Board of Executive Directors
For consideration
On or after 5 June 2013

PR-4013
21 May 2013
Original: Spanish
Public Document
Simultaneous Disclosure

To:	The Executive Directors
From:	The Secretary
Subject:	Panama. Proposal for a loan for the project "Strengthening Macrofinancial and Fiscal Management II"

Basic Information:

Loan type .... Programmatic Policy-Based Loan (PBP)
Borrower .... Republic of Panama

Amount .... up to US$200,000,000
Source .... Ordinary Capital

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Remarks: This operation is the second loan in a programmatic series of two consecutive single-tranche operations, technically related to one another but independently financed in accordance with document CS-3633 "Policy-Based Loans: Guidelines for preparation and implementation".

As established in document GN-1838-1, "Criteria and norms for Board and Management relations", dated 1 July 1994, policy-lending operations are considered by the Board of Executive Directors by Standard Procedure.

Reference: GN-1838-1(7/94), DR-398-11(4/11), GN-2200-13(4/05), CS-3633(4/05), PR-3948(10/12), DE-182/12, CS-4008(5/13), CS-4009(5/13)

PUBLIC
SIMULTANEOUS DISCLOSURE

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PANAMA

STRENGTHENING MACROFINANCIAL AND FISCAL MANAGEMENT II

(PN-L1089)

LOAN PROPOSAL

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ABBREVIATIONS

CCF	Financial Coordination Council
CMF	Capital Markets and Financial Institutions Division
FAP	Fondo de Ahorro de Panamá [Panama Savings Fund]
GDP	Gross domestic product
IFRS	International Financial Reporting Standards
IMA	Independent Macroeconomic Assessment
IMF	International Monetary Fund
IPACOOP	Instituto Panameño Autónomo Cooperativo [Autonomous Panamanian Cooperatives Institute]
MEF	Ministry of Economy and Finance
NFPS	Nonfinancial public sector
OC	Ordinary Capital
SBP	Superintendencia de Bancos de Panamá [Superintendency of Banks of Panama]
SMV	Superintendencia del Mercado de Valores [Stock Market Superintendency]
WAL	Weighted average life

PROJECT SUMMARY
PANAMA
STRENGTHENING MACROFINANCIAL AND FISCAL MANAGEMENT II
PN-L1089

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<tr><th colspan="5">Financial terms and conditions</th></tr>
<tr><td colspan="3" rowspan="6">Borrower: Republic of Panama
Executing agency: Ministry of Economy and Finance (MEF)</td><th colspan="2">Flexible Financing Facility*</th></tr>
<tr><td>Amortization period:</td><td>20 years</td></tr>
<tr><td>Original weighted average life:</td><td>12.75 years</td></tr>
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<tr><th>Source</th><th>Amount
(US$ million)</th><th>%</th><td>Inspection and supervision fee:</td><td>**</td></tr>
<tr><td rowspan="2">IDB (OC)</td><td rowspan="2">200</td><td rowspan="2">100</td><td>Credit fee:</td><td>**</td></tr>
<tr><td>Currency:</td><td>U.S. dollars from the Ordinary Capital of the Bank</td></tr>
<tr><th colspan="5">Project at a glance</th></tr>
<tr><td colspan="5">Objectives: The general objective of the program is to reduce the fiscal risk of macroeconomic and financial shocks by strengthening the macrofinancial and fiscal management framework. The specific objectives are: (i) to reduce sovereign risk; and (ii) to maintain financial stability (paragraph 1.29). To this end, the program will strengthen the country’s macrofinancial and fiscal management framework through four key components: (i) macroeconomic stability; (ii) development of government asset and liability management tools; (iii) development of macroprudential regulations, supervision, and instruments; and (iv) strengthening of risk-based supervision (paragraphs 1.33 to 1.36).</td></tr>
<tr><td colspan="5">Special contractual conditions: Disbursement of the loan will be subject to the fulfillment of the policy conditions set out in Annex II (Policy Matrix), as well as the other conditions of the loan contract (paragraph 2.1).</td></tr>
<tr><td colspan="5">Exceptions to Bank policies: None</td></tr>
<tr><td colspan="5">Project consistent with country strategy: Yes [X] No [ ]</td></tr>
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</table>

* Under the Flexible Financing Facility (document FN-655-1), borrowers have the option of requesting changes in the amortization schedule, currency conversions, and interest rate, in every case subject to the final amortization date and the original WAL. In considering such requests, the Bank will take operational and risk aspects into account.

** 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 the applicable policies.

I. DESCRIPTION AND RESULTS MONITORING

A. Context and objectives[1]

1.1 **Macroeconomic context.** Between 2007 and 2011, the country's real GDP grew by 9% annually, spurred by a strategic program of investments to promote competitiveness, in particular expansion of the Panama Canal.[2,3] Real GDP growth in 2012 was on the order of 10.7%, and is expected to come in at 8% in 2013. This growth has taken place in a framework of fiscal and macroeconomic sustainability. The public debt stock fell as a proportion of GDP, thanks to the solid expansion of the nominal GDP. The debt, which between 1996 and 2005 averaged more than 68% of GDP, has fallen steadily in recent years, to 39.3% of GDP in 2012. The growth of the Panamanian economy has gone hand in hand with strong financing requirements,[4] a significant portion of which (8.4% of GDP between 2007 and 2012) has come in the form of foreign direct investment.

1.2 **Panama's financial system.** The financial system consists of the International Banking Center, insurance and reinsurance companies, nonbank financial companies, the stock market, and the institutions of the pension system. The International Banking Center includes two State-owned banks, 48 general license banks, 29 international license banks, and 14 branch offices,[5] which channel savings and investments to and from Latin American and Caribbean countries and other countries in the world. The National Banking System does not include the 29 international license banks.

1.3 At the end of the fourth quarter of 2012, the International Banking Center had assets totaling US$89.771 billion, having posted 10% growth over the previous year, while the National Banking System had assets totaling US$72.937 billion, 10.5% higher than the year before.[6] Domestic loans to the private sector of the National Banking System amounted to US$33.095 billion, a 14.2% increase over the previous year. Domestic loans to the private sector are geared primarily to business (32%), mortgages (27%), personal consumption (20%), construction (10%), industry (5%), and other sectors (6%). The International Banking Center's

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1 Based on Article IV of the IMF (2013) and the IDB's 2013 Independent Macroeconomic Assessment (IMA).

2 Direct and indirect activities associated with the Panama Canal together account for around one fifth of the country's GDP; the Canal expansion has a cost US$5.3 billion and is expected to boost annual GDP growth by approximately 3.5%. The Canal's contribution to the nonfinancial public sector is estimated at US$1 billion (IMA, 2013).

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

4 Gross financing requirements for the 2012-2014 period are estimated at US$4 billion. This operation will meet 5% of that amount. Financing requirements are expected to be covered primarily with domestic debt. External public debt is expected to fall from 35.5% of GDP in 2011 to 26.6% in 2014, while domestic debt is expected to double from 6.2% of GDP in 2011 to 12.6% in 2014.

5 Current data from Panama's Superintendency of Banks (SBP).

6 SBP data, banking activity report, fourth quarter of 2012.

liabilities totaled US$80.194 billion, registering an 11.5% annual increase. Some 79.8% of liabilities correspond to deposits, with 76.2% held by individuals, 15% held by banks, and 8.7% held by the government.

1.4 The International Banking Center is of enormous importance in Central America because of the high concentration and internationalization of the region's banking activities. Panama holds 52.1% of the assets and 41.3% of the equity of Central America's banking industry. Its main member banks help finance international trade, manage liquidity for important international groups, and develop private banking in the region.[7]

1.5 According to the World Economic Forum,[8] Panama is fourth among 144 countries in terms of availability of financial services and soundness of banks; second in terms of affordability of financial services (first in Latin America and the Caribbean); and 78th and 89th in terms of regulation of securities exchanges and protection of borrower and lender rights.

1.6 **Institutional framework of the financial sector.** Panama's regulatory framework is based on the 1998 Banking Law, which consolidated supervision of the banking sector in the Superintendency of Banks of Panama (SBP), a technical agency with administrative, economic, and financial autonomy and legal status under public law. In addition, there are some 583 active cooperatives in Panama, supervised by the Autonomous Panamanian Cooperatives Institute (IPACOOP), of which 168 are credit unions.[9] Panama's Superintendency of Insurance and Reinsurance supervises the insurance sector, while the Stock Market Superintendency supervises the capital markets, pension and investment funds, and financial intermediaries. The Finance Company Division of the Ministry of Commerce and Industry oversees lending and leasing companies.

1.7 The Panamanian economy is dollarized; the United States dollar has been the legal tender since 1904, while the national currency, the balboa, is only used as a unit of account. Panama does not have a central bank, which means that its money supply grows through the exportation of goods and services and through loans and foreign investments.

1.8 Since Panama does not have a monetary authority that can program monetary aggregates or inject liquidity into the financial system during a crisis, monetary policy cannot be used for addressing a crisis, nor does the financial system have a traditional lender of last resort. For those reasons, it is of critical importance to strengthen prudential regulations as the first line of defense for preserving stability in the financial system; moreover, a prudent fiscal management framework is key to maintaining the country's macrofinancial stability.

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7 Technical note "Sistema financiero e inclusión financiera en Panamá," IDB, CMF, December 2011.

8 Global Competitiveness Report 2012-2013.

9 IPACOOP, Statistics, September 2012.

1.9 **Risk prevention.** In this context, the Panamanian government considers it very important to develop a comprehensive strategy to manage macrofinancial and fiscal risk, understood as the expected fiscal impact of a macroeconomic or financial shock, weighted by the probability of occurrence. To manage these risks, the government has adopted a comprehensive strategy based on strengthening the country's financial and fiscal management framework, in line with international best practices. This initiative is consistent with the recommendations of international organizations.[10] A stronger financial and fiscal management framework would directly benefit Panama's public sector[11] and financial system and, thus, the country's population as a whole.

1.10 The recent international financial crisis has shown that a financial and fiscal management framework intended to prevent macrofinancial and fiscal risks should have two dimensions:[12] (i) control of the country's balance sheet risk, that is, sovereign risk, defined as the country's at-risk assets and its capacity to meet its financial obligations;[13] and (ii) protection of financial stability, with attention to both the risks of individual financial entities (microprudential approach) and the aggregate risk for the financial system, or systemic financial risk (macroprudential approach).[14] An effective financial and fiscal management framework should develop the instruments needed for controlling both types of risk in order to reduce the fiscal cost of a macroeconomic and financial crisis.[15] Logically, the two types of risk are related in various ways; the purpose of separating them is to facilitate analysis and explanation. The principal risks facing Panama are: on the financial side, an abrupt reversal in foreign capital inflows and, on the real sector side, a standstill in international trade. Both scenarios would affect the health of the banking system and the flow of credit to the economy, with substantial fiscal risks. It is estimated that a sharp downturn in economic activity in the United States (between 4.8% and 1.8% of GDP) would dampen expected growth by between two and six percentage points.[16]

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[10] IDB, IMF. For an analysis of Panama's current sovereign risk status, see Moody's Panama Risk Appraisal, December 2011.

[11] Specifically, on the revenue side, the functions of the Ministry of Economy and Finance (MEF) in particular would be strengthened; on the expenditure side, the public sector as a whole would be strengthened.

[12] See IMF: Stability Report, 2012 (April).

[13] In the document, sovereign risk is understood to include both the at-risk value of the public sector balance sheet (like stock), including the flows implicit in that valorization, and the country's risk of default on its financial obligations. Thus, the definition of sovereign risk includes the criteria of both solvency and liquidity.

[14] See IMF: The Interaction of Monetary and Macroprudential Policies. January 2013, and Macroprudential Policy: an Organizing Framework. Monetary and Capital Markets Department. 2011.

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

[16] IMF, Article IV, 2013. Panama's risks not only stem from the United States' business cycle, but also from the performance of capital flows to the region and the situation of key economic actors for Panama (Colombia and Venezuela) and for the global economy (China and Europe).

1.11 **Sovereign risk.** Instruments to mitigate sovereign risk aim to maintain a robust public sector balance sheet with sustainable debt and deficit levels.[17] These instruments include fiscal rules, which play a key role as institutional mechanisms for strengthening fiscal credibility and discipline.[18] Also, the public sector balance sheet should be robust both on the assets side and on the liabilities side. Panama's most important assets include the strategic resources associated with the expansion of the Panama Canal, and one of its most significant liabilities is its debt. In developing the financial and fiscal management framework, tools for managing government assets and liabilities must be strengthened, as must tools for managing and controlling the fiscal risks inherent to macroeconomic and financial shocks stemming from Panama's economic ties with international trade and, mainly, the United States business cycle (Article IV, IMF 2013). One strategy for managing government liabilities and assets is to reduce the country's vulnerabilities to strong real and financial external shocks.

1.12 **Financial stability.** Maintaining financial stability is key to ensuring that the financial system fulfills its functions effectively. This involves addressing both the soundness and solvency of individual financial institutions (microprudential approach), as well as the systemic or aggregate risks of the entire financial system (macroprudential approach). The traditional approach to banking regulation and supervision (microprudential) has been typically based on promoting the solvency and liquidity of individual financial entities in the understanding that this will shore up the financial stability of the system as a whole.

1.13 The last international financial crisis revealed the importance of also having a macroprudential approach, in order to control aggregate risk in the financial system, or systemic risk, understood as "a risk of disruptions to financial services that is caused by an impairment of all or parts of the financial system and can have serious negative consequences for the real economy."[19] Systemic risk has two dimensions:[20] (i) the time dimension, associated with the inherent procyclicality of the financial system, that is, with the fact that risks tend to be generated during expansionary phase of the economic cycle and are manifested during the recessionary phase of the cycle; and (ii) the crosscutting dimension, which refers to the systemic importance of some components of the financial system at a given point in time, such as the concentration of risk in a few financial entities, economic sectors, geographic areas, or other actors in the financial system. As in the case of the first operation (PN-L1086), this operation has both microprudential and macroprudential measures. The latter include actions to

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17 IMF: Stability Report. 2011 (April).

18 IMF: Fiscal Rules—Anchoring Expectations for Sustainable Public Finances. IMF Fiscal Affairs Department. 2009.

19 IMF: Macroprudential Policy: an Organizing Framework. Monetary and Capital Markets Department. 2011.

20 Op. cit. 7.

check systemic risks associated with the procyclicality of the financial system, as well as others to mitigate systemic risks at a given point in time.[21]

B. Analysis of government asset and liability management in Panama

1.14 **Macrofiscal situation.** Panama's nonfinancial public sector (NFPS) had a primary surplus of 0.8% of GDP in 2010, 0.1% in 2011, and an estimated deficit of 0.1% in 2012. The total NFPS deficit fell from 2.2% to 2.1% of GDP from 2011 to 2012. This is consistent with the strong surge in public investment by the government[22] related to the expansion of the Panama Canal. Having peaked in 2011, public investment is expected to gradually decline, falling to 2008 levels by 2015.

1.15 **Macroeconomic assessment.** Based on the Independent Macroeconomic Assessment (IMA) conducted in 2013, macroeconomic conditions in Panama are stable, and the policy framework is consistent with budgetary support operations. Accordingly, the country is in a good position to implement a policy reform program that contributes to the strengthening of macrofinancial and fiscal management. In addition, the country maintains relations with the IMF via the Article IV consultation framework and successfully concluded the 2012 process.

1.16 **Regulatory framework.** Panama's Social and Fiscal Responsibility Law is the cornerstone of the country's macrofiscal system. It mandates that the NFPS deficit remain below 1% of GDP and that once the public debt to GDP ratio falls below 40%, it may not exceed that threshold again. Because of the natural disasters of 2010, the Panamanian government made use of the exceptions provided under the Law to request an increase in the deficit above 1% between 2011 and 2013. In June 2012 the Law was amended to adjust the fiscal deficit ceiling upwards to 2.9% of GDP in 2012, 2.8% in 2013, and 2.7% in 2014, gradually decreasing it thereafter until reaching 1% of GDP in 2017. Despite raising the deficit ceiling, the government has not made full use of the additional fiscal space.

1.17 **Pending business.** As noted in the assessments of the international organizations (IMF, Article IV; and IDB, IMA), government asset and liability management has gained strategic importance for the Panamanian government due to its ambitious public investment program and the good reasons for continuing to anchor fiscal policy within the framework of the Social and Fiscal Responsibility Law. The government considers it essential to continue to strengthen the public sector balance sheet on the government asset and liability side, in order to reduce sovereign risk associated with possible economic downturns.

1.18 **Government assets.** The investments in the Panama Canal will begin to generate a permanent and relatively stable income stream (tolls, rates, dividends) starting

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[21] For an empirical estimate using panel data on the effectiveness of macroprudential policies in reducing systemic risk, see: Table 3. IMF. Global Financial Stability Report. 2011. September.

[22] The government has been promoting a plan that has increased public investment from 8.2% of GDP in 2008 to 15.2% of GDP in 2011. During those years, aggregate investment rose from 27.6% to 29% of GDP.

in 2015. According to IMF estimates (Article IV, IMF 2013), the FAP will have cumulative income on the order of 8% of GDP by 2025. Since this large amount of income is not tied to domestic economic activity, it could generate spending pressures if applied exclusively and automatically to the public budget, creating long-term fiscal sustainability problems. Managing a portion of these assets off the public sector balance sheet is therefore important to control this risk. In turn, recent experience shows that sovereign funds that prudently invest their resources abroad are effective instruments for diversifying country risk and have the ability to mitigate the effects of financial and macroeconomic shocks.[23] As explained further on, an intergenerational approach should frame the development of the FAP and the management of government revenues from the Panama Canal, in order to reduce net public debt and amass savings for periods of economic slowdown or states of emergency. The FAP's resources should also be managed in accordance with guidelines to diversify country risk, with investments abroad as recommended by international best practices (Article IV, IMF 2013). It is therefore of key importance to further regulate the FAP, developing an organizational structure independent of political power, with prudent investment guidelines for the management of risk/profitability.

1.19 **Government liabilities.** In 2012, domestic public debt stood at 9.6% of GDP, representing 24% of total public debt. Domestic public debt instruments in the local primary (secondary) capital market amounted to US$0.9 (0.27) billion, 3% (1%) of GDP, which is comparatively low.[24] Deepening the domestic public debt market and making it more efficient are key aspects of country risk diversification and mitigation, since they act as a buffer against external shocks. This market is still not liquid or deep enough to attract private investors, especially international investors. Therefore, it is necessary to improve incentives to consolidate market-making agents that provide liquidity and stimulate private investment (in the primary and secondary markets), and to regulate key elements of the market such as price makers and sovereign issuers. This will help develop a more solid domestic rate curve and increase the share of domestic debt in total debt.[25]

C. Analysis of the framework for regulation and supervision in Panama

1.20 **Soundness of the banking system.** Panama's financial system is solid and profitable, adequately capitalized, and has conservative lending practices that mitigate market, operational, and credit risks.[26] Both the national and international

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[23] El-Erian, Mahamed A. IMF. 2010. June. Sovereign Wealth Funds in the New Normal.

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

[25] See the FSAP recommendations in Article IV of the IMF, 2012 and 2013.

[26] Op. cit. 27.

banking sectors have high levels of capitalization (average capital adequacy ratio above 16% since 2008) and low levels of arrears, with the International Banking Center's overdue portfolio standing at 2.96% at the end of 2012, compared with 1.79% at the beginning of the year. Profitability levels are adequate (1.88% return on assets and 14.76% return on equity in 2012). At the end of 2012, the average liquidity ratio of the National Banking System was 64.7%, exceeding by far the minimum required by law.[27]

1.21 **Regulatory framework.** The regulations of Panama's financial system are aligned with key international standards and consistent with the Basel Core Principles (Article IV, IMF 2013). Specifically, progress has been made in the areas of regulation and supervision, based on the main recommendations of earlier assessments by international organizations.[28] The country still does not have a deposit guarantee fund and, as mentioned earlier, it has prudential regulation of liquidity requirements.

1.22 **Pending business.** Two key aspects of macroprudential regulation and supervision in Panama require further efforts: (i) to develop a countercyclical provisioning framework whose regulatory parameters change in accordance with the macrofinancial situation.[29] This will help mitigate systemic risk created by the procyclicality of the financial system, which can increase economic vulnerability to potential macrofinancial shocks; and (ii) to strengthen coordination between regulatory authorities in order to reduce the cost of information and of implementing comprehensive measures for the entire financial system. Therefore, an institutional framework responsible for macroprudential supervision is necessary. With regard to microprudential regulation and supervision, the country lacks a complete risk-based supervision framework that meets all the core principles of the Basel Committee. It does, however, have the legal foundation for developing this framework, which includes the Banking Law and an accounting framework aligned with international standards and based on the International Financial Reporting Standards (IFRS). In this connection, it is important to continue efforts to regulate and manage risks, and to strengthen the SBP institutionally, adapting its organizational structure and training its personnel in the new regulations and procedures. It is also important to extend the regulatory perimeter to include cooperative financial institutions, which are currently not subject to prudential regulation or supervision, leading to regulatory arbitrage because cooperatives are able to compete with regulated financial entities to

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27 Defined as 30% of sight deposits and terms of less than 186 days. IMA 2013 data.

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

29 See C. Lim, F. Columba, A. Costa, P. Kongsamut, A. Otani, M. Saiyid, T. Wezel, and X. Wu. (2011) Macroprudential Policy: What Instruments and How to Use Them? IMF WP/11/238.

attract deposits and make loans without having to meet the same level of regulatory requirements as regulated entities.[30]

1.23 **Countercyclical dynamic provisioning.** The last international financial crisis underscored the importance of counteracting procyclical trends in the banking system in order to mitigate systemic risks associated with procyclicality. An instrument used to mitigate the expected loan losses that tend to occur on a large scale in recessionary stages of the business cycle is known as countercyclical dynamic provisioning. The idea behind countercyclical dynamic provisioning is to build up a general buffer in expansionary phases of the business cycle that can be used in the recessionary phase of the cycle to cover expected loan losses. These systems boost the financial system's resilience in periods of recession or instability by requiring institutions to have funds in place before the losses occur. In order to be able to correctly calibrate the parameters, an effective countercyclical dynamic provisioning system must be able to obtain and calibrate information on loan losses in different phases of the business cycle.[31]

1.24 **Macroprudential institutional framework.** Coordination between the financial system's supervisory bodies requires an institutional structure that systematizes the exchange of information and has a clear mandate for macroprudential supervision. To this end, a Financial Coordination Council (CCF) was created as the foundation of the macroprudential regulation system, as a condition of the program's first operation and in accordance with the recommendations of the international organizations. The CCF has a mandate for macroprudential regulation and involves the participation of the country's main supervisory bodies. This second operation will move forward to put the technical and regulatory capacities of the CCF into practice.

1.25 **Risk-based regulation and supervision.** The Superintendency of Banks of Panama (SBP) is developing a comprehensive risk-management system for the banking system that will make it possible to identify, assess, monitor, and control materially important risks, in accordance with the size and complexity of the operations of the financial entity. In the first operation, the SBP moved forward in regulating operational and technological risk, preparing manuals and guidelines to facilitate application, and providing training for its inspectors and analysts. In addition, progress was made with regard to corporate governance regulations and transparency of banking system operations. To support and expand these efforts, new standards need to be developed for managing credit and liquidity risks; in addition, the processes, responsibilities, and structure needed for financial entities to perform effective comprehensive risk management need to be defined. In line

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[30] See IMF: Panama: Detailed Assessments of Observance of Standards and Codes for Banking Supervision, Insurance Supervision, and Securities Regulation. Paragraph 7. February 2007.

[31] Wezel, T; Chan-Lau, A; Columba, F. (2012) Dynamic Loan Loss Provisioning: Simulations on Effectiveness and Guide to Implementation. IMF Working Paper. WP/12/110.

with international standards, this process will include support to strengthen the framework of the accounting and external audit profession.[32]

1.26 **Regulation of credit unions.** In Panama there are 168 credit unions and 25 multipurpose cooperatives that offer loan products, and whose assets total US$1.3 million. The four largest credit unions account for 53% of assets and 60% of deposits. The members of cooperatives represent an estimated 6.1% of the Panamanian population and 13.1% of the economically active population,[33] which shows the importance of bringing the sector under appropriate supervision and regulation to mitigate the crosscutting systemic risk (associated with a specific client segment and area) that can result from its performance.

1.27 **Financial stability.** The following issues have been identified: (i) analysis of the bases for countercyclical dynamic regulation of provisioning; (ii) development of the institutional framework for macroprudential supervision; (iii) strengthening of risk-based supervision; and (iv) development of regulations for the credit union sector.[34]

D. Government priorities and recent progress

1.28 **Government commitment.** Given the economic implications of macroeconomic and financial shocks for the country, which could have a fiscal impact of between 5% and 10% of GDP according to the recently compared experience (see the operation's cost-benefit analysis), the Panamanian government is actively involved in strengthening the country's financial and fiscal management, as evidenced in the 2010-2014 Strategic Government Plan, the technical dialogue between its authorities and the IMF, and its request for the Bank's technical and financial support.

E. Proposed program

1.29 **Objectives.** The general objective of the program is to reduce the fiscal risk of macroeconomic and financial shocks by strengthening the macrofinancial and fiscal management framework. The specific objectives are: (i) to reduce sovereign risk; and (ii) to maintain the stability of the financial system.

1.30 **Structure of the program.** This is the second operation of a programmatic loan involving two sequential operations, in accordance with the guidelines for the preparation and implementation of policy-based loans (document CS-3633). The Bank approved the first operation in November 2012, in the form of a guarantee, for a sum of up to US$350 million (loan 2842/OC-PN). At the request of the Panamanian government, the amount of this operation was reduced to US$265 million, and its term was shortened from three years to one year, in

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32 Global Financial Stability Report. 2012. October. IMF

33 Technical note "Sistema financiero e inclusión financiera en Panamá," IDB, CMF, December 2011.

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

accordance with the terms and conditions approved by the Bank. The first operation laid the groundwork for the reforms envisaged for this second operation with the entry into force of the foundational regulatory framework (Laws on the FAP and the CCF, Market Makers Program, regulatory and organizational framework for risk-based supervision) and core guidelines for new reforms (dynamic provisioning; credit, liquidity, and market risk; and regulation of the cooperative sector). The second operation aims to develop or supplement the regulatory frameworks approved under the first operation and to further the reform efforts that have been initiated.

1.31 In agreement with the government, the policy matrix for the second operation was changed: (i) to make greater progress on what had initially been planned in certain areas of reform, such as operation of the FAP (appointment of the executive secretary), government liability management (incorporation of regulation of sovereign issuers, price makers, and the international foreign exchange market – Forex), and strengthening of training at the CCF, the SBP, and the IPACOOP Audit Department; and (ii) to sequence certain reforms that were initially considered, in order to ensure effective implementation (bring the sector and the regulatory body in line with the recently approved regulations; develop associated learning and training needs; manage timelines for dissemination of the standards). With regard to the second point, the following agreements were established: (i) preparation of draft legislation on the cooperative credit sector and the accounting profession, instead of entry into effect of the law; and (ii) presentation of credit and dynamic provisioning regulations for public consultation, and preparation of regulations on liquidity, market, and financial conglomerate risk, instead of entry into force (see full explanation in the aide memoire of the March 2013 analysis mission). Effective implementation of these reforms is under way. The commitment and efforts made by the government to the reforms, as well as the continued technical cooperation provided by the Bank and the IMF in these areas, will help support and further the reform process under way.

1.32 As with the first operation, this one has four components. Components I and II aim to reduce sovereign risk, and Components III and IV aim to preserve financial stability.

1.33 **Component I.** Appropriate macroeconomic context consistent with program objectives.

1.34 **Component II. Development of government asset and liability management tools.** This component has two subcomponents. **Subcomponent II.1. Development of the Panama Savings Fund (FAP).** The rules governing the operation and investments of this fund will establish a countercyclical mechanism based on international best practices,[35] which include investing its resources

[35] International best practices include the recommendations of the International Working Group of Sovereign Wealth Funds (IWG-SWF), as set out in the "Santiago Principles." For a review of best practices, see: IMF.

abroad, operating as a financing fund that cannot be used for expenditures or automatic transfers, and giving it a governance structure that guarantees that investment decisions are functionally and operationally independent of political power. **Subcomponent II.2. Development of the public debt market.** Strengthening the Market Maker Program and improving trading infrastructure will help increase the depth of domestic debt markets. The Market Maker Program will stimulate competition between market makers, and clearly and transparently regulate the mechanisms for access to the program, participant responsibilities, measurement of program performance, and the spreads and fees of market operations. The Market Maker Program will be supplemented by development of a strategic plan for improving the domestic public debt market, to include improving debt and capital market operations, especially dissemination and programming of public auctions, and regulating sovereign issuers and price makers.

1.35 **Component III. Development of macroprudential regulations, supervision, and instruments.** This component has two subcomponents. **Subcomponent III.1. Development of a countercyclical dynamic provisioning system.** Under this subcomponent, draft regulations will be developed for a countercyclical dynamic provisioning arrangement to be adopted by the financial entities. It will include evaluation of countercyclical dynamic provisioning systems, information requirements, alternative calculation and calibration methodologies, and the guidelines and key functional and operational elements required for its implementation. **Subcomponent III.2. Development of the Financial Coordination Council (CCF).** This subcomponent will focus on developing a strategic plan for the recently created CCF, as the coordinating hub for the different supervisory agencies of Panama's financial system. The CCF will include all agencies responsible for financial supervision and will establish mechanisms for the exchange of information between them, especially regarding the regulation and supervision of financial groups. The strategic plan will contain a description of the Council's technical and regulatory capacities, establish a methodology for macroprudential supervision, and include a staff training plan on this subject.

1.36 **Component IV. Strengthening of risk-based supervision.** This component has three subcomponents. **Subcomponent IV.1. Regulation of risk-based supervision.** This subcomponent aims to strengthen the regulation of comprehensive risk management in line with the principles of the Basel Committee, including: credit risk (qualitative and quantitative management framework); market risk (including interest rate and exchange rate risks); liquidity risk; and the regulations on financial conglomerates and exposure limits for financial conglomerates with economic groups and related parties. This subcomponent will also develop the regulations needed to implement a regulatory

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2008. Sovereign Wealth Funds – A Work Agenda. Prepared by the Monetary and Capital Markets and Policy Development and Review Departments.

and risk-based supervision arrangement in the exchange market. **Subcomponent IV.2. Institutional strengthening of the Superintendency of Banks of Panama (SBP).** Strengthening of the SBP will include: adapting the organizational structure to the new regulations and supervision and improving human resources policies, especially training for supervisory officials on the International Financial Reporting Standards (IFRS) and International Standards on Auditing (ISA). **Subcomponent IV.3. Regulation of the credit union sector.** This subcomponent will focus on developing a regulatory system that defines responsibilities in the cooperatives sector, and regulatory needs in relation to the largest operators.

F. Results indicators

1.37 The reason for developing a financial and fiscal management framework is to minimize the fiscal impact of macroeconomic and financial shocks. The key indicator for measuring this objective will be the evolution of public debt, such that the debt-to-GDP ratio remains below 40% of GDP in accordance with the Social and Fiscal Responsibility Law. The objective of reducing sovereign risk will be measured by the sovereign debt rating, while maintenance of financial stability will be monitored by credit growth (macroprudential component) and the legal liquidity ratio (microprudential component). More detailed information can be found in the program's results matrix and monitoring and evaluation plan.

G. The Bank's country strategy with Panama

1.38 The program is consistent with the Bank's country strategy with Panama for 2010-2014 (document GN-2596). The program objectives to reduce the country's fiscal vulnerabilities by mitigating macrofiscal risk will have a positive impact on the country's public finances. Therefore, it is consistent with the strategic objective to "improve the management and efficiency of public expenditure."

1.39 The Bank's Ninth General Capital Increase (GCI-9) spells out the Bank's strategic objectives for the coming years. This program is consistent with the strategic objective of "lending to small and vulnerable countries." In addition, given the importance of Panama as a regional financial hub for Central America and the Caribbean, it will also contribute to the strategic priority of strengthening financial integration in the region.

II. FINANCING STRUCTURE AND MAIN RISKS

A. Financing instrument

2.1 **Program amount and conditions precedent.** This second operation will be in the form of a loan for a total of US$200 million. Disbursement of the loan proceeds will be subject to the fulfillment of the policy conditions indicated in Annex II (Policy Matrix), as well as the terms of the loan contract.

B. Environmental and social safeguards, risks, and key issues

2.2 According to directive B.13 of the Bank's Environment and Safeguards Compliance Policy (document GN-2208-20 and manual OP-703), this operation does not require classification because it is a programmatic policy-based loan.

2.3 **Coordination between donors.** The Bank has worked in close coordination with the IMF on the design of the program to guarantee consistency and complementarity with that institution's actions. Also, the program takes into account the IMF's 2013 Article IV recommendations.

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

III. IMPLEMENTATION AND MANAGEMENT PLAN

A. Summary of execution arrangements

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

B. Summary of the monitoring and evaluation plan

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

C. Supplementary Bank interventions and technical assistance

3.3 The activities for obtaining the commitments for the second operation are expected to be completed by the date of approval of the loan. Some of the activities of the second operation will receive the support of technical cooperation programs, such as preparation of the draft legislation to update the regulatory framework for the accounting profession in Panama, and IFRS training for supervisors, for a total of US$220,000, with resources from loans 1757/OC-PN and 1941/OC-PN. These activities supplement the Bank's technical assistance with the SBP on risk-based supervision and training, valued at US$943,000, as part of loan 1757/OC-PN (see details in economic analysis).

Development Effectiveness Matrix			
Summary			
I. Strategic Alignment			
1. IDB Strategic Development Objectives	**Aligned**		
Lending Program	**Lending to small and vulnerable countries.**		
Regional Development Goals	**i) Percentage of firms using Banks to finance investments and ii) Ratio of actual to potencial tax revenue.**		
Bank Output Contribution (as defined in Results Framework of IDB-9)			
2. Country Strategy Development Objectives	**Aligned**		
Country Strategy Results Matrix	**GN-2596**	**Improve the management and efficiency of public expenditure.**	
Country Program Results Matrix	**GN-2696**	**The intervention is included in the 2013 Country Program Document.**	
Relevance of this project to country development challenges (If not aligned to country strategy or country program)			
II. Development Outcomes - Evaluability	**Highly Evaluable**	**Weight**	**Maximum Score**
	8.0		**10**
3. Evidence-based Assessment & Solution	**8.2**	**33.33%**	**10**
4. Ex ante Economic Analysis	**10.0**	**33.33%**	**10**
5. Monitoring and Evaluation	**5.7**	**33.33%**	**10**
III. Risks & Mitigation Monitoring Matrix			
Overall risks rate = magnitude of risks*likelihood	**Low**		
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 (VPC/PDP criteria)	**Yes**	**The project relies on the use of all Financial Management Sub-systems.**	
The project uses another country system different from the ones above for implementing the program			
The IDB's involvement promotes improvements of the intended beneficiaries and/or public sector entity in the following dimensions:			
Gender Equality			
Labor			
Environment			
Additional (to project preparation) technical assistance was provided to the public sector entity prior to approval to increase the likelihood of success of the project	**Yes**	**Non reimbursable resources included in the operation 1757/OC-PN PN-L1009 aimed at technically supporting the development of the risk based regulation and technical capabilities.**	
The ex-post impact evaluation of the project will produce evidence to close knowledge gaps in the sector that were identified in the project document and/or in the evaluation plan			

This is the second operation of two consecutive policy-based loans (PBL) for the government of Panama. It will be entirely financed with resources from the Bank's ordinary capital by US$ 200 millions. The general objective of the program is to minimize fiscal risk due to macroeconomic and financial shocks by enhancing the macrofinancial and fiscal management framework. The specific objectives are reducing sovereing risk and maintaining financial stability.

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

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

POLICY MATRIX

POLICY OBJECTIVES	AGREEMENTS 1ST LOAN	AGREEMENTS 2ND LOAN
Component I. Macroeconomic stability		
To maintain a stable macroeconomic environment consistent with program objectives	Macroeconomic policy framework consistent with the guidelines of the sector policy letter.	Maintain a stable macroeconomic environment consistent with program objectives.
Component II. Development of government asset and liability management tools		
Subcomponent II.1. Development of the Panama Savings Fund (FAP)		
To improve government asset management: To develop a savings fund for macroeconomic stabilization	Creation of the FAP, based on international best practices: • Macroeconomic stability mandate • Investment of assets abroad • No systematic or automatic financing of expenditures, and funds transferred only to the Treasury • Governance based on best practices	Regulations issued for the FAP law, in order to establish conditions for investment, security, performance, liquidity, risk diversification, and limitations on the use of FAP resources, following international best practices. FAP investment guidelines issued by the MEF that consider benchmark indices and placement limits by asset class. Institutional framework developed by the FAP that includes: (i) internal rules; (ii) a suitable operating budget; and (iii) appointment of an Executive Secretary.
Subcomponent II.2. Development of the public debt market		
To improve government liability management: To develop and regulate the domestic debt market in the capital market.	Entry into effect of the Market Maker Program, to include: • Incentives for market-making agents • Publicity mechanisms in public debt auctions	Strategic plan in place for the domestic public debt market and capital market, to include actions for improving the efficiency and liquidity of the debt market and for expanding the capital market. Market Maker Program formally instituted by executive branch approval and strengthened so it can be expanded to: • Construct a domestic rate curve • Increase market depth and efficiency • Improve competition between market makers Activities of price makers regulated by the Stock Market Superintendency (SMV), based on best practices.

POLICY OBJECTIVES	AGREEMENTS 1ST LOAN	AGREEMENTS 2ND LOAN
		Progress made by the SMV in regulating investment activity in the international foreign exchange market (Forex), through preparation and consultation of the regulations. Regulations developed by the SMV on sovereign issuers in order to deepen the sovereign debt issuer market in Panama.
Component III. Development of macroprudential regulation, supervision, and instruments		
Subcomponent III.1. Development of a countercyclical provisioning system		
To develop macroprudential instruments and regulations to mitigate the probability of a financial crisis	Development of guidelines and identification of the scope of a study to establish the principles for regulation of a countercyclical provisioning system.	Regulations for the countercyclical provisioning system prepared and submitted for public consultation that adapt international best practices to the country's situation, in line with IMF recommendations.
Subcomponent III.2. Development of the Financial Coordination Council (CCF)		
To develop the institutional and organizational framework for macroprudential supervision	Creation of a CCF with the mandate to: • Bring together all entities responsible for financial supervision. • Establish mechanisms for the exchange of information between responsible entities, especially with regard to financial groups. • Propose improvements in supervision and regulation.	Strategic plan approved by the CCF to strengthen its technical and regulatory capabilities, to include: • Design, approval, and entry into force of a methodology or manual on macroprudential supervision • Design and launch of a training plan on macroprudential supervision Consumer education program on financial services developed and launched.
Component IV. Strengthening of risk-based supervision		
Subcomponent IV.1. Regulation of risk-based supervision		
To improve the comprehensive regulation of risks of financial entities regulated by the Superintendency of Banks of Panama (SBP), in accordance with international best practices, including operational, credit, market, and technological risk.	Entry into force of regulations on operational risk. Definition of types of operational risk, and strategy for identification, monitoring, control, mitigation, and reporting. Entry into force of regulations on credit risk. Qualitative framework. Entry into force of regulations on technological risk. Entry into force of regulations on electronic banking and	Implementation under way of regulations issued by the SBP on operational and technological risk management, and electronic banking. Progress made on regulations for managing, and SBP personnel trained in, the following risks: • Credit risk (qualitative and quantitative framework) • Market risk (including interest rate, exchange rate, and other risks)

<table>
<tr><th>POLICY OBJECTIVES</th><th>AGREEMENTS
1ST LOAN</th><th>AGREEMENTS
2ND LOAN</th></tr>
<tr><td></td><td>management of related risks.</td><td>• Liquidity risk
Progress made on regulations on financial conglomerates and exposure limits in economic groups and related parties.</td></tr>
<tr><td>To consolidate the risk-based supervision framework</td><td>Entry into force of the Consolidated Manual on Risk-Based Supervision, approved by the SBP, to include:
• Policies, processes, and procedural guidelines
• Bank rating and risk assessment system.
• Early warning system, to include: “red flag” prudential indicators, stress tests, position of net financial assets, and value at risk (for determining market and credit risk)
Launch of pilot testing of in situ inspections, based on the new manual (Consolidated Manual on Risk-Based Supervision), and used in one nationally licensed bank and one internationally licensed bank.
Installation of software to automate and support the administration of supervisory functions, including the new processes covered in the Consolidated Manual on Risk-Based Supervision.</td><td>Supervision conducted of at least 3 financial groups, 3 national banks, and 2 international banks, and including implementation of the resulting recommendations.
Curriculum designed and e-learning courses developed and launched to provide new supervisors with training in the methodology of the Consolidated Manual on Risk-Based Supervision.</td></tr>
<tr><td>To improve corporate governance and transparency</td><td>Entry into force of the regulations on corporate governance in the banking system, specifically:
• Require banks to have a clear framework for internal control and basic mechanisms for implementing it.
• Specify responsibilities and regulate the governing boards and senior management
• Establish risk management as a responsibility of the governing boards
Entry into force of regulations on the content and dissemination of interest rates and product and service fees.
Entry into force of regulations on the collection of certain fees and surcharges by banking entities.</td><td>Implementation under way of the regulations on corporate governance and transparency.
Progress made on preparing draft legislation to update the regulatory framework for the accounting profession in Panama, and the code of ethics of the accounting profession, based on best practices.</td></tr>
</table>

Policy Objectives	Agreements 1st Loan	Agreements 2nd Loan
Subcomponent IV.2. Institutional strengthening of the Superintendency of Banks of Panama (SBP)		
To adapt the organizational structure of the SBP to the new regulations and risk-based supervision	Modification and application of the new organizational structure of the SBP in order to adapt it to the changes in the supervision process.	SBP's Department of Supervision Coordination, Quality, and Policies strengthened through staffing. Effective implementation of the actions set out in the quality control plan for external audit firms.
To improve training for SBP personnel and its human resources policy	Launch of training workshops on the new supervision process (Consolidated Manual on Risk-Based Supervision) for all supervisors. Approval and implementation of a comprehensive training plan. Approval and implementation of a code of ethics and professional conduct for the SBP. Approval and implementation of a professional advancement plan to include a competencies manual and plans for promoting and retaining talent. Approval and implementation of new wage policy. Launch of training on International Financial Reporting Standards (IFRS) for 100 IFRS-certified SBP staff.	Training delivered to SBP personnel as provided in the training plans, and activities performed as set out in the code of ethics, the professional advancement plan, and the wage policy. Job description manual and organization and functions manual reviewed, and recommended modifications approved. As part of the technical training program, seminars held for supervisors on International Financial Reporting Standards (IFRS) related to the supervision processes and International Standards of Auditing (ISA) (internal and external).
Subcomponent IV.3. Regulation of the credit union sector		
To define a regulatory system for the credit union sector	Agreement on the defining principles of guidelines for regulation in the credit union sector, based on a study conducted for that purpose.	Quality certification process conducted for the processes of the Audit Department of the Autonomous Panamanian Cooperatives Institute (IPACOOP). Draft legislation presented to regulate the sector encompassing credit unions and multipurpose cooperatives with lending departments.

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PROPOSED RESOLUTION DE-__/13

Panama. Loan ____/OC-PN to the Republic of Panama
Strengthening Macrofinancial
and Fiscal Management II

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with the Republic of Panama, as Borrower, for the purpose of granting it a financing to cooperate in the execution of a program to strengthen macrofinancial and fiscal management II. Such financing will be for the amount of up to US$200,000,000, from the resources of the Bank's Ordinary Capital, and will be subject to the Financial Terms and Conditions and the Special Contractual Conditions of the Project Summary of the Loan Proposal.

(Adopted on ___ __________ 2013)

LEG/SGO/CID/IDBDOCS#37745622
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