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REPORT AND RECOMMENDATION

OF THE

PRESIDENT OF THE

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

TO THE

EXECUTIVE DIRECTORS

ON A

PROPOSED FINANCIAL SECTOR ADJUSTMENT LOAN

IN AN AMOUNT EQUIVALENT TO US$300 MILLION

TO

THE REPUBLIC OF VENEZUELA

FOR FINANCIAL SECTOR ADJUSTMENT

MAY 21, 1990

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CURRENCY EQUIVALENTS

Currency Unit = Bolivar (Bs)

US$1 = Bs 43

FISCAL YEAR

January 1 - December 31

ABBREVIATIONS

BANAP	-	National Savings and Loans Bank
BANDAGRO	-	Agricultural Development Bank
BCV	-	Central Bank of Venezuela
BIS	-	Bank for International Settlements
BIV	-	Venezuelan Industrial Bank
CORPOINDUSTRIA	-	Small and Medium Industry Development Corporation
DFI	-	Development Finance Institution
FCA	-	Agricultural Credit Fund
FDF	-	Fruit Development Fund
FICAM	-	Foreign Exchange Guarantee Fund
FINEXPO	-	Export Finance Fund
FINTEC	-	Industry and Technology Development Fund
FIV	-	Venezuela Investment Fund
FOGADE	-	Deposit Insurance Corporation
FONCAFE	-	Coffee Fund
FONCREI	-	Industrial Credit Fund
FONDUR	-	Urban Development Fund
IBRD	-	International Bank for Reconstruction and Development
ICAP	-	Institute of Credit for Farming and Cattle
IDB	-	Inter-American Development Bank
IFC	-	International Finance Corporation
IMF	-	International Monetary Fund
IVSS	-	Social Security Institute
LSP	-	Letter of Sectoral Policy
MH	-	Ministry of Finance
PDVSA	-	Venezuelan Petroleum Company
S&Ls	-	Savings and Loans
SBIF	-	Superintendency of Banks
TA	-	Technical Assistance
T-bill	-	Treasury Bill

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VENEZUELA

FINANCIAL SECTOR ADJUSTMENT LOAN

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MAP

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VENEZUELA

FINANCIAL SECTOR ADJUSTMENT LOAN

LOAN AND PROGRAM SUMMARY

Borrower: Republic of Venezuela

Amount: US$300 million equivalent

Terms: 15 years, including 5 years of grace, at the standard variable interest rate

Loan Objectives: The main objectives of the proposed Financial Sector Adjustment Loan are to: (i) liberalize the financial policy environment (interest rates, allocation of credit, foreign ownership, universal banking, etc.); (ii) reduce the Government's direct role in financial intermediation (privatization and liquidation of public banks, consolidation of DFIs, rationalization of housing finance policy, limiting the BCV's role in the financial support of institutions to bank liquidity and monetary management needs); and (iii) strengthen the competitiveness and financial condition of intermediaries (adequate prudential regulations and supervision, capital standards, mechanisms for handling problem banks).

Loan Description: The loan objectives would be achieved by: (i) completely liberalizing commercial bank interest rates except for agricultural lending; (ii) substantially reducing the interest rate subsidy and the portfolio requirement for commercial bank lending to agriculture; (iii) simplifying the plethora of rates offered by government-owned development finance institutions by establishing two preferential rates at levels substantially above current levels; (iv) partially liberalizing foreign ownership of financial institutions; (v) privatizing 3 commercial banks owned by the BCV; (vi) liquidating the Agricultural Development Bank (BANDAGRO; 3% of assets of commercial banking system) and restructuring the Industrial Bank (BIV; the largest public commercial bank, with 11% of assets of commercial banking system) and its 4 regional banks; (vii) streamlining the DFI subsector with the consolidation of at least 5 funds into two new second-tier credit institutions; (viii) revamping prudential regulations, supervision, and the mechanisms for dealing with problem banks; (ix) promoting the transparency of banks' financial statements as a mechanism for forcing the recapitalization of weak institutions; and (x) reorienting BCV credit towards liquidity support of solvent institutions and promoting the use by the BCV of T-bills for open market operations.

Benefits: The proposed operation would increase the overall efficiency of the financial system and thus enhance its ability to finance investment and growth. This would result from increased resource

mobilization, improved credit allocation, and a lower cost of credit. The proposed reforms will contribute to these goals by: (i) enhancing competition in the financial sector with the liberalization of interest rates, credit allocation, and the participation of foreign banks; (ii) enhancing the transparency of the condition of intermediaries and depositor confidence in the intermediaries through improved prudential regulation and supervision of banks; (iii) reducing inefficiencies created by the excessive Government participation in the banking system; and (iv) providing adequate mechanisms for dealing with banking distress.

Risks: Given the complex nature and political implications of many of the proposed reforms, there is a risk of some delays in the implementation of the reform program. However, the momentum created by the macroeconomic reforms successfully carried out to date, coupled with the recognition within the administration, the Congress, and financial markets of the need for the reform, will help sustain the process. A special coordinating unit has been created within the BCV which, among other functions, will garner support for the reforms. In order to reduce potential political opposition to the reforms, high-ranking Government officials have been holding discussions with key members of Congress to ensure support for the proposed legal changes. A further risk, although slight in the case of Venezuela, is that failure to maintain macroeconomic stability could endanger the success of financial sector reform measures. To reduce this risk, loan conditionality will stipulate that for each tranche release the Bank shall be satisfied that the macroeconomic framework is consistent with the financial sector reform objectives.

Estimated Disbursements: Disbursement of the entire loan is expected to be completed within three years of loan effectiveness. Loan proceeds will be disbursed under the following categories: (i) financing of debt reduction (25% of the proceeds or US$75 million), (ii) three tranches for import financing (first tranche US$71 million, second tranche US$71 million, and third tranche US$76 million), and (iii) Technical Assistance component (US$7 million). Funds for debt-reduction would be available upon loan effectiveness and agreement between the Bank and the Government on a debt-reduction program satisfactory to the Bank. After February, 28, 1991 unused funds for debt-reduction can be reallocated in equal portions to the three import financing tranches. Each tranche for import financing will be disbursed upon fulfillment of specific conditions. The first tranche is expected to be disbursed soon after loan effectiveness. The second and third tranches are expected to be disbursed after successive six-month intervals. Retroactive financing in the amount of US$60 million would be available for eligible expenditures incurred after March 31, 1990. Funds for technical assistance are expected to be disbursed within three years.

REPORT AND RECOMMENDATION OF THE PRESIDENT
OF THE INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
TO THE EXECUTIVE DIRECTORS
ON A PROPOSED LOAN TO THE REPUBLIC OF VENEZUELA
FOR FINANCIAL SECTOR ADJUSTMENT

1. I submit the following report and recommendation on a proposed loan to Venezuela for US$300 million equivalent on standard IBRD terms in support of a program of Financial Sector Adjustment.

PART I - THE ECONOMY

Background

2. In the period since the first oil price shock in 1973, Venezuela has failed to realize the potential for economic development offered by its petroleum and other natural resources. The reasons for this disappointing performance have been fourfold. First, Venezuela lacked a coherent and viable long-term development approach and strategy. Instead, there was a steady increase in the extent and complexity of direct economic controls by the state. This led to increasing structural rigidities and an inability to generate sufficient growth in productive capacity to sustain the growing population. Venezuela's non-oil productive sectors grew up behind high barriers of protective tariffs and restrictions, which left them ill-equipped to compete externally or to utilize resources efficiently. Venezuela's economy was governed by a highly complex and intertwined set of regulations and subsidies, which affected virtually all modern sector activities and introduced innumerable distortions. Second, as a consequence of those policies, Venezuela has remained dependent on petroleum, which provided 95% of its export earnings before the 1986 collapse in prices and still accounts for over 70% of earnings. Third, Venezuela failed to address the problems of poverty adequately and develop effective policies and services in the social sectors. Finally, Venezuela's public institutions and public administration remained weak and could not provide the basis needed for modernization of government operations, in support of a sustainable medium-term development strategy.

3. When the newly-elected Administration of President Pérez took office on February 2, 1989, the economic situation was untenable: operating reserves were depleted, imports were accelerating in expectation of devaluation, and the Central Bank had built up arrears to Venezuelan nationals, as it stopped providing foreign exchange at the overvalued official rate. Furthermore, there were shortages of price-controlled staples, such as bread, coffee, sugar, and rice. The new Government almost immediately initiated a sweeping program of reforms, not only to correct the immediate imbalances and distortions, but also to redefine the role of the state in the economy, increase the role of market forces in the allocation of resources, and create an open, competitive economic environment, which would stimulate the efficient growth of the non-oil productive sectors. To address the problem of persistent poverty, the Government moved to convert indirect subsidies into targeted social programs.

The Initial Adjustment Program

4. The basic components of the initial adjustment program included: replacing the multiple exchange rate system by a unified market-determined

exchange rate system (under which the bolivar immediately depreciated to about Bs 36 per US$1.00, compared to the previous official rate of Bs 14 per US$1.00); rationalizing and liberalizing the trade regime, by reducing the coverage of quantitative restrictions, setting a maximum tariff rate of 80%, and eliminating exonerations of tariffs; allowing most interest rates to be determined by market forces, which led to a substantial increase in deposit and most lending rates; increasing the prices for petroleum products in the domestic market and for most public utilities; dismantling most of the domestic price control system; and curtailing fiscal expenditures.

5. From the beginning of the adjustment program, it was recognized that its success in restoring growth on a sustainable basis would require adequate external financing to permit increases in imports, investments, and international reserves during the period of adjustment toward a more competitive export sector and efficient import substitution, as well as toward higher domestic savings. As a first step, the Government sought the support of the international financial institutions. Based on the strength of the adjustment program, the IMF responded with approval in March 1989 of a First Credit Tranche purchase of SDR 343 million and approval in June 1989 of a three-year Extended Fund Facility of SDR 3.7 billion (about US$4.8 billion equivalent). Likewise, the World Bank approved in June 1989 a Structural Adjustment Loan of US$402 million and a Trade Policy Loan of US$353 million.

6. The economic program initiated in February 1989 has succeeded in correcting major internal and external imbalances in less than a year. On the internal side, the overall deficit of the consolidated, non-financial public sector has declined from 8.3% of GDP in 1988 to an estimated 1.4% of GDP in 1989. Performance on the external side was also strong: the current account balance shifted from a deficit of 7.5% of GDP in 1988 to an estimated surplus of 4.6% of GDP in 1989. This surplus was the result of a 20% increase in oil export earnings, due to strong oil prices, a surge of over 30% in non-oil exports, and a 37% decline in imports, the latter due to both the devaluation of the bolivar and a sharp decline in non-oil GDP of 9.3%. This current account outcome, helped by significant capital repatriation in recent months, made it possible to begin to rebuild international reserves from the dangerously low level of end-1988. These significant improvements in both public finances and the balance of payments, together with a tight monetary policy, have led to a rapid stabilization of inflation and exchange rates. Domestic inflation initially accelerated from a 1988 annual rate of 24% to an annual rate of 150% during the first half of 1989, due to the devaluation and increases in Government-controlled prices. However, the annual inflation rate in the second half of 1989 fell to only 32%, and is expected to fall below 30% during 1990. In a similar pattern, the bolivar continued to depreciate slightly following the sharp devaluation in March 1989, from about Bs 36 per US$1.00 to about Bs 43 per US$1.00 in October 1989. But, since that time, it has remained stable, in the range of Bs 42 to Bs 46 per US$1.00.

7. The short-run cost of correcting these imbalances has been high. In 1989, total GDP declined by 8.1%, and non-oil GDP, by 9.3%. This sharper-than-expected decline reflected: (a) overshooting the fiscal target of a 4% deficit, due in part to delays in recognizing exchange losses on letters of credit from the earlier multiple exchange rate system and in legislative approval of the investment program; (b) a sharp reduction in inventories, which had been built up in 1988 in anticipation of devaluation and decontrol of prices; and (c)

the sluggish response of private sector investment to the new policy environment. However, provided that the external financing constraint can be alleviated, it is expected that growth can resume in 1990 given: increasing private sector confidence in a more stable economic environment; an end to inventory reductions, as stocks reach normal levels; an increase in public sector investment, consistent with a fiscal deficit target of les than 2% of GDP; and increased utilization of idle capacity, which will require more imports of intermediate goods. But it should be recognized that, given the severity of the 1989 recession, even healthy growth in 1990 would not restore output to the 1988 levels.

The Current Adjustment Program

8. The Government has continued to adequately fulfill the macroeconomic performance targets established under the EFF, and on May 14, 1990, the IMF approved the purchase under the EFF associated with the December 1989 performance criteria. Also, in recent months, the Government has taken further steps in the reform program initiated in early 1989. In March, the Government announced that, consistent with its schedule for trade reform over a two-year period, as agreed under the Trade Policy Loan, the maximum tariff rate was reduced from 80% to 50%, and the share of imports covered by non-tariff barriers was further reduced. These steps, together with recent measures to eliminate barriers to foreign investors, should over the medium term stimulate investment in competitive exports and efficient import substitution. Having completed significant steps toward a macroeconomic policy environment which promises to achieve a sustainable growth path, the Government is now turning its attention to the sectoral, institutional, and legal reforms necessary to support the supply response to the macroeconomic adjustment program. Areas of priority are the programs of financial sector and public enterprise reform, both to be supported by Bank loans. A third critical area in which the Government plans to begin a reform effort is agricultural trade, pricing and regulatory policy.

Status of Negotiations with Commercial Bank Creditors

9. As noted above, restoration of growth in 1990 and beyond will also depend on sufficient external financing. For this purpose, Venezuela had been negotiating with its commercial bank creditors on an agreement to reduce the burden of the existing debt overhang. After prolonged negotiations, on March 20, 1990, the Government and members of its Bank Advisory Committee announced agreement in principle on the basic terms of options to be offered to the banks holding about US$20 billion of Venezuela's external debt. The options to be offered to the creditor banks are: principal discount bonds and par bonds with below-market interest rates, which would have principal fully collateralized and interest payments partly collateralized; temporary interest reduction bonds, which would have partial collateralization of interest payments during the five years of below-market interest rates; cash buybacks at a fixed price, taking into account the secondary market price for existing debt; and debt conversion bonds, in proportion to purchases of new money bonds. Soon after achieving this agreement in principle, the Government cleared its arrears with the commercial banks. As soon as the term sheets for these options are finalized, the creditor banks will be asked to indicate how much of their existing claims would be offered for buyback or exchange under these options. Once this final package is known, Venezuela would formally seek Bank and IMF support, as well as that of official bilateral sources, for this program of debt and debt service

reduction. The impact of this proposed program is discussed briefly in the following section.

Medium-Term Macroeconomic and Policy Framework

10. The Government's medium-term strategy is designed to restore high rates of growth of output and employment in a context of low inflation and viable balance of payments. This growth would be achieved through a fundamental restructuring and diversification of the economy which would result from the implementation of deep-rooted structural reforms aimed at: (a) reducing the scope of the public sector in the economy through fiscal restraint, deregulation, and privatization of selected public enterprises; (b) enhancing the efficiency of resource use by liberalizing trade, allowing prices to move to economic levels, and redefining the relationship between the government and public enterprises; and (c) strengthening the financial sector and increasing its efficiency. The objective is to strengthen national savings, encourage private investment, and increase economic efficiency.

11. Venezuela's medium-term macroeconomic and policy framework, taking into account the possible impact of the proposed debt reduction program, is described by the projections presented in Annex I. These are the Bank's preliminary revisions of projections which had been agreed among the Government, the Bank, and the IMF in late 1989. These revised projections show a smaller financing gap (prior to debt reduction) than the projections of late 1989 due not only to the assumption of slightly higher oil prices but also to the initial impact of the adjustment program in boosting non-oil exports and encouraging capital repatriation (which was apparently used to pay off overextended credit lines and thereby reduces projected interest payments). Discussions will begin soon between the IMF and the Government on targets for the 1990/91 program year under the EFF, and the outcome of these discussions, as well as any further changes in the medium-term external outlook, may require updating of these projections. The scenario presented is consistent with annual GDP growth of about 5% during 1990-95, and is predicated on the path of roughly constant real oil prices now projected by the Bank. The scenario assumes the Government's continued commitment to the ongoing reform program. Also, the scenario assumes that the proposed program of debt and debt servic. reduction is successfully implemented, with virtually all of the eligible debt offered for buyback or exchange; this results in lower interest payments to the commercial banks on the order of US$700-800 million annually.[1/] Given this assumption, the proposed debt reduction program closes the financing gap which would otherwise arise. Finally, the scenario already takes into account the proposed Bank lending, including the two adjustment loans in FY90 and including the possible Bank support for the debt reduction program which is necessary to achieve this scenario.

12. The most notable features of this scenario, over the next five years, are as follows:

(a) Gross fixed investment would need to grow from about 20% of GDP in 1990 to about 25% by 1995, with an increasing share of private sector

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1/ The scenario arbitrarily assumes a particular allocation of existing debt among options; the results would not change significantly for other allocations.

investment; gross national savings also would need to grow to about 26% of GDP by 1995;

(b) Per capita private consumption would grow at an annual average rate of 1.3% over 1990-95;

(c) The consolidated public sector moves to a fiscal surplus, reflecting rising domestic revenues from the petroleum sector and declining external interest payments as a share of GDP. If this were to occur, the already small stock of public domestic debt would be progressively reduced, and the public sector would be a net lender to the private sector;

(d) Non-oil exports would grow at a rate of 10-20% per annum in nominal dollar terms (compared to over 30% growth in 1989); nevertheless, the share of petroleum sector exports would remain high because non-oil exports are starting from a small base;

(e) The current account as traditionally defined by the Central Bank would be almost balanced, with deficits of less than 1% of GDP in most years before 1995. However, deducting the imputed private interest income on assets held abroad which is counted in these figures, the deficit would be on the order of 2% of GDP. This favorable current account position reflects the impact of the assumed debt reduction plan, without which the current account deficit would increase by about 1.3% of GDP;

(f) Gross international reserves, including gold at US$300 per ounce, would be rebuilt to the level of 7-8 months of imports, which is prudent given the country's dependence on volatile oil revenues and the Government's intention to maintain a floating exchange rate regime and an open capital account. Such reserve accumulation, given the projected increasing oil prices, would provide an essential cushion against temporary oil price declines. Such a level of reserves is essential to provide confidence to foreign exchange and domestic financial markets and thereby to sustain the recovery of investment. Based on fluctuations in the price of oil during the 1980s, one standard deviation reduction in the projected price of oil in the 1990-94 period is equivalent to US$4.6 per barrel. Such a reduction in a single year would reduce Venezuela's export earnings by almost US$3 billion in that year, equal to one third of the average level of liquid reserves projected for the 1990-94 period.

(g) MLT capital inflows would be 3-5% of GDP in 1990-93; this would finance the current account deficit, the buyback and collateralization of some part of the commercial bank debt under the proposed debt reduction program (which will cost US$3-4 billion), and the essential build-up of international reserves. By 1994, as the trade surplus grows toward 3% of GDP, MLT capital inflows would begin to fall toward 2%; and

(h) Venezuela's external debt ratios, following the debt reduction program, would fall significantly to levels consistent with

sustainable growth: the debt service to export ratio would decline from almost 40% in 1988 to about 20% in 1991 and beyond.

13. In implementing this macroeconomic framework, particular attention must be given to the following. First, there must be a policy environment conducive to the growth of private investment, which would generate increased demand for credit from the banking system and require expanded imports of capital and intermediate goods. An important thrust of the Government's program of deregulation and liberalization has been to create such an environment. Defining in a more limited way the role of public enterprises, privatizing selected public enterprises, and ensuring efficient provision of essential services (such as ports and telecommunications) by the relevant public enterprises are also essential and would be supported by the public enterprise reform loan. Second, there must be an efficient and sound financial system to effectively channel the investment of both private and public savings. Creation of such a financial system is the objective of the financial sector reform program. Third, to ensure that public sector resources are not wasted on uneconomic investments by the public enterprises, a new and sound relationship must be established between the Government and the public enterprises. A framework must be created, in which the investment decisions of those enterprises (other than natural monopolies) are subject to market discipline and the natural monopolies are guided by appropriate regulations. This is the thrust of the public enterprise adjustment program. Fourth, to ensure that the expansion of net credit to the private sector does not simply lead to capital flight, the Central Bank must maintain sufficiently attractive real interest rates on domestic assets and avoid overvaluation of the exchange rate. And, fifth, careful attention must be given to the management of international reserves to ensure that, during periods in which the price of oil is at or above its expected trend levels, reserves are accumulated to provide a cushion against future price declines. Achieving all of these objectives will require careful and continuous monitoring. For this, the existence of the IMF's EFF program will make an important contribution in the near-term. Under the proposed operation, maintenance of a macroeconomic framework consistent with the objectives of the adjustment program is a condition of effectiveness and second and third tranche release.

14. In addition to the crucial contribution made by the international financial institutions (IFIs) to the development of the policy framework described above, the IFIs have an important role to play in the financing required for returning Venezuela to a sustainable growth path. The relative role of the IFIs must be viewed in the context of the proposed debt and debt service reduction program now under negotiation. Under the proposed program, the major contribution of the commercial banks would be to relinquish claims equal in present value terms to 25-30% of the face value of their existing claims. (There is an option under the program for the banks to contribute new money, but the maximum amount of new money (net of rights for debt-equity swaps at par) is US$700 million.) During 1990-95, the program would reduce by about US$600 million annually the net financing required by the growth path in the scenario presented in Annex 3. Given this assumed level of debt and debt service reduction, the remaining annual average of net disbursements during 1990-92 would be about US$3.8 billion and during 1993-95 only about US$1.2 billion. During 1990-92, the World Bank would contribute about 22% and the IMF about 38% of these net disbursements; these figures include estimates of additional lending to support the debt and debt service reduction program. These net disbursements would not only support the policy reform programs to which they are directed but

also make possible the implementation of the debt reduction program and the continued build-up of international reserves to prudent levels. Over 1990-95, the Bank (based on the current lending program) would contribute about 24% and the Fund, 18%. Given the fact that the Bank had no exposure to Venezuela in 1989, the planned increases in net disbursements by the Bank would not be excessive: although the Bank's share of the reduced debt stock would rise to about 12% in 1998, projected debt service to the Bank in that year would be only 2.2% of total exports.

PART II - FINANCIAL SECTOR STRUCTURE AND SIZE

Structure of the Financial System

15. The Venezuelan financial system is conceptually based on a system of specialized banking whereby different types of institutions have different functions. Commercial banks were conceived to borrow and lend short-term for working capital and other short-term needs. Finance companies were to lend for fixed assets and consumer goods as well as support the development of commercial companies. Mortgage banks were to borrow using long term instruments and lend for construction, home improvement and expansion, and home and commercial property purchases. Savings and loans (S&Ls) were to also borrow long term and lend for consumer purchases of homes. In practice, there is a de facto universal banking system since financial institutions have formed financial groups whereby a group offers clients a full array of financial services and diversification options.

16. Table 1 depicts the structure of the financial system as of end-1989. Presently, there are 41 commercial banks, 16 mortgage banks, 29 finance companies, and 20 S&Ls. There are also 31 leasing companies, 3 pension funds, around 27 liquid asset funds, brokerage houses, and foreign exchange offices.[2] As the table shows, commercial banks are the most important banking institutions, accounting for 73% of assets of the financial system. From 1987 through 1989, commercial banks and finance companies increased their share of assets, funds attracted and credits, while mortgage banks and S&Ls decreased theirs.

17. The system's six largest commercial banks account for 57% of the total assets of the system and 63% of total bank deposits. These commercial banks are part of the six largest financial groups which are dominant in the financial sector. This concentration has increased during the past two years. Below this group are 15 medium-sized commercial banks which hold between 1% and 4.9% of deposits each (29% of the total), and 20 small banks which hold less than 1% of deposits each (8% of the total), with less than 1% of deposits.

2/ These latter institutions are not included in the percentages indicated in this section.

Table 1: STRUCTURE OF THE FINANCIAL SYSTEM
(Billions of Bolivares, as of 12/31/89)

	No. of institutions	Assets Total	Assets %	Deposits Total	Deposits %	Equity Total	Equity %	Leverage[a]
Commercial banks:	41	549.3	73	385.8	71	31.7	78	16.3
Private national	31	454.4	61	355.4	66	26.4	65	16.2
Private foreign	2	4.8	1	2.3	0	0.5	1	8.3
Public	8	90.0	12	28.0	5	4.7	12	17.8
Mortgage banks	16	69.9	9	58.9	11	3.2	8	20.5
Finance companies	29	84.4	11	64.3	12	5.9	14	13.2
Savings and loans	20	45.2	6	32.6	6	-	-	-
System total	106	748.8	100	541.6	100	40.8	100	17.4

Source: BCV.

a/ Total debt/total equity.

Monetary Aggregates and Financial Deepening

18. Over the last ten years, the stock of money broadly defined (M3, which includes currency, demand, saving and time deposits, as well as mortgage bonds) has fluctuated widely (see Table 2). M3 rose over the early 1980s, reaching a peak of almost 42% of GDP in 1984. It has since declined steadily, to 27% of GDP in 1989, the lowest figure in the decade. The drop in monetization coincided with the period of negative real interest rates. In 1987 and 1988, interest rates were negative in real terms by about 10 percentage points. The shift to market-determined interest rates should facilitate a remonetization of the economy in the near future.

Table 2: REAL INTEREST RATES AND FINANCIAL DEPTH, 1980-89

	Real interest rates[a]		Ratios to GDP (%)[b]			Real money indices[c]		
	Lending	Deposit	M1	M2	M3	M1	M2	M3
1980	-7.0	-5.4	15.0	31.4	35.4	108.0	87.1	94.0
1981	-1.8	-0.4	14.4	33.1	35.8	104.2	94.4	98.0
1982	5.2	7.5	13.3	34.7	36.4	89.1	91.1	93.2
1983	7.6	10.7	15.0	39.5	40.8	108.8	107.3	107.7
1984	1.0	3.2	15.1	40.6	41.5	100.0	100.0	100.0
1985	0.0	3.2	15.0	39.4	40.1	103.1	99.7	99.3
1986	-1.6	2.1	15.2	37.5	38.0	112.3	103.1	102.2
1987	-14.4	-11.2	14.4	34.1	34.1	107.3	97.2	91.0
1988	-11.8	-8.5	13.4	29.8	29.8	97.3	78.0	77.8
1989	3.0	0.0	10.5	27.0	27.0	56.9	58.9	58.9

Source: The BCV.

a/ Yearly averages deflated by consumer price increase (CPI) over the year; for 1989, end-of-year interest rate is deflated by the increase in consumer prices in the second semester only.
b/ Average money stock over the year.
c/ Stocks at the end of the year, deflated by CPI, index 1984 = 100.

19. The decline in M3 as a proportion of GDP was accompanied by important changes in the composition of monetary aggregates. Given the extremely low interest rates, the public sought liquidity. From the peak monetization in 1984 to 1988, sight deposits increased from around 29% of M3 to around 38%. This process was reversed in 1989 due to the rise in interest rates. Between February and December 1989, time deposits rose sharply, surpassing their share in M3 in 1984, prior to the disintermediation period. The opportunity cost of holding non-interest bearing demand deposits rose considerably, and hence the public shifted into fixed term remunerated accounts.

20. Traditionally, the most important source of M3 has been regular deposits. However, liquid asset funds have become one of the most important single sources of funds in recent years. Liquid asset funds are a mechanism to sell fractions of a trust fund, with an obligation to repurchase such fractions at a premium corresponding to interest accrued during the period. Liquid asset funds require a higher minimum investment than ordinary accounts, and their yield to investors depends on the holding period. They are not a true "investment fund" as they are generally conceived, but are simply a secondary funding mechanism for financial institutions. Commercial banks, mortgage banks, and other financial institutions created liquid asset funds to offer investors higher returns than on other deposit accounts whose interest was fixed by the BCV at negative real rates. Further, liquid asset funds are not subject to reserve requirements.

21. Liquid asset funds represented 16.5% of M3 in December 1986, and reached a peak of 30% by December 1988. Although no reliable figures exist on the volume of these funds, their share of M3 does not seem to have declined in 1989 despite the upward adjustment in interest rates. Given that liquid asset funds were created as a way of circumventing interest rate ceilings in the first place, a financial reform oriented to achieve market-determined interest rates can be expected to be accompanied by stronger substitution of deposits away from liquid asset funds in the future.

Monetary Policy: Instruments and Constraints

22. The BCV in the past played a pervasive role in the financing of activities in most sectors in the economy. In particular, the BCV expanded credit by: (i) financing government deficits through the purchase of domestic public debt; (ii) subsidizing public and private enterprises through foreign exchange guarantees at heavily over-valued rates; (iii) providing liquidity to the banking system through a liberal rediscount program, and (iv) supporting special sectoral incentive programs and channelling them through the financial system.

23. Monetary policy was subordinated to the achievement of these objectives, and was made even more precarious by the virtual absence of flexible instruments of monetary control. The result was that the BCV only had a loose grip over money supply and very little reliance was placed on monetary regulation through the price mechanism. Moreover, some of these activities (like the complex array of sectoral incentive programs) were premised on, and operated through, the application of interest rates well below their market-clearing levels. Reserve requirements failed to have a disciplinary effect on money supply as these requirements were frequently transgressed and their highly differential nature meant that money supply was vulnerable to portfolio shifts

across different types of deposits and institutions. Monetary control was exercised in a rudimentary fashion by ad-hoc policies restricting BCV credit to banks or inducing additional bank deposits at the BCV's money desk. However, the flexibility of the BCV's money desk facility as an instrument of monetary contraction had been lost due to the fact that the rate paid was only infrequently adjusted according to the monetary objectives of the BCV. Aside from the relaxation of monetary control, the direct nature of these instruments had other lasting side-effects: (i) it increased the BCV's responsibility for the losses of financial institutions; (ii) it made monetary policy more vulnerable to political pressures; and (iii) it resulted in the bureaucratization of monetary policy-making.

24. The new economic policies pursued after February 1989 sought to stem the first two categories of credit expansion listed above (para 22) through the reduction of public sector deficits and the unification of the exchange rate. Domestic financing of the budget deficit is estimated to have decreased by 4.7% in 1989, and the budget is expected to move into surplus by 1991. At the same time, the BCV has scrapped all exchange guarantee programs, and the flotation of the exchange rate has reduced the BCV's responsibility for losses arising from discrete devaluations. The third source of domestic credit expansion, the provision of liquidity to the banking system, has been curtailed significantly since November 1989, with only one bank receiving any BCV credit as of February 1990. From October 1989 to February 1990, rediscounts had been cut by 70%. Finally, as regards the BCV's financing of special incentive programs through the financial system, the actions so far have been mixed and in some cases have even been regressive. At present, the only sectors that receive preferential treatment by the banking system are agriculture and housing. However, a network of specialized financial institutions and development funds continues to fragment credit markets.

25. The BCV's efforts at monetary control will be constrained in the future by three sources of monetary expansion: (i) the lingering impact of the previous fiscal and exchange rate management practices, as old public long-term debt continues to compromise the BCV's earnings capacity in the future and prior foreign exchange commitments are satisfied; (ii) liquidity credits to a few financial institutions that can only be phased out as mechanisms for addressing the problems in ailing institutions are developed and other sources of liquidity emerge; and (iii) the expansion of the external debt/equity swap program under a new auction mechanism. Monetary policy must play a key role in ensuring that these factors or constraints are consistent with the broader objectives of sustainable growth and price stability.

26. The BCV is currently in the process of reevaluating its monetary instruments with a view to enhancing their flexibility and effectiveness while minimizing their disruptive effect on banking. The BCV is aware of the need to move toward a system of open market operations and gradually to phase out its money desk and general or sectoral rediscount operations. To this effect, the BCV has issued short-term paper, is promoting the creation of a secondary market in BCV bills, and is developing an open market capability. The BCV is also in the process of revamping the reserve requirement regime with a unification of all requirements at 12%.

PART III - MAIN FINANCIAL SECTOR ISSUES

27. The main issues affecting the financial system are: (a) excessive government regulation of interest rates and credit allocation in the economy; (b) the large number of government-owned financial intermediaries (banks and development funds), many of which are either bankrupt or poorly managed; (c) the insufficient transparency in the BCV's operations with the public sector and the financial system, which makes the evaluation and prioritization of credit policies difficult and undermines the ability of the BCV to carry out monetary policy effectively; (d) a weak institutional and regulatory environment, and inadequate supervision of financial institutions by the Superintendency of Banks (SBIF); and (e) the weak financial condition of an important number of private financial institutions and inadequate mechanisms to deal with ailing banks.

Excessive Government Intervention in the Determination of Interest Rates and Credit Allocation

28. Commercial Bank Interest Rates. The liberalization of interest rates was one of the first measures adopted by the new Government in 1989. Complete deregulation was achieved by March 1989, but was subsequently rendered void by a Supreme Court ruling that required the BCV to set interest rate limits. Since then, the BCV has been adjusting interest rate limits. Despite the stated objective of the BCV to adjust interest rate ceilings so as to replicate the market rate, interest rates have remained mostly negative in real terms and adjustments in the ceilings have not reflected a consistent adjustment policy. For instance, after raising the maximum lending rate to 45% in November 1989, the BCV subsequently reduced it in three steps to 35% by end-March 1990. This experience has shown that a system of flexible ceilings cannot replicate full market determination of interest rates for three reasons: (i) interest rate ceilings are likely to be set in a backward-looking fashion whereas market rates are determined to a greater extent in a forward-looking fashion, (ii) the existence of interest rate regulations increases the vulnerability of the BCV to political and social pressures; and (iii) each adjustment in the ceiling is interpreted by the banks and the public as a signal on monetary objectives, thereby affecting the market's expectations.

29. The liberalization of interest rates will have a small impact on the Government's fiscal accounts from the increased public debt service burden. The volume of public and publicly guaranteed internal debt amounted to Bs 101.5 billion (US$2.36 billion equivalent) as of end-1989. Of this amount, about 71% was issued prior to April 1989 at a fixed interest rate in the 8-15% range. The remaining 29% was issued at a variable rate[3/] based on the average commercial bank deposit rate, and is currently yielding around 30%. Thus, the annual debt service cost of a 10 percentage point rise in interest rates would be US$68 million. Furthermore, 69% of the total volume of public debt is held by public entities including the BCV and the portfolios managed in trust by the BCV. Hence, a significant portion of this increase in the Treasury's debt service would result in a quasi-fiscal gain of US$47 million for these entities. The fiscal cost of a 10 percentage point rise in interest rates would therefore

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3/ For the purposes of this calculation, it is assumed that the outstanding volume of zero-interest T-bills has been converted to variable rate debt according to the exercise presented in para 48.

be US$21 million on a consolidated basis. This calculation illustrates that the net fiscal effect of the liberalization would in any case be manageable. Also, given the new policy of fiscal restraint, it can be assumed that the Government's internal borrowing requirement will be near zero and hence it will not need to float much additional debt at the higher interest rates.

30. Since interest rates will become the focal point of competition, credit allocation and financial discipline, it is imperative that the public be aware of and understand the range of services and rates available. The non-competitive nature of the sector in the past has led to a lack of uniformity in interest rate calculation methods and insufficient information disclosure. Users of financial services need to be made more discriminating, so that they can exert the market discipline that will be expected of them in the new environment.

31. Preferential Interest Rates. The agricultural sector is the beneficiary of a rediscount and a lending rate ceiling 7 percentage points below those for other sectors. In addition, there is a plethora of interest rates applied by each development fund. In December 1989 when interest rates peaked, nominal lending rates fluctuated between the general adjustable lending rate ceiling of 45% and the 3% fixed rate for peasants under the agrarian reform law. In between there is a wide gamut of rates which, in April 1990, stood at about 15% for subsidized housing, 14% for certain agricultural products, 22-29% for certain industries, and 28% for other agricultural loans. Furthermore, several government-owned financial institutions (funds) segment the market even further by charging different rates based on the activity or sector being financed. The Venezuela Investment Fund (FIV), which acts as second-tier lender to several funds, also charges differential interest rates to the various funds, not based on clear criteria. The first column in Table 3 illustrates the spread in interest rates for a range of development funds.

32. The prerogative to set interest rates is decentralized in each fund, and indeed each fund has its own policy regarding interest rates. Therefore, the adjustment of rates does not occur in a consistent fashion, and an economy-wide adjustment of rates becomes very burdensome administratively and politically. This represents an erosion of the BCV's ability to regulate credit and a loss of discipline for the public sector generally.

33. Agricultural Credit Requirement for Commercial Banks. Restrictions on the allocation of credit according destination of the funds segment markets and therefore preclude the full market determination of interest rates. Portfolio requirements fragment the credit market, and by themselves result in a proliferation of interest rates. Commercial banks are subject to a 22.5% lending portfolio requirement for agriculture and agroindustry. Agricultural credits are in some cases made at interest rates well below the maximum lending rate applicable to agriculture, which implies that the requirement imposes a binding restriction on banks' activities. Also, there is evidence that some of the credits that purportedly satisfy the requirement are being channeled to other uses.

Table 3: COMPARISON OF CURRENT VERSUS PROPOSED INTEREST RATES
(in percent, as of April 15, 1990)

	Lending rate floors/ceilings	
	Current	Proposed[a]
Commercial banks:		
Commercial lending	35	35
Agricultural lending	28	30
Fondo de Inversiones de Venezuela (FIV):		
Direct investment loans	18	32
Tourism projects	17-22	32
Loans to public enterprises	28	32
Loans to FONCREI	22	30
Loans to CORPOINDUSTRIA	17	30
Loans to Agricultural Credit Fund	17	30
Fondo de Crédito Agropecuario (FCA)	14	30
Fondo de Crédito Industrial (FONCREI)	22-29	32
Fondo Financiamiento Exportaciones (FINEXPO)	25	32
Fondo de Desarrollo Urbano (FONDUR)		
Tourism projects	12	32
Purchase of real estate	12	32
Mortgages	15	32

a/ On development loans to end-users, 85% and 90% of average commercial bank lending rate for agriculture and other sectors, respectively. On second-tier lending, average borrowing rate of commercial banks. It is assumed that commercial bank interest rates continue at current levels--i.e., 35% average lending rate and 28% average deposit rate.

Excessive Public Sector Participation in the Financial System

34. Public Sector Commercial Banks. The public sector currently owns nine commercial banks in Venezuela. The Central Government owns six (the Industrial Bank of Venezuela [BIV], the Agricultural Development Bank [BANDAGRO], and four regional banks), and the BCV owns three (Banco República, Banco Italo-Venezolano and Banco Occidental de Descuento). All of these banks have poor asset quality, although the extent of the problem varies from bank to bank. The Government has already agreed to privatize the three banks owned by the BCV, and has named FIV as the agent for privatization.

35. BANDAGRO is one of several financial intermediaries which the State has established to assist the agricultural sector. Since its inception, BANDAGRO, a public sector commercial bank, has had difficulties attracting deposits and has increasingly depended on the Government for support. In fact,

it has been under intervention since 1981. Several commissions have been established to restructure the bank, yet none has been successful. Among the findings of an "intervention committee" in February 1989 were: (i) BANDAGRO's net losses exceed its capital (its bad loan portfolio equalled 61% of total loans at the end of August 1989); (ii) it has US$500 million in foreign currency debt obligations (against US$200 million in total book assets[4/]); (iii) it is unable to act as the financial arm of the agricultural sector; (iv) during the last few years, the bank's new loans have been limited to short-term financing for cereal production; (v) it has a serious credit documentation problem that has prevented it from obtaining payment on many loans; (vi) it sustains net losses each year, including in 1989; (vi) it lacks a computer system, operating procedures and administrative guidelines, which has led to interest accrual mistakes and other accounting difficulties; and (vii) it is heavily influenced by government agencies and unions which limit its ability to make objective financial decisions. In the committee's view, the institution should be either restructured or liquidated.

36. BIV is Venezuela's oldest state-owned commercial bank, and was created to support the industrial sector although in practice it became the bank of the public sector. BIV is very heavily dependent on government funding, with the consequent prevalence of political interference which has impeded it from making its own decisions and attaining its objectives. It is technically insolvent, and confronts serious liquidity, administrative and economic problems: (i) its asset structure is heavily burdened with government paper and commitments which are not properly serviced; (ii) it is heavily dependent on volatile government deposits (48% of BIV's total); (iii) it acts largely as an executor of the Government's short-term financial decisions; (iv) the term structure of its assets and liabilities is heavily mismatched; (v) its loan portfolio is of poor quality with approximately one third of its credits past due at the end of August 1989; (vi) some of BIV's assets are overvalued or represent an activation of losses, while others are undervalued (such as holdings of dollar-denominated bonds which are recognized at Bs 4.3/US$); (vii) off-balance sheet contingent accounts are very large to the extent that total net worth would be lost if only 7.3% of guarantees and other contingent obligations were called.

37. The four regional banks owned by BIV also have large volumes of non-performing loans which exceeded their total net worth at the end of 1989 on a consolidated basis. More important, the role and functions of these institutions in BIV's strategy is not clear.

38. Need to Re-evaluate the Functions of Development Finance Institutions. There are 23 state-owned development finance institutions (DFIs)--excluding commercial banks. While DFIs were created to provide long-term financing, several are used as conduits to implement political decisions through the channeling of funds to particular projects at below-market interest rates. In general, their loan portfolios are of poor quality, their funding comes primarily from the Government, and their management teams need to be improved. DFIs are mostly second-tier institutions operating outside the purview of the regulatory authorities and the BCV. They are controlled by the corresponding sectoral ministries (except for FIV, which has ministerial rank), and obtain their funding from direct transfers of the Government, loans from the FIV, or

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4/ As of September 30, 1989, valued at a rate of exchange of Bs 43/US$.

government-guaranteed external financing. The most important DFIs are: the FIV, the Industrial Credit Fund (FONCREI) which supports large and medium-sized private corporations; the Small and Medium Industry Development Corporation (CORPOINDUSTRIA) which finances small-scale private sector companies; the Export Finance Fund (FINEXPO); and the Agricultural Credit Fund (FCA).

39. FIV was established in 1974 to manage the windfall the country obtained from the oil price hike of the early 1970s. It has principally financed state enterprises including electricity generation. Among other functions, it acts as a development finance intermediary. In this role it has mostly acted as a second-tier lender to public commercial banks and development funds. Its current portfolio amounts to only US$65 million. It has in the past lent at very low interest rates (7.5-12% per annum).

40. FONCREI was also created in 1974 to provide medium- and long-term credit to industry. It is a second-tier institution which only lends through the commercial banking system yet retains up to 40% of the credit risk of the final borrower. Its main sources of funds are direct transfers from the Government and lines of credit from domestic (FIV) and foreign (Andean Development Corporation, IDB) sources. FONCREI's cost of funds is approximately 24% while the average return on its loan portfolio is 10%. A large part of its loans are at fixed rates, which is gradually decapitalizing FONCREI.

41. CORPOINDUSTRIA is a mostly first-tier lending institution created to finance small-scale industry. It has a few joint programs with the banking system. It lends at longer maturities and lower interest rates than FONCREI, with interest rates ranging from 6% to 20% per annum. Its main sources of funds are government transfers (70%) and lines of credit from FIV and foreign sources (30%). As in the case of FONCREI, it confronts a significant mismatch between the average interest rate in its loan portfolio and its cost of funds. In addition, its loan supervision is weak and its procedures for loan recovery are poor.

42. FCA was created in 1976 as a second-tier lending institution to provide medium- and long-term credit to the agricultural sector through commercial banks. FCA's computed cost of funds is 14%, but this does not include the opportunity cost of the funds it receives from the Government or the exchange rate risk on a line of credit it obtained from the IDB, its major sources of funds at present. In spite of this measure, FCA is facing losses since the average return on its loan portfolio is below 7.5% per annum while it is charging its borrowers 14% per annum.

43. FINEXPO was created in 1973 to support the country's nontraditional exports. It provides pre- and post-export financing and technical assistance to exporters. FINEXPO's main sources of funds are direct transfers from the Government and BCV rediscounts. Its portfolio amounted to about US$57 million as of June 1989. Short-term credits are provided for pre-export financing to domestic producers. Post-export credits are provided to foreign importers of Venezuelan goods and have longer maturities. It also provides guarantees to third parties, an activity which has grown quite rapidly in the recent past.

44. The most important deficiency of DFIs is that their collective role is not clearly defined and their individual goals and functions overlap. The Government has not clearly determined which areas cannot be supported by private

financial intermediaries, yet warrant State assistance because of other economic justifications. Once the role of the public sector and individual DFIs has been determined, the appropriate structure of DFIs can be designed to fit this role and clear performance criteria can be developed.

Distortions in the Financial System caused by BCV Operations

45. There are two challenges ahead for the BCV: (i) to make explicit its quasi-fiscal contribution to financing the national budget and the financial system, and (ii) to develop appropriate instruments of monetary control. These two objectives are interrelated to the extent that quasi-fiscal financing by the BCV limits the use of some instruments of monetary control and places an onerous burden on the remaining instruments.

46. BCV Credit to the Public Sector. BCV financing of government deficits occurs through its holdings of unremunerated Treasury bills (T-bills), its purchases of low-interest long-term Treasury bonds at face (above market) value, and the BCV's holdings of converted government external debt purchased under the debt/equity swap program. BCV credit to the public sector is subject to an overall ceiling based on the average fiscal revenues in the preceding five years. However, this ceiling does not include external debt issued within the last three years, or the BCV's rights to government bonds earned through the external debt swap program. Therefore, credit ceilings have often been surpassed in practice, with a corresponding loosening of fiscal discipline and crowding out of credit to the private sector.

47. T-bills of maturity less than one year must be repaid by the Government within the same fiscal year in which they are issued. The spirit of providing only intra-year financing to the Government is often transgressed when the T-bills are converted into long-term bonds at the end of the fiscal year in order to finance their redemption. Moreover, the lack of fixed-term negotiable T-bills has precluded the use of these instruments in open market operations by the BCV. Instead, the BCV has had to issue its own short-term bills, at the risk of generating quasi-fiscal losses. T-bills must, by law, be placed through a preferential list of economic agents, implying that they need not carry market rates of interest. In practice, only the BCV and commercial banks hold them, the latter as assets satisfying reserve requirements. The use of T-bills as a reserve asset negates the monetary objective of the reserve requirement; the requirement becomes merely a vehicle for forced lending to the Government.

48. As of end-February 1990, the BCV held no T-bills and commercial banks held Bs 11.4 billion (US$265 million equivalent) in T-bills. On the one hand, if these T-bills were eliminated and assuming that the financing requirement of the Treasury remains constant, the Treasury would have to replace them with bonds (which yield a variable rate based on the average commercial banking deposit rate, currently standing at 30%). The fiscal cost to the Government of paying interest on this amount would be US$80 million per year. On the other hand, T-bills are held by commercial banks in satisfaction of legal reserve requirements; if they were eliminated, this amount would be deposited in unremunerated accounts at the BCV. Thus, the Treasury's fiscal loss would be compensated by a quasi-fiscal gain for the BCV, and there would be no fiscal effect on a consolidated basis.

49. Credit to the Financial System. BCV rediscounting, advancing and repurchasing of securities in the hands of financial institutions has often been used to support specific sectors in the economy and bank solvency rather than to provide liquidity to banks or as an instrument of monetary regulation. The liberal rediscount policy has had deleterious effects in many respects: (i) it has had a large expansionary effect in monetary terms; (ii) it has subjected the BCV to political pressures and has implied a sharing of responsibility for bank distress with the monetary authority; (iii) it has inhibited the development of the interbank and secondary debt markets, which has in turn retarded the development of the BCV's open market capability as an instrument of monetary control; and (iv) in so far as it has been used as a covert means of keeping insolvent institutions afloat, it has permitted delays in the resolution of bank crises during which time losses have mounted. Access to the rediscount window had been made attractive by: (a) the heavily subsidized rediscount rate; (b) the relatively long maturity on the rediscounts permitted by law (up to one year): (c) the valuation of underlying instruments or guarantees at face (above market) value; and (d) the lack of penalties imposed on heavy and/or frequent borrowers.

50. The subsidy element of the rediscount window has been cut down significantly in recent months, as the non-preferential rediscount rate has been increased to about market lending levels. However, the persistence of a special rate for agricultural rediscounting still signals the possibility of using the rediscount window for sectoral development purposes. Nevertheless, the volume of rediscounts has been curtailed considerably to only Bs 4.5 billion in February 1990. Some portfolio purchase programs by the BCV remain. As of January 1990, the BCV held Bs 6.3 billion in agricultural credits purchased from commercial banks. Since the banks retain the credit risk on these loans, these programs constitute a less transparent alternative to rediscounting.

51. Credit for Housing Finance. The BCV has indirectly supported the provision of housing finance by financially supporting mortgage banks, S&Ls and BANAP. This support has taken the form of subsidized rediscounted credit as well as the purchase of low-yielding liabilities of these institutions. The BCV currently holds Bs 4.3 billion of the latter instruments. This has represented a quasi-fiscal drain on the BCV and has helped maintain afloat a number of institutions that would otherwise become insolvent. In addition to these indirect forms of support, a recently enacted housing law calls for the allocation of the BCV's profits for financing subsidies to mortgage borrowers. The earmarking of the BCV's profits is not allowed by the BCV's Law, which requires all its profits, after reserves, to be channelled directly to the Treasury.

52. The BCV's Role as Fideicomisario (Trustee). The BCV acts as trustee of several public entities, including the Social Security pension fund and the deposit insurance fund. In this role, it invests their portfolios in government securities and private instruments (mostly mortgage bonds), in most cases at below market rates. The outside portfolios currently being managed by the BCV are utilized as a conduit for financing budget deficits and as a backdoor mechanism for the BCV to acquire government securities at face value. The result is that these funds are being decapitalized. Annex IX presents an estimate of the hidden transfer which amounts to about US$300 million in stock terms. Also, the fact that these public entities do not administer their portfolios directly precludes them from becoming important institutional investors in the capital markets.

Weaknesses of the Institutional and Regulatory Structure

53. Lack of Clarity on the Functions of the Main Regulators. There is lack of clarity on the role of the BCV, the Ministry of Finance (MH), the SBIF, and the Deposit Insurance Corporation (FOGADE) with regard to their respective regulatory and oversight functions over the financial system. Several aspects of this indefinition are noteworthy. First, approval of the MH is required for many actions by FOGADE and the SBIF, which tends to delay actions, diffuse responsibilities, and infuse a degree of politization over the regulatory process. Second, decision-making authority and reporting procedures between the SBIF and FOGADE are vague, creating conflict between the institutions and inconsistency in policy-making. This is exemplified by the lack of norms on who initiates actions in cases of insolvent financial institutions. Third, functions are often overlapping, which further weakens accountability and often leads to inaction as one institution relies on the other to act. For instance, FOGADE and the BCV can both grant liquidity credits to insufficiently capitalized institutions. Finally, some of these institutions are performing functions that clearly overstep their roles. For example, the BCV often acts as a shadow superintendency and is the trustee for investments of several large public sector agencies; similarly FOGADE cannot focus its efforts entirely on handling ailing banks because it is also charged with the management, recovery and sale of assets it inherited from the BCV upon its creation.

54. Lack of Autonomy and Powers of the SBIF. The SBIF and the other superintendencies of financial institutions (insurance companies and S&Ls) are weak, and lack the ability to establish strict prudential norms and enforce them. There is a need to redefine the status of these superintendencies, particularly of the SBIF, to increase their autonomy. The SBIF is heavily dependent on the National Executive, and lacks the power to undertake several important actions which should be in its jurisdiction such as: (i) intervening ailing financial institutions, (ii) authorizing new institutions, (iii) authorizing changes in the capital base of institutions, (iv) authorizing the sale, merger or liquidation of financial institutions, and (v) suspending or revoking the operating licence of financial institutions.

55. Weak Prudential Regulations. Current regulations are not effective in ensuring the solvency and financial stability of financial intermediaries. Norms on loan portfolio classification, provisioning, capital requirements, lending concentration, lending to related parties, control mechanisms, and fines and sanctions, among others, need to be strengthened. The Chart of Accounts and accounting rules are not sufficiently clear, external audits are inadequate, and information disclosure by banks and by the SBIF is deficient.

56. SBIF supervision of banks is weak because examinations are too infrequent and they tend to focus on enforcing specific monetary, fiscal and other accounting regulations rather than on credit risk analysis and on the assessment of the overall solvency condition of intermediaries. Major problems found in banking regulations and supervision result in: (a) inadequately capitalized banks, (b) insufficient provisioning for bad debts, and (c) severe risk exposure due to lending concentration and lending to related parties.

57. Inadequate Mechanisms for Managing and Solving Bank Crises. Although FOGADE is charged with effecting bank rescue operations, this has proven to be

an inadequate mechanism for handling bank crises for a number of reasons. There is a lack of clear rules on the conditions that can cause the SBIF to intervene a financial institution, and, if required, on the transfer mechanism of an intervened institution to FOGADE. FOGADE's Law does not give it an adequate mandate nor the appropriate mechanisms to rehabilitate or liquidate insolvent banks. FOGADE is often prompted into inaction because of the approval requirements and its precarious financial condition. In any case, since FOGADE's assistance is not made conditional on change of ownership, financial assistance for rehabilitation can be misused to bail out existing shareholders and managers of failing banks. Oftentimes, FOGADE's assistance to banks amounts to liquidity support, which may be provided at preferential rates and for unnecessarily long maturities.

Weak Financial Condition of Financial Intermediaries

58. A serious problem in the financial system is the weak financial position and potential insolvency of some institutions. While available data is limited and suspect, problems identified as afflicting many banks are poor asset quality, lending concentration, foreign exchange risk exposure, inadequate capital, vulnerability to liquidity shortfalls and poor profitability.

Commercial Banks

59. Asset Quality and Capital Adequacy. While the magnitude of problems related to asset quality is difficult to estimate because of poor supervision and widespread rolling over of non-performing loans, the registered level of non-performing credits increased by approximately 50% from May to August 1989 for commercial banks not under intervention. The portfolio of non-performing loans for the six largest private banks, while still remaining low at 3.2% of total credits, more than doubled over this period. Of 38 banks not intervened, 12 had non-performing portfolios which exceeded their total estimated capital base in August 1989.[5/] These institutions together comprise approximately 22% of the total assets of the system.[6/] The assets of the Banco Industrial (BIV) represent over half of the total of this sub-group. None of these institutions was among the six largest private commercial banks. While the implication of these figures is that loan portfolio quality has deteriorated, banks in the greatest danger are likely to be BIV and some smaller banks. While at least three of the six largest banks may need some capital increases, the Bank believes that improvements in the regulatory structure will not render them insolvent. Nevertheless, BIV and some smaller banks may, as a result, have to be heavily recapitalized, merged, or liquidated.

60. Given the asset quality issues indicated above, current levels of capital may be insufficient to compensate for potential losses for several commercial banks. At the end of December 1989, 13 of 38 commercial banks had

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5/ Capital and reserves data for August 31, 1989, was interpolated from data for June 30 and December 31. Non-performing loans may be overestimated because they are calculated before the effects of provisions, while provisions are deducted from capital and reserves. Provisioning data was not made available to the Bank.

6/ As of December 31, 1989 based on a total of 41 institutions.

total debt to total equity ratios above 20:1 and three were above 25:1.[7/] Equity is not only insufficient for certain institutions in relation to non-performing assets but also in relation to non-liquid assets.

61. Reform of the bank regulatory requirements will likely result in the recognition of significant losses to commercial banks and other financial intermediaries. As of December 31, 1989, were 10% of loans to be written down or written off, public and private commercial banks would experience losses of approximately US$693 million. In order for banks not to individually violate a 20:1 total debt to total equity limit, they would have to increase capital by US$547 million, or 73% of pre-existing capital and reserves.

62. Profitability. Returns on average equity decreased for commercial banks since the liberalization of interest rates in February 1989. Real returns on equity for all commercial banks decreased from 17.8% for 1988 to -14.2% for 1989. An important factor explaining the decline in profitability in 1989 has been the reduction of bank operations in letters of credit which contributed significantly to profits in 1988. In order to increase profitability there is a need to reduce high overhead costs, increase the level of repayment on existing loans, and find creditworthy projects that can bear market lending rates. Evidence suggests that fixed costs from large branch networks remain high and could be reduced.

63. Liquidity. Commercial banks faced liquidity shortages between February and October 1989, although at a declining rate, due to their obligations to honor letters of credit that existed before the devaluation. BCV rediscounts had assisted those institutions facing liquidity shortages helping to restore liquidity to the system. Late in the year, BCV rediscounts were virtually eliminated for banks (except for BIV). BCV rediscounts fell from Bs 15.0 billion during November of 1989 to Bs 4.5 billion in February 1990. Increased borrowing through the BCV's money desk helped to absorb Bs 9 billion in excess liquidity from end-November 1989 to end-February 1990. These high levels of liquidity in the banking system could decline if the relative interest rates offered were to decline or loan demand at high rates were to increase significantly. Further development of the BCV's indirect monetary instruments and the interbank money market would provide greater flexibility to financial institutions to modify their liquidity position as needed.

64. Effects of Reforms. Reforms in regulation and supervision of loan classification and provisioning would likely have additional implications for the financial positions of banks. The reasons are as follows: (i) non-performing loans in commercial banks are often rolled over to new loans which, at least for 30 days, are considered current; (ii) improved scrutiny and enforcement of loan classification would increase the level of provisions required, especially since such a system would require provisions for credits that are current yet reflect a diminished ability to pay by the borrower; (iii) consolidation of financial statements and controls over asset sales would

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7/ Neither BCV nor SBIF provides data on the leverage of each bank according to the BCV's methodology which is the basis for the legal 20:1 leverage requirement. Under this methodology, BCV obligations and some debt which is on the balance sheet yet considered contingent are excluded from the debt total.

expose intra-group transfers of non-performing assets between financial and non-financial enterprises; and (iv) lower levels of earning assets in the financial system would compromise future profits and thus further reduce capital.

65. If improved accounting rules were in place and enforced, the reported financial condition of many institutions would likely deteriorate. Further, the economic adjustment program is likely to worsen the quality of the loan portfolio of many institutions. This will require increases in capital to mitigate risk or decreases in total assets and liabilities. An effective program to attack insolvency problems in individual institutions is therefore needed before they worsen.

Mortgage Banks and S&Ls

66. Housing Finance Policy. Mortgage banks and S&Ls are experiencing major financial problems largely due to the mismatch between the maturity and rate structure of their assets and liabilities. It should be noted, however, that mortgage banks and S&Ls only represent 9% and 6% of the assets of the financial system, respectively (see Table 1). Multiple government-sponsored programs which provide subsidies in order to limit the rate paid by borrowers have forced most institutions to become highly dependent on government subsidies in order to survive. This is particularly true since the interest rate liberalization initiated in early 1989. The Ley de Protección del Deudor Hipotecario passed in 1989 covers the difference between 25-30% of a borrower's monthly income and his or her monthly mortgage payment (calculated at a variable market rate). All primary homes are covered by this subsidy up to a purchase price of Bs 3.4 million (US$80,000 equivalent). The amount of subsidy required in 1990 to support these loans is estimated at Bs 10 billion, or 0.7% of GDP.

67. Mortgage Banks. The financial condition of mortgage banks has weakened since February 1989, as a result of increases in interest rates and their inability to charge market interest rates on non-subsidized loans. Debt-to-equity ratios have increased, in some cases significantly above the already very high 30:1 legal ceiling, and profitability has dropped.[8] The performance of the system needs to be monitored closely and steps should be taken to strengthen its capital base, particularly because asset quality deteriorated as a result of higher interest rates (given that not all borrowers are covered by the subsidy).

68. The Savings and Loans System. As with mortgage banks, S&Ls face several problems which stem from the structure of the subsector. S&Ls have severe mismatches between the maturities of their assets and liabilities yet have virtually no capital to cover this risk. As a result, recurrent liquidity shortages have been solved through government purchases of mortgage bonds at full face value and through increases in financial support from the National Savings and Loans Bank (BANAP). S&Ls in general have high operating costs, in part because they effectively have no shareholders to be held accountable to, and in part because government-sponsored housing programs channeled through S&Ls are designed in a way that provides little incentive for efficiency or profitability. While S&Ls are required to allocate a minimum of 80% of net earnings to capital

8/ Even assuming that yet-to-be-transferred subsidies for 1989 are received by mortgage banks.

reserves, most institutions are highly unlikely to build up a capital base from retained earnings sufficient to serve as a buffer against risk. In general S&Ls may pay relatively high rates on deposits in order to attract funds.

69. Because of their narrow capital base, virtually all S&Ls face quick insolvency in the event that subsidies on preferential rate loans are cut. In spite of these subsidies, however, several institutions are near insolvency. At the end of June 1989, six institutions representing 31% of the assets of the S&L subsector had losses which greatly exceed their capital. S&Ls have been losing their share of the market for deposits since 1987. They have found it difficult to offer attractive rates of interest given their asset margins and cost structures.

70. BANAP, which acts as a second-tier financing institution of the S&Ls, has borne an inordinate share of the multiple risks facing these institutions and has provided a large volume of credits to S&Ls financed from external debt. Several institutions have large obligations with BANAP. While the average amount of obligations with BANAP represented 26.6% of the total liabilities of the existing 20 S&Ls at the end of June 1989, 5 had obligations that represented more than 40% of their liabilities. The perception among some managers is that BANAP will provide for the solvency needs of all S&Ls regardless of the cost. While some mergers have to date been forced on certain institutions, other measures certainly are needed.

71. BANAP itself faces severe financial difficulties which need to be remedied. First, as of December 1989, 60% of BANAP's total liabilities were loans received from foreign banks. This US$1.5 billion worth of loans is maintained in its books at an exchange rate of Bs 7.5/US$. Were these liabilities to be revalued according to the market rate of exchange, BANAP would suffer a foreign exchange loss of US$1.2 billion.[9/] Second, BANAP likely has set aside insufficient provisions for contingencies in its role as guarantor of credits. Third, BANAP's capital base may be insufficient to cover future losses stemming from the amortization of costs associated with previous mergers of selected S&Ls. Fourth, given the weaknesses indicated in the financial position and capital base of the S&Ls, it is likely that BANAP does not have sufficient resources to provide these entities with the liquidity support they will need unless assisted by the BCV. This raises the question of the self-sustainability of the savings and loans system.

Capital Markets

72. Capital markets are not well developed--short-term money markets lack depth and long-term capital markets are minimal. Equity markets have had little significance in mobilizing capital for the country's development. There are several factors which have precluded the growth of capital markets. Subsidized rates of interest and easy credit policies have contributed to debt financing being favored over equity. Weak regulatory authorities and a loose regulatory environment have prevented market transparency and discouraged investor confidence. Investors are skeptical of becoming one of many diverse

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9/ US$1.2 billion represents 2.6 times BANAP'S total assets when these assets are valued at Bs 42.5/US$.

holders of company shares after years of economic concentration and state intervention.

PART IV - THE PROPOSED FINANCIAL SECTOR ADJUSTMENT LOAN

73. The financial sector reform program envisioned by the Government aims at: (i) liberalizing the financial policy environment (interest rates, allocation of credit, foreign ownership, universal banking, etc.); (ii) reducing the Government's direct role in financial intermediation (privatization and liquidation of public banks, consolidation of DFIs, rationalization of housing finance policy, limiting the BCV's role in the financial support of institutions to bank liquidity and monetary management needs); and (iii) strengthening the competitiveness and financial condition of intermediaries (adequate prudential regulations and supervision, capital standards, mechanisms for handling problem banks).

74. The Government has formed a team which is working on the implementation of these reforms, including the identification of required legislative and executive changes, the evaluation of institutional upgrading needs, and the sequencing of reforms. The Bank has worked closely with this team in the preparation of the loan to ensure both consistency and support for the proposed measures.

75. The proposed loan would support the first phase of the comprehensive financial sector reform program. It would focus on: (a) liberalizing and rationalizing interest rates and credit allocation; (b) reducing public sector participation in the commercial banking system and redefining the role of the public sector in development finance; (c) rationalizing the BCV's credit operations with a view to enhancing their transparency and minimizing their disruptive effects in the financial system; (d) strengthening the regulatory and institutional framework; (e) improving the financial strength of financial intermediaries and upgrading mechanisms for dealing with problem banks; and (f) enhancing the competitive environment for financial intermediaries.

76. The second phase of the financial sector reform program would build on and complete the reforms initiated in the first stage supported by this loan. In particular, it would target: (i) the full liberalization of interest rates and credit controls following the strengthening of the regulatory and supervisory framework; (ii) completing the restructuring of the development finance system; and (iii) a full program for reform of the housing finance system. In addition, it would pursue reforms in the areas of capital markets and insurance which are largely outside the scope of the first phase. The Bank expects to support these reforms either through investment projects (for instance, an industrial restructuring operation) or through a possible second financial sector loan. In addition, the Bank (through this loan) and the IFC will provide technical assistance to the stock exchange and to the National Securities Commission to review the functioning of the securities markets, the trading framework, and the supply and demand of the various financial instruments and securities. The review will also include an analysis of the legal and regulatory framework following up on earlier work done with joint IBRD/IFC financing. It is expected that this work could lead to important areas of improvement in the legislation which could be addressed in the second phase of the reform program.

77. The reform program is described in the Government's Letter of Sectoral Policy (LSP) (Annex III). The policy matrix (Annex IV) summarizes the objectives of the Government's financial sector reform program, actions already taken, and actions that will be taken as part of the proposed loan and their expected timing. Key actions which are specific conditions of tranche release in the legal documents are identified with an asterisk (*) in the policy matrix and are underlined in the text. All other actions specified in the matrix are part of the financial sector reform program as described in the LSP, and satisfactory progress in their implementation will also be reviewed prior to tranche releases.

78. The reform program will result in significant costs for the Government, which the loan will help finance. On the one hand there are the costs narrowly associated with the implementation of the program such as institution-building, human resource upgrading, undertaking policy studies or financial analyses, and the formulation of the legislative and executive reforms. These costs will be financed largely through the TA component of the loan. More broadly, however, the reforms will have significant fiscal repercussions which the loan will help defray through its fast-disbursing component: (i) the capital replenishment of FOGADE to cover the unrealized losses hidden in its balance sheet and to allow it to become the prime mechanism for resolving the solvency problems already detected in a number of institutions; (ii) the costs associated with the rehabilitation or liquidation of selected public financial institutions and the subrogation of their external debt; (iii) the assumption by the BCV or the Treasury of the capital losses of the portfolios of some public entities held in trust at the BCV; and (iv) the increased cost of public debt service with the flotation of T-bills and the liberalization of interest rates. It is estimated that these costs will be no less than the equivalent of US$1.2 billion.

79. The financial sector reform is an important element of the overall adjustment program of the Government, and complements other reforms supported by the Bank. The Bank's operational strategy for Venezuela has been framed in the context of the Policy Options Report which was submitted to the Government in early 1989 and of ensuing discussions. The proposed loan complements the ongoing SAL and TPL operations by improving the policy framework of the financial sector and by strengthening and modernizing financial institutions so that they can play a supportive role in the stabilization and adjustment process. It is therefore a critical element of the reform program, and is necessary to ensure the coherence of the overall adjustment effort. On the other hand, financial sector reform presupposes a stable financial environment that is conducive to the monetization of transactions and savings and investment. Therefore, all tranche releases will be conditional on the maintenance of a macroeconomic policy framework that is consistent with the objectives of the financial reform program.

Rationalization and Liberalization of Interest Rates and Credit Allocation

80. Interest Rate Policy. The objectives of the reform of the interest rate policy are to: (i) allow interest rates to reflect the opportunity cost of funds in the economy and encourage resource mobilization; (ii) allow variation in interest rates based on relative risks and costs of funds rather than on the nature of the source or the sectoral destination of the funds; (iii) quickly respond to changing economic conditions; and (iv) remove administrative discretion over interest rate determination by any public entity other than the BCV in its capacity as monetary authority. These objectives can be achieved

by allowing full market determination of interest rates, and by granting the BCV full and exclusive prerogative to set all administered interest rates that cannot be set on the basis of supply and demand.

81. Bank Interest Rates. Pending modification to BCV's Law to eliminate the BCV's obligation to set interest rate limits, the Government has agreed that the BCV will set interest rate limits so that they do not exert pressures on the market. Accordingly, in April 1990 the BCV Board issued a resolution setting the minimum deposit rate at 10% and the maximum lending rate at 60% for commercial and mortgage banks, finance companies and S&Ls. The spread between these limits allows sufficient scope for market determination of interest rates. In the weeks following this liberalization of interest rates, rates remained steady. As the LSP indicates, the lending rate ceiling will be immediately increased whenever it is binding, and the minimum deposit rate will be immediately reduced when it becomes binding. This will remove the discretion which currently exists over the determination of interest rate ceilings. In so doing, it will enhance the credibility of the reform process and will help prevent backtracking.

82. In order to enhance market discipline over financial intermediaries, the BCV intends to promote the transparency and public disclosure of the market interest rate structure. In May 1990 the BCV Board issued a resolution dictating daily publication by the BCV of the average and range of interest rates observed in the market (including rates offered to the public, on the interbank market, and the effective yield on BCV bills) as well as the rediscount rate. By second tranche, the BCV will issue a directive to financial intermediaries requiring them to announce and post their rates on all deposit and credit services, specifying the method for calculation of interest and other charges or fees. By third tranche, the BCV will publish in its monthly bulletin the average interest rates offered by a wide range of financial institutions on representative deposit and credit contracts. The interest rate data will be presented according to a uniform interest computation methodology.

83. Preferential Lending Rates. As Table 3 illustrates, the current administrative structure of interest rates contains major differences in rates for different sectors and institutions, resulting in large subsidies and the consequent inefficient use of resources. The Government has agreed to gradually reduce subsidies on development or other sectoral credits and to ultimately eliminate them. The first priorities must be: (i) to simplify the current plethora of interest rates; (ii) to tie the subsidized interest rates to market rates so that the former reflect market developments even though they need not coincide with market rates; and (iii) to set subsidized rates in a way that allows gradual phasing out of the subsidy element without a need to completely rework the interest rate determination mechanism. In other words, the interest rate adjustment process must be consistent with the ultimate objective of market determination. To this effect, the best anchor of rates would be the weekly average lending rate of commercial banks toward which currently subsidized rates will tend during the adjustment period.

84. Following these principles, a new structure of preferential rates was instituted in May 1990. According to the new structure, the preferential interest rate on agricultural lending by commercial banks will be 85% of the average lending rate of the six largest commercial banks on non-preferential credit. All direct lending by government-owned DFIs for agricultural and non-

agricultural activities will be set at rates not less than 85% and 90%, respectively, of the average lending rate of the six largest commercial banks on non-preferential credit. Preferential rates will be revised weekly. As the LSP states, the Government is committed, as a medium-term objective, to gradually reduce and ultimately eliminate the interest rate differential between market rates and preferential rates.

85. Table 3 compares the interest rates prevailing prior to the enactment of the recent changes with the rates currently in effect for a selected range of sectors and institutions. The newly established preferential rates currently stand at 28-30% The table shows significant reductions in interest subsidies relative to the situation in mid-April 1990 and a substantial reduction in the dispersion of interest rates across sectors. Furthermore, given projected inflation of 20-25%, preferential rates would be positive in real terms.

86. This interest rate policy will apply to all housing finance programs, except for those covered by the Ley de Politica Habitacional which enjoy lower fixed rates. Mortgage relief provided through budgetary allocation may be granted, as long as the total interest rate received by the first-tier financial institution is in accordance with the above guidelines on banking or preferential interest rates. No other interest rate limitations will apply to banks, finance companies and S&Ls.

87. Second-tier Lending Rates. In the LSP, the Government has indicated that second-tier lending by government-owned financial intermediaries (including BANAP), will be channelled to first-tier institutions at no less than the average cost of remunerated deposits of the commercial banking system. This will ensure that incentives for resource mobilization prevail. First-tier institutions will absorb the entire credit risk of final borrowers.

88. Portfolio Requirements on Commercial Banks. The Government is aware of the distortions caused by forcing commercial banks to lend a share of their portfolio to agriculture at preferential interest rates, and to finance these subsidies from their own resources. Accordingly, the LSP indicates the Government's commitment to a medium-term policy of eliminating all directed credit. The agricultural portfolio requirement was reduced by a Presidential Decree from 22.5% to 17.5% in May 1990, and will be further reduced to 12% by third tranche release.

89. Modifications to the BCV Law. In order to institutionalize the changes in interest rate policy brought about by administrative action, changes in the BCV Law are desirable. These modifications would eliminate the obligation to set minimum deposit rates and maximum lending rates and permit the BCV Board to administer preferential interest rates of the development funds. Accordingly, the Government has agreed to present to Congress by release of the second tranche proposed modifications to the Central Bank Law designed to: (i) extend to the BCV the power to regulate interest rates of all government-owned financial intermediaries (including banks and funds); and (ii) eliminate the BCV's obligation to establish interest rate limits for banks and non-bank financial intermediaries, and thus allow interest rates to be determined by the market. With this legal reform, the Government's current policy of not interfering with financial market conditions will be strengthened. At the same time, the setting of preferential and other administrative rates will be centralized at the BCV,

which should facilitate further future reductions, and the ultimate elimination of, interest rate subsidies.

Reduction of Public Sector Participation in the Financial System

90. Privatization of Commercial Banks owned by the BCV. In order to eliminate the BCV's participation in commercial banking, the Government has issued a resolution indicating its intention to privatize the three banks owned by the BCV, and has already prepared preliminary valuations of their net worth. In the LSP the Government has agreed to take all actions necessary to divest its stake in these banks. All three banks will have been brought to the point of sale prior to the release of the second tranche. To this effect, the Government shall have completed the valuation and tender or bidding documents pertaining to the sale of these banks to the satisfaction of the Bank, and will have issued these bidding documents to prospective purchasers. By third tranche, each of these banks will have been divested from the public sector.

91. Restructuring or Liquidation of Other Public Commercial Banks. In addition to the 3 commercial banks owned by BCV, the Government owns 6 other commercial banks: BIV, the four regional banks owned by BIV, and BANDAGRO. BIV and BANDAGRO are not viable institutions in their present state. Accordingly, the Government has decided to liquidate BANDAGRO and to restructure BIV and its four regional banks. As a short-term measure, as a condition for first tranche release the Government will issue a resolution forbidding BIV and BANDAGRO from engaging in new lending operations by requiring that all new deposits and loan recoveries be invested in securities of the BCV or the Treasury. BIV's lending will only resume once its restructuring is substantially under way.

92. Prior to second tranche the Government will present to Congress a Law mandating the liquidation of BANDAGRO within a specified time frame. By second tranche, the Government will also submit a plan acceptable to the Bank specifying the future role envisioned for BIV, and the actions to be taken for its restructuring or liquidation. The plan should include: mechanisms for asset valuation and sales, a schedule for amortization of losses and debt subrogation, a revised organizational structure and staffing plan, new lending operating procedures, measures to enhance accountability, and the schedule of resumption of BIV's lending activities. The plan will also analyze the situation of the four regional banks owned by BIV and decide on their future. Satisfactory progress in carrying out this plan will be reviewed prior to third tranche release.

93. Restructuring BANAP. Prior to second tranche release, the Government will submit a plan acceptable to the Bank to restructure and promote the financial independence of BANAP. The plan will contain a phasing-out of government, BCV and any external sources of funding of BANAP, and will define its policies regarding its financial support of S&Ls. Satisfactory progress in carrying out this plan will be reviewed prior to third tranche release.

94. Streamlining the Development Banking Functions Carried out by the Government. The Government is aware of the need to reorganize the DFI subsector in order to increase efficiency and create incentives so that DFIs increasingly respond to market conditions. These institutions should have the following objectives: (i) to operate principally as second-tier financial intermediaries, (ii) to lend at market rates of interest, (iii) to assist clients through

technical assistance, transfer of technology and dissemination of market knowledge, and (iv) to compete for private sources of funds. To accomplish these objectives, the Government has defined in the LSP the role of the major development banks and funds and the main steps that will be taken to start their restructuring.

95. The Government recognizes the duplication created by the existence of multiple development banks and funds. As a means of consolidating and sharpening the focus of development credit, prior to second tranche release the Government will present action plans acceptable to the Bank for the formation of two second-tier credit institutions, one for agriculture and one for industry, and for the liquidation of BANDAGRO in conjunction with the creation of the new agricultural credit fund. These two new institutions will absorb the operations of the largest funds. The new agricultural credit fund will absorb the FCA and the lending activities of the Fruit Development Fund (FDF) and the Coffee Fund (FONCAFE). The new industrial credit fund will absorb FONCREI, FINTEC, and the second-tier lending activities of FIV. <u>By second tranche release the Government will submit to Congress proposed laws for the creation of two second-tier credit institutions (for agriculture and industry, respectively), and for the closure of those existing funds that will be absorbed by the two new institutions</u>. Prior to third tranche release, the Government will demonstrate satisfactory progress in the formation of these two consolidated second-tier credit institutions, and in the liquidation of BANDAGRO. These two new funds will depend from the MH and will be supervised by the SBIF. In each case, commercial banks will be required to take on the entire credit risk of the final borrower for rediscounted lines of credit.

96. In addition to these second-tier funds, the Government owns two first-tier development funds: the Credit Institute for Agriculture and Livestock (ICAP) provides credits to small farmers, and CORPOINDUSTRIA which lends to small and medium industry and to artisans. In light of their focus on segments of the economic agents that would find access to bank credit difficult at least in the first phase of the financial reform program, these funds will remain as separate entities. Relative to the commercial banking system, these funds are insignificant. The Government will prepare prior to second tranche action plans for the restructuring of CORPOINDUSTRIA and ICAP. The plans will assess the need for first-tier lending through these institutions. <u>By the time of release of the third tranche, the Bank will ensure that satisfactory progress is being made in the implementation of these plans</u>.

<u>Rationalization of the BCV's Credit Operations</u>

97. The BCV's credit operations will be rationalized under the current reform program so as to increase their transparency and reduce their negative quasi-fiscal effects. In broad terms, this will be achieved by: (i) pricing BCV credit according to market conditions; (ii) reducing the BCV's intermediary role by forcing financial institutions to seek liquidity in the money market, allowing public entities to invest their funds directly in the capital markets instead of placing them in trust at the BCV, and privatizing the three commercial banks owned by the BCV; and (iii) limiting more strictly the Treasury's access to BCV financing of its operations.

98. <u>Credit Operations with the Government</u>. The BCV's credit operations with the Government are obscured by: (i) its holdings of zero-coupon non-

negotiable T-bills; and (ii) the exclusion from the credit ceiling of some categories of Government debt. Under the current reform program, proposed amendments to the Ley Orgánica de Crédito Público will be presented to Congress by second tranche to allow the Treasury to issue negotiable fixed-term T-bills that need not be repaid within the fiscal year in which they are issued. The revised Law shall explicitly allow market determination of interest rates on T-bills, and will abolish the preferential placement provisions currently contained in the Law. The BCV will purchase T-bills in the secondary market, or, on a residual basis, in primary auctions at the average clearing price. In the interim, the BCV has agreed not to purchase any more zero-yield T-bills after Board presentation. Also by second tranche, revisions to BCV's Law will be presented to Congress to allow the BCV to purchase these T-bills subject to the overall credit limit for the Government. This limit will be made to encompass all forms of foreign debt or any kind of claims on, or rights to, government debt. The lending limit will not be raised over the level contained in the current law, but debt arising from the ongoing external public debt reduction and restructuring program will be excluded from this limit on a transitory basis. Finally, the use of T-bills as a reserve asset by banks in satisfaction of the reserve requirement will be eliminated. Accordingly, revisions to the Bank Law will be submitted to Congress by third tranche requiring reserve requirements to be held exclusively in liabilities of the BCV and not in T-bills.

99. These reform measures are designed to strengthen the Treasury's fiscal discipline and improve the financial condition of the BCV. In addition, they will allow the BCV to use T-bills in the future as an instrument of monetary regulation through open market operations. The introduction of BCV bills in November 1989 allowed open market operations to be used for monetary management. In the future, however, the BCV should move towards trade in T-bills rather than BCV bills in order to avoid the quasi-fiscal implications of the latter.

100. Credit Operations with Financial Intermediaries. The BCV's credit operations with financial intermediaries currently take three forms: (i) advances, rediscounts and repurchase agreements (heretofore referred to together as the rediscount facility) backed by government or private instruments; (ii) credit portfolio purchases; and (iii) purchases of banks' financial liabilities. The Government intends to restrict use of the rediscount facility, eliminate all portfolio purchases by the BCV, and tighten the conditions for purchases of bank liabilities. Aside from streamlining the BCV's operations and enhancing its financial position, these measures are designed to promote the development of money and capital markets. Given that banks are potentially large players in these markets, forcing them to seek liquidity outside the BCV will act as a catalyst for their development.

101. As the LSP indicates, under the reform program the rediscount window will be used as a temporary liquidity support facility. While the BCV is developing its open-market capabilities, rediscounts may also be used in the near future as an instrument of monetary expansion (e.g. to accommodate seasonal demand for credit). However, the BCV intends to only use the rediscount facility for monetary control purposes if it is not able to achieve the same effect through its open market operations. In no case will the rediscount window be used for sectoral incentive purposes.

102. To ensure this transformation of the rediscount window, the BCV has implemented or will implement a number of reforms. First, a BCV Board resolution was issued in May 1990 mandating that all general rediscounts (including to FOGADE and BANAP) be offered at the same rate, which will be linked to the yield on BCV bills auctioned. The rediscount rate will be reviewed at least weekly and in no case will be set below the yield on BCV bills auctioned. A special rediscount rate, equal to 85% of the general rediscount rate, will be maintained for rediscounting of agricultural documents. This special rediscount rate will be phased out in step with the program for reduction of agricultural interest rate subsidies. Second, the BCV Board also issued in May 1990 instructions to the Vice-president for monetary operations establishing procedures for automatic referral of large or frequent borrowers to the SBIF for review. Third, the BCV Board will issue a resolution, prior to second tranche, switching to market (or equivalent) valuation of the underlying security or the collateral on rediscount contracts. Fourth, a proposed revision to the BCV Law will be submitted to Congress by second tranche to restrict individual rediscount contracts with financial intermediaries to a maximum duration of 30 days.

103. The indirect forms of BCV credit to the financial system will be curtailed. Credit portfolio purchases by the BCV will be eliminated, with a BCV Board resolution to this effect being passed before second tranche release. The BCV will also pass a resolution by second tranche requiring that all purchases of private debt instruments from any source by the BCV be priced at market value. The resolution will specify that in no case will financial instruments be bought at a yield less than that offered on BCV bills in the secondary market at the time of purchase of the instruments.[10/]

104. Portfolios Managed in Trust by the BCV. The BCV's intermediation role will be reduced by disengaging the external portfolios it currently manages. As a transitory measure, the BCV issued in May 1990 a resolution terminating direct transactions of securities at face value by portfolios managed in trust by the BCV. The only exception which will be permitted in the future will be the sale at face value back to the BCV of securities purchased at face value prior to Board presentation. In this way, the managed portfolios' holdings of government paper will yield market returns, thereby arresting the chronic decapitalization they have been suffering. Ultimately, the BCV's trustee functions should be discontinued, and the public entities should administer their portfolios directly, with appropriate profitability targets. The trust portfolios can then become institutional investors and as such can become important players in the development of money and capital markets. To implement the divestment of the administered portfolios, the BCV will submit a program to the Bank before second tranche release presenting the actions to be taken (including required executive and legislative changes), and the timing of these actions. Annex IX outlines the information requirement and content of the disengagement program. Only the Foreign Exchange Guarantee Fund (FICAM) will remain under BCV management. As part of this program, the BCV has submitted a notice to the Venezuelan Petroleum Company (PDVSA) of non-renewal of the management contract upon expiration of the current contract at the end of 1990, and FOGADE's portfolio will be disengaged by third tranche release. This will

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10/ If by second tranche release the secondary BCV bill market is still nonexistent or is deemed to be too thin, the yield on BCV bill auctions in primary issues will be used for this purpose.

require submission to Congress by third tranche of proposed revisions to the FOGADE's Law, which currently mandates it to place all its funds at the BCV.

105. The spirit of the reform is that all subsidy programs should flow through the national budget, and should not originate in the BCV's operations. Therefore, a final area of reform concerning the BCV is that it will not finance the housing subsidies directly either with its profits or with direct contributions. Any housing subsidies envisioned in the Ley de Proteccion del Deudor Hipotecario will be channeled only through the national budget.

Reform of the Regulatory Framework and Improvements in Bank Supervision

106. Strengthening the Operational Effectiveness and the Functional Autonomy of the Main Regulators. In the past there has been a lack of clarity on the role of the BCV, the MH, the SBIF, and FOGADE with respect to their functions as regulators of financial intermediaries. Under the loan, the legal framework will be revised and amended in order to clarify their roles. The broad objective is to enhance accountability by: (i) establishing clear functions and responsibilities; (ii) increasing the organizational, functional and budgetary autonomy of each agency or institution; (iii) insuring that all the required regulatory functions are being performed by one of the institutions; (iv) clearly specifying reporting and authorization procedures; and (v) avoiding duplication of efforts and responsibilities.

107. Under the reform, the autonomy and authority of the SBIF will be strengthened. In addition to monitoring compliance with regulations, its bank surveillance and examination capabilities will be geared towards evaluating the condition of individual banks and of the banking system generally. FOGADE will continue to be responsible for guaranteeing bank deposits. FOGADE's functions will be upgraded so as to become the prime vehicle for resolving bank crises, and it will be responsible for designing bank rescue operations. In addition, its functions will be expanded to include the liquidation of institutions, currently the domain of the SBIF. The regulatory and formal approval powers of MH will be eliminated. It will not have any executive functions in the operations of the SBIF and FOGADE, although it will exercise oversight over these institutions. The role of the BCV will also be changed to strengthen monetary control and reduce deficit financing functions. Its support of financial institutions will be restricted to the provision of liquidity in cases where solvency is not impaired. The LSP outlines the Government's intentions regarding the specific tasks to be undertaken by each institution.

108. Strengthening Prudential Regulations, Auditing, and Information Disclosure. Improved regulation and supervision is needed to: (i) improve the transparency of bank financing, (ii) improve asset quality and capital adequacy, (iii) regulate loans to related parties and loan concentration, (iv) ensure that banks compete according to a uniform set of rules and accounting standards, and (v) liquidate those institutions that may be insolvent. As outlined in the LSP, the Government has agreed to undertake a major overhaul of the prudential regulations under the discretion of the SBIF. As a first step, by first tranche release the SBIF will issue the changes required to tighten regulations on: loan classification, provisioning, roll-over of credits and accrual of interest, charge-offs, evaluation of investment portfolios, and evaluation of property received as collateral. The SBIF will, by second tranche, issue and implement all changes required to regulate the following areas: lending concentration and

lending to related parties and insiders, controls on intra-group transactions, consolidation of accounts of financial groups, uniform publication criteria of financial statements, and valuation of foreign exchange risk. Annex VI highlights the more important aspects of these regulations, and policies to be adopted for their implementation.

109. In order to improve auditing procedures and information disclosure, by the time of release of the first tranche the SBIF will issue clear audit guidelines for banks specifying requirements for auditing of loan quality and loan concentration. The SBIF will require banks to direct auditors to include assessments in these areas in their audits. By third tranche, the SPIF will issue a new chart of accounts which will facilitate full disclosure of the financial condition of banks according to transparent accounting criteria. The following aspects will be treated in the new chart of accounts: a system for loan portfolio classification, a policy to register overdue interest, provisioning guidelines, and criteria to revalue securities and measure foreign exchange risk, among others. Also by third tranche, the SBIF will issue audit guidelines to complement and expand those developed by Board presentation. The guidelines will specify the scope, content and format of audits in accordance with the new chart of accounts. Further, by third tranche, the SBIF will begin to publish and distribute publicly a monthly bulletin disclosing financial statements and indicators of individual financial institutions and of the financial system as a whole. Such indicators will include measures of capital adequacy, lending concentration, loan portfolio quality and adequacy of provisions.

110. The Government has agreed to consolidate the overhaul of prudential regulations by proposing to Congress changes in the Bank Law and by proposing to Congress a new Law of the SBIF. By second tranche the Government will submit to Congress for its approval a proposed Law of the SBIF which will tighten norms on capital requirements, lending concentration and intra-group transactions, internal control mechanisms, and will widen the scope of nonpecuniary sanctions and fines. Annex VI lists some of the required changes in the proposed SBIF Law and discusses additional required changes in the Bank Law.

111. Improving the Operations and Autonomy of the SBIF. Upgrading the institutional capacity at SBIF will be pivotal in the enforcement of the administrative and legal regulations indicated above. These include: (i) significant improvement in on-site inspection; (ii) development of an improved automated risk assessment system for credits, borrowers, banks and economic activities; (iii) development and implementation of internal control requirements by banks for risk management and to detect fraud; (iv) increased emphasis on the financial analysis of banks rather than merely on compliance with legal regulations; and (v) development of a close dialogue between SBIF and banks to enforce public information disclosure. These reforms will be supported with institutional strengthening through the TA component (detailed in Annex V) and with changed in the SBIF's legal standing. Accordingly, as a condition of second tranche the proposed Law of SBIF that will: (i) reorganize the SBIF as an autonomous entity with its own sources of revenue (bank assessments based on the volume of bank assets, and extraordinary contributions from the Treasury) and with a budget subject only to the approval of the BCV Board; (ii) eliminate the MH's formal approval and decision-making functions in the operations of the SBIF; and (iii) enhance the Superintendent's decision-making authority by stipulating that only bank liquidations and interventions and raising the minimum capital requirement requires approval by a Consultative Committee (composed of the

Minister of Finance, the Presidents of the BCV and FOGADE, and the Superintendent). By third tranche, the Government will submit to Congress proposed revisions to the Bank Law to ensure its consistency with the new proposed SBIF Law and with the spirit of these reforms.

Improving the Strength of Financial Intermediaries and Upgrading the Mechanisms for Dealing with Problem Banks

112. The Government recognizes that the financial condition of the banking system is weaker than reported. In an attempt to identify and attack insolvency problems in a timely fashion, by first tranche release the SBIF will commission or undertake studies of the financial condition of all private commercial banks and selected mortgage banks and finance companies. These studies will focus on: portfolio review, fixed asset valuation, loan concentration and foreign exchange losses. The studies will be completed to the Bank's satisfaction by the time of second tranche release.

113. Short-Term Measures Designed to Strengthen the Financial Condition of Intermediaries. Given the lax regulatory and supervisory framework in the past, the condition of many institutions is not adequately revealed by their statements. As an immediate short-term measure for increasing the basic financial strength of institutions, by first tranche release the SBIF will issue directives to banks to establish a general loan-loss provision of at least 2% of the total loan portfolio and to charge off loans past due by more than 36 months. The directives include appropriate sanctions for non-compliance with these requirements. These measures will be fully implemented by third tranche release, with an intermediate 1.5% general loan-loss provision being implemented by second tranche release. Also by second tranche, the SBIF will require additional provisions and charge-offs for those banks which the studies reveal are in need of additional strengthening measures. Provisions established in accordance with a new loan classification system would be counted against the 2% general provision. Charged-off loans will be taken off the balance sheet and written off against any specific attached provisions already created and ultimately against capital. By second and third tranche releases, the SBIF will submit evidence to the Bank that these requirements are being adequately enforced. Further, by second tranche the SBIF will prepare a program acceptable to the Bank for the amortization of the foreign exchange losses assessed in the course of its studies. The recognition of these losses will help reveal the true financial condition of intermediaries and will help force recapitalization.

114. The Government recognizes that existing requirements for entry of new banks are too lenient and that new banks should not be entering the market while the SBIF is being strengthened and the condition of the banking system is not known with more precision. As a result, another immediate short-term measure indicated in the LSP is that the MH will stop issuing licenses for opening new banks until the SBIF is strengthened, is capable of adequately scrutinizing applications for new bank licenses, and is able to determine the real financial condition of the banking system.

115. It is expected that some troubled institutions will be identified as these short-term measures are implemented and as prudential regulations and accounting standards are stiffened. These will be handled jointly by FOGADE and the SBIF through the mechanisms institutionalized in this reform process. The

increased transparency of the problems will help to prompt support for the necessary actions.

116. Improving the Mechanisms for Managing and Solving Bank Crises. A key element of the reform program is the establishment of clear and efficient mechanism for handling bank crises. The provision of workable exit mechanisms is an integral part of any liberalization program to the extent that: (i) competition cannot be expected to result in greater discipline unless institutions are forced to bear the cost of their actions; and (ii) a more open entry policy that is not accompanied with exit or consolidation devices will result in an undue bloating of the financial system. The LSP indicates the policies and procedures that will be implemented for the management of bank crises.

117. The guidelines for handling bank crises are detailed in Annex VII. In essence, while the shareholders' incapacity or unwillingness to act in a case of insolvency has not yet been determined, the SBIF will assume the leadership in evaluating and/or intervening in the bank. The BCV will provide the necessary financial support with liquidity credits at market rates as long as solvency is not deemed to be impaired. At this stage the SBIF will fully inform and coordinate closely with FOGADE. Once the SBIF has determined that there is a fundamental solvency problem and that rehabilitation is both feasible and cheaper than satisfying the deposit guarantee, it will refer the case to FOGADE by intervening the bank, reducing capital to the extent of losses, and offering a capital subscription to FOGADE. At that point, FOGADE will assume leadership; the SBIF will stop the intervention, and the BCV will no longer provide liquidity support. FOGADE, acting as majority owner of the bank, will provide financial support and will restructure the bank's operational and administrative procedures. It will be authorized to purchase assets from the bank or provide loans, both of which will be priced at market value. Concessional assistance will only take the form of additional capital subscriptions by FOGADE. FOGADE will be required to sell its ownership stake in any bank within a year of purchasing it.

118. These new procedures will be implemented early on in the reform process subject to the restrictions imposed by the current legal framework. Strengthening the process is essential so that the authorities can deal effectively with any problem banks that are identified in the process of upgrading the regulatory, supervisory and accounting framework. The second step envisioned under the loan is to consolidate these new procedures into the legal framework. This will help strengthen confidence in the system and will prevent back-sliding in the administrative gains achieved.

119. Accordingly, the Bank Law to be revised and submitted to Congress by third tranche, will establish: (i) the events or conditions that will trigger action by the authorities, (ii) the nature and sequencing of these actions, and (iii) the role of the regulatory institutions at each stage. In addition, for FOGADE to stand up to the new role envisioned under this program, some fundamental reforms are necessary in its legal framework and financial position. Revisions to FOGADE's Law will be submitted to Congress by second tranche. Annex VIII details the necessary changes in FOGADE's Law. These changes can be grouped under five categories: (i) clearly delineating its functions (allowing it to act in liquidations; more detailed rehabilitation guidelines); (ii) enhancing its powers (procedures for gaining control of banks; reduction

in required approvals); (iii) a new more independent organizational structure (more independence from the National Executive; clear reporting channels with the SBIF); (iv) endowing it with more adequate and transparent sources of financing (requiring government contributions; charging market rates for BCV credit); and (v) clarifying FOGADE's accounting and control standards (use of accounting criteria dictated by the SBIF; losses should be reported in a transparent fashion). These changes in FOGADE's operational framework will be incorporated into the institution's manual for internal procedures (Reglamento Interno), which will be revised to the Bank's satisfaction prior to the release of the third tranche. Specifically, the Reglamento will incorporate those principles established in Annexes VII and VIII that are consistent with the law in effect at that time.

120. It is not possible at this stage to evaluate the financial condition of FOGADE because of the lack of transparency in its accounting (a balance sheet as of end-1989 is contained in Annex VIII). It holds fixed assets and credit portfolios acquired either in the course of (or in repayment for) bank assistance operations, or from the BCV upon its creation. These assets are all valued at the original purchase price, which in turn was given in most cases by the nominal value in the sellers' books. Given that there is no assessment of the current market value or collection prospects of these assets, FOGADE will be required by second tranche to contract an independent study of its asset quality according to the new guidelines issued by the SBIF. On the basis of this analysis, FOGADE and the Bank will jointly analyze the needs for additional capital injections to FOGADE by the Treasury. By third tranche release, the Government will have drawn up a plan, acceptable to the Bank, establishing the targets and schedule for the full recapitalization of FOGADE. Monthly capital contributions will have been made by the Treasury beginning in January 1991. By third tranche release, the total value of these capital contributions will be at least equal to 50% of the capital losses detected at FOGADE.

121. In order to minimize the loss of market discipline inherent in any deposit protection scheme, FOGADE will undertake a campaign to publicize the types of financial institutions and deposits that are covered by its guarantee, and the maximum deposit coverage. This publicity campaign, to be performed prior to second tranche release, will focus in particular on the fact that liquid asset funds are not covered.

Enhancing the Competitive Environment for Financial Intermediaries

122. In order to reverse the current fragmentation and lack of dynamism in the financial markets, by third tranche the Government will propose to Congress modifications to the Bank Law to enhance competition among intermediaries and substantially liberalize banking activities and foreign ownership. First, proposed revisions to the Bank Law will permit the creation of universal banks and will allow commercial banks to undertake transactions previously limited to mortgage banks and finance companies. Second, proposed revisions will establish the same capital requirement for all commercial banks, mortgage banks and finance companies. The new requirement will be asset based, and a minimum 5% equity-to-total assets ratio will be established in the proposed Law. The Law should allow in the future the risk-weighting of assets and the inclusion of some contingencies for purposes of calculation of this ratio. Third, a proposed revision to the Bank Law will increase the minimum capital requirement for entry to at least the equivalent of US$6 million for commercial

and mortgage banks. The Superintendent could be allowed to raise (but not to reduce) the minimum capital threshold at his discretion. Fourth, in order to facilitate consolidation of institutions, the SBIF will revamp its mechanisms for reviewing and approving requests for mergers among financial institutions.

123. Recognizing that competition from foreign banks can se.ve to reinvigorate the local banking system and can promote the modernization of banking practices, the Government has accepted the need to allow a greater degree of foreign participation in the banking system. Accordingly, by third tranche revisions to the Bank Law will be submitted to Congress to: (i) allow up to 20% foreign ownership of local commercial banks (with discretion being granted to the Executive to increase this to 30%); and (ii) allow the National Executive to authorize foreigners to acquire up to full ownership of financial institutions other than commercial banks. The National Executive establish regulatory criteria for the functioning of foreign-owned non-bank financial institutions. As the LSP indicates, the establishment of these operational criteria is not intended to discourage foreign investment in these institutions.

124. Once financial institutions adapt to a new environment of market-determined signals, information disclosure and close supervision, there will likely emerge a system composed of a smaller number of institutions with a stronger capital base that will find sufficient incentives to decrease costs and increase efficiency.

Technical Assistance Component

125. The Technical Assistance (TA) component is designed to assist in: the restructuring of government-owned banks and funds; strengthening the regulatory agencies including the SBIF, FOGADE, BANAP, and the Superintendency of Insurance Companies; and assisting in the development of capital markets. In addition, the TA component will provide funds to a temporary coordinating unit in the BCV which will be established to oversee the progress of the financial sector adjustment program and to implement the technical assistance component.

126. Assistance under the TA component will be provided in some or all of the following areas: (i) development of a new legal and/or executive regulatory framework; (ii) reorganization of institutions' structure and internal policies and procedures; (iii) development of training programs; (iv) funding of special studies; and (v) upgrading of information systems, including the procurement of equipment.

127. The studies that will be financed under the TA component include among others: (a) external audits of commercial banks and selected mortgage banks and finance companies; (b) an analysis of the market value of assets under FOGADE's management/sale; (c) evaluation of the financial condition of individual S&Ls and BANAP; (d) a study on the regulatory norms on insurance companies and the design of a new supervision system; (e) restructuring options for BIV; (f) the creation of the two second-tier development funds and liquidation options and procedures for BANDAGRO; (g) action plans to restructure ICAP and CORPOINDUSTRIA; and (h) analysis of the functioning of Venezuelan capital markets. These studies will become the basis for policy actions, and hence they are an integral part of the reform process.

128. Annex V details the assistance program, including a schedule of estimated costs. The total cost will be US$7.0 million, which will be allocated as follows: US$4.02 million for SBIF, US$0.35 million for FOGADE, US$0.21 million for BANAP, US$0.45 million for the Superintendency of Insurance Companies, US$1.8 million to support the restructuring of public sector financial intermediaries, US$0.25 million for legal support, and US$0.20 million to support a study of capital markets. US$0.10 million will remain unallocated.

PART V - LOAN FEATURES

Loan Amount, Borrower and Implementing Agency

129. The Bank would support the financial sector reform program with a fast disbursing loan of US$300 million. The loan would include the financing of complementary technical assistance. The borrower would be the Government of Venezuela, and the implementing agency would be the BCV. The Inter-American Development Bank (IDB) will cofinance this operation.

Letter of Sectoral Policy

130. The basis for the loan is provided by a LSP (Annex III) in which the Government declares its commitment to adopt and implement the previously mentioned reforms. In particular, this letter: (i) describes the Government's macroeconomic and financial sector objectives, (ii) indicates the reforms intended to meet these objectives; and (iii) presents a timetable for the implementation of these reforms.

Loan Disbursement and Procurement

131. Loan proceeds would be disbursed under the following categories: (i) financing of debt reduction (25% of the proceeds or US$75 million), (ii) three tranches for import financing (first tranche US$71 million, second tranche US$71 million, and third tranche US$76 million), and (iii) the TA component (US$7 million). The conditions for tranche release are listed in Annex II. Funds for debt-reduction would be available upon loan effectiveness and agreement between the Bank and the Government on a debt-reduction program satisfactory to the Bank. After February, 28, 1991 unused funds for debt-reduction can be reallocated in equal portions to the three import financing tranches. The import financing component of the loan would be disbursed upon fulfillment of the corresponding specific tranche conditions, and would be used to finance 100% of the c.i.f. costs of general imports not contained in a negative list. Ineligible imports comprise goods financed by other multilateral or bilateral sources, luxury goods and goods intended for military use. No more than 15% of the loan amount can be disbursed for imports of foodstuffs. Retroactive financing in the amount of US$60 million would be available for eligible expenditures incurred after March 31, 1990. IDB funds would be released in three equal tranches subject to compliance with conditionality as agreed under this operation. The TA component would finance 100% of the local and foreign costs of approved expenditures.

132. Procurement will be carried out in accordance with the Bank's Procurement Guidelines. All contracts for the procurement of general imports to cost the equivalent of US$5.0 million or more shall be awarded through simplified international competitive bidding. Contracts of the private sector costing over US$1 million and under the equivalent of US$5.0 million would be

procured following established commercial practices which should include whenever possible requiring two quotations from eligible bidders from at least two foreign countries. Contracts of the private sector costing less than US$1 million would be procured according to commercial practices acceptable to the Bank. Public sector contracts below US$5 million would be procured according to limited international competitive bidding or shopping procedures acceptable to the Bank. To ensure the acceptability of the procedures, the Bank will exercise strong ex post supervision. The procurement of equipment under the TA component costing the equivalent of US$50,000 or less would be made through local or international shopping; above US$50,000 they would be made through Limited International Bidding (LIB). All LIB would have prior review in the Bank. Consultants to be financed with the proceeds of the loan will be employed in accordance with the principles and procedures set forth in the "Guidelines for the Use of Consultants by World Bank Borrowers and by the World Bank as Executing Agency" published by the Bank in August 1981.

133. The BCV will be responsible for maintaining loan accounts, and for preparing and submitting withdrawal applications. Disbursements from the proposed loan would be made on the basis of a summary from BCV detailing individual import transactions in each relevant period, together with a certification of payments of the amounts involved, and of their eligibility under the loan. Applications for withdrawals will be consolidated and submitted in amounts not less than US$1 million.

134. The BCV will maintain separate accounts to record and monitor loan disbursements and repayments. All records and accounts in support of statements of expenditures financed under the proposed loan will be made available to Bank missions and will be audited each year in accordance with sound auditing principles by independent auditors acceptable to IBRD.

Benefits and Risks

135. Benefits. The proposed operation would increase the overall efficiency of the financial system and thus enhance its ability to finance investment and growth. This would result from increased resource mobilization, improved credit allocation, and a lower cost of credit. The proposed reforms will contribute to these goals by: (i) enhancing competition in the financial sector with the liberalization of interest rates, credit allocation, and the participation of foreign banks; (ii) enhancing the transparency of the condition of intermediaries and depositor confidence in the intermediaries through improved prudential regulation and supervision of banks; (iii) reducing inefficiencies created by the excessive Government ownership participation in the banking system; and (iv) providing adequate mechanisms for dealing with banking distress.

136. While it is very difficult to isolate the impact of the proposed reforms from the influence of other economic policies, the major contribution of the reform program in the medium term will be derived from the enhanced financial/monetary stability and fiscal discipline induced by the reforms. In this respect, the reforms are an integral part of the stabilization effort.

137. The proposed reforms are expected to have a positive social impact. On the one hand, interest rates will rise following the liberalization of commercial banking rates and the streamlining of the preferential interest rate structure. However, this will be offset by the following factors: (i) the

expansion in the range of eligible borrowers as credit programs are rationalized and widened; (ii) the elimination of credit rationing in formal credit markets, so that small borrowers need not go to informal markets where they might pay exorbitant rates; (iii) enhanced small deposit protection with the strengthening of financial institutions and of FOGADE as a last recourse; and (iv) the reduction in intermediation spreads which represents a tax on mobilized resources.

138. Risks. Given the complex nature and political implications of many of the proposed reforms, there is a risk of some delays in the implementation of the reform program. However, the momentum created by the macroeconomic reforms successfully carried out to date, coupled with the recognition within the administration, the Congress, and financial markets of the need for the reform, will help sustain the process. A special coordinating unit has been created within the BCV which, among other functions, will garner support for the reforms. In order to reduce potential political opposition to the reforms, high-ranking Government officials have been holding discussions with key members of Congress to ensure support for the proposed legal changes. A further risk, although slight in the case of Venezuela, is that failure to maintain macroeconomic stability could endanger the success of financial sector reform measures. To reduce this risk, loan conditionality will stipulate that for each tranche release the Bank shall be satisfied that the macroeconomic framework is consistent with the financial sector reform objectives.

PART VI - COUNTRY ASSISTANCE STRATEGY AND BANK OPERATIONS

139. After a 15-year hiatus in its lending relationship with Venezuela, the Bank in FY89 initiated a substantial program to support the Government's efforts to create a policy environment for sustainable growth. The Bank's current focus is on sustaining and deepening the policy reforms already started. Increasingly, the Bank's focus will shift toward investment lending in the social sectors, public infrastructure, and environment.

History of Bank Assistance

140. Between 1961 and 1974, the Bank approved 13 loans to Venezuela, totalling US$383 million, of which US$342 was disbursed. IBRD loans to Venezuela included support for agricultural development (two projects), transport (four projects, including an airport loan), power (four projects, including part of the Guri hydroelectric project), telecommunications (two projects), and water supply (one project). Most projects were viewed as relatively successful, and funds were fully repaid as of June 1989.

141. After the 1973 oil windfall, Venezuela chose not to borrow from the Bank, and subsequently the country's per capita income increased to levels above the Bank's graduation limit. However, the Bank maintained a Resident Mission in Caracas through 1979 and provided technical assistance to help in the appraisal of proposed projects and in general economic analysis.

142. The Bank's current role reflects a recent resumption of lending based on the strength of the Government's economic program. However, confronted by the onset of the debt crisis and a sustained decline in economic output in the mid-1980s, Venezuela sought a renewed borrowing relationship with the Bank and was declared eligible to borrow in 1986. As described earlier, the new

administration of President Pérez introduced a strong program of economic reforms and requested substantial technical and financial support from the Bank and the Fund. The Bank responded with the US$402 million Structural Adjustment Loan (SAL) and the US$353 million Trade Policy Loan (TPL) approved in June 1989.

Bank Operational Strategy

143. The Bank's operational strategy in Venezuela has two basic thrusts. The first is to use adjustment lending operations to assist the Government in sustaining and broadening the policy and institutional reform process. The SAL and TPL have supported the basic policy changes required up front to reduce distortions in the economy, increase the role of market forces in the allocation of resources, and expose domestic producers to greater competition through trade liberalization. The Financial Sector Adjustment Loan will support efforts to strengthen and liberalize the financial sector. The Public Enterprise Reform Loan, which is also expected to be approved in FY90, will support efforts to redefine the role of the public sector in the economy and to maximize the productive response to the adjustment program through restructuring of key state enterprises, clarifying their relationship with the central Government, eliminating the barriers to entry for private enterprises, and privatizing selected enterprises. Assuming that efforts to sustain and broaden the reform process are continued, additional lending has been planned for FY91 and FY92, including an agricultural sector adjustment loan and a second loan for trade policy reform. Through such adjustment lending, the Bank will help build an economic environment in which market-determined prices can guide the efficient allocation and utilization of resources, in both the public and private sectors. These adjustments are important prerequisites for achieving greater efficiency of public investment.

144. With the basic policy reforms in place, attention should shift to sector-specific issues which need to be tackled in the context of project lending. The second basic thrust of our strategy is to build up a pipeline of investment projects. The pace of preparation, appraisal, and implementation of investment projects is likely to be slowed by the newness of our relationship with Venezuela and the Government's inexperience with Bank requirements and procedures. To facilitate the preparation of projects, a Technical Assistance Loan (TAL) has been included in the FY90 program. The planned shift toward investment lending will begin in FY91.

145. Our analysis indicates that the country is creditworthy for Bank lending of about US$750 million per annum. The Bank's key contribution is likely to be the assistance provided by Bank staff in designing and implementing the investment projects.

Sectoral Composition of Bank Lending

146. Trade, Finance and Industry. Support to these sectors would seek to consolidate the reforms begun with the TPL and to lay the groundwork to make public and private enterprises more efficient. Severe weaknesses in the financial sector would be addressed in the Financial Sector Adjustment Loan (FY90). With these under way, the stage would be set for the Private Sector Restructuring Loan (FY91) intended to assist the restructuring of private sector industry to cope with international competition. The Second TPL (FY92) is

expected to support the completion of trade reform with emphasis on the reduction of the level of protection over time and on export promotion measures.

147. Agriculture. It would be difficult to undertake viable lending operations without first instituting some basic reforms. Currently there is an interlocking and complex web of price supports, subsidies, directed credit at highly subsidized interest rates and import and export controls. The Agriculture Sector Adjustment Loan (FY91), which will concentrate on liberalizing agriculture trade and domestic pricing, is intended to set the stage for Bank project lending in agricultural infrastructure and support services, possibly an Irrigation Project (FY93).

148. Infrastructure. Institutional and financial reforms are under way in some key agencies in the infrastructure sectors, but Bank assistance is deemed necessary as many of these institutions will virtually have to be rebuilt. The Water and Sewerage Project (FY93) while supporting the reorganization of the sector upon the planned restructuring of INOS (a centralized water and sanitation agency) will also finance high-priority investments in the sector. The Power Distribution Project (FY92) is intended to support the decentralization of a national utility company's distribution services, upon completion of the ongoing sector reforms.

149. Social Sectors and Environment. The program for FY91 includes two investment projects directed towards poverty alleviation and designed to ameliorate the social impact of adjustment, particularly on the poorest and the most vulnerable groups. The Social Development Project is designed to support the nationwide expansion of a program for maternal-infant health and nutrition. The Slum Upgrading Project (FY92) will improve the physical infrastructure and basic services in poor urban neighborhoods. It is anticipated that such social sector projects, with a strong poverty alleviation orientation, will have a central place in the Bank's lending to Venezuela. Environment will be another area of focus. The Environmental Protection Project (FY93) will support establishment of the country's legal and institutional framework for environmental protection while helping to prepare and finance specific investment projects to reverse the contamination of Lake Maracaibo and the Tuy River.

IFC Operations

150. Because per capita income exceeded the Bank Group's graduation limit, IFC was not active for several years in Venezuela. However, IFC resumed operations in Venezuela in the mid-1980s and now has an active program. Between 1960 and December 31, 1989, total gross commitments by IFC were US$162.3 million, of which US$158.9 million were loans and US$3.4 million were equity. In the past three years, IFC has moved quickly to make major investments in areas that had previously been the preserve of the public sector. In 1988, it approved an investment to VENCEMOS for cement production; in 1989 it approved investments to OPCO and PROPILVEN for hot-briquetted iron production and polypropylene production, respectively. IFC has directed its efforts at supporting the Government's strategy of exploiting natural resources to support the balance of payments and to diversify the economy.

PART VII - COLLABORATION WITH THE IMF

151. There has been close coordination with the IMF in the preparation of this proposed reform program. The Government requested technical assistance from the Fund's Central Banking Department to help prepare a program for financial sector reform. At the request of the Government, the Fund's technical assistance mission and the Bank's preparation mission visited Caracas at the same time to facilitate coordination. Close coordination was established between both missions which resulted in very similar recommendations for reform. IMF staff have been consulted at different stages during the preparation of the reform program and have expressed their full support. We expect to continue collaborating closely with the Fund, not only in the design of the reform program but also in the assessment of the appropriateness of macroeconomic management for ensuring a stable environment required for the success of the operation.

PART VIII - RECOMMENDATION

152. I am satisfied that the proposed loan wou d comply with the Articles of Agreement of the Bank and recommend its approval y the Executive Directors.

Barber B. Conable
President

Attachments

Washington, DC
May 21, 1990

VENEZUELA - Key Macroeconomic Indicators

Debt Reduction Scenario

Key Indicators 1/	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
	Actual				Prelim.	Estimate	Projections					
GDP Growth	-1.4%	0.3%	5.2%	4.5%	6.2%	-8.1%	5.3%	5.2%	5.0%	4.8%	4.8%	4.8%
GDY Growth	0.1%	-2.9%	-0.6%	5.2%	4.1%	-5.8%	5.8%	5.1%	5.2%	5.0%	5.0%	5.1%
GDY/Capita Growth Rate	-2.7%	-5.7%	-3.4%	2.5%	1.5%	-8.1%	3.2%	2.7%	2.7%	2.7%	2.6%	2.9%
Private Consumption/Capita Growth Rate	n.a.	-5.1%	7.1%	0.4%	3.5%	-7.1%	0.1%	0.8%	1.6%	1.2%	1.6%	2.2%
Debt Service (US$ millions)	4726.4	4290.5	4989.2	4669.0	4989.0	5152.0	4998.9	3581.7	3787.1	4703.7	4902.9	5676.5
Debt Service/XGS	27.2%	24.5%	42.4%	37.2%	39.2%	34.5%	31.1%	20.2%	19.2%	21.5%	20.2%	21.2%
Debt Service/GDP	8.1%	6.9%	8.2%	10.0%	8.3%	12.7%	11.8%	7.7%	7.5%	8.5%	8.0%	8.4%
Gross Fixed Investment/GDP	14.0%	15.2%	20.3%	21.8%	22.9%	17.3%	19.9%	21.9%	23.7%	24.6%	25.1%	25.3%
Domestic Savings/GDP	25.2%	20.6%	20.4%	23.1%	20.6%	23.3%	25.0%	25.9%	26.4%	27.5%	28.2%	28.7%
National Savings/GDP	22.0%	15.2%	17.8%	19.9%	17.6%	17.1%	20.7%	22.5%	23.3%	24.5%	25.4%	26.0%
Marginal Domestic Savings Rate	..	..	..	45.4%	13.3%	53.8%	65.5%	47.3%	35.5%	38.9%	33.6%	27.5%
Public Fixed Investment/GDP	6.3%	6.4%	12.1%	10.6%	10.7%	10.0%	11.5%	12.3%	12.9%	13.1%	13.1%	13.1%
Public National Savings/GDP	16.9%	17.8%	12.3%	10.3%	4.6%	9.6%	12.6%	16.3%	18.4%	18.7%	18.9%	19.2%
Private Fixed Investment/GDP	9.5%	10.4%	8.2%	11.2%	12.1%	7.3%	8.4%	9.6%	10.8%	11.5%	12.0%	12.2%
Private National Savings/GDP	5.1%	-2.6%	5.6%	9.6%	13.0%	7.5%	8.0%	6.2%	4.9%	5.8%	6.5%	6.8%
Ratio of Public/Private Investment	66.3%	61.5%	147.2%	95.0%	88.5%	137.8%	137.8%	128.7%	119.9%	114.6%	109.4%	107.3%
Government Revenues/GDP	31.8%	30.0%	28.1%	28.9%	24.6%	31.4%	33.6%	35.5%	37.4%	37.5%	37.6%	37.4%
Government Expenditures/GDP	27.3%	25.2%	30.8%	30.9%	32.8%	32.8%	34.1%	33.0%	33.5%	33.5%	33.1%	32.8%
Deficit (-) or Surplus (+)/GDP	4.5%	4.8%	-2.6%	-2.0%	-8.3%	-1.4%	-0.5%	2.5%	3.9%	4.1%	4.3%	4.7%
Export Growth Rate 2/	15.9%	1.0%	5.1%	-1.7%	7.9%	2.1%	9.4%	6.2%	5.9%	5.8%	5.5%	4.9%
Exports/GDP 2/	28.3%	25.6%	19.8%	21.4%	20.7%	33.3%	34.7%	35.1%	35.6%	36.2%	36.6%	37.0%
Import Growth Rate 2/	56.1%	-11.0%	21.5%	2.2%	18.9%	-33.0%	30.6%	11.4%	10.8%	6.6%	5.9%	5.3%
Imports/GDP 2/	17.0%	16.0%	20.2%	23.4%	27.3%	24.2%	29.7%	31.5%	33.3%	33.8%	34.0%	34.0%
Current Account (US$ Million)	4598.0	3694.0	-1505.0	-1103.0	-4513.0	1889.0	332.0	62.0	-448.4	-311.7	-111.5	189.1
Current Account/GDP	7.9%	6.0%	-2.5%	-2.4%	-7.5%	4.6%	0.8%	0.1%	-0.9%	-0.6%	-0.2%	0.3%

1/ All GDP ratios are at current prices.
2/ Exports and imports of goods and non-factor services (National Accounts).

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VENEZUELA - BALANCE OF PAYMENTS

(US$ millions at current prices)

	Actual		Prelim.	Estimate	Projections								
	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
A. Exports of Goods & NFS	10111.0	11279.0	11206.0	13598.1	14682.3	16221.6	18024.5	20132.6	22386.3	24880.8	27825.3	30850.4	34385.4
1. Merchandise (FOB)	9122.0	10567.0	10269.0	12585.0	13561.1	14980.9	16651.4	18611.7	20701.6	23014.7	25772.0	28591.2	31899.7
2. Non-factor services	989.0	712.0	937.0	1013.1	1121.2	1240.7	1373.0	1520.9	1684.7	1866.1	2053.3	2259.2	2485.7
B. Imports of Goods & NFS	10061.0	10880.0	13946.0	9198.2	12537.2	14586.8	16867.3	18795.0	20794.4	22880.1	24959.3	27360.6	29994.3
1. Merchandise (FOB)	7862.0	8832.0	11414.0	7138.2	9994.6	11628.6	13446.6	14983.3	16577.2	18239.9	19897.5	21811.8	23911.3
2. Non-factor services	2199.0	2048.0	2532.0	2060.0	2542.6	2958.3	3420.8	3811.7	4217.2	4640.2	5061.8	5548.8	6082.9
C. Resource Balance	50.0	399.0	-2740.0	4400.0	2145.1	1634.8	1157.1	1337.5	1592.0	2000.8	2866.0	3489.8	4391.1
D. Net Factor Income	-1483.0	-1374.0	-1650.0	-2374.0	-1673.0	-1432.8	-1465.6	-1509.2	-1563.5	-1671.7	-1685.8	-1660.8	-1579.1
1. Factor Receipts	1734.0	1411.0	1642.0	1472.0	1511.1	1616.1	1811.6	1927.5	1968.7	1978.2	2028.0	2127.6	2214.1
2. Factor Payments	3217.0	2785.0	3292.0	3846.0	3184.2	3048.8	3277.2	3436.7	3532.2	3649.9	3713.7	3788.4	3793.2
(interest payments)	3095.0	2674.0	3082.0	3621.0	2927.3	2747.4	2925.8	3037.4	3080.5	3148.5	3155.9	3170.9	3111.8
E. Net Current Transfers	-72.0	-128.0	-123.0	-137.0	-140.0	-140.0	-140.0	-140.0	-140.0	-140.0	-140.0	-140.0	-140.0
1. Current Receipts	..	..	..	..	..	..	..	..	..	..	..	..	..
2. Current Payments	72.0	128.0	123.0	137.0	140.0	140.0	140.0	140.0	140.0	140.0	140.0	140.0	140.0
F. Current Account Balance	-1505.0	-1103.0	-4513.0	1889.0	332.0	62.0	-448.4	-311.7	-111.5	189.1	1040.2	1689.0	2672.0
G. Long-Term Capital Inflow	-1365.7	-1459.8	-119.0	1118.0	2017.7	1524.6	2336.4	1720.7	1628.7	1368.8	1516.3	747.5	347.6
1. Direct Invest incl debt/equity swaps	16.0	21.0	89.0	213.0	410.0	470.0	500.0	530.0	525.0	560.0	600.0	650.0	700.0
2. Official Capital Grants	34.0	-22.0	-31.0	-29.0	-34.0	-40.0	-47.0	-53.0	-55.0	-57.0	-60.0	-63.0	-66.0
3. Net LT Loans	-1415.7	-1458.8	-177.0	572.6	1401.7	914.6	1733.4	1123.7	1083.7	825.8	976.3	160.5	-286.4
a. Disbursements	478.5	518.2	1780.0	2194.0	3483.3	2258.9	3069.9	3018.1	2833.6	3081.0	3253.5	3427.1	3565.1
b. Repayments 1/	1894.2	1977.0	1957.0	1621.4	2081.6	1344.3	1336.5	1894.4	1749.9	2255.3	2277.3	3266.6	3851.5
4. Other LT Inflows (Net) 2/	0.0	0.0	0.0	361.4	240.0	180.0	150.0	120.0	75.0	40.0	0.0	0.0	0.0
H. Total Other Items (net)	-1014.3	1439.8	-151.0	-1820.0	-3072.1	-444.6	-460.0	-506.1	-550.1	-311.3	-613.3	-578.4	-597.4
1. Net Short-Term Capital	1695.0	2277.3	938.0	-3647.0	405.6	71.4	90.3	15.9	14.2	-4.6	-63.3	-28.4	-47.4
2. Capital Flows N.E.I. 3/	-775.0	-866.0	-1083.0	-1090.0	-4227.7	-1016.0	-1050.3	-1022.0	-1064.3	-806.6	-1050.0	-1050.0	-1050.0
3. Errors and Omissions 4/	-1934.3	28.5	-6.0	2917.0	750.0	500.0	500.0	500.0	500.0	500.0	500.0	500.0	500.0
I. Changes in net reserves	3885.0	1123.0	4783.0	-1187.0	722.3	-1142.0	-1427.9	-902.9	-967.1	-1246.6	-1943.1	-1858.2	-2422.3
1. Net Credit from the IMF	0.0	0.0	0.0	998.0	1977.4	1605.0	677.3	-371.9	-572.6	-672.8	-672.8	-672.8	-672.8
2. Other reserve changes	3885.0	1123.0	4783.0	-2185.0	-1255.1	-2747.0	-2105.2	-530.9	-394.6	-573.8	-1270.3	-1185.4	-1749.5
[- indicates increase]													

1/ Includes pre-payment of debt via debt/equity swaps.
2/ Capital gains on debt/equity swaps.
3/ Counterpart to private interest receipt plus funds used for debt reduction operations.
4/ Historical is errors & omissions as estimated by government (include net capital flight). Future is projected reverse capital flight.

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VENEZUELA - BALANCE OF PAYMENTS

(US$ millions at current prices)

	Actual		Prelim.	Estimate	Projections								
	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
J. Shares of GDP (spot exchange rate)													
1. Resource Balance	0.1	0.9	-4.6	10.8	5.1	3.5	2.3	2.4	2.6	3.0	3.9	4.3	4.9
2. Total Interest Payments	5.1	5.7	5.1	8.9	6.9	5.9	5.8	5.5	5.0	4.7	4.3	3.9	3.5
3. Current Account Balance	-2.5	-2.4	-7.5	4.6	0.8	0.1	-0.9	-0.6	-0.2	0.3	1.4	2.1	3.0
4. LT Capital Inflow (line G)	-2.2	-3.1	-0.2	2.7	4.6	3.3	4.6	3.1	2.7	2.0	2.0	0.9	0.4
5. Net Credit from the IMF	0.0	0.0	0.0	2.5	4.7	3.5	1.3	-0.7	-0.9	-1.0	-0.9	-0.8	-0.8
Memorandum Item:													
GDP (Atlas Method)	65053.8	57317.4	58964.7	50374.0	49268.1	46824.0	50438.6	55404.7	60854.4	66959.6	74040.7	81612.0	89442.4
GDP (Spot Exchange Rate)	60882.6	46857.9	60138.3	40715.6	42280.9	46239.6	50632.3	55653.1	61146.9	67281.4	73968.7	81099.0	89098.6
Foreign Exchange Reserves:													
1. International Reserves	8264.0	7591.0	3526.4	4519.2	5184.3	7841.2	9946.4	10477.3	10871.9	11445.7	12716.0	13901.4	15650.8
2. Gold (End-yr at $300/oz)	3439.0	3439.0	3439.0	3439.0	3439.0	3439.0	3439.0	3439.0	3439.0	3439.0	3439.0	3439.0	3439.0
3. Gross Reserves incl. Gold	11703.0	11030.0	6965.4	7958.2	8623.3	11280.2	13385.4	13916.3	14310.9	14884.7	16155.0	17340.4	19089.8
4. Gr. Res. in Months Imports	10.6	9.7	4.8	7.3	6.6	7.7	8.0	7.5	7.1	6.7	6.8	6.7	6.8
Exchange Rates													
1. Nom. Off. X-Rate (IFS rf)_	8.1	14.5	14.5	34.3	48.0	53.3	56.2	59.2	62.3	65.5	69.5	73.6	78.0
2. Real Eff. X-Rate Base 1986=100	100.0	71.6	83.6	55.8	53.1	53.1	53.1	53.1	53.1	53.1	53.1	53.1	53.1
3. X-Rate for GNP Conversion	7.6	11.9	14.8	27.7	41.2	52.7	56.4	59.4	62.6	65.9	69.4	73.3	77.7
Inflation Rates													
1. GDP Deflator	-0.5%	32.1%	20.8%	74.3%	38.0%	15.5%	9.9%	10.4%	10.4%	10.6%	11.2%	10.9%	11.1%
2. Domestic Absorption Deflator	13.2%	33.1%	23.7%	61.3%	39.0%	16.0%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%

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VENEZUELA - Projected Long-Term Financing Requirements

(US$ millions, annual average)

Gross Disbursements	1986-89	1990-92	1993-95
Long-Term Sources:			
Multilateral	130.4	1225.5	832.0
of which IBRD	28.8	815.0	444.6
Bilateral	91.8	396.3	201.2
Suppliers Credits	435.7	844.0	1319.3
Financial Markets to Public Sector	428.9	233.3	100.0
Private Non-Guaranteed LT	31.0	240.0	525.0
IMF Purchases	249.5	1461.5	0.0
Financial Gap	0.0	0.0	0.0
TOTAL	1367.2	4400.6	2977.6

Net Disbursements	1986-89	1990-92	1993-95
Long-Term Sources:			
Multilateral	109.5	1205.9	699.2
of which IBRD	15.2	815.0	373.0
Bilateral	-39.9	247.9	96.2
Suppliers Credits	201.4	453.0	442.6
Financial Markets to Public Sector	-348.9	-108.9	-88.4
Private Non-Guaranteed LT	-518.3	153.7	361.3
IMF Purchases	249.5	1419.9	-539.1
Net Short-Term Debt	207.8	387.6	267.9
Financial Gap	0.0	0.0	0.0
TOTAL	-138.8	3759.2	1239.9

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VENEZUELA - Debt Service Assumptions

(US$ millions, annual average)

Principal Repayments	1986-89	1990-92	1993-95
Multilateral	20.9	19.5	132.8
of which IBRD	13.6	0.0	71.6
Bilateral	131.7	148.4	105.0
Suppliers Credits	234.3	391.0	876.7
Financial Markets to Public Sector	777.7	342.2	188.4
Private Non-Guaranteed LT	549.3	86.3	163.7
IMF Repurchases	0.0	41.6	539.1
Financial Gap	0.0	0.0	0.0
TOTAL	1713.8	1029.1	2005.6

Interest Payments	1986-89	1990-92	1993-95
Multilateral	18.3	146.8	366.8
of which IBRD	1.2	85.4	232.0
Bilateral	67.6	91.5	123.3
Suppliers Credits	65.5	180.1	300.4
Financial Markets to Public Sector	2180.8	1432.7	1123.8
Private Non-Guaranteed LT	469.3	497.0	533.8
IMF Service Charges	10.8	296.5	353.7
Short-Term Debt	305.9	222.2	287.0
Financial Gap	0.0	0.0	0.0
TOTAL	3118.0	2866.8	3088.8

Key Ratios	1988	1989	1990	1991	1992	1993	1994	1995
Total Interest/XGS	24.2%	24.2%	18.2%	15.5%	14.9%	13.9%	12.7%	11.8%
DOD/XGS	282.4%	220.4%	188.8%	186.6%	181.5%	167.7%	155.0%	142.1%
Net Disbursements/Total Interest 1/	51.5%	10.7%	134.8%	109.2%	102.6%	41.7%	33.3%	20.6%
Net Transfers/GDP 1/	-2.5%	-7.9%	2.4%	0.5%	0.1%	-3.2%	-3.4%	-3.7%
o/w Funds used for Debt Conversion/GDP	0.0%	0.0%	7.6%	0.0%	0.1%	0.0%	0.1%	-0.3%

1/ Includes IMF, FAR/BIS, Short-Term Capital, Reverse Capital Flight and Pre-Payment under Debt-Equity Swaps.

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VENEZUELA - FINANCIAL SECTOR ADJUSTMENT LOAN

SUPPLEMENTARY LOAN DATA SHEET

Section I: Timetable of Key Events

(a)	Time taken by the country to prepare credit	:	14 months
(b)	Credit prepared by	:	Central Bank
(c)	First presentation to the Bank	:	June 1989
(d)	Departure of appraisal mission	:	March 1990
(e)	Completion of negotiations	:	May 1990
(f)	Planned date for effectiveness	:	June 1990

Section II: Special Bank Implementation Action

None

Section III: Special Conditions

1. The proposed loan will be released in three tranches (excluding the technical assistance component). The release of the first tranche will be subject to the following conditions:

(a) The Bank must be satisfied that the macroeconomic policy framework is adequate to sustain the financial sector adjustment program.

(b) Studies of the financial condition of commercial banks and selected mortgage banks and finance companies will have been commissioned.

(c) SBIF will have issued all the changes required to tighten regulations on: provisioning, loan classification, roll-over of credits and accrual of interest, charge-offs, evaluation of investment portfolios, and evaluation of property received as collateral.

(d) SBIF will have issued instructions to banks to: (i) establish a general loan-loss provision of at least 1.5% of loans by December 1990 and 2% of loans by June 1991 (with specific provisions counted against the general provision); (ii) write off loans past due by more than 36 months by June 1991; and (iii) require their auditors to include an assessment of loan classification and concentration in audits.

(e) Government will have issued a resolution forbidding BIV and BANDAGRO from engaging in lending operations by requiring that any new deposits and all loan recoveries be invested in securities of the Treasury or the BCV. BIV's operations will resume once its restructuring is substantially under way.

2. The release of the second tranche will depend on compliance with the following:

(a) Maintenance of a macroeconomic policy framework including adequate management of international reserves, satisfactory to the Bank and consistent with the program.

(b) Satisfactory progress will have been made in implementing the agreed reform program as stated in the Letter of Sectoral Policy.

(c) Submission to Congress of a proposed new Law of Superintendency of Banks in accordance with suggestions in Annex VI.

(d) Submission to Congress of revisions to the Law of the Central Bank. The proposed Law must: (i) allow full market determination of interest rates; (ii) grant the BCV full and exclusive prerogative to set interest rates on all transactions of intermediaries; (iii) allow the BCV to purchase negotiable T-bills subject to the Government's credit ceiling; (iv) include foreign-currency denominated debt in the Government's credit ceiling; and (v) restrict all rediscount contracts given by the BCV to no more than 30 days.

(e) Submission to Congress of revisions to FOGADE's Law. Modifications should be in accordance with suggestions in Annexes VII and VIII.

(f) Submission to Congress of revisions to Public Credit Law to permit issuance of fixed-term, negotiable, interest-bearing, short-term T-bills.

(g) Submission to Congress of proposed laws creating two second-tier credit institutions (for agriculture and industry, respectively) which will absorb at least 5 funds.

(h) SBIF will have issued and implemented all the changes required to regulate the valuation of exchange risk, loan concentration limits controls of intra-group transactions, consolidation of accounts of financial groups, and uniform publication criteria of financial statements.

(i) The three banks owned by BCV will have been brought to the point of sale. All valuation and tender or bidding documents for the sale of the banks will have been completed to the satisfaction of the Bank, and bidding documents will have been issued to prospective purchasers.

(j) SBIF will have completed all studies of financial condition of all private commercial banks and of selected mortgage banks and finance companies.

(k) Submission of program acceptable to the Bank to disengage all managed portfolios from the BCV (except FICAM). The program should contain the information listed in Annex IX.

(1) Submission of action plan acceptable to the Bank for the restructuring of BIV and its four regional banks, inlcuding a specification of their new role.

3. The release of the third tranche will depend on compliance with the following:

(a) Maintenance of a macroeconomic policy framework including adequate management of international reserves, satisfactory to the Bank and consistent with the program.

(b) Satisfactory progress will have been made in implementing the agreed reform program as stated in the Letter of Sectoral Policy.

(c) Submission to Congress of modification of the Bank Law which will include all aspects of the reform program agreed in the Letter of Sectoral Policy and loan documents.

(d) Government will have issued decree reducing the agricultural lending requirement on commercial banks to 12% of their total portfolio.

(e) Presentation to the Bank of satisfactory program for the full recapitalization of FOGADE.

(f) Monthly capital contributions to FOGADE will have been made by the Treasury beginning in January 1991, which together will cover at least 50% of the estimated losses of FOGADE.

(g) The three banks owned by BCV will have been divested from the public sector.

(h) Satisfactory progress in carrying out the action plan for restructuring CORPOINDUSTRIA and ICAP.

(h) FOGADE's investment portfolio will have been disengaged from the Central Bank.

VENEZUELA - FINANCIAL SECTOR ADJUSTMENT LOAN

DRAFT GOVERNMENT'S LETTER OF SECTORAL POLICY

May 16, 1990

Mr. Barber B. Conable
President
International Bank for Reconstruction and Development
1818 H Street, N.W.
Washington, D.C. 20433
USA

Dear Mr. Conable:

1. The Government of Venezuela hereby requests a World Bank loan to support a financial sector reform program. The objectives of the reforms are: (i) to reduce intermediation costs; (ii) to mobilize greater financial savings, (iii) to allocate resources more efficiently, and (iv) to enhance the stability and solvency of the financial sector. These reforms are of fundamental importance to allow the financial system to carry out the role assigned to it under our country's macroeconomic program and increase its capacity for financing economic development. The reforms will focus on strengthening both the legal and institutional framework of regulatory agencies, improving the financial condition and promoting the competitiveness of intermediaries, and rationalizing the Government's role in the financial sector.

2. The financial assistance hereby requested will release counterpart funds which will help finance the costs associated with the reform program. Among others, these costs include: required capital contributions to the Deposit Insurance Corporation (FOGADE), expenses relating to rehabilitation or liquidation of some state-owned financial institutions and the subrogation of their foreign debt, and increases in the internal public debt service due to the new policy of issuing debt at market-determined interest rates.

3. Before setting out in detail the sector's problems and the scope of the reform program, it is useful to provide a summary of the macroeconomic reform program--of which financial sector reform will be a part--that is now being carried out by the Government.

The Macroeconomic Reform Program

4. The short-term objective of the reform program has been to stabilize the economy and, in particular, the balance of payments and fiscal accounts. The cornerstone of the stabilization program was establishment of a unified, market-determined exchange rate. This measure alone dampened pressure on international reserves, by restraining import demand and reduced quasi-fiscal

losses of the Central Bank on account of foreign exchange guarantees. The fiscal situation was also improved by the rise in public enterprise tariffs and petroleum products, by tax administration measures, and by spending restraint.

5. While the stabilization effort must not weaken in the medium term, there are clear indications that it is succeeding. The nonfinancial public sector (which includes the Central Bank's quasi-fiscal accounts) registered a deficit equal to less than 2% of gross domestic product in 1989, down from about 9% the previous year. The deficit is attributable to losses on foreign currency guarantees granted under the previous import and exchange regime. The current account of the balance of payments registered a US$2,500 million surplus in 1989, although the overall balance of payments (as measured by changes in the Central Bank's net reserves) was in deficit because of lower than anticipated medium-term commercial bank financing. The exchange rate itself had displayed a notable stability during the first seven months of the program, remaining within a Bs 36.6-38.5/US$1.00 range. However, it has since depreciated to the range of Bs 43-46/US$1.00. Monthly inflation has been kept at just over 2% per month, following an inflationary surge in the first two months of the program. A resurgence of inflation in September and October 1989 was arrested with effective monetary measures.

6. Beyond stabilization, the longer-term objectives of the adjustment program are: (i) to promote private activity by enhancing the role of markets in resource allocation; (ii) to modernize and restructure the public administration system, so as to reduce unnecessary regulations and interference in private activity; (iii) to establish and maintain a trade regime that is neutral in creating incentives among productive activities; (iv) to reduce the reliance on petroleum by promoting non-oil exports and alternative sources of Government funding; and (v) to increase domestic savings in order to limit foreign borrowing requirements. If these reforms are successful, it is expected that the result would be a sustainable rate of growth, with a greater degree of resistance to external shocks.

7. The measures taken thus far reflect considerable progress in most, if not all, of these areas. The rise in public enterprise prices and tariffs, in addition to contributing to improving the fiscal position, is a useful first step in public enterprise reform, as it allows evaluation of economic costs through the price mechanism. At the same time, ongoing trade reforms and elimination of price controls and subsidies on many products are allowing private sector prices to reflect true economic costs, and have ended the shortages experienced prior to the new economic policy. In the financial area, the liberalization of interest rates in February 1989 was designed to improve the financial condition of intermediaries and to promote additional resource mobilization. While interest rate ceilings were reinstituted because of a Supreme Court ruling, the increase in interest rate ceilings over time has decreased the distortions in the financial system. Finally, the public investment program and social welfare expenditures are being reviewed to target beneficiaries more precisely, within the constraints imposed by the new fiscal responsibility.

8. Although growth prospects remain good in the medium term, the short-term costs of adjustment are proving to be quite severe. Non-oil GDP dropped by about 9.1% in 1989. Given this result, the adjustment process needs to be

implemented in a way that is least disruptive and puts special emphasis on social sectors. In order to achieve this objective the Government has designed and presented to Congress an investment plan aimed at promoting economic growth and specially targeting social needs.

9. The Government will maintain a macroeconomic policy framework consistent with the objectives of its adjustment program. This framework will involve continuation of a unified, market-determined exchange rate and a financial regime in which interest rates are freely set in the marketplace. The fiscal position, together with the rate of growth of monetary aggregates, will be consistent with the restoration of real GDP growth and declining inflation rates. It is expected that the Government will maintain its policy of further improving the fiscal balance of the consolidated nonfinancial public sector. Also, given the impact of oil price movements on Venezuela's external balance, management of international reserves is crucial to macroeconomic stability, and, therefore, in the event of increasing oil prices, increases in the international reserves of the Central Bank are expected.

Main Components of the Proposed Reforms of the Financial System

10. There is a consensus within the Government that the financial system has to improve in order to perform its functions more efficiently. The Government has designed a comprehensive program aimed at confronting the following issues: (i) an inadequate framework of regulatory and supervisory institutions (including overlapping functions and imprecise responsibilities among different regulatory entities, weak supervision of financial institutions, and inadequate mechanisms for liquidating or rehabilitating banks); (ii) excessive Government controls over interest rates and credit allocation, which distorts the incentives of intermediaries; (iii) solvency problems in a number of financial institutions (including some private commercial banks, public banks, state-run development funds, mortgage banks, and savings and loans [S&Ls]); (iv) the need to define and rationalize the Government's role as a financial intermediary; and (v) the need to provide greater clarity in the BCV's financial transactions with the Government and with financial institutions.

I. Reform of the Institutional and Regulatory Framework

11. The Government recognizes that the institutional framework within which the financial system operates suffers from major deficiencies that must be corrected. The main deficiencies are: (i) co-existence of various regulators (Superintendencies, BCV, Ministry of Finance [MH], FOGADE, and the National Savings and Loans Bank [BANAP]) with overlapping functions; (ii) imprecise separation of roles, approval procedures and communication channels between these regulatory agencies; (iii) insufficient powers and independence of the Superintendencies; and (iv) concentration of powers in the MH that should be exercised by the Superintendency of Banks (SBIF).

12. A key element of the reforms will be the bolstering of the regulatory process, aimed at reducing the overlap of functions and ensuring functional, administrative, and financial independence of the SBIF. The SBIF will be responsible for the analysis and control of financial entities under its supervision. FOGADE will guarantee the public's deposits up to an established limit, provide financial support to rehabilitate entities with

solvency problems, and, if necessary, liquidate entities. MH and BCV, each acting within their own jurisdiction, will be the lead agencies responsible for issuing general policies that the SBIF and FOGADE must follow, yet will not have powers over these agencies' operations other than those specified by law. Finally, BCV will seek to maintain the stability of the exchange rate, money and credit, and will limit its transactions with banking institutions to managing short-term liquidity at market rates of interest.

13. The Government will submit for congressional enactment amendments to the FOGADE Law, the BCV Law, and the Bank Law. The first two will be submitted to Congress by the end of 1990. The Bank Law will be submitted to the Congress by mid-1991. In addition, a proposed new law for SBIF will be submitted to Congress by the end of 1990. In the preamble to these proposed laws, the Executive will stress the importance of the reforms and the need to speed their passage through Congress.

14. Prudential Regulation and Supervision and the SBIF. The proposed SBIF Law will grant autonomy to the SBIF by transforming it into an independent agency. Ample decision-making authority will be granted to the SBIF, and any requirements for approval by the MH on the SBIF's actions will be eliminated. The following actions will require approval from a Consultative Committee composed of the Minister of Finance, the President of the BCV, the President of FOGADE and the Superintendent: (i) the intervention, dissolution or liquidation of financial institutions, (ii) the revocation or suspension of bank licenses, (iii) the fixing of the minimum capital requirement. The SBIF will be financed through direct annual contributions from the entities supervised as a fixed percentage of their assets, but can also receive extraordinary contributions from the Treasury. The SBIF's annual budget will require approval by the Board of Directors of the BCV. The proposed Law will reinforce the powers of the SBIF to identify and address financially distressed institutions and will specify its scope for penalties and sanctions. It will also broaden the SBIF's powers to authorize, control, intervene, and proceed with the liquidation of financial institutions. The proposed Law and its implementing regulations will strengthen the SBIF's responsibility for setting capital requirements, standards for loan concentration and lending to insiders or related parties, preventive capitalization procedures for distressed institutions, and the conditions that prompt action by FOGADE. Finally, the proposed Law will also eliminate unnecessary provisions contained in the current Bank Law and will authorize the SBIF to raise minimum capital requirements until the Bank Law can be amended to that effect. The Bank Law and the BCV Law will be amended to include provisions supporting the new spirit of regulatory institutions.

15. The SBIF's enhanced autonomy and regulatory powers will be complemented by upgrading its functional organization and operating procedures. Together, these measures will result in the strengthening of prudential regulations and the SBIF's supervisory capability.

16. By June 1990, the SBIF will issue a series of resolutions to strengthen rules in the following areas: loan portfolio classification and provisioning, loan rollovers and interest accrual, asset write-offs, measures of investment quality, and criteria for the valuation of property received as collateral. By June 1990, the SBIF will instruct credit institutions to contract their auditors to review and render an opinion on the classification

of their portfolio and concentration of loans as part of their regular audits. By December 1990, the SBIF will also issue resolutions establishing: criteria for valuation of foreign exchange risk, limits on lending concentration, controls on intra-group transactions, uniform criteria for publication of balance sheets with notes to clearly and accurately reflect the financial position of the institution, and a methodology for consolidation of the accounts of financial groups and the accounts of overseas branches. Before July 1991, the SBIF will issue a new Chart of Accounts for financial entities in order to facilitate the analysis of the true financial condition of intermediaries and will issue audit guidelines in accordance with this new Chart of Accounts. By the same date the SBIF will also initiate monthly publication of a bulletin disclosing the status of certain indicators on the financial condition of financial institutions. By that time, the SBIF will have consolidated a number of organizational changes, including: (i) hiring and training of suitable staff, (ii) computerization of its operating systems, (iii) establishment of improved inspection procedures, (iv) internal reorganization to enhance its early-warning capability to detect potential banking problems, and (v) improved management of a credit information system (SICRI).

17. <u>Mechanisms for Handling Bank Crises and FOGADE</u>. The financial sector reform will strengthen FOGADE's capacity to handle bank crises by reinforcing its legal, institutional and financial position. FOGADE's Law will be amended to redefine its procedures for granting financial support in cases of bank insolvency, empower it to carry out liquidations, and enhance its financial position. FOGADE will intervene only by referral of a bank by the SBIF, and will grant assistance to banks only after removal of the bank's Board of Directors. Concessional assistance to financial institutions by FOGADE will take the form of capital contributions, while all credits and asset purchases will be performed at market value. It will administer or financially support institutions only after a majority of shares have been voluntarily sold or pledged to it. To finance FOGADE, the Treasury will make regular contributions matching the amount contributed by financial institutions. BCV management of FOGADE investments in trust will be eliminated, allowing FOGADE to manage its own funds directly. FOGADE will prepare its balance sheet and will account for its losses in accordance with standards established by the SBIF. By December 1990, FOGADE will contract a special study by external auditors to appraise the value of assets received from the BCV and in the course of financial support operations. This valuation will be performed on the basis of market costs and SBIF standards. On the basis of this study, the Government agrees to prepare a program by mid-1991 for equity contributions by the Treasury to cover all losses. A partial recapitalization of FOGADE will be included in the proposed Budgetary Law for 1991 to cover during the first semester of 1991 at least 50% of the losses estimated by the study mentioned above. After Budget approval, contributions will start in January 1991. By July 1991, FOGADE will review its internal regulations to make them consistent with this new approach and the law in effect at that time.

18. FOGADE will carry out operations to rehabilitate insolvent banks in those cases where rehabilitation is less costly than liquidation, and when necessary to prevent widespread destabilization of the banking system. To enhance market discipline, the Government will carry out during the second

semester of 1990 a publicity campaign indicating that in the event of liquidation, FOGADE will only cover deposits up to the amount determined by law.

19. Capital Markets. The Government has decided that before December 1990 it will undertake a comprehensive evaluation of capital markets. In particular, it will aim to study options for the expansion of market activities, and the promotion of efficiency and technical capacity.

II. Rationalization and Liberalization of Interest Rates and Credit Allocation

20. The Government's policy is to allow interest rates to be freely determined in the marketplace. In cases where this is not possible, only the BCV as monetary authority will have the prerogative to set interest rates. The BCV's exclusive authority in setting interest rates will ensure greater consistency with the monetary goals set by the BCV itself. For this purpose, amendments to the BCV Law will be proposed to Congress by the end of 1990 to: (i) transfer to the BCV exclusive power to set interest rates over all financial intermediaries including government-owned development funds; and (ii) allow it not to exercise this power, thereby permitting full market determination of interest rates.

21. Within the current legal framework, deposit and lending interest rates are subject to minimum and maximum limits respectively. These rates will be periodically revised in order to ensure sufficient scope for market determination. No interest rate regulations other than these limits will apply to commercial and mortgage banks, finance companies and S&Ls. The only bank credits that would not be subject to this policy are preferential industrial and agricultural credits (see below) and housing credits financed under the Ley de Politica Habitacional.

22. In order to enhance market discipline in the determination of interest rates, it is important that the public be informed of the interest rate regime offered by banks. With easy and transparent access to this type of information, the users of banking services can better exert the market discipline on which this reform program is based. For this purpose, the BCV will publish average interest rate indicators on a daily basis starting in June 1990, and will issue a directive to banks by December 1990 requiring them to announce and post their rates on all deposit and credit services, specifying the methodology for their calculation. Before June 1991, the BCV will publish in its monthly bulletin a table comparing interest rates offered by the various financial institutions, using a uniform methodology for presentation purposes.

23. Preferential Credits. The Government's medium-term policy is that all interest rates be set by the market. As a first step towards the elimination of interest rate subsidies, the Government has decided to increase preferential interest rates on all direct loans from government financial intermediaries, including development funds, and to increase the interest rates on agricultural loans granted through the commercial banking system. All preferential rates will be based on a market reference rate given by the average lending rate of the six largest banks on non-preferential credits. Beginning in June 1990, lending to agricultural activities by commercial banks

will occur at a rate not greater than 85% of the market reference rate, lending to agricultural activities by DFIs will occur at a rate not less than 85% of the market reference rate, and lending to other activities by DFIs will occur at a rate not less than 90% of the market reference rate. The availability of funds for non-agricultural credits at preferential rates will take into account the fiscal restrictions and the need to improve the efficiency of credit allocation.

24. For second-tier credits, the Government's financial intermediaries (including BANAP) will lend to the first-tier intermediaries at a rate not lower than the average cost of interest-bearing deposits in the banking system. First-tier institutions will absorb the entire credit risk of the final borrowers.

25. Credit Requirements. The maintenance of the agricultural credit portfolio requirement is warranted by the need to adjust this sector gradually, but firmly, to the new market conditions prevailing in the financial sector. This measure is temporary in nature, and the Government expects to eliminate it under the current financial sector reform program. Beginning in June 1990, the minimum portfolio requirement on commercial banks will be reduced to 17.5%. The requirement will be further reduced to 12% by June 1991.

III. Strengthening the Financial Condition of and Increasing Competition between Private Financial Institutions

26. The Government believes that there are solvency problems in some financial institutions, including both public and private entities (commercial and mortgage banks, finance companies, and S&Ls). Also, the Government believes that competition in the financial sector must be enhanced to reduce intermediation margins and encourage greater banking efficiency. With these objectives in mind, the SBIF will issue a resolution before June 1990 requiring all commercial and mortgage banks and finance companies to institute a general loan-loss provision for bad debts of not less than 2% of their total loan portfolio, and further requiring them to write off any loans that have been overdue for more than three years. These write-offs, which will be in addition to the minimum 2% provision, will start in July 1990 and will be completed by June 1991. Accordingly, the December 1990 financial statements of financial institutions will include provisions of at least 1.5% of their respective loan portfolios, and the June 1991 financial statements will at least complete the 2% provision requirement. The SBIF will undertake studies of all commercial banks and some other financial institutions, focusing on their solvency, loan portfolio quality, concentration of risks, and foreign currency exposure and exchange losses. These studies will be completed by end-1990. If as a result of these studies the SBIF determines that some institutions need to increase their provisions or write-offs, it will require them to adjust them in accordance with plans to be agreed upon. Also by December 1990, the SBIF will prepare an analysis of foreign exchange losses of public and private financial entities and a program for their amortization. The Government will not authorize the creation of new banks or finance companies until the SBIF has been strengthened, which is expected to take place by mid-1991.

27. By mid-1991, the Government will submit to Congress amendments to the Bank Law to promote greater competition in the financial sector. The changes will include: allowing the creation of universal banking, unifying and tightening capital requirements of commercial and mortgage banks and finance companies, and gradually liberalizing the entry of foreign banks. The legislated capital requirement will be asset-based, will permit risk-weighting in the future (including some contingencies), and the minimum equity/total asset ratio will not be less than 5%. Recognizing that an enhanced presence of foreign banks can produce a significant increase in the efficiency of the domestic financial system and could facilitate the Government's task in seeking recovery of selected financial institutions, the following changes will be introduced: (i) foreign banks will be permitted to acquire up to 20% of the capital of local commercial banks; the Executive could further increase this percentage up to 30%; (ii) legal power will be granted to the Executive to authorize foreigners to acquire a larger participation up to full ownership of, or to establish new, financial intermediaries other than commercial banks subject to operational criteria established by the Executive. The establishment of the criteria is not intended to discourage foreign investment in these institutions.

IV. Rationalization and Reduction of the Government's Role in Financial Intermediation

28. The Government recognizes that its financial intermediation role (acting through state-owned banks and development funds) has brought about significant losses to the Treasury and has contributed to the segmentation and inefficiency of financial markets. The rationalization of the Government's development finance agencies will seek to increase efficiency, target benefits more precisely, and curtail fiscal or quasi-fiscal losses to the State.

29. The Government is profoundly concerned about the inefficiencies noted in state-owned banks, development finance institutions and development funds, including among others: the Venezuelan Industrial Bank (BIV), Industrial Credit Fund (FONCREI), Corporation for the Development of Small and Medium Industry (CORPOINDUSTRIA), the Agricultural Development Bank (BANDAGRO), the Agricultural Credit Fund (FCA), the Farming and Livestock Credit Institute (ICAP), the Coffee Fund (FONCAFE), the Fruit Development Fund (FDF). All of these organizations, to a greater or lesser extent, suffer from the following problems: (i) high rates of arrears in their loan portfolios, (ii) inefficient resource allocation, (iii) little capacity to mobilize private independent resources to finance their operations, (iv) loan portfolios yielding below market rates, and (v) a precarious or sometimes insolvent financial position.

30. The Government has decided to rationalize its participation in commercial banking and in development finance in order to increase the role of market forces and to reduce its losses. For this purpose, it has decided to take a number of measures including the merger of selected funds, and the privatization, restructuring or liquidation of public banks.

31. Those funds that grant financing to productive sectors will be merged into two large second-tier funds: an industrial credit fund and an agricultural credit fund. The industrial credit fund will absorb, among others, FONCREI, the Industry and Technology Development Fund (FINTEC), and

the second-tier financial intermediation functions of the Venezuelan Investment Fund (FIV). The agricultural fund will absorb, among others, the FCA, and the intermediation operations of FONCAFE and FDF. Their respective organic laws, which will be submitted to the Congress by December 1990, will provide for the transfer of operations of the existing funds to the new institution and will stipulate the expiration of their activities. Action plans for the creation of these two new second-tier funds will be prepared before December 1990. Because of their social welfare functions, CORPOINDUSTRIA and ICAP will remain as independent funds, and will only perform those first-tier lending activities arising from programs authorized by the Executive. The Government has also decided to prepare action plans for the restructuring of ICAP and CORPOINDUSTRIA. These plans will be ready by December 1990 and we expect that by mid-1991 there will be substantial progress in their implementation. All existing and newly created funds will be organizationally located under the MH, and supervised by the SBIF.

32. The Government is also aware of the need for actions to strengthen BIV, the largest state-owned commercial bank. To resolve this situation, the Government will: (i) require that any new deposits and portfolio recoveries be invested in securities of the Treasury or the BCV after June 1990; (ii) commission an independent analysis of BIV's financial condition and solvency; (iii) prepare before December 1990 a detailed restructuring plan including an implementation schedule. The plan will contain programs for financial recovery, staffing rationalization, and administrative reorganization of the BIV and of its four regional banks, and the schedule for the resumption of BIV's lending activities.

33. The Government has also decided to resolve the crisis at BANDAGRO, which has been under intervention for the last nine years. The Government will prepare a law to be presented to Congress by December 1990 proposing the liquidation of BANDAGRO in conjunction with the creation of the new agricultural credit fund. This law will specify what objectives formerly pursued by BANDAGRO will be pursued by the new fund. By June 1990, the Government will adopt interim measures to limit the bank's operations and to forbid any new ones. Accordingly, any new deposits or portfolio recoveries will be invested in securities of the Treasury or the BCV.

34. BANAP, which acts as the second-tier bank of the S&Ls, is also beset with serious financial difficulties. The Government will prepare a financial restructuring program for BANAP which will eliminate future needs for financing by the BCV or the Government. This restructuring program, including a new, more restrictive credit policy to S&Ls, will be prepared by December 1990.

35. The Government's subrogation of foreign debt obligations will be a significant element of the restructuring, recovery or liquidation programs, as the case may be, of the public financial institutions mentioned above.

36. The Government has initiated the process of reprivatization of the three banks owned by the BCV (Banco del Occidente, Banco República, and Banco Italo-Venezolano) through the Investment Fund of Venezuela (FIV). All three banks will be offered for public sale before the end of 1990, and the public sector's participation in these banks will have been divested by mid-1991.

V. Increasing the Clarity of the BCV's Credit Operations

37. The BCV will seek greater clarity in its credit operations with both the Treasury and the financial system. The basic criterion will be that all subsidy programs be made explicit in the Government's budget and not be concealed in BCV's operations. This will facilitate better prioritization of public spending and will endow the BCV with greater flexibility in managing monetary policy by eliminating its quasi-fiscal losses. To this end, the Government will propose to Congress amendments to the Bank Law, the Law of the Central Bank, and the Law of Public Credit.

38. Considerable progress has been made toward enhancing the clarity of the BCV's operations. For example, unification of the exchange rate and the elimination of exchange rate guarantee programs have eliminated sources of income and expenditures that were not reflected in the budget and that resulted in quasi-fiscal losses for the BCV. The increase in the BCV's discount rate from 8 percent in January 1989 to the current 33 percent, as well as the new restrictive rediscounting policy, also resulted in the reduction in the implicit subsidy to the financial system. Finally, the issuance of bonds by the BCV at market rates will allow monetary policy to be conducted in an efficient, clear, and non-discriminatory manner.

39. The credit relationship the BCV will maintain with the Government will not be different from the relationship the BCV maintains with other economic actors with regard to rates and procedures. Accordingly, the BCV will no longer buy Treasury bills unless the bills are negotiable and pay market rates of interest. Further, the Treasury's debt instruments will be made more flexible by establishing in the Public Credit Law the power to issue fixed term Treasury bills that are not required to be redeemed within the fiscal year in which they are issued. The value of the Treasury bills will be determined in the marketplace and they will not be placed through preferential purchasing arrangements. The necessary amendments to the Public Credit Law will be submitted to Congress before December 1990. A reform of the BCV law will also be presented to Congress to allow the BCV to acquire on its own initiative Treasury bills, subject to BCV's monetary program and to the overall Treasury debt limit. This limit will be made applicable to any debt or rights to debt in either domestic or foreign currency, and will not be raised from the level contained in the current law. On a transitory basis, debt related to the ongoing external public debt reduction and restructuring program will not be counted within this limit. BCV purchase of Treasury bills will take place after an auction, on a residual basis, and at the average clearing price at such auction. Finally, an amendment to the Bank Law will be proposed to eliminate the use of Treasury bills as instruments satisfying the reserve requirement. The reserve requirement will be maintained only with BCV liabilities. These reforms will allow Treasury bills to be used in the future by the BCV as an alternative to BCV bills in open-market operations.

40. In the future, the discount window will be made available exclusively as a last-resort source of liquidity for financial entities (including BANAP). However, rediscounting will be kept as a tool for monetary expansion while the BCV's capacity for indirect monetary regulation is being

developed. In any event, the BCV's credit relationship with the financial system will be revised to prevent subsidization and to ensure that the BCV's financial support is used strictly to accommodate liquidity needs of solvent institutions.

41. Procedures will be established for information sharing and coordination between BCV and SBIF that enable SBIF to identify the best program for support in the case of insolvent banks that are not eligible for BCV liquidity credits. With regard to the elimination of implicit subsidies, the Government will set the discount rate based on the yield of BCV bonds, which reflects market conditions. Given the new orientation of rediscounting as an instrument for banking liquidity and monetary policy rather than as a sectoral development instrument, all rediscounts, excluding the rediscounts for agricultural credits at preferential rates, will be granted at a rate not lower than the yield of BCV bonds. Credits offered to BANAP and FOGADE will also be made at this market based rate. Rediscounts of agricultural credits at preferential rates will be granted at a rate not lower than 85% of the discount rate on other rediscounts. This special rate for agricultural rediscounts will only subsist as long as there is preferential credit for agriculture. Furthermore, all rediscount contracts will be issued for a term not exceeding 30 days. The collateral required by the BCV in its credit operations will be valued at market or equivalent prices, and credit portfolio purchase programs will be eliminated since the same liquidity objective can be attained through rediscounting. Finally, the BCV will buy or sell any security or financial instrument only at market value. To ensure this goal, the BCV will not purchase securities that have an effective yield that is less than the yield of its own bonds.

42. Trust arrangements and other portfolios administered by the BCV represent an administrative burden, and have frequently been used as vehicles for financing fiscal deficits. The Government proposes eliminating these trust arrangements (with the exception of the Foreign Exchange Insurance Fund [FICAM]). For this purpose, a plan will be formulated by end-1990 establishing the necessary legislative and executive changes, and an implementation schedule. As part of this program, the management contract with the Venezuelan Petroleum Company (PDVSA) will be cancelled by December 1990, and the trust arrangement with FOGADE will be terminated before July 1991. As long as the portfolios continue to exist, transactions with the BCV will be made only at market value, with the exception of securities that are currently held by the administered portfolios.

43. The Government will not channel subsidies through the BCV, either by means of interest rate subsidies or by any other direct contribution from the BCV. In this spirit, all housing subsidies will be financed by direct appropriation in the Government's budget.

Implementation of Financial System Reform

44. The BCV will be the executing agent for reform of the financial system. Due to the complexity of the reform, the BCV has agreed to create a temporary unit which will be in charge of implementing the reform program and of policy-setting. This unit will submit monthly reports to the Executive Branch (through the Minister of Finance) and to the BCV's Board of Directors, and will oversee the implementation of the technical assistance component.

The unit will be composed of high level staff or consultants who will work full-time on the reform program. The staff will include economists, administrators, and attorneys, and will be directed by a professional of acknowledged prestige and managerial ability.

Sincerely yours,

Ministro de Hacienda

Ministro de Estado
Jefe de CORDIPLAN

Presidente del Banco Central
de Venezuela

VENEZUELA - FINANCIAL SECTOR ADJUSTMENT LOAN

POLICY MATRIX

Issues and objectives	Actions taken to date	By Board presentation[a]	By second tranche	By third tranche
1. Liberalize & rationalize interest rates & credit allocation.				
1.1 Allow market determination of commercial interest rates.		a)• Policy Statement indicates that, as long as setting interest rate limits is required in the BCV Law, minimum deposit (maximum lending) rates will be reduced (increased) if the limit becomes binding.	• Modifications to BCV Law submitted to Congress will allow full market determination of interest rates.	
		b)• BCV Board has issued resolution setting the minimum deposit rate & maximum lending rate at 10% & 60%, respectively, which are not binding by a wide margin.		
1.2 Reduce & rationalize preferential interest rates.		a)• Policy Statement indicates that the Government's medium-term objective is full liberalization of interest rates. Meanwhile, subsidized rates on direct lending by government-owned financial intermediaries & other preferential credits will be reduced. Rates will be based on the average non-preferential lending rate of the six largest commercial banks. Preferential interest rate on agricultural credits by commercial banks will be 85% of this reference rate, while direct preferential credits by DFIs will not bear interest lower than 85% & 90% of this reference rate for agricultural & other activities, respectively.		
		b)• Policy Statement indicates that government-owned		

Issues and objectives	Actions taken to date	By Board presentation[a]/	By second tranche	By third tranche
		financial intermediaries (including BANAP) will on-lend to first-tier financial intermediaries at no less than the average cost of remunerated deposits of the banking system. First-tier institutions will absorb the entire credit risk of the final borrowers.		
1.3 Ascribe to BCV the prerogative to set interest rate determination mechanisms for all operations of financial intermediaries.			• Modifications to BCV Law submitted to Congress will grant full & exclusive prerogative to BCV to set interest rates of government-owned financial intermediaries.	
1.4 Public disclosure of interest rate structure.		BCV Board has issued Resolution requiring daily publication by the BCV of the average & range of interest rates observed in the market (rates offered to the public, interbanks, & on BCV paper), as well as the rediscount rate.	BCV Board will issue a directive to financial intermediaries requiring them to announce & post their rates on all deposit & credit services, specifying the mechanism for their calculation.	BCV will publish in its monthly bulletin interest rates offered by a range of financial institutions.
1.5 Reduce restrictions on banks' discretionary allocation of credit.		a)• Policy Statement indicates Government's medium-term policy of eliminating all directed credit. b)• Government has issued a Presidential Decree reducing agricultural lending requirement on commercial banks from 22.5% to 17.5% of total portfolio.		• Government will issue decree reducing agricultural lending requirement on commercial banks to 12% of total portfolio.

Issues and objectives	Actions taken to date	By Board presentation[a/]	By second tranche	By third tranche
2. Rationalize public sector participation in the financial system.				
2.1 Commercial banking system	BCV has issued resolution starting the privatization of the 3 commercial banks it owns.		a)* The 3 banks owned by the BCV will have been brought to point of sale. All valuation & tender or bidding documents will have been completed to the satisfaction of the Bank & issued to prospective purchasers.	* All 3 banks will have been divested from the public sector.
		a)* Policy Statement indicates intention to restructure BIV & its 4 regional banks & to liquidate BANDAGRO.	b)* Government will specify an action plan to restructure BIV & its 4 regional banks, including specification of its new role.	Plan being carried out in accordance with its time frame.
		b)+ Government will issue a resolution forbidding BIV & BANDAGRO to engage in lending operations until they are either restructured or liquidated.	c) Submission to Congress of Law to liquidate BANDAGRO.	
2.2 Development banking system.		* Policy Statement outlines the formation of two second-tier credit institutions (for industry & agriculture, respectively) which will absorb the largest funds. It also indicated the main steps to be taken to create them.	a)* Submission to Congress of proposed law for the creation of an agricultural second-tier credit institution which would absorb at least 3 funds.	
			b) Action plan to close BANDAGRO & form the agricultural credit institution will be presented to the Bank.	Plan being carried out in accordance with its time frame.
			c)* Submission to Congress of proposed law for the creation of an industrial second-tier credit institution, which would absorb at least 2 funds.	
			d) Action plan to create an industrial second-tier	Plan being carried out in accordance with its time

Issues and objectives	Actions taken to date	By Board presentation[a/]	By second tranche	By third tranche
			credit institution will be presented to the Bank.	frame.
			e) Submission to Bank of strategic plan indicating role of CORPOINDUSTRIA & ICAP as first-tier institutions & an action plan for their restructuring.	• Plan being carried out in accordance with its time frame.
2.3 Housing finance system.			Submission to Bank of action plan to restructure & promote the financial independence of BANAP, including phasing out of all new government, BCV or external sources of funding & new policies in support of S&Ls.	Plan being carried out in accordance with its time frame.
3. Enhance the transparency of BCV's credit operations.				
3.1 BCV credit to the Government should be subject to an all-encompassing ceiling. BCV should be free to invest in Government debt of any maturity subject only to this overall credit ceiling.		• BCV Board has issued resolution stating that no zero-yield T-bills will be purchased at any time after the date of Board presentation.	a)• Modifications to Public Credit Law submitted to Congress to permit issuance of fixed-term negotiable short-term T-bills; Law should permit market determination of their price, & should not specify preferential order of placement of such bills among different types of economic agents. b)• Modifications to BCV Law submitted to Congress will: (i) allow the BCV to purchase fixed-term T-bills not necessarily redeemable in the fiscal year in which they are issued, at the average clearing price of primary issue auctions or in the secondary market; & (ii) include BCV holdings of, or rights to, government debt obtained through debt equity swaps & any	• Modifications to Bank Law submitted to Congress will eliminate use of T-bills as instruments for reserve requirements.

Issues and objectives	Actions taken to date	By Board presentation[a/]	By second tranche	By third tranche
			kind of foreign currency denominated debt in the overall credit limit to the Government. The limit will not be raised from the level contained in the current law. On a transitory basis, purchase of government debt obtained through ongoing debt reduction & restructuring programs will not be included in the ceiling.	
3.2 All subsidy programs should flow through the national budget, & should not originate in BCV's operations.	Volume of rediscounts has been cut significantly, with only one bank receiving funds.	a) Policy Statement outlines Government's intention to turn the rediscount window into a facility for temporary liquidity support once open-market capabilities are fully developed.	a) BCV Board will issue resolution switching to market valuation of collateral on rediscounts, advances & repurchase contracts.	
			b) BCV Board will issue resolution barring any new purchases of bank credit portfolios.	
	Rediscount rate has been brought up to close to average market lending rate.	b) BCV Board has issued resolution linking rediscount rate to yield on BCV bills auctioned. The general rediscount rate will be reviewed at least weekly, will not be set below the yield on BCV bills, & will apply to all financial intermediaries (including BANAP & FOGADE). A special rediscount rate, equal to 85% of the general rediscount rate, will be applied to rediscounting of agricultural documents. The Policy Statement indicates that the special rediscount rate will be phased out in step with agricultural preferential lending rates.	c) BCV Board will issue resolution requiring purchase of all private debt instruments by the BCV from any source at market value. In no case will such instruments be bought at a yield less than that offered on BCV bills in the secondary market at the time of purchase of the instruments.	
			d)* Modifications to BCV Law submitted to Congress will restrict discounting, rediscounting, advancing or repurchase contracts with financial institutions to a maximum duration of 30 days.	
		c)* BCV Board has issued instructions to Vice-president of Monetary Operations establishing		

Issues and objectives	Actions taken to date	By Board presentation[a/]	By second tranche	By third tranche
		the procedure for automatic referral of large borrowers (e.g., those with outstanding BCV credit in excess of 25% of their equity) to SBIF for review.		
		d) Policy Statement indicates that the Government will not finance any housing or related subsidies with BCV contributions or profits.		
3.3 BCV should not manage external portfolios; these portfolios should not be used to finance budget deficits.		a)* BCV Board has issued a Resolution mandating that all direct transactions of securities between the BCV & its managed portfolios take place at market value. The only exception will be the sale of securities previously purchased at face value which can be sold to the BCV at face value.	a)* Submission of program acceptable to the Bank to disengage all portfolios from BCV (except FICAM). b)* Modifications of FOGADE Law submitted to Congress will allow it to manage its own funds.	* FOGADE portfolio to be disengaged from BCV.
	PDVSA's portfolio at the BCV has been drawn down entirely.	b) Submission of notice by BCV to PDVSA of non-renewal of management contract at end-1990.		
4. Reform the Regulatory Structure.				
4.1 Redefine the regulatory role & strengthen the financial autonomy of: the Central Bank (BCV), Ministry of Finance (MH), the Superintendency of Banks (SBIF), & the deposit insurance corporation (FOGADE).		Policy Statement describes the division of labor between institutions.	* Submission to Congress of proposed new Law of SBIF to inter alia: (i) reorganize SBIF as an autonomous entity with its own sources of revenue; & (ii) eliminate MH's formal executive & decision-making functions in the operations of SBIF.	

VENEZUELA - FINANCIAL SECTOR ADJUSTMENT LOAN

POLICY MATRIX

Issues and objectives	Actions taken to date	By Board presentation[a]/	By second tranche	By third tranche
4.2 Strengthen prudential regulations, auditing, & information disclosure.		a)+ SBIF will issue all the changes required to tighten regulations on: provisioning, loan classifications, roll-over of credits & accrual of interest, charge-offs, evaluation of investment portfolios, & evaluation of property received as collateral. b)+ SBIF will issue instructions to banks to ask auditors to include assessment of loan classification & concentration in audits.	a)* SBIF will issue & implement all the changes required to regulate the valuation of exchange risk, loan concentration limits & controls of intra-group transactions, consolidation of accounts of financial groups, & uniform publication criteria of financial statements. b)* Submission to Congress of proposed new Law of SBIF to tighten norms on capital requirements & lending concentration, & widen the scope of sanctions & fines.	a) SBIF will issue a new chart of accounts which will facilitate full disclosure of the financial condition of banks. b) SBIF will issue audit guidelines in accordance with the new chart of accounts. c) SBIF will start issuing a monthly bulletin disclosing the financial condition of banks & the overall condition of the financial system. d) Modifications to Bank Law submitted to Congress will be proposed to ensure consistency with the new proposed SBIF Law and to eliminate any remaining redundancies.
5. Improving the Financial Strength of Intermediaries & Upgrading the Mechanism for Dealing with Problem Banks.				
5.1 Review financial condition of banks.		+ SBIF will undertake studies of the financial condition of all private commercial banks & selected mortgage banks & finance companies. The studies will focus on: portfolio review, fixed asset valuation, loan concentration, & foreign exchange losses.	* Completion of all studies undertaken by the SBIF to the Bank's satisfaction.	
5.2 Increase provisions for loan-losses, foreign		a)+ SBIF will issue directive to banks to establish a general loan loss provi-	a) Review banks' compliance with loan-loss provision. Establish additional pro-	Review banks' compliance with loan-loss provision & write-off requirements.

Issues and objectives	Actions taken to date	By Board presentation[a]/	By second tranche	By third tranche
exchange losses & charge-off bad assets.		sion of at least 1.5% of loans by December 1990 & 2% of loans by June 1991. Specific provisions will be counted against the general provision. b)* SBIF will issue directive to banks to write off loans past due by more than 36 months by June 1991.	visioning or write-off requirements for institutions that are in vulnerable positions according to the studies performed under 5.1. b) SBIF will prepare & submit to the Bank a program for the amortization by intermediaries of foreign exchange losses assessed under 5.1.	
5.3 Establish sounder requirements for entry.		* Policy Statement indicates that the MH will stop issuing licenses for opening new banks until the SBIF is strengthened.		* Modifications to Bank Law submitted to Congress will increase minimum capital requirements for entry to at least the equivalent of US$6 million for commercial & mortgage banks.
5.4 Improve the existing mechanisms for managing & solving banking crises.		* Policy Statement defines the policy & procedures with regard to managing bank crises. FOGADE will be provided with greater capacity to handle crises. Policy Statement outlines program of technical, legal, institutional & financial upgrading of FOGADE.	a)* Modification to FOGADE's Law will be submitted to Congress to: (i) more clearly define its role in the management of banking crises; (ii) strengthen its mechanisms for resolution of crises; (iii) strengthen its financial position; & (iv) enhance the transparency of its operations & financial condition. b) FOGADE will commission study to determine market value of its assets under management/sale. c) FOGADE will have undertaken campaign to publicize the types of accounts & institutions that are covered, & its maximum coverage limit.	a) Revise FOGADE's Reglamento Interno in accordance with principles established in Annexes VII & VIII. b)* Monthly capital contributions to FOGADE will have been made by the Treasury after January 1990. By third tranche, total contributions should amount to at least 50% of estimated losses of FOGADE. c)* Presentation to Bank of program to complete the recapitalization of FOGADE. Program will take into account losses uncovered in the study & will contain timing of capital replenishment by the Treasury.

Issues and objectives	Actions taken to date	By Board presentation[a/]	By second tranche	By third tranche
				d)* Modifications to Bank Law submitted to Congress will establish the procedures & the role of the various government agencies in solving bank crises, as outlined in Annex VII.
6. Enhance the competitive nature & financial strength of financial intermediaries.				
6.1 Permit universal banking & promote consolidation of financial intermediaries.				* Modifications to Bank Law submitted to Congress will allow universal banking & introduce procedures to facilitate mergers & consolidation (e.g., of specialized banks into universal banks).
6.2 Unify capital requirements of commercial banks, mortgage banks, & finance companies.				* Modifications to Bank Law submitted to Congress will establish the same minimum 5% equity:total assets ratio for commercial banks, mortgage banks & finance companies. The Law should permit the future introduction of a risk-weighted system (including some contingencies) for the computation of the asset base.
6.3 Liberalize foreign ownership of financial institutions.				* Modifications to Bank Law submitted to Congress will: (i) allow up to 20% foreign ownership of commercial banks (or 30% with the Executive's approval); (ii) allow Executive to authorize foreign institutions to

Issues and objectives	Actions taken to date	By Board presentation[a]	By second tranche	By third tranche
				acquire up to full ownership of, or to establish new, financial institutions other than commercial banks under operational criteria to be established by the Executive.
7. Macroeconomic Framework.		◆ Maintenance of macroeconomic policy framework consistent with the objectives of the financial reform program.	* Maintenance of macroeconomic policy framework consistent with the objectives of the financial reform program.	* Maintenance of macroeconomic policy framework consistent with the objectives of the financial reform program.

a/ All Board presentation conditions have been met.

* Specific condition for Board presentation or tranche release.
◆ Condition of first tranche release.

VENEZUELA - FINANCIAL SECTOR ADJUSTMENT CREDIT

TECHNICAL ASSISTANCE COMPONENT

1. The technical assistance (TA) component is designed to assist in the restructuring of government-owned banks and funds; strengthen the Superintendency of Banks (SBIF), the Deposit Insurance Corporation (FOGADE), the National Savings and Loans Bank (BANAP), and the Superintendency of Insurance Companies; and assist in the development of capital markets. In addition, it will provide funds to the coordinating unit in the Central Bank. For each institution, financial assistance, among other, will be provided in one or more of the following areas: (i) development of a new regulatory framework; (ii) reorganization of the institutions' structure, policies and procedures; (iii) development of training programs, (iv) funding of special studies; and (v) upgrading of information systems. The TA component will cost US$7.0 million and is detailed in the table at the end of this annex.

2. A unit will be established to coordinate and implement the financial sector reform program. The unit will submit monthly reports to the Executive Branch (through the Ministry of Finance) and to the BCV's Board of Directors. It will be responsible for ensuring that the program's reforms are effectively coordinated and implemented. It will also approve the hiring of consultants to provide advice and perform studies as indicated below. In order to assist the unit in its work and to coordinate the entire TA component, an International Consultant will be contracted for 24 months at a cost of US$8,000 per month for a total cost of US$192,000. A local consultant will assist the International Consultant for 24 months at a cost of US$3,000/month for a total cost of US$72,000.

3. The amounts indicated for each of the institutions in Table 1 shall be global allocations. Each institution will have the flexibility to reallocate funds from one function to another within each's global limit. Reallocations greater than US$50,000 within one institution will require Bank approval. All reallocations between institutions will also require Bank approval. A sixth category of unallocated funds has also been included. These funds can be allocated to each of the five institutions, subject to the approval of the BCV Coordinating Unit Head, Chief Consultant, and the Bank.

I. Support for Legal Changes.

4. Professionals with regulatory and legal experience will be contracted, by the BCV coordinating unit, under the TA component to assist in the drafting of amendments to the Central Bank Law, FOGADE Law, Bank Law, Laws for creation of development credit funds, and the Public Credit Law. Such professionals will also assist in the drafting of a new SBIF Law. These professionals (lawyers and consultants) will be hired for approximately 2,300 hours at a cost of US$100/hour for a total cost of US$230,000.

II. Support for the Restructuring of Public Sector Financial Intermediation

5. Assistance to the Ministry of Finance (MH) in the Incorporation of New Functions related to Credit Funds. US$200,000 will be allocated under the TA component to assist the MH in the incorporation of credit funds. Studies

for their incorporation and restructuring will be contracted for US$104,000 and consultants will be contracted to coordinate the implementation of these incorporation and restructuring plans (12 months @ US$5,000 and 12 months @ US$3,000).

6. Restructuring of BIV. The TA component will assist the restructuring of BIV by supporting the development of a restructuring plan (US$100,000) and supporting a consultant (12 months @ US$5,000) to coordinate the implementation of this action plan.

7. Consolidation/Restructuring of BANDAGRO and Agriculture Funds. Consolidation of agriculture funds and liquidation of BANDAGRO will be achieved with the assistance of an international consultant (US$7,000 x 12 months) and a local consultant (US$3,000 x 18 months) who will be responsible for implementing the action plan below. A local or international firm will be contracted for US$90,000 to develop and assist in the implementation of an action plan for the consolidation of these funds. A firm will also be contracted for US$70,000 to develop an action plan for the liquidation of BANDAGRO an incorporation of selected functions into the new agricultural credit fund.

8. Consolidation/Restructuring of Industry and Commerce Funds. As with agriculture funds, consolidation of industry and commerce funds will be achieved with the assistance of an international consultant (US$7,000 x 12 months) and a local consultant (US$3,000 x 18 months) who will be responsible for implementing the action plan below. In addition, a local or international firm will be contracted for US$100,000 to develop and assist in the implementation of an action plan for the consolidation of these funds.

9. Restructuring of ICAP and CORPOINDUSTRIA. Restructuring of ICAP and CORPOINDUSTRIA will be assisted by studies contracted for development of restructuring programs for each (US$55,000 each). Further, a consultant will be contracted for 12 months @ US$5,000/month to assist in the implementation of the restructuring programs developed in the studies.

III. Support to the Superintendency of Banks

10. The TA component will provide approximately US$3.9 million to restructure and strengthen the SBIF in support of the policy reforms contained in the loan.

11. Regulatory Framework. Given the new role envisioned for the SBIF, a new regulatory framework needs to be developed. The TA component will provide funds to hire a highly experienced international consultant to prepare a comprehensive regulatory framework for the SBIF and to direct the implementation of the new regulations. The consultant will assist in preparing the SBIF resolutions and draft legislation required for tranche releases. This consultant will also supervise the work of other consultants, acquisitions, and training at SBIF indicated below. The consultant will be contracted for 24 months, with a salary of US$8,000/month for a total cost of

US$192,000. A local consultant will assist the Chief Coordinator for 24 months at a cost of US$3,000/month for a total cost of US$72,000.

12. Information Systems. The SBIF's ability to diagnose the financial situation of the institutions under its supervision needs to be strengthened. For this purpose, the TA component will provide US$1.6 million for consultant assistance, computers and other equipment necessary to systematize information collected from banks. This effort will result in an early warning system of illiquidity and insolvency problems. It will consist of software, hardware and a network system. A MIS consultant will direct equipment purchases, design information systems, adapt software to SBIF's needs, and train staff. The cost of mainframe, personal computer and portable computer hardware will be US$1,200,000, software US$100,000, and peripherals US$200,000. The MIS consultant will receive US$5,000/month for 18 months for a total cost of US$90,000.

13. Manuals. An international consultant (US$5,000/month for 6 months) and a local consultant (US$3,000/month for 12 months) will be contracted to develop an inspection manual. Another local consultant (US$3,000/month for 12 months) will also be contracted to develop a synthesis of revised SBIF norms. The total cost of preparing these manuals will be US$102,000.

14. Training. TA component funds will be provided to the SBIF to train personnel and to build up a solid team of bank inspectors who can effectively monitor compliance with prudential norms and regulations. These funds will finance staff participation in courses and seminars held in Venezuela and abroad. Forty training trips abroad will be funded, at a cost of US$4,000/trip. The following in-house courses will be offered: four courses on credit evaluation (US$100,000 each), two courses on financial analysis of banks (US$100,000 each), and two courses on internal control of banks (US$50,000 each). Each in-house course offered will be for 30 people. Total training costs at the SBIF are estimated at US$860,000.

15. External Audits of Credit Portfolios. The TA component will provide US$1,200,000 to perform external audits of the 100 largest credits in 50 selected institutions {(US$240 per credit) x (100 credits) x (50 institutions)}. The estimated cost per credit of US$240 assumes that auditors familiar with each bank audit each credit in 6 hours at a cost per hour of US$40. This will include 31 private commercial banks and 19 mortgage banks and finance companies identified by the SBIF as in the most precarious financial position. These studies should be completed in approximately three months and immediately submitted both to SBIF and the Bank. Such submission will be a condition for second tranche release.

IV. Support to FOGADE

16. FOGADE's new role will be strictly defined and limited to rehabilitating ailing financial institutions, assisting in their merger, and liquidating banks. The TA component will support the definition of this role and implementation of measures to achieve it through a program costing US$348,000.

17. Goals, Management and Operating Procedures. An international consultant will be contracted for 2 years at US$7,000/month (US$168,000) to redefine the objectives of FOGADE, and develop a new operational plan, procedures and staffing profiles to achieve these objecti ,. The consultant will advise in the drafting of amendments to the FOGADE Law and the Bank Law, will coordinate a study of FOGADE's financial condition, and will supervise training of FOGADE staff.

18. Study of FOGADE's Financial Condition. A consulting firm will be contracted to assess FOGADE's financial condition and design a medium-term financial management and capitalization plan. In particular, the study will evaluate the market value of the assets which FOGADE purchased from the BCV upon its creation, assets it has acquired in the process of bank assistance operations, and assets it can expect to acquire in future operations. The cost of this study will be US$100,000.

19. Training. The TA component will provide US$80,000 for 20 training trips abroad for selected FOGADE staff, costing US$4,000 each.

V. Support of Reforms of the Savings and Loan System

20. BANAP and the S&L system are facing serious financial problems, and hence, US$212,000 from the TA component has been allocated to assess the financial position of BANAP and S&Ls, and develop a restructuring program.

21. Studies on S&Ls and BANAP. The TA component will provide US$90,000 for studies of the value of portfolios of 20 S&Ls (US$4,500 each). US$50,000 will also be allocated to prepare a study of the financial position of BANAP (incorporating the findings from the 20 studies) and to develop an action plan for its financial restructuring.

22. Regulatory Framework and Financial Restructuring. A full-time consultant will be hired to: (i) develop and implement action plans for the merger, restructuring or liquidation of S&Ls taking into account the studies commissioned; and (ii) implement an action plan to financially restructure BANAP in accordance with the restructuring plan suggested in the study. The consultant's assignment would be for 12 months, at US$6,000/month for a total of US$72,000.

VI. Support to the Superintendency of Insurance Companies

23. A diagnosis of the financial situation of the insurance industry and regulatory changes required to strengthen it will be supported with US$447,000 from the TA component.

24. Coordination of Studies and Norm Design. An international consultant will be contracted for 12 months (at US$6,000/month) to coordinate studies of individual insurance companies (see below), integrate these studies into an analysis of the insurance industry, and design revised norms for the Superintendency, for a total cost of US$72,000.

25. Evaluation of Condition of Insurance and Reinsurance Companies. Fifty companies will be evaluated in order to assess the state of the

insurance industry. The cost of each study will be US$7,500, with a total cost of US$375,000.

VII. Capital Markets Development

26. The TA component will assist the Government in facilitating the development of Capital Markets by commissioning studies to assess the functioning of these markets, determine what legal or institutional constraints exist to their further development, and develop an action plan for legal and institutional reform. These studies will cost US$200,000.

VII. Unallocated

27. US$289,000 has been allocated to supplement funds provided in the previous five categories.

VENEZUELA - FINANCIAL SECTOR ADJUSTMENT LOAN

SUMMARY OF TECHNICAL ASSISTANCE COMPONENT COSTS
(US Dollars)

Item	Sub-amount	Total
International Consultant (24 mos @ US$8,000/mo)		192,000
Legal Local Consultant (24 mos @ US$3000/mo)	72,000	
1. Support for Legal Assistance		
Legal Assistance/Advice (2,300 hrs @ US$100/hr)		230,000
2. Support for the Restructuring of Public Sector Financial Intermediation		
Assistance to the Ministry of Finance (MH) in the Incorporation of Credit Funds		200,000
Development of Action Plans for Incorporation of Funds	104,000	
Consultant to Coordinate Implementation of Action Plans (12 mos x US$5,000/mo) + (12 mo x US$3,000/mo)	96,000	
Restructuring of BIV		160,000
Development of Action Plan for Restructuring of BIV	100,000	
Local Consultant to coordinate implementation of BIV Restructuring Plan (12 mos @ US$5,000)	60,000	
Development of Consolidated Agricultural Credit Fund		298,000
Develop Action Plan for consolidation of Agricultural Funds	90,000	
Development of Action Plan for liquidation of BANDAGRO	70,000	
International Consultant to coordinate implementation of Action Plans (12 mos @ US$7,000/mo)	84,000	
Local Consultant to assist implementation of Action Plan (18 mos @ US$3,000/mo)	54,000	
Development of Consolidated Industrial Credit Fund		238,000
Develop Action Plan for consolidation of Industrial Funds	100,000	
International Consultant to coordinate implementation of Action Plans (12 mos @ US$7,000)	84,000	
Local consultants to assist implementation of Action Plans (18 mos x US$3,000/mo)	54,000	
Restructuring of ICAP & CORPOINDUSTRIA		170,000
Development of Action Plan to Restructure ICAP	55,000	
Development of Action Plan to Restructure CORPOINDUSTRIA	55,000	
Consultant to Coordinate Implementation of Action Plans (12 mos @ US$5,000/mo)	60,000	
Subtotal		1,656,000
3. Superintendency of Banks		
International Consultant/Coordinator (24 mos @ US$8,000/mo)		192,000

Local Consultant(24 mos @ US$3,000/mo)		72,000
Information System		1,590,000
MIS Consultant (18 mos @ US$5,000/mo)	90,000	
Hardware	1,100,000	
Software	200,000	
Peripherals	200,000	
Manuals		102,000
International Consultant (6 mos @ US$5,000)	30,000	
Local Consultant (12 mos @ US$3,000)	36,000	
Manual on Rules & Regulations		
Local Consultant (12 mos @ US$3,000)	36,000	
Training		860,000
Training Trips (40 @ US$4,000/trip)	160,000	
Credit/Evaluation courses (4 @ US$100,000)	400,000	
Financial Analysis courses (2 @ US$100,000)	200,000	
Internal Control courses (2 @ US$50,000)	100,000	
External Audits (50 institutions @ US$24,000)		1,200,000
Subtotal		3,944,000
4. Deposit Insurance Corporation		
Consultant to establish new Goals, Management & Operating Procedures (24 mos @ US$7,000/mo)		168,000
Study on FOGADE's Financial Condition & Medium-Term Action Plan		100,000
Training Trips (20 @ US$4,000/trip)		80,000
Subtotal		348,000
5. Savings & Loan System		
Study of Financial Condition of 20 S&Ls (US$4,500 ea)		90,000
Study of Financial Condition of BANAP & Action Plan for Restructuring		50,000
Consultant to Restructure BANAP & S&Ls (12 mos @ US$6,000/mo)		72,000
Subtotal		212,000
6. Superintendency of Insurance Companies		
International Consultant to Analyze Insurance Industry & Design of New Rules (12 mos @ US$6,000/mo)		72,000
Diagnosis of Insurance Companies (50 @ US$7,500)		375,000
Subtotal		447,000
7. Capital Markets Development		
Study of Mechanisms to Improve the Functioning of Capital Markets		200,000
8. Unallocated		121,000
Total		7,000,000

VENEZUELA - FINANCIAL SECTOR ADJUSTMENT LOAN

CHANGES IN PRUDENTIAL REGULATIONS

1. The Government is committed to overhauling its banking regulatory framework and modernizing the Superintendency of Banks (SBIF). Under the loan, the Government will improve the prudential regulatory framework and banking supervision through a combination of proposed legal reforms and changes in administrative norms and regulations at the SBIF. Implementation of a modernization and strengthening program will also be undertaken with technical assistance funds provided by this operation (see Annex V).

I. Changes in Legislation

2. Under the loan, a proposed new Law of Superintendency (SBIF Law) will be presented to Congress by December 1990. This proposed Law will clarify the role, organization, functions and powers of the SBIF as well as establish key prudential regulations. The proposed SBIF Law will modify the substance and spirit of several articles of the current Bank Law as well as provide new provisions for issues not currently being addressed.

3. A main feature of the proposed Law would be to increase the administrative, functional and financial autonomy of the SBIF. Provisions in the proposed Law would ensure that: (i) SBIF has sufficient autonomy and is shielded from political interference, (ii) the overall regulatory framework is adequate, (iii) SBIF has adequate resources to hire, train and retain competent personnel and acquire appropriate technology; and (iv) SBIF has sufficient authority to enforce its decisions without having to resort to the extreme action of recalling a bank's charter to operate. The proposed Law would provide SBIF with powers to carry out the following actions: impose fines and non-pecuniary penalties, issue cease and desist orders, restrict dividend payments, restrict branching, limit special operations in which managers have no expertise, intervene banks, request administrative actions, remove or fine managers and directors, force write-offs and provisions, force changes in published financial statements, require capital increases, and impose special punitive reserve requirement regimes.

4. The following changes in the Banking Law should be superseded, modified and subsumed in the SBIF Law:

o Bank licenses should be authorized by the SBIF.

o SBIF should have the power to authorize: (i) the dissolution of financial entities, (ii) mergers, (iii) sales of equity, (iv) capital expansion or reduction, (v) changes of objectives, and (vi) changes in statutes.

o SBIF should have the power to suspend or revoke licenses of banks and finance companies.

o Variation in reserve requirements according to location should be eliminated.

o Reserve requirements should not be allowed to be held in T-bills.

o New branches should be authorized by the SBIF, if necessary.

o Minimum capital requirements for the opening of new banks and finance companies should be increased to the equivalent of US$6 million. This amount should not be made to vary according to geographic location, and should be adjusted periodically to maintain its real value. The Superintendent should be authorized to raise (but not lower) the minimum capital requirement at his discretion.

o A global leverage limit should be established of a minimum capital and reserves to assets ratio of 5% for commercial banks, housing banks and finance companies. In the future, consideration should be given to switching to a risk-weighted capital requirement.

o The organizational guidelines for the SBIF should be revised to reflect a new authority structure to achieve new goals and objectives.

o The scope of provisioning requirements should be broadened and SBIF enabled to issue general provisioning norms and establish more precise rules for accruing interest on credits. Provisioning criteria for investments and other kinds of assets should also be included.

o Clearer limits on lending concentration should be established. The definition of related party should be clarified and made more specific. There should not be exceptions based on location, type of business, or public vs. private ownership.

o Application of special loss amortization provisions should be limited to those cases of banks undergoing rehabilitation.

o Guidelines for bank liquidation should be modified in order to reflect standards provided in Annex VII on Handling Bank Crises.

o Law should modify relationship among FOGADE, BCV and SBIF in treatment of problem banks to reflect suggestions in Annex VII on Handling Bank Crises. In this context, SBIF should have the authority to take action (intervention or preventive capitalization) without previous clearance from FOGADE and BCV.

o Administrative sanctions for non-compliance with legal norms should be strengthened through increases in fines and updated to maintain their real value. Non-pecuniary penalties should also be prescribed where appropriate.

o SBIF's Law should take precedence over the respective laws of specialized banks.

o The proposed SBIF Law will grant autonomy to the SBIF by transforming it into an independent agency.

o Ample decision making authority will be granted to the SBIF, and any requirements for approval by the MH of the SBIF's actions will be eliminated.

o The following actions will require approval from a Consultative Committee composed of the Minister of Finance, the President of the BCV, the President of FOGADE and the Superintendent: (i) the intervention, dissolution or liquidation

of financial institutions, (ii) the revocation or suspension of bank licences, (iii) the fixing of the minimum capital requirement, and (iv) any other matters that the Superintendent refers to the Consultative Committee.

II. Administrative Changes in Regulations

5. Beyond legal changes, the operations of SBIF must be transformed in order to strengthen the regulation of financial institutions. This section indicates the reforms of the regulatory framework which should be established through administrative directives or resolutions. These should be used as general guidelines only and further refined to accommodate Venezuelan conditions.

A. Asset Quality Assessment, Accounting Regulations and Provisioning

6. Loan Portfolio Classification. Every semester, each financial institution should be required by SBIF to review the quality of most (perhaps 70%) of its loan portfolio and classify each loan in its portfolio according to specified criteria. Failure to submit such loan valuations should be sanctioned by fines. Loans should be classified based both objectively on performance and subjectively on the debtor's financial condition and cash flow position. In particular, each bank will examine: (i) the repayment status of loans, including rollovers; (ii) the capacity to pay of the borrower, including earnings from operations, investments which support these earnings, and the indebtedness; and (iii) the quality of loan guarantees, including how the guarantees are legally constituted and the value of rapid liquidation of pledged assets.

7. Using these criteria, commercial loans would be expected to assessed and placed into the following categories: Normal Loans would be those less than 30 days past due[1/] and adequately guaranteed. Specially Mentioned Loans would be those which although still current, exhibit some characteristic suggesting the potential for partial uncollectibility in the future. Potentially Problematic Loans would be those that are: (i) 30-90 days past due; (ii) showing signs that liquidity generation may not be sufficient to cover loan payments in the short-term but will generate funds after a short-term lapse; (iii) those where the borrower has increased leverage above a prudent point for the section in which the firm is operating, or (iv) those where guarantees cannot be quickly and easily liquidated or some doubts exist as to their documentation. Doubtful Loans would be those (i) 90-365 days past due; (ii) with payments judicially suspended; those where (iii) information about the borrower is insufficient, confused, not audited or too old to determine potential recovery; (iv) litigation has begun against the borrower; (v) evidence exists suggesting the incapacity of borrower to satisfy contractual obligations and an inability to recover its short-term financial position; (vi) uncertainty exists over total debt recovery; (vii) doubt exists over the ability to exercise guarantees unless at a discount; or (viii) individual borrowers have had their financial position compromised through divorce or through the transfer of key assets to family members or others. Lost Loans would be those where: (i) the borrower or principal shareholder have

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1/ Past due is defined as: (i) principal or interest past due more than 30 days; (ii) the loan has been capitalized, refinanced or rolled over in such a way as to cover payment of at least 30 days' interest; or (iii) Current accounts (working capital) exceed authorized repayment limits or have maturities of 30 or more days.

declared bankruptcy; (ii) no documentation exists or grave defects exist in the form of the guarantee, legal procedures for asset seizure, or legal processes for execution and adjudication are difficult, slow and probably will be unsuccessful; or (iii) no interest payment has been received in 365 days and no interest has been showed by the borrower in negotiating alternative financing mechanisms.

8. Because consumer loans are generally small and time-consuming to monitor they are best placed into the above categories automatically according to the number of monthly payments past due. Collateralized housing loans generally have predictable collateral and are therefore similarly classified automatically according to the number of monthly payments past due.

9. Classification of Other Investments and Off-Balance Sheet Commitments. Improved mechanisms for evaluating, valuing and provisioning for financial investments, fixed assets and contingent credit obligations should also be developed at SBIF. In particular, losses in the difference between historic and market values of debt (including government bonds) or equity should be appropriately provisioned. Improved mechanisms for valuing guarantees would also need to be developed at SBIF. Finally, as SBIF develops an improved bank accounting and financial reporting system, it should also increase its capacity to assess off-balance sheet commitments and require provisions for such commitments if necessary. Since in Venezuela required provisions will likely be significant for a number of banks, it is recommended that a phased-in program for establishing such provisions be developed.

10. Provisioning. The principal behind adequate provisioning is that full provisions should be established for the expected loss for each loan category.[2] The following percentages are general indicators of possible probabilities of loss and therefore the provision amount: Normal (none); Specially Mentioned Loans (1%); Potentially Problematic Loans (20%); Doubtful Loans (50%); and Lost Loans (100%). Since in Venezuela required provisions will likely be significant for a number of banks, it is recommended that a phased-in program for establishing such provisions be developed. A 2% general loan-loss provision should be assessed against the entire amount of the portfolio. When specific provisions exceed 2% of the total portfolio, the general loan-loss provision will not apply.

11. The system to control provisions should be that financial institutions will indicate provisions established according to their portfolio quality assessment and SBIF inspectors evaluate the sufficiency of such provisions. Penalties should be imposed if large discrepancies exist between the institutions' assessment of required provisions and SBIF's.

12. Write-off Procedures. Write-offs should occur independently of the judicial process which often takes several years. At a minimum, after a loan is 36 months past-due it should be required to be written off regardless of its legal status.

2/ The formula for reaching such a provision would be: [(Probability of default) * (Outstanding Loan Balance)] - (Immediate liquidation value of guarantee + legal and administrative costs).

13. Reprogramming, Rescheduling or Refinancing of Loans. Reprogramming, rescheduling or refinancing of loans should take place only after a financial institution has verified the financial viability of the borrower and has received a separate strengthened guarantee to ensure the new commitment. The borrower should be required to pay all past-due interest before a loan is rescheduled. Rescheduled loans should in no case enable institutions to cancel provisions for doubtful accounts nor should such rescheduling improve the status of the loan as determined by the financial institution and SBIF inspectors. Rescheduled loans should be shown separately in the balance sheet.

14. Interest Accrual. Separate balance sheet accounts should be established for accrued yet uncollected interest. In any case, no interest should be recognized as income for loans past due more than 30 days.

B. Loan Concentration and Lending to Related Parties

15. Mechanisms should be developed to limit risk concentration or lending to related parties. In this way, banks should limit loans to individual borrowers or to those groups indicated below to a percentage of equity. Such groups would include shareholders, management (or those with relations with members of management that have input into credit decisions), subsidiaries, affiliated companies, and presumed related parties. SBIF should also develop controls on bank exposure to related economic groups and risk units (organizations whose economic solvency, fund generation or future viability depends on one of the above components).

16. While limits on loans to related parties is a legal matter, such limits should include (i) a global limit of loans to related parties (not to exceed 25% of capital and reserves), (ii) limits on lending to acquire shares in other companies, and (iii) limits on the amount of loans to a single individual, family or financial group. Each of these limits should be determined as a percentage of a financial institution's capital and reserves. It is imperative that a system of fines and sanctions be developed and enforced by SBIF in order for lending limits to be effectively applied.

C. Other Risks

17. It is important that SBIF assess and monitor foreign exchange risk, maturity/interest rate risk, and sectoral/business risk. The SBIF should consider mechanisms to control net foreign exchange exposure and net maturity risk exposure of fixed rate instruments for financial institutions. Foreign exchange losses could be assessed and provisioned for according to a phased-in program. Improved and more clear mechanisms are also needed for the amortization of foreign exchange losses.

D. Account Consolidation

18. SBIF should develop a program to consolidate the financial statements of overseas branches with those of domestic operations of Venezuelan banks. Recognizing that such consolidation could significantly increase the leverage of many banks, such a program should involve a phase-in of leverage limitations for the overseas branches. SBIF should also consider the imposition of financial norms for financial groups based on consolidated financial statements.

E. Information Disclosure and Audit Requirements

19. Information Disclosure. An adequate level of information disclosure is critical to facilitate public scrutiny of the performance of banks which allows depositors to discriminate between banks. SBIF should publish on a monthly basis a summary of the financial statements of each financial institution and key indicators for the financial system. Such bulletins should calculate key financial indicators of asset quality, capital adequacy, liquidity and profitability for each institution. Further, aggregate data should be provided in such bulletins indicating for example, monetary aggregates, foreign exchange exposure, and system-wide liquidity and asset quality. In addition, financial institutions should be required by SBIF to clearly note to depositors in new account information, passbooks and advertising that their deposits are insured up to the amount established by law.

20. In addition, SBIF should establish mechanisms to consolidate the financial statements of parties within financial groups and disclose summaries of this information in the monthly bulletins.

21. Audit Requirements. The SBIF should establish clear guidelines and standards on the scope of audits. Auditors should be required to audit the loan portfolio including adequacy of loan loss provisions. As SBIF revises its account manual, it should carefully disseminate the criteria for such accounts to both auditors and financial institutions to ensure that the accounting criteria are well understood and to make it clear that sanctions will be applied when SBIF requires account reclassification.

F. Bank Management and Internal Controls

22. Internal bank management procedures and control mechanisms are as revealing as the financial statements themselves in determining the condition and risks of banks. Furthermore, the viability of a bank in the long term is given by the current quality of its management. It is important that the SBIF devote more effort to assessing the quality of banks' management and controls. Accordingly, the SBIF should develop a capability to make assessments in this area.

VENEZUELA - FINANCIAL SECTOR ADJUSTMENT LOAN

MECHANISMS FOR HANDLING BANK CRISES

The banking legislation proposed to Congress under the financial sector reform program must contain mechanisms that allow the resolution of banking crises in an effective and timely manner. The key is to clearly specify the situations that may require action on the part of banking authorities, and the nature of the actions that will be prompted in those cases. The cases and administrative processes that should be envisioned under the proposed legislation are detailed below.

1. Gradual decapitalization. This case arises when an institution ceases to comply with the capital requirements because: (i) the institution has, through steady over-borrowing, surpassed the permissible leverage ratio for more than 30 days; or (ii) the financial institution incurs in losses, or the SBIF detects the existence of losses, that would reduce its equity by less than 50%. When the SBIF determines that such a case has occurred, it will apply a preventive surveillance regime (régimen de vigilancia preventiva), under which institutions will be subjected to the following measures:

a) Neutralization of the lending capacity of the institution until it reaches the required capital ratio. This will be achieved with the imposition of a special non-remunerated reserve requirement held at the BCV in an amount given by: (i) the increase in the level of deposits or other obligations by the bank over and above their level on the date on which the régimen was imposed; and (ii) any loan recoveries obtained after that date.

b) SBIF authorization will be required in order to the use the BCV's rediscounting facilities.

c) Depending on the nature of the problems and the prospects for their solution, the SBIF can impose a special surveillance (veeduría), under which the veedor retains veto power over all Board decisions.

If the capital position of the bank deteriorates further, the SBIF's actions will revert, depending on the case, to those for cases of either acute decapitalization (case 2 below) or continued non-compliance with the SBIF's orders and regulations (case 6c below).

2. Acute decapitalization. When the SBIF detects losses in a financial institution that would drive the institution into non-compliance with the minimum capital ratio and reduce its equity by more than 50%, it will apply a capital replenishment regime (régimen de reposición patrimonial) for a period not to exceed 90 days. The SBIF will summon shareholders to replenish capital within this period, and will subject the institution to the following measures:

a) Neutralization of the lending capacity of the institution with the imposition of a special non-remunerated reserve requirement to be held at the BCV in an amount given by: (i) the increase in the level of deposits or other obligations by the bank over and above their level on the date on which the régimen was imposed; and (ii) any loan recoveries perceived after that date.

b) No access to BCV rediscounts.

c) Special surveillance by the SBIF through a veeduría. The veedor, appointed by the SBIF, has veto power over all Board decisions or operations of the bank.

During this 90 day period, SBIF and FOGADE will analyze the viability of the institution. If any more losses are detected that would further undermine the institution's net worth, SBIF will require shareholders to put up the additional capital during the same period of 90 days.

3. Intervention by SBIF. If existing shareholders fail to satisfy the SBIF's request for additional capital in the prescribed period, SBIF and FOGADE will jointly determine whether the institution will be rehabilitated or liquidated. The minimum cost alternative will be chosen, taking into account the guaranteed deposit payments required of FOGADE in the case of liquidation (case 5 below). If the rehabilitation option is chosen, SBIF will adopt the following measures simultaneously:

a) Intervention of the institution, with displacement of the general assembly of shareholders.

b) Removal of directors. On a transitory basis, the SBIF will assume the management of the bank.

c) Charge-off of losses against equity.

d) Capital subscription offering to FOGADE in the amount necessary to consolidate the institution's capital position.

These measures will be undertaken in simultaneous fashion so that the SBIF's administration of the bank will not exceed 24 hours. Once FOGADE has subscribed the new capital, the institution ceases to be under intervention, as FOGADE then acts as majority owner of the institution (case 4 below). The procedure is designed to recognize losses and inject new capital without undermining the public's confidence in the bank.

4. Financial assistance by FOGADE. FOGADE's financial assistance will occur mostly through capital injections into ailing institutions. FOGADE will administer or financially support institutions only after a majority of shares have been voluntarily sold or pledged to it. If larger than expected losses become apparent later on, FOGADE can subscribe additional capital only if the volume of additional capital required is less than the cost to FOGADE of

satisfying the deposit guarantee. As the majority owner of the bank, FOGADE will assume the management of the bank. It will be allowed to increase, diminish, restructure or change the value of the bank's stock. Likewise, it will be authorized to restructure the bank's operations, personnel and internal policies and procedures. To this effect, FOGADE can purchase any assets from the bank at market value. Liquidity support to the institution will be provided by FOGADE rather than the BCV, but only under market conditions. Within a period of one year, FOGADE must sell its entire ownership participation in the bank.

5. Liquidation. All forced liquidations must be handled by FOGADE. FOGADE will pay-off guaranteed deposits, and will assume the claim on those deposits. FOGADE's claims on liquidation proceeds will have the same priority as any claims by the Treasury. FOGADE, as the receiver of the liquidated bank, should be authorized to sell any assets individually or in bundles, or to set up trusteeships (fideicomisos) holding those assets under litigation. Consideration should be given to granting FOGADE special coercive powers to recover assets, and to requiring FOGADE to sub-contract all asset recovery and sale procedures. FOGADE should strive to complete liquidation procedures within two years.

6. Intervention by SBIF for other reasons. The following occurrences should prompt an intervention or special surveillance (through a veeduría) by SBIF, depending on the nature of the case:

a) Administrative or managerial instability, where serious disputes among managers and/or directors undermine the normal operation of the bank.

b) Acute and persistent liquidity crisis, with rediscounts at the BCV in excess of the banks' equity.

c) Recurring non-compliance with the SBIF's orders, especially in the areas of loan classification and provisioning, loan concentration, or the special reserve requirement imposed in cases of decapitalization.

d) When there are reasons to doubt that the bank's accounts reflect its true financial position.

In any of these cases, the actions taken by the SBIF will be geared towards solving the particular problems detected in a period of less than six months. To accomplish this, the SBIF will be authorized to remove directors, replace management, and implement changes in the bank's policies, procedures and operations. If the problem deteriorates into, or makes apparent a process of decapitalization, the SBIF will impose the pertinent regime as described above (cases 1 or 2 above).

VENEZUELA - FINANCIAL SECTOR ADJUSTMENT LOAN

INSTITUTIONAL STRENGTHENING OF FOGADE

I. Reform of FOGADE's Law

1. Below are the proposed changes to FOGADE's Law (*Estatuto Orgánico del Fondo de Garantía de Depósitos y Protección Bancaria*). They are intended to: (i) more clearly define its functions and role within the financial sector regulatory framework; (ii) set up a suitable organizational structure that is responsive to the requirements imposed on both FOGADE and the Superintendency; (iii) strengthen the operational procedures of FOGADE by broadening the mechanisms with which it can fulfill its role and by favoring rules over discretion; (iv) provide a level of financing that is commensurate with its role; and (v) clarify the accounting principles by which FOGADE should abide in order to reflect accurately the costs and losses assumed by FOGADE.

2. It is expected that most of these changes will be reflected in the proposed revised Law that should be submitted to Congress by the end of 1990. Some of the items, however, could be implemented with changes in FOGADE's administrative regulations including changes in its *Reglamento Interno*.

A. Definition of Basic Functions and Operations

3. The proposed revised Law should state as a general principle that any financial support from FOGADE should not benefit existing shareholders and should be conditional on the replacement of management. It should also be made explicit that FOGADE will continue being a mechanism to liquidate or rehabilitate insolvent institutions and that it shall not become a mechanism for keeping alive insolvent institutions.

4. The proposed revised Law should specify broad criteria for the determination of the course of action to be followed in crises. FOGADE should adopt the minimum cost alternative including liquidation, subject to the preservation of the stability of the banking system as a whole. This notwithstanding, FOGADE's rescue operations should not necessarily be geared towards recovering its own investments in troubled institutions as its fundamental business is likely to require FOGADE to absorb losses.

5. Aside from its deposit payoff function, the current Law lays out FOGADE's role as an "instrument of support" for problem banks. This latter role should be strengthened to include active management of bank crises. FOGADE should always be the receiver in cases of liquidation.

B. Organizational Structure and Relations with Superintendency

6. FOGADE's current two-tier Board system should be replaced with a single Board with members having recognized technical expertise in the banking area.

7. All actions by FOGADE should be prompted by the referral of the SBIF. The proposed revised Law must clarify that, while FOGADE participates in the

solution to the crisis, SBIF continues to be responsible for the examination and supervision of the institution. FOGADE acts in the institution as equity investor, but does not assume SBIF's normal functions as supervisor.

8. SBIF rather than FOGADE should be the one to require banks' submission of semi-annual audits. Audits should be available to FOGADE under specific circumstances. Similarly, SBIF rather than FOGADE should outline wrongful behavior on the part of bank managers and shareholders. The proposed revised Law should specify the cases in which FOGADE could request information from the SBIF. FOGADE should not have an active role in maintaining a data base on the condition of the financial system. The entire chapter on sanctions and enforcement powers could be transferred to the SBIF's new proposed Law as these correspond to SBIF. A single article should establish sanctions against the non-payment of bank assessments.

C. Operational Procedures: Rehabilitation and Financial Assistance

9. No financial assistance will be offered by FOGADE unless a majority of bank shares have been voluntarily sold or pledged to it. Distribution of dividends should be restricted and require the authorization of FOGADE in all cases while the institution is under a rehabilitation program. In the same vein, FOGADE should authorize increases in salaries or other operational costs while the institution is under a rehabilitation program.

10. No long-term assistance should be provided to financial institutions as FOGADE's role is strictly rehabilitation or liquidation. Accordingly, the maximum maturity on loans offered by FOGADE should be reduced from 10 years to 5 years.

11. Any loans provided by FOGADE should be given at average market lending rates. Likewise, any asset purchases should be valued at market price according to the valuation criteria established by the SBIF. No special Board approval procedures should be required for asset purchases from troubled banks as opposed to any other forms of financial assistance.

12. Financial assistance to non-intervened institutions should have the same approval procedures as for intervened institutions, without authorization from the National Executive.

13. Any bank shares purchased by FOGADE should be reprivatized within a year in order to avoid a de-facto nationalization of banking services.

D. Operational Procedures: Liquidations and Deposit Payoffs

14. The procedure for deposit payoffs in cases of liquidation, including the timing of all actions, should be clearly specified, and should not require approval by the Ministry of Finance. Deposit payoffs should be initiated only after liquidation has been declared. In cases where the deposit guarantee must be paid off, the Law should allow: (i) cash payments directly to the depositor, or (ii) deposit transfers to other financial institutions, where FOGADE would compensate these institutions at less than the full value of the deposits assumed by them.

15. Interest should accrue on the guaranteed amount of deposits from the day the liquidation is ordered to the day payments on the guarantee are actually made. This interest would not be counted towards the coverage limit specified in the Law, and would be calculated on the basis of market interest rates.

16. In cases of liquidation, FOGADE assumes depositors' claims on the proceeds of liquidation to the extent of deposit payoffs. The proposed revised Law should specify that FOGADE's resulting claims will have the same priority as other Government claims.

E. Financing

17. The Treasury should be required to contribute to the fund on the same basis as commercial banks. It is suggested that the Government's contribution match that of the banking system. On the other hand, FOGADE should not be allowed to float its own bonds or to take debt from any institution other than the BCV.

18. Interest should be paid on any debt owed to the BCV by FOGADE. The general rediscount rate which applies to any other borrower should be used for this purpose, as this rate reflects the BCV's opportunity cost of funds. Annual profits should not necessarily be used to repay debts with BCV. Advances from BCV will carry a market rate of interest, and hence FOGADE should decide on its own whether to pre-pay any debts with BCV.

19. FOGADE should be able to manage its own funds. The requirement to hold liquid resources at the BCV should be lifted. Instead, the Law should restrict FOGADE's investments to domestic or foreign Government securities.

F. Accounting Standards and Control Functions

20. FOGADE should be required to report losses on the same basis as any other financial institutions. Accordingly, the provision allowing FOGADE to disguise losses as deferred charges should be eliminated, and replaced with the requirement that FOGADE's accounts be prepared using the standards of the SBIF (including regulations on provisioning, rollovers, accrual of interest, revaluation of foreign currency accounts, etc.). Also, FOGADE should be required by Law to be audited externally every six months under the same norms as for any other financial institution.

21. Regular assessments, whether from the Government or banks, should not be booked as capital. The requirement that proceeds from bank assessments be used only to pay-off deposits on liquidated banks should be lifted.

22. FOGADE will inform periodically to the Ministry of Finance and to the SBIF in its capacity as inspector of FOGADE, about its operations and financial condition.

II. FOGADE's Financial Position

23. Table 1 shows the balance sheet of FOGADE as of end-1989. There are several noteworthy aspects of the balance sheet. First, all assets under

management/sale are booked at purchase price, which in turn was determined on the basis of their book values in the institution they were purchased from (either financially assisted institutions or the BCV). There is no estimate of the market value of these assets, but their nature (including Bs. 4.8 billion in loan portfolios and Bs. 3.2 billion in receivables) suggest that the value of these assets is over-represented in the balance sheet. These assets are only provisioned against in the amount of 6% of their value. Second, credits provided by FOGADE under assistance programs are not provisioned against, despite the fact that these have been given precisely to institutions in a weak financial position.

Table 1: Audited Balance Sheet of FOGADE
(as of December 31, 1989, in Bs. billion)

ASSETS:			17.98
Short-term/liquid assets		4.54	
Credits issued under assistance programs		3.09	
Assets under management/sale [a]		9.74	
assets purchased under assistance programs	1.33		
assets received in payment	3.68		
assets transferred from the BCV	5.33		
Less: provisions and special reserve	0.60		
Claims on institutions under liquidation from payment of guaranteed deposits		0.02	
Fixed assets		0.21	
Other assets		0.34	
LIABILITIES:			13.17
Short-term liabilities		0.14	
Debts with BCV			11.44
Short-term	0.03		
Advances	5.83		
Debt associated with transferred assets	5.58		
Other Liabilities		1.59	
EQUITY & RESERVES:			4.80

a/ The breakdown of assets under management/sale is:

Stocks & bonds	0.78
Receivables	3.16
Land, buildings & equipment	1.56
Loan portfolios	4.79
Other	0.05
Total	10.34

24. These factors suggest that a precise determination of the net worth of FOGADE is not possible at this point. Under this loan, studies will be commissioned to determine the market value of the Bs. 10.34 billion in assets under management/sale and the Bs. 3.09 billion in credits to financial institutions. The valuation should be performed under the principles established

by the SBIF. Together, these assets amount to 70% of FOGADE's assets, or 270% of its net worth.

25. Finally, it should be noted that FOGADE's debt with the BCV amounts to Bs. 11.4 billion (equivalent to US$265 million) as of end-1989.

VENEZUELA - FINANCIAL SECTOR ADJUSTMENT LOAN

PROGRAM FOR THE ELIMINATION OF MANAGED PORTFOLIOS AT THE BCV

I. Status of the Managed Portfolios

1. BCV manages a set of portfolios under management contracts mostly with Government institutions. The composition of these portfolios is detailed in Table 1.

2. The total value of these portfolios amounts to Bs. 40 billion (equivalent to US$930 million), and the annual weighted average return is equal to 17%. The return is very low as compared to current inflation levels (36% annual rate for the second semester of 1989) or deposit rates in the banking system (around 35% for time deposits), which implies a significant decapitalization of the portfolios. This situation arises because the portfolios contain low-interest instruments purchased at face value. In most contracts, there is an agreement with the BCV for re-sale of the instruments to the BCV at the original purchase price, which means that in case of divestment capital losses would be borne by the BCV.

II. Cost of Disinvestment of Portfolios

3. It is hard to estimate the magnitude of the losses that will be incurred in the process of disinvestment of the portfolios because many of the private instruments (particularly those of mortgage banks and S&Ls) are not traded due to their poor grade. As a rough estimate, one can assume that the market price of all instruments would be that which would produce a yield equivalent to that on BCV zero-coupon bills, which currently stands at 36%. This measure is likely to underestimate the size of the losses because it does not take into account differences in credit risk between BCV bills and the private instruments held by the portfolios. In addition, it assumes that the current interest rate structure would prevail in the future. Using this procedure, the capital losses would be as indicated in Table 2. The cost of disengagement of all portfolios except FICAM would amount to Bs. 13 billion (equivalent to US$300 million).

Table 1: COMPOSITION OF PORTFOLIOS ADMINISTERED BY THE BCV BY TYPE OF INSTRUMENT AS OF JANUARY 31, 1990 (Nominal Value of Investment in Bs. Billion and Weighted Average Return of Local Currency Investments)

Total	IVSS[a]		FICAM[b]		FOGADE[c]		PENS.		BCV		Other[d]
	Amt.	Rate	Amt.	Rate	Amt.	Rate	Amt.	Rate	Amt.	Rate	Amt.
Public Instruments	10.96	23%	15.80	16%	1.94	15%	0.29	40%	0.01	13%	29.00
-Treasury Bonds[e]	9.66	25%	13.32	19%	1.94	15%	0.05	25%	0.01	13%	24.89
-Housing Bonds[f]	1.30	9%	0.36	11%	-		-	-	1.66		
-For. Curr. Bonds	-		2.11	na	-		-		-		2.11
-BCV Bills[g]	-		-		-		0.24	43%	-		0.24
Private Instruments	6.79	7%	0.82	37%	2.66	10%	0.21	34%	0.10	36%	10.58
-Commercial Banks	-		-		-		0.21	34%	0.09	37%	0.30
-Mortgage Banks	3.87	7%	0.17	7%	2.66	10%	-		0.00	9%	6.70
-Finance Companies	0.06	11%	-		-		-		0.00	9%	0.06
-Savings & Loans	2.87	7%	-		-		-		-		2.87
-Other[h]	-		0.65	45%	-		-		-		0.65
Total	17.75	17%	16.62	21%	4.60	12%	0.49	38%	0.11	33%	39.57

Source: Departamento de Fideicomisos, BCV.

a/ Pension fund of Social Security System; does not include other IVSS funds not maintained at the BCV.

b/ FICAM holds the insurance premia paid by enterprises on exchange rate guarantees issued by the BCV. FICAM will be used to compensate the BCV for any losses it will have incurred as a result of the exchange rate guarantee program.

c/ Temporary investment portfolio of FOGADE, as of December 31, 1989, prior to the creation of the new *fideicomiso*.

d/ The more active portfolios are: Trabajadores Petroleros, Fundación Bicentenario de Simón Bolivar, and FOGADE's Fondo Especial para la Vivienda. The less active portfolios are: Prestaciones Sociales del Sector Público, and Corporación Venezolana de Guayana. PDVSA's portfolio currently holds no funds.

e/ Treasury bonds issued after April 1989 have a variable rate; the rate used here is the one effective on January 31, 1990.

f/ Bonds of FONDUR and MINDUR.

g/ BCV bonds are valued at the discounted price offered in the market. Therefore, the interest rate quoted is the effective yield.

h/ *Pagarés* of Elecricidad de Caracas.

Table 2: NOMINAL VS. MARKET VALUE OF ADMINISTERED PORTFOLIOS
(As of January 31, 1990, in Bs. Billion)

	Nominal Value	Current Return	Market Value[a] (assuming 36% yield)	Capital Loss (difference)
IVSS	17.75	17%	8.38	9.37
FICAM	16.62	21%	9.70	6.93
FOGADE	4.60	12%	1.53	3.07
PENSIONS BCV	0.49	38%	0.52	-0.03[b]
OTHER	0.11	33%	0.10	0.01
TOTAL				
incl. FICAM	39.57	17%	18.69	20.88
excl. FICAM	22.95	16%	10.20	12.75

a/ Calculated as: (nominal value)*(current return)/(market yield), where the market yield is taken to be the current yield on BCV bills of 36%.

b/ Capital gain is due to the drop in the BCV bill yield after January 31, 1990.

4. This stock loss can be absorbed in three ways:

(a) By the entities holding the managed portfolios themselves. The BCV would purchase the investments from the portfolios at their market value of Bs. 10 billion. The BCV would then own a stock of instruments effectively yielding a market rate (36%, or the same as its own bills), and hence would not be subjected to losses as long as interest rates don't change. As was said before, this option may not be possible because of contractual obligations of the BCV. Even if it were possible, the Government should cover the cost of the policy it itself imposed by forcing purchases of instruments at face value. Otherwise, the respective funds would be severely decapitalized.

(b) By the Central Bank. The BCV could absorb the stock loss and transform it into annual flow losses in two ways. One alternative would be for the BCV to purchase the entire volume of instruments held by the portfolios at their nominal value of Bs. 23 billion. To sterilize this, it would need to issue an equivalent amount of BCV bills on which it currently pays 36%. However, the BCV would derive only a 16% return from the instruments purchased from the portfolios. Assuming that these rates prevail in the future, the annual flow loss to the BCV would be given by the interest rate differential, or Bs. 4.6 billion (36%-16% times 23 billion, or US$175 million). Alternatively, the portfolios could retain the stock of investments they currently hold, and the BCV could complement this with a Bs. 13 billion contribution to the portfolios so as to increase their market value to Bs. 23 billion. This contribution would need to be sterilized with a Bs. 13 billion issue of BCV bills. Then the annual flow loss of the BCV is given by the interest

payments on those bills, or Bs. 4.6 billion (36% of 13 billion). In either case, the flow losses of Bs. 4.6 billion are the same, and discounting them at 36% gives the original stock loss of Bs. 13 billion. Having the BCV absorb the losses through either of these mechanism is not an acceptable option because it involves large annual quasi-fiscal losses for the BCV.

(c) By the National Treasury. The Treasury could cover the losses with a direct budgetary appropriation. The portfolios would retain their entire investments, and the Treasury would give them a Bs. 13 billion supplement (either in the form of cash or Treasury instruments) so as to increase the market value of the portfolios to Bs. 23 billion. The annual cost of servicing the T-bills will depend on the rate at which they are floated, but should in principle be equivalent to the cost calculated previously for the BCV. However, this would be the cleanest option in so far as it would not undermine the financial position of the BCV.

5. This analysis has assumed that all portfolios (with the exception of FICAM) will be disengaged at the same time. However, in practice this will be done in a staggered fashion according to the plan prepared by the Government.

III. Program for Divestment of Portfolios from BCV

6. The program to disengage all portfolios from the BCV (except for FICAM) should be prepared according to the following guidelines. The program should cover all portfolios with current management contracts, even if no activity has been registered in recent times, and whether or not there is a formal fideicomiso. It should include all portfolios managed by any department at the BCV including the Departamento de Fideicomisos.

7. For each managed portfolio, the following information will be made available for Bank review and approval:

(a) A mention of any law or decree requiring that the funds be placed at the BCV. If divestment of the portfolios does require legal changes, the program should suggest a schedule for the modification of the corresponding laws or decrees.

(b) The terms of the management contract, highlighting: (i) the amount of advance notice required for cancellation of the management contract; and (ii) any contractual obligation regarding the repurchase price on instruments held by the portfolio. The BCV will present a schedule detailing the date of notification of cancellation as well as the date of effective cancellation of the management contract.

(c) A brief letter from the owner of the funds commenting on the divestment schedule prepared by the BCV and explaining the plans for the management of the resources.

(d) A detailed list of investments in the portfolio, detailing the nature, volume of investment, and interest rate on each type of instrument.

(e) An estimation of the value of the portfolio according to three valuation criteria: (i) nominal value, (ii) original purchase price, and (iii) market value. Where no market price exists, the price will be determined as being that which yields an effective return equivalent to that on similar marketable instruments. From these figures, the program will contain an estimate of the losses to be absorbed by the BCV if instruments were sold at the original purchase price rather than at market price.

8. In addition, the program should specify how the Government plans to absorb the losses that will arise from the divestment program. In particular, the Government will need to propose: (i) whether the portfolios themselves or the BCV will keep the instruments currently held by the portfolios; and (ii) the share of losses to be absorbed by the Treasury and by the BCV.

VENEZUELA - FINANCIAL SECTOR ADJUSTMENT LOAN

STATUS OF BANK GROUP OPERATIONS IN VENEZUELA

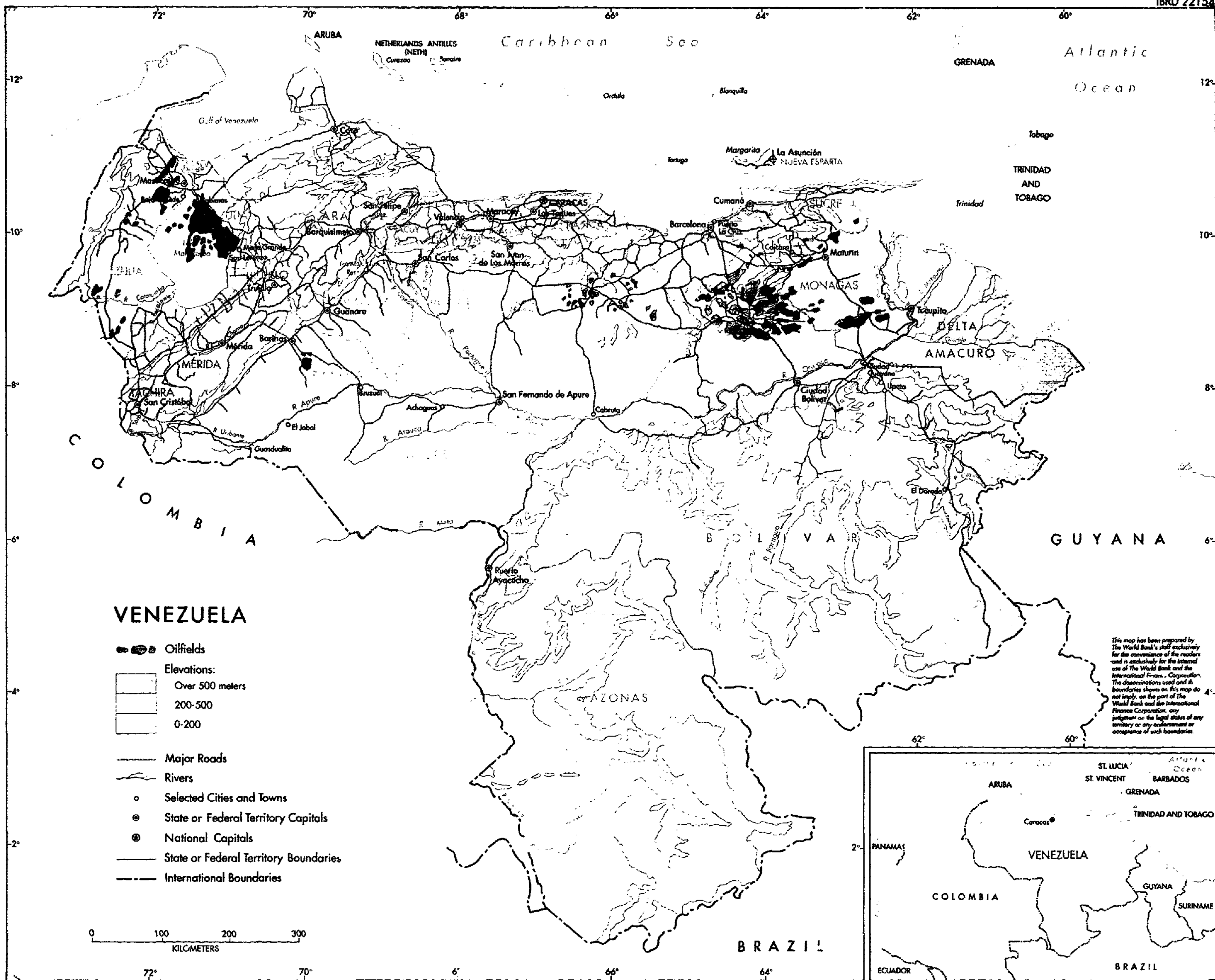
A. Statement of World Bank Loans and IDA Credits as of December 31, 1989
(In US$ Million)

Loan or credit number	Fiscal year	Borrower	Purpose	Amount (less cancellation) Bank	Undis-bursed	Total
13 loans fully disbursed & closed				342.2		342.2
3091	1989	Government	Structural adjustment	80.0	322.0	402.2
3092	1989	Government	Trade policy	35.0	318.0	353.0
Total				457.2	640.0	1,097.2
Of which has been repaid				314.7		
Amount sold				27.5		
Of which has been repaid				27.5		
Total now outstanding				115.0		
Total now held by Bank & IDA				115.0		
Total undisbursed					640.0	640.0

B. Statement of IFC Investments as of December 31, 1989
(In US$ Million)

Date	Borrower	Type of business	Loan	Equity	Total
1964,1968, 1971	CAVENDAS	Development finance	17.50	1.34	18.84
1971	CONCECA	Cement & construction material	2.01	-	2.01
1961	DIABLITOS	Food & food processing	0.50	-	0.50
1966,1972	DOMINGUEZ	Tin cans	1.00	0.52	1.52
1989	OPCO	Iron & steel	73.13	-	73.13
1989	PROPILVEN	Chemicals, petrochemicals	47.00	-	47.00
1969,1973	PROTINAL	Food & food processing	5.06	-	5.06
1960,1964	SIVENSA	Iron & steel	2.70	0.44	3.14
1975	SOFIMECA	Money & capital markets	-	0.70	0.70
1975	VALIVENCA	Money & capital markets	-	0.35	0.35
1988	VENCEMOS	Cement & construction material[a]	10.00	-	10.00
	Total gross commitment		158.90	3.35	162.25
	Less cancellations, terminations & sales		71.49	3.35	74.84
	Total commitments now held by IFC		87.41	-	87.41
	Total undisbursed		35.26	-	35.26

a/ In addition, IFC provided a guarantee of a local bond issue for US$10.3 million equivalent.


IBRD 22154
VENEZUELA
Oilfields
Elevations:
Over 500 meters
200-500
0-200
Major Roads
Rivers
Selected Cities and Towns
State or Federal Territory Capitals
National Capitals
State or Federal Territory Boundaries
International Boundaries
0 100 200 300
KILOMETERS
Caribbean Sea
Atlantic Ocean
ARUBA
NETHERLANDS ANTILLES (NETH)
Curazao
Bonaire
GRENADA
Orchila
Blanquilla
Gulf of Venezuela
Coro
Tobago
Margarita
La Asunción
NUEVA ESPARTA
Tortuga
TRINIDAD AND TOBAGO
Trinidad
Maracaibo
Cabimas
Cumaná
SUCRE
San Felipe
Maracay
CARACAS
Los Teques
Valencia
Barquisimeto
Barcelona
Puerto La Cruz
Maturin
San Carlos
San Juan de Los Morros
Trujillo
MONAGAS
Guanare
Tucupita
DELTA AMACURO
Mérida
MÉRIDA
Barinas
TACHIRA
San Cristóbal
San Fernando de Apure
Achaguas
Cabruta
Ciudad Bolívar
Upata
R. Apure
R. Arauca
R. Urbante
R. Orinoco
El Jobal
Guasdualito
El Dorado
COLOMBIA
GUYANA
BOLIVAR
R. Paragua
R. Meta
Puerto Ayacucho
AMAZONAS
BRAZIL
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ST. LUCIA
ST. VINCENT
BARBADOS
ARUBA
GRENADA
TRINIDAD AND TOBAGO
Caracas
PANAMA
VENEZUELA
COLOMBIA
GUYANA
SURINAME
ECUADOR
BRAZIL
MARCH 1990