VI Regional Integration and Financial System Issues

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Central America has made good progress over the past decade in stabilizing the macroeconomic environment and establishing a sound and efficient financial system. Macroeconomic stability and measures to address financial sector weaknesses have contributed to increased intermediation and improvements in key financial sector indicators.

At the same time, credit to the private sector from locally licensed banks remains relatively low and the ability of banks to withstand shocks would benefit from improved financial sector risk management.[1] Dollarized balance sheets and lending to a largely unhedged private sector make some systems vulnerable, particularly to adverse exchange rate movements, underscoring the need for further crisis-proofing. This is particularly important in countries with high debt levels and in a region that is susceptible to shocks such as commodity price movements and natural disasters.

Financial sector integration brings important benefits, but it also poses new risks and challenges. Ongoing financial sector integration and consolidation will help the region take advantage of economies of scale and promote competition and efficiency. At the same time, however, financial sector integration without appropriate regulations and supervision could undermine adequate prudential monitoring of bank activities and allow undue risk-taking. Harmonizing prudential norms and financial supervision between countries and strengthening the capacity to conduct consolidated supervision to keep pace with the growth of cross-border banking activities will help the region capitalize on the opportunities that integration offers.[2]

[1]In some countries, banking crises have occurred (Dominican Republic and Nicaragua); in others, the banking system has experienced episodes of stress (Costa Rica, Guatemala, and Honduras).

[2]This section is largely based on the results of (bilateral) Financial Sector Assessment Programs (FSAPs) carried out by the IMF and the World Bank for all Central American countries in recent years.

Financial Sector Development and Structure

Macroeconomic Policies and Resilience to Shocks

Financial stability in Central America has benefited from the stabilization gains achieved in the region. During the 1990s, the region experienced a recovery in growth, lower inflation rates, and improved external positions arising from higher exports and remittances. These developments were accompanied by efforts to reduce fiscal deficits and the debt burden.

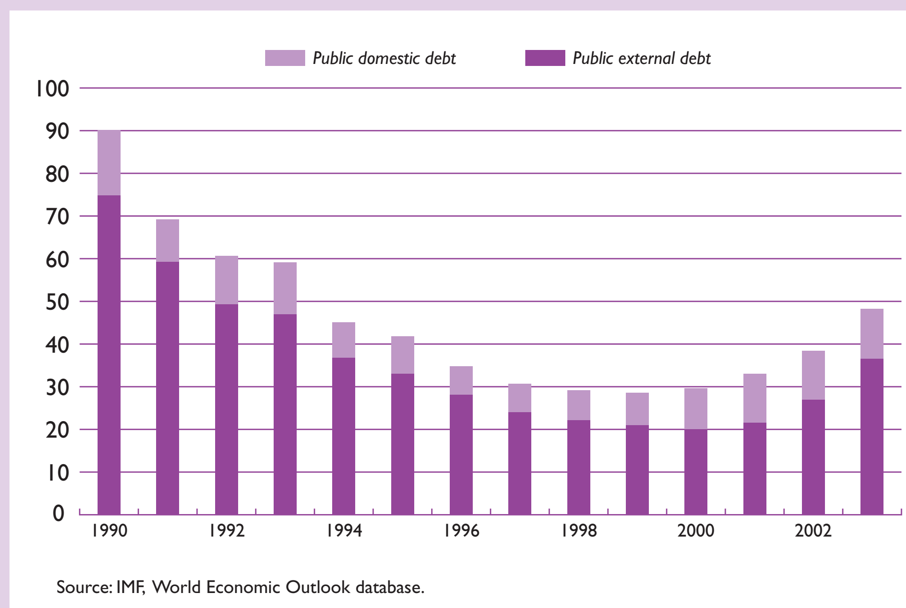
Lower spreads on sovereign debt in recent years have reduced financing costs for countries that have access to international capital markets but they have also caused renewed borrowing. In the face of weakening growth from the late 1990s (except in Costa Rica), underlying weaknesses in the public finances reemerged in some countries, also reflecting contingent liabilities arising from costly pension systems and problem banks. This led to a renewed increase in public debt, in particular foreign debt, in recent years (Figure 6.1).

Given these vulnerabilities, the capacity of the Central American economies to absorb shocks is still limited, which in turn affects the financial system. This is of particular importance since the region has historically been subject to large exogenous shocks related to price fluctuations in primary product markets (such as coffee) and natural disasters such as hurricanes and earthquakes.

Structure of the Financial Systems

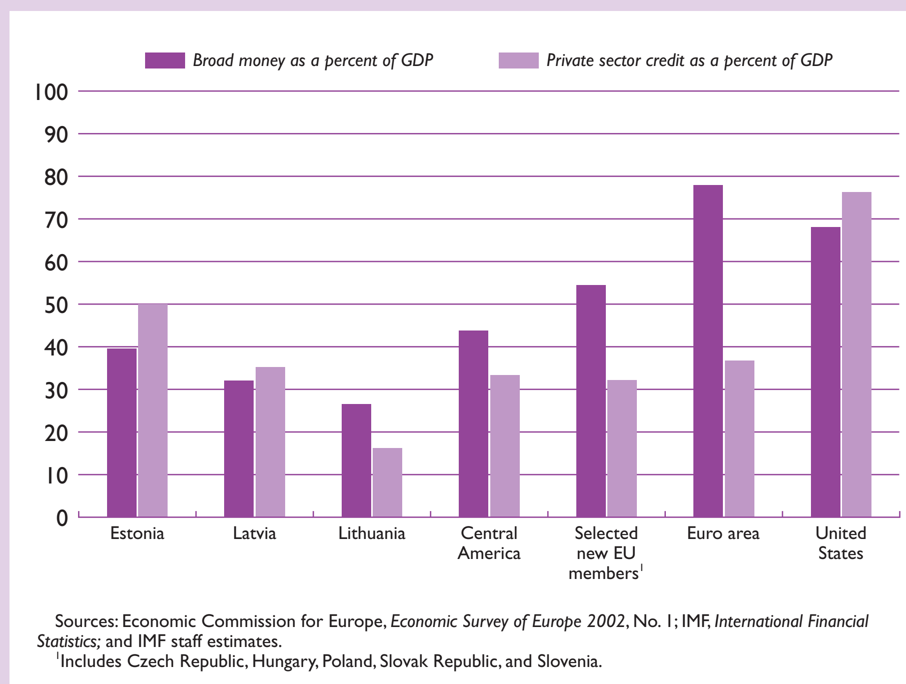
Increasing confidence in the financial system has spurred financial intermediation. Credit to the private sector has been rising from an average of about 14 percent of GDP in 1996 to about 38 percent of GDP in 2003, similar to levels in countries that joined the European Union in 2004 (Figure 6.2). Central America's banking systems are almost exclusively privately owned (except in Costa Rica).

Figure 6.1. Central America: Public Debt, 1990–2003
(In percent of GDP)



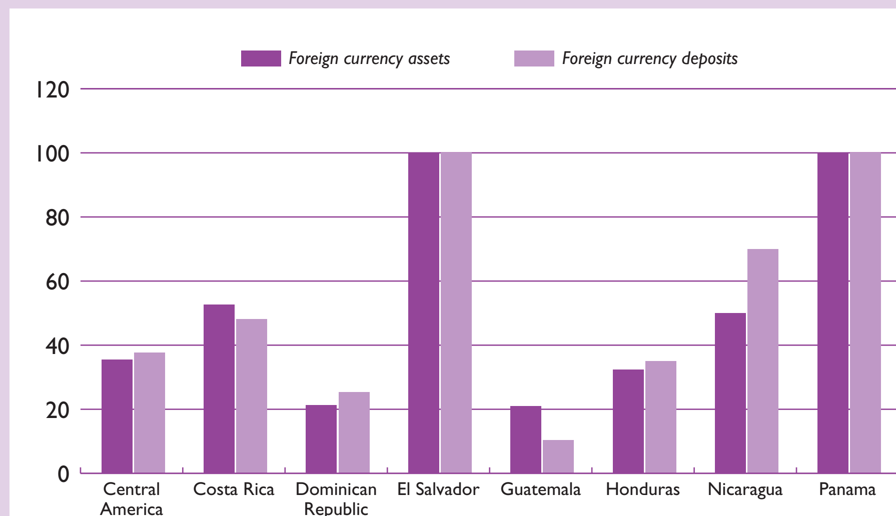
Source: IMF, World Economic Outlook database.

Figure 6.2. Central America: Financial Sector Development



Sources: Economic Commission for Europe, *Economic Survey of Europe 2002*, No. 1; IMF, *International Financial Statistics;* and IMF staff estimates.
[1]Includes Czech Republic, Hungary, Poland, Slovak Republic, and Slovenia.

Figure 6.3. Banking Sector Dollarization, 2003
(Percent of total assets/deposits)



Source: Central American Monetary Council.

The share of assets managed by public banks has decreased on average from about 8 percent of GDP in 1996 to less than 3 percent in 2003.

However, access to credit remains limited and financial systems in Central America continue to be largely bank based. Also, given the relatively large number of banks compared with the small size of the countries concerned (Table 6.1), the region is likely to be faced with consolidation pressures.

Despite the stabilization gains and reforms, a history of inflation and exchange controls, regulatory burdens, and lingering uncertainty about the future direction of policies have spurred informal dollarization and offshore or parallel financing transactions.[3] These factors induced a strong preference of depositors for keeping assets in foreign currency, while some borrowers and bankers sought to avoid taxation and strengthened prudential regulations by moving activities to foreign jurisdictions (Figure 6.3).

Financial dollarization

Financial dollarization in Central America has increased significantly in recent years. As of 2003, 40 percent of total assets (in countries not officially dollarized) were in dollars, and almost 55 percent when Panama and El Salvador are included.[4] The high degree of dollarization reflects a history of high inflation (Costa Rica) or even hyperinflation (Nicaragua), regulatory biases against domestic currency intermediation, and lingering uncertainty about the future direction of economic policy.

Other factors have also contributed, especially on the lending side. Financial sector integration and cross-border lending, including through banks conducting cross-border operations, increased competition in dollar intermediation, which in turn spurred dollarization. As locally licensed banks have been trying to compete with external intermediaries by reducing their net interest margin on dollar-denominated loans, U.S. dollar loans have become more attractive.

The choice of a particular exchange rate system to anchor expectations appears to have contributed to some degree to the dollarization of loans. Countries in Central America show a wide variety of exchange rate arrangements, ranging from official dollarization (El Salvador and Panama), to prean-

[3]Spontaneous dollarization (or partial dollarization) is an endogenous process that differs from the use of the U.S. dollar as legal tender in Panama and El Salvador. In the rest of this section, the term dollarization is used to describe spontaneous dollarization.

[4]Dollarization for transaction purposes is somewhat less pronounced, but in some countries certain contracts (such as mortgages, rents, and suppliers' contracts) are predominantly in U.S. dollars.

Table 6.1. Central America: Structure and Performance of the Financial Sector, 1996–2003[1]

	1996	1997	1998	1999	2000	2001	2002	2003
Number of banks	26	25	25	24	23	21	19	20
Total assets								
Private banks	20	19	21	20	18	16	16	16
Total assets of private banks (percentage of GDP)	33.8	36.0	49.5	45.7	47.4	49.9	52.2	43.4
Public banks	3	2	2	2	2	2	1	2
Total assets of public banks (percentage of GDP)	5.5	5.2	1.7	1.5	1.4	1.2	1.1	2.0
Foreign banks	2	2	2	2	2	2	2	2
Total assets of foreign banks (percentage of GDP)	0.7	0.7	1.0	1.2	1.4	1.7	1.6	1.8
Bank concentration								
Number of banks accounting for at least:								
25 percent of total assets	2	2	2	2	2	1	2	2
75 percent of total assets	7	7	9	8	8	8	7	7
Dollarization and maturity structure								
Banking system assets as percentage of GDP	41.9	45.4	56.9	54.9	55.4	57.9	57.5	65.5
Assets in foreign currency as percentage of banking system assets	37.8	38.8	38.2	35.9	35.0	37.1	37.7	35.4
Foreign currency deposits as percentage of banking system deposits	20.2	19.1	22.5	23.2	23.5	27.9	32.3	31.1
Deposits with less than 30 days maturity as percentage of total deposits	51.3	43.1	48.8	46.7	49.1	50.1	51.7	51.4
Contingent and off–balance sheet accounts as percentage of total assets	5.5	4.2	5.8	6.9	6.5	6.9	7.6	11.3
Contingent and off–balance sheet accounts in foreign currency as percentage of total assets	3.3	2.4	6.2	7.5	7.4	7.0	8.4	8.4
Capital								
Ratio of capital to risk-weighted assets	13.8	11.7	10.6	14.0	15.1	14.7	16.3	15.5
Asset quality								
Credit to the private sector as percentage of GDP	13.9	27.9	35.8	38.6	39.9	37.7	32.9	37.6
Ratio of nonperforming loans to total loans	4.0	3.9	4.4	7.3	5.5	4.9	4.1	3.1
Provision coverage								
Ratio of provisions to total loans	4.9	3.7	3.3	3.5	3.7	3.5	3.9	3.5
Ratio of provisions to nonperforming loans	12.8	92.0	59.2	56.4	61.6	72.9	70.9	119.5
Ratio of foreign currency credit to total private credit	15.7	15.7	16.8	15.7	19.1	22.8	26.1	28.0
Ratio of real estate loans to total loans	12.5	19.8	26.0	22.1	22.2	23.4	25.2	24.5
Management								
Ratio of administrative expenses to total assets	4.8	4.5	5.6	5.6	5.1	5.0	4.8	3.2
Profits per employee (in thousands of U.S. dollars)	3.5	10.4	14.9	12.1	15.3	13.5	11.7	5.0
Profitability								
Pre-tax return to average equity	25.8	15.2	12.4	14.2	12.3	13.5	12.6	11.2
Pre-tax return to average total assets	1.8	1.3	1.2	1.5	1.2	1.0	1.1	1.1
Liquidity								
Ratio of loans to deposits	72.2	77.0	84.0	83.9	75.6	75.8	74.5	77.0
Ratio of liquid assets to deposits	46.6	37.7	43.7	40.7	42.5	39.5	41.4	43.8
Central bank credit to banks as percentage of banking assets	0.1	0.4	0.6	0.5	0.3	0.3	0.0	0.0
Interest margin								
Annual average financial spread (percentage)	6.9	7.1	9.1	9.2	8.9	8.7	7.3	5.7

Sources: Central banks; country authorities; and IMF staff estimates.
[1]Average (median) excluding the Dominican Republic and Panama.

Box 6.1. Institutions Conducting Cross-Border Financial Transactions in Central America

Several types of financial institutions operate regionally throughout Central America, with varying implications for how strictly regional financial groups are supervised.

- Branches of foreign banks have an identifiable head office located abroad. Some foreign banks operate regionally from branches located in one particular Central American country (Panama and Honduras). These banks are normally first-rate institutions (for example, Citibank, HSBC, and Primer Banco del Istmo).
- Bank subsidiaries are incorporated under the law of the host country. Operations are consolidated in the corresponding parent company's host country. Salvadoran banks and one Nicaraguan bank operate through subsidiaries or affiliates (local banks in which they have purchased a majority share). In recent years, regional financial groups have chosen to locate in Panama, to take advantage of that country's status as a well-supervised international financial center.
- Parallel banks are banks licensed in different jurisdictions that have the same beneficial owners and consequently often share common managed and interlinked business, although they are not part of the same financial group for regulatory consolidation purposes.[1] For example, many Nicaraguan financial groups include a parallel bank that conducts local Nicaraguan activities, but they are not subject to consolidated supervision.
- Offshore banks, for the purposes of this section, are those banks licensed in offshore financial centers that are allowed to conduct business only with clients that are not residents of the licensing jurisdiction. Offshore financial centers are improving supervisory standards, making dubious operations less likely.
- Shell banks are banks that have no physical presence in the country where they are incorporated and licensed, and are not affiliated with any financial services group that is subject to effective consolidated supervision. Management is located in another jurisdiction, often in the offices of an associated entity or sometimes in a private residence.[2]

[1]Basel Committee on Banking Supervision, 2003, *Shell Banks and Booking Offices*, Basel Committee Publications No. 94 (Basel, January).

[2]Basel Committee on Banking Supervision, 2003, *Parallel Owned Bank Structures,* Basel Committee Publications No. 95 (Basel, January).

nounced crawling pegs (Costa Rica and Nicaragua), a de facto crawling peg (Honduras), and a float (Dominican Republic and Guatemala). However, among countries that are not formally dollarized, those with an announced crawling peg show the highest degree of dollarization of loans and other financial assets.[5]

Financial sector dollarization is associated with substantial risks in those countries that have not officially adopted the U.S. dollar. Although banks are broadly hedged—foreign currency assets are broadly matched by foreign currency liabilities—lending to unhedged private sector entities leaves the banks exposed to credit risk, and borrowers are exposed to exchange rate risk. Large devaluations could therefore adversely affect banks' capital positions.[6]

Regional financial sector integration and cross-border lending

Financial sector integration gained momentum over the past few years. Some financial institutions that originally focused on the home market have expanded throughout the region by establishing offices, branches, or subsidiaries or by using other arrangements (Box 6.1). The percentage of assets held by regionally operating banks is particularly high in El Salvador, Nicaragua, and Panama. The most important groups are the Cuscatlán Group (El Salvador), Primer Banco del Istmo (Panama), and the Banco de América Central (Nicaragua) (Table 6.2).

Consolidation of regional financial operations is only partial. Only one Nicaraguan financial group is formally consolidated in Panama, and Salvadoran and Panamanian banks operate through subsidiaries (see, for example, the structure of Cuscatlán, in Figure 6.4). The rest of cross-border financial intermediation takes place on an unconsolidated basis.

The establishment of subsidiaries and branches of financial institutions foreign to the region is still limited. Citibank and Scotiabank are the only institutions with capital from outside the region, and only

[5]This phenomenon can be explained partly by the fact that preannounced crawling pegs have been associated with a reduction in exchange rate volatility while the volatility of domestic interest rates remains high.

[6]The high degree of dollarization, in turn, has reduced the authorities' freedom to move toward greater exchange flexibility.

Table 6.2. Regional Banks, 2003
(In millions of U.S. dollars)

Regional Banks	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua	Central America Total
Banks with regional capital	1,287	6,084	603	1,112	1,603	10,689
Grupo Pacific-Banco Uno	39	188	143	137	200	707
Banco de América Central	488	371	122	216	337	1,534
Banpro	124	115	. . .	85	559	883
Banco Cuscatlán	174	2,418	153	. . .	. . .	2,745
Lloyds Bank	. . .	. . .	185	68	. . .	253
Banco Agrícola	. . .	2,992	. . .	. . .	84	3,076
Banco del Itsmo	462	. . .	. . .	606	. . .	1,068
Bancentro	. . .	. . .	. . .	. . .	424	424
Banks with capital outside the region	281	582	118	69	0	1,051
Citibank	75	182	118	69	. . .	445
Scotiabank	206	400	. . .	. . .	. . .	606
Total assets of regional banks	1,568	6,666	722	1,181	1,603	11,740
Memorandum item:						
Total assets of banking system	21,779	18,728	9,483	19,248	2,123	71,361

Sources: Bankscope, EDSS, and FitchSearch.

Scotiabank operates at the retail level. However, given the experiences of other regions, including the European Union, implementation of CAFTA-DR will likely lead to increased presence of foreign financial institutions.

The formation of regional conglomerates and cross-border lending allows financial institutions to take advantage of economies of scale and provide services to customers across countries. However, it also represents to some extent regulatory arbitrage, since prudential requirements are different across Central America.[7] Capital requirements are highest in El Salvador and lowest in Panama (Table 6.3). Substantial differences also exist with respect to reserve requirements, which are only 10 percent in Costa Rica but are 20 percent in the Dominican Republic, amounting to an additional implicit tax.[8] Moreover, the regionalization of financial services can lead to gaps in monitoring that can create new vulnerabilities, warranting increased cooperation among regulators and supervisors.

Increased regionalization of banking services could limit the capacity of country authorities to regulate their respective financial systems effectively. For example, a tightening of capital requirements in one country could encourage financial institutions to establish a holding company in another country with lower capital requirements, and then operate through branches or subsidiaries. Differences in prudential requirements can also encourage "adverse selection," as strong banks might opt to establish holding companies in countries that have a reputation of strong regulation and supervision. By doing so, these institutions signal that they are financially sound. This rationale might explain, for example, why an increasing number of Central American banks have opted to incorporate in Panama (Box 6.2). On the other hand, weaker institutions might have an incentive to move their headquarters to the countries with less demanding financial sector regulations and supervision requirements.

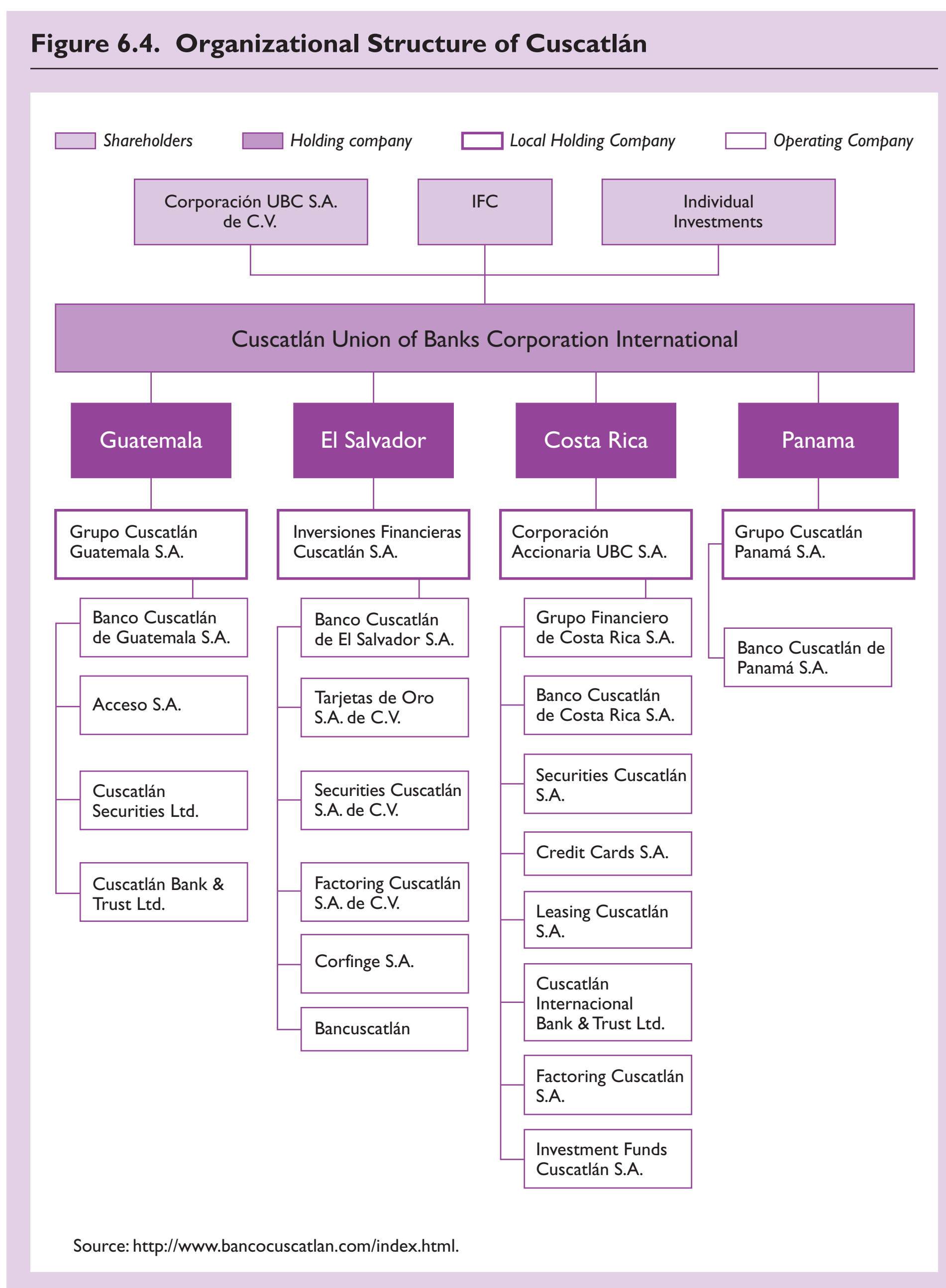
Challenges for Financial Regulation and Monitoring

IMF Financial Sector Assessment Programs (FSAPs) in Central American countries took place during periods marked by varying degrees of stress in the respective systems (Table 6.4). In Costa Rica and El Salvador, tensions were building at the time

[7]Avoidance of prudential supervision and cross-border activities also pose the risk that it might be associated with money laundering and the financing of terrorism.

[8]Substantial differences also exist in the area of deposit insurance.

Figure 6.4. Organizational Structure of Cuscatlán



Source: http://www.bancocuscatlan.com/index.html.

of the FSAP, as economic growth was slowing down, and as the external current account and fiscal deficits were rising, all of which raised the banking system's vulnerability to risks. In Guatemala and Honduras, the FSAP took place in a period when prudential indicators were weakening as a result of increasing nonperforming loans, insufficient provisioning, and deteriorating capital adequacy and profitability. In Nicaragua, the FSAP was conducted during a process of consolidation following the 2000–01 banking crisis. In the Dominican Republic, the 2001 FSAP found moderate stress and inadequate information, which obscured elements that underlay the banking crisis that erupted two years later (Box 6.3).

Efforts to upgrade banking supervision and regulation have been made in response to increasing stress. In some cases, new regulations were prepared with the support of other multilateral organizations, chiefly the Inter-American Development Bank (IDB). In several countries, noticeable progress has

Table 6.3. Prudential Requirements

	Capital Requirements	Reserve Requirements		Liquid Asset Requirements	
		Domestic currency	Foreign currency	Domestic currency	Foreign currency
Costa Rica	10 percent	10 percent	10 percent	. . .	. . .
Dominican Republic	10 percent	20 percent[1]	20 percent	8 percent[2]	none
El Salvador[3, 4]	12 percent	20–25 percent	not applicable	3 percent[5]	not applicable
Guatemala	10 percent	14.6 percent	14.6 percent	none	none
Honduras	10 percent	12 percent	12 percent	none	38 percent
Nicaragua	10 percent	16.25 percent	16.25 percent	. . .	. . .
Panama[3]	8 percent	none	not applicable	35 percent	not applicable

Source: Country authorities.
[1]Includes cash in vault (up to a maximum of 5 percent of liabilities subject to reserve requirements).
[2]Compulsory investment requirement equivalent to 8 percent of bank's deposits. To be held at the central bank yielding 15 percent.
[3]El Salvador and Panama are fully dollarized economies.
[4]Upon dollarization, reserve requirements were substituted by remunerated liquidity requirements.
[5]Since January 1, 2005, banks were required to hold an additional 3 percent of the daily average of deposits of the previous month in foreign securities.

taken place in on-site and off-site supervision, including the initiation of steps toward a risk-based supervision framework (Costa Rica and Nicaragua). In El Salvador, a new banking law allows for implementation of consolidated supervision, and in Guatemala, offshore banks have been brought into the regulated system and a new bank resolution framework has been put in place. Many countries (El Salvador, Guatemala, Panama, and Nicaragua) concluded agreements with supervisory authorities in countries where banks owned by residents were incorporated. In a few countries, market risk became a factor for the determination of capital requirements in recent years (Dominican Republic and Nicaragua). Moreover, all countries embarked on efforts to comply with anti–money laundering standards.

The main problems facing the financial sector are associated with credit risk, which often is not reflected in the level of nonperforming loans until it comes to the fore after a downturn in economic activity and/or external shocks. High credit risk is generally found to be related to sector concentration and related lending, and it is often compounded by the small scale of intermediation, as high transaction costs are reflected in wide interest rate spreads. In the presence of an economic slowdown or a sizable external shock (for example, the decline in coffee prices in recent years), the corresponding deterioration of the loan portfolio could be rapid. Moreover, unhedged foreign currency lending is a common practice, other than in the two countries that formally adopted the dollar (El Salvador and Panama). Regulatory action in these areas has been delayed partly because of a lack of specific guidelines under the Basel framework.

Other problems affecting financial institutions in Central America included significant exposure to government bonds, especially in countries with high public debt. The risks associated with holding government securities are in turn compounded by liabilities of the government emerging from pension system reforms, and in some cases from bank restructuring.

An important deficiency in the regulatory framework is the limited supervisory coverage of cross-border financial operations. The highest risk is in cases in which unsupervised entities could be used as vehicles for dumping impaired assets or generating fictitious capital for supervised institutions. However, financial problems may arise even if all financial institutions belonging to a group are supervised, but on a nonconsolidated basis. When the soundness of financial groups is difficult to ascertain, regulators do not know the extent to which domestic activities are financed through triangular operations or what the potential spillover effects of difficulties in a different location might be. In 2001, other countries had begun producing general information with a view to facilitating the integration of related institutions under the umbrella of their national supervisory authorities (Costa Rica and Guatemala).[9] Other groups, such as some Nicaraguan and Salvadoran financial groups, have consolidated in Panama, presumably to take

[9]Guatemala has since brought its offshore banks into the regulatory framework as part of licensed and supervised financial conglomerates.

Box 6.2. Panama's Financial System and Regional Offshore Center

Panama's financial system is the most developed and sound in Central America. Total bank assets amount to 250 percent of GDP, of which more than 50 percent are managed by foreign institutions. Banks are liquid, show low nonperforming loans, and are capitalized well above Basel standards. An important regional offshore center has developed, with 32 internationally licensed banks (six banks are headquartered in Panama) out of a total of 73 banks.[1] An IMF assessment of Panama's offshore financial sector in 2001 found a high level of compliance with the Basel Core Principles. Since then the authorities have introduced measures to address a few remaining weaknesses.

The 1998 banking law provides an adequate framework for banking supervision. The superintendency has the power to supervise conglomerates, including nonbank affiliates, on a consolidated basis. Offices of foreign banks are subject to consolidated supervision by their home country supervisors. Given that a number of Panamanian banks have subsidiaries and affiliates in other Central American countries, and that Central American banks are establishing their legal domicile in Panama for supervisory purposes, the Superintendency of Banks has signed memoranda of understanding (MOU) with other superintendencies in the region. These MOUs provide the legal foundation to ensure the sharing of information among supervisors across countries and to allow on-site inspections. The superintendency also allows foreign supervisors from jurisdictions without MOUs to conduct on-site inspections in Panama upon request and on a case-by-case basis.

Panama's financial system has been resilient to shocks (including from the financial crisis in Argentina), despite the lack of a lender-of-last-resort facility and the absence of a deposit insurance scheme. The authorities rely on market forces for financial sector workouts, and the government has refrained from bailing out failing institutions. Main prudential concerns relate to the vulnerability to corporate failures due to high loan concentration, a heavy reliance on interest income as opposed to income from fees or commissions, and overbanking. A challenge in the coming years will be the capacity to absorb increasing bank consolidation resulting from increased financial sector integration and cross-border financial intermediation in Central America.

[1]Panama's offshore legislation requires that internationally licensed banks establish a physical presence in Panama and maintain an office with local staff. Internationally licensed banks cannot lend to or take deposits from residents.

Panama: Financial Sector Indicators[1]
(In millions of U.S. dollars unless otherwise indicated)

	1996	2000	2003
Structure			
Number of banks	90	75	73
Of which: foreign banks	66	52	54
Total bank assets (in percent of GDP)	411.5	387.0	250.0
Of which: foreign banks	291.8	231.0	132.1
Private banks	365.6	345.0	216.1
Public banks	46.0	42.0	33.9
Credit to the private sector as percentage of GDP	79.4	98.6	74.6
Bank concentration			
Number of banks accounting for at least			
25 percent of total assets	2	2	3
75 percent of total assets	24	23	20
Capital			
Ratio of capital to risk-weighted assets	. . .	16.0	18.5
Asset quality			
Ratio of nonperforming loans to total loans	1.1	1.6	2.7
Provision coverage			
Ratio of provisions to total loans	1.4	2.0	3.5
Ratio of provisions to nonperforming loans	134.9	124.1	127.7
Management			
Ratio of administrative expenses to total assets	0.6	0.8	1.0
Profits per employee (in thousands of U.S. dollars)	51.0	38.0	55.8
Profitability			
Pre-tax return to average equity	22.2	14.0	21.3
Pre-tax return to average total assets	1.5	1.3	2.4
Liquidity			
Ratio of loans to deposits	82.0	80.0	77.0
Ratio of liquid assets to deposits	3.5	38.1	30.5
Interest margin			
Annual average financial spread (percentage)	1.8	1.6	2.9

Sources: Superintendency of Banks; and Central America Monetary Council.
[1]Includes general license banks and international license banks.

Table 6.4. Financial Sector Assessment Programs

	Original	Update	Offshore
Costa Rica	8/1/2002		
Dominican Republic	11/1/2001		
El Salvador	12/1/2000	3/9/2004	
Guatemala	7/1/2001		
Honduras[1]	4/28/2003		
Nicaragua[2]	2/2/2004		
Panama			8/31/2001

[1]The Financial System Stability Assessment (FSSA) was issued on April 28, 2003. The FSAP report is ongoing.

[2]The date is for the second FSAP mission. All the reports are ongoing.

advantage of its position as an international financial center.

Financial Soundness

Stress in the financial system has not always been reflected in bank statements. This was to a large extent a result of reporting deficiencies, such as the high percentage of loans reclassified during inspections, which reflect inadequate risk management practices by banks. Financial stress has generally been reflected in the financial statements only when a crisis was imminent. Intervention of banks experiencing financial difficulties did not occur until several years after the first signs of stress started to show. Also, particular shocks and pressures from interest groups led to special treatment of specific segments of the loan portfolio.

Capital positions and profitability are often reported to be comfortable, but these measures were often inflated, primarily because of underprovisioning. Moreover, because financial statements of many financial groups are not consolidated, it has not yet been possible to assess the effective solvency of such groups. Other specific weaknesses in individual countries include exemptions to provisioning rules, exclusion of provisions from total expenditure in the banks' income statements, and lax definitions of nonperforming loans.

Spontaneous dollarization entails higher liquidity and credit risk. Direct access to foreign currency deposit holdings fosters an eventual deposit drain in the face of financial uncertainties. However, it may not be a decisive factor. In Nicaragua, deposits stayed within the system following the 2000–01 banking crisis (with "flight-to-quality" shifts within the domestic banking system), possibly supported by a blanket government guarantee on deposits. Unhedged foreign currency lending had increased more markedly in countries with a pre-announced crawling peg (Costa Rica and Nicaragua), possibly reflecting moral hazard behavior in the face of an exchange rate guarantee. In Honduras, where dollarization is moderate relative to other Central American countries, the authorities adopted specific prudential measures against dollarization risks, including higher liquidity requirements on foreign currency deposits, and restrictions on lending in foreign currency to unhedged borrowers. However, attempts to prevent dollarization by legal means could be damaging; in Costa Rica and Guatemala, a legal prohibition on conducting financial transactions in foreign currency induced the emergence of unsupervised offshore banking.[10]

Box 6.3. Dominican Republic: Banking Crisis and Financial Reform

The Dominican banking system came under severe stress in 2003 following financial scandals, which involved unreported liabilities in a separate set of accounts, at one large and two medium-sized banks. All three banks (including Baninter) have been resolved without imposing losses on depositors, which has helped contain deposit outflows and avoided a systemic crisis, albeit at a high cost. Behind the banking crisis were weaknesses in transparency, accounting procedures, and fiscal control.

Currently, banking reforms are taking place in the following five broad areas: (1) institutional arrangements (including the creation of an asset recovery unit at the central bank); (2) legal and regulatory changes (new law on bank resolution under systemic risk and update of prudential norms in line with international best practices); (3) actions for the resolution of weak banks; (4) rules for the provision of emergency liquidity; and (5) restructuring of public banks to ensure equal treatment with respect to private institutions.

Additional reform priorities include (1) bank recapitalization; (2) establishment of an independent asset management unit; (3) strengthening of the superintendency of banks; (4) development of a plan for savings and loans, development banks, and public banks; and (5) regulatory changes to bring the prudential framework in line with international best practices.

Legal and Regulatory Framework

Deficiencies in legal and institutional arrangements undermine the autonomy of supervisory au-

[10]Offshore operations continued once foreign currency deposits were allowed.

thorities. Supervisory authorities are often institutionally weak against the courts. Supervisory authorities in some cases cannot close a bank, suspend its operations, or revoke its license without a court ruling; in other cases, critical judicial determinations rule on how the superintendency should proceed. Moreover, some interinstitutional arrangements discourage effective banking supervision. This problem is compounded by the absence of legal protection for bank supervisors.

Consolidated supervision constitutes a major challenge. In jurisdictions where consolidated supervision has been pursued, the legal structure of companies has sometimes complicated this effort. Also, a careful assessment is needed of the definition of financial groups, and accounting criteria for consolidating financial statements need to be clear. However, in most jurisdictions consolidation was still partial. In one case, companies were required only to consolidate their reporting for entities in which they had a majority interest. In most countries, not all nonbank financial institutions were included in legal provisions for consolidated supervision. To mitigate the risks associated with the slow progress toward effective consolidated supervision, second-best ring-fence measures have been implemented.[11] However, these measures are still imperfect substitutes for regional consolidated supervision.

Prudential supervision and enforcement remain in need of further improvement in the following areas:

- effective prevention of excessive related lending;
- adequate rules for valuation of loans and the norms of provisioning in most countries;
- narrowly focused on-site inspection and off-site analysis (not yet fully integrated into a risk-based approach);
- oversight of sales or transfers of significant shares of a bank's capital;
- harmonization of accounting standards with a view to bringing them in line with international standards;
- greater reliance on external auditors, with appropriate accountability provisions;
- a centralized credit information system;
- a system of prompt corrective action with appropriate sanctions and remedial measures; and
- fit and proper criteria.

Crisis management frameworks suffer from several deficiencies. Systemic liquidity has often been made unduly available for institutions with solvency problems, to support failed banks for extensive periods and in relatively large amounts. Appropriate triggers for prompt correction have generally been absent; as a result, intervention in banks generally serves only as a first step toward their liquidation. Existing legislation has not allowed the supervisory authority to impose a graduated regime of prompt correction.

Corporate reorganization and liquidation proceedings are hindered by a slow judicial process, disincentives for creditor participation, and the lack of effective out-of-court solutions. Execution of both unsecured and secured claims is often cumbersome and requires the use of inefficient judicial enforcement proceedings. The legal framework for insolvency neither facilitates the reorganization of viable enterprises nor allows the efficient liquidation of nonviable ones. Some countries show positive features: in El Salvador, the real estate registration system is well advanced, and Nicaragua possesses an expedient process to execute collateral when the creditor is a bank.

Supervision of public banks is generally weaker than that applied to private institutions. In some cases, public banks and their affiliates did not report consolidated accounts, reported nonperforming loans showed data inconsistencies, and the provisions coverage of bad loans was low. This has led to quasi-fiscal exposures arising from public banks.

Some basic legislation has recently been modified. Central bank, banking, and bank supervision laws were updated in the Dominican Republic and Guatemala following the FSAP. The purpose was to eliminate inconsistencies in prevailing practices in financial markets and to strengthen the autonomy of the central bank and supervisory bodies in monitoring and regulating the financial system. At the time of the FSAP update in El Salvador, the authorities had made some progress in establishing troubled bank resolution procedures, although those procedures have not yet been tested. In Nicaragua, the legal framework is being overhauled, to bring it in line with most standards and best practices.

Key Policy Recommendations

The legal framework for financial intermediation should be improved. This would entail strengthening the functions and structure of the supervisory authority, removing bank secrecy in lending operations, and introducing legal protection of supervisors. In several countries the national authorities have secured approval of new legislation or have prepared draft legislation for consideration by legislatures.

Consolidated supervision requires action and coordination at the regional level, with strict enforce-

[11]Ring fences are temporary, stricter-than-normal prudential measures aimed at preventing noncompliance with other norms that are more difficult to enforce.

ment at the domestic level. This is a key element for compliance with the Basel Core Principles for Effective Supervision. Country authorities are well aware of the advantages of consolidated supervision, although they still lack the capacity to implement it individually. Effective regional coordination toward consolidated supervision would be a significant step forward in the prudential monitoring capacity of supervisors in the region.

Bank supervision should move to a risk-based approach as soon as possible. In this process, the following steps need to be taken: improve loan classification and provisioning rules, enhance interaction between supervisors and external auditors, strengthen oversight of "fit-and-proper" attributes, implement international accounting standards, and enhance supervision for anti–money laundering and combating of terrorism financing. Country authorities have already taken some steps in this direction.

Crisis management frameworks need significant improvement in most countries in the region. Some reforms were introduced in countries more recently affected by a banking crisis. However, implementation of these reforms is still pending in most cases, as is the integration of emergency liquidity facilities and supervisory action.

Insolvency and creditor rights also require significant improvement. To the extent that the rights of creditors are not fully enforced, there will be limitations to further progress in financial development.

Recent Progress and Looking Forward

Important steps have been taken in recent years toward improving the framework for financial activities in Central American countries. In addition to advances in legislation, countries are making efforts to improve rules for the valuation of loans and provisioning, to integrate on-site inspection and off-site analysis, and to fully adopt fit-and-proper criteria. Country authorities are also actively restructuring their bank resolution frameworks. Some other specific measures aimed at improving the framework for financial activities are as follows.

- In Costa Rica, information requirements have been upgraded to put more emphasis on consolidated reports. Also, international accounting standards are being introduced, and the supervisory framework is moving toward a risk-based approach. Moreover, draft regulations on external audit and corporate governance have been prepared.
- In El Salvador, the definition of "financial conglomerate" was revised, and new supervisory guidelines were issued to make consolidated supervision more effective. Improvements were made in on-site and off-site bank examinations, and anti–money laundering procedures were introduced. Emphasis has been placed on developing a friendly environment for microfinancing operations.
- In Guatemala, the authorities have undertaken a comprehensive financial sector-restructuring program, including a modernization of the legal framework with new central bank, banking, monetary, and financial supervision laws. Also, unregulated (offshore) financial intermediaries are being brought into the regulated system. Onsite examinations have become more focused and a CAMEL-type methodology is helping improve the effectiveness of off-site surveillance. Starting May 2004, a central database of debtors is accessible to banks.
- In Honduras, new banking legislation was introduced at the end of 2004. The authorities are working to strengthen the rules of loan classification and provisioning, with a view to aligning them with international standards. The authorities are also considering introducing stricter standards for provisioning foreclosed assets and the restructured agricultural portfolio.
- In Nicaragua, the superintendency is taking steps toward a risk-based approach for banking supervision. Regulations introduced include a norm on liquidity management based on maturity mismatches, and capital requirements for an open foreign currency position (to be phased in over two years).

Regional efforts are necessary to consolidate progress at the country level, especially on consolidated supervision. The Inter-American Development Bank is supporting coordination among Central American countries to harmonize regulations that would help put in place a common framework for supervising financial groups. Effective cooperation among Central American countries in this area would help eliminate incentives for regulatory and tax arbitrage.

The development of a regional market for government securities would facilitate better liquidity management by financial institutions. This is especially important for Central America, where domestic debt is increasing as a result of pension reforms, a shift away from external debt, and in some cases the need to finance bank restructuring. Some steps have been taken to strengthen the primary market, including standardizing securities and developing a basic public debt management strategy. Further steps are nec-

essary to develop interbank markets, secondary markets, and the infrastructure for security settlements, and to regulate collective investment.

Central American countries have an opportunity to integrate workers' remittance flows into the financial sector. It is estimated that only about one-tenth of remittances are intermediated by the banking system. A common effort in improving the infrastructure to provide better remittance-related services would help reduce transaction costs and facilitate financial deepening.

Significant economies of scale could be achieved by adopting common standards for countries' payment systems. Regulations to process checks and securities, common standards for book entry systems, and the development of a common framework for electronic payments and settlements would contribute to the development of the regional financial system and would help to better integrate cross-border financial transactions.

Central American countries need to develop the insurance sector, since their economies are subject to large shocks, such as natural disasters and crop diseases. Lack of insurance against major disasters is one factor limiting credit flows to small firms, particularly in rural areas. There may be an advantage in regionally based insurance that would help pooling risks over a larger and more diverse area. There may be a similar unmet demand for hedging of commodity price movements that could best be met by a regional initiative, and for securitized mortgages.

Conclusions

Central America has made good progress in establishing sound financial systems, which in turn has contributed to increased financial intermediation and improvements in key financial sector indicators. Credit to the private sector has been rising, from an average of 14 percent of GDP in 1996 to almost 40 percent of GDP in 2003. However, for certain sectors, access to credit remains limited, and the financial systems continue to be largely bank based. Bank resolution frameworks have been strengthened in a number of countries, but the actual implementation continues to lag behind. Thus, financial systems still face significant vulnerabilities associated with a high degree of dollarization, balance sheet mismatches, nonperforming loans, unregulated offshore activities, related lending, and supervisory weaknesses and forbearance.

Over the past few years, regional financial sector integration has been accelerating and cross-border activities have increased. Some financial institutions that initially focused on the home market have expanded throughout the region. Assets of these regionally operating banks amounted to more than 15 percent of GDP in 2003. Financial sector integration and consolidation will help the region to take advantage of economies of scale and promote competition and efficiency. At the same time, financial sector integration increases the risk of spillovers leading to contagion in the case of a banking crisis, and the regionalization of financial services reflects, in part, regulatory arbitrage. Increased policy attention to the regional aspects of financial sector activities is therefore a priority. Since consolidation of regional financial operations is only partial, and most cross-border financial intermediation takes place on an unconsolidated basis, it is essential that the region move forward with consolidated supervision at both the domestic and regional levels.