REPORT AND RECOMMENDATION
OF THE
PRESIDENT OF THE
INTERNATIONAL DEVELOPMENT ASSOCIATION
TO THE
EXECUTIVE DIRECTORS
ON A
PROPOSED FINANCIAL SECTOR ADJUSTMENT CREDIT
IN AN AMOUNT EQUIVALENT OF SDR 51.8 MILLION
TO THE
REPUBLIC OF NICARAGUA

APRIL 9, 1998
**CURRENCY EQUIVALENTS**

US$1 = 9.8 Nicaraguan Córdobas

**Fiscal Year**

January 1 - December 31

**LIST OF ACRONYMS AND ABBREVIATIONS**

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<th>Acronym</th>
<th>Description</th>
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<tr>
<td>BANADES</td>
<td>National Development Bank</td>
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<tr>
<td>BANIC S.A.</td>
<td>Nicaraguan Bank for Industry and Trade, Inc.</td>
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<td>BCP</td>
<td>Popular Credit Bank</td>
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<td>BIN</td>
<td>Inmobiliario Bank</td>
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<td>BOFOS</td>
<td>Development Bonds</td>
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<td>CAS</td>
<td>Country Assistance Strategy</td>
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<td>CBN</td>
<td>Central Bank of Nicaragua</td>
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<td>CENIS</td>
<td>Negotiable Investment Certificates</td>
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<td>CERAP</td>
<td>Executive Committee for Public Administration Reform</td>
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<td>COBANICSA</td>
<td>Nicaraguan Collection Agency</td>
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<td>CORFIN</td>
<td>Nicaraguan Financial Corporation</td>
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<td>EBE</td>
<td>Expert Bank Examiners</td>
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<td>EMTAC</td>
<td>Economic Management Technical Assistance Credit</td>
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<td>ERC II</td>
<td>Economic Recovery Credit II</td>
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<td>FSAC</td>
<td>Enhanced Structural Adjustment Facility</td>
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<td>FNI</td>
<td>National Investment Fund</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>IDA</td>
<td>International Development Association</td>
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<td>IDB</td>
<td>Inter-American Development Bank</td>
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<td>IDC</td>
<td>Institutional Development Credit</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<td>INSER</td>
<td>State Insurance Company</td>
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<td>PFP</td>
<td>Policy Framework Paper</td>
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<td>PHRD</td>
<td>Policy and Human Resources Development Grant</td>
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<td>SBIF</td>
<td>Superintendency of Banks and Other Financial Institutions</td>
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<td>SDR</td>
<td>Special Drawing Right</td>
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<td>USAID</td>
<td>United States Agency for International Development</td>
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Vice President: Shahid Javed Burki, LCRVP  
Country Managing Unit Director: Donna Dowsett-Coirolo, LCC2C  
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Task Team Leader: Ronald E. Myers, LCSPR
NICARAGUA: FINANCIAL SECTOR ADJUSTMENT CREDIT

CREDIT AND PROGRAM SUMMARY

Borrower: Republic of Nicaragua

Amount: SDR 51.8 million (equivalent to US$70 million)

Terms: Standard IDA terms, with an amortization period of 40 years, including a grace period of 10 years.

Program Objectives: The proposed Financial Sector Adjustment Credit (FSAC) would support the Government's structural adjustment program, which aims to: (i) carry out a major reform of the state banking sector; (ii) improve financial intermediation, especially in rural areas; and (iii) improve the regulatory framework for private banking.

Credit Description: To help achieve the program’s objectives, the proposed FSAC would support measures to: (i) maintain a stable macroeconomic framework; (ii) restructure the state banking system, including the closure of one state bank and the capitalization by private investors of another state bank; (iii) foster private banking presence in the rural and agricultural sectors; and (iv) strengthen the regulatory framework for, and supervision of, private banking. A policy matrix spelling out the objectives of the proposed credit and measures already taken is provided as Annex B.

Benefits: Implementation of the reform program would allow the Government to address major obstacles to sustainable private sector-led growth, namely: resolving the long standing threats to fiscal stability and financial markets posed by the state banks, directly promoting improved financial intermediation with regard to the critically important rural and agricultural sectors, and taking key steps to strengthen the regulatory framework for the financial sector. Approval of the FSAC should enable the Government to mobilize additional balance of payments support, which would permit a more predictable and orderly economic adjustment path. To the extent that implementation of the proposed reform program succeeds in maintaining economic growth within a stable macroeconomic environment, the Government would be in a stronger position to resist political pressures for more populist and interventionist policies, or risk the real gains achieved in Nicaragua’s transition to a market economy.

Risks: The proposed credit involves three major risks. First, the capitalization of BANIC could be complicated by existing and future claims against the bank both within and outside Nicaragua. The Government is seeking through pending legislation to assume financial responsibility for those claims (which should resolve issues relating to domestic claimants) and in any case will seek to resolve external claims should the legislation not prove sufficient. Second, the sale of BANIC shares (and Government assumption of claims against the bank) requires congressional approval which could be controversial causing delays or halting the implementation of the BANIC capitalization. However, the
NICARAGUA

PROPOSED FINANCIAL SECTOR ADJUSTMENT CREDIT

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This document has a restricted distribution and may be used by recipients only in the performance of their official duties. Its contents may not otherwise be disclosed without the International Development Association's authorization.
1. I submit for your approval the following report and recommendation on a proposed Financial Sector Adjustment Credit (FSAC) for SDR 51.8 million (US$70 million equivalent) to the Republic of Nicaragua in support of the Government's financial sector adjustment program. The credit would be on standard IDA terms, with an amortization period of 40 years, including a grace period of 10 years.

I. HISTORICAL PERSPECTIVE AND RECENT DEVELOPMENTS

2. The second poorest country in Latin America, Nicaragua is struggling to complete a transition from a centrally planned to a market economy, while reinforcing stability and democracy after years of political turmoil and economic decline. The economy is small (GDP of US$2.0 billion) with a GNP per capita in 1996 of only US$400. Tremendous achievements have been realized on the macro front since the early 1990s, as detailed in the Country Assistance Strategy Paper which is being circulated for consideration by the Executive Directors in parallel with this document. In brief, the democratically elected government of President Chamorro confronted a devastated economy and a highly polarized society after more than a decade of economic mismanagement and warfare. Most of Nicaragua's limited infrastructure base was either destroyed or in an advanced state of disrepair; exports and GDP per capita had fallen to 40 percent of the levels attained in the mid 1970s, and major economic imbalances had resulted in hyperinflation and a huge external debt of more than 5 times GDP. A far-reaching land reform and urban property redistribution program had left a complex property rights problem, and the basic institutions that had once supported a market economy were defunct.

3. Relying on strong support from the international donor community, the Government embarked on an ambitious stabilization and reform program. Although progress was never easy and occasionally sidetracked by political disruptions, the results over the course of the Chamorro administration were impressive, including a drastic reduction of the fiscal deficit (by almost 20 percentage points of GDP), elimination of price controls, sale of most state owned productive firms, liberalization of the exchange and trade systems, resolution of many property disputes, the re-emergence of private banking, creation of a Superintendency of Banks, and reduction of the share of state banks in total credit. By most measures, the program was a success: inflation fell to low double digits, the economy has been growing steadily since 1994, a significant number of private financial intermediaries have emerged, private domestic and foreign investment is recovering, and open unemployment is estimated to have fallen from 23 percent in 1993 to 14 percent in 1997.
4. Nonetheless, much remains to be done by the present Government, which took office in January 1997, to complete the transition to a peaceful and sustainable market economy, with real gains in the standard of living of the majority of the population. Poverty is widespread, the country still faces an unsustainable debt burden, and a sound framework is needed for market-led private sector development. In this context, some of the most important challenges concern the financial system, and it is on this agenda that the proposed operation would focus, as detailed in Section IV below.

II. THE FRAMEWORK FOR GROWTH

5. Most of Nicaragua’s medium-term growth potential, and the key to extreme poverty alleviation, lies in the revitalization of agriculture and rational exploitation of the country’s abundant natural resources. About two-thirds of all the poor and close to four-fifths of the extreme poor are concentrated in rural Nicaragua; and three out of four poor households derive most of their income from agriculture. Unlike several of its neighbors, Nicaragua does not have a high population density in relation to good, arable land; indeed Nicaragua was once the most successful agriculture economy in the area. There have been some clear signs of an agricultural recovery since about 1994. Building on this will require maintaining a competitive real exchange rate and eliminating remaining anti-agricultural biases in the trade regime, as well as improvements in the workings of land markets, rural financial markets, technology investments, and agricultural markets. Formulation of a social policy agenda to support human development and poverty alleviation will also be critical. A large share of Government resources are allocated to the social sectors, but absolute per capita expenditures in health and education are still well below regional averages. Given budgetary constraints, improving social services will depend on effective targeting, efficient use of limited resources, developing cost-recovery options, and directing a larger share of foreign aid to these sectors. Macroeconomic imbalances remain large and the business environment requires considerable strengthening. These challenges set the agenda for the present administration and its international partners.

A. MACROECONOMIC FRAMEWORK

6. After several years of little apparent response to the initial stabilization and reform efforts of the early 1990s, the economy began to turn around in 1994, when it registered an annual growth rate of 3.3 percent despite mixed weather conditions which depressed agricultural output below potential. This upward trend continued in 1995 and 1996, with growth of 4.3 and 4.5 percent respectively. Inflation averaged around 11.6 percent during those two years and the external current account deficit (excluding interest obligations) declined slightly to 17.8 percent of GDP in 1996, with strong growth (27 percent) in the dollar value of exports of goods and non factor services. Although agreements reduced the outstanding stock of debt from 541 percent of GDP in 1995 to 282 percent of GDP by November 1997, effective debt payments increased from 11.3 percent in 1995 to 16.2 percent of GDP in 1997.
7. Despite the improvements in the real economy, the incoming Aleman administration in January, 1997 confronted serious challenges, not the least of which a 15.7 percent of GDP fiscal deficit before grants (7.1 percent of GDP after grants). Foreign reserves were minimal, and state bank finances were deteriorating. In response the new Government initiated a comprehensive fiscal program including a broad tax reform and a significant revenue collection effort, cuts in Government recurrent and capital spending other than in the social sectors, and expanded private participation in infrastructure. As a result, the combined fiscal deficit before grants declined to 9.6 percent of GDP (3.6 percent of GDP after grants) by year end. Despite this fiscal tightening and adverse weather, real growth in 1997 is estimated to have increased to 5.0 percent while inflation fell to 7.3 percent.

8. Given a macroeconomic situation which is fragile and vulnerable to shocks and reductions in foreign assistance, the Government has designed and begun implementing an ambitious stabilization program. This effort will be supported by an ESAF program which is being presented to the IMF Board on March 18, 1998. Assuming continued expansion of agriculture, non-traditional exports and increased investment, real GDP growth is projected to accelerate to 5-6 percent per year over the next three years. Inflation is projected to decline to 8 percent in 1998 and to remain in single digits. A major improvement in the foreign reserve position is also envisioned, with gross reserves rising from the equivalent of less than one week of imports at the end of 1997 to 3 months at end-2000.

9. The fiscal program aims at increasing the combined public sector savings by 6 percentage points of GDP over the 1998-2000 period with a sizable effort coming in the first year. The fiscal targets would be achieved by reducing current outlays through a freeze in non-social current expenditures and reduction in export subsidies, and a reduction in the size of the public sector. The Government also plans to accelerate the privatization program. The increased savings would permit the maintenance of public investment at around 12 percent of GDP while reducing the combined deficit before grants from 15.7 percent of GDP in 1996 to 4 percent of GDP by the year 2000. The deficit after grants would fall from 7.1 percent of GDP in 1996 to a small surplus in 2000.

10. The monetary program will be geared to achieve the targets on inflation and international reserves, and to continue to enhance the participation of private banks in financial intermediation. The net domestic assets of the Central Bank are programmed to decline over 1998-2000 reflecting improvements in the fiscal position, increased reserve deposits of the commercial banks as a result of the unification of the reserve requirements across deposits and currencies, and reduced operational losses of the Central Bank. The growth in financial system liabilities to the private sector is expected to slow from 63 percent in 1997 to 16-20 percent per year in 1998-2000. Credit to the private sector is projected to grow by 12-14 percent per year over the same period.

11. Nicaragua will continue to rely heavily on foreign financing for the foreseeable future even though the current account deficit excluding interest obligations is projected to improve somewhat (US$350 million or 17.9 percent of GDP in 1996 versus US$259
million or 10.9 percent in the year 2000). Total gross disbursements of official grants and loans would average about US$400 million per year over the same period. Private capital is projected to add US$216 million annually. Given Nicaragua’s heavy debt burden, exceptional financing needs for 1998 are estimated at US$846 million (including clearance of bilateral arrears), US$129 million in 1999, and US$108 million in 2000. Significant reduction of the high level of external debt and debt service burden is key to external and fiscal sustainability. Access to the HIPC initiative would eventually provide much needed debt relief which should create the fiscal space essential for more aggressive anti-poverty and social development efforts.

B. MEDIUM TERM ADJUSTMENT PROGRAM

12. In parallel with the above macro-management objectives and targets, the current Government is committed to carrying out a far-reaching adjustment program to modernize and decentralize central Government operations, reform and strengthen the financial system, and develop a sound framework for private sector development. It aims to increase public sector savings, reorient remaining public sector activities, and expand the scope for the private sector. Major accomplishments to date include the passage of tax reform legislation last April which improves the efficiency of the tax system, introduces a flat land tax, and adopts a bold tariff reform program (maximum tariffs will be reduced to 10 percent by 1999). A free trade agreement with Mexico went into effect in January 1998. Legislation presented to Congress in December 1997 seeks to streamline central government operations through elimination of four ministries (External Cooperation, Tourism, Social Action, and the Presidency) and the Government projects a major reduction over three years in the number of public entities through consolidation and privatization. The legislation also aims to eliminate duplication of responsibilities and to allocate functions more rationally among remaining institutions. Private sector participation in infrastructure (power generation, port stevedoring services and road maintenance) has begun. The Government plans to privatize the state telecommunications company and is preparing the electricity company and water company for increased private participation.

13. The proposed FSAC operation would support the financial system reform elements of the adjustment program. It would underpin fiscal strengthening by virtually eliminating the threat to government finances stemming from the state banking sector, improve the environment for sustainable and sound expansion of the private financial sector by addressing the most pressing issues of banking regulation, as well as promote the development of financial intermediation serving the needs of small rural borrowers.

14. In subsequent years, as outlined in the Letter of Development Policy (Annex A), the Government would extend and deepen current initiatives, perhaps supported by a future IDA adjustment credit. Possible initiatives would include a comprehensive reform of the legal framework of the financial sector and commercial laws, strengthening of property rights and reforming the commercial justice system, reforming the pension system, accelerated transformation of the public sector into a regulator rather than
producer of goods and services through privatization of utilities and strengthening the planning and regulatory capacity of the state, decentralization of activities to local government, and adopting more pro-active policies and mechanisms to effectively promote foreign private investment as an indispensable condition for a successful integration into the global market economy.

III. IDA ASSISTANCE STRATEGY

15. IDA has played an important role in supporting Nicaragua's efforts since the early 1990s to revive growth and alleviate poverty. Investment operations have concentrated on reviving agriculture, developing human capital, providing social and economic infrastructure to the poorest regions, rehabilitating critical roads, improving natural resource management, and reforming the state. IDA has also supported the reduction of the country's commercial debt burden through a buy-back operation and IDA reflows. In coordination with the IMF, IDB, and bilateral donors, IDA has provided financial and analytical support and other non-lending services to the structural adjustment process. Formal economic and sector work has focused on understanding poverty and improving the effective use of public resources. IDA has provided a wide-range of non-lending services with emphasis on gender, agriculture and natural resources, education, health, indigenous groups and rural finance. More recently, IDA has been working with the Government on options to develop a sound private-led rural financial system; bringing the private sector more actively into infrastructure and, through FIAS, attracting foreign investment; and promoting national consensus on the development strategy and contentious policy issues.

16. The new CAS proposes a strategy aimed at reducing poverty and income inequality by helping Nicaragua accelerate its transition to a full market economy. Within a sound enabling environment the rural sector is a major potential source of private-sector led growth. IDA support will target: (i) consolidating macroeconomic stability by increasing public savings through state bank reform, pensions reform and reducing external debt to sustainable levels through the HIPC initiative; (ii) improving access to social services, particularly nutrition, primary education and strengthening the social safety net; (iii) strengthening the institutional capacity of the public sector and promoting decentralization; (iv) creating the enabling environment for private-sector led growth by developing a sound financial system and improving basic infrastructure; and (v) developing the rural sector and strengthening environment protection, developing well-functioning land markets, rural financial services, improving agricultural productivity, and stimulating non-farm economic activity.

IV. THE FINANCIAL SECTOR

17. After taking power in July 1979, the Sandinista Administration dismantled Nicaragua's private financial system, which at the time was considered one of the more advanced in Central America. All private banks were nationalized, control of state bank
operations was transferred to a holding company, and the number of financial institutions was reduced to five. Over the following decade, subsidies channeled as loans coupled with the use of the banking system to pursue political objectives completely undermined the soundness of the system, as well as the loan repayment culture in Nicaragua.

18. The Chamorro Government, which came to office in April 1990, reopened banking to the private sector. Banking supervision and regulation were introduced, interest rate and credit controls were eliminated, and an interbank foreign exchange market was established. These reforms, together with rising private capital inflows and economic recovery since 1994, have resulted in a deepening of financial intermediation and improved allocation of financial resources. However, much remains to be done to complete the transformation. State banks continued until recently to be sources of fiscal drain and financial market distortion despite recapitalization and restructuring efforts, rural credit mechanisms were inadequate to meet the needs of small borrowers, and the growth of private banking has exposed gaps in the legal and regulatory framework. For that reason, the current Government is moving aggressively, with significant IDA technical support, in the first phase of a financial sector overhaul to virtually close the state banking system, design alternative policies and institutional arrangements, mostly private-led, to support active rural financial intermediation, as well as strengthen the regulatory climate for private banking.

Overview of the Financial System

19. At present, Nicaragua’s financial system consists of 10 private commercial banks, 3 state-owned development banks, 2 private finance companies, 1 state-owned investment fund, 1 state-owned and 4 private insurance companies, 7 private deposit warehouses, 1 stock exchange with 13 registered brokerage houses (11 active), and numerous small, non-profit financial intermediaries (credit unions, NGOs). Nicaragua’s financial system has experienced a spectacular growth since 1991, evidenced by the rise in the ratio of liquid liabilities of financial intermediaries (M3) to GDP which is now comparable to the level observed in middle-income countries (Chart 1).

![Chart 1: Private Financial Savings and Currency Deposits](chart.png)

Despite largely stable macroeconomic and financial conditions in recent years and the unification of the exchange rate market, this growth has been mainly in dollar denominated deposits with the share of dollar denominated financial savings increasing from 29 percent in 1991 to 63 percent in 1997. Effective dollarization is higher still, since practically all córdoba
denominated financial assets and liabilities, except sight deposits, include a “maintenance of value” provision indexing the return in local currency to the official exchange rate.

20. The allocation of financial resources through the market has improved significantly. As the share of state banks in total private sector credit has declined since 1991 (Chart 2), the share of the private banks has increased rapidly, leading to a sectoral recomposition of credit in line with market signals rather than political criteria. The availability of investment capital, however, continues to be very limited—56 percent of the loans are for less than 18 months. Interest rates have remained stable in nominal terms but as inflation has fallen, real interest rates have increased somewhat (Table 1). Nevertheless, Nicaraguan interest rates are roughly in line with the dollar equivalent rates of other Central American countries. Reduction in interest rates will require increased efficiency and competitiveness of the region’s financial market.

Table 1 - Interest Rates 1993-97

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<td><strong>Commercial Bank Interest Rates</strong></td>
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<td>(annual averages)</td>
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<td><strong>Local Currency</strong></td>
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<tr>
<td>Short-Term Loans</td>
<td>20.2</td>
<td>20.1</td>
<td>19.9</td>
<td>20.7</td>
<td>21.0</td>
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<td>Deposits (180 days)</td>
<td>13.4</td>
<td>13.6</td>
<td>13.7</td>
<td>14.8</td>
<td>14.1</td>
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<td><strong>Foreign Currency</strong></td>
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<td>Short-Term Loans</td>
<td>...</td>
<td>15.2</td>
<td>15.5</td>
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<td>17.6</td>
</tr>
<tr>
<td>Deposits (180 days)</td>
<td>5.9</td>
<td>6.7</td>
<td>7.5</td>
<td>8.1</td>
<td>8.2</td>
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<tr>
<td>CPI Inflation</td>
<td>20.4</td>
<td>7.8</td>
<td>11.2</td>
<td>11.6</td>
<td>9.2</td>
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21. Despite this progress, the financial system is still in its infancy. Money market funds, leasing, commercial paper, private placement and securitization by non-bank issuers
are practically non-existent. The Managua Stock Exchange, opened in 1994, largely trades Central Bank and Government paper, with only a small share of private issues, the majority coming from one economic group. The private banking sector remains small, undercapitalized, and with high administrative costs and lending margins. In 1996, total equity in the banking system was only US$70 million, compared to US$178 million in Honduras and US$512 million in El Salvador. There is a need to fill some important gaps in the regulatory and legal framework and to limit the considerable discretion exercised thus far in the application of norms and regulations.

**Legal Framework**

22. Although the legal framework underpinning Nicaragua’s financial system has undergone numerous changes in recent years as the Government has sought to re-establish a modern private financial sector, a unified and clear legal structure has not yet emerged. There are more than 12 legal sources referring to the financial system. Information is not only spread throughout many documents, but interpretation is made difficult by major gaps, as well as vague and sometimes contradictory definitions. For example, the recent introduction of leasing and franchising activities has not been accompanied by the necessary changes in the Commercial Code. As a result, leasing still requires two separate contracts (the lease purchase option agreement and the contract to execute the sale) that contribute to unnecessarily high transaction costs. The commercial code itself was approved in 1904, modeled on earlier Spanish laws derived from the Napoleonic era. There is a need for more detailed procedures for bankruptcy and corporate reorganization, a reliable and well-indexed registry for liens on movable property and inventories, modern patent and copyright laws, and an updated companies law.

23. The weaknesses of the judicial system also undermine the implementation and enforcement of commercial laws. Court dockets are overloaded, litigation can be prolonged, and there is less than full confidence in judicial decision-making processes or results. Concerns about judicial enforcement of contracts leads to the under-utilization of promissory notes, mortgage agreements, conditional sales agreements, leases, letters of credit, insurance policies and even bank checks. Real property titles remain a major problem as the procedures established to resolve title disputes resulting from expropriation and confiscation of real estate during the Sandinista period remain a source of insecurity.

24. This legal environment as well as political uncertainties in the earlier 1990s have probably hampered foreign investment in the banking system. A recent FIAS study found a confusing legal interpretation on whether foreign branches can be opened, since recent reforms do not appear to have explicitly superseded the 1979 Bank Nationalization Law, which expressly barred foreign branches from accepting local deposits. The considerable

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1. A recently-approved Property Law guarantees tenure to small-scale farm and urban property owners, while setting in place mechanisms for the legal adjudication of confiscated property and compensation mechanisms.

discretionary powers vested in the Superintendency, in large measure to compensate for the gaps in the legal framework, have also discouraged foreign investors. These issues in addition to general country risk and the limited size of the local market have directed banking foreign investment elsewhere and domestically into local banks, rather than the establishment of foreign bank branches.

**The Banking System**

25. The banking system dominates Nicaragua's financial sector. Excluding CBN, the banking sector accounted for C$13.4 billion in assets as of September 1997 (about US$1.4 billion, equivalent to about 75 percent of GDP). In mid 1997 state banks accounted for 21 percent of total assets (down from nearly 95 percent in late 1991) and private banks for 79 percent. Deposits in the banking sector accounted for 85 percent of total liabilities in the financial system, of which private banks accounted for 79 percent.

**State Banks.** At the beginning of 1997 Nicaragua's state banking sector included two large development banks and a small bank lending to small-scale enterprises:

- **BANADES.** Historically the largest of the state-owned banks, BANADES was established in 1912 as a private bank, nationalized in 1920 and transformed in 1956 into the state development bank for the agriculture sector. During the Sandinista administration BANADES was used to channel a wide range of subsidies to the agriculture sector.

- **BANIC.** The second largest of the state-owned banks, BANIC was created as a private bank in 1953, nationalized in 1979, and absorbed a number of nationalized commercial banks in the 1980s. It is largely oriented toward the urban sector.

- **Banco de Credito Popular.** The smallest state bank, whose assets accounted for 2.3 percent of the banking system total in September, 1997, it lends mainly to micro and small-scale commercial and industrial enterprises.

26. **State Bank Reforms 1991-96.** To address state domination of the financial sector, the Chamorro Government initially closed two financial institutions, and set about reforming the remaining three, particularly BANADES and BANIC. In order to allow the state banks to operate under the same rules as the private banks, the Government decided to restructure them and bring their capital level in line with the norms of the Superintendency of Banks and Other Financial Institutions (SBIF). The recapitalization program of 1992 cost about US$240 million, complemented by major cost-reduction programs in the banks. Nevertheless, within two years they continued to dominate the financial system, and their situation had again deteriorated, with mounting losses and dismal loan recovery rates. The Government did not consider that there was a sufficient

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3 Following completion of the BANADES reform program, the state share fell to about 13 percent by end 1997.
national consensus to be able to close or privatize these banks. Moreover the Nicaraguan Constitution explicitly guarantees the existence of state banking. Private banks had emerged rapidly (there were seven by mid-1994) but they remained small and extremely cautious in their lending. The Government therefore opted for a strategy of containment, keeping the state banks under close monitoring while allowing private banks to grow. BANADES and BANIC continued to face financial problems nonetheless, but this time the Government did not recapitalize them. Instead it adopted a restructuring program with two key aims: (i) substantially down-size BANADES, leaving it as a small intermediary focused only on small-scale farmers; and (ii) privatize BANIC through a capital increase from private investors, who would also gain operating control of the bank. As a first step in the process, in early 1996 non-performing assets in the two banks (C$1.5 billion, nearly 40 percent of their portfolios) were transferred to a newly-created collection agency (COBANICSA). The Government also initiated measures to down-size BANADES and prepare BANIC for capitalization. Momentum, however, slowed as the 1996 elections approached and the restructuring plan was effectively suspended.

27. **Private Banks.** Private banking has grown rapidly since its re-emergence in 1991. There are currently 10 private commercial banks, many with well-trained and experienced management which had practiced banking outside the country during the 1980s. Assets total about US$1.1 billion (September 1997), with no bank accounting for more than 12 percent of the total domestic credit market. Economic recovery, high intermediation margins, and profitable investments in public bonds have permitted private banks to achieve annual returns in the range of 15-35 percent over the past few years (reflecting the ratio of profits before taxes to equity of the seven largest private banks). Banking penetration has been extremely low, but the number of private bank branches has been increasing rapidly, from 42 in 1995 to 62 by September 1997 (excluding the 36 branches obtained from BANADES). Private banks have started to lend to small borrowers and the rural sector and by September, 1997, they represented 97 percent of private bank clients and 27 percent of banks’ portfolios. Since 1991 one bank (BECa) had to be closed and absorbed by a larger bank, and two other banks faced difficulties which were resolved with infusions of foreign capital. These restructurings were orderly and well handled by SBIF.

28. However, Nicaragua’s private banking sector remains fragile. The banks have limited economies of scale and hence high administrative costs. Capitalization levels are low. The law that allowed the establishment of private banks specified a minimum social capital of only C$10 million (equivalent to US$2 million at the time, about US$1 million currently). Initially, private banks were subject to a capital adequacy requirement of 6

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4 Private banks have only recently shown interest in extending beyond the capital and other major urban centers. This has been the result of the BANADES restructuring plan that has auctioned branches, high liquidity in the system, and the entry into the system of two regional banking groups (from El Salvador and Guatemala/Mexico) interested in covering small borrowers.

5 The minimum social capital has not been formally adjusted to take account of the depreciation of the córdoba, but SBIF nonetheless appears to require a minimum capital of US$2 million. The last four institutions licensed in 1995 and 1996 (2 banks and 2 finance companies) had an average capital of C17.5 million as of December 1996 (a little less than US$2 million).
percent, although in April 1996, SBIF approved new prudential norms in line with international standards establishing a minimum risk-weighted capital ratio of 8 percent, rising to 10 percent within four years. While there was an important infusion of capital into the banks in 1997 (about US$17 million), which allowed them to meet the 8 percent requirement, reliance is still placed on 5 year Development Bonds (BOFOS) issued by private banks and purchased by the central bank counting as tier 2 capital.

29. Risk-weighted capital ratios, which for the seven largest private banks averaged 8.09 percent at the end of 1996, were only 6.99 percent if only tier 1 capital is considered. Deducting loan loss provisions from tier 1 capital would further lower the average risk-weighted capital ratios of private banks. According to SBIF, private banks face an average weighted risk in their loan portfolio of 2.04 percent. However, this is likely to underestimate the risk of the loan portfolio of private banks as the published figures represent the banks’ own classification and provisioning, not the classification made by SBIF following its most recent inspection. Accounting within banks is in line with international standards as mandated by the SBIF through its Accounting Manual.

30. **Non-Bank Financial Institutions** included until recently COBANICSA. This state collection agency was created in 1996 as a dependent agency of the Central Bank to administer and liquidate the unrecoverable portfolio transferred from the state banks. Its recoveries of unpaid debt were minimal, as threats of legal recourse against defaulters are not credible due to weaknesses in the judiciary and legal framework, plus a tradition of repayment forgiveness and the political context of an election year. The Government recently terminated COBANICSA operations.

31. **Fondo Nicaragüense de Inversion (FNI)** has been restructured from a state bank into a second-tier non-bank (non-depository) financial intermediary on-lending commercial loans and donor funds at interest rates based on the average of private bank deposit rates. It also acts as an intermediary for donated funds for special development projects. Its portfolio has been cleaned up twice in the 1990s. Its capital is US$52.1 million, with a loan portfolio of US$31.8 million and investments of US$28.3 million in local private banks. FNI has very high administrative costs and considerable liquidity as it has found it difficult to disburse and expand lending.

32. **Capital and Insurance Markets.** Money market funds, leasing, commercial paper, private placement and securitization by non-bank issuers are practically non-existent in Nicaragua. The Managua Stock Exchange, the newest in Central America, opened in 1994 and largely trades BCN and Government paper. The state monopoly in insurance was eliminated in 1995 and four new insurance companies have emerged, partly or wholly

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6 Tier 1 capital, or core capital, is defined as equity capital and disclosed reserves plus non-cumulative preference shares. Tier 2 capital, or supplementary capital, consists of undisclosed or hidden reserves, revaluation reserves, general provisions/loan loss reserves, certain equity-type hybrid instruments, and subordinate term debt.

7 Mission estimates, calculated by taking the distribution by risk category of the banks’ portfolio for September 1997 published in the SBIF Bulletin and weighting it by the appropriate provisions (A by 0 percent, B by 1 percent, C by 10 percent, D by 50 percent and E by 100 percent).
owned by local banks, which compete with the state-owned insurance company (INISER). In September 1997, insurance companies had assets of C$355 million (about US$36 million), of which over 60 percent were investments.

**Regulatory Framework**

33. The financial system is supervised by SBIF, which was created in April 1991, and empowered to establish regulations and norms, and license new financial intermediaries. It has jurisdiction over the state and private banking system, the stock exchange, insurance companies, deposit warehouses and any other activity or institution that intermediates funds from the public, including leasing, factoring, credit cards, funeral companies and pawn shops. Currently SBIF supervises 35 institutions, but in practice it concentrates its efforts only on 15 entities, mainly banks. Its Executive Board is chaired by the Minister of Economy and includes the Minister of Finance, the President of the Central Bank of Nicaragua, a representative of the major opposition political party (Sandinista), and the Superintendent. The term of the current Superintendent, elected by the last Congress, expires in 1999. Seventy-five percent of SBIF’s funding comes from a charge of 0.1 percent on the assets of supervised institutions and the remaining 25 percent from CBN.

34. The banking regulatory framework is based on the principles established by the members of the Bank for International Settlements (Basle Committee’s Core Principles for Effective Banking Supervision) and specific regulations are in line with international standards (with the exception that no regulation exists covering loans to related parties, i.e., insider loans). Reviews of banking supervision practice in Nicaragua have recognized that considerable flexibility in the enforcement of regulations has been necessary to help restore the private banking system. As the system matures, however, there is a need to strengthen the capacity of the Superintendency and to institutionalize discretionality in terms of involving the SBIF Council in decisions granting exemptions to regulations and reaching agreements on plans to meet regulatory standards by individual banks.

**Agricultural Credit**

35. Nicaragua is emerging from a period of misguided Government interventions in rural financial markets that benefited the few and hurt the majority of the rural poor by crowding out private financial services. BANADES was the most important source of agricultural credit until 1996 (Chart 3). It disbursed some US$70 million (out of US$80
million in total bank credit) in 1993, but more than half of all its loans went to some 500 clients. The bank also lost an estimated average of US$50 million annually during 1991-97 (as a result of low recovery rates). It also channeled large sums of donor funds through many rural development projects with subsidized interest rates and contradictory credit policies, which acted to impede the development of efficient and sustainable financial institutions by promoting a non-repayment culture and unfair competition.

36. Despite these deficiencies, agricultural credit has expanded, due largely to suppliers credits, the private banks, and to a lesser extent NGOs. In 1997, agricultural credit increased sharply, reflecting more willingness of private banks to lend to the sector, an overall increase in liquidity, and the much reduced presence of state banks. As a result the state bank share of agricultural bank credit has declined from 90 percent in 1993 to 19 percent in the first half of 1997. There are indications that non-bank credit (credit cooperatives, NGOs and trade credit including agricultural input suppliers, marketing agencies and agricultural processors) has increased substantially over the last few years. While many micro-finance NGOs are very small and of doubtful sustainability, some are growing rapidly and showing some indication of long-run financial viability. Credit cooperatives, on the other hand, largely continue to be very weak because they had been politicized by Government policies in the 1980s and, in some cases, weakened further in the 1990s by external attempts to strengthen them through nonviable subsidized credit mechanisms.

V. THE FINANCIAL SECTOR ADJUSTMENT PROGRAM

37. When the current Government took office in early 1997 it faced a state banking sector in crisis. Despite the reform efforts over the previous five years, including downsizing, managerial changes, external technical assistance, recapitalization and two portfolio clean-ups, the two biggest banks continued to record substantial losses due to high administrative costs and dismal loan recovery rates. The largest state bank, BANADES, was effectively bankrupt, although BANIC had shown some signs of recovery. Their mounting losses—especially BANADES—posed a serious threat to the macro stabilization plan. Moreover, it was clear that the two banks were not performing a development function, as their loan portfolios were concentrated on relatively larger farmers and enterprises and, despite considerable downsizing, continued to crowd out private sector activities. The other two state financial institutions, BCP and FNI, were also in a weak position but because of their small size posed less of an immediate problem. Faced with this situation, the new Government set about designing and implementing a prioritized program to reduce state banks as a source of fiscal and monetary disequilibrium, strengthen the capacity of the authorities to regulate a growing private financial sector, and facilitate private banking in the rural sector.
A. STATE BANKS

BANADES Resizing Program

38. As of December 1996, the loan portfolio of BANADES was C$731 million with increasing arrears, which had reached 37 percent by August 1997. Liabilities totaled C$1,250 million, of which 76 percent were deposits of the public. Administrative costs were very high compared to the volume of operations as BANADES had a headquarters and 43 branches, with a total staff of 902. A clean up of the balance sheet and accounts in May, 1997 reduced the capital account from C$84 million to a negative C$250 million, confirming that BANADES was bankrupt.

39. The Government evaluated its options and constraints. A major concern was the constitutional provision requiring the existence of state banking which some feared could be used to legally stop any attempt at outright privatization or closure. Secondly, the authorities worried that rapid closure of BANADES branches would leave many isolated areas without access to banking services as the private banking sector, although growing rapidly, remained small, dispersed among many banks, undercapitalized and concentrated in larger urban centers. Thirdly, there was a risk of a run on BANADES deposits which the Government could find difficult to stem and which could create widespread opposition to the reforms. Lastly, whatever reform option the Government adopted, it was clear it would involve substantial retrenchment of staff, which could generate union opposition and risk more confrontation in the highly politicized environment of the country.

40. In May 1997, the Government appointed a new president of BANADES with the mandate to design and carry out a major restructuring/resizing program. Supported by technical assistance from IDA and following initial discussions with private bankers to gauge interest, the Government decided that the best option would be to auction its branches to the private sector. This would encourage private banks to expand into new areas, particularly the rural sector, and ensure that the majority of BANADES depositors retained access to banking services. Even if all branches could not be sold, the remaining branches could be closed later or BANADES maintained as a shell unable to perform banking functions. The existence of other state financial institutions was determined to be sufficient to meet any constitutional requirements for a public sector presence in the financial sector.

41. In order to prevent a run on deposits, BANADES secured a line of credit from the Central Bank sufficient to confront any liquidity problems. It negotiated a labor reduction plan with severance payments exceeding the minimum required by the Labor Code with the union representing BANADES staff. A public information campaign outlined the bank's mounting losses (pointing out that they exceeded the budget of the Ministry of Education), emphasized that BANADES was no longer an important source of agricultural credit and that the sale of branches would promote competition and higher economic growth by encouraging the private sector to expand into agricultural lending and the provision of banking services outside major urban centers. Concurrently the
Government undertook to develop alternative mechanisms to encourage the expansion of rural credit, especially directed to small-scale farmers.

**The Bidding Process**

42. From the outset, and in consultation with IDA, the bidding and adjudication process was designed to be open, fair, and transparent: (i) it would be carried out with the participation of SBIF, the Comptroller General’s Office, the Ministry of Finance, the Central Bank, and the Office of the Vice President of Nicaragua; (ii) the opening and adjudication of bids would take place simultaneously; and (iii) be open only to private commercial banks that met SBIF’s prudential norms. The branches were grouped into two kinds of blocks for auction. The banks in the first group were to be sold as operating units (including their loan portfolio rated A, B and C, real estate and buildings; and furniture and equipment, plus all the deposits of the public) to the private bank that offered the highest price for the assets if above a minimum price set by BANADES. The second group covered branches where loan portfolios were basically non-existent and the private bank that offered to pay BANADES the highest commission for the existing deposits would buy the branch.

43. The bidding process was carried out in six rounds—September 26, October 3, October 14, and October 31, 1997 and January 23, and January 29, 1998. As a result all branches have been sold, closed, or in the case of 6 small branches located in remote rural areas, their physical assets leased to private banks (to be sold on or before May 31, 1998). Six private banks purchased the BANADES branches (Table 2). As a consequence BANADES has ceased to operate as a financial intermediary and by mid February it had zero deposits from the public. In July 1997, the SBIF had issued Resolution LVI-2-97 granting BANADES an exemption regime regarding compliance with prudential norms on capital adequacy until May 31, 1998. After this date, assuming BANADES was not in full compliance with prudential norms, the SBIF was to have rescinded the bank’s banking license. In fact, through Resolution LXVI-1-98 of February 27, 1998 the SBIF moved more rapidly to rescind BANADES’s license and suspend its operations. The Government now plans to submit legislation to formally close BANADES.

<table>
<thead>
<tr>
<th>Table 2: Private Banks Purchasing or Administering BANADES Branches (Number of branches)</th>
</tr>
</thead>
<tbody>
<tr>
<td>BANPRO</td>
</tr>
<tr>
<td>CALEY-DAGNAL</td>
</tr>
<tr>
<td>BAMER</td>
</tr>
<tr>
<td>BANCAFE</td>
</tr>
<tr>
<td>BANEXPO</td>
</tr>
<tr>
<td>BANCAMPO</td>
</tr>
<tr>
<td>Closed</td>
</tr>
<tr>
<td>TOTAL</td>
</tr>
</tbody>
</table>

Source: BANADES
44. BANADES transferred to COBANICSA all its loans rated D and E in the remaining portfolio. The labor reduction plan is being implemented smoothly and by mid February, 1998, 241 employees had been directly laid-off under the plan and 510 transferred as part of the sale of branches. A preliminary estimate of the total costs through December, 1997 yields a net capital loss to BANADES of C$765 million including additional costs stemming from the labor reduction plan, extraordinary administrative expenses and the payment of other liabilities to the public (Table 3).

Table 3: Results of BANADES Restructuring Program (as of February 15, 1998)

<table>
<thead>
<tr>
<th>Activities</th>
<th>Branches</th>
<th>Loan Portfolio CS m</th>
<th>Deposits CS m</th>
<th>Employees</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Original</td>
<td>41</td>
<td>710.8</td>
<td>915.2</td>
<td>921</td>
</tr>
<tr>
<td>Sold</td>
<td>30</td>
<td>226.2</td>
<td>875.6</td>
<td>510</td>
</tr>
<tr>
<td>In Administration</td>
<td>6</td>
<td>33.6</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Closed</td>
<td>5</td>
<td>39.6</td>
<td>0</td>
<td>48</td>
</tr>
<tr>
<td>Labor Reduction Plan</td>
<td></td>
<td></td>
<td></td>
<td>241</td>
</tr>
<tr>
<td>Transf. to COBANICSA</td>
<td></td>
<td></td>
<td></td>
<td>432.9</td>
</tr>
<tr>
<td>Total Restructured</td>
<td>41</td>
<td>692.7</td>
<td>915.2</td>
<td>799</td>
</tr>
<tr>
<td>Total Remaining</td>
<td>0</td>
<td>18.1</td>
<td>0</td>
<td>122</td>
</tr>
</tbody>
</table>

Source: BANADES and staff estimates.

BANIC Capitalization Program

45. A private bank nationalized in 1979, BANIC implemented a number of restructuring plans in the 1990s. In June 1992, the Government performed a balance sheet clean-up and capitalized the bank setting the new capital at C$35 million and designated the Ministry of Finance as the holder of the bank’s shares. Total employment in BANIC fell from 2,380 in 1990 to 631 in 1996. In 1996, there was another loan portfolio clean-up by which bad loans and other assets were transferred to CBN to repay liabilities with CBN and FNI.

46. Although BANIC’s situation had begun to improve in 1996, the previous Administration was already considering options for privatizing the bank. As a corporation whose shares are owned by the state, the Government at the time considered two options for BANIC—privatization through the outright sale of the State’s shares or a capitalization plan, which could involve increasing the bank’s capital and attracting a private investor as a majority shareholder, who could also manage the bank. The Government opted for capitalization as it would provide an important infusion of fresh private capital into the weakly-capitalized banking system.

47. In the first nine months of 1997, the new (although still public sector) management of BANIC launched an ambitious business plan aimed at improving profitability and market share. On the portfolio side, the bank offered softer terms to borrowers in the cattle sector which has been a troubled segment of BANIC’s portfolio. In an attempt to diversify its lending, it began to offer new loan products, such as Prime Rate, mortgage
loans, student loans, vehicle loans, and loans for agricultural machinery and equipment. As a result of these efforts, the total loan portfolio increased by 37 percent in the first three quarters of 1997. BANIC also obtained a US$30 million line of credit from US and European banks, to be used to issue sight letters of credit, and export and coffee pre-financing. In January 1997 the bank entered the credit card market offering BANICARD, which is affiliated to MasterCard International and VISA International. The financial results have been mixed. On one hand, both the loan portfolio and total deposits of the public have substantially increased (more than 30 percent) to C$829 million and C$1,309 million respectively in the first nine months and arrears dropped from 8.4 to 4.9 percent. A small profit of C$13.3 million is reported for 1997. However, BANIC’s operating expenses have increased in 1997, especially in its headquarters. This is a result of several factors, including increased spending on infrastructure and equipment, the hiring of new staff, and increased advertising expenses.

48. The new Government, seeking to increase capitalization in the sector and reduce the state’s role in financial market operations, reconfirmed in late 1997 the plan to capitalize BANIC through a sale of shares and has decided to seek congressional approval for the capitalization plan. IFC has advised the Government on the capitalization plan and has been contracted to promote and execute the bidding process. In preparation for the capitalization effort, the Government has prepared draft Terms of Bidding, and BANIC plans to complete an independent valuation of its assets by May, 1998.

49. The draft law submitted to Congress for the capitalization plan provides that the Government would assume liability for any legal claims arising from the nationalization of the financial system in 1979. A complicating factor emerged in August, 1997, when a number of external creditors filed suit in a New York court against the Government and BANIC as an original debtor. The Government is reviewing its options and intends to resolve these claims prior to capitalizing BANIC.

Banco de Credito Popular

50. The SBIF has recently determined that Banco de Credito Popular (BCP) is insolvent if obliged to make the mandatory bad loan provisions. The bank also registers high levels of loan concentration despite its supposed focus on small creditors. Consequently the SBIF approved Resolution LXIII-1-98 in early January, 1998 granting BCP a special exemption regime until December 31, 1998, during which compliance with Capital Adequacy and Classification of Risk Assets norms are suspended and the total loan portfolio before provisioning is capped at an upper limit of US$19 million equivalent. At the end of this period, the bank will comply with all prudential norms or the SBIF will revoke its banking license. In the meantime the Government will review its options with regard to Banco Popular, although it will not use public funds to recapitalize the bank in any manner. The no recapitalization with public funds pledge also applies to FNI where the Government has submitted legislation to permit private participation in the institution.
COBANICSA and Loan Recovery

51. Given the poor performance of COBANICSA in collecting on the bad loans transferred from state banks, despite the several ad hoc decisions by the Government to postpone the dates when agreements between COBANICSA and debtors needed to be finalized, the authorities decided to close the collection agency. A special commission, composed of the Ministry of Finance and Central Bank, has been established to dispose of the loans by selling them to private banks, placing them in administration with private collection agencies or banks (those that are being serviced), or referring them to the courts for legal action. To strengthen the incentive for debtors to make and adhere to debt restructuring agreements, the SBIF has issued a regulation requiring a 100 percent provisioning on commercial bank loans to ex-COBANICSA debtors that have not signed debt agreements or are not adhering to those agreements.

B. STRENGTHENING BANK SUPERVISION

52. The SBIF focuses its supervision activities mainly on banking and to a lesser extent the insurance system. While regulations have been issued for other intermediaries and data is received, SBIF does not have the resources (with only 40 professional staff) to supervise them effectively with on-site inspections and data verification. Given these constraints and the rapid growth of banking, the Government and several international agencies and donors (especially the IDB) have provided considerable support to strengthening the SBIF, particularly in banking supervision, in line with Basle principles and international standards. As part of the current adjustment effort the Government has designed a program targeting the most pressing supervisory issues, including modifications in the implementation of key prudential norms (plus adoption of a regulation on related party lending), technical assistance to improve SBIF institutional capacity in general and on-site inspection practices in particular, as well as measures to institutionalize and regularize discretionality exercised in the enforcing of prudential regulations. The cumulative result of the reforms initiated will be a doubling of capital in existing private banks as well as substantive improvements in SBIF oversight of the banking system.

53. With support from IDA and other institutions, the SBIF reviewed its operations during 1997. The studies revealed shortcomings in several areas, including the following:

**Capital Adequacy** - The current capital adequacy norm establishes a minimum risk-weighted capital of 8 percent, which will increase to 10 percent by June 2000. This is an appropriate step, especially given the fragility of Nicaragua’s private banking sector, but will be complicated by the additional need of many banks to replace tier 2 capital (development bonds issued in 1993 which in 1999 become ineligible to count as capital). Moreover, the minimum level of capital needed to start a bank has been eroded by inflation and may be unduly small.

**Evaluation and Classification of Assets** - The norm on asset valuation and classification sets out the criteria for valuing various kinds of assets and the required provisioning.
While the criteria of classification is in line with Basle principles, the Superintendency has enforced the level of provisioning with considerable discretionality. Moreover the required level of provisioning is low by international standards. As of December 1996, SBIF publishes in its Bulletin an individual bank’s asset distribution classified by risk, but it is the bank’s own classification, not the classification determined by the most recent SBIF inspection, making it difficult to monitor provisions and provide early warning for banks facing problems.

**Portfolio Concentration** - The prudential norm on portfolio concentration appropriately defines the concepts to be included, such as risk exposure, and grants SBIF authority to define connected debtors in order to apply a limit by group. However, the Banking Reform law of June 1997 specifies that a 15 percent limit will apply to an individual and 30 percent limit to a group debtor for investment in one business or enterprise. Thus, the limit can be avoided by a borrower if the proceeds of the loan are invested in different businesses. Second, while the SBIF has a list of groups and their related companies, thus far the limits have not been applied. Third, following negotiations between the banking sector and the Government, the SBIF issued a norm on exceptions for loans above the 15 and 30 percent limit. The total amount of exceptions to be authorized was limited to 200 percent of the capital of the bank, reduced by 50 percentage points annually from June 1996. SBIF does not appear to exercise strict control on the exceptions, as it seems some exceptions are either not authorized or it is not clear they conform to the criteria for exemptions established in the norm.

**Lending to Related Parties** - The absence of a prudential norm placing limits on individuals or groups connected with the ownership or management of a bank is a key deficiency in the current regulatory framework. The law does not provide a legal basis for placing specific limits on lending to related parties—only the formalities to be followed in approving such loans are spelled out. Strengthening controls in this area would be especially important to prevent such lending to meet the new capital adequacy standards.

**Central Credit Rating Agency** - A Central Credit Rating Agency is being developed by SBIF and it commenced operations in 1997 with debt data to September 1996. The Agency is expected to become fully operational by end-1998, but has yet to gather information on collateral and data on older loans. One problem is that not all creditors have a single Tax Identification Number, which requires considerable work to verify creditor names.

**Non-Profit Financial Intermediaries** - The Banking Reform law requires SBIF to supervise non-bank, non-profit financial entities, which largely represents NGOs involved in micro-credit financing and credit cooperatives. SBIF has already decided to establish a Microcredit Department, is in the process of recruiting staff, is receiving technical assistance from a bilateral donor, and has elaborated a chart of accounts and is preparing appropriate norms. Despite this progress, a number of important issues have yet to be defined, including: (i) minimum capital requirements; (ii) whether deposit-taking institutions will be subject to the reserve requirement; and (iii) the extent to which those
entities providing loans and mobilizing deposits would be subject to the same prudential norms as commercial banks.

**Discretionality** - Supervision of the financial sector, but especially banking, is characterized by the considerable and arbitrary discretion exercised by SBIF. While some special degree of discretionality was necessary during the early 1990s, its current scope can create inconsistent enforcement of standards and unpredictability which hampers growth of the sector.

**Bank Supervision Action Plan**

54. To strengthen the regulatory framework and institutional capacity of the SBIF, the authorities have designed and initiated a comprehensive Bank Supervision Action Plan. Agreed during credit negotiations (Annex C) and adopted on February 11, 1998 by the SBIF Council, the Plan involves three components: (i) a Program of Immediate Measures; (ii) Regulatory Strengthening; and (iii) Institutional Strengthening. Immediate measures include: (i) completion in the near term of an assessment of the solvency of all private commercial banks and adoption of warranted remedial actions (in conducting these assessments the SBIF will be assisted by international experts selected with the assistance of IDA); (ii) completion in the near term of a study, and adoption of a resulting action plan, to improve the banking safety network addressing specifically the issues of bank exit, crisis resolution, the structure of a Resolution Agency, and deposit insurance; and (iii) creation of a Financial Analysis Unit within the SBIF. Regulatory strengthening will involve adoption of a regulation on Related Party Lending in line with international standards, as well as specific actions to reinforce the interpretation and/or enforcement of existing regulations relating to capital adequacy, risk concentration, and evaluation and classification of assets. The level of appropriate provisioning in the latter regulation will be determined following a review of existing international and Nicaraguan practices. This study will be based on a detailed on-site inspection of several private commercial banks by the SBIF, assisted by international experts selected with the assistance of IDA. The international experts would also assist the SBIF in identifying weaknesses and formulating a set of recommendations for an Inspection Strengthening Plan to improve inspection processes and procedures. Finally, SBIF institutional strengthening will be promoted by improvements in the insurance division, specific measures to strengthen on-site bank inspections, development of the Credit Risk Evaluation Facility within the SBIF, as well as measures to regularize the exercise of discretion by increasing the oversight role of the SBIF Council. Satisfactory progress in the implementation of the program, including several specified key measures, will be conditions of the two floating tranche releases.

**C. IMPROVING AGRICULTURAL CREDIT**

55. To expand access to financial services in rural areas, the Government is encouraging the development of private financial services. With the state largely removed from banking, private banks have already started to serve rural areas and will increase their
presence further as they lend to former BANADES clients in good standing. The strategy to auction branches of BANADES to the private banks rather than liquidate them had as an objective to rapidly increase private banking presence in the rural sector and in agricultural credit. With IDA assistance, the Government provided a small subsidy for start-up costs to establish 22 branches in rural areas (of which 12 were former BANADES branches). The Government will also create an Agricultural Fund to rationalize donor funded credit lines and operate as a second-tier lender to sustainable non-bank intermediaries at market interest rates. Land titling and modernization of the registry will be a priority to facilitate the use of land as collateral; legal and institutional reforms needed to enable the issuance of liens on movable property and inventories will also be introduced. Regulations will be reviewed with a view to reducing the cost of managing small loans without increasing the risk of default. The Government will also help disseminate successful rural lending experiences from other parts of the world, Bolivia and Indonesia for example, so that local bankers and non-bankers can adapt those lessons to conditions in Nicaragua.

56. IDA is assisting the Ministries of Agriculture and Finance to develop these initiatives through direct technical assistance and PHRD grants. To determine the current situation of rural financial markets, IDA is supporting: (i) a rural financial module as part of the Living Standards Measurement Survey; (ii) a stand alone survey to evaluate the extent of bank and non-bank financial intermediation in rural areas; and (iii) an analysis of financial sustainability of different intermediaries. To encourage rural financial services, IDA will finance two seminars in March, 1998 targeted at bankers and non-bankers to demonstrate the profit potential of rural financial operations and appropriate management systems. A study to analyze how current prudential regulations impact the provision of formal credit is currently being conducted. A major study of the legal and institutional framework for secured transactions, which includes a draft of a new secured transaction law, is also about to be completed. In addition IDA is assisting the Government to find ways to reduce the risk of lending to agriculture by analyzing the feasibility of introducing sound insurance schemes, such as private crop insurance.

57. The lack of an inexpensive, reliable and public means of creating, perfecting and enforcing collateral pledges against movable property (such as inventories, crops, equipment, cattle and accounts receivable) is a major constraint on credit among agricultural producers and marketers, as well as dealers and suppliers of farm inputs in particular. Access to credit in Nicaragua has typically been limited to the value of real estate a borrower with established title could pledge as collateral. While the Government’s efforts to clarify and establish clear property titles are critical to the proper functioning of land markets and integral to a well-functioning financial system, the ultimate magnitude of credit that could be secured by movable property in Nicaragua is enormous. (For example, movable assets secure about 40 percent of total credit in the United States.) Therefore IDA has worked closely with the Government to develop a legal framework for secured transactions that will facilitate the efficient collateralization of movable property in Nicaragua. A law drafted in close consultation with lawyers from the private and Government sectors and with key input from lenders, credit-sellers, borrowers
and credit-buyers along the entire credit chain is expected to be presented to Congress shortly.

VI. THE PROPOSED CREDIT

Rationale, Size, and Tranching

58. The proposed FSAC would support implementation of the Government's structural adjustment program. The project aims at: (i) virtually eliminating the state banking sector as a source of fiscal drain and financial distortion; (ii) fostering private banking presence in the rural and agricultural sectors; and (iii) strengthening the regulatory framework for banking. It represents a major step toward creating a sound and sustainable financial system, but will need to be complemented by additional actions over the next years. A proposed Economic Management Technical Assistance Credit (EMTAC) now under preparation would support review and reform of the legal and regulatory framework for the financial and business sectors, as well as institutional strengthening support for the Superintendency of Banks and other selected public agencies. The balance of payments support provided by the FSAC would reduce fiscal and financial pressures by compensating in part for the significant costs associated with state banking reforms (estimated at US$80.5 million for closing BANADES taking into account net reimbursements to depositors and severance payments to employees). No estimates are available regarding net proceeds from the sale of BANIC shares, but are projected to total less than US$15 million. The project and its financing plan have been developed within the context of the Government's stabilization program being supported by an Enhanced Structural Adjustment Facility program with the IMF.

59. The SDR 51.8 million credit (US$70 million equivalent) is designed as a three tranche operation. The first tranche of SDR 29.6 million (US$40 million equivalent) would be available upon credit effectiveness as all conditions will be met prior to Board Presentation of the operation. The two remaining tranches of SDR 11.1 million (US$15 million equivalent) each would not be sequential, but rather would “float” with separate conditions. Disbursement of the “BANADES” tranche would be conditioned primarily on the withdrawal of BANADES’ operating license (accomplished on February 27, 1998) plus satisfactory progress in the strengthening of banking system supervision. The “BANIC” tranche would be linked primarily to bringing that bank to the point of sale as well as continued satisfactory implementation of the banking supervision action plan. In addition to the actions specified below, each tranche release would be contingent on the maintenance of an appropriate macroeconomic framework and satisfactory overall progress in implementation of the adjustment program, as described in the attached Matrix of Policy Actions (Annex B) and the Government’s Letter of Development Policy (Annex A). The Republic of Nicaragua would be the Borrower, the Ministry of Finance will be in charge of overall implementation of the program, and disbursements will be handled by the Central Bank.
**Conditions for Tranche Release**

60. The following policy actions were taken before Board presentation:

(i) All BANADES branches were either closed or auctioned to private banks, and BANADES ceased to operate as a financial intermediary;

(ii) Draft audit of BANIC 1997 financial statements was approved by BANIC Board;

(iii) Draft legislation, acceptable to IDA, was submitted to the National Assembly transferring claims on BANIC to the Government and authorizing sale of shares sufficient to transfer majority control to private concerns;

(iv) SBIF informed the commercial banks of their loan loss provisioning obligations effective immediately in respect of loans to customers which are also State Bank Debtors (Debtors of state banks pursuant to “CD Superintendencia-XXXIII-1-95”);

(v) Banco de Credito Popular undertook to refrain from increasing the size of its portfolio to an amount higher than US$19 million equivalent and the Borrower refrained from providing any cash or bond contributions for the capitalization of Banco de Credito Popular;

(vi) SBIF Council adopted the Bank Supervision Action Plan to strengthen supervision of banks;

(vii) SBIF established a Financial Analysis unit to assess situations of bank solvency, propose supervision and adjustment programs, and in general strengthen technical aspects of SBIF policies, regulations, and operations;

61. The following actions would be BANADES tranche release conditions:

(i) SBIF shall have revoked BANADES’ license to operate as a financial institution;

(ii) SBIF shall have verified compliance by the commercial banks of their loan loss provisioning obligations in respect of loans to customers which are also State Bank Debtors and shall in the event of any non-compliance apply the corresponding fines thereto;

(iii) Banco de Credito Popular shall have refrained from increasing the size of its portfolio to an amount higher than US$19 million equivalent and the
Borrower shall have refrained from providing any cash or bond contributions for the capitalization of Banco de Credito Popular;

(iv) SBIF shall have made progress, satisfactory to IDA, in the implementation of the Action Plan for the Supervision of Banks. In particular, the SBIF shall have:

(a) (i) finalized a diagnosis of the solvency situation of the three commercial banks which during the period January 1, 1997 through January 31, 1998 had the highest increase in the number of operating branches;

(ii) based on such diagnosis, instructed any bank which does not meet SBIF’s prudential regulations to take the measures that are required to restore compliance with such regulations;

(b) adopted prudential norms, satisfactory to IDA, for related party lending and capital adequacy; and revised the existing risk concentration prudential regulation to set forth the provisioning requirements; and

(c) adopted the Inspection Strengthening Plan described in paragraph 54 of this report.

62. The following actions would be BANIC tranche release conditions:

(i) BANIC shall have brought to the point of sale to private investors shares of its capital stock:

(a) in numbers representing a percentage of the total number of shares higher than 50; and

(b) with voting rights enabling the transfer of the management control of BANIC to the prospective owner of such shares.

(ii) SBIF shall have verified compliance by the commercial banks of their loan loss provisioning obligations in respect of loans to customers which are also State Bank Debtors and shall in the event of any non-compliance apply the corresponding fines thereto;

(iii) Banco Popular shall have refrained from increasing the size of its portfolio to an amount higher than US$19 million equivalent and the Borrower shall have refrained from providing any cash or bond contributions for the capitalization of Banco Popular;
(iv) SBIF shall have made progress, satisfactory to IDA, in the implementation of the Action Plan for the Supervision of Banks. In particular, the SBIF shall have:

(a) taken the actions required in (iv) (b) of paragraph 61 on related party lending, capital adequacy, and risk concentration norms;

(b) (i) finalized a diagnosis of the solvency situation of all commercial banks;

(ii) based on such diagnosis, instructed any bank which does not meet SBIF’s prudential regulations to take the measures that are required to restore compliance with such regulations; and

(c) adopted a prudential regulation, satisfactory to IDA, for evaluation and classification of assets

**Procurement, Disbursements, and Audits**

63. The Borrower will open an account in its Central Bank. Upon effectiveness in the case of the first tranche, and following agreement with IDA that conditions have been met with regard to the two additional tranches, proceeds of the credit will be deposited by IDA into this account at the request of the Borrower. If, after deposit in this account, the proceeds of the credit are used for ineligible purposes (i.e., to finance items imported from non-member countries, or goods or services on the standard negative list), IDA will require the Borrower to either: (a) return that amount to the account for use for eligible purposes; or (b) refund the amount directly to IDA, in which case IDA will cancel an equivalent undisbursed amount of the credit. Although routine audit of the account will not be required, IDA reserves the right to require it. The closing date for the credit is December 31, 1999. It is expected that the first tranche will be disbursed by July 1998, the BANADES tranche by September, 1998, and the BANIC tranche by late 1998.

**Relations with other Financial Organizations and Donors**

64. IDA has worked closely with the IMF and IDB to ensure consistency in the stabilization and adjustment program agreed with the Nicaraguan authorities. The Government’s Policy Framework Paper, prepared in collaboration with the IMF and IDA, presents the Government’s medium-term reform program. A new three-year ESAF Arrangement is scheduled to be presented to the IMF Board on March 18, 1998, which includes key reforms in the financial sector supported by the proposed FSAC.

65. IDB and IDA have coordinated closely to ensure consistency in the area of state bank reform supported by separate operations. In June 1996 the IDB approved a US$32 million quick disbursing loan to support the Government’s structural adjustment program. That loan was conditioned on adjustments in the areas of tax policy, public sector reform, and state bank reform. Its design and conditionality were closely coordinated with IDA.
through several joint missions, and collaboration with the IDB has continued with the conditionality in the FSAC building on the earlier IDB loan. The IDB is now considering the preparation another quick disbursing operation to be presented by the end of calendar 1998 to support and extend financial sector reforms initiated in the FSAC.

**Technical Assistance Requirements**

66. The main technical assistance provided to implement this adjustment program include: (i) the modalities for closing BANADES; (ii) preparation of BANIC for sale; (iii) review of options to promote rural credit, both to former small-scale borrowers of BANADES as well as broader rural credit development; and (iv) diagnosis and strengthening of banking supervision. Through PHRD resources IDA provided technical assistance for the design of the BANADES closure, and fairly extensive support for BANIC’s restructuring and preparation for sale. Support for BANIC’s capitalization is now being provided by the IFC. The Technology and Land Management project (Credit 25360-NI) has provided resources for the subsidized purchase of BANADES branches in the rural areas as well as support for the assessment and design of the Agricultural Fund. Finally, PHRD funds financed studies of the SBIF by external experts. Immediate efforts to assess private bank solvency and strengthen banking supervision are expected to be financed from the IDA financed Institutional Development Project (Credit 2690-NI). The proposed Economic Management Technical Assistance Credit now under preparation may also support further strengthening of the Superintendency of Banks. In the past IDB and GTZ have also provided technical assistance to the Superintendency.

**Benefits and Risks**

67. **Benefits.** The main benefit of the program is to address major obstacles to sustainable private sector-led growth. The reforms undertaken target the most pressing financial sector issues, namely: resolving the long standing threats to fiscal stability and financial markets posed by the state banks; directly promoting improved financial intermediation with regard to the critically important rural and agricultural sectors; and taking key steps to strengthen the regulatory framework for the financial sector. Approval of the FSAC should enable the Government to mobilize additional balance of payments support which would enable it to maintain a predictable and orderly economic adjustment path. To the extent that implementation of the proposed reform program succeeds in maintaining economic growth within a stable macroeconomic environment, the Government would be in a stronger position to resist political pressures for more populist and interventionist policies, or risk the real gains achieved in Nicaragua’s transition to a market economy and democracy.

68. **Risks.** The proposed credit involves three major risks. First, the capitalization of BANIC could be complicated by existing and future claims against the bank both within and outside Nicaragua, imperiling the Government’s ability to bring the bank to the point of sale and release of the BANIC tranche. The Government has submitted legislation to
assume financial responsibility for those claims (which should resolve issues relating to domestic claimants) and will seek to resolve external claims should the legislation not prove sufficient. Second, the sale of BANIC shares, as well as the Government assumption of claims against the bank, require congressional approval. There is always a risk that this might not be forthcoming, but through passage of far reaching tax reform legislation the Government has demonstrated an ability to secure necessary legislative support for major reform legislation. Moreover, the Executive, with technical support from IDA, has initiated a broad education campaign on the justification and nature of the reforms supported by the credit. Third, enforcement of new or modified prudential regulations and other key aspects of the Bank Supervision Action Plan could be undermined by the limited institutional capacity or commitment of the SBIF and/or resistance from the private banking sector. However, the majority of the SBIF Council, representing the Executive Branch has demonstrated its commitment to reform in the financial sector through actions to address BANADES and BANIC, ensured approval of the Bank Supervision Action Plan including the expanded role for the SBIF Council, and is welcoming various forms of technical assistance from IDA to strengthen banking supervision. The evolution of the financial sector attending state bank reform and changes in rural financial intermediation, plus the inadequacies identified in the bank regulatory framework, warrant efforts to address key banking supervision issues which have been identified now. Nicaragua’s continuing need for IDA assistance in general, and in the financial sector specifically, will provide further opportunities for support to the SBIF over the coming years.

VII. RECOMMENDATION

69. I am satisfied that the proposed credit would comply with IDA’s Articles of Agreement and recommend that the Executive Directors approve it.

James D. Wolfensohn
President

by Caio K. Koch-Weser

April 9, 1998
Washington, D.C.
Annexes

Annex A  Letter of Development Policy
Annex B  Matrix of Policy Actions
Annex C  Bank Supervision Action Plan
Annex D  Nicaraguan Financial Sector
GOBIERNO DE NICARAGUA
Ministerio de Finanzas

LETTER OF DEVELOPMENT POLICY
FINANCIAL SECTOR ADJUSTMENT CREDIT

Managua, Marzo 1998
Mr. James D. Wolfensohn
President
The World Bank
Washington, DC 20433

Dear Mr. President:

1. I write to convey to you the structural adjustment strategy and development policies which the Government of Nicaragua plans to implement and to request the financial support of the International Development Association for this effort through the proposed Financial Sector Adjustment Credit.

2. Nicaragua is in the midst of a transition from an inefficient centrally planned economy to one based on private sector led growth and fully integrated into the world economy. To put the country's situation in perspective, during the 1980s Nicaragua ran up foreign debt to a level six times GDP, and in 1990 alone registered public savings of negative 27 percent of GDP, with public investment at only 1.5 percent of GDP. Hyper-inflation reached 13,000 percent during 1990. As a result, per capita income fell to levels recorded in the 1920s and the standard of living of the majority of the population declined to poverty level. In response, the elected Government which took office in April 1990 implemented a series of stabilization and reform measures which emphasized sharply reducing inflation, reducing the size of the public sector, liberalizing prices, and restoring the preconditions for a market economy. Considerable progress was achieved. The public sector was reduced in size, with nearly 350 nationalized firms returned to the private sector and a process begun to reorient the role of Government.

3. Despite these accomplishments, much remains to be done to ensure Nicaragua's ability to catch up with other developing nations and to find an appropriate place in the global economy. While war and instability are now behind us, Nicaragua must complete the transition from a command to a market economy. Our Government, which came to office in January 1997, is committed to achieving this objective. I believe we have already made a sound start. The agenda ahead is an ambitious one, and includes actions to address still high under- and unemployment, loss-making state banks, uncertainty of ownership of urban and rural properties, and nascent and weak institutions. Unfortunately, we must achieve this while our people continue to suffer historic levels of poverty, particularly in rural areas.
4. Only by accelerating this transition can Nicaraguans expect rising standards of living and incomes. The Government’s goal, to improve greatly the lives and prospects of its citizens, will be pursued through three major approaches. The first is to create a modern, democratic society, within a legal and institutional framework conducive to the security of all citizens and their possessions. The second is to use this framework to turn Nicaragua into a vibrant market economy, with an agile private sector leading the economy in an accelerated growth pattern. The third is to ensure Nicaragua’s rural inhabitants are major beneficiaries of this growth.

THE MACROECONOMIC FRAMEWORK

5. The economic situation of Nicaragua remains fragile and highly dependent on concessional financing. Nicaragua’s debt levels are excessive, foreign reserves are low, and the size of the state is still large in terms of cost and mandate. This undermines savings and investment, redirects scarce resources from their most productive potential uses, and threatens the predictability of economic activity. Accordingly the Government has recently elaborated with the IMF a macroeconomic program for 1998-2000 which aims to strengthen the basis for sustained and equitable growth by consolidating the gains achieved in macroeconomic stabilization and intensifying the process of structural reforms. The program, to be supported by an ESAF Arrangement with the IMF, as well as the proposed Financial Sector Adjustment Credit from IDA, will advance further the transition to a private sector-led and outward oriented economy, and help to move toward external viability.

Maintaining a Stable Macroeconomic Framework

6. The proposed macroeconomic program is outlined in the Government’s three year Policy Framework Paper. It is designed to fight poverty and reduce unemployment, restore the sustainability of government and external finances, and implement the structural reforms necessary to achieve sustained high rates of economic growth. The program aims at achieving output growth of about 5 percent in 1998 rising to around 6 percent by 2000, reducing inflation from 8 percent in 1998 to 5 percent by 2000, and increasing gross international reserves from levels equivalent to one week of imports in late 1997 to more than three months imports by 2000. The fiscal deficit before grants would fall from 15.5 percent of GDP in 1996 to under 4 percent in 2000. Public sector savings, during the period, are expected to increase by 5.5 percent of GDP through: (i) a reduction in non-social sector current expenditures; (ii) an increase in the operating surplus of state enterprises
stemming from revenue strengthening and cost containment measures; and (iii) an increase in general revenues through a broadening of the tax base and strengthening of tax collection. The planned privatization of public utility companies, and the debt relief which Nicaragua hopes to achieve once it has completed the eligibility process for the HIPC initiative, should create the fiscal space to permit an intensification of support for the social sectors and other priority poverty-reducing development programs. Broad money will increase in line with nominal GDP.

7. In the medium term Nicaragua must continue to ensure a stable macroeconomic environment, with additional progress in increasing public savings, controlling inflation, and strengthening the country’s international reserve position. There is a need to increase the capacity of the public sector, and especially to monitor macroeconomic policy implementation. More measures are required to build an environment attractive to private local and international investment, to complete the process of restoring the operation of property markets based on a respect for property rights, and to address the looming problems of the under funded national pension system.

FINANCIAL SECTOR ADJUSTMENT PROGRAM

Reforming the Public Banking Sector

8. To permit a sustained expansion in market investment and activity to support higher growth and employment generation, Nicaragua needs a sound financial system. The Government therefore has designed and initiated implementation of a phased program of financial sector reform. The most immediate requirements for the first phase are to eliminate the misallocation of financial resources caused by an inefficient state banking system, and to strengthen the public sector’s capacity to assure an appropriate framework for the private banking system. To this end the Government intends to sharply reduce the state banking sector by selling to the private sector a controlling interest in one state bank (BANIC), limiting the operations of a second smaller state bank (BCP), and ensuring the sound operation of a second-tier financial institution (FNI) which mobilizes financing for on-lending to commercial banks and other private financial intermediaries. In addition the Government is taking steps to cease the banking function of the largest state bank (BANADES). To improve overall financial sector performance and achieve a sound deepening of financial intermediation, the Government will strengthen its regulation and supervision of the private banking sector.
9. Despite a major recapitalization in 1992 of the largest state bank, BANADES, and serious efforts to revitalize the bank, it has not been possible to improve its performance in a satisfactory manner. The bank has continued to incur large financial losses with negative implications for the Government's fiscal position, and without yielding significant benefits to the poor. Moreover, its weak loan recovery record (due to a general culture of nonpayment to state banks induced by the history of high inflation and frequent restructuring or forgiveness of loans) has undermined the proper functioning of the financial system more generally, with the result that the private banking sector has been reluctant to move aggressively to meet credit demands, particularly in the non-urban areas.

10. To eliminate the risk to fiscal stability and growth, and to facilitate the expansion of credit in the rural areas, the government has decided to end BANADES' role in financial intermediation, by transferring the bulk of BANADES' assets and all deposits to the private banking sector through a transparent system of auctions. Presently all branches of BANADES have been transferred or closed and the remaining skeletal headquarters operation does not intermediate credit. We expect that BANADES' license to conduct business will be withdrawn by mid-1998, in line with Superintendency of Banks Resolution LVI-2-97 of July, 1997. As BANADES has not in fact provided much credit in rural areas, the government is simultaneously developing alternative instruments to address the needs of this clientele. The objective is to rely on commercial bank branches, cooperatives, and specialized NGOs, utilizing the best practices in this area, to meet credit needs of the rural poor without distorting the growth of private banking services and resource mobilization.

11. The second largest state bank, BANIC, suffered from similar difficulties in loan repayment and has required two major recapitalizations to bring it into line with prudential norms. While BANIC's performance has improved over the last two years, its financial situation remains fragile. Moreover, the Government fears that without a change in ownership structure and incentives, the bank ultimately would fall back into the more normal poor performance pattern of state banks. The Government, therefore, intends to capitalize BANIC, believing the bank would better serve the needs of Nicaragua with an infusion of private capital and operation under private management. Legislation is being presented to the National Assembly to authorize the sale of newly issued shares for the purpose of attracting new (private) resources and management, in order to strengthen the financial position of the bank as well as increase competitiveness in the entire banking sector. The legislation would also permit the Government to assume the financial responsibility for any claims by former owners against BANIC. The new shares to be sold
will exceed in value and voting power the shares retained by the Government; the plan is to sell a controlling group of these new shares to the highest evaluated private bidder, whether domestic or foreign. An invitation to bid offer to the private sector will be widely published in financial journals in the Western Hemisphere and Europe, and we expect to complete the bidding process by the third quarter of 1998, with the assistance of the International Finance Corporation of the World Bank Group.

12. Given the present situation of the small state-owned Banco de Credito Popular (BCP), SBIF has granted this bank an exceptional supervision regime until the end of 1998. If after that period BCP does not comply with all prudential norms the exceptional supervision regime will not be extended and the SBIF will revoke the authorization of Banco Popular to operate. The Government is committed to maintain the current policy of not providing any infusions of cash or bonds from the Government to recapitalize this institution. The Government plans to strengthen the operations of the second-tier Nicaraguan Investment Fund (FNI), and for this purpose has presented to the National Assembly legislation that would permit private sector participation in it. In any case, it is our policy to ensure both that FNI on-lends resources to private financial institutions at market rates of interest and that it maintains a positive return on equity.

13. Non-performing loans of the state banks have been transferred over the last few years to a Collection Agency (COBANICSA) created in 1996 and charged with loan recovery. A system of incentives and penalties was established to encourage repayment by the borrowers of these non-performing loans. However, loan recovery has remained disappointingly slow and the Government has therefore decided to dissolve COBANICSA and to create instead a commission of the Central Bank and Ministry of Finance which will decide, on a case by case basis, to place these debts in administration, auction them to private banks, or institute recovery procedures in the courts. The Superintendency of Banks will also ensure through its regular supervision efforts that a 100 percent provisioning requirement will apply to all loans by any Nicaraguan bank to any debtor of the former COBANICSA who does not have, or is not adhering to, a debt repayment agreement with the Agency or otherwise not meeting the terms of the debtor's loan.
Strengthening Supervision of the Financial Sector

14. A second key component of the first phase of the financial sector reform program involves implementing a comprehensive action plan to strengthen banking supervision. While there were none in 1990, now there are ten private banks that account for over seventy percent of financial assets in the sector. Prudential norms to establish limits on exemptions to individual lending limits, and modify regulations regarding asset classification and provisioning, and loan concentration have been issued to increase the safety and solvency of the banking sector. The Superintendency of Banks has also established a debtor reporting system to routinely share with all banks the classification of debtors. This system is being automated and we expect it to be on-line within a few months. Yet capitalization of some of the private banks remains low and measures are needed to ensure that Nicaragua's banking sector meets global standards for safety and security especially given the rapid expansion of private banking in Nicaragua. Therefore the Superintendency is initiating a detailed action program including measures to assess the performance of the banking sector, refine the regulatory framework as appropriate, and strengthen the institutional capacity of the Superintendency. During 1998 we intend to issue new or revised prudential norms relating to capital adequacy, risk concentration, lending to related parties, and the evaluation and classification of assets, and provisioning requirements.

15. With these reforms we believe the path will be open to significantly increase the scope and depth of the financial sector in Nicaragua. Continued vigilance, however, is needed to ensure that the state banking system is operating in a sound manner, and that public and private institutions are addressing adequately the needs of small borrowers in rural areas. To further service this market, Nicaragua will need to establish under a second phase of the financial sector reform program an appropriate framework for the operation of non-bank private rural financial institutions. To increase national savings in general, comprehensive and coherent programs to promote and appropriately regulate a securities market and the insurance industry are also a priority for the next two years. This Government will take measures to strengthen the social security system and has initiated studies of options for a major reform of that system, including the introduction of a private pension system where individuals have greater responsibility for pension fund investment decisions under appropriate regulatory oversight by the public sector. The Government intends to undertake a full assessment of the legal framework of the financial sector to determine the need for new legislation.
CONCLUSIONS

16. It is our belief that over the last seven years Nicaragua has made major progress toward reestablishing macroeconomic stability and laying the basis for sustained, market based economic growth and social progress. These advances are even more remarkable given that Nicaragua simultaneously was successfully pursuing policies of demobilization and democratization. Over the last year, the Administration of President Arnoldo Aleman has intensified the pace of reform with the passage of major legislation relating to taxes, foreign trade, and property rights; by making significant improvements in fiscal and monetary performance; and by initiating an important restructuring of the central government. We have also implemented far reaching reforms in state banking. Nicaragua has counted on the strong support of the World Bank over the last few years, and request your continued financial and technical assistance. There is no viable alternative to continued redimensioning of the size and responsibilities of the public sector in order to expand the scope for sustainable private sector led growth. The reform of the Government’s role in the financial sector, involving a reduction in any direct operational role simultaneous with a strengthening of its regulatory capacity, is fully in line with the type of transformation that we are seeking.

Ministro de Finanzas
Esteban Duque Estrada
Minister of Finance
Annex B: Nicaragua--Financial Sector Adjustment Credit
Matrix of Policy Actions

<table>
<thead>
<tr>
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<td><strong>I. Macroeconomic Framework</strong></td>
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</table>

1 Debtors of state banks pursuant to “CD Superintendencia-XXIII-1-95
| SBIF shall have established a Financial Analysis unit to assess situations of bank solvency, propose supervision and adjustment programs, and in general strengthen technical aspects of SBIF policies, regulations, and operations. | (a) (i) finalized a diagnostic of the solvency situation of the three commercial banks which during the period January 1, 1997 through January 31, 1998 had the largest increase in the number of operating branches; (ii) based on such diagnostic, instructed any of the banks which do not meet SBIF solvency regulations to take the measures necessary to restore compliance with such regulations; (b) adopted prudential regulations, satisfactory to IDA, for capital adequacy and related party lending, and revised existing risk concentration prudential regulations to set forth the required provisioning; and (c) adopted the Inspection Strengthening Plan for the following 12 months, acceptable to IDA, to strengthen on-site inspections of commercial banks. | (a) (i) finalized a diagnostic of the solvency situation of all commercial banks; (ii) based on such diagnostic, instructed any of the banks which do not meet SBIF’s solvency regulations to take the measures necessary to restore compliance with such regulations; (b) adopted a prudential regulation, satisfactory to IDA, for evaluation and classification of assets, including provisioning requirements; (c) completed a study of options and recommendations for bank exit, crisis resolution, structure of resolution agencies, and deposit insurance, and approved action plan to strengthen the banking safety network. |
ANNEX C

BANK SUPERVISION

ACTION PLAN
ANNEX C: BANK SUPERVISION ACTION PLAN

The Nicaraguan banking system is evolving rapidly with the growth of private banking and restructuring of the state banking system. In line with its responsibility for ensuring an appropriate legal and regulatory framework for the sound operation of the banking system, the SBIF Council has adopted this Action Plan to strengthen the policies and institutional capacity of the SBIF to oversee the banking system to IDA’s satisfaction and will take all necessary steps to implement the following measures within the deadlines specified:

I. PROGRAM OF IMMEDIATE MEASURES

1. Diagnosis of bank solvency

a) Establish a Financial Analysis Unit within the SBIF with sufficient staff to assess situations of bank insolvency, propose supervision and adjustment programs and in general strengthen technical aspects of SBIF policies, regulations, and operations (February 13, 1998).

b) SBIF will initiate (March 1, 1998) a diagnosis of the solvency of all private commercial banks and, based on such diagnosis, instruct any bank which does not meet SBIF’s prudential regulations to take the measures that are required to restore compliance with such regulations.

2. Strengthening banking safety network

a) Complete a study of options with recommendations for bank exit, crisis resolution, structure of Resolution Agencies, and deposit insurance (September 30, 1998). SBIF Council will review and approve an action plan to strengthen the banking safety network (December 15, 1998).
II. REGULATORY STRENGTHENING

3. Market access and licensing

Issue a new prudential norm on market access and licensing by May 15, 1998, including the following:

a) minimum capital requirements for new commercial bank licenses set at US$2 million equivalent;
b) minimum capital for all Non-Bank Financial Intermediaries set at 50% or more of the commercial banks requirements.
c) information requirements regarding the ultimate origin of capital and eligibility requirements for managers, directors and owners, to be applied upon change of bank management or ownership, in compliance with the existing legislation;
d) the formal administrative process for opening and closing branches (eliminating any requirement for a feasibility study to open branches);
e) an increase in the maximum penalty for non-compliance with SBIF regulations to the maximum allowed by current legislation.

4. Capital adequacy

Issue new prudential norm on capital adequacy by May 15, 1998, which will:

a) mandate the use of an international rating agency satisfactory to IDA for rating foreign banks and weighing the investments of the Nicaraguan banks in foreign institutions. The assets not rated by this international rating agency will be weighted at 100% for the purpose of calculating capital adequacy.
b) prohibit banks from giving loans directly or through foreign connected institutions to the bank’s shareholders for capital increase.
c) exclude pending provisions from equity in the calculation of the capital adequacy ratio and for any other established limits;
d) define and establish permanently the components of TIER I and TIER II capital;
e) provide for the establishment of a progressive schedule to comply with legislated capital adequacy ratios of 8% in 1998 and 10% in 2000; SBIF will establish an adjustment plan for each bank that does not comply.
f) exclude by June, 1999 Development Bonds of less than 5 years maturity from capital. No new issues of this kind of bonds will be considered suitable as a component of tier II.
g) establish that loans guaranteed by other banks should be weighted at 100% for the purpose of calculating capital adequacy unless the guarantor bank is in full compliance with the SBIF prudential regulations; in which case the loan will be weighted at 50%.
5. Evaluation and classification of assets

a) By appointment of the SBIF Council, a study will be carried out to evaluate the assets classification process and the level of provisioning, in order to improve the respective prudential norm. The SBIF should:
   i) in consultation with IDA, select a sample of banks to be inspected according to the attached guidelines, with the assistance of international experts selected in consultation with IDA. To perform the study, the SBIF will grant the expert team access to all relevant information;
   ii) implement the special on-site inspections with the participation of the international expert team, to evaluate the assets portfolio and review the quality of credit risk policies, classification procedures and control systems of the selected banks;
   iii) develop a time series analysis of the credit repayment behavior of groups of debtors for each category of assets classification in order to compare the final recovery rates with the current level of provisioning;
   iv) based on the above analysis, propose an amendment to the prudential norm which would improve the classification criteria and increase the required levels of provisioning;

b) in consultation with IDA, adopt as appropriate any proposed amendments by July 15, 1998 and make them effective not later than June 1999.

6. Risk Concentration

a) By May 15, 1998, the SBIF will produce quarterly reports on the progressive elimination of risk concentration limit exceptions, to be completely eliminated by June 2000.

b) The SBIF will issue an amendment to the prudential norm on concentration of risks by May 15, 1998 establishing 100% provisions for loans above the risk concentration limit.

7. Related party lending

Issue a prudential norm to restrict bank transactions with related parties by May 15, 1998 that will be effective by January 1, 2000 including the following:

a) a definition of related parties, as by ownership, management, or familial relation to management and shareholders.

b) a limit on total transactions with related parties of less than 50% of the bank's equity in aggregate.

c) a requirement of 100% provisioning for transactions exceeding this limit, except in the event that there is an adjustment plan approved by the SBIF Council and the institution is in compliance with the plan.
III. INSTITUTIONAL STRENGTHENING

8. Structure of the SBIF

a) Strengthen the capacity of the insurance division to effectively supervise the insurance sector (July 15, 1998).

b) Adopt and initiate a program (May 15, 1998) to strengthen and extend on-site bank inspections including:
   1) increasing the review of individual loans to at least 50% of the bank’s total loan portfolio;
   2) an assessment of repossessed collateral (Bienes Adjudicados), fixed assets, the investment portfolio and, in particular, assets held by off-shore institutions;
   3) a review of the risk concentration of the bank’s portfolio;
   4) an extrapolation of the average risk ratio resulting from the sample of assets reviewed to the entire loan portfolio; and
   5) the prompt and timely submission of inspection results to the SBIF Council with recommendations for action.

c) Complete development of the Credit Risk Evaluation Facility within the SBIF, to provide full and immediate access to this data to all financial intermediaries. (September 15, 1998)
ANNEX C: BANK SUPERVISION ACTION PLAN  
ATTACHMENT 1  

TERMS OF REFERENCE  
FOR A STUDY ON THE EVALUATION AND CLASSIFICATION OF  
BANK ASSETS IN NICARAGUA  

INTRODUCTION  

The Nicaraguan banking system is evolving rapidly with the growth of private banking and restructuring of the state banking system. In line with its responsibility for ensuring an appropriate legal and regulatory framework for the sound operation of the banking system, the Superintendency of Banks and Financial Institutions (SBIF) Council has adopted these Terms of Reference according to the attached Action Plan to strengthen the policies and institutional capacity of the SBIF to oversee the banking system and to take all necessary steps for a better supervision of the Nicaraguan banking system. As part of this Plan there is a need to evaluate the credit risk measuring mechanisms currently applied in Nicaragua. For this purpose, the SBIF Council has commissioned a study that will be carried out to evaluate the banks asset classification process and the level of provisioning with the assistance of international experts selected in consultation with IDA, in order to improve the respective prudential norm. The objective, activities and expected results of the study are described below.

OBJECTIVE OF THE STUDY  

To evaluate the bank’s current asset risk classification process and provisioning levels and from this evaluation, formulate proposals and amend the respective prudential norm accordingly.

ACTIVITIES OF THE STUDY  

i) In consultation with IDA, select a sample of at least three banks to be inspected. The criteria to select the banks will be based on size, diversification of the loan portfolio, and targeted economic sector;  
ii) Implementation of special on-site inspections assisted by an international expert team, selected in consultation with IDA, to evaluate the assets portfolio and review the quality of credit risk policies, classification procedures and control systems of the selected banks;  
iii) Development of a time series analysis of the credit repayment behavior of groups of debtors for each category of assets classification in order to compare the final recovery rates obtained with the current level of provisioning;  
iv) Based on the above analysis, formulate a proposal for an amendment to the prudential norm which would improve the classification criteria and increase the required levels of provisioning.
Assisted Examinations

In order to carry out the inspections the SBIF will be assisted on-site by Expert Bank Examiners (EBE) to reinforce the Teams of Inspectors (TOI) that will be in charge of conducting such inspections. The work of the selected EBEs will be conducted in three phases, as follows:

The first phase will consist of a review of the planning and preparatory work for bank examinations as they are currently being conducted, and preparing the work plan to conduct the special inspections with the SBIF technical staff --expected duration of one week;

The second phase will consist in an active collaboration in on-site inspections with the TOI assigned to each of the banks. --expected duration of about three to six weeks;

The third phase will consist in supporting the SBIF in the preparation of the report elaborating upon the results of the bank inspections. --expected duration of about two weeks.

Phase One: Review of the plans for the examination

During this phase, the EBE will familiarize themselves with the profile and features of the targeted banks and their related parties. They will also proceed to review the plans developed by the SBIF to carry out full scope examinations of the targeted institutions. The EBE will evaluate and suggest changes as appropriate in the following:

1) The latest SBIF report(s) or summary analysis available for the banks inspected, including:
   a) financial performance analysis;
   b) profile of lending portfolio -- as per the information available from the credit risk bureau -- and investment portfolio;
   c) relevant communications between SBIF and the board and senior management of the bank;
   d) key results and conclusions reached by SBIF as per previous examinations conducted of the bank;
   e) significant existing risk positions.

2) The current structure and organization of the bank and its ownership and management; and the information available to SBIF regarding related parties of both major shareholders controlling the bank and of directors and key senior managers.

3) Existing recent audit reports, and reports and conclusions reached by SBIF following meetings with external auditors for their review, eventually including that of the working papers of the audit.
Based on the conclusions reached during the review as per the paragraphs above, the EBE will evaluate SBIF procedures and plans for examinations and whether there is a need to change them.

The parameters or elements which the EBE will evaluate, among others, are as follows:

a) the letter first requesting information addressed to the bank’s board;
b) the management representation letter requested at the inception of the examination;
c) the timing, objectives and scope of the review of the banks;
d) the timing and duration estimated for the examination;
e) the profile and composition of the examination team;
f) the scope, extension, objectives, and special procedures planned;
f) the distribution of tasks and the possibility of using complementary methods for assessing banks -- e.g., increase reliance on external auditors or ad-hoc diagnostics to be requested.

During this phase the EBE will be granted access to all relevant information and materials considered necessary to the examination, as regards related interests between the banks and their major shareholders, directors and senior management who might have a significant control, or be in the position to exert control, whether in Nicaragua or abroad.

Phase Two: Support during the examination

In this phase, the EBE will be actively involved in supporting the TOI’s work in areas like the evaluation of the loan, trading and investment portfolio, and other risk activities: non-performing assets, real estate owned and repossessed, other assets and items pending from conciliation, guarantees and other off balance sheet activities like fiduciary activities, money desk operations, and sale of credit assets with or without recourse to the bank, the accuracy of earnings reported, and the evaluation and effect upon net worth and earnings; and intra-group transactions among related and affiliated parties to the bank, as well as the overall management performance of the bank.

Phase Three: Reporting and Recommendations for Actions and Follow Up

During this phase the EBE will help the SBIF prepare summary reports of the examinations of each bank, a draft presentation of the report to the respective Board of Directors, and recommendations whether formal enforcement actions are required. The EBE will also provide support in preparing a set of financial simulations with the probable evolution of the bank’s position without additional support from its shareholders or significant restructuring and reorganization actions. Also, based on the results of those simulations, the EBE will support the SBIF in evaluating the impact of alternative measures to be presented to the board of the inspected bank in terms of strengthening its financial position.
Finally, the EBE, based on the findings of the overall findings of the special inspections performed, will formulate recommendations on SBIF inspection mechanisms and procedures, including proposals to amend the prudential norm on asset classification.

**Time series analysis**

For the development of a time series analysis of the credit recovery rates obtained from debtors, the EBE will take a sample of a number of debtors and their loans, distributed by their initial category of classification made by the bank, from the same sample of banks selected for the assisted inspections, with a record of classification in the last two years and on which the SBIF has information, in order to compare the banks' initial classification with the resulting repayment behavior, as a mechanism to check if the current scale of provisioning is a reasonable *a priori* proxy to the real credit risk of these debtors and their loans. The study will also include an analysis of the classification of debtors over time as made by the banks, as compared with the classification made by the SBIF.

Based on the findings of these exercises, the EBE will propose an adjustment to the current percentages of provisioning by asset classification category.

**FINAL PRODUCTS OF THE STUDY**

The study will result in a report to be submitted to the SBIF Council and satisfactory to IDA that will include:

a) The findings on current asset risk classification process and on-site inspection procedures - identifying weaknesses and formulating a set of recommendations to be adopted by the SBIF to strengthen these processes and procedures;

b) The findings on the time series analysis and the proposed adjustments to the current percentages of provisioning; and

c) Draft proposals for amendments to the corresponding prudential norm.
ANNEX D

NICARAGUAN FINANCIAL SECTOR
Annex D: Nicaragua’s Financial Sector

A. Introduction

1. By the late 1970s, Nicaragua had one of the more developed financial systems in Central America with a mix of public, private, and subsidiaries of foreign banks providing a wide range of financial services. However, after taking power in July 1979, the Sandinista administration dismantled Nicaragua’s private financial system—all private banks were nationalized, control of state bank operations was transferred to a holding company (which evolved into the Corporación Financiera de Nicaragua, CORFIN), and the number of financial institutions was reduced to five: (BANADES-Banco Nacional de Desarrollo; BANIC-Banco Nicaragüense de Industria y Comercio; BCP-Banco de Credito Popular; BIN-Banco Inmobiliario; and, FNI-Fondo Nicaragüense de Inversión). Myriad subsidies and the use of the banking system to pursue political objectives completely undermined the loan repayment culture in Nicaragua.

2. In 1991, the Chamorro Government initiated a comprehensive stabilization and reform program to correct major macroeconomic imbalances and transform Nicaragua from a centrally planned to a market economy. Reform of the state banking system and encouragement of a dynamic and efficient private financial sector were among the key objectives. Initially, the Government tried to restructure the state banks and reduce their size, requiring them both to compete with the emerging private banking sector and to perform development banking functions. Banking supervision and regulation were introduced, interest rate and credit controls were eliminated, an inter-bank foreign exchange market was established, exchange restrictions were phased out and the exchange rate was unified in January, 1996. These reforms, together with rising private capital inflows and economic recovery since 1994, have resulted in a substantial deepening of financial intermediation and improved allocation of financial resources.

B. Overview of the Financial System

3. Nicaragua’s financial system has experienced a spectacular growth since 1991, but remains underdeveloped. The system has gained depth as indicated by the rise in the ratio of liquid liabilities of financial intermediaries (M3) to GDP which is now comparable to the level observed in middle-income countries. Growth has been mainly in dollar denominated deposits (Chart 1), increasing the dollarization process that first emerged as a response to the hyperinflation of 1990-91. The share of dollar denominated financial savings increased from 29 percent in 1991 to 63 percent in 1997. Effective dollarization is higher still, since practically all córdoba denominated financial assets and liabilities, except sight deposits, include a “maintenance of value” provision indexing the rate of return in local currency to the official exchange rate. Thus, despite relatively stable macroeconomic and financial conditions in recent years and the unification of the exchange rate market, the market has continued to express a strong preference for dollar or dollar-indexed transactions.
4. The allocation of financial resources has improved significantly. The share of state bank in total private sector credit has declined steadily since 1991 (Chart 2), and the decline accelerated in 1996 with the transfer of the non-performing assets of the state banks to a collection agency (described below). At the same time, the private sector portfolio of the private banks has increased rapidly from zero to 28 percent of GDP in just 6 years. This has led to a sectoral recomposition of credit in line with market signals rather than political criteria. The availability of investment capital, however, continues to be very limited: 56 percent of the loans are for less than 18 months. Interest rates have remained stable in nominal terms but as inflation has fallen, real interest rates have increased somewhat (Table 1). Nevertheless, interest rates in Nicaragua are roughly in line with the dollar equivalent rates\(^1\) of other Central American countries (Chart 3). Reduction in interest rates will require increased efficiency and competitiveness of the region's financial market.

Table 1 - Interest Rates 1993-97

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<td><strong>Commercial Bank Interest Rates</strong></td>
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<td>(annual averages)</td>
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<td><strong>Local Currency</strong>(^1)</td>
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<td>Short -Term Loans</td>
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<td>19.9</td>
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<td>Deposits (180 days)</td>
<td>13.4</td>
<td>13.6</td>
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<td><strong>Foreign Currency</strong></td>
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<td>Short -Term Loans</td>
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<td>15.2</td>
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<tr>
<td>Deposits (180 days)</td>
<td>5.9</td>
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**Memorandum items:**

| CPI Inflation           | 20.4 | 7.8  | 11.2 | 11.6 | 9.2  |

\(^1\) Before indexation to the exchange rate.

Source: Central Bank of Nicaragua.

\(^1\) In Nicaragua, interests rates quoted on domestic transactions are dollar-equivalent, as they are indexed to the exchange rate. For other countries in Central America, the ex-post dollar-equivalent rates presented in Chart 3 were calculated my deflating the nominal interest rate by the rate of exchange rate depreciation.
5. Despite remarkable progress, the financial system is still in its infancy. State banks continue to control an important share of the financial sector and their performance is poor. The private banking sector remains small, undercapitalized, and with high administrative costs and lending margins. In 1996, total equity in the banking system was only US$70 million, compared to US$178 million in Honduras and US$512 million in El Salvador. On the supervision side, the legal framework for the banking sector is broadly appropriate, but there is a need to fill some important gaps and limit the considerable discretion exercised thus far in the application of norms and regulations. Money market funds, leasing, commercial paper, private placement and securitization by non-bank issuers are practically nonexistent. The Managua Stock Exchange, opened in 1994, largely trades Central Bank and Government paper, with only a small share of private issues, the majority coming from one economic group.

C. Monetary Policies

6. Since 1991 the Central Bank of Nicaragua’s (CBN) efforts to conduct prudent monetary policies have been undermined by financial difficulties of the state-owned banks, fiscal weakness and instability of external flows. The Central Bank Law approved in 1992 placed stringent conditions on CBN financing of the Government and the financial system. Nevertheless, central bank credit expanded considerably during 1992-94 and the early part of 1995, as the CBN continued to provide financing to the state banking system and the Government did not service its debt with the CBN. In late 1995, credit policies were tightened as the CBN discontinued all lines of credit to the state banks; the placement of open market paper was intensified and external aid recovered. Prudent policies continued into March 1996 but a weakened fiscal position and a decline in state bank deposits in the Central Bank led again to an expansion in net domestic assets in 1996. The CBN’s credit stance in 1997 was weakened by a major debt forgiveness granted to debtors of the largest state bank (BANADES), virtually eliminating state bank repayments to the CBN (compared to expected repayments of 1.5 percent of GDP). Thus, completing the reforms of the state banks is critical to the sustained implementation of sound monetary policies. The scope for active monetary policy, however, will continue to be limited by dollarization and the losses of the CBN. The latter stem from payments of foreign exchange obligations by the CBN, exchange losses and high cost of open market operations.

7. As part of the reform process, the CBN has liberalized the financial system from direct controls and introduced indirect monetary policy instruments. Nicaragua has phased out credit controls, directed credit and floor rates on savings accounts. Interest rates are market determined and the authorities are laying the foundations for liquidity management through open market operations. Central Bank monetary intervention relies largely on reserve requirements and open market operations—mainly the placement of negotiable investment certificates (CENIS) in domestic currency (with maintenance of value). Until early 1996, reserve requirements varied by instrument, currency denomination (25 percent requirement on foreign currency deposits and 15 percent on córdoba deposits) and maturity (córdoba deposits with over one year maturity had no reserve requirement). Only deposits held with BCN were eligible and córdoba reserves were marginally remunerated. In May 1996, CBN eliminated the reserve requirement for deposits

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Remuneration accrued daily at 16 percent annual rate on one third of the requirement, provided full requirement was met on that day.
of more than one year in order to stimulate the absorption of longer-term funds, which resulted in a rapid
shift to term deposits slightly over one year. In November 1997, CBN unified reserve requirements at 17
percent and eliminated remuneration on local deposits as well as the exemption for deposits of over one
year, and extended reserve requirements to Repo operations and commercial paper of over one year. The
net effect of these changes was to increase the reserve requirement by 2 percentage points. This measure is
expected to reduce volatility in the deposit base and absorb liquidity, but it will also have a negative impact
on the profitability of the banking system.

8. During 1996-97 the CBN intensified its use of open market operations to sterilize pressures on its
credit and international reserves position. The CBN first issued CENIS in 1995. By 1996, the outstanding
stock of CENIS was only US$69 million, but by the end of 1997 it had jumped to US$255 million. With
respect to the system to issue CENIS, up to June 1997 CENIS were available on demand at fixed interest
rates to individuals and commercial banks through direct sales by CBN, or through placement in the stock
exchange with yields on the 360-day CENIS hovering around 25 percent before indexation in 1996. The
authorities have recently replaced the system with an auction system where the quantity of CENIS offered
is based on the need to sterilize excess liquidity and the interest rate is determined at auction. The interest
rate on 360-day CENIS has declined to approximately 11 percent before indexation (January 1998). In
1998 the CBN plans to reduce the stock of CENIS by the equivalent of approximately 2.5 percent of GDP
and to place CENIS only when needed to sterilize excess liquidity.

D. Legal Framework

9. The legal framework underpinning Nicaragua’s financial system has undergone numerous changes
in recent years, as the Government has sought to re-establish a modern private financial sector. The
changes, however, have not resulted in a unified and clear legal framework. Today, there are more than 12
legal sources referring to the financial system. Information is not only spread throughout many documents,
but interpretation is made difficult by major vacuums, as well as vague and sometimes contradictory
definitions. For example, the recent introduction of leasing and franchising activities has not been
accompanied by the necessary changes in the Commercial Code. As a result, leasing still requires two
separate contracts (the lease purchase option agreement and the contract to execute the sale) that contribute
to unnecessarily high transaction costs.

10. More broadly, the general weaknesses of the judiciary and legal system for business transactions
constrain the efficient development of financial markets. Implementation and enforcement of commercial
laws is hampered by weaknesses and lack of confidence in the court system. Dockets are overloaded,
decisions are delayed and litigation can be prolonged for unpredictable periods. The failings of the legal
system are exacerbated by disputes involving real property titles. Although a considerable effort has been
made to regularize property rights, the procedures established to resolve title disputes resulting from
expropriation and confiscation of real estate during the Sandinista period remain a source of insecurity. In
addition, the growing unreliability of title registers appears to be of particular concern. Over and above the
efficiency of the court system, there is a need to modernize the whole legal framework. Legal certainty
would be increased with a modern commercial code (the current laws date back to 1904), a more detailed

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3 This figure includes US$65 million issued to cover the net negative worth of BANADES branches sold to the private
sector, and US$75 million issued in a special operation with Lehman Brothers.

4 A recently-approved Property Law guarantees tenure to small-scale farm and urban property owners, while setting in place
mechanisms for the legal adjudication of confiscated property and compensation mechanisms.
procedure for bankruptcy and corporate reorganization, a reliable and well-indexed registry for liens on movable property and inventories, modern patent and copyright laws, and an updated companies law.

E. Structure of the Financial System

11. At present, Nicaragua's financial system consists of 10 private commercial banks, 3 state-owned development banks, 2 private finance companies, 1 state-owned investment fund, 1 state-owned and 4 private insurance companies, 7 private deposit warehouses, 1 stock exchange with 13 registered brokerage houses (11 active), and numerous small, non-profit financial intermediaries (credit unions, NGOs). Activity in the stock exchange, which is just three years old, is limited to the public sector or to the issuance of short-term paper by corporations.

12. The financial system is supervised by SBIF (Superintendencia de Bancos y Otras Instituciones Financieras), created in April, 1991 and empowered to establish regulations and norms, and license new financial intermediaries. Its Executive Board is presided by the Minister of Economy and includes the Minister of Finance, the President of CBN, a representative of the political party that came in second in the last general elections, and the Superintendent. The Superintendent and the Deputy-Superintendent are elected by Congress from a list submitted by the Executive for a 4 year term with possible re-election. SBIF has jurisdiction over the state and private banking system, the stock exchange, insurance companies, deposit warehouses and any other activity or institution that intermediates funds from the public, including leasing, factoring, credit cards, funeral companies and pawn shops. The recently approved Law 244 will bring non-bank, non-profit intermediaries within SBIF supervision. Currently SBIF supervises 35 institutions, but in practice concentrates efforts only on 15 entities, mainly banks. Seventy-five percent of SBIF's funding comes from a charge of 0.1 percent on the assets of supervised institutions and the remaining 25 percent from CBN.

The Banking System

13. The banking system dominates Nicaragua's financial sector. Excluding CBN, the banking sector accounted for C$13.4 billion in assets as of September 1997 (about US$1.4 billion, equivalent to about 75 percent of GDP). State banks accounted for 21 percent of total assets (down from nearly 95 percent in late 1991) and private banks for 79 percent. Deposits in the banking sector account for 85 percent of total liabilities in the financial system, of which private banks accounted for 79 percent. Nicaragua's banking system is poorly capitalized, with high intermediation margins and administrative costs—the result of a system that is growing and expanding geographically (private banks) and the inefficiencies of the still-large state banking sector. The financial sector reforms planned for 1998-99, supported by the Financial Sector Adjustment Credit (FSAC), will strengthen the private banking system and reduce state bank participation.

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5 SBIF's legal mandate also covers supervision of the Central Bank. The regulatory framework is discussed in greater detail in the last section of this annex.

6 Following completion of the BANADES reform program, the state share is estimated to have fallen to about 13 percent by end-1997, though these figures are not yet available from the SBIF.
**State Banks**

14. Nicaragua has three development banks:

- **BANADES.** Historically the largest of the state-owned banks, BANADES was established in 1912 as a private bank, it was nationalized in 1920 and in 1956 transformed into the state development bank for the agriculture sector. During the Sandinista administration, BANADES was used to channel a wide range of subsidies to the agriculture sector.

- **BANIC.** The second largest of the state-owned banks, BANIC was created in 1953 and nationalized in 1979. In the 1980s BANIC absorbed a number of nationalized commercial banks, and is largely oriented toward the urban sector.

- **Banco de Credito Popular (BCP).** BCP is the smallest state bank, with assets of 2.3 percent of the banking system total in September 1997, lending mainly to small-scale commercial and industrial enterprises.

**State Bank Reforms, 1991-97**

15. To address the state domination of the financial sector inherited from the Sandinista era, the Chamorro Government closed CORFIN and BIN, and set about reforming the remaining state banks, focusing particularly on the two largest, BANADES and BANIC. With the aim of having the state banks operate under the same rules as the private banks, the Government restructured them and brought their capital in line with SBIF norms. In June 1992, the Government bought their non-performing loans with long-term bonds, which the state banks used to repay CBN. The recapitalization program is estimated to have cost about US$240 million. The state banks undertook a major cost-reduction program, substantially reducing branches and staff. Despite these efforts, two years later the two largest banks continued to dominate the financial system, and their situation had again deteriorated, with mounting losses and dismal loan recovery rates.

16. Despite the poor performance of the state banks and the threat their mounting losses posed to the stabilization program, the Government concluded that there was not a sufficient consensus either to close or privatize them. Private banks had emerged rapidly (there were seven by mid-1994), but they were still small (Chart 2) and extremely cautious in their lending. Instead it opted for a containment strategy, keeping the state banks under close monitoring while allowing private banks to grow. As private banking expanded, the Government expected that state banks would become increasingly marginal, eventually making it politically easier to close or privatize them. It aimed to avoid further recapitalization through public funds or revaluation of assets, subjecting state banks to prudential regulations and requiring them to shift their larger more-established clients to the private banking system. However, BANADES and BANIC continued to have serious loan recovery problems. External audits confirmed that loan-loss provisioning would make them effectively insolvent, but since neither the option of recapitalization or liquidation was open, SBIF exempted the two banks from prudential norms for two and a half years. At the same time, the Government adopted a restructuring program that sought to go beyond the containment strategy, with two key aims: (i) substantial down-sizing of BANADES, leaving it as a very small intermediary focused only on small-scale farmers; and (ii) privatizing BANIC, not by selling its assets but rather through a capital increase from private investors who would also gain operating control of the bank. As a first step in the process, in early 1996 non-performing assets in the two banks (C$1.5 billion, nearly 40 percent of their portfolios) were transferred to a newly-created collection agency (COBANICSQA).
17. In 1997, when the new administration took office, the two largest state banks, BANADES and BANIC, continued to face severe financial difficulties. It was clear that BANADES was not fulfilling its mandate to serve small producers; its clientele had fallen to 8,250 borrowers, of which only 630 held more than half of all loans (Chart 4). Credit recoveries continued to be dismal and the annual operating costs were excessive in relation to the volume of operations. BANIC had made progress in reducing administrative costs but continued to face loan recovery problems. Furthermore, its loan portfolio was highly concentrated, about 314 clients held more than 80 percent of its loans. By mid-1997, after evaluating a number of options for a major reform of BANADES, the Government decided that the best option was to auction BANADES branches to the private sector and once it was reduced to a shell, to withdraw its banking license. At present, all BANADES branches have been either closed, sold, or transferred (FSAC Board Presentation condition). For BANIC, the Government decided to continue with the capitalization plan set out by the previous administration (BANIC tranche release condition of FSAC).

**Private Banks**

18. Private banking has grown rapidly since its re-emergence in 1991. There are currently 10 private commercial banks with assets totaling about US$1.1 billion (September 1997). Economic recovery, high intermediation margins, and highly profitable investments in public bonds have permitted private banks to achieve annual returns in the range of 15-35 percent over the past few years (reflecting the ratio of profits before taxes to equity of the seven largest private banks). Despite the relatively large number of private banks in a country of 4.6 million people, until recently banking penetration was extremely low. The number of private bank branches has been increasing rapidly, from 42 in 1995 to 62 by September 1997 (excluding the 36 branches obtained from BANADES), but have been largely confined to Managua. Also, private banks have started to lend to small borrowers; by September 1997, these represented 97 percent of private bank clients and 27 percent of their portfolio (Chart 4). During the short period in which private banks have re-emerged, one bank had to be closed and absorbed by a larger bank, and two other banks faced difficulties which were resolved with infusions of foreign capital. These restructurings were orderly and well handled by SBIF.

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7 The first private bank was established in August 1991.

8 Private banks have only recently shown interest in extending beyond the capital and other major urban centers. This has been the result of the BANADES restructuring plan that has auctioned branches, high liquidity in the system, and the entry into the system of two regional banking groups (from El Salvador and Guatemala/Mexico) interested in covering small borrowers.
Table 2- Capital Adequacy of the Banking System - Dec. 1997

<table>
<thead>
<tr>
<th></th>
<th>State Banks</th>
<th>Private Banks</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overdue Loans/Total Loans (%)</td>
<td>3.4</td>
<td>1.7</td>
<td>2.0</td>
</tr>
<tr>
<td>Provisions/Overdue Loans (%)</td>
<td>193.1</td>
<td>131.5</td>
<td>149.7</td>
</tr>
<tr>
<td>Tier 1 Capital (US$ millions)</td>
<td>10.7</td>
<td>55.7</td>
<td>66.3</td>
</tr>
<tr>
<td>Tier 2 Capital (US$ millions)</td>
<td>0</td>
<td>22.5</td>
<td>22.5</td>
</tr>
<tr>
<td>Total Capital/Weighted assets (%)</td>
<td>7.4</td>
<td>10.9</td>
<td>10.3</td>
</tr>
</tbody>
</table>

Source: SBIF, Central Bank of Nicaragua.

19. Despite rapid growth, Nicaragua’s private banking sector remains fragile. Total assets are low and diffused among 10 small commercial banks, none of which accounts for more than 12 percent of the total domestic credit market. Private banks have limited economies of scale and hence high administrative costs. The fragility of existing banks is not fully reflected in the official figures, as reported in Table 2. While total capital for private banks as a percent of weighted assets appears adequate at nearly 11 percent, as do capital provisions as a percent of overdue loans (149.7 percent), these figures are somewhat misleading due to the poor classification of loans and the inclusion of Development Bonds (BOFOS) as a significant portion of the banks’ capital. Nicaragua’s banking system needs a sizable infusion of capital as low capitalization restricts the growth of the system and weakens its ability to deal with cyclical downturns and shocks.

20. The law that allowed the establishment of private banks specified a minimum social capital of only C$10 million (equivalent to US$2 million at the time, about US$1 million currently). Initially, private banks were subject to a capital adequacy requirement of 6 percent, but in April 1996, SBIF approved new prudential norms establishing a minimum risk-weighted capital ratio of 8 percent, rising to 10 percent within four years. At the same time, SBIF established that BOFOS issued by private banks and purchased by CBN could count as tier 2 capital provided they were for longer than 5 years. This caused some problems for private banks which held large amounts of BOFOS under 5 years. Following a negotiation with SBIF, it was agreed that BOFOS below 5 years would count as secondary capital for a two year period, provided private banks would raise additional capital for the same amount. As a result, during the first half of 1997, there was an important infusion of capital in Nicaraguan banks (about US$17 million), which allowed private banks to meet the 8 percent requirement.

21. The fragility of private banks is also reflected in their low risk-weighted capital ratios, which for the seven largest private banks averaged 8.09 percent at the end of 1996, but 6.99 percent if only tier 1

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9 BOFOS were issued by banks between 1993 and 1995 and purchased by CBN as a way of providing refinancing to investment projects. BOFOS, however, do not conform to Basle definitions of tier 2 capital.

10 The minimum social capital has not been formally adjusted to take account of the depreciation of the córdoba, but SBIF nonetheless appears to require a minimum capital of US$2 million. The last four institutions licensed in 1995 and 1996 (2 banks and 2 finance companies) had an average capital of C17.5 million as of December 1996 (a little less than US$2 million).

11 As discussed subsequently, due to the absence of norms on lending to related parties, it is not possible to estimate how much of this increase was an infusion of fresh capital.
capital is considered. Deducting loan loss provisions from tier 1 capital would further lower the average risk-weighted capital ratios of private banks. According to SBIF, private banks face an average weighted risk in their loan portfolio of 2.04 percent. However, this is likely to underestimate the risk of the loan portfolio of private banks because the published figures represent the banks’ own classification and provisioning, not the classification made by SBIF following its most recent inspection.

Non-Bank Financial Institutions

22. **Fondo Nicaragüense de Inversión (FNI):** In 1993, FNI was restructured into a second-tier non-bank (non-depository) financial intermediary and its portfolio cleaned up. A large part of FNI’s financial activity, however, continued to involve refinancing of the three state banks. In 1996, the Government carried out a second portfolio restructuring exercise, transferring 75 percent of FNI’s portfolio to COBANICSA. FNI, with capital of US$52.1 million, has a loan portfolio of US$31.8 million and investments of US$28.3 million, the latter placed in local private banks. FNI has very high administrative costs and considerable liquidity as it has found it difficult to expand lending. FNI sets loan interest rates based on the average of private bank deposit rates, which at a time of high liquidity in the system appears to make these lines of credit unattractive to private banks. As of September 1997, FNI was reported to have more than US$20 million in donor funds which it was unable to place with private banks.

23. The Government is considering a number of options to reform FNI. It plans to convert FNI into a limited liability company with private participation. It would remain as a second-tier institution, complementing the private financial sector, especially in helping to stimulate capital markets. The reform proposals have generated much debate and key issues remain unresolved. These include the extent of state ownership, the autonomy of its Board of Directors and management, especially independence from political influence, and the possible equity participation of bilateral donors.

24. **COBANICSA:** The collection agency COBANICSA (Cobranzas de Nicaragua Sociedad Anónima) was created in 1996 as a dependent agency of the Central Bank to administer and liquidate the unrecovable portfolio transferred from the state banks. Debtors in the COBANICSA portfolio were offered advantageous conditions to liquidate, renegotiate or restructure their debt numerous times, creating incentives for delinquent borrowers not to repay on the expectation that even more favorable terms or complete debt forgiveness would be offered eventually. Weaknesses in the judiciary and legal framework also hindered COBANICSA’s loan recovery efforts, as threats of legal recourse against defaulters are not credible. COBANICSA had made four attempts to sell restructured debt to private banks but received no offers. The lack of interest was a result of the problems mentioned above but also because the implicit discounts on the debt offered by COBANICSA were lower than those offered to the debtors themselves. Given the poor performance of COBANICSA in collecting bad debts, the authorities decided to close it. In lieu of COBANICSA, a special commission composed of the Ministry of Finance and Central Bank has been established to dispose of the loans by selling them to private banks, placing them in administration with private agencies or banks, or referring them to court for legal action. To improve loan recovery, the

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12 Tier 1 capital, or core capital, is defined as equity capital and disclosed reserves plus non-cumulative preference shares. Tier 2 capital, or supplementary capital, consists of undisclosed or hidden reserves, revaluation reserves, general provisions/loan loss reserves, certain equity-type hybrid instruments, and subordinate term debt.

13 Mission estimates, calculated by taking the distribution by risk category of the banks’ portfolio for September 1997 published in the SBIF Bulletin and weighting it by the appropriate provisions (A by 0 percent, B by 1 percent, C by 10 percent, D by 50 percent and E by 100 percent).

14 About half of this capital is constituted by a promissory note from the Ministry of Finance to issue bonds.
SBIF has issued regulations requiring a 100 percent provisioning on commercial bank loans to ex-COBANICSA debtors that have not signed debt agreements or are not adhering to those agreements (Board Presentation condition of FSAC).

Capital Markets

25. Money market funds, leasing, commercial paper, private placement and securitization by non-bank issuers are practically non-existent in Nicaragua. The Managua Stock Exchange, the newest in Central America, opened in 1994. As of mid 1997, 13 brokerage houses were registered, 8 of which were partially or wholly owned by local private banks. The Exchange largely trades CBN and Government paper, with only a small share of private issues, the majority coming from one economic group. The main instruments traded are Government CENIS, which provide domestic financing of the fiscal deficit, and Compensation Bonds issued by the Government to settle property disputes. As of 1996, the total volume of equities and bonds negotiated on the local capital market reached only US$320 million, with about 70 percent of the total transactions concentrated in Government bonds. Over 40 percent of transactions in the stock exchange have less than 30 days maturity.

The Insurance Market

26. The state monopoly in insurance was abolished in June, 1995 (Law 227). Since then, 4 new insurance companies have emerged, partly or wholly owned by local banks, which compete with the state-owned insurance company (INSER). As of September 1997, insurance companies had assets of C355 million (about US$36 million), of which over 60 percent were investments. INSER accounts for 82 percent of assets in the insurance sector. Insurance companies require a minimum capital of C10 million and thus far have only issued general insurance policies. Foreign companies are not permitted to open branches but can participate in the market by investing in local companies, the purchase of local companies or full incorporation in Nicaragua.

F. Agricultural Credit

27. Nicaragua is currently emerging from a period of misguided Government interventions in rural financial markets that benefited a few and hurt the majority of the rural poor by crowding out private financial services. Until 1996, BANADES was the most important source of agricultural credit, disbursing some US$70 million per year in 1993 and generating losses estimated at US$50 million per year on average during 1991-97. More than half of all BANADES loans were in the hands of some 500 clients. In addition, the Government channeled large sums of donor funds through many projects (rural development projects) with often contradictory credit policies at subsidized interest rates. These policies impeded the development of efficient and sustainable financial institutions by promoting a non-repayment culture and unfair competition.
28. Despite prevailing deficiencies, agricultural credit has expanded. The main sources of growth have been suppliers credits, the private banks and to a lesser extent NGOs. Total banking sector credit remained fairly constant until 1996, reflecting a rise in credit from private banks that more than fully offset the decline in credit from BANADES (Chart 5). In 1997, agricultural credit appears to have increased sharply, reflecting more willingness of private banks to lend to the sector and an overall increase in liquidity. State banks' share of bank credit to agriculture has declined from 90 percent in 1993 to 19 percent in the first half of 1997. Although accurate figures are not available, there are clear indications (Chart 6) that non-bank credit (credit cooperatives, NGOs and trade credit, i.e., agricultural input suppliers, marketing agencies and agricultural processors) has increased substantially over the last few years. This has been possible in large part because non-bank intermediaries are much less hindered by inadequacies in Nicaragua's legal and regulatory infrastructure than private banks, which rely more heavily on formal mechanisms to facilitate loan recovery. While many micro-finance NGOs are very small and of doubtful sustainability, some are growing rapidly and showing some indication of long-run financial viability. Credit cooperatives, on the other hand, largely continue to be very weak because they had been politicized by Government policies in the 1980s and, in some cases, weakened further in the 1990s by external attempts to strengthen them through nonviable subsidized credit mechanisms. Agricultural trade credit is playing a large and growing role, supporting a marked expansion of agricultural exports.

29. To expand access to financial services in rural areas, the Government will remove the state from banking in general and rural banking in particular, and will encourage the development of private financial services. Private banks have already started to serve rural areas and will increase their presence further as they lend to former BANADES clients in good standing. With IDA assistance, the Government has provided a small subsidy for start-up costs to establish 22 branches in rural areas (of which 12 correspond to former BANADES branches). The Government will create an Agricultural Fund that will rationalize donor funded credit lines and operate as a second-tier lender to sustainable non-bank intermediaries at market interest rates. Land titling and modernization of the registry will be a priority to facilitate the use of land as collateral; legal and institutional reforms needed to enable the issuance of liens on movable property and inventories will also be introduced. Regulations will be reviewed with a view to reducing the cost of managing small loans without increasing the risk of default. The Government will also help disseminate successful rural lending experiences from other parts of the world, Bolivia and Indonesia for example, so that local bankers and non-bankers can adapt those lessons to conditions in Nicaragua.

30. IDA is supporting the Ministries of Agriculture and Finance to develop these initiatives through direct technical assistance and PHRD grants. To determine the current situation of rural financial markets, IDA is supporting a rural financial module as part of the Living Standards Measurement Survey and a stand alone survey to evaluate the extent of bank and non-bank financial intermediation in rural areas and financial sustainability of different intermediaries are being carried out. To encourage rural financing services, IDA will finance two seminars in March targeted at bankers and non-bankers to demonstrate the profit potential of rural financial operations and appropriate management systems. A study to analyze how current prudential regulations impact the provision of formal credit is currently being conducted, also a major study of the legal and institutions framework for secured transactions, which includes a draft of a
new secured transaction law, is about to be completed. IDA is also helping the Government find ways to reduce the risk of lending to agriculture by analyzing the feasibility of introducing sound insurance schemes, such as private crop insurance.

G. Foreign Investment in the Financial Sector

31. The Government has an interest in attracting foreign direct investment in the banking sector, in order to improve the efficiency of the sector and thus reduce the cost of credit to local firms. In addition, foreign capital will be needed to privatize state banking. However, a foreign investor contemplating entry into Nicaragua’s financial sector faces numerous obstacles. A major challenge is the unstable and unclear legal framework which creates confusion for potential investors. The inherent fragility of the banking system also represents an important risk as it raises concerns among investors over the ability to deal with cyclical downturns or major shocks to the system. In addition, the attraction to foreign investors is also reduced by a number of more general problems, including general country risk, the lack of a well functioning legal structure for business transactions, the weak enforcement of laws and contracts, the absence of a good accounting framework, and the limited size of the local market.

32. As discussed earlier, the lack of a unified and clear legal framework is a major weakness in Nicaragua’s financial system. A major concern for foreign investors is whether they can open a branch in the country and accept local deposits. A recent study on the foreign investment environment in Nicaragua by FIAS, found a confusing legal interpretation on whether foreign branches can be opened, since recent reforms do not appear to have explicitly superseded the 1979 Bank Nationalization Law, which expressly barred foreign branches from accepting local deposits. The considerable discretionary powers vested in SBIF, in large measure to compensate for the gaps in the legal framework, discourage foreign investors. For example, although the issue was not regulated explicitly by Law 125, the Superintendency has prohibited the establishment of foreign banking representative offices in the country, even though these are generally used as a first point of entry by a foreign bank. Reform of the entire financial (and commercial) legal framework is expected to be supported by a separate project supported by IDA.

H. Regulatory Framework

33. The regulatory framework for the Nicaraguan banking system is established in three key laws: (i) the 1963 Law on Banks and Other Financial Institutions; (ii) Law 125, which created the SBIF in 1991; and (iii) and Law 244 of 1997, amending the 1963 Law on Banks and Other Financial Institutions. In addition, there are more than 12 legal sources referring to the financial sector, which in some cases are contradictory and their interpretation varies according to vague definitions. To improve the regulatory framework of the banking system and the country’s institutional capacity to supervise the banking sector, the Government has adopted a Bank Supervision Action Plan which will be supported by the FSAC (Annex C).

Supervisory Scope and Capacity

34. In practice, SBIF supervision focuses mainly on the banking system and, to a lesser extent, the insurance system. While regulations have been issued for other intermediaries and data is received, SBIF does not have the resources to supervise them effectively with on-site inspections and data verification. SBIF has a staff of 80, of which half are involved in supervision and the other half in support functions.

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35. With respect to insurance, SBIF limits itself to off-site supervision, reviewing financial statements and authorizing insurance policy contracts. It has recently issued a set of insurance norms, but does not have the staff or experience to monitor them effectively. Currently, SBIF has almost no capacity to supervise capital markets, for which the regulatory framework has yet to be established. International experience suggests that the possibility of creating a specialized agency to supervise the stock exchange should be explored. Since SBIF has not built up its capacity in this area, there would be considerable advantages to establishing a separate supervisory entity that could be built up and strengthened gradually. Also, alternative mechanisms should be considered to streamline SBIF's formal supervisory responsibility, for example through truth-in-lending legislation to cover other institutions that provide credit such as pawn shops and funeral companies.

**Capital Adequacy**

36. The current capital adequacy norm establishes a minimum risk-weighted capital of 8 percent, which will increase to 10 percent by June 2000. While this is an appropriate step, given the fragility of Nicaragua's private banking sector, SBIF has not proposed or requested that banks present capitalization plans or schedules to meet the 10 percent requirement. To avoid eventual pressures to weaken or postpone the new capital adequacy norm, SBIF will discuss with banks a timetable for phasing in this new requirement. This is especially important because by mid-1999, almost the total volume of the BOFOS (currently counted as tier 2 capital) will have come due, making it even harder for private banks to increase their capital. Similarly, the capital adequacy norm does not stipulate convertibility conditions for subordinate debt categorized as tier 2 capital. There is also a need to supplement the current regulation by clarifying the conditions under which the issuance of subordinated obligations can be treated as capital.

Some banks have proposed increasing their capital by reinvesting profits, but SBIF maintains profits must first be distributed and thus taxed. In addition, banks have not been allowed by SBIF to issue shares in the stock market, on the grounds that they are not rated by a reputable international rating agency. The Bank Supervision Action Plan approved by the SBIF Council will produce improvements in the capital adequacy norm.

**Lending to Related Parties**

37. The absence of a prudential norm placing limits on individuals or groups connected through the ownership or management of a bank is a key deficiency in the current regulatory framework. The law does not provide a legal basis for placing specific limits on lending to related parties—only the formalities to be followed in approving such loans are spelled out. Issuance of such a norm is strongly resisted by bankers as it would affect many domestic interests and would have implications for the capitalization of banks. The latter occurs because, without limits on lending to related parties, a bank can lend to its own shareholders which can then use the loan proceeds to increase the capital of the bank. Under the Bank Supervision Action Plan, the Government is committed to issue such norm by May 15, 1998, to become effective by January 1, 2000.

**Asset Valuation and Classification**

38. The norm on asset valuation and classification adequately sets out the criteria for valuing various kinds of assets and the required provisioning. In applying the norm, however, SBIF does not appear to...

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16 Although private banks have made no attempts to issue shares, likely reflecting a traditional reluctance to widen ownership, this may be an important option for some banks which will face difficulties in raising their capital base.

17 Three key elements are used to assess debtor risk: repayment capacity, quality of collateral, and repayment history. Five risk categories are defined (A, B, C, D and E) with the corresponding provisioning (0, 1, 10, 50, and 100 percent) on
insist that the banks maintain, at least, the level of provisions determined by the most recent SBIF inspection. As of September 1997, SBIF publishes the bank’s asset distribution classified by risk, but it is the bank’s own classification not the classification carried out by SBIF. This makes it difficult to monitor provisions and provide early warning for banks facing problems. In cases where SBIF’s valuation differs from that of a bank, the Superintendency has the authority to defer full provisioning or to require gradual compliance. While this is normal practice in most countries, it appears that SBIF has relied excessively on this prerogative, resulting in somewhat discretionary enforcement of provisioning norms. Under the Bank Supervision Action Plan the authorities will use assisted inspections to review classification and provisioning practices in Nicaragua to prepare a modified norm and improve implementation.

**Portfolio Concentration**

39. The prudential norm on portfolio concentration appropriately defines the concepts to be included, such as risk exposure, and grants SBIF authority to define connected debtors in order to apply a limit by group. However, there are two important problems in this area. First, Law 244 (June 1997) specified that the 15 percent limit will apply to an individual or group debtor for investment in one business or enterprise. Thus, the limit can be avoided by a single borrower if the proceeds of the loan are invested in different businesses, which would make it easy to evade this norm through the creation of paper companies. Second, following negotiations between the banking sector and the Government, SBIF amended the norm on exceptions for loans above the 15 and 30 percent limit. The total amount of exceptions to be authorized was limited to 200 percent of the capital of the bank, reduced by 50 percentage points annually from June 1996. SBIF does not seem to exercise strict control on the exceptions, as it appears that some exceptions are either not authorized or it is not clear they conform to the criteria for exemptions established in the norm. Moreover, Law 244 maintains the exceptions regime, continuing to allow CBN and SBIF discretionality in exemptions to prudential norms. A sounder approach would be to encourage loan syndication among banks, rather than maintain a discretionary system of exceptions. Under the Bank Supervision Action Plan the SBIF will adopt a revised norm on portfolio concentration.

**Accounting Norms**

40. The lack of clear, uniform accounting rules forces banks and other financial institutions to incur additional processing and information-gathering costs. SBIF has produced a chart of accounts for commercial banks which is mandatory. Several accounting firms have been trying to disseminate uniform accounting rules, but these efforts have had a limited success so far. For example, most companies use different accounting principles for determining asset depreciation and the effects of inflation. The anticipated reform of the commercial legal framework to be supported by a separate IDA credit would address accounting issues.

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18 Lending to a single debtor is limited to 15 percent of the capital and reserves of the bank, and lending to a single group connected by ownership, parent company, or management, to 30 percent of the bank’s capital and reserves, as long as the portion exceeding 15 percent is covered by collateral.

19 In principle, exceptions can be authorized by SBIF provided the loans are long term, for investment in equipment, agricultural inputs or working capital for the importation of basic inputs, and other categories defined by the Ministry of Economy.

20 The 1963 Banking Law set a 15 percent limit by individual debtor, establishing an exemption mechanism to promote exports. In May 1994, without amending the Law SBIF established a 30 percent limit for debtor groups and an exemption regime broader than exports. Law 244 introduces the 30 percent limit but also establishes an exemption regime based on CBN and SBIF discretionality.
Central Credit Rating Agency
41. A Central Credit Rating Agency (Central de Riesgos) is being developed by SBIF, although it commenced operations in 1997 with debt data to September 1996. The Agency is expected to become fully operational by end-1998. The Agency has yet to gather information on collateral and data on older loans. An important problem has been the fact that not all creditors have a single Tax Identification Number, which requires considerable work to verify creditor names. As conceived, the Agency should become a useful tool for on-site inspections of the risk classification of bank debtors, facilitate the identification of defaulters on state bank loans, and help to improve monitoring of economic groups and those connected with the ownership or management of banks. Thus far, banks have not been enthusiastic users of the Agency. This may be because banks are required to make written inquiries. A more effective system would be for the Agency to make the necessary information available electronically to banks.

Non-Profit Financial Intermediaries
42. Law 244 requires SBIF to supervise non-bank, non-profit financial entities, which largely represents NGOs involved in micro-credit financing and credit cooperatives. SBIF has already decided to establish a Micro-credit Department and is in the process of recruiting staff (2 analysts and 2 inspectors). SBIF is receiving technical assistance from GTZ, has elaborated a chart of accounts and is preparing appropriate norms. Although details are still being worked out, in principle, NGOs that wish to lend only will be able to request SBIF supervision, which will be reflected in a supervision agreement and would be used by NGOs to access donor funds and financing from FNI. A number of important issues, however, have yet to be defined. First, a decision is needed on minimum capital requirements (which the Law empowers SBIF to set), although C1 million appears likely, but it is not clear whether this will apply regardless of whether the entity lends only or also accepts deposits. An appropriate approach would be to set minimum capital of C$1 million for NGOs that only lend, but minimum capital in line with commercial banks for those that also want to accept deposits. Second, it is not clear whether deposit-taking institutions will be subject to the reserve requirement, although it has been decided they will not have to pay SBIF 0.1 percent of assets. Third, the extent to which those entities providing loans and mobilizing deposits would be subject to the same prudential norms as commercial banks is not well established. Subjecting all deposit-taking intermediaries to the same prudential norms would be advisable. Under the Bank Supervision Action Plan the authorities will review and adjust the minimum capital requirements for non-bank financial intermediaries.

Discretionality
43. Supervision of the financial sector, but especially banking is characterized by the considerable and arbitrary discretion exercised by SBIF. As the legal framework for supervision is not always clear, SBIF interprets and applies norms and regulations with considerable discretion. This, however, creates unpredictability which hampers growth of the sector and inconsistent enforcement of standards, which contributes to the instability which currently characterizes the banking sector in particular. The discretionary powers of SBIF were clearly necessary in the early stage of the transition—when rules of the game were not clearly defined or rudimentary, and there was an urgent need to quickly establish a dynamic private financial system—but they now represent a source of instability in the system. At this stage, there is a need to establish a sounder legal framework, with precise and automatic rules and definitions.

I. Overall Strategy and Donor Support
44. The Government has embarked on a major reform of the financial sector to create a sound financial system, necessary for the sustained expansion of the Nicaraguan economy and the reduction of poverty. The first phase of the reforms are to eliminate the misallocation of financial resources caused by an
inefficient state banking system and to strengthen the public sector's capacity to assure an appropriate framework for the private system to flourish. To improve the allocation of financial resources the Government plans to liquidate BANADES, to privatize BANIC, restrict the operations of BCP and strengthen the financial position of FNI. To improve the legal and regulatory framework for private banking the Government will implement a targeted action plan to strengthen supervision and to fill key gaps in banking regulation (e.g., related party lending). These reforms will increase the efficiency and soundness of the financial system. However, much more will have to be done to increase the availability of term financing and to ensure that the system adequately addresses the needs of small borrowers in rural areas. A second phase of reforms, requiring more time for preparation and to be supported by a separate IDA operation(s), is expected to aim at increasing savings, developing capital markets and expanding rural financial services will include: a comprehensive and coherent program to promote and appropriately regulate securities market and the insurance industry, the development of a private pension system, an appropriate framework for non-bank rural financial institutions and a unification of the financial sector legal framework. The Government is already examining various elements of the second phase of the reform.

45. IDA, in close coordination with the IMF and the IDB, will support the Government's financial sector reform efforts. IDA will provide adjustment support through the FSAC, a technical assistance credit and a future adjustment credit that would include support for pension reform. The IMF will support the reforms through the ESAF program and technical assistance. The IDB approved in 1996 a US$32 million quick disbursing loan that includes conditionality on state bank reforms. It is also considering another operation in 1998 to support financial sector reform and is likely to support the future pension reform.
Nicaragua at a glance

**POVERTY and SOCIAL DEVELOPMENT**

<table>
<thead>
<tr>
<th>Nicaragua</th>
<th>Latin America &amp; Caribbean</th>
<th>Low-Income</th>
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<tbody>
<tr>
<td>Population mid-1996 (millions)</td>
<td>4.5</td>
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<tr>
<td>GNP per capita 1996 (US$)</td>
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<td>GNP 1996 (billions US$)</td>
<td>1.8</td>
<td>1.790</td>
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**Average annual growth, 1990-96**

<table>
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<th>Nicaragua</th>
<th>Low-Income</th>
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<td>Population (%)</td>
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<tr>
<td>Labor force (%)</td>
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**Most recent estimate (latest year available since 1993)**

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<th>Nicaragua</th>
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<tr>
<td>Poverty, headcount index (% of population)</td>
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<td>Urban population (% of total population)</td>
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<td>74</td>
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<td>Life expectancy at birth (years)</td>
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<tr>
<td>Infant mortality (per 1,000 live births)</td>
<td>46</td>
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<td>Child malnutrition (% of children under 5)</td>
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<tr>
<td>Access to safe water (% of population)</td>
<td>57</td>
<td>80</td>
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<tr>
<td>Illiteracy (% of population age 15+)</td>
<td>34</td>
<td>13</td>
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<tr>
<td>Gross primary enrollment (% of school-age population)</td>
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<td>110</td>
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<tr>
<td>Male</td>
<td>102</td>
<td>112</td>
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<tr>
<td>Female</td>
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**KEY ECONOMIC RATIOS and LONG-TERM TRENDS**

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<tr>
<td>GDP (billions US$)</td>
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<td>2.7</td>
<td>1.9</td>
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<td>Gross domestic investment/GDP</td>
<td>21.4</td>
<td>23.1</td>
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<td>Exports of goods and services/GDP</td>
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<td>Total debt service/exports</td>
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**Growth rates of output and investment (%)**

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<td>GDP</td>
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**Structural changes of the economy**

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<tr>
<td>(% of GDP)</td>
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<tr>
<td>Agriculture</td>
<td>22.4</td>
<td>23.7</td>
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<td>Industry</td>
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<td>Manufacturing</td>
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<td>41.3</td>
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<td>21.8</td>
<td>56.4</td>
<td>61.9</td>
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**Growth rates of output and investment (%)**

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<tr>
<td>Agriculture</td>
<td>-2.3</td>
<td>2.1</td>
<td>5.5</td>
<td>9.8</td>
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<tr>
<td>Industry</td>
<td>-2.5</td>
<td>-1.3</td>
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<td>4.9</td>
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<td>Manufacturing</td>
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<td>Services</td>
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<td>-1.0</td>
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<td>Private consumption</td>
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<td>General government consumption</td>
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<td>-10.4</td>
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<td>Gross domestic investment</td>
<td>1.3</td>
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<tr>
<td>Imports of goods and services</td>
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<td>2.8</td>
<td>10.9</td>
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<tr>
<td>Gross national product</td>
<td>-3.5</td>
<td>-0.2</td>
<td>19.8</td>
<td>7.6</td>
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Note: 1996 data are preliminary estimates. Figures in italics are for years other than those specified.

* The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.
### PRICES and GOVERNMENT FINANCE

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<td><strong>Domestic prices</strong>&lt;br&gt;(% change)</td>
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<td>Consumer prices</td>
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<td>Implicit GDP deflator</td>
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<td><strong>Government finance</strong>&lt;br&gt;(% of GDP)</td>
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<td>Current revenue</td>
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<td>35.7</td>
<td>28.8</td>
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<td>Overall surplus/deficit</td>
<td>..</td>
<td>-22.2</td>
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### TRADE

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<td><strong>Export and import levels (mill. US$)</strong></td>
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<td>Total exports (fob)</td>
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<td>526</td>
<td>635</td>
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<td>Cotton</td>
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<td>118</td>
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<td>116</td>
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<td>Meat</td>
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<td>75</td>
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<td>Manufactures</td>
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<td>36</td>
<td>165</td>
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<td>Total imports (cif)</td>
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<td>892</td>
<td>962</td>
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<td>Food</td>
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<td>200</td>
<td>241</td>
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<td>Fuel and energy</td>
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<td>128</td>
<td>154</td>
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<td>Capital goods</td>
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<td>251</td>
<td>234</td>
<td>308</td>
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<td>Export price index (1987=100)</td>
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<td>86</td>
<td>125</td>
<td>114</td>
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<td>Import price index (1987=100)</td>
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<td>Terms of trade (1987=100)</td>
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<td>114</td>
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### BALANCE of PAYMENTS

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<td><strong>Current account balance to GDP ratio (%)</strong></td>
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<td>Exports of goods and services</td>
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<td>344</td>
<td>644</td>
<td>781</td>
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<tr>
<td>Imports of goods and services</td>
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<td>Resource balance</td>
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<td>Net income</td>
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<td>Net current transfers</td>
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<td>Current account balance, before official capital transfers</td>
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<td>Changes in net reserves</td>
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<td>Reserves including gold (mill. US$)</td>
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<td>184</td>
<td>222</td>
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<td>Conversion rate (local/US$)</td>
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### EXTERNAL DEBT and RESOURCE FLOWS

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<td><strong>Composition of total debt, 1996 (mill. US$)</strong></td>
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<td>Total debt outstanding and disbursed</td>
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<td>IDA</td>
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