

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK
MULTILATERAL INVESTMENT FUND

NICARAGUA

**SUPPORT FOR THE SUPERINTENDENCY OF BANKS AND OTHER
FINANCIAL INSTITUTIONS**

(TC-99-12-01-3)

DONORS MEMORANDUM

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ANNEXES

Annex I Logical framework

ABBREVIATIONS

| | |
|------|---|
| BCN | Banco Central de Nicaragua [Central Bank of Nicaragua] |
| CESI | Committee on Environment and Social Impact |
| GDP | Gross domestic product |
| MIF | Multilateral Investment Fund |
| NGO | Nongovernmental organization |
| SBIF | Superintendencia de Bancos y Otros Instituciones Financieras [Superintendency of Banks and Financial Institutions] |

SUPPORT FOR THE SUPERINTENDENCY OF BANKS AND OTHER FINANCIAL INSTITUTIONS

(TC-99-12-01-3)

EXECUTIVE SUMMARY

| | | |
|-----------------------------------|---|---------------------|
| Executing agency: | Superintendency of Banks and Financial Institutions (SBIF) | |
| Beneficiary: | The direct beneficiary of the project will be the SBIF, which will thus be able to strengthen its organizational structure, procedures, and systems, in order to enhance its capacity to supervise the country's financial institutions. Indirect beneficiaries of the project will be the depositors and borrowers of national financial institutions, particularly those in low-income groups with less access to financial information from financial institutions and less capacity to analyze such information on their own. | |
| Financing: | MIF (Facility I) Nonreimbursable: | US\$ 1,238,000 |
| | Local contribution: | <u>US\$ 839,000</u> |
| | Total: | US\$ 2,077,000 |
| Objectives and components: | The general objective of the project is to reduce the vulnerability of the country's financial system, and to give broad segments of Nicaraguan society access to credit without jeopardizing deposits by the public. The specific objective is to consolidate and strengthen the SBIF in its capacity to regulate, supervise, and inspect bank and nonbank financial intermediaries and their operations and to ensure that they are technically and administratively efficient. To attain these objectives, the project will be divided into the following five components: (i) updating the framework for regulation and supervision of the financial banking sector; (ii) updating and developing a framework for regulation and supervision of nonbank financial institutions; (iii) transforming the technology platform and developing systems audit capacity; (iv) consolidating and expanding personnel technical capacity; and (v) strengthening the SBIF's organizational and administrative structures. | |
| Terms: | Execution period: | 36 months |
| | Disbursement period | 42 months |

**Special
contractual
clauses:**

As a condition precedent to the first disbursement, the executing agency shall present to the Bank (i) evidence that the project coordinator has been selected; and (ii) a work plan for year one and an acceptable schedule of activities (paragraph 9.1).

**Environmental
and social
review:**

The project was reviewed by the Committee on Environment and Social Impact (CESI) on 18 August 2000 (TRG 31-00), and its design reflects the comments expressed at that meeting (paragraph 6.3).

I. COUNTRY AND PROGRAM ELIGIBILITY

- 1.1 The Donors Committee declared Nicaragua eligible for all forms of financing from the Multilateral Investment Fund (MIF) on 30 March 1995. The project is consistent with the general aims of the MIF and conforms to the provisions of the Technical Cooperation Facility. The MIF resources will be used to help develop a national financial market through a more effective framework for governing banking and nonbanking institutions and through institutional strengthening of the regulatory body in its capacity of supervision and oversight, thus reducing potential financial risks to the general public, and producing a climate more conducive to private-sector investment.

II. BACKGROUND

A. Financial sector

- 2.1 During the 1990s, the Nicaraguan financial system underwent sweeping changes. A system comprised entirely of state intermediaries was transformed into one in which private providers were predominant with broad participation by institutions and with a wide array of products. Since 1991 when the first private bank was authorized to operate, 14 private institutions have entered the market. During that same period, state-owned banks stopped offering the services of a first-tier bank. By the end of 2001, total deposits in the banking system amounted to US\$1.874 billion, or 96% of GDP, compared with total deposits of US\$585 million, or 35% of GDP a decade earlier.¹
- 2.2 As in the case of banks, the number of nonbank financial institutions has grown rapidly during the 1990s. These include specialized financial institutions such as bonded warehouses, finance companies, and private providers of insurance services. In November 2001, the value of merchandise held in bonded warehouses totaled US\$26 million and premiums collected by the insurance industry US\$26.5 million. In addition, the advent of the Nicaraguan stock exchange in 1995 formally established a capital market in the country. Although debt instruments are virtually the only securities traded on the exchange at the present time, the value of transactions executed in November 2001 was US\$95 million.
- 2.3 In recent years, a crisis in the Nicaraguan banking system led to the closure of 9 of 15 commercial and state-owned banks operating in the sector (7 private commercial banks and two official development banks were forced to liquidate or merge with

¹ Although the data for early 1990s reflect official statistics, they should be considered inflated because of the high proportion of low-quality assets held by the dominant state-owned banks.

other banks²), owing mainly to such problems as poor management, loans to related parties, irregular operations, high portfolio concentration, loss of public trust and runs on deposits which increased the risks of illiquidity and/or insolvency and undermined profitability. The estimated cost to taxpayers was approximately US\$313 million, or 16% of GDP in real terms. All of these new banks had been regulated and supervised by the Office of Supervision. This exposes the fragility, vulnerability, shortcomings, and weaknesses of the financial system in addition to the problems affecting the real economy that affected the coffee industry in particular. Now, more than ever before, the body regulating financial activities in the country needs to be strengthened in prudential regulation, *ex situ* and *in situ* supervision, information systems, staff development, organization and administration to prevent the entire sector from being undermined by a systemic crisis.

B. Structure of banking regulation and supervision in Nicaragua

- 2.4 Developing the predominantly privately owned financial sector went hand in hand with the creation of a framework for regulation and supervision that did not in fact exist during the 1980s. In 1991, the Superintendency of Banks and Financial Institutions (SBIF) were set up as an independent body to regulate and supervise the sector. Subsequently, the first prudential standards were issued for the financial sector. By 1999, the regulatory and legislative base for the financial sector was modernized. This included a reform of the Bank Act (Law 314), the Charter of the Office of Bank Supervision (Law 316), the Central Bank Act (Law 317), and the Financial Institutions Deposit Guarantee Act (Law 371), which were approved and took effect in late 1999 as part of the second phase of financial sector reform. Also, prudential standards were amended to reflect international "*Best Practices*" (particularly the Basle Principles). At the same time, the SBIF's technical capacity and organizational structure were strengthened so that the legislative and supervisory framework could be put in place.
- 2.5 At present, the Nicaraguan legislation is in various stages of preparation. So far, activities have focused mainly on establishing a basis for regulation and supervision for the banking sector and to a lesser extent for nonbank providers of financial services. Consequently, the framework for regulation and supervision for such service providers as well as the SBIF's technical capacity have lagged behind developments in the market, permitting regulatory arbitrage—allowing nonbank institutions to operate unregulated and financial groups to take advantage of these gaps and incur greater risks. Moreover, a broad segment of the Nicaraguan

² The following public and private banks closed, went into administration, and/or were liquidated: Banco Nacional de Desarrollo (voluntary liquidation, 1995, and court-ordered liquidation), Banco Centroamericano (1996), Banco del Sur (1999), Primer Banco Inmobiliario (1999), Banco de Crédito Popular (voluntary liquidation, 2000), Banco Intercontinental (2000), Banco del Café (2000), Banco Mercantil (2001), and Banco Nicaragüense de Industria y Comercio (2001).

population does not have access to credit and financial services. As a result, it has become necessary to develop prudential standards that encourage institutions serving small business and microenterprise to join the financial system and to provide housing loans for low-income groups. The absence of proper legislation and standards hampers stock market transactions and financial operations, making primary securities the sole instrument available for savings in the country.

- 2.6 Growth of the banking sector calls for careful review of standards and the organizational structure of the SBIF. These two aspects of this regulatory body (standards and organizational structure) take on even more importance in light of the opening up of the financial sector, the formation of financial groups in the region, and the increasing globalization of the Nicaraguan economy, which will demand broader capacity for regulation and supervision for the SBIF. The modernization of the regulatory framework as well as the instruments of the SBIF and its organizational structure are pivotal for permitting the continued deepening of the Nicaraguan financial market through the entry of new service providers and the development of new products in a competitive and orderly process. Such a process should include professional requirements for positions directly related to the process of supervision and a proposed amendment of the organizational structure with a view to making it function in accordance with the new methodology for supervision.
- 2.7 **Money laundering.** Nicaragua is a member of the Caribbean Financial Action Group and has at its disposal legal mechanisms for preventing and punishing money laundering by law and decree as well as administrative standards.³ In addition, the recently established Financial Analysis Committee whose members are the SBIF, the Public Prosecutor's Office, the national police, and specialists in accounting and bank law. Also, the National Antidrug Commission approved a national plan, which sets out specific actions to control money laundering. Nonetheless, weaknesses persist in how these legal instruments will be applied because of budgetary constraints and insufficient human resources. Under way are a number of programs for international and regional cooperation to help rectify these shortcomings.

C. MIF experience with microfinancing

- 2.8 Since 1990, a significant number of microcredit service providers were established as nongovernmental organizations (NGOs), savings and loan associations, and other types of credit unions. However, most of these entities have not succeeded in expanding their services and sustaining their performance as measured against best

³ Law 285 and Decree 74-99 published in 1999; Law on Narcotics, Psychotropic Substances, and Other Controlled Substances; Laundering of Money and Assets from Illicit Activities; and Regulations to Law 285; and SBIF Board of Directors Resolution adopted in 2002 entitled "Resolution to Prevent the Laundering of Money and Other Assets".

practices in the region. The MIF, through equity investment and technical assistance, has been lending support to financial intermediaries that specialize in credit for small businesses and microenterprises that do not have access to financing from commercial banks. Also, two MIF projects are now in preparation, the first for a line of credit and the other for an equity contribution for financial institutions specializing in microcredit that have been recently approved or are in the final stages of approval. One of the lessons learned is that, for sustainable development of the specialized financial services industry, it is essential to have a regulatory framework governing nonbank institutions. Specialized financial entities frequently spring up as subsidiaries of large economic groups and very often they operate within a regime that is not properly defined so that a level of supervision similar to that in place for bank institutions is required.

III. BASIC OBJECTIVES AND COMPONENTS OF THE PROGRAM

A. Objectives

- 3.1 The general objective of the project is to reduce the vulnerability of the country's financial system, and to give broad segments of Nicaraguan society access to credit without jeopardizing deposits by the public. The specific objective is to consolidate and strengthen the SBIF in its capacity to regulate, supervise, monitor, and inspect bank and nonbank financial intermediaries and their operations and to ensure that they are technically and administratively efficient.
- 3.2 To attain these objectives, the project will be divided into the following five components: (i) updating the framework for regulation and supervision of the financial banking sector; (ii) updating and developing a framework for regulation and supervision of nonbank financial institutions; (iii) transforming the technology platform and developing systems audit capacity; (iv) consolidating and expanding personnel technical capacity; and (v) strengthening the SBIF's organizational and administrative structures.
- 3.3 To fulfill the specific objectives and adapt the standards to the new laws and the legislative framework recently introduced, the project will develop a wide range of activities that will focus overall on efforts to consolidate and strengthen SBIF capacity. The proposed activities will encompass the general performance of the SBIF and its different offices (cross-cutting issues) as well as specific areas of support for the SBIF, as described below.

B. Component 1. Updating the framework for regulation and supervision of the financial banking sector (MIF: US\$357,000; Local counterpart: US\$188,600)

- 3.4 This component will center mainly on bank supervision, by helping to design and introduce standards and to develop the SBIF's basic technical capacity, particularly in the consolidated supervision of financial groups.
- 3.5 More specifically, consultants with proven experience in financial systems legislation and supervision will be hired to assist the SBIF in (i) reviewing and evaluating compliance with Basle Principles by the banking sector; (ii) reviewing and updating the regulations for supervision, including prudential standards for the bank sector, particularly with respect to portfolio rating, market and operational risks, preventive measures, and operations with offshore entities; and (iii) consolidating the process of strengthening *ex situ* analytical capacity of technical experts. This includes building analytical models that incorporate early warning signals and estimation models.⁴
- 3.6 Furthermore, instruments and standards for consolidated supervision of financial groups would be developed and introduced as would standards for consolidated financial statements, definition and design of multisector or centralized areas of action such as permanent *ex situ* monitoring systems, computerized audits of financial institutions, introduction and monitoring of "know your customers rules" to prevent money laundering.
- 3.7 All of these efforts will come together to establish a mechanism and approach to consolidated supervision within the SBIF. To help the SBIF discharge its functions of supervision and control more efficiently, a methodology for comprehensive and preventive supervision that assesses key areas of regulated bodies and evaluates the risks facing each institution will be essential. This methodology will make it possible to evaluate objectively the condition of a financial institution so that structural measures can be proposed to ensure its long-term viability. The organizational plan for consolidated supervision will include developing integrated analytical mechanisms, an integrated and preventive supervision manual, updating and standardization of the master chart of accounts (a single manual for any type of financial intermediary), modernizing the chart of accounts of financial intermediaries to facilitate overall risk evaluation, and designing a standardized penalty matrix to cover all entities in the system.

⁴ Such models will include a diagnostic assessment to determine the financial condition of banks, computerized products for asset control, control of related and nonrelated economic groups, compliance with legal limits, financial projection models for financial entities and consolidated supervision.

C. Component 2. Updating of the framework for regulation and supervision of the nonbank financial institutions (MIF: US\$278,000; Local counterpart: US\$50,000)

- 3.8 At present, the SBIF supervises a growing number of nonbank financial intermediaries, including finance companies, bonded warehouses, insurance companies, brokerage firms, and providers of financial leasing services and other financial products.
- 3.9 As part of this component, prudential standards will be developed for nonbanking institutions and providers of other credit services, by increasing SBIF capacity to regulate and control such intermediaries. Also, specialized consultants will be hired to assist the SBIF in (i) consolidating the reform of the legislative framework and updating standards for supervision of insurance markets that includes preparing provisions and methodologies for supervision of insurance companies; (ii) monitoring the process of approving and implementing proposed regulations, developing manuals and guidelines for inspection, regulations for registration of policies and investments and standards relating to reinsurance; and (iii) implementing models for *ex situ* analysis for analysts and inspectors in the field.
- 3.10 The component will provide financing for: (i) reviewing and updating the Bonded Warehouses Act, by strengthening the mechanisms for issuance of securities, leases for premises and warehouses, and protection of merchandise, and by developing methods for supervision for analysts and inspectors in the field; (ii) developing a legislative framework and standards for regulation of financial leasing and trust operations and designing systems for supervision; (iii) reviewing the present provisions on home financing and recommending modifications to the legislative framework as a means of promoting the mortgage market; and (iv) consolidating the process of strengthening capital market supervision, by adapting the framework to the proposed Securities Market legislation, reviewing the appropriate framework for development of a sound, transparent, and competitive capital market, and reviewing the present model for on-site and off-site supervision. Attention will also focus on regulating the standards and procedures to be followed by corporate entities that make capital investments in auxiliary financial institutions, such as securities, insurance, and mutual funds, whose models for supervision need to be developed.
- 3.11 In addition, experts will be hired to develop prudential standards for banks and specialized entities that grant microcredit, and to formulate methodologies for supervision of microcredit portfolios. Based on a number of earlier private initiatives to develop a special framework, the project will cover the cost of consultants hired to analyze and amend the present bill, and propose a legal framework that can be adapted to the particular conditions of each sector.

D. Component 3. Transformation of technology platform and development of systems audit capacity (MIF: US\$81,000; Local counterpart: US\$176,400)

- 3.12 The present capacity of SBIF information systems is fairly basic. However, expanding its areas of action and moving forward with the process of accelerated obsolescence of technology solutions to start up these activities calls for modernization and expansion of the information systems platform. This technology transformation will help to enhance the release and dissemination of transparent financial information. Also, the SBIF needs to expand and improve the capacity of its computer equipment, network connections with intermediaries, modems, and programs to integrate intermediaries in the exchange of financial information.
- 3.13 This component will help the SBIF in two specific areas. First, the present information system platform will be reviewed and strategic short- and medium-term plans for investment in technology will be developed for all areas of operations and the institution as a whole. This will permit the consolidation of those systems that support the tasks of supervision and the standardization of applied tools and services while facilitating economies of scale in procurement and implementation of technical solutions. The project resources will be used for procurement of certain tools and equipment.
- 3.14 The project resources will also be used to contract advisory assistance to enable the SBIF to develop computerized systems for collecting, validating, analyzing, and disseminating financial data for the institutions and for the general public. In particular, information systems solutions will be developed for on-line communication and direct electronic transmission of financial information between financial institutions and the SBIF and remote access to the information provided to the general public.
- 3.15 Lastly, under this component, financing will be provided for initial development of a centralized risk management system to improve the financial debtor database that includes information-based exit products and technical assistance will be provided for developing a manual to help analysts using the centralized risk management system.

E. Component 4. Consolidating and expansion of personnel technical capacity (MIF: US\$200,000; Local counterpart: US\$42,000)

- 3.16 The growth of the Nicaraguan financial sector and the increasing number of financial products available in the market makes permanent specialized training and instruction for SBIF staff a necessity. Supervision of financial institutions in the modern age is a career path that is not now offered in post-secondary education, and it must be learned in the workplace or through courses and seminars given by international financial experts in different fields of expertise. Under the project, experts will be hired to assist the SBIF in implementing and developing a training

plan for its technical staff giving them the technical tools to perform the tasks of supervision effectively. The project will permit access to training facilities not available in the country by designing and implementing an exchange program with foreign agencies engaged in financial oversight.

- 3.17 The project will finance modules with courses and programs that systematically train SBIF professional and technical personnel in such topics as risk circuits and management assessment, portfolio evaluation procedures, external and internal audit evaluation, standards interpretation, and system fundamentals.
- 3.18 A series of in-service training courses and exchanges with on-hands practical experience will be offered abroad so that SBIF technical staff has access to the modus operandi of counterpart institutions in other countries. Two- and three-week visits will be made by 20 officials to countries having experience in regulation and supervision of banking and nonbank institutions, and in the development of financial information and management systems.

F. Component 5. Strengthening of SBIF organizational and administrative structure (MIF: US\$200,000; Local counterpart: US\$0)

- 3.19 The updating of standards and the review of the legal framework governing financial service providers are not sufficient to ensure that the market as it stands can effectively perform the necessary supervision. In order to discharge fully the functions and powers conferred by law, the SBIF will need an efficient organizational and administrative structure. Moreover, as a result of the spate of new institutions and financial products that have entered the Nicaraguan financial market since its inception in 1992, the SBIF has set up special offices for nonbank sectors⁵ in addition to the already existing Office of Bank Supervision.
- 3.20 Although these special offices were created to supervise specific markets, it also brings with it the risk of isolating areas of joint action for the entire financial sector and of creating a structure that is less cost efficient in terms of the size of the financial market. More effective coordination is needed particularly between the four different offices and between the units that will supervise the introduction of new financial products such as financial leasing, factoring, mutual investment funds, and fiduciary operations. Such coordination would go hand in hand with efforts to strengthen the offices' working methods and procedures, especially in areas of financial analysis and monitoring as well as on-site supervision.
- 3.21 This component will assist the SBIF in developing a proposal for a medium-term organizational structure for the institution that will include identifying the number

⁵ The SBIF is presently organized into four offices (banks and financial institutions, insurance, securities, and bonded warehouses).

of special sector offices and their functions, and the design of SBIF management information and administrative systems. The proposal will complement the short- and medium-term human resources strategy developed.

- 3.22 In addition, management tools will need to be developed so that the SBIF can administer and control its resources efficiently. This component will help the institution to perform an independent evaluation of its present administrative and audit capacity and to develop and implement proposed reforms based on a strategic management and audit plan. These activities will also include (i) senior executive support for the Superintendent; (ii) a review of the SBIF's operational and administrative structure; (iii) development and implementation of mechanisms, processes, intra-institutional and interinstitutional coordination methods for establishing and monitoring operating performance targets in different areas including reforms to procedures for receipt, retrieval, filing, and document destruction; (iv) development of a methodology for budgeting, accounting, cash flow, and procurement, and a cost control system; (v) drafting of a code of ethics and legal protection for SBIF officials; and (vi) development of human resources management policies and processes (employee performance appraisal).

IV. EXECUTING AGENCY AND EXECUTION MECHANISM

A. Executing agency

- 4.1 The project will be carried out by the Superintendency of Banks and Financial Institutions (SBIF). This institution was created in 1991 pursuant to Law 125 of 21 March 1991, and is presently governed by the Superintendency of Banks and Financial Institutions Act (Law 316) passed on 29 September 1999. As of February 2002, the SBIF was supervising the activities of 26 financial institutions and the securities exchange. The institution was structured into four offices of supervision and vigilance and four supporting offices. It has a staff of 92 employees, 60% of whom are management and technical personnel and it is administrated by a Superintendent, who reports to a Board of Directors chaired by the President of the Central Bank of Nicaragua (BCN). Pursuant to Law 316, the SBIF finances its activities by means of contributions from each institution it supervises in an amount equivalent to 0.1% of the supervised institution's average assets, and a contribution from the BCN corresponding to 25% of its annual budget. For 2001, the contributions received from financial institutions amounted to approximately US\$2 million and the BCN contribution to US\$800,000.

B. Executing mechanism

- 4.2 The Superintendent's Executive Assistant will act as project manager, devoting 25% of his time to project administration. The project manager's main duties will be: (i) to supervise the work of the coordinator (see paragraph below); (ii) to ensure

that all mechanisms are set up for project management and execution; (iii) to see to it that manuals are properly prepared and procedures applied; (iv) to ensure proper use of operating resources so that project targets can be fulfilled; and (v) to coordinate and form alliances with other public and private institutions, serving as liaison between the Bank and the executing agency.

- 4.3 To facilitate execution of the project, a project coordinator and an administrative assistant will be hired to prepare and implement procedures for contracting consultants and the terms of reference for short- and medium-term consultants for specific activities. They will also be involved in day-to-day administration of the project. The project coordinator will report to the project manager, who will be supported by the different offices and by SBIF technical and legal advisors.
- 4.4 The responsibilities of the project coordinator will include: (i) implementing and maintaining proper systems for contract administration, financial administration, and internal control of project resources in accordance with the Bank's procedures; (ii) submitting disbursement requests and documentation justifying expenses; (iii) preparing and presenting the project financial statements and any other financial reports that may be required by the Bank; and (iv) maintaining separate bank accounts solely for administration of the MIF contribution and the local counterpart funding.

C. Beneficiaries

- 4.5 The direct beneficiary of the project will be the SBIF, which will thus be able to strengthen its organizational structure, procedures, and systems, in order to enhance its capacity to supervise the country's financial institutions. Indirect beneficiaries of the project will be depositors and borrowers of national financial institutions, particularly those in low-income groups with less access to financial information from financial institutions and less capacity to analyze such information on their own.

V. COST AND FINANCING OF THE PROGRAM

- 5.1 The total cost of the program will be US\$2,077,000, of which US\$1,238,000 will be contributed by the MIF on a nonreimbursable basis. The remaining US\$839,000 will come from the SBIF, with one half of this amount being provided in cash. The local counterpart will be equivalent to 40% of the total cost of the project. The itemized budget is available on request in the technical files. The project resources will be used to cover short- and long-term consulting services and specialized technical assistance as well as the organization and subcontracting of training and development activities, including to a lesser extent procurement of computer equipment and tools that are needed to enhance data collection and dissemination systems and the efficiency of supervision. The financing will not cover recurrent

costs of the SBIF. The MIF resources will be used mainly to hire consultants for project implementation and for training courses, dissemination materials, and seminar organization, project coordination, and scheduled evaluations and audits. The local counterpart will defray the project manager's fees, the training and technical assistance activities, dissemination materials, and seminar organization, in-service training, premises (office remodeling), operating equipment and overhead, and administrative expenses.

Table 5.1: Table of Costs (US\$)

| Activities | MIF | Local | Total | % |
|--|------------------|----------------|------------------|----|
| 1. Updating of banking framework | 357,000 | 188,600 | 545,600 | 26 |
| 2. Updating of nonbank framework | 278,000 | 50,000 | 328,000 | 16 |
| 3. Transformation of the technology platform and development of systems audit capacity | 81,000 | 353,700 | 434,700 | 20 |
| 4. Consolidation and expansion of personnel technical capacity | 200,000 | 42,200 | 242,200 | 12 |
| 5. Strengthening of overall SBIF strategic and institutional development | 200,000 | 0 | 200,000 | 10 |
| Administration | 72,000 | 204,500 | 276,500 | 13 |
| Evaluation | 30,000 | 0 | 30,000 | |
| Audits | 10,000 | 0 | 10,000 | |
| Contingencies | 10,000 | 0 | 10,000 | |
| TOTAL | 1,238,000 | 839,000 | 2,077,000 | |
| % | 60 | 40 | 100 | |

- 5.2 **Disbursement period.** The project will be carried out in 36 months and the Bank's contribution will be disbursed over 42 months. Depending on the projected needs, a revolving fund will be set up in the amount of 10% of the MIF contribution, to be administered in an independent account to permit timely payment of funds for the various activities planned. The executing agency will be responsible for submitting semiannual reports on the status of the revolving fund within 60 days after the end of each six-month period.
- 5.3 **Accounting and audits.** An external audit of the financial statements will be performed by a firm of independent auditors acceptable to the Bank, based on terms of reference approved in advance by the Bank. The auditors' reports will be presented within 90 days after the date of the last disbursement. The costs of the audit will be charged to the project and financed out of the MIF contribution. The

SBIF will be required to submit to the Bank for its approval a chart of accounts in which are recorded all transactions financed out of the MIF resources and the local counterpart.

VI. JUSTIFICATION AND RISKS

A. Justification

- 6.1 A modern legal framework is essential for guaranteeing the proper functioning of an open and diversified financial sector. In general, nonbank institutions have a fragile legal framework that needs to be strengthened in order to prevent banking asymmetry. By supporting consolidation and strengthening the systems of financial regulation and supervision, the project will reduce the vulnerability of the financial system, by lowering the potential economic and social costs. The project is fully consistent with the objectives of the MIF insofar as trust, solvency, and market efficiency are essential for the sustainable growth of the Nicaraguan economy. The financial crises that have occurred in different countries in the hemisphere over the last 10 years underscore the macroeconomic costs of unstable financial systems. More effective supervision of the financial sector will be a precondition for increased private investment.

B. Financial sector reform program (NI-1014-SF)

- 6.2 Since the early 1990s, the Bank has supported the development of a competitive financial market through a number of different programs. Thanks to the financial sector reform program (NI-1014/SF) approved in 1998, considerable headway has been made towards modernizing the financial system. Under the program, support was furnished for the privatization of three State-owned banks and for a regulatory and legislative framework underpinning a stable financial market. The present sector loan is accompanied by a smaller technical-cooperation loan (NI-1015/SF) that would help the Central Bank and SBIF fulfill the disbursement conditions, including the review and reform of the legislative framework, the use of prudential standards, and supervision of private and State-owned banks. The technical-cooperation loan should undoubtedly be restructured owing to the far-reaching banking crisis that erupted in 1999 since the authorities were forced to take immediate steps to take over problem banks and arrange for their liquidation. Consequently, a significant portion of the resources, including funds initially earmarked for the Central Bank, were used to assist the SBIF during the crisis. Amongst other things, the funds were used to finance assisted inspections and enhanced SBIF monitoring capacity, to devise regulations for intervening in and liquidating problem banks, and to provide high-level technical assistance on a personal level and support for the Superintendent. However, only a fraction of the funding was used to cover the review of the bank regulations, in response to the changes to the bank legislation approved in 1999 as part of the reform process, and

to meet contingencies and ad hoc lessons learned during the crisis. The technical-cooperation operation provided in parallel with the sector loan was essentially completed in March 2002.

- 6.3 The present MIF operation meshes fully with the framework for consolidating the progress made in establishing an effective and efficient supervisory structure. In addition, the updating of standards is considered an ongoing improvement on international standards, which require in turn an ongoing review as the financial market evolves. Once the necessary human-resource skills levels have been determined and the SBIF technical infrastructure is in place, the need for external resources will diminish. Subsequent updates of the standards and improvements in the performance of supervisory functions could be built on the foundations laid down up to now with the Bank's help, on the basis of mechanisms for international and institutional cooperation and specific advisory assistance. In this way, the project will establish the proper conditions for ensuring the sustainability of strengthening efforts and consequently supervisory capacity in the medium term.

C. Environmental considerations

- 6.4 The project was reviewed by the Committee on Environment and Social Impact (CESI) on 18 August 2000 (TRG 31-00), and its design reflects the comments expressed at that meeting. These features include adding considerations of environmental risks to the credit risk management training component.

D. Risks

- 6.5 The present project represents an ambitious attempt to consolidate and strengthen the SBIF during a phase of financial sector growth. Given its complexity and the scope of the activities to be carried out and the fact that the SBIF will be carrying out its day-to-day tasks at the same time, implementation of the project will come up against major challenges. The way in which its implementation is structured will result in efficient coordination between all of the units involved in the process while minimizing the effects on the work load.
- 6.6 The limited size of the Nicaraguan financial market places major constraints on SBIF economic capacity, which is financed by means of contributions from the financial entities that it supervises, and computed on the basis of their asset size. Such constraints have meant that the technical and organizational solutions must be designed and implemented to maximize economies of scale.

VII. MONITORING AND EVALUATION

A. Reports

- 7.1 The logical framework (Annex I) sets out the elements for implementing, monitoring, and evaluating the program. The SBIF will submit to the Bank semiannual progress reports on project execution. The reports must describe the overall status of project execution and such aspects as quality and the extent to which the project objectives are met, project financial performance, status of procurement, and the hiring of consultants. Each program report will be delivered to the Country Office for approval within 60 days after the end of the six-month period under review, and a final report within 60 days after the final disbursement. The Country Office in Nicaragua will use these reports to monitor the project and prepare a project completion report within three months after the final disbursement.

B. Evaluation

- 7.2 Two evaluations of the project will be performed by independent consultants hired by the Bank out of the MIF contribution. The first will be carried out 18 months after the first disbursement and will consider at least the following points: the SBIF institutional capacity; implementation of the activities planned for the project; the need for new services; the quality of the services offered through training and technical assistance activities; the capacity of the services delivered for developing and implementing the methodology, the extent to which the services are provided, and their quality and user satisfaction on the basis of interviews. The final evaluation will be carried out within three months after completion of the project and prior to the final disbursement, analyzing the extent to which the specific project objectives have been fulfilled, the quality of the services delivered, user satisfaction based on surveys, and the sustainability and extent to which the consolidated model of supervision has been developed, upon disbursement in full of the MIF contribution.

VIII. EXCEPTION TO THE BANK'S POLICIES AND PROCEDURES

- 8.1 No exceptions to Bank policy are anticipated.

IX. SPECIAL CONTRACTUAL CONDITIONS

- 9.1 As a condition precedent to the first disbursement, the executing agency will be required to present to the Bank (i) evidence that the project coordinator has been selected; and (ii) a work plan for year one and an acceptable schedule of activities.

- 9.2 **Readiness.** The project is at an advanced stage of readiness. A logical framework outlining the targets, quantitative indicators, and itemized budget has been prepared with the help of SBIF technical staff.

LOGICAL FRAMEWORK

| OBJECTIVES | VERIFIABLE INDICATORS | MEANS OF VERIFICATION | ASSUMPTIONS |
|--|---|--|---|
| <p>Aim:</p> <p>To reduce the vulnerability of the country's financial system, and to give broad segments of Nicaraguan society access to credit without jeopardizing deposits by the public.</p> | <ul style="list-style-type: none"> – A more stable financial sector in terms of improvements in prudential standards, risk profiles, and transparency of sector. | <ul style="list-style-type: none"> – Periodic SBIF reports describing financial sector management. – General publication of SBIF. – Final project report. | <ul style="list-style-type: none"> – Macroeconomic conditions are stable and administered under sound macroeconomic policies. – Ongoing commitment on part of government to apply policies and to have a structure that is efficient enough to strengthen the financial sector, maintain sector transparency, and ensure rapid processing of executive actions. |
| <p>Purpose:</p> <p>To consolidate and strengthen SBIF capacity to regulate, supervise, and inspect bank and nonbank financial intermediaries and their operations and to ensure that they are technically and administratively efficient.</p> | <p>Upon completion of project:</p> <ul style="list-style-type: none"> – The SBIF has a set of standards adapted to the bank and nonbank financial market and the analytical tools for effective prudential and preventive monitoring of financial intermediaries under its supervision. – A financial system that is better supervised and more consolidated in terms of stability as gauged against management indicators for financial institutions (gauged insofar as is possible by numerical indicators such as a capital adequacy ratio between 12% and 13% calculated on the basis of weighted assets at risk and improvements of at least 20% in matching of terms with national financial system. – The SBIF's new functions with analytical capacity and expanded procedures are being applied consistently and enhanced in terms of higher efficiency. – The SBIF is performing consolidated supervision (which will have at least 10 complete supervision reports from the principal regulated financial institutions). | <ul style="list-style-type: none"> – Periodic SBIF reports describing financial sector management. – General publication of SBIF. – Final project report. | |

| OBJECTIVES | VERIFIABLE INDICATORS | MEANS OF VERIFICATION | ASSUMPTIONS |
|--|--|---|---|
| <p>Components:</p> <p>1. Revise and update of the framework for regulation and supervision of the financial banking sector.</p> | <p>Upon completion of this component:</p> <ul style="list-style-type: none"> – Compliance with Basle Principles reviewed and evaluated for six commercial banks and four finance companies. – Prudential standards revised and strengthened and introduced for market risk, operating risks, preventive measures, offshore operations. Thirteen reports produced on existing issues with prudential standards. – The process of strengthening consolidated ex situ analytical capacity. – Analysis model, early warning system developed. – Consolidated supervision mechanism established and organized; standards for consolidated supervision of financial groups and consolidated financial statements developed and put in place; integrated and preventive supervision manual developed; and chart of accounts handbook introduced. At least 6 consolidated supervision reports produced based on number of major financial groups. | <ul style="list-style-type: none"> – Project progress reports. – Analysis by consultants. – Inspectors' reports. – Surveys of beneficiaries and course evaluations by participants. – On-site inspections of equipment and programs. – Publication of executing agency. – Project audit. | <ul style="list-style-type: none"> – SBIF has the budgetary resources to discharge its established functions – SBIF professional staff acquire the projected level of preparation and are therefore in a position to internalize the training received. – Quality consulting and other services are available and these specialized consultants can be quickly identified. – Equipment and programs available in accordance with terms of project. – Regulators in other countries are available for professional staff to do in-service training. – The country's legal framework is sufficiently stable to permit such legal amendments as may be necessary for proper supervision of financial institutions. – The SBIF has identified source of supplementary financing for carrying out on a comprehensive basis systems modernization project. |

| OBJECTIVES | VERIFIABLE INDICATORS | MEANS OF VERIFICATION | ASSUMPTIONS |
|---|--|-----------------------|-------------|
| <p>2. Framework revised, updated, and developed for regulation and supervision of nonbank financial sector.</p> <p>3. Technology platform transformed and systems audit capacity developed.</p> <p>4. Technical capacity of staff consolidated and expanded.</p> <p>5. Strategic and institutional development of SBIF strengthened as a whole.</p> | <p>Upon Completion of this component:</p> <ul style="list-style-type: none"> – Prudential standards updated and supervision models for nonbank entities: insurance, bonded warehouses, financial leases, factoring, and fiduciary operations developed; legislative framework for microfinance developed; mortgage market strengthened; legislative framework for securities market developed and in line with new Securities Act. As to last point, at least 10 inspection reports produced for principal positions in exchange. <p>Upon completion of this component:</p> <ul style="list-style-type: none"> – Remote connection system and electronic transmission of financial information set up. At least 10 leading regulated financial institutions connected to the system. – Technology risk standards and systems audit capacity established. At least 10 technology audits performed. – Centralized risk management system developed and guidelines for its use developed. Data from at least 80% of the large debtors of the 10 financial institutions entered into system. – 20 SBIF officials have taken part in in-service training with other regulatory agencies, thus expanding their capacity to use tools and methods of supervision. – 20 SBIF technical experts trained and possess greater expertise in its administration. – New mechanisms, processes, and methods of intra-institutional and interinstitutional coordination developed and introduced. | | |

| OBJECTIVES | VERIFIABLE INDICATORS | MEANS OF VERIFICATION | ASSUMPTIONS |
|--|---|--|-------------|
| | <ul style="list-style-type: none"> – Performance evaluation systems developed and guidelines for implementing them set up. – Budgetary control and administrative capacity developed. – Code of ethics developed and guidelines for its application established. – Processing of standardized and computerized documentation. | | |
| <p>Activities:</p> <p>1.1 Prepare terms of reference and hire specialized consultants.</p> <p>1.2 Supervise the consulting work.</p> <p>2.1 Prepare terms of reference and hire specialized consultant.</p> <p>2.2 Supervise the consulting work.</p> <p>3.1 Procure and install equipment and programs for establishing an integrated information system, including development of a centralized risk management system.</p> <p>4.1 Prepare terms of reference and hire trainers.</p> <p>4.2 In-service training with other supervisory bodies in the region</p> <p>4.3 Supervise the training courses.</p> <p>5.1 Prepare terms of reference for consultants and hire consultants.</p> <p>5.2 Supervise the consulting work.</p> | <p>Budget</p> <p>Supporting documentation</p> | <ul style="list-style-type: none"> – Project progress reports. – Analysis by consultants. – Surveys of beneficiaries. – Publication of executing agency. – SBIF accounting records. | |