regarding their intentions to carry out the reform program as presented. The program is subject to the risk that the Government will not be able to generate the momentum required to execute the reforms, as demonstrated by the limited progress achieved during the preparation of the program (the implications for the specific initiatives are detailed in Chapter IV). However, disbursement of program resources have been backloaded to mitigate

the risk.

SPECIAL CONTRACTUAL CONDITIONS:	Disbursement of program resources will be subject to the conditions presented in the Policy Matrix in Annex I.
POVERTY-TARGETING AND SOCIAL SECTOR CLASSIFICATION	The proposed operation is a financial sector loan and does not qualify as a poverty-targeted operation.
EXCEPTIONS TO BANK POLICY:	None.
PROCUREMENT:	The Bank's new simplified procedures for sectoral loans shall apply in this case, eliminating the requirement for international bidding as stipulated in the old procedures. Funds shall be disbursed upon request by the borrower and presentation of evidence of compliance with all contractual conditions. Loan resources shall be deposited in segregated accounts. The Bank will require the borrower to maintain appropriate records of funds disbursed from the loan, and reserves the right to require the borrower to furnish an audited report of disbursed funds.

I. BACKGROUND

1.1 The Government of Nicaragua (GON) has requested the Bank's support for a macroeconomic stabilization program anchored in an Enhanced Structural Adjustment Facility (ESAF) agreement with the International Monetary Fund (IMF) approved in March 1998. The GON endeavors to stabilize the currently fragile macroeconomic situation through an aggressive reduction of current fiscal expenditures, a corresponding accumulation of international reserves, and a program of structural reforms designed to eliminate sources of persistent fiscal and monetary imbalances and create a legal and regulatory framework for the development of private sector-led economic growth.

1.2 The proposed operation is designed to support the structural reform program of the financial sector. The program provides continuity to the comprehensive program of sectoral loans, global loan and technical cooperation operations financed by the Bank since 1991 as parts of a systematic program of support to the development of the legal and regulatory framework of the financial system, management of the deterioration of the state banks, and expansion of financial services through the growth of the private banks.

A. The Macroeconomic situation

1.3 The Nicaraguan economy achieved positive growth of 3.3% in 1994 for the first time in a decade, and has increased steadily to 5% by 1997. Inflation was reduced to single digits in 1997. Nevertheless, Nicaragua remains one of the world's most highly indebted countries, with an outstanding debt stock of 280% of GDP at the end of 1997 (reduced from 540% of GDP in 1995 through reduction agreements), and debt payments equal to 16% of GDP. The economy is still characterized by profound structural imbalances in the internal and external accounts, which impede the overall development of the economy.

1.4 The table below provides a summary of key economic indicators that illustrate the principal sources of macroeconomic imbalances.

				projections		
	1995	1996	1997	1998	1999	2000
Combined Public Sector Balance (before grants)	(12.4)	(15.7)	(9.7)	(9.0)	(5.1)	(3.7)
[Of which, Central Bank operating losses]	0.1	(0.2)	(0.8)	(2.2)	(1.3)	(0.6)
Grants	6.1	8.6	5.1	5.1	4.6	5.0
Financing	6.3	7.1	4.6	3.9	.05	(1.3)
external	4.3	6.7	2.8	11.0	3.5	3.4
domestic	2.0	.04	1.9	(7.1)	(3.0)	(4.7)
[Of which, Central Bank]	3.8	1.2	6.5	(6.3)	(2.6)	(3.9)
Net International Reserves (in US$ millions)	(64)	(66)	(8.2)	95.4	150	206.6
Adjusted International Reserves (months of imports)	1.6	1.4	0.2	1.8	2.4	3.0

1.5 The Combined Public Sector (CPS) deficit reflects the overall effect of persistent problems that continue to undermine fiscal performance. The first annual arrangement of the June 1994 three-year ESAF agreement expired without a mid-term review due to deterioration of fiscal performance, the state banks, and poor performance of the state-owned enterprises, particularly the water company (INAA), the power company (ENEL) and the social security institution (INSS). Expenditure overruns during the election year of 1996 contributed to the abrupt increase in the CPS deficit over the previous year. Global performance improved in 1997, mainly through increases in fiscal revenues and sharp reductions in capital investment. CPS consumption in 1997 was still 23% of Gross Domestic Product (GDP), a modest reduction from 24.7% in 1996 and roughly the same as 1995.

1.6 It is important to note that poor fiscal performance and poor performance of the public enterprises has at least two effects that undermine the objectives of the overall macroeconomic program. First, social sector spending and capital outlays tend to be crowded out. Social expenditure has declined steadily from 12.3% of gross domestic product (GDP) in 1995 to 10.3% in 1997. Second, the CPS deficit increases the county's dependence on internal financing and external resources, generating additional interest expenses, crowding out private investment, and exacerbating the volatility of the monetary program.

1.7 The flow and composition of financing sources illustrates the impact of Nicaragua's dependence on grants and external financing to cover the persistent CPS deficit. A sharp decline in net external financing during 1997 provoked an immediate increase of domestic credit to the public sector and consequent pressure on international reserves. In response, the Central Bank of Nicaragua (BCN) began using CENIs aggressively as a vehicle for sterilizing the effect of public sector financing. Gross emission of CENIs was equal to 18% of GDP in 1997, contributing to operating losses of the BCN (compounding in turn the CPS deficit) equal to almost 1% of GDP. Even with the abrupt emission of CENIs, however, net international reserves remained negative and Adjusted Gross Reserves fell to a week of imports.

1.8 Finally, it is important to single out the effect of the accumulated losses of the Banco Nacional de Desarrollo (BANADES) that materialized in 1997. First, the sequence of debt forgiveness programs offered to BANADES debtors during 1997 virtually eliminated BANADES payments to the BCN, and the shortfall equal to approximately 1.5% of GDP seriously weakened the BCN's overall credit position with the public sector. In addition, the BCN advanced approximately US$65 million to liquidate the deposits of BANADES, which was reflected in the extraordinary US$340 million CENIs emission of 1997. The BCN has programmed a US$62 million

reduction in the stock of CENIs for 1998, which could be financed through recovery of the approximately US$250 million in state bank assets awarded to the BCN in compensation for the advances. However, political interference has seriously undermined recuperation efforts, leaving the BCN no other option but to borrow externally to reduce the CENI stock.

1.9 The 1998-2000 IMF ESAF program builds on the progress achieved during 1997. The Government completed the first semester of the program within the general parameters of the ESAF program, due in large part to robust fiscal revenues. However, revenue performance of the public enterprises continues to lag, and targets for domestic financing and net international reserves were not met due to delays in anticipated disbursements of external financing. The dramatic increase programmed for external financing in 1998 includes US$108.5 million of anticipated disbursements from the Bank (US$15 million from the RAP, US$28.5 million from the Public Enterprise Reform Program, and US$65 million from the proposed operation). As in 1997, the composition of domestic financing, the BCN CENIs program, and international reserve levels will deviate dramatically from the program if anticipated flows of external financing do not materialize.

1.10 In broader scope, the performance of the 1998-2000 stabilization program will depend to a significant degree on the results of the Bank's sectoral lending program. The stabilization program assumes reduction in current consumption expenditures and increases in tax revenues, as a result of the reorganization of the state and tax reform supported through the Programa de Reforma de Administración Pública (RAP-979/SF-NI). Improvements in performance of the public enterprises is related to tariff structure reform and eventual privatization, reflected in the conditions for final disbursement of the Public Enterprise Reform Program (933/SF-NI) and the objectives of the Programa Hybrido de Apoyo al Sector Electrico (NI-0069), currently in preparation. And the primary objective of the proposed operation is to eliminate the persistent costs associated with the state banks and GON credit programs.

1.11 It is important to note that the stabilization program projections assume full achievement of these reforms, and that expenditure overruns, failure to implement tariff adjustments in the public enterprise, or additional losses generated by the remaining state banks and credit funds will undermine the integrity of the program with or without external financing. Moreover, the resulting imbalances will be compounded if the GON borrows externally to compensate for reform failure, but fails to eliminate the sources of future losses.

B. <u>History of Financial Sector Reform</u>

1.12 The Bank has supported the transformation of the Nicaraguan

financial system through a series of operations beginning in 1991. 1/ The first phase of this transformation began in April of 1990 when the Chamorro government assumed power. In March of 1991, the GON implemented a plan with the assistance of the IMF that included the conversion of the currency to the Cordoba de Oro and an aggressive adjustment of relative prices, notably in the case of the interest rates of the financial sector. The financial system was comprised exclusively of state banks, which were consolidated from five to three. With the support of the Commerce and Finance Sector Loan, the GON began to build the basis for an open-market, regulated financial system. In April 1991, the National Assembly passed the law creating the Superintendencia de Bancos y Otras Instituciones Financieras (SBIF) and authorizing the regulation and licensing of private commercial banks. At that time, no prudential norms existed except those established in the 1963 Banking law, and the 8% capital adequacy ratio established in the 1978 modification of the law.

1.13 The second phase of the transformation extended approximately from mid-1992 through 1993, and was characterized by the expansion of both the private and public banks. By November of 1993, seven private commercial banks were operating and collectively held 45% of the total deposits of the banking system. With the assistance of the Credit Program for Non-conventional Financial Intermediation, the GON launched a strategy for deepening of the market by fomenting the links between the emerging banking sector and the various non-regulated entities that were providing credit to sectors of the population with no access to the regulated banks. In parallel, the GON, with the assistance of the Agricultural Sector Loan, pursued a strategy of transforming the largest of the state banks, BANADES, into a "public commercial bank." The organic law of BANADES was reformed, and the GON recapitalized the bank with a sum of US$240 million in order to remove the non-performing portfolio. In addition, the Financiera Nicaraguense de Inversiones (FNI) was transformed into a second-tier development bank chartered as an autonomous public entity. Immediately following the restructuring, BANADES began to expand with financing of the BCN. In March of 1992, 70% of BANADES' disbursements were financed with credit lines from the BCN, which grew at a real rate of 180% over the period.

1.14 The period of 1994 through 1997 was characterized by the deterioration of the state banks, BANADES in particular, and continuing expansion of the banking sector and capital market. By December of 1994, the SBIF emitted a resolution subjecting BANADES to limits on its operations and a special regime for reducing

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1/ The principal sectoral operations (and parallel Technical Cooperations) that have supported financial sector reform have been: El Program Sectorial de Ajuste Comercial y Financiero (864/SF-NI, September 1991), el Programa de Ajuste del Sector Agropequario (November 1992), and the Programa de Reforma de Administracion Publica (979/SF-NI, May 1996). In addition, the Credit Program for Non-conventional Financial Intermediation (789/OC-NI, November 1993) provided support to FNI, and 960/SF-NI financed the second program of institutional support to the BCN.

operating costs and rebuilding capital through earnings. The effort failed, however, and in January 1996, the GON was forced to remove around US$170 million of bad loans from BANADES and the rest of the state banks, resulting in the loss of about half of FNI's assets and imposing quasi-fiscal burdens on the Ministry of Finance and the BCN. During this period, the GON abandoned the strategy for transforming BANADES into a viable commercial bank, but was unwilling to privatize or liquidate the bank. With the assistance of the RAP program, the GON opted to contain the deterioration of the state banks by imposing limits on their growth and access to BCN or FNI credit lines. The private banking sector continued to expand, and was comprised of 10 banks and 2 finance companies by the end of 1997. From 1991 to 1997, the ratio of M3 to GDP grew from 18% to 52%, and the private banks held 87% of the total assets by the end of the period. In June 1996, the SBIF emitted a series of prudential norms which introduced basic standards for portfolio classification, risk concentration, and capital adequacy ratios. The stock exchange began functioning in 1994, based on a Presidential Decree of 1993, and gradually captured around 80% of the secondary market trading of public debt.

1.15 In early 1997, the Aleman government assumed power and inherited the legacy of the state banks. The GON initiated an aggressive plan for the liquidation of BANADES, which distributed the approximately US$100 million in losses accumulated since 1996 to the BCN and the Ministry of Finance. During 1997, the Aleman Government negotiated a second ESAF agreement with the IMF, which was approved in March 1998. Despite the GON's efforts to close BANADES, however, the success of the economic program requires immediate solutions to the residual problems of the other state banks. During the liquidation of BANADES, Banco Nicaraguense (BANIC) has exceeded the size of BANADES, and Banco de Credito Popular (BCP) has deteriorated to the point of insolvency. FNI continues to suffer from lack of political independence, high operating costs and a distorionary interest rate structure for its lending operations. Recovery of the US$250 million in assets separated from the state banks since 1996 has languished due to political ambivalence and intervention. And the private banking system is showing signs of stress related to undercapitalization and lack of adequate prudential norms in areas of increasing risk.

C. Recommendations of the Evaluation Office (EVO) regarding sectoral loans in Nicaragua

1.16 The EVO report on the Programa Sectorial de Comercio y Finanzas (PPR-14/97, October 1997) draws lessons from that loan which are relevant generally for future sectoral loans, and in particular for financial sector adjustment operations in Nicaragua. The report concludes that the Program failed to achieve its objectives in large part due to the lack of commitment and credibility of the Nicaraguan authorities regarding the reform of the state banks, the lack of precision of the disbursement conditions, and the Bank's

willingness to disburse the financing resources without requiring full compliance of the conditions. In light of these conclusions, the report observes that the option of closing all of the state banks, or at least consolidating them into a single bank, should have been considered during preparation of the program, despite the political difficulties associated with this course of action.

II. THE SECTORAL PROGRAM

A. Objective

2.1 The objective of the proposed reform program is to liquidate or privatize Nicaragua's state-owned banks, and foment the stability and efficiency of the private banking sector through the strengthening of the legal and regulatory framework of the financial system.

2.2 The program embodies a medium term vision for the Nicaraguan financial system based on the principles of a competitive and efficient market. Direct government intervention in the delivery of financial services, and the accompanying distortions it causes, shall cease. Foreign capital and direct competition should contribute to a deepening of the finance and capital markets, characterized by financial service innovation and a broadening of the client base. The legal framework of the financial sector will provide a foundation for this deepening process, as well as appropriate regulatory mechanisms that conform to international standards of safety and soundness. The institutional structure of the central bank and the banking and securities market regulator will provide the necessary autonomy and professional leadership to ensure macroeconomic and regulatory stability in the emerging sector. And the regulatory and supervision regime will maintain a level of discipline in the Nicaraguan market that conforms to international standards of safety and soundness.

2.3 This medium term vision of the sector is reflected in the three principal areas of reform proposed in the program: (1) liquidation or privatization of the state banks, (2) modernization of the legal and regulatory structure of the financial system, and (3) modernization of the institutional and normative framework for prudential regulation and supervision.

B. Relationship to the Programa de Reforma de Administración Publica

2.4 The proposed operation has been structured in conjunction with a reformulation of the second tranche of the RAP in order to achieve more ambitious reform objectives within a time line consistent with the parameters of the GON's economic program. The proposed scenario employs the RAP as a vehicle for compensating the GON immediately for the extraordinary expenses incurred in closing BANADES, and the proposed NI-0104 operation as a more robust reform program with longer term objectives.

2.5 Previous reform efforts to bring the state banks into compliance with the legal and prudential framework of the financial system have failed due to persistent political interference and intractable weaknesses in the state banks' corporate culture and operating systems. The current Government initiated the

liquidation of BANADES as a condition prior to the first disbursement of the RAP, paving the way for a permanent solution that will surpass the original objectives of the RAP program. Reform efforts in the other state banks have languished, however. And the measures now required to achieve a permanent solution for the rest of the state banks, as well as the financing needs of the GON, exceed the original objectives, resources and time frame of the RAP.

2.6 The proposed operation is structured to achieve reform objectives that exceed those of the RAP by aspiring to either liquidate or sell all of the state-owned commercial banks to private sector investors and give full GON support to the development of a private financial services sector. In the proposed scenario, the financial sector component of the RAP has been reformulated to disburse the second tranche upon legal dissolution of BANADES. The Administration has requested waivers for specific conditions regarding BCP, BANIC, FNI, reform of prudential norms, and the recovery of state bank assets contained in the second tranche of the RAP, and proposes a reformulation of these conditionsin the proposed NI-0104 operation.

C. Coordination with the World Bank Financial Sector Adjustment Credit

2.7 The policy matrix of the proposed program has been structured to complement the actions contemplated in the World Bank's Financial Sector Adjustment Credit. The specific objectives of the individual reforms are the same in both operation; the World Bank program is limited to intermediate steps in the reform process, while the proposed conditions of the Bank's program require completion of the reforms prior to disbursement of program resources.

D. The Macroeconomic Program

2.8 The success of the GON's stabilization program is measured in the performance targets structured in the IMF ESAF program. Thus the Bank will accept the performance indicators of the ESAF program as a framework for quarterly monitoring of the macroeconomic program.

E. The State Banks

1. Banco Nacional de Desarrollo (BANADES) and the Fondo de Crédito Rural

a. Current Situation

2.9 In May 1997, the current Government took decisive steps to arrest the accelerating deterioration of BANADES, at the time the largest of the state banks. The SBIF emitted a resolution subjecting BANADES to a special regime which required revocation of the bank's license if not in full compliance with prudential norms by May

1998. A new management team was installed with the mandate to liquidate the bank's assets and liabilities by the end of the special regime. By February of 1998, the management team had succeeded in reducing the portfolio from C$719 million to C$34 million (US$73.4 to US$3.4 million), liquidating deposits of C$961, and selling all but six of the branch offices. In this process, BANADES sold over C$170 million of loans to the private banks, and transferred C$676 million in deposits. These actions were sufficient to declare the RAP eligible for first disbursement in December 1997.

2.10 In March 1998, the SBIF emitted a resolution revoking BANADES' banking license. And in June 1998, the National Assembly published the law that legally dissolved BANADES. However, due to a constitutional mandate to maintain the existence of the state banks, the same law constituted the Rural Credit Fund (Fondo de Crédito Rural) as a substitute for BANADES. The law dictates that the Fondo will to be constituted as a second-tier facility, capitalized and funded by GON budget resources and loans from bi-lateral and multi-lateral development agencies, and mandated to channel lending resources via non-regulated entities such as foundations and credit unions who provide credit to small businesses in rural areas. The Fondo will be administrated by FNI under a trust agreement.

2.11 The proposed institutional structure and mandate of the Fondo are incompatible with the profile and objectives of a sustainable second-tier finance facility, and with the objectives of the program. Lessons drawn from similar initiatives in Nicaragua and the region suggest that the Fondo will likely incur significant costs in the form of operating deficits and loan losses. As currently structured, these losses are likely to undermine the performance of FNI and generate both fiscal and quasi-fiscal costs that will undermine the performance of the economic program, much like BANADES.

2.12 In addition, the distribution of public funds across weak and unregulated organizations is also likely to exacerbate the very same moral hazard problem among rural borrowers that the GON aspires to correct by closing the state banks. This threatens to undermine the recent aggressive expansion of the private banking system in the microenterprise and rural sectors, which are already showing some signs of stress from excessive supply of credit services from undisciplined lenders. Finally, the proposed mandate and activities of the Fondo would overlap with and undermine existing policy instruments and programs with similar objectives. In particular, efforts to streamline the Programa Nacional de Desarrollo Rural (PNDR), financed by the Bank, would be handicapped by the creation of the proposed Fondo.

b. <u>Proposed actions</u>

2.13 Given the significant problems associated with government credit programs and banks in the recent past, the GON has indicated that it will abstain from passing resources to state credit programs, facilities or institutions, with the exception of FNI's lending facilities to private commercial banks, for the duration of the program. The GON acknowledges that this prohibition also applies to the Fondo, regardless of the legal authority established in the previously mentioned law. This condition will be included as a general macroeconomic condition applied to all tranche disbursements.

2. Banco Nicaragüense de Industria y Comercio (BANIC)

a. Current situation

2.14 BANIC was formally a private bank that was nationalized in 1979. Both in 1992 and in 1996, the GON removed non-performing loans from BANIC's portfolio in order to maintain the solvency of the bank. The 1996 transaction was conceived as part of a program of actions, reflected in the conditions of the RAP program, designed to stabilize BANIC, limit its growth and sell controlling interest in the bank to private shareholders. Despite the strict limits on the total loan portfolio, however, BANIC has grown rapidly, investing aggressively in physical infrastructure, diversifying its lending through a broad range of new products, contracting foreign lines of credit for export financing and launching a credit card program. As a result, BANIC's loan portfolio at the end of May 1998 was C$1,055 million, well above the C$600 limit established in the RAP conditions and even larger than BANADES at the time of its management change in May 1997. In addition, BANIC's operating costs have risen to uncompetitive levels, due in large part to a bloated payroll. The SBIF reports that BANIC's balance sheet provides an accurate assessment of the bank's assets. Nevertheless, as of March 1998, BANIC's capital adequacy ratio was just under the 8% required by the SBIF, and BANIC has not yet presented a strategy for gradually raising this ratio to the 10% that will be required by mid 2000.

2.15 The Aleman government has affirmed the plans for sale of 51% of BANIC's shares, and in January 1998, BANIC contracted the services of the International Finance Corporation (IFC) to assist in the public offering. In July 1998, the National Assembly passed a law authorizing the sale of BANIC and transferring responsibility to the GON for settling all existing legal claims brought against BANIC by previous owners and creditors. However, the law also imposes a restriction on the sales price of BANIC shares that is likely to discourage international investors. The results of an independent portfolio classification will be made public in September, providing investors with verified information regarding the actual financial position of the bank. And the public offering is scheduled for the same month.

b. Proposed actions

2.16 The first disbursement of the program will be conditioned upon execution of the public offering of BANIC shares, at a share price that reflects the results of the independent portfolio assessment. The second tranche will be conditioned upon completion of the sale of a minimum of 51% of BANIC's shares to private sector investors.

3. Banco de Credito Popular (BCP)

a. Current Situation

2.17 BCP is the smallest of the state owned banks, and was also recapitalize during the 1992 and 1996 portfolio transfers cited previously. After removal of non-performing loans from BCP's portfolio in 1996, the SBIF reports indicated that the bank was solvent and in compliance with prudential norms. Given the priority assigned to the BANADES and BANIC reforms, the RAP program merely imposed limits on BCP's portfolio of C$150 million and required compliance with prudential norms and an action plan previously negotiated with the Bank.

2.18 BCP's portfolio grew beyond the limit established in the RAP program, and in November 1997 the SBIF reported that BCP was insolvent due to significant deterioration of its portfolio. In lieu of compliance with the original RAP conditions, the GON expressed its intentions to freeze the operations of the bank. The SBIF subsequently emitted Resolution LXIII-1-98 subjecting BCP to a special regime which limits the portfolio of BCP to the equivalent of US$19 million and anticipates revocation of the bank's license if not in full compliance with prudential norms by December 1998.

2.19 The SBIF special regime explicitly exonerates BCP from compliance with prudential norms until the expiration of the resolution in December 1998. Moreover, during the first half of 1998, the SBIF has emitted periodic reports indicating that BCP has not complied with the conditions imposed by the special regime. Consequently, the GON replaced the management of BCP in August 1998 with a management team recommended by the BCN with a mandate to comply with the SBIF special regime and prepare BCP for sale to the private sector. The same management team is also preparing a draft law for approval by the National Assembly that authorizes the reconstitution of BCP as a shareholder corporation, and subsequent sale of shares to the private sector.

b. Proposed actions

2.20 The GON has expressed its intention to sell controlling interests of BCP to the private sector. In order to allow sufficient time for the proposed transaction, disbursement of the second tranche of the operation will be conditioned upon execution of the public offering of BCP shares; the third tranche on completion of the

sale. However, if it is not possible to bring BCP to the point of sale by the expiration of the special regime, the GON has indicated that it will liquidate BCP, as anticipated in the special regime, according to procedures established in the general banking law.

4. <u>Financiera Nicaragüense de Inversiones (FNI)</u>

a. <u>Current situation</u>

2.21 FNI was reconstituted as a legally autonomous, public, second-tier development finance facility in 1992, with a Board of Directors presided by the President of the BCN. The Bank has supported a substantial institutional strengthening effort during the execution of the Micro Global Program (789/SF-NI), and provided addition support during execution of the RAP Program. However, FNI's performance has suffered since its creation from the lack of institutional autonomy and from credit policies and operating procedures that have not always been compatible with the institution's role as an efficient second-tier bank. The GON created FNI with the promise to emit and pay interest on the bonds registered in FNI's equity capital balance. FNI has continued to accrue the interest due on the bonds, but has never received cash payment. The bonds were finally issued in late 1997 as part of conditions prior to disbursement of the RAP program, with the promise to include interest payments in future budgets. However principal and interest payments on the bonds were subsequently omitted from the national budget, perpetuating FNI's weak capital and revenue position. FNI's investment policies have also suffered from periodic sterilization of FNI cash reserves in the BCN accounts in the interest of the global monetary program. Internally, FNI has assimilated a broad range of lines of credit, each with distinct credit guidelines and lending conditions, and operating costs have been high by regional standards.

2.22 During 1996, FNI lost approximately half of its assets due to the sanitization of non-performing loans from the state banks. Despite little progress in unifying its credit guidelines or streamlining operations, FNI was able to register an accounting surplus by the end of 1997, due to high margins earned on concessional funding sources and accrued interest on the GON bonds. The GON reconstitute FNI as a shareholder corporation in August of 1998, as a strategy for developing FNI through private sector participation in the management and capitalization of the institution. However, the law passed by the National Assembly in April 1998 imposed parameters for the constitution of FNI, S.A that will likely discourage any private sector investors. The new law maintains BCN control of the Board of Directors, prohibits sale of Government shares without additional legislation, and establishes the capital of FNI at twice the current level. Moreover, the GON has indicated that it intends to continue to use FNI to channel concessional resources at subsided interest rates, and to administrate the Fondo de Credito Rural under a trustee agreement, despite the prohibition in FNI's

charter against lending funds to institutions not regulated by the SBIF.

b. Proposed actions

2.23 During the course of program preparation, the GON has agreed to a course of action designed to increase the efficiency of FNI and define its role in the Nicaraguan banking system. Prior to disbursement of the first tranche, the GON will present evidence that 1) FNI, S.A has been established in conditions that permit private sector participation, 2) the GON has canceled all capitalization bonds with payment in cash, or transfer of portfolio assets, 3) lending rates on FNI loans not subject to contractual limitations imposed by the funding source will be equal to or greater than the weighted average cost of funds in the banking system, adjusted for the effect of the legal reserve requirements, and 4) FNI will require borrowing banks to be in compliance with SBIF norms and bi-lateral compliance agreements.

2.24 In addition, FNI will agree with the Bank on a plan for gradual reduction of operating costs to a level equal to 2% of FNI's gross portfolio. As long as the GoN maintains control of FNI, the disbursement of second and third tranches will be conditioned upon compliance with the indicators established in the first tranche, as well as satisfactory progress in the plan for reduction of operating costs. In the event that FNI is not able to achieve the levels of portfolio growth projected by the FNI administration, the GON will insure that FNI accelerates the reduction of operating costs.

5. Recovery of Assets Separated from the State Banks

a. Current situation

2.25 The separation of non-performing assets from the state banks in January 1996 established a point of departure for the reform programs of the individual state banks supported in the RAP. The RAP program also contemplated the creation of the Comision Liquidadora de Carteras y Cobranzas Bancarias de Nicaragua S.A. (COBANICSA) as an agency charged with liquidating the separated assets. COBANICSA's performance was extremely poor, however, due to the nature of its mandate, inadequate management and persistent government intervention in the recuperation process in favor of the borrowers. As a result, the GON agreed as conditions for disbursement of the RAP to (1) close COBANICSA by December 31, 1997, (2) create a Commission within the BCN with a more limited mandate of liquidating the assets through sale, placement in administration, or legal process, and (3) refrain from granting additional concessions to delinquent clients beyond the concessions granted in September 1997. The SBIF also emitted a resolution to the commercial banks imposing a mandatory 100% provisioning of any loan to a delinquent debtor of the state banks, in order to create

an incentive for borrowers to cooperate with recuperation efforts.

2.26 In January 1998, the BCN and Ministry of Finance established the Commission with the mandate as described. The Commission has proceeded to liquidate the assets via public auction, contracts with third party portfolio administrators, and judicial process. The BCN reports that C$407 million (US$38.4 million at current exchange rate) have been recovered during the period of May 20, 1996 to July 31, 1998.

b. Proposed actions

2.27 The disbursement of the first tranche of the proposed operation will be conditioned upon presentation of evidence of recuperation of the C$407 million reported by the BCN. In addition, the GON has agreed to abstain from granting any additional concessions to the borrowers during the recuperation process. Finally, disbursement of the third tranche will be conditioned upon presentation of an external audit, approved by the Contraloría General de la República, that certifies the final liquidation of the assets.

F. The Legal and Regulatory Framework of the Financial System

2.28 The legal framework of the Nicaraguan financial system needs to be improved in areas related to the institutional structure of the sector, regulation and supervision, and the delivery of more modern financial products.

1. Legal and institutional framework

a. Current situation

2.29 The BCN has been engaged in a process of internal reingineering as part of the national transition to an open market economy, and has made significant improvements at the operational level. The BCN functions as a hub of the institutional framework for Nicaragua's financial system. The BCN is legally autonomous from the Central Government, and the BCN President presides the Board of Directors of the state second-tier development bank, FNI, and is a member of the Board of the SBIF. However, the organic law of the BCN does not provide an adequate basis for politically autonomous and professional leadership of the institution. Specifically, the role, professional profile, and procedures for appointing the Board of Directors needs to be adapted to ensure autonomy, professional leadership and internal control of the BCN.

2.30 The SBIF was created in 1991 as legally autonomous institution governed by a Board of Directors dominated by representatives of the Central Government and the BCN. The SBIF currently regulates approximately 35 institutions, including banks, finance companies, insurance companies, the stock exchange, bonded warehouses and a variety of other institutions that take deposits from the public.

In general terms, the SBIF has developed the regulatory framework for the banking sector in line with the Basle Committee's standards. However, the pattern of modifications to the regulatory framework and discretional application during the supervision process point to the need to improve the governance structure of the SBIF as well.

2.31 The legal framework of the banking system has evolved through periodic modifications to the General Banking Law of 1963 that have expanded the range of financial institutions and services without providing adequate legal basis for all of the corresponding transactions, or for an adequate regulatory regime. The governance structure, minimum capital requirements and scope of activities of the different financial intermediaries governed by the banking law need to be organized within a coherent framework for the banking sector. In this context, the GON will consider the possibility of establishing a form of financial intermediary adaptable to specialized markets, such as the microenterprise and rural sectors. This will entail a revision of Law 244 that was passed in 1997, authorizing the SBIF to license non-profit foundations as financial intermediaries, without addressing the fundamental weaknesses associated with the legal constitution of such entities, or defining key aspects of the regulatory framework.

2.32 In broader scope, the commercial code needs to be strengthened in areas related to financial sector transactions, such as trust law, corporate organization, bankruptcy and secured transactions.

b. Proposed actions

2.33 The Central Bank, SBIF and the National Assembly recently formed a legal commission for the purpose of drafting revisions of the financial sector legal framework. The proposed program will provide technical support to the legal commission through the parallel technical cooperation (NI-0106). The GON has consolidated legal reform initiatives related to the financial sector in order to create a coherent and comprehensive legal framework for the sector. The legal commission, with the technical support of the IMF, will provide support to a broad range of institutional reform initiatives, involving modifications to the banking law, the organic laws of the BNC and the SBIF, as well as complementary modifications to the commercial code in the areas of trust law, corporation governance and bankruptcy, secured transactions, and the creation of a capital markets law. As a condition prior to disbursement of the second tranche, the Government will agree with the Bank regarding the principal reforms to be incorporated into the revised legal framework, based on the preparatory work of the Legal Commission, and the policy guidelines presented in the Policy Letter in Annex II. The Legal Commission will then complete the drafting of the BCN organic law, the SBIF organic law, and the General Banking Law. And the third tranche disbursement will require legal effectiveness of these laws.

2.34 The legal reform will give priority to definition of a governance structure for the Central Bank and SBIF that provides an adequate degree of political autonomy and professional leadership within an institutional structure appropriate for Nicaragua. The primary objective of the banking law, capital law and commercial code reforms will be to establish 1) coherent market structure and composition, 2) a legal basis for financial sector transactions and 3) a legal basis for market regulation, in accordance with international standards.

2. Capital markets

a. Current situation

2.35 Nicaragua has a functioning stock exchange, the Bolsa de Valores de Nicaragua (BVN), dealing exclusively in debt instruments. The volume of traded instruments is indicative of the incipient stage of development of the capital market. There is no specific capital markets law, nor a dedicated oversight agency charged with the sole responsibility of regulating the primary and secondary markets. The securities depository, Central Nicaragüense de Valores (CENIVAL) is reasonably efficient, but does not provide a guaranteed system for clearing and settling transactions through a delivery-versus-payment system, functions that are critical for acceptance by international investors. The liquidity of public debt instruments, which account for around 80% of all trading volume, is impaired by lack of standardization and immobilization in a central securities depository.

b. Proposed actions

2.36 The capital market law will be approved prior to disbursement of the third tranche, and will establish a comprehensive legal framework for (1) a regulatory and supervision regime for both self-regulated exchanges and over-the-counter transactions, (2) a clearance and settlements system that guarantees delivery versus payment according to internationally accepted standards, and (3) rationalization of public sector debt management. This part of the program will be supported as well by the MIF capital markets development operation (MIF-TC-97-04-17-4) currently under preparation, which provides support to the development of the institutional structure of the capital markets.

G. Prudential Regulation and supervision

1. Current situation

2.37 The RAP program supported the emission of prudential norms in 1996 that established a satisfactory basis for regulation of capital adequacy, risk concentration, portfolio classification and financial reporting. However, subsequent SBIF resolutions and changes to the banking law have undermined the effectiveness of

these aspects of the regulatory framework precisely in those areas where the banking sector is showing signs of stress. The 1996 resolution regarding capital adequacy established a transition period for compliance with a 10% ratio of first tier capital to risk-weighted assets by June of 2000. However, a 1997 SBIF resolution extended to 1999 the time allowed the banks for replacing short-term government development bonds (BOFOs) with acceptable forms of first or second tier capital. As a result, banks will have to make an abrupt transition to the 10% capital regime at the same time that they are applying more rigorous portfolio classification and provisioning standards and replacing existing second-tier capital with paid in contributions. The SBIF will now have to move decisively to establish a formal agreement with each of the banks for a graduated transition to the 10% standard, providing special attention to those banks whose financial performance is below the industry average.

2.38 During the period of preparation of the proposed operation, the SBIF has emitted a series of resolutions with the objective of strengthening prudential norms and establishing mechanisms for monitoring their gradual implementation. In January 1998, the SBIF emitted a norm limiting for the first time the global amount of loans to related parties to less than 50% of capital. In March 1998, the SBIF strengthened the regime for loan classification and provisioning. And in August 1998, the SBIF emitted a norm phasing out exceptions to risk concentration limits by 1999. Finally, the SBIF emitted a resolution requiring all of the banks to present by October 1998 a calendar by which they will raise their capital adequacy ratio to 10% by the year 2000, in full compliance with the recently modified norms.

2. Proposed actions

2.39 The proposed program is based primarily on the implementation of the recently strengthened norms and monitoring of the bi-lateral compliance agreements with the banks. The first tranche conditions have been fulfilled with the emission of the SBIF resolutions cited above. Disbursement of the second and third tranches will be conditioned upon on-going compliance of the normative regime, in particular supervision of the banks' compliance agreements. The SBIF will also emit a resolution defining prudential norms for FNI by the second tranche. As a condition of all of the tranches, the SBIF will provide evidence of enforcement of the norm imposing 100% reserve requirements on all loans to borrowers who are not in compliance with their loan agreements that originated with the state banks.

2.40 In addition to the reforms defined above, the regulatory framework needs to be upgraded in areas related to consolidated supervision of bank holding companies, consolidated reporting, and the authority of the SBIF to intervene in failing institutions. The parallel Technical Cooperation (TC) Loan will provide support to

SBIF efforts to improve procedures for data collection, analysis and information disclosure. Bank performance reporting systems will be adapted to provide information required to enforce the evolving legal and normative framework. Off-sight analysis techniques will be upgraded. And information dissemination policies and the SBIF Bulletin format will be upgraded to provide more rigorous performance indicators to the public. The SBIF will focus, in particular, on development of the credit bureau service, and will strictly enforce the resolution regarding 100% provisioning of all loans to creditors with delinquent debts originated from the state banks.

H. Parallel Technical Assistance Program

2.41 The program will include a parallel TC Loan to provide technical support to the implementation of the policy reforms. The TC program will include subcomponents for (1) support to the Legal Commission for drafting of the legal documents, (2) support to the SBIF in the areas of information systems and off-site inspection analysis.

III. FINANCING AND EXECUTION

A. Financing

3.1 The total amount of the Program will be US$65.850 million, consisting of US$65 million of fast-disbursing resources to be disbursed according to the normal conditions of the Fund for Special Operations (FSO), US$765,000 for a Technical Cooperation Loan (NI-0106) to be disbursed from the FSO, and US$85,000 in local counterpart funding.

3.2 The terms and conditions of the loan are provided below:

Terms and Conditions	**Detail**
Amount	Total: US$65,850,000 - fast-disbursing funds: US$65,000,000 - technical cooperation: US$ 765,000 - counterpart funding: US$ 85,000
Grace period	10 years
Amortization period	40 years
Disbursement period	24 months for fast-disbursing funds; 36 months for technical cooperation financing
Interest rate	1% per annum for the first 10 years; 2% per annum until final repayment of the loan
Inspection and Supervision	1%
Credit fee	0.5% per annum of the undisbursed balance

B. Borrower and Executing Agency

3.3 The Borrower of the fast disbursing resources will be the Republic of Nicaragua; the borrower of the TC Loan will be the Banco Central de Nicaragua.

3.4 Program execution will be coordinated by the BCN, which will be responsible for presentation of all evidence of compliance with tranche conditions. The institutions responsible for execution of the individual reforms will carry out the respective activities: BANIC will supervise the process of sale of its shares; the recently installed management team of BCP will will be responsible for the public offering of BCP shares, while the SBIF is ultimately responsible for the intervention and management of BCP upon termination of the special regime; the BCN is responsible for the liquidation of assets separated from the state banks; FNI will be responsible for development and execution of its institutional development plans; the Legal Commission of the BCN will be responsible for elaboration of the draft laws related to the financial sector; the SBIF will be responsible for emission of prudential norms and all matters related to the SBIF institutional development; and the National Assembly is ultimately empowered with

the promulgation of the any of the legal changes required in the reform program.

C. Disbursement schedule

3.5 The proposed operation will be disbursed in three consecutive tranches, subject to compliance with the conditions presented below, and in the policy matrix in Annex I. The first tranche disbursement will be US$15 million, the second tranche US$25 million, and the third tranche US$25 million.

D. Disbursement conditions

3.6 All tranche disbursements will be subject to compliance with the following conditions:

a. *maintenance of a macroeconomic framework consistent with program objectives;* and

b. *The GON has not passed state resources, or funds acquired by loans, to credit programs, facilities or institutions, with the exceptions of 1) funds passed to FNI for the purpose of on-lending to private banks or finance companies subject to the General Banking Law, and 2) funds required for the privatization or liquidation of state financial institutions.*

E. First tranche disbursement conditions

3.7 The disbursement of the first tranche amount will be subject to presentation of evidence of [that]: 2/

a. *legal enactment of legislation authorizing sale of BANIC shares and charging the State with responsibility for settling claims brought against BANIC by previous owners or creditors;*

b. the public offering for sale of at least 51% of BANIC shares at a realistically acceptable book value;

c. *BCP has been placed under the control of a management team, proposed by the BCN, with the mandate to (a) comply with the special supervision regime emitted by the SBIF in January 1998, and (b) prepare BCP for sale of controlling interests to the private sector;*

d. compliance with the conditions defined in the Special Supervision Regime for BCP by the SBIF in January 1998;

2/ First tranche conditions presented in italics have been complied.

e. *the constitution of FNI, S.A. in conditions that permit the participation of the private sector in the management and capitalization of this corporation;*

f. *as long as the GON maintains majority control of FNI, the eligibility standards for FNI, S.A. borrowers require full compliance with prudential norms and the bi-lateral compliance agreements between the banks and the SBIF; and*

g. the interest rate charged on FNI loans not subject to contractual limitations imposed by the funding agency is equal to or greater than the weighted average cost of funds in the Nicaraguan banking system, adjusted for the effect of legal reserve requirements;

h. the GON has liquidated the capitalization bonds of FNI, either with cash payment or with assignment of loan portfolio;

i. the GON has agreed with the Bank to a plan for the reduction of FNI operating costs to a level less than or equal to 2% of its gross loan portfolio;

j. *no addition concessions have been granted to state bank or Liquidation Commission debtors beyond concessions granted prior to May 1998;*

k. *a minimum of C$400 million has been recovered from the assets separated from the state banks since January 1, 1996.*

l. *implementation of SBIF resolution imposing 100% provisioning requirement for delinquent debtors of the state banks under management of the Liquidation Commission;*

m. *implementation of SBIF resolution on asset classification and provisioning;*

n. *implementation of SBIF resolution eliminating exceptions to risk concentration limits and imposing a 100% provisioning requirement on loans that exceed the established limits;*

o. *implementation of SBIF resolution requiring immediate formalization of agreements with individual financial institutions establishing calendar for compliance with (1) 10% capital: asset requirement, excluding Bonos de Fomento with maturities of less than five years, and (2) all other prudential norms, without exceptions, by December 2000.*

F. <u>Second tranche disbursement conditions</u>

3.8 The disbursement of the second tranche amount will be subject to presentation of evidence of [that]:

a. sale of controlling interests of BANIC (51% of shares) to private investors;

b. the public offering of controlling shares of BCP to the private sector, or, initiation of liquidation procedures according to the General Banking Law.

c. compliance with the conditions defined in the Special Supervision Regime for BCP by the SBIF in January 1998;

d. as long as the GON maintains majority control of FNI, compliance with the performance indicators defined in the FNI plan for reduction of operating costs; and

e. the eligibility standards for FNI, S.A. borrowers require full compliance with prudential norms and the bi-lateral compliance agreements between the banks and the SBIF; and

f. the interest rate charged on FNI loans not subject to contractual limitations imposed by the funding agency is equal to or greater than the weighted average cost of funds in the Nicaraguan banking system, adjusted for the effect of legal reserve requirements;

g. no addition concessions have been granted to state bank or Liquidation Commission debtors beyond concessions granted prior to May 1998;

h. on-going implementation of first tranche conditions related to SBIF resolutions;

i. implementation of SBIF resolution establishing prudential norms for supervision of FNI;

j. the GON has agreed with the Bank regarding the principal reforms to be implemented through modifications to the General Banking Law, the Organic Law of the BCN and the Organic Law of the SBIF.

G. Third tranche disbursement conditions

3.9 The disbursement of the third tranche amount will be subject to presentation of evidence of [that]:

a. sale of controlling interest of BCP to the private sector, or, liquidation of BCP;

b. as long as the GON maintains majority control of FNI, compliance with the performance indicators defined in the FNI plan for reduction of operating costs; and,

c. the eligibility standards for FNI, S.A. borrowers require full compliance with prudential norms and the bi-lateral compliance agreements between the banks and the SBIF; and,

d. the interest rate charged on FNI loans not subject to contractual limitations imposed by the funding agency is equal to or greater than the weighted average cost of funds in the Nicaraguan banking system, adjusted for the effect of legal reserve requirements;

e. no addition concessions have been granted to state bank or Liquidation Commission debtors beyond concessions granted prior to May 1998;

f. an external auditing firm has emitted a report, with the concurrence of the Contraloría General de la República, certifying the liquidation, or placement in administration, of the assets separated from the state banks;

g. evidence of enactment of reforms, consistent with the principles presented in the Policy Letter, of (1) the general banking law, (2) the SBIF organic law, (3) the BCN organic law, and, (4) the legal framework for the capital markets.

H. Disbursement procedures and conditions

3.10 Fast-disbursing resources from the Program will be used to finance the total cost in hard currency of eligible imports from the Bank's member countries. The Bank's new simplified procedures for sectoral loans shall apply in this case, eliminating the requirement for international bidding as stipulated in the old procedures. Funds shall be disbursed upon request by the borrower and presentation of evidence of compliance with all contractual conditions.

3.11 Ministry of Finance, in coordination with the BCN, is responsible for maintenance of accounting records and preparation and presentation of disbursement requests. The borrower will submit a simple application to the Bank for disbursement of the loan resources for the borrower's use. Loan resources shall be deposited in segregated accounts. The Bank will require the borrower to maintain appropriate records of funds disbursed from the loan, and reserves the right to require the borrower to furnish an audited report of disbursed funds.

I. Inspection and Supervision

3.12 The Bank shall establish such inspection procedures as it deems necessary to ensure satisfactory execution of the program. The borrower shall cooperate fully in providing all assistance and information required for this purpose.

J. Technical Cooperation Loan

3.13 The Technical Cooperation Loan will be disbursed according to the conditions presented in the Plan of Operations in Annex III.

IV. BENEFITS, VIABILITY AND RISKS

A. Benefits

4.1 Successful completion of the program should produce two principal benefits for the country. First, the fast disbursing resources will provide external financing in support of the IMF ESAF program, which is expected to provide macroeconomic stability. This benefit has far reaching and immediate positive effects for all sectors. Successful completion of the state bank reform program will also eliminate the reoccurring costs associated with the state banks, thereby facilitating a more rational allocation of budget resources. Secondly, the financial sector reform will also establish the legal and regulatory framework required for the development of safe and efficient financial markets, a prerequisite for sustained economic growth.

B. Viability and Risks

4.2 The success of the proposed sectoral reforms is subject to maintenance of stability in an extremely delicate macroeconomic environment. Given the severity of the imbalances in Nicaragua's internal accounts, failure to meet the ESAF targets for expenditure reductions, tax revenue increases, tariff adjustments in the public enterprises, or disbursement schedules of future loans and grants will likely result in an abrupt expansion of domestic credit, requiring emergency measures that will be politically difficult to implement. The ESAF agreement relies on significant flows of external financing from policy-based loans and grants in 1998 to cover existing deficits, and assumes that the necessary reforms will be enacted in time to drastically improve fiscal performance in the latter part of the three-year program. In this respect, the ESAF program assumptions are ambitious, and the GON will have to accelerate the current pace of the reform program in order to meet the programmed targets.

4.3 The proposed program is the result of an intensive effort to define critical financial sector policy reforms within a time frame consistent with the ESAF's proposed schedule for disbursement of external resources from bilateral and multi-lateral donors. The specific objectives of the individual reforms are defined by concrete actions that are achievable, and represent definitive completion of the respective initiatives. However, there is a risk that the GON will not be able to generate the momentum required to execute the reforms, as demonstrated by the limited progress achieved during the preparation of the program. The implications for the specific initiatives are listed below.

4.4 The proposed liquidation or sale of the state banks is subject to debated constitutional interpretation, opposition in the National Assembly, and political ambivalence regarding the role of the state in providing credit to strategic economic sectors. Moreover, under

prevailing conditions, the offer of BANIC shares is likely to be met with extreme caution from the private sector; and the GON has not yet established a legal basis for the sale or liquidation of BCP. BCP is known to be insolvent, and the financial condition of BANIC is yet to be confirmed. Under these conditions, failure to carry out the reforms will likely result in future costs associated with the persistent deterioration of the state banks, undermining the macroeconomic program and prolonging distortions in the banking system.

4.5 Persistent Government intervention in favor of state bank borrowers has undermined recuperation of the assets separated from the state banks and contributed to a steady deterioration of the state bank portfolios. Failure to collect the assets currently managed by the Liquidation Commission will likely exacerbate future losses of the state banks.

4.6 The SBIF has been reticent to implement and enforce prudential norms in key areas where the banking system is showing signs of increasing stress. The reform program contemplates specific reforms to correct existing weaknesses and enable the banking system to weather the exit of the state banks. Failure to implement the proposed reforms would have unfavorable consequences for the development of the banking system in the medium term.

4.7 Finally, under current conditions, development of the financial and capital markets is hampered by the lack of political autonomy and professional governance of the SBIF and the Central Bank. Changes to the governance structure of these institutions will require political commitment to reassess their basic functions, and change their organic laws.

4.8 The President of the Republic and his economic cabinet have made clear declarations of their intentions to carry out the reform program as presented. In order to mitigate the risk that the GON will not be able to generate the political momentum to carry out the program, the disbursement of the major portion of program resources has been programmed for the final two tranches.

C. Environmental and Social Considerations

4.9 The Committee on Environmental and Social Impact (CESI) approved the Loan Document by short procedure on May 29, 1998, with no specific recommendations. The Project Team recommends that the proposed operation has no significant negative social or environmental impact. During the liquidation of BANADES, net credit to the rural sector has increased steadily as private banks have expanded aggressively into the rural areas, acquiring the branch offices and clients of BANADES. In recent history, BANADES had abandoned its alleged focus on the small producers and its portfolio was invested in large loans. During the liquidation, BANADES' clients were offered numerous opportunities to restructure their debt obligations. Given the nature of the final liquidation

process, it is likely that remaining small loans will be written off, or settled for a fraction of their face value.

Proposed Matrix for Financial Sector Reform Program III (NI-0104)

REFORM	FIRST TRANCHE CONDITIONS[1]	SECOND TRANCHE CONDITIONS	THIRD TRANCHI CONDITIONS
) MIC WORK	- *maintenance of a macroeconomic framework consistent with program objectives;* - *The GON has not passed state resources, or funds acquired by loans, to credit programs, facilities or institutions, with the exce 1) funds passed to FNI for the purpose of on-lending to private banks or finance companies subject to the General Banking La funds required for the privatization or liquidation of state financial institutions.*		
	- *legal enactment of legislation authorizing sale of BANIC shares and charging the State with responsibility for settling claims brought against BANIC by previous owners or creditors*; - the public offering for sale of at least 51% of BANIC shares at a realistically acceptable book value;	- sale of controlling interests of BANIC (51% of shares) to private investors;	
) DE CREDITO AR	- *BCP has been placed under the control of a management team, proposed by the BCN, with the mandate to (a) comply with the special supervision regime emitted by the SBIF in January 1998, and (b) prepare BCP for sale of controlling interests to the private sector*; - compliance with the conditions defined in the Special Supervision Regime for BCP by the SBIF in January 1998;	- the public offering of controlling shares of BCP to the private sector, or, initiation of liquidation procedures according to the General Banking Law; - compliance with the conditions defined in the Special Supervision Regime for BCP by the SBIF in January 1998;	- sale of controlling interest the private sector, or, liqui BCP;

Proposed Matrix for Financial Sector Reform Program III (NI-0104)

REFORM	FIRST TRANCHE CONDITIONS[1]	SECOND TRANCHE CONDITIONS	THIRD TRANCH CONDITIONS
CIERA AGUENSE ERSIONES	- *the constitution of FNI, S.A. in conditions that permit the participation of the private sector in the management and capitalization of this corporation*; - *as long as the GON maintains majority control of FNI, the eligibility standards for FNI, S.A. borrowers require full compliance with prudential norms and the bi-lateral compliance agreements between the banks and the SBIF; and,* - the interest rate charged on FNI loans not subject to contractual limitations imposed by the funding agency is equal to or greater than the weighted average cost of funds in the Nicaraguan banking system, adjusted for the effect of legal reserve requirements; - the GON has liquidated the capitalization bonds of FNI, either with cash payment or with assignment of loan portfolio; - the GON has agreed with the Bank to a plan for the reduction of FNI operating costs to a level less than or equal to 2% of its gross loan portfolio;	as long as the GON maintains majority control of FNI: - compliance with the performance indicators defined in the FNI plan for reduction of operating costs; and, - the eligibility standards for FNI, S.A. borrowers require full compliance with prudential norms and the bi-lateral compliance agreements between the banks and the SBIF; and, - the interest rate charged on FNI loans not subject to contractual limitations imposed by the funding agency is equal to or greater than the weighted average cost of funds in the Nicaraguan banking system, adjusted for the effect of legal reserve requirements;	as long as the GON maintain control of FNI: - compliance with the perfo indicators defined in the F reduction of operating cos - the eligibility standards fo borrowers require full con with prudential norms and lateral compliance agreem between the banks and the and, - the interest rate charged o not subject to contractual l imposed by the funding ag equal to or greater than th average cost of funds in th Nicaraguan banking syste for the effect of legal reser requirements;

Proposed Matrix for Financial Sector Reform Program III (NI-0104)

REFORM	FIRST TRANCHE CONDITIONS[1]	SECOND TRANCHE CONDITIONS	THIRD TRANCHE CONDITIONS
LIQUIDATION	- *no addition concessions have been granted to state bank or Liquidation Commission debtors beyond concessions granted prior to May 1998;* - *a minimum of C$400 million has been recovered from the assets separated from the state banks since January 1, 1996;*	- no addition concessions have been granted to state bank or Liquidation Commission debtors beyond concessions granted prior to May 1998;	- no addition concessions h granted to state bank or Li Commission debtors beyo concessions granted prior 1998; - an external auditing firm h a report, with the concurre Contraloría General de la certifying the liquidation, placement in administratio assets separated from the s

Proposed Matrix for Financial Sector Reform Program III (NI-0104)

REFORM	FIRST TRANCHE CONDITIONS[1]	SECOND TRANCHE CONDITIONS	THIRD TRANCH CONDITIONS
/REGULATORY M OF THE CIAL M	- *implementation of SBIF resolution imposing 100% provisioning requirement for delinquent debtors of the state banks under management of the Liquidation Commission;* - *implementation of SBIF resolution on asset classification and provisioning;* - *implementation of SBIF resolution eliminating exceptions to risk concentration limits and imposing a 100% provisioning requirement on loans that exceed the established limits;* - *implementation of SBIF resolution requiring immediate formalization of agreements with individual financial institutions establishing calendar for compliance with (1) 10% capital:asset requirement, excluding Bonos de Fomento with maturities of less than five years, and (2) all other prudential norms, without exceptions, by December 2000.*	- on-going implementation of first tranche conditions related to SBIF resolutions; - implementation of SBIF resolution establishing prudential norms for supervision of FNI; - the GON has agreed with the Bank regarding the principal reforms to be implemented through modifications to the General Banking Law, the Organic Law of the BCN and the Organic Law of the SBIF.	- evidence of enactment of consistent with the princip presented in the Policy Le the general banking law, (SBIF organic law, (3) the organic law, and, (4) the le framework for the capital

[1] Conditions presented in italics have been complied.

Policy Letter
Financial Sector Reform Program III

Mr. Enrique Iglesias
President
Inter-American Development Bank
Washington, D.C. 20577

Dear Mr. President:

Our government assumed office in January 1997 with a firm commitment to facilitating Nicaragua's transition to an internationally competitive, open-market economy. The Government signed an Enhanced Structural Adjustment Facility (ESAF) with the International Monetary Fund in March 1998, formalizing a three-year macroeconomic plan based on both stabilization measures and structural reforms. The ESAF program contemplates a growth in public sector savings through reduction of current expenditures, a forceful reduction in the operating losses of state owned enterprises, and an increase in tax revenues. At the same time, the Government endeavors to establish the conditions for an efficient and competitive financial market through an aggressive structural reform of the financial system.

The Government is requesting financing from the Inter-american Development Bank through the Financial Sector Reform Loan III in support of the ESAF macroeconomic program. The reform program will consist of initiatives related to the state banks, the institutional structure of the Superintendencia de Bancos y Otras Instituciones Financieras (SBIF) and the Banco Central de Nicaragua (BCN), and the legal/regulatory structure of the financial system.

The principal objective of the Government's state bank reform program is to reduce to a minimum the potential for future distortions of the financial markets and fiscal costs for the government, and to facilitate capitalization and management of the banks by the private sector. This objective will be achieved by: (i) concentrating state participation in the financial sector in the Financiera Nicaraguense de Inversiones (FNI) as a second-tier development bank, and (ii) transferring control of the rest of the state banks to the private sector by sale of shares, in a manner consistent with the constitutional obligation of the State to guarantee the existence and operations of the state financial institutions.

In May 1997, the Government initiated the liquidation process of Banco Nacional de Desarrollo (BANADES), at the time the largest of the state banks. BANADES liquidated is assets and liabilities under the supervision of the SBIF and with the financial support of the BCN. In March 1998, the SBIF revoked BANADES' banking license, and soon thereafter the National Assembly emitted a law legally dissolving BANADES.

The Government initiated the privatization of Banco Nicaraguense (BANIC) in December 1997 by contracting the International Finance Corporation as an investment advisor for the sale of controlling shares to the private sector. The National Assembly recently approved a law authorizing the sale of BANIC's shares, and formally charging the State with full legal responsibility for paying any obligations arising from claims against BANIC brought be previous owners and creditors. The Government intends to sell controlling shares of BANIC through an international public offering during the course of 1998.

Banco de Credito Popular (BCP), the smallest of the state banks, does not currently comply with the prudential norms for capital adequacy and is subject to a special regime of the SBIF which limits the bank's operations and

anticipates revocation of BCP's banking license by December 31, 1998 if not in compliance with prudential norms. The Government is determined to sell controlling shares of BCP to the private sector as a means to capitalizing the bank. As of September 1, 1998, management of BCP was transferred to a management team recommended by the BCN, with the mandate to ensure compliance with the SBIF special regime and to prepare the bank for sale to the private sector. The GON has requested financial assistance from the BID to contract the services of a financial advisor for preparation of the public offering, as well as preparation of the law that will authorize the sale. The Government will not provide additional capital or loans to BCP, , with the exception of the support required to transfer control of the bank to the private sector. The SBIF will suspend the operating license of BCP if it is not in compliance with the prudential norms and terms specified in the special regime, and it is not possible to sell the shares of the bank to the private sector.

The National Assembly passed a law in May 1998 which authorizes the Procurador to constitute the Financiera Nicaraguense de Inversiones (FNI) in the form of a corporation. The Government has constituted FNI, S.A. with statutes and by-laws that permit private sector participation in the capitalization and/or management of FNI. The GON will proceed to offer 49% of the shares of FNI in an international public offering with the intention of attracting the participation of international development finance institutions. In the meantime, the Government will ensure that FNI makes the policy and operational changes necessary to meet minimum standards of an efficient, second-tier financing facility. Administrative costs will be reduced to a level consistent with similar institutions in the region, eligibility criteria for qualifying borrowing institutions will be strengthened, the credit guidelines and interest rates of FNI's lines of credit will be unified under conditions consistent with the market.

The Government is committed to creating an institutional framework and maintain operating policies of FNI,, permitting the administration of trust funds, in a manner conducive to the long term development of the Nicaraguan financial market. The Government will abstain from passing state resources, or funds acquired by loans, to credit programs, facilities or institutions, with the exceptions of 1) funds passed to FNI for the purpose of on-lending to private banks or finance companies subject to the General Banking Law, and 2) funds required for the privatization or liquidation of state financial institutions. In addition, loans will be priced according to the prevailing cost of funds in the market, except for those loans subject to contractual restrictions regarding on-lending rates. Strict eligibility criteria will be applied. And all services will be financial self-sustainable.

In January 1998, the BCN and Ministry of Finance established the Liquidation Commission to assume responsibility for liquidation of the assets separated from the state banks during the 1990's. In early June of 1998, the Commission conducted a public offering with the private banks for the sale of the portfolio not subject to restrictions (12% of the total). The majority of the remaining portfolio has been placed with private, specialized liquidation companies. Non-performing loans that cannot be sold will be passed to third-parties charged with recovery via judicial process. Throughout the liquidation process, the Government will ensure aggressive enforcement of the SBIF resolution imposing a mandatory 100% provisioning requirement on any loan to a delinquent debtor of the state banks or the Commission.

Parallel to the state bank reforms, the Government will implement a sequence of reforms of the legal and institutional framework of the financial system in order to establish the conditions favorable to the development of a sound and efficient financial market.

By the beginning of 1999, the Executive Branch will present to the National Assembly draft laws that introduce changes to the Organic Law of the Central Bank and the founding law of the Superintendencia de Bancos y Otras Institutiones Financieras, with the purpose of guaranteeing the autonomy, professional orientation and coordination of these two institutions.

The Government also intends to submit during the same period a draft law reforming the General Banking Law, in order to establish the legal basis for an appropriate market structure and internationally competitive financial products and transactions. The new capital markets law will establish the legal basis for regulation and supervision of the self-regulated stock exchange and securities depository, and the creation of a clearings and settlement system that

complies with international standards. The regulatory and supervisory structure for the capital market will also be established.

The banking act and commercial code will be updated to improve the legal framework for: 1) minimum capital requirements for banks, 2) regulation of risk concentration and related party lending, 3) consolidated regulation and supervision banks and their affiliate companies, 4) market entry guidelines and mechanisms for liquidation of failed banks, 5) scope and limit of banking activities, and 6) creation, perfection and execution of secured transactions. In this same context, the Government will consider the possibility of establishing within the banking law a form of limited financial intermediary adaptable to specialized markets. This will entail a revision of the provisions established in Law 244 in 1997 regarding the eligibility of non-profit organizations as financial intermediaries. The SBIF will make every effort to ensure an orderly transition to the 10% capital adequacy ratio by December of 2000. The new 10% regime will require full paid in capital, net of the Bonos de Fomento or other short term or transitional capitalization instruments. The regime for asset classification and provisioning will be reinforced. Limits for risk concentration and insider lending will be clarified and enforced. And discretional authorization of exceptions will be strictly limited. The SBIF will also continue to upgrade mechanisms for data collection, disclosure, analysis and enforcement of the prudential norms. Bank performance reports will be developed according the international standards for purposes of off-site analysis and publication in the monthly SBIF bulletin.

Conclusion
Nicaragua has made significant progress in stabilizing its economy, and laying the legal and institutional framework for a competitive and open-market economy. The Financial Sector Loan III requested from the Inter-american Development Bank represents an important component of this transition. The reduction of the state banks to the limits permitted by the constitution, and the proposed legal, institutional and regulatory reforms will establish a foundation for the development of a safe and efficient financial system led by private sector initiative.

Sincerely,

(Original firmado)

Noel J. Sacasa C.
Minister of Economy and Development and Governor of the Inter-American Development Bank

cc: Members of the Economic Cabinet

TECHNICAL COOPERATION LOAN

TECHNICAL SUPPORT TO FINANCIAL SECTOR LOAN III
(NI-0106)

EXECUTIVE SUMMARY

BORROWER AND GUARANTOR:	Central Bank of Nicaragua	
EXECUTING AGENCY:	Central Bank of Nicaragua and the Superintendencia de Bancos y Otras Institutiones Financieras	
AMOUNT AND SOURCE:	BID (FSO)	US$ 765,000
	Counterpart:	US$ 85,000
	TOTAL:	US$ 850,000
FINANCIAL TERMS AND CONDITIONS:	Amortization period:	40 years
	Grace period:	10 years
	Execution period:	24 months
	Disbursement period:	30 months
	Interest rate:	1% for first 10 years; 2% thereafter
	Inspection and supervision:	1%
	Credit fee:	0.5%
OBJECTIVES:	The objective of the proposed Technical Cooperation Loan is to provide technical support to the BCN and SBIF in the implementation of the NI-0104 Financial Sector Loan.	
DESCRIPTION:	The TC program is comprised of two components: (1) support to the Legal Commission of the BCN for preparation of draft laws related to the legal framework of the financial system, and (2) support to the SBIF for development of information systems related to bank performance reporting, and development of regulatory and supervisory mechanisms for non-bank financial intermediaries.	
BENEFITS:	The principle benefits of the program will be achieved through completion of the reforms contemplated in the NI-0104 program.	
RISKS:	The TC program is subject to the risks inherent in the financial sector reform program.	
EXCEPTIONS TO BANK POLICY:	See Procurement section directly below.	
PROCUREMENT OF GOODS, WORKS AND	For activities related to Component A with the BCN, direct hiring of the International Monetary Fund is recommended as an exception to the required procedure of selection by open competition. This agency will carry out any	

CONSULTING SERVICES	procurement, contracting of consultants or other required activities, observing the procedures of the Bank. Direct hiring is in accordance with Chapter GS-403 of the Procurement Manual.
SPECIAL CONTRACTUAL CONDITIONS:	Prior to disbursement of funds for Component A, the BNC will submit to the Bank: (1) an agreement with the IMF/MEA, defining the role of the IMF in identification and superivision of consultants, technical review and commentary of consultant reports and support to the BCN in the preparation of program progress reports, and (2) a final action plan and budget for use of program resources and counterpart funding.
	Prior to disbursement of funds for Component B, the BCN will submit to the Bank: (1) a subsidiary agreement with SBIF defining the SBIF's responsibilities regarding procurement, reporting and counterpart funding, and (2) an action plan and budget submitted by the SBIF.

TECHNICAL COOPERATION
PLAN OF OPERATIONS

I. PROGRAM OBJECTIVES AND DESCRIPTION

A. Objectives

1.1 The objective of the proposed Technical Cooperation (TC) program is to support the BCN and the SBIF in the implementation of the NI-0104 reform program.

B. Program description

1.2 The TC program is comprised of 2 components: (1) support to the Legal Commission of the BCN for preparation of draft laws related to the legal framework of the financial system, and (2) support to the SBIF for development of information systems related to bank performance reporting, and development of regulatory and supervisory mechanisms for non-bank financial intermediaries. The TC funds will be used to contract consultants and acquire equipment in support of the institutional development plans of the respective counterparts.

C. Component A: Support to the Legal Commission of the BCN

1.3 The TC program will provide support to the recently formed joint Legal Commission of the BCN and the SBIF for the purpose of drafting revisions of the financial sector legal framework. The Government has consolidated legal reform initiatives related to the financial sector in order to create a coherent and comprehensive legal framework for the sector. The legal commission will provide support to a broad range of institutional reform initiatives, involving modifications to the banking law, the organic laws of the Banco Central de Nicaragua and the SBIF, as well as complementary modifications to the commercial code in the areas of trust law, corporation governance and bankruptcy, secured transactions, and the creation of a capital markets law.

D. Component B: Support to the SBIF

1.4 This component will support SBIF efforts to improve procedures for data collection, analysis and information disclosure. Bank performance reporting systems will be adapted to provide information required to enforce the evolving legal and normative framework. Off-sight analysis techniques will be upgraded. And information dissemination policies and the SBIF Bulletin format will be upgraded to provide more rigorous performance indicators to the public. In addition, the SBIF will develop policies and procedures for regulating and supervising the non-bank financial intermediaries that will be established in the new banking law.

II. PROGRAM EXECUTION

A Borrower and Executing Agency

2.1 The BCN will borrow the resources for the TC Loan and function as the lead executing agency. The SBIF will be responsible for execution of the SBIF component.

B. Execution arrangements

2.2 The TC Program will be comprised of Component A and Component B.

2.3 Component A will be executed by the BCN with the technical support of the Monetary and Exchange Affairs (MEA) Department of the International Monetary Fund. The IMF will function as a sole-source, specialized agency for providing assistance to the Legal Commission of the BNC in the identification and supervision of the advisors and consultants. The MEA Department has a clear technical advantage in the strengthening of central banks and has an extensive network of consultants and professionals on which to draw in order to fill the positions defined in the proposed program. In addition, the IMF has a clear institutional advantage in that it can coordinate the technical assistance provided by the TC program with the global program of technical support provided by the IMF.

2.4 Prior to disbursement of funds for Component A, the BNC will submit to the Bank: (1) an agreement with IMF/MEA, defining the role of the IMF in the identification and supervision of consultants, technical review and commentary of consultant reports and support to the BNC in the preparation of program progress reports, (2) a final action plan and budget for use of program resources and counterpart financing.

2.5 Component B will be implemented by the SBIF. Prior to disbursement of resources for Component B, the BCN will submit to the Bank (1) a subsidiary agreement with the SBIF defining the SBIF's responsibilities regarding procurement, reporting and counterpart funding, and (2) an action plan and budget submitted by the SBIF.

2.6 During the execution of the two components, all terms of reference and candidate profiles will be presented for approval of the Bank prior to allocation of program resources.

C. Program supervision

2.7 The Bank will supervise the program through periodic administration missions and administrative relations with the Nicaragua Country Office.

D. Reporting and auditing

2.8 The BCN shall submit to the Bank semi-annual program progress reports. The BCN report shall be presented with the technical commentary of the IMF/MEA. The SBIF shall be responsible for preparation of the report relating to Component B.

2.9 All consultants contracted with program resources shall submit reports to the respective counterpart and to the Bank.

2.10 The BNC shall submit annual financial reports, audited by an independent firm approved by the Bank, of the goods and services procured with program resources.

2.11 Within three months of completion of the program, the BNC shall submit a final program evaluation report that provides a detailed account of achievements and failures of program execution. Within the same period, the BNC shall submit a final financial report, audited by an independent firm approved by the Bank, of the goods and services procured with program resources.

III. FINANCING

3.1 Total cost of the proposed program is US$822,000 consisting of US$737,000financed by the Bank, and US$85,000 in counterpart funds. Counterpart funds will used to contract local consultants, purchase equipment, and cover general administration expenses.

BUDGET

Item		Bank Financing	Counterpart	Total
1.	Component A			
-	international consultants	$255,000		$255,000
-	local consultants		$35,000	$35,000
-	contingency	$20,000		$20,000
2.	Component B			$0
-	international consultants	$400,000		$400,000
-	administration		$50,000	$50,000
-	equipment	$50,000		$50,000
-	contingency	$40,000		$40,000
	Total	$765,000	$85,000	$850,000

3.2 The program execution period will extend to 24 months beyond the effective date of the contract, and the final disbursement will be made no more than 30 months beyond the same date.

3.3 The Bank financing component will be disbursed in dollars of the United States of America and charged to the Fund for Special Operations. The executing agency will pay a 1% up-front inspection and supervision fee as well as a commission equal to .5% of the committed amount. The loan will be amortized over 40 years, including a 10 year grace period on principal payments. In addition to the commission, the executing agency will pay 1% over the declining balance of the outstanding loan obligation in interest over the first 10 years (the grace period) and 2% over the amortization period from years 11 through 40.

3.4 For activities related to Component A with the BCN, direct hiring of the International Monetary Fund is recommended as an exception to the required procedure of selection by open competition. This agency will carry out any procurement, contracting of consultants or other required activities, observing the procedures of the Bank. Direct hiring is in accordance with Chapter GS-403 of the Procurement Manual.

3.5 An advance of funds equivalent to 5% of the amount of financing provided by the Bank will be made to facilitate efficient disbursement of program resources.

RGII-NI106P
NI-0104
Original: Spanish

PROPOSED RESOLUTION

NICARAGUA. LOAN ___/SF-NI TO THE REPUBLICA DE NICARAGUA
(Financial Sector Reform Program III)

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with the República de Nicaragua, as Borrower, for the purpose of granting it a financing to cooperate in the execution of the Financial Sector Reform Program III. Such financing will be for the amount of up to US$65,000,000, or its equivalent in other currencies, except that of Nicaragua, which are part of the resources of the Bank's Fund for Special Operations, and will be subject to the "Terms and Financial Conditions" and the "Special Contractual Conditions" of the Executive Summary of the Loan Proposal.

RGII-NI112P
NI-0104
Original: Spanish

PROPOSED RESOLUTION

NICARAGUA. LOAN ______ /SF-NI TO THE BANCO CENTRAL DE NICARAGUA (Technical Cooperation to Support the Financial Sector Reform Program III)

The Board of Executive Directors

RESOLVES:

1. That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such agreements as may be necessary with the Banco Central de Nicaragua and to adopt such measures as may be pertinent for the execution of the plan of operations with respect to Technical Cooperation to Support the Financial Sector Reform Program III, referred to in Annex III of Document PR- .

2. That up to the sum of US$765,000, or its equivalent in other currencies, except that of Nicaragua, which are part of the resources of the Bank's Fund for Special Operations, is authorized for the purposes of this resolution.

3. That the above-mentioned sum is to be provided on a reimbursable basis.