

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

**PANAMA**

**FINANCIAL AND FISCAL STABILITY AND TRANSPARENCY  
IMPROVEMENT PROGRAM**

**(PN-L1100)**

**LOAN PROPOSAL**

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ELECTRONIC LINKS	
<b>REQUIRED</b>	
1.	Policy Letter <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=38367160">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=38367160</a>
2.	Means of Verification Matrix <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=38175833">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=38175833</a>
3.	Results Matrix <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=38220387">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=38220387</a>
<b>OPTIONAL</b>	
1.	Cost-benefit analysis (CBA) <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=38222411">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=38222411</a>
2.	Financial sector monitoring and evaluation plan <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=38222409">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=38222409</a>
3.	Economist Intelligence Unit. Country Finance. Panama <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=36935763">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=36935763</a>
4.	Macro-prudential Policy: What Instruments and How to Use Them? IMF working paper 2011 <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=36935764">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=36935764</a>
5.	Law on Fiscal Social Responsibility of Panama <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=36935765">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=36935765</a>
6.	Panama Banking Law. Consolidated text <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=36935766">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=36935766</a>
7.	Government Strategic Plan 2010 - 2014. Republic of Panama <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=36935768">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=36935768</a>
8.	The Bank's Country Strategy with Panama, 2010 - 2014 <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=35803696">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=35803696</a>
9.	Aide-mémoire of the analysis mission. October 2013 <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=38206177">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=38206177</a>
10.	Draft Law 483, creating the Panama Saving Fund and issuing other provisions <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=37695726">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=37695726</a>

## ABBREVIATIONS

AML/CFT	Anti-money laundering/Combating the financing of terrorism
CCF	Consejo de Coordinación Financiera [Financial Coordination Council]
CMF	Capital Markets and Financial Institutions Division
DEF-MICI	Dirección de Empresas Financieras del MICI [MICI Financial Enterprises Bureau]
DNFBPs	Designated nonfinancial businesses and professions
ENGFRD	Estrategia nacional de gestión financiera de riesgos de desastres [National disaster risk financial management strategy]
FAP	Fondo de Ahorro de Panamá [Panama Savings Fund]
FATF	Financial Action Task Force
FDI	Foreign direct investment
FSAP	Financial Sector Assessment Program
GDP	Gross domestic product
IBC	International Banking Center
IMA	Independent Macroeconomic Assessment
IMF	International Monetary Fund
IPACOOOP	Instituto Panameño Autónomo Cooperativo [Panamanian Autonomous Cooperatives Institute]
IRM	Integrated risk management
KYC	Know your customer
LLR	Lender of last resort
LRSF	Ley de Responsabilidad Social Fiscal [Fiscal Social Responsibility Law]
MEF	Ministry of the Economy and Finance
MICI	Ministry of Trade and Industry
PALEX	Programa de Asistencia de Liquidez Extraordinaria [Special Liquidity Assistance Program]
PBL	Policy-based loan
SALM	Sovereign asset and liability management
SBN	Sistema Bancario Nacional [National Banking System]
SBP	Panamanian Banking Superintendency
SMV	Securities Market Superintendency
SSRP	Superintendency of Insurance and Reinsurance of Panama

## PROJECT SUMMARY

### PANAMA FINANCIAL AND FISCAL STABILITY AND TRANSPARENCY IMPROVEMENT PROGRAM (PN-L1100)

Financial Terms and Conditions					
<b>Borrower:</b> Republic of Panama <b>Executing agency:</b> Ministry of the Economy and Finance			<b>Flexible Financing Facility*</b>		
			Amortization period:		20 years
			Original weighted average life:		11.25 years
			Grace period:		30 months
			Disbursement period:		18 months
<b>Source</b>	<b>Amount</b>	<b>%</b>	Interest rate:		LIBOR-based
IDB (Ordinary Capital)	US\$300 million	100	Inspection and supervision fee:		**
Local	0	0	Credit fee:		**
Total	US\$300 million	100	Currency:		U.S. dollars from the Ordinary Capital
Project at a Glance					
<b>Project objectives:</b> The program’s general objective is to reduce the fiscal risk of macroeconomic, financial, and natural-disaster shocks by improving integrated risk management (IRM). The two specific objectives are to: (i) strengthen sovereign asset and liability management; and (ii) improve financial stability. To that end, a program will be developed consisting of three basic components: (i) macroeconomic stability; (ii) the development of sovereign asset and liability management tools; and (iii) the strengthening of financial stability (paragraphs 1.19 to 1.22).					
<b>Special contractual conditions:</b> Disbursement of the loan proceeds is contingent upon fulfillment of the policy conditions set out in Annex II (Policy Matrix), in addition to the other conditions set forth in the loan contract (paragraph 2.3).					
<b>Exceptions to Bank policies:</b> None					
<b>Project qualifies as:</b>					
	SEQ [ ]	PTI [ ]	Sector [ ]	Geographic [ ]	Headcount [ ]

\* Under the Flexible Financing Facility (document FN-655-1), the borrower has the option of requesting changes to the amortization schedule, as well as currency and interest rate conversions, subject in all cases to the final amortization date and the original weighted average life. The Bank will take market conditions as well as operational and risk management considerations into account when reviewing such requests.

\*\* The credit fee and inspection and supervision fee will be established periodically by the Board of Executive Directors as part of its review of the Bank's lending charges, in accordance with applicable policies.

## I. DESCRIPTION AND RESULTS MONITORING

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

- 1.1 **Macroeconomic context.** The Panamanian economy has grown strongly in recent years, with annual GDP growth close to 10% between 2007 and 2012. This has largely been driven by investment, especially that associated with the Panama Canal expansion.<sup>2</sup> Nonetheless, in the second quarter of 2013, real GDP grew by 7.6% in relation to the same period in 2012, which is closer to the economy's potential growth rate of around 6% to 6.5%. The current account deficit in 2012 was 9% of GDP and is expected to converge progressively with its trend level (around 7.5%). This deficit is mainly financed through a high level of foreign direct investment (FDI). As gross financing needs for the period 2012-2014 are estimated at US\$4 billion, this operation is equivalent to 7.5% of the disbursements required.
- 1.2 **Economic model.** Panama is a very open economy (the sum of its exports and imports represented about 155% of GDP in 2012). The main economic sectors are transportation and communications, construction and real estate, and financial services, all of them closely related to the Panama Canal cluster<sup>3</sup> and the International Banking Center (IBC).<sup>4</sup> The higher leverage required in a production structure based on services (95% of exports) and low domestic savings (16% of GDP in 2012) increases the importance of access to external financing through bank credit and FDI to sustain the economy's growth rates.<sup>5</sup>
- 1.3 **Policy challenges.** Panama's financial and trading links with the rest of the world are the strength of its economic model; but they also make it more vulnerable to external financial and macroeconomic shocks. Panama is also vulnerable to catastrophic natural disasters capable of causing heavy economic losses.<sup>6</sup> Although it has sound macroeconomic fundamentals for coping with the impact

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<sup>1</sup> Based on IMF Article IV (2012) and the IDB's 2013 Independent Macroeconomic Assessment (IMA).

<sup>2</sup> Public investment in Panama is forecast to hold steady at 12.2% of GDP in 2010-2014, before gradually falling back to previous levels (5.7% between 2003 and 2009). In addition to the expansion of the Panama Canal (estimated at US\$5.25 billion in 2010), the Public Investment Program includes US\$15 billion of investments mainly in road and transportation infrastructure, complementary to the Canal works. In the next few years, the exploitation of copper deposits is expected to attract investment equivalent to the cost of the Panama Canal.

<sup>3</sup> This cluster encompasses all activities related to the Panama Canal, including ports, transportation, logistics, and trade (including the Colón Free Trade Zone), as well as financial services and telecommunications. In 2008, the Panama Canal Authority estimated that this cluster represented about 22% of GDP.

<sup>4</sup> In Central America, the IBC is very important given the region's highly internationalized banking activities. Panama accounts for 52.1% of the assets and 41.3% of the capital of the Central American banking sector. Technical Note "Financial system and financial inclusion in Panama," IDB, CMF, 2011.

<sup>5</sup> For an analysis of the importance of external financing in the Panamanian economy, see Fernández, Marco A. "Vulnerabilities and Risks in the External Sector: The Case of Panama." IDB. Mimeo.

<sup>6</sup> The main threats are floods, landslides, and earthquakes. In the case of an extreme event (likelihood of one occurring every 100 years or more), the country could incur maximum probable losses of between 5% and 9% of GDP. See IDB. 2011. "Diagnostic Assessment of Vulnerability to the Impacts of Natural Hazards."

of such shocks,<sup>7</sup> a reversal of international capital flows or an economic slowdown in its key trading partners<sup>8</sup> could have important implications for growth.<sup>9</sup> The development of instruments to manage these risks is all the more relevant given the financial and monetary uncertainty prevailing internationally, which in the coming years is expected to make financial flows more volatile and raise risk premiums in emerging economies.<sup>10</sup> The recent international crisis shows the importance of tools to prevent external shocks.<sup>11</sup> In Panama, dollarization and the absence of a monetary authority<sup>12</sup> increase the need to develop strategies to avoid financial and fiscal risks, as key policy challenges (IMF, 2013).

- 1.4 **Integrated risk management (IRM).** The Government of the Republic of Panama considers it important to develop an IRM strategy to reduce the expected fiscal impact of exogenous macroeconomic, financial, and natural-disaster shocks.<sup>13</sup> Lowering the expected fiscal cost of an exogenous shock directly benefits a country's risk level and hence the capacity of the public sector to fulfill its social and economic functions.<sup>14</sup> This approach reflects the lessons of recent international experience and recommendations from international organizations,<sup>15</sup> which view strengthening IRM capacity and tools as a fundamental part of the process of building institutions for a more balanced form of development that weighs economic growth and risk exposure more evenly. IRM should meet two

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<sup>7</sup> Panama has a diversified economy (no sector accounts for over 25% of GDP) and sustainable debt and deficit levels.

<sup>8</sup> Especially the United States, but also Colombia or Venezuela (the main export destinations of the Colón Free Trade Zone).

<sup>9</sup> For example, an increase in international financial instability, proxied by a one-standard-deviation increase in the VIX index, would reduce GDP growth and lending to the real sector by 1% and 1.3% respectively (IMF, Article IV, 2013).

<sup>10</sup> See IMF: Stability Report, 2013 (October).

<sup>11</sup> The financial crisis demonstrated the importance of the actions of monetary authorities as a front-line response to the crisis (e.g. through liquidity facilities), as well as the constraints caused by the lack of an exchange rate policy. IMF, *Stability Report*, 2012. (April).

<sup>12</sup> As Panama has no central bank, the money supply grows through exports of goods and services and through credit and FDI. Since there is no monetary authority to program the monetary aggregates or to inject liquidity into the financial system, the country cannot use monetary policy to deal with a crisis, and the financial system has no traditional lender of last resort.

<sup>13</sup> The fiscal cost of a systemic and sovereign debt crisis in the region ranges between 4% and 12% of GDP. See Laeven, Luc and Fabian Valencia. *Systemic Banking Crises: A New Database*. WP/08/224. When the cost of a natural disaster (op. cit., 6) is added to these amounts, they imply very significant risks to the economy.

<sup>14</sup> This operation is therefore expected to directly benefit Panama's financial sector and the net worth of the public sector. Indirectly, or on a second level, the operation would also benefit the country's businesses and households.

<sup>15</sup> For examples supporting this approach in the financial risk management of natural disasters, see "Improving the assessment of disaster risks to strengthen financial resilience." <http://www.gfdrr.org/>.

basic objectives:<sup>16</sup> (i) improvements to sovereign asset and liability management (SALM), which means strengthening the value-at-risk of the public-sector balance sheet;<sup>17</sup> and (ii) the protection of financial stability, which means strengthening the balance sheet of the financial sector. Logically, there are interrelationships between the two objectives,<sup>18</sup> and they are only treated separately for clarity of exposition.

- 1.5 **Strategic alignment.** This operation is consistent with the Bank's 2010-2014 Country Strategy with Panama (document GN-2596), in particular with the strategic objective of strengthening public finances. The program is also consistent with the Bank's Ninth General Capital Increase (GCI-9) (document AB-2764) and the lending program priorities for small and vulnerable countries, and support for regional cooperation and integration. The program will also contribute to the regional target of increasing the amount of tax revenue actually collected with respect to the potential, and of raising the number of public systems either implemented or upgraded. The operation supplements other Bank programs in Panama for the management of fiscal, financial, and natural-disaster risks: (programmatic policy-based loans (PBLs) for the Reduction of Natural Disaster Vulnerability and Climate Change (loans 2588/OC-PN and 2730/OC-PN); (ii) the Contingent Loan for Natural Disaster Emergencies (PN-X1007); and (iii) the PBLs for Strengthening Fiscal and Financial Management in Panama (loans 2842/OC-PN and 2942/OC-PN). Whereas those programs (already disbursed) established the basic framework for reducing vulnerability to natural disasters and macrofinancial risks,<sup>19</sup> this new program consolidates certain lines of reform that have been initiated, while seamlessly introducing some new fundamental aspects related to the management of financial risks, as described in this document.<sup>20</sup> The program also draws on lessons learned in the design and implementation of the

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<sup>16</sup> For a review of evaluations of the implications greater financial and fiscal stability on the fiscal cost of macrofinancial shocks see, Sinha, A. *Financial Sector Regulation and Implications for Growth*. BIS Papers number 62; and Ahrend, R. et al., 2009. *Prudential Regulation and Competition in Financial Markets*, OECD WP 735.

<sup>17</sup> In this document, the value-at-risk of the public sector balance sheet is understood to include the flows implicit in that valuation, such as the contingent financial obligations that could cause unforeseen liquidity problems in the banking sector.

<sup>18</sup> For a detailed analysis of the links between the public, financial, and corporate sector balance sheet, see Gray, D, Merton, R; Zvi Bodie. 2006. *A New Framework for Analyzing and Managing Macrofinancial Risks of An Economy*. NBER WP 12637.

<sup>19</sup> Key milestones in these reforms were: the creation of the Panama Savings Fund and the Financial Coordination Council, and the creation of the National Integrated Disaster Risk Management Policy and the National Platform for Disaster Risk Reduction.

<sup>20</sup> This program complements earlier ones in key respects, such as: (i) the design of a management strategy for public assets and liabilities; (ii) the creation of a reserve fund for emergency response to the most frequently recurring natural disasters; and (iii) measures to improve the stability and transparency of the financial sector (creation of a liquidity fund, regulation of the insurance and capital markets, and financial transparency regulation).



earlier programs, including: (i) the importance of stakeholder coordination; and (ii) the provision of technical assistance for risk estimation.

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

- 1.6 **Fiscal context.** Panama's growth has been accompanied by the development of a fiscal and macroeconomic sustainability framework, institutionalized in the Social and Fiscal Responsibility Law (Law 34 – LRSF).<sup>21</sup> Its nonfinancial public sector recorded a total (primary) deficit in 2012 equivalent to 2.1% (0.1%) of GDP in 2012, mainly due to the robust public investment program. Different sustainability analyses performed by the IMF show that country's debt levels are sustainable in the medium and long terms under different risk scenarios (Article IV, 2012, 2013).
- 1.7 In recent years Panama has made significant progress in strengthening its public finance management, including: (i) the creation of the Panama Savings Fund (FAP) in 2012 as a mechanism for accumulating Panama Canal revenues exceeding 3.5% of GDP;<sup>22</sup> (ii) active public debt management and, in particular, an increase in the proportion of debt issued on the local market and a lengthening of its average maturity.<sup>23</sup> Both elements were supported by PBLs for Strengthening Macrofinancial and Fiscal Management in Panama I and II.
- 1.8 **Outstanding issues.** As noted by international organizations (IMF, Article IV, 2013), the main threat to the country's public sector accounts stems not only from its fiscal position, but from the potential effects of exogenous shocks to its overall balance sheet. Risks to the public sector balance sheet relate not only to "flow variables," but also the value-at-risk of cumulative balances of public assets and liabilities. Panama is particularly susceptible to contingent fiscal liabilities or those stemming from risks of events whose timing and intensity of occurrence are largely beyond government control. This type of risk has major impacts on both the liability and asset sides, often affecting both together, which justifies SALM strategies. This operation lays the foundation for developing this strategy through: (i) improvements to integrated sovereign asset and liability management; and (ii) the development of a specific strategy for managing contingent fiscal liabilities resulting from natural disasters and systemic bank liquidity crises. The latter are addressed in the aforementioned financial stability component.
- 1.9 **Development of an integrated sovereign asset and liability management (SALM) strategy.** SALM strategies help prevent and enhance public sector capacity to absorb external shocks. Panama's financial volatility in 2008 fueled

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<sup>21</sup> Panama has always complied with the overall fiscal deficit ceiling set in the LRSF, although it has availed itself of planned extensions to the limit to respond to the flooding and landslides of November 2012. The overall fiscal deficit ceiling in 2013 is 3.1% of GDP.

<sup>22</sup> The MEF forecasts cumulative FAP income in 2025 on the order of 5.8% of GDP.

<sup>23</sup> The level of domestic public debt rose from 13% to 18% of total debt between 2011 and 2012. The average maturity and duration of domestic public debt increased from 12.4 to 13 years and from 7.9 to 8.2 years between 2011 and 2012, respectively. MEF data.

significant increases in the yield and cost of public debt, thereby reducing the country's fiscal reaction capacity,<sup>24</sup> while other exogenous shocks can compromise public sector capacity at crucial moments. Developing SALM strategies to manage these risks and strengthen the country's balance sheet requires: (i) transparently and accurately estimating overall sovereign assets and liabilities, especially contingent tax liabilities—both explicit (court cases brought against the State, guarantees, etc.) and implicit (natural disasters or financial crises)<sup>25</sup>— which, in Panama, are crucial given its vulnerabilities, in conjunction with the high level of public investment financed by public companies and “turnkey” contracts;<sup>26</sup> (ii) making progress towards optimal management of public sector liquidity thereby improving its performance; and (iii) strengthening sovereign assets through the FAP. Accordingly, this program includes the following actions: (i) the formulation of a SALM strategy for transparently estimating overall public assets and liabilities, as a first step in designing financial instruments for risk management and mitigation; (ii) the establishment of a Single Treasury Account (CUT) to manage government bank accounts on a unified basis, with the aim of optimizing public sector liquidity; and (iii) increased funding for the FAP through the future sale of shares in companies under public ownership.

#### 1.10 **Comprehensive strategy for the financial management of natural disasters.**

Natural disasters represent one of the key fiscal contingencies in Latin American countries.<sup>27</sup> Comprehensive risk management strategies aim to reduce the expected fiscal cost of natural disasters by: (i) reducing their impact through prevention, mitigation, and readiness actions; and (ii) diversifying the costs between the State, economic agents, and both national and international insurers and multilateral agencies through risk transfer and retention mechanisms.<sup>28</sup> Along these lines, this operation supports the following actions: (i) the development of tools to reduce natural-disaster risk in Public Investment Projects (PIPs) through

<sup>24</sup> Bond yields rose by 69% between the third and fourth quarters of 2008 (from 6.11% to 10.31%), before returning to pre-shock levels by the second quarter of 2009.

<sup>25</sup> The existence of contingent fiscal liabilities is a key factor in episodes of fiscal and banking crisis. See Das, U., Papaioannou, M., and Trebesch, M. 2012. *Sovereign Debt Restructurings 1950-2010: Concepts, Literature Survey, and Stylized Facts*. IMF WP/12/203.

<sup>26</sup> Contingent liabilities generated by public enterprises (mainly in the energy and airport sectors), and the funding of public works using the German or “turnkey” method, account for about 2.5% and 6% of GDP respectively (Moody's Full Rating Report, 2012 and IMF, Article IV, 2012).

<sup>27</sup> The Bank has extensive experience in the analysis of the fiscal impacts of natural disasters, and it has implemented several disaster risk financial management operations through the Contingent Credit Facility for Natural Disaster Emergencies in Costa Rica (CR-X1010), the Dominican Republic (DR-X1003), Ecuador (EC-X1008), Honduras (HO-X1016), and Panama (PN-X1007).

<sup>28</sup> Financial risk management can significantly reduce the costs associated with catastrophic events. In the case of Honduras, for example, it is estimated that the impact of Hurricane Mitch in October 1998 would have been around 8% of GDP in 1999 under a financial risk management strategy, whereas the actual cost was 80% of GDP in the absence of such a strategy. Artana, D. 2008. *Honduras: Creation of a Reserve Fund for Emergency Response to Natural Disasters. Assessment of Financial and Operational Viability*. IDB. Mimeo.

methodologies to include disaster risk assessment in PIPs, and the approval of a new of expenditure item within the Budget Classifications Manual (MCP) that makes it possible to allocate resources to the entire universe of public entities to undertake disaster risk prevention, mitigation, and readiness actions; (ii) the development of a national disaster risk financial management strategy including a technical report to determine the optimal financial coverage that would afford the country the liquidity needed to cope with the emergency phase of a catastrophic event, and the scaling of a Reserve Fund that makes it possible to cover the fiscal expenditures generated by recurrent events. These actions adequately complement the US\$100 million Contingent Loan for Natural Disaster Emergencies (PN-X1007) approved by the Bank in 2011, which aims to cover events of low probability of occurrence but of severe or catastrophic magnitude.

### **C. Analysis of the financial stability framework in Panama**

- 1.11 **Financial context.** Panama is a major regional banking center with a deep financial market (in 2012 the total assets of the banking sector exceeded 266% of GDP), together with adequate capitalization, liquidity, and profitability.<sup>29</sup> These sound fundamentals, along with high levels of deposits (88% of GDP in 2012), a diversified ownership structure (52% of assets controlled by foreign banks), and weak linkage to the European banking sector, contributed to the rapid recovery of credit flows that accompanied the country's economic recovery from the 2008 international financial crisis. In 2012, private sector credit grew by 14%, in line with GDP growth. While the financial sector is mainly banking, there are also significant asset values managed by brokerages, the insurance sector, and credit unions (with total assets of 10%, 5% and 4.5% of GDP, respectively).
- 1.12 **International Banking Center (IBC).** The financial system consists of the IBC, insurance and reinsurance companies, nonbank financial companies, the stock market, and pension system institutions. The IBC encompasses two official banks, 48 general-license banks, 29 banks with an international license, and 14 representative offices,<sup>30</sup> which channel saving and investment to and from Latin America and the Caribbean and other countries. The National Banking System (SBN) excludes the 29 institutions with international licenses.<sup>31</sup> In 2012, domestic lending by the SBN to the private sector totaled US\$35.246 billion, the largest shares of which were commercial loans (13%), mortgages (16.4%), consumer credit (11.9%), and construction loans (13.5%).

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<sup>29</sup> The banking sector displays high levels of capitalization (average capital adequacy ratio (CAR) of 16% since 2008) and liquidity (liquid assets-deposits ratio of 34%), a low arrears rate (2.5% in 2013), and adequate levels of profitability (return on assets of 1.86% and return on equity of 17.6% in 2013). The 2013 data mentioned in this footnote are from June.

<sup>30</sup> Current data from the SBP.

<sup>31</sup> At the end of the second quarter of 2013, the assets of the IBC and SBN were US\$95.412 billion and US\$77.887 billion, respectively, up by 12.7% from the same period the previous year.

- 1.13 **Regulatory and institutional framework.** The regulation of Panama's financial system abides by the main international standards and is consistent with the Basel II Principles (IMF 2012, Article IV). In particular, progress has been made in regulation and supervision, by fulfilling the main recommendations made in previous evaluations by international organizations. The country does not have a deposit guarantee fund and is governed by prudential regulation of liquidity requirements that sets a 30% floor on the liquid assets-deposits ratio.<sup>32</sup> The regulatory framework is based on the 1998 Panama Banking Act, which consolidated supervision of the banking sector in the Panamanian Banking Superintendency (SBP). There are also some 583 active cooperatives controlled by the Panamanian Autonomous Cooperatives Institute (IPACOOOP), of which 168 are saving and loan associations.<sup>33</sup> The Superintendency of Insurance and Reinsurance of Panama (SSRP) supervises the insurance sector, while the Securities Market Superintendency (SMV) regulates the capital market, and the Ministry of Trade and Industry (MICI) Financial Enterprises Bureau (DEF-MICI) regulates finance and leasing companies. In addition, the Financial Coordination Council (CCF) aims to coordinate the work of all financial system supervisors.
- 1.14 **Outstanding issues.** In general, stability is essential to prevent distortions in financial markets that have serious consequences for the real economy and the public sector. In the case of Panama, financial stability is, if anything, even more relevant given the importance of external financing for its development model, as noted above. Studies and international experience both show the importance of safeguarding stability in the financial sector and reducing its vulnerability to exogenous shocks, particularly in dollarized economies without a monetary authority,<sup>34</sup> by: (i) setting up liquidity facilities to act as lender of last resort; (ii) strengthening the financial regulation and supervision framework; and (iii) ensuring financial transparency in the form of mechanisms to enhance the quality of information provided by the entities and transactions in the financial system, to promote market discipline and financial intermediation that is less susceptible to exogenous shocks.<sup>35</sup> Panama faces specific challenges in these three areas, which are addressed by this program.
- 1.15 **Lender of last resort (LLR).** The recent international crisis shows the importance of having liquidity facilities to avoid the serious consequences that

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<sup>32</sup> Liquid assets include bank liabilities payable in Panama with maturities of up to 186 days.

<sup>33</sup> IPACOOOP, Statistics, September 2012.

<sup>34</sup> Experience shows that in emerging economies about 50% of episodes of significant capital account variations (defined as an increase above the median) end in banking crisis or recession. The probability of a banking crisis increases when the capital flows are of a banking or portfolio investment type, and it decreases significantly when the quality of banking supervision and regulation increases. Moreover, quality banking supervision and moderate credit growth reduce the likelihood of a recession. See Powell, A. Ed. 2012. *The World of Forking Paths. Latin American and Caribbean Macroeconomic Report*. IDB. March.

<sup>35</sup> See IMF. 2012. Draghi, M.; Giavazzi, F.; and Merton, R. 2003. *Transparency, Risk Management and International Financial Fragility*. NBER WP 9806. Also: *Anti-money laundering and Combating the Financing of Terrorism Inclusion in Surveillance and Financial Stability Assessments -guidance note*.

gridlocked financial intermediation can have on the real economy.<sup>36</sup> The LLR prevents coordination problems in the interbank market from causing temporary liquidity constraints, which: (i) generate solvency problems (or an excessive accumulation of liquid reserves); and (ii) permanently reduce the flow of credit to the real economy.<sup>37</sup> The effects of the recent financial crisis in Panama illustrate the importance of liquidity effects in dollarized economies that do not have a monetary authority: (i) a major impact on financial system liquidity when interbank borrowing seizes up (a contraction of nearly US\$2.8 billion in the SBN's international interbank credit lines);<sup>38</sup> (ii) increased borrowing costs and credit constraints (credit growth to the private sector fell from 14.6% to 1.3% between 2008 and 2009);<sup>39</sup> and (iii) a sharp drop in real GDP growth (almost 9 percentage points between the first quarter of 2007 and 2009). Moreover, Panama's interbank market is biased, since lending by the large international banks is directed toward large national banks, which makes it even more important to introduce mechanisms for managing bank liquidity crises (Financial Sector Assessment Program (FSAP), 2012). For these reasons the Panamanian government is prioritizing the creation of a bank liquidity facility, in keeping with the diagnostics made by international organizations (IMF, Article IV and FSAP 2013, 2012). International experience shows that such interventions need to create flexible and clearly defined mechanisms, which are implemented through government structures to avoid moral hazard<sup>40</sup> and coordination risk.<sup>41</sup> Drawing on these lessons, this program supports the adoption of a Special Liquidity Assistance Program (PALEX) that would define: (i) the objectives and scheduling of the creation of the liquidity facility; (ii) eligible entities and access conditions (rates, amounts, guarantees, and approvals system); (iii) the legal structure and the

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<sup>36</sup> Op. cit., 30.

<sup>37</sup> Lack of liquidity may cause solvency problems even in advanced and efficient interbank markets, owing to coordination failures. See Vives, X. and Rochet, J. C. 2004. "Coordination Failures and the Lender of Last Resort: Was Bagehot Right After All?" *Journal of the European Economic Association*.

<sup>38</sup> International credit lines as a percentage of foreign deposits fell from nearly 50% in the fourth quarter of 2008 to below 30% in the first quarter of 2010. The quarterly decline was sharper in the fourth quarter of 2009, when lending of this type dropped by roughly 30% in relation to the previous quarter. Although there was a contraction in the SBN's foreign deposits caused by an outflow of capital to safer havens (flight to quality), this was significantly smaller than the restrictions on international credit lines (SBP).

<sup>39</sup> In addition to restrictions on the amount there were also price increases. Lending rates on personal loans from Panamanian (commercial) banks rose by about 3 (2) percentage points between the first quarter of 2008 and the second quarter of 2009 (SBP).

<sup>40</sup> The moral hazard problem is generated by the incentives to risk-taking faced by banks in the presence of an LLR. Traditional mechanisms to reduce moral hazard are: (i) the role of regulation and oversight, particularly to ensure that interventions address problems of liquidity and not solvency; (ii) penalty interest rates and the creation of safeguards to prevent arbitrage between the interbank market and the liquidity facility; and (iv) adequate banking regulation and supervision.

<sup>41</sup> In the case of Panama, there is a coordination problem in financing the liquidity fund. The greater vulnerability of smaller banks to a global liquidity shock discourages larger banks from contributing, while the amount necessary to provide liquidity assistance to the larger banks is very costly for the government alone and is also more likely to generate moral hazard problems.

entity responsible for its management; (iv) the target scale; and (v) the funding sources.

- 1.16 **Strengthening of financial system regulation and supervision.** Financial sector regulation and supervision contributes to stability by preventing the accumulation of risks and enhancing the sector's ability to cope with external shocks. Although regulation of the banking system in Panama complies with Basel II principles, the regulation of other important financial sectors such as insurance and securities is less developed.<sup>42</sup> The SBP was setup in 1998, and the SMV and SSRP were created in 2011 and 2012 respectively; so clearly they have not had much time to develop technical, organizational, and regulatory capabilities. This program contributes to the process of improving the regulation and supervision of the overall system by: (i) strengthening the financial training provided by the CCF to all supervisory authorities and the population at large; (ii) enhancing regulation of the insurance industry by developing a new framework for regulating the technical reserves that insurance companies have to provision in each line of business, and regulation of the activity of insurance brokers and sales agents; (ii) improving regulation of the securities sector by implementing capital requirements for brokerages and firms operating on the foreign exchange market (FOREX); and (iii) stricter regulation of banks, the regulation of financial conglomerates' credit risk, market risk and liquidity risk, thereby laying the foundation for achieving the Basel III standards.
- 1.17 **Financial transparency.** The accumulation of risks (operational, credit, legal, and reputational) grows in the absence of mechanisms to: (i) promote transparency and the quality of information in the financial system; and (ii) prevent financial transfers between the formal sector and the illegal sector. A transparent framework for customers, owners, and the entities responsible for transactions in the financial sector, and between the latter and the real sector, contribute to: (i) preventing fraudulent transactions that could jeopardize the credibility and stability of the banking system; and (ii) promoting more efficient financial intermediation that is less susceptible to exogenous shocks.<sup>43</sup> In the case of Panama, greater financial transparency could generate major benefits in terms of:<sup>44</sup> (i) avoiding a "stigma" effect that could compromise the country's ability to attract the capital needed to finance its productive activities on a stable basis; and (ii) reducing the risks associated with financial instability caused by fraudulent or criminal activities. In this regard, the diagnostic assessments made by

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<sup>42</sup> Panama ranks fourth out of 144 countries in terms of access to financial services and banking health, and ranks 78th and 89th in terms of securities market regulation and protection of the rights of borrowers and lenders. Global Competitiveness Report 2012-2013.

<sup>43</sup> See IMF. 2012. *Anti-money laundering and Combating the Financing of Terrorism Inclusion in Surveillance and Financial Stability Assessments-guidance note*. Draghi, M. Giavazzi, F., and Merton, R. 2003. *Transparency, Risk Management and International Financial Fragility*. NBER WP 9806.

<sup>44</sup> For a comprehensive review of the effects of financial transparency on the functioning of the financial sector, see Masciandaro, D. 2013. *Is Anti Money Laundering Compliance Convenient? International Capital Flows and Stigma Effect in Latin America*. IADB-DP-311.

international agencies,<sup>45,46</sup> indicate that Panama's strategic challenges include: (i) improving the regulatory framework for the prevention of money laundering and the financing of terrorism (AML/CFT); (ii) increasing transparency concerning the legal beneficiary of legal entities; and (iii) increasing know your customer (KYC) requirements and strengthening the supervision of designated nonfinancial businesses and professions (DNFBPs).<sup>47</sup> In this area, the operation supports: (i) the adoption of a new regulation on bearer shares, as a mechanism to promote adequate, accurate, and timely information on the beneficial owners and control of legal entities;<sup>48</sup> (ii) the development of new AML/CFT regulations; and (iii) the development of new regulations for trust fund activities and their respective oversight.

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

- 1.18 **The government's commitment.** Given the economic significance for the country of macroeconomic, financial, and natural-disaster shocks, which could have a fiscal impact of between 10% and 20% of GDP according to recent experience (see the operation's [cost-benefit analysis](#)), the Panamanian government is actively strengthening integrated risk management, as evidenced by the Government's 2010-2014 Strategic Plan, technical dialogue between the authorities and the IMF, and the request for technical and financial support from the Bank.

#### **E. Proposed program**

- 1.19 **Objectives.** The program's general objective is to reduce the fiscal risk of macroeconomic, financial, and natural-disaster shocks by improving IRM. The two specific objectives are to: (i) strengthen sovereign asset and liability management; and (ii) improve financial stability. The program is structured in three components:
- 1.20 **Component I. Macroeconomic stability.** As indicated in the document CS-3633, maintaining a stable macroeconomic framework consistent with the program's objectives will be a condition for disbursement of the loan proceeds. Such consistency will be established in the Policy Letter and assessed through the Independent Macroeconomic Assessment (IMA).

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<sup>45</sup> IMF. 2007. *Panama: Detailed Assessments of Observance of Standards and Codes for Banking Supervision, Insurance Supervision, and Securities Regulation*.

<sup>46</sup> Compliance with the recommendations of the Financial Action Task Force (FATF) for combating money laundering and the financing of terrorism (AML/CFT) was assessed in 2007 as part of an evaluation of the financial system in Panama under the IMF program for the assessment of offshore financial centers. This evaluation was based on the FATF Recommendations in force at the time. Panama is expected to be evaluated again in 2014 under the FATF's *International Standards on Combating Money Laundering and Financing of Terrorism and Proliferation* adopted in 2012, and the respective methodology. The new methodology incorporates criteria of effectiveness in assessing compliance with the Recommendations.

<sup>47</sup> DNFBPs include casinos, real estate agents, dealers in precious stones, lawyers, notaries, and other independent legal professions, as well as trust funds and trust company service providers.

<sup>48</sup> This issue is also relevant in the review by the Global Forum on Transparency and Exchange of Information for Tax Purposes. Panama's Compliance with the standards set by the Global Forum will be reviewed in the second quarter of 2014.

1.21 **Component II. Strengthening of sovereign asset and liability management.**

This component is divided into two subcomponents.

**a. Subcomponent II.1. Strengthening integrated risk management.**

Upgrade MEF capacities to manage sovereign assets and liabilities through: (i) the formulation of a sovereign asset and liability management (SALM) strategy; (ii) the establishment of a unified structure of government bank accounts through a CUT system; and (iii) strengthening of FAP funding by incorporating into its assets the future sale of shares in State-owned mixed-capital enterprises. The second operation provides for SALM strategy implementation, including estimates of risks and the development of prevention and control tools.

**b. Subcomponent II.2. Development of financial instruments for natural-disaster risk management.**

This component targets: (i) the formulation of a national disaster risk financial management strategy (ENGFRD), which includes estimation of the coverage and appropriate financial instruments to enable the country to deal with emergencies caused by catastrophic events, and the scaling of a reserve fund to respond to recurrent events; (ii) the development of tools for public investment in actions to reduce natural-disaster risk through the development of a basic methodological guide for including disaster risk assessment in PIPs, a proposal to amend the Integrated Planning, Monitoring, and Evaluation system, and the Rules and Procedures of the National Public Investment System; and (iii) the adoption of a new expenditure item within the Budgetary Classifications Manual, making it possible to allocate funding for disaster risk prevention, mitigation, and readiness actions. The program's second operation includes implementation of the ENGFRD and the reserve fund, as well as the implementation of tools for public investment in natural-disaster risk management.

1.22 **Component III. Strengthening of financial stability.** This component is divided in three subcomponents.

**a. Subcomponent III.1. Development of tools to manage bank liquidity crises.** Approval of the PALEX Special Liquidity Assistance Program. The second operation envisages the entry into force of PALEX.

**b. Subcomponent III.2. Improving the Regulation and Supervision of the Financial System.** This consists of the following actions:

(i) strengthening of banking regulation and supervision through the approval of the new credit risk regulations and presentation of the regulation on financial conglomerates for public consultation; (ii) improvement of regulation and supervision in the insurance market



by presenting, for public consultation, regulations on the technical reserves that insurers and reinsurers must provide for each line of business, and approval of the regulation of the activity of insurance brokers and brokerages, and account executives; (iii) improvement of regulation and supervision in the stock market with the entry into force of the regulation on capital requirements for brokerage firms and regulation of the foreign exchange market; and (iv) strengthening the CCF strategy on financial education to boost confidence in the financial system. The second operation will implement measures in each of these areas, including the entry into force of: (i) the regulation of financial conglomerates, market risk, liquidity risk, and derivatives for the banking system; (ii) regulations on provisioning by insurance and reinsurance companies; (iii) a risk-based inspection and supervision process in the SVP; and (iv) a comprehensive training plan for financial system regulators led by the CCF.

- c. **Subcomponent III.3. Financial transparency strengthening.** This subcomponent will include the following actions: (i) the draft law issued by the MEF, agreed upon with relevant public institutions to adopt measures to prevent money laundering and combat the financing of terrorism; (ii) regulations to strengthen and standardize KYC requirements in simplified processes for opening bank accounts; (iii) National Assembly approval of the Law on Bearer Shares; (iv) approval of a draft law on trust funds and their supervision by the SBP; and (v) presentation for public consultation of a new law on the Accounting Profession in Panama. In the program's second operation, a GAP analysis will be performed to identify compliance with the new standards and develop an institutional strengthening plan.

## **F. Results indicators**

- 1.23 Strengthening the country's IRM aims to minimize the fiscal impact of macroeconomic, financial, and natural-disaster shocks. The key indicator for measuring this objective will be behavior of the country's risk rating, which is expected to remain stable or improve from its current BBB level. Further details can be found in the program's [Results Framework](#).

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

### **A. Financing instrument**

- 2.1 This operation is the first of two consecutive loans, each of a single tranche, which are technically linked to each other but financed independently in the form of programmatic policy-based loans (PBLs). This financing instrument is considered appropriate because of the flexibility it affords by adapting the policy dialogue with the government to the priorities and optimal sequencing of the reforms.

- 2.2 While this first operation is proposed for a total of up to US\$300 million, the amount of the second operation will depend on the country's financial needs and the availability of programming resources.
- 2.3 **Conditions precedent to disbursement.** Disbursement will be subject to compliance with the policy conditions specified in Annex II (Policy Matrix), in addition to the conditions of the loan contract.

**B. Environmental and social safeguards**

- 2.4 As stipulated in Directive B.13 of the Bank's Environment and Safeguards Compliance Policy (document GN-2208-20 and Operational Policy OP-703), this operation does not require classification since it is a programmatic PBL. Any policy changes introduced under this operation will have no direct or significant social or environmental impacts and will not impinge on the country's natural resources.

**C. Risks and key issues**

- 2.5 **Coordination between donors.** The Bank has worked closely with the IMF in the design of the program to ensure consistency and complementarity with the actions undertaken. The program takes into account the recommendations made in the IMF's Article IV consultation in 2013 and the FSAP in 2012.
- 2.6 **Program risks. (i) Development risks.** Delay in fulfilling the conditions of the policy matrix is considered a medium risk due to the technical complexity of some of the regulations involved. This risk is mitigated by the technical assistance provided by the Bank and the IMF and close monitoring of progress (see paragraphs 1.5 and 3.3). **(ii) Macroeconomic and fiscal risks.** Public accounts may deteriorate due to changes in the public investment plan or macrofinancial shocks; but this is a low risk because the government has managed growth prudently; **(iii) Governance and public sector management risks.** The presidential elections scheduled for April 2014, along with inadequate coordination among public agencies, lack of technical and financial resources, or opposition to certain regulations from groups with vested interests, could delay the adoption of laws and regulations included in the program. This risk is considered medium and is mitigated by the high degree of public-private dialogue maintained by the authorities on the issues addressed by the program, as well as the technical assistance provided by the Bank and the IMF (see paragraphs 1.5 and 3.3).

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

**A. Summary of implementation arrangements**

- 3.1 The executing agency is the Ministry of the Economy and Finance of Panama (MEF), which will designate the Bureau of Public Credit as Program Coordinator with responsibility for: (i) helping the participating entities to implement and coordinate the technical execution; (ii) filing monitoring reports, (iii) monitoring compliance with the Policy Matrix (see Annex II); and (iv) gathering evidence of compliance with the program objectives specified in the [Results Matrix](#).

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

- 3.2 The program's implementation will be monitored by the Panamanian government through the MEF. The borrower and the Bank will hold quarterly meetings to review performance and the status of the required conditions. At the end of the programmatic series, the Bank will produce a project completion report to evaluate outcomes.

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

- 3.3 Activities to achieve the commitments defined in this first operation are expected to be completed by the loan approval date. The Bank is providing technical assistance for: (i) the design and implementation of an integrated sovereign asset and liability management strategy (PN-T1119, US\$250,000); (ii) a financial transparency strategy under the regional technical cooperation program to prevent money laundering and terrorism financing" (RG-T2224); (iii) improved financial sector regulation (market and liquidity risk) under the regional technical cooperation program to improve the productive environment (RG-T1670); and (iv) improvement of the financial management of natural disasters (operation ATN/OC-12763-PN, US\$650,000). The IMF has provided technical assistance through CAPTAC/IMF for the design of the liquidity fund and creation of the CUT.

**IV. POLICY LETTER**

- 4.1 **Policy Letter.** The [Policy Letter](#) reflects the agreement between the Bank and the Panamanian government: (i) the government's commitment to the objectives and activities included among the program's operations; and (ii) the consistency of policies for improving financial and fiscal stability and transparency.

Development Effectiveness Matrix				
Summary				
I. Strategic Alignment				
1. IDB Strategic Development Objectives		Aligned		
Lending Program	i) Lending to small and vulnerable countries, and ii) Lending to support regional cooperation and integration.			
Regional Development Goals	Ratio of actual to potencial tax revenue.			
Bank Output Contribution (as defined in Results Framework of IDB-9)	Public financial systems implemented or upgraded.			
2. Country Strategy Development Objectives		Aligned		
Country Strategy Results Matrix	GN-2596	Improve the effectiveness and efficiency of public expenditure at the federal and subnational level.		
Country Program Results Matrix	Not available	Pending to be approved.		
Relevance of this project to country development challenges (If not aligned to country strategy or country program)				
II. Development Outcomes - Evaluability		Highly Evaluable	Weight	Maximum Score
		9.1		10
3. Evidence-based Assessment & Solution		9.6	33.33%	10
3.1 Program Diagnosis		3.0		
3.2 Proposed Interventions or Solutions		3.6		
3.3 Results Matrix Quality		3.0		
4. Ex ante Economic Analysis		10.0	33.33%	10
4.1 The program has an ERR/NPV, a Cost-Effectiveness Analysis or a General Economic Analysis		4.0		
4.2 Identified and Quantified Benefits		1.5		
4.3 Identified and Quantified Costs		1.5		
4.4 Reasonable Assumptions		1.5		
4.5 Sensitivity Analysis		1.5		
5. Monitoring and Evaluation		7.7	33.33%	10
5.1 Monitoring Mechanisms		1.0		
5.2 Evaluation Plan		6.7		
III. Risks & Mitigation Monitoring Matrix				
Overall risks rate = magnitude of risks*likelihood		Medium		
Identified risks have been rated for magnitude and likelihood		Yes		
Mitigation measures have been identified for major risks		Yes		
Mitigation measures have indicators for tracking their implementation		Yes		
Environmental & social risk classification		B.13		
IV. IDB's Role - Additionality				
The project relies on the use of country systems				
Fiduciary (VPC/PDP Criteria)	Yes	The project relies in all financial management country systems.		
Non-Fiduciary				
The IDB's involvement promotes improvements of the intended beneficiaries and/or public sector entity in the following dimensions:				
Gender Equality				
Labor				
Environment				
Additional (to project preparation) technical assistance was provided to the public sector entity prior to approval to increase the likelihood of success of the project	Yes	The Bank is providing technical assistance for: i) the design and implementation of a strategy on integrated management of sovereign assets and liabilities (PN-T1119, US\$250.000); ii) a financial transparency strategy, under the regional technical cooperation aimed at preventing money laundering and terrorism financing (RG-T2224); iii) improving financial sector regulations (market and liquidity risks) under the regional technical cooperation aimed at improving the productive atmosphe (RG-T1670); and iv) support financial management of natural disasters (ATN/OC-12763-PN, US\$650.000).		
The ex-post impact evaluation of the project will produce evidence to close knowledge gaps in the sector that were identified in the project document and/or in the evaluation plan				

The objective of the program is to reduce the fiscal risk of macroeconomic or financial shocks and natural disasters through the improvement of the overall risk management. The operation is aligned with the following lending programs: i) Lending to small and vulnerable countries and ii) Lending to support regional cooperation and integration. It is also aligned with the Regional Development Goal ratio of actual to potential tax revenue. The operation contributes to the Results Framework Output of Public financial systems implemented or upgraded. The loan is aligned with the country strategy.

The diagnosis presents adequate information on Panama's vulnerability to possible macroeconomic or financial shocks or natural disasters. The vertical logic is adequate and the proposed indicators allow measuring the results of the operation. The document presents an appropriate economic analysis that compares the benefits in reducing the cost of facing an external shock to the cost of borrowing.

The Monitoring and Evaluation Plan is adequate, it is planned to develop a rigorous study on the effect of reforms on the key performance indicators. The document identifies the risks of the operation and proposes mitigation measures.

## POLICY MATRIX

POLICY OBJECTIVES	AGREEMENTS FIRST LOAN <sup>1</sup>	AGREEMENTS SECOND LOAN
<b>Component I - Macroeconomic stability</b>		
Maintain a stable macroeconomic environment consistent with the program's objectives.	Macroeconomic policy framework consistent with the guidelines of the Sector Policy Letter	Macroeconomic policy framework consistent with the guidelines of the Sector Policy Letter.
<b>Component II – Strengthening of public sector asset and liability management</b>		
<b>Subcomponent II.1 – Strengthening integrated risk management</b>		
Strengthening of the capacities in the Ministry of the Economy and Finance (MEF) to manage sovereign assets and liabilities.	Formulation of a sovereign asset and liability management (SALM) strategy  Strengthen the capital of the Panama Saving Fund (FAP), incorporating the future sale of shares in mixed ownership state enterprises into the Fund's assets.  Establishment of a unified structure of government bank accounts through a Single Treasury Account (CUT) system.	Implementation of the SALM strategy, including estimations of risks and the development of prevention and control tools.
<b>Subcomponent II.2 – Development of financial instruments for natural-disaster risk management</b>		
Development of a natural-disaster risk financial management strategy.	Formulation of a proposal for a national disaster-risk financial management strategy.  Identification of the coverage needed to deal with emergencies and the scaling of a reserve fund for recurrent events.	Entry into force of the National Disaster Risk Financial Strategy and establishment of the Reserve Fund for Recurrent Events.
Development of instruments allowing for public investment in reducing fiscal contingent liabilities associated with natural disasters.	Approval of the design of tools to incorporate the analysis of natural-disaster risk and vulnerability into public investment projects:	Implementation of tools to incorporate the analysis of natural-disaster risk and vulnerability into public investment projects, and the allocation of budgetary funding to reduce disaster risk through the expenditure item created.

<sup>1</sup> See the [Means of verification matrix](#) for further details on the instruments associated with the agreements, the decision-making authority, and level of approval required.

POLICY OBJECTIVES	AGREEMENTS FIRST LOAN <sup>1</sup>	AGREEMENTS SECOND LOAN
	<ul style="list-style-type: none"> <li>Methodological guidelines for including disaster risk management in public investment projects in Panama.</li> <li>Proposal to modify the SIPMEP integrated project planning, monitoring, and evaluation system.</li> <li>Proposal to modify the standards and procedures of the National Public Investment System (SINIP).</li> </ul> <p>Approval of a new expenditure item in the budgetary classifications manual, making it possible to allocate resources to prospective, corrective, and reactive disaster risk management actions.</p>	
<b>Component III – Strengthening of financial stability</b>		
<b>Subcomponent III.1 – Development of tools to manage bank liquidity crises</b>		
Development of a strategy for managing bank liquidity risk.	Design of a Liquidity Fund (PALEX – Special Liquidity Assistance Program), in accordance with international best practices.	Entry into force of the Liquidity Fund, in accordance with international best practices.
<b>Subcomponent III.2 – Improving the regulation and supervision of the financial system</b>		
Improvement of risk-based bank regulation and supervision.	Entry into force of the new credit risk regulation. Presentation of the regulation on financial conglomerates for public consultation.	Entry into force of the regulation on financial conglomerates, market risk, liquidity risk, and derivative instruments.
Improvement of regulation and supervision in the insurance market.	<p>Presentation of the regulation on the reserves of insurance and reinsurance companies (mathematical, prevention, mismatch, and catastrophic risks), for public consultation.</p> <p>Regulation of the activities of insurance brokers and brokerages and insurance sales account executives.</p>	<p>Entry into force of the regulation governing provisioning by insurance and reinsurance institutions.</p> <p>Entry into force of a human resource policy and a Job Description Manual for the Superintendency of Insurance and Reinsurance of Panama.</p> <p>Launch of a system for obtaining, processing, and analyzing information from the regulated and supervised entities.</p>

POLICY OBJECTIVES	AGREEMENTS FIRST LOAN <sup>1</sup>	AGREEMENTS SECOND LOAN
Improvement of regulation and supervision in the securities market.	Entry into force of the regulation governing the capital requirements of securities brokerages. Entry into force on the regulation on the international foreign exchange market (FOREX).	Entry into force of a risk-based inspection and supervision process that includes: preparation of a risk-based supervision manual; training for SVP inspection staff; and implementation in at least three entities. Entry into force of regulations on the transparency rules governing the operations of supervised entities.
Strengthening of the Financial Coordination Council (CCF)	Approval of a training plan on financial education to improve confidence in the financial system.	Design and launch of a training plan on macroprudential supervision (of the Superintendencies of Securities, Insurance, and Banks, and IPACOOOP).
<b>Subcomponent III.3 – Financial transparency strengthening</b>		
Enhanced prevention of money laundering.	Draft law defining measures to prevent money-laundering and the financing of terrorism, to be adopted by the MEF, as agreed upon with the relevant public institutions. Regulation to strengthen and standardize “know your customer” requirements in simplified processes for opening bank accounts.	Performance of a Gap Analysis to verify compliance with the new Financial Action Task Force (FATF) standards and respective methodology, and development of a plan with the institutional strengthening actions needed to fulfill it.
Greater transparency in financial reporting and corporate governance	Approval of the Law on Bearer Shares by the National Assembly: <ul style="list-style-type: none"> <li>Adopting an authorized custody regime applicable to the issuance of bearer shares, which maintains a register of the beneficial owner of such instruments, and</li> <li>Indicating that the custody agents are regulated and registered.</li> </ul> Approval of a Draft Law on Trust Funds and the Regulation and Supervision of Trust Funds by the Panamanian Banking Superintendency (SBP). Presentation of a new Law Regulating the Accounting Profession in Panama, for public consultation.	Accounting training for staff of the regulatory institutions, based on the Law to Update the Regulatory Framework Governing the Accounting Profession in Panama, Code of Ethics of the Accounting Profession, and NIF and NIE standards. Entry into force of the Law Regulating the Accounting Profession in Panama, and the Draft Law on Trust Funds and SBP Regulation and Supervision of Trust Funds.