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AGENCY FOR INTERNATIONAL DEVELOPMENT
WASHINGTON, D.C. 20523

JUN 17 1991

ACTION MEMORANDUM FOR THE ASSISTANT ADMINISTRATOR, LAC

FROM: Peter Bloom, LAC/DR

SUBJECT: Panama - Approval to Implement the Private Sector Low Cost Shelter Project (525-0287)(525-HG-013)

Action Requested: The A.I.D. Mission in Panama requests your approval to move forward with a previously authorized $25 million Housing Guarantee Program.

Background: A $25 million private sector Housing Guarantee (HG) and $675,000 development grant were authorized in 1986/87. Because of the temporary closure of the A.I.D. program in 1987, the HG was not implemented and the grant was deauthorized. The HG Loan and accompanying grant were designed to increase the involvement of the private sector in the production and financing of low-cost shelter. A trust mechanism would have been established to manage the program on behalf of the Borrowers to provide security for the A.I.D. Guaranty and to manage the reflow of funds generated by the program.

The Mission and RHUDO/CAR are now requesting AID/W concurrence in reactivating this private sector HG with some minor design modifications through the submittal of a project paper supplement. Financial inputs from the HG Program remain at $25 million. Two of the original five institutional outputs are being eliminated: 1) The trust mechanism as a management/implementation tool is being dropped and substituted with a Program Administrator and 2) The savings and loan institutions and the public sector Caja de Ahorros will not participate in the program due to weakened financial conditions. A Program Administrator, which could be one of the three U.S. money center banks (Chase Manhattan, Citibank or Bank of Boston), will be contracted to manage and oversee certain aspects of the program. It will also act to protect A.I.D.'s interests in the event of any default.

Discussion: LAC/DR, PPC and APRE/H reviewed the PP supplement on May 23, 1991, with representatives from the Mission and RHUDO in attendance. The review recommended that, subject to the following guidance, the Mission proposal to implement the HG and authorize the development grant be approved.

Eligibility: As you know PPC is responsible for approving country risk eligibility for Housing Guaranty Programs. Under current A.I.D. Country Risk Eligibility criteria, PPC won't clear HG proposals for (1) countries in the Export-Import Bank country risk classification system which are rated "D" or below or (2) countries ineligible to borrow from the World Bank. Panama is rated "C" on the Ex-Im Bank country risk classification list as of May 9, 1990 but is currently ineligible to borrow from the World Bank.

To reduce risk under the HG, private financial institutions will have to meet strict financial conditions using the CAMEL methodology which will address capital adequacy, asset quality, management, earnings and liquidity. Experience with prior HGs demonstrate that all HG loans to private sector borrowers in Panama have been and continue to be current. It should also be noted that in Panama there is no foreign exchange risk as the dollar is the medium of exchange.

With respect to eligibility to borrow from the World Bank, Panama is close to coming to an agreement with the IBRD/IDB for an economic recovery loan. Our Economic Recovery program conditionality requires Panama to reach agreement with the IBRD/IDB prior to receiving specific disbursements. To be consistent with that conditionality and to assure the credit worthiness of Panama, the Mission will not initiate contracting the HG until the Government of Panama has demonstrated that it has reached agreement with the World Bank for its Economic Recovery loan.

With the signing of an agreement with the World Bank, Panama will have satisfied both of PPC's eligibility conditionalities. It is also reasonable to assume that Ex-Im's rating for Panama will improve as a result of the recent favorable changes in its economy and the upcoming clearing of arrearages with the IFIs.

Complementary Grant The Mission will authorize a grant of $300,000 to cover part of the costs of the technical assistance program, specific legal assistance for the program and audit/evaluation. The RHUDO has committed to provide up to $100,000 in support of short-term technical assistance on shelter related issues.

<u>Recommendation</u>: That you approve the Mission's request to move forward with the Private Sector Low-Cost Shelter project once the Mission has evidence that Panama and the World Bank have reached agreement on an economic recovery loan.

Approved: Jmw

Disapproved: ______

Date: 6/30/91

Attachment: Panama Project Paper Supplement

Clearance:

LAC/DR:MSilverman MS date 6/4/91
PPC/PB:TBarker TB date 6/12/91
GC/LAC:TGeiger date 6/14/91
APRE/H:FHansen Draft date 6/10/91
DAA/LAC:AWilliams AW date 6/20/91
SA/AA/LAC:KHarbert date 6/18/91

DRAFTED:LAC/DR/CEN:EMarkeset:afs:6/4/91:647-8669:63950

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AGENCY FOR INTERNATIONAL DEVELOPMENT

**PANAMA: PROJECT PAPER SUPPLEMENT**

**PRIVATE SECTOR LOW-COST SHELTER**

AID/LAC/P-340
5/28/91

Loan Number: 525-HG-013
Project Number: 525-0287

# PANAMA HG 013 PROJECT PAPER SUPPLEMENT

## I. Background Information--1986 to 1990

In 1986 and 1987, a total of $25 million in Housing Guaranties (HGs) were authorized for Panama. These resources were to be provided to the mortgage banks and other financial institutions in Panama to help meet the shelter needs of low-income families. Additionally, a $675,000 Development Grant was authorized to complement the HG loan and to address long-term development issues including strengthening the Savings and Loan Industry, Credit Unions and Cooperatives; helping to establish the program's institutional structure; and for audits and evaluations. Shortly thereafter, the political situation in Panama changed, and the Housing Guaranty was put on hold. The grant funds were subsequently deobligated.

### A. The Economic Environment.

By the middle of 1987, economic policy performance weakened and political conditions began to deteriorate. Per capita GDP fell by 20 percent between 1987 and 1989; the economy suffered through a financial and fiscal crisis; unemployment and underemployment rose; private businesses suffered physical damage; and the country's infrastructure deteriorated. The situation began to improve in 1990, as the economy recovered by a modest 3.4 percent. Merchandise exports rose by another 4 percent, while imports were up by 13 percent. Capital started to flow back to the country. The fiscal deficit fell to about 5 percent of GDP by the end of the year, aided by the release by the United States of prior year revenues that had been frozen in 1988-89.

### B. Prospects for Economic Growth.

The World Bank has indicated that the long-term outlook for the economy of Panama will depend crucially on (a) the ability of the Government to provide growth incentives and infrastructure support to the private sector, (b) the capacity of the economy to generate export earnings and (c) the level of debt service and external capital inflows. Nevertheless, if the economy is able to achieve these goals, then Panama will probably attain an overall growth rate of 5.9 percent in the 1990-92 period and 4.0 percent for the 1993-1998 period. The financial markets appear to reflect these growth prospects. The current financial transfer-risk credit rating for Panama, as reflected in the March 1991 issue of LDC Debt Report, is B+ over the next eighteen months and A for the next five years, which indicates that risk of a deteriorating economy is minimal.

C. The Banking System.

The political and economic crisis had a severe impact on all of Panama's financial institutions. Panama's conflict with the United States, economic sanctions, and above all, the lack of confidence in the banking system forced a banking holiday for nine weeks in 1988. This was followed by a freezing of all banking accounts and time deposits with restrictions being lifted on current accounts in December 1988, on savings accounts in April 1990 and on time deposits in July 1990.

Although all financial institutions were affected to some degree, public institutions in general fared worse than private institutions. The Government-owned Banco Hipotecario Nacional (BHN), already in weak financial condition prior to the crisis, faltered further. The Caja de Ahorros, a public savings bank and major housing investor, suffered serious decapitalization and is now concentrating on recuperating both capital and profitable operations. The mutually owned Saving and Loan Institutions continued to decline during the crisis, and the size of the banking system is less than half of what it was in mid-1987.

The Mortgage Banks and the Commercial Banks came through the crisis in good condition, but with an increased percentage of slow paying loans. During this period, commercial and mortgage loan activities declined precipitously. By 1989 such lending had virtually ceased. However, to the sector's relief, savings have grown vigorously since the unfreezing of time deposits. While initially deposit rates were set high to attract and maintain deposits, the strong response has pushed interest rates on 5 year CDs downward from 12 percent to about 10 percent by the start of 1991. The financial condition of the banking system has in general returned to conditions that existed prior to the crisis, although the size of the banking system is less than half of what it was in mid-1987.

D. The Construction Sector.

With the drying up of construction and mortgage lending, building activities plummeted. Many builders were forced to interrupt or cancel projects due to a lack of both construction and "take out" financing. Construction permits for privately developed projects in Panama City dropped from a near record high of $156 million in 1987 to only $12.4 million in 1989. With the release of funds, banks have begun to make loan commitments and construction activities have resumed. Estimates for 1990 suggest that construction spending will reach 80 percent of 1987 levels, which indicates that the construction industry is recovering. The increase in spending also suggests a pent up demand for housing that the industry must strive to meet.

E. Employment and Incomes.

As economic activities decreased during this period, unemployment surged. The number of unemployed doubled between 1987 and 1990, and according to most observers has not significantly improved with the upturn in the economy. Underemployment rose also, while increasing numbers of workers earned less than the minimum wage for a 40 hour week. These employment factors have had a corresponding effect on incomes. One of the best indicators of the decline in incomes is the median income figure, which showed a decrease from $585 in 1986 to $468 in 1990, a fall of about 18 percent over the four year period. The downward revision of the median income figure was based on a corresponding decrease of 20 percent in GDP.[1]

## II. The HG Project as Designed Originally

The Housing Guaranty Loan and accompanying Development Grant Program were designed in 1986 to increase the involvement of the private sector in the production and financing of low-cost shelter. Private sector Mortgage Banks would have borrowed the HG funds, and by mixing these funds with internally generated resources, would have financed long-term mortgage loans for the beneficiary group. One innovative feature of this Program was to have been that the Host Country Guaranty would not have been required, and instead a number of other security arrangements would have been adopted to provide A.I.D. with the requisite guarantees.

A. The Borrowers.

The Program would have been managed by a to-be-created trust mechanism, with a first-line Commercial Bank selected as the trustee by the Borrowers and A.I.D. The Borrowers would have been a consortium of Mortgage Banks and possibly one quasi-public financial institution, the Caja de Ahorros. The Borrowers would have also functioned as the Mortgage Lenders and accordingly have had responsibility for underwriting the projects, as well as qualifying project beneficiaries in accordance with A.I.D. requirements. They would also have serviced the mortgage loans to beneficiaries and guaranteed repayment of the Housing Guaranty loan to the U.S. lenders.

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[1]The $585 figure was derived from a study by the Panamanian Ministry of Planning and Economic Policy and adjusted in 1986 by the PP team. The $468 figure was based on the PP figure of $585 in 1986 and deflated in 1990 to correspond with the decline in GDP.



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B. The Contractors.

Private sector project developers and builders would have been responsible for purchasing sites, preparing plans, securing permits and constructing the houses. They would also have been responsible for securing construction loans to build the housing, and once built, market the houses.

C. The Trust Mechanism.

A trust mechanism would have been established to manage the program on behalf of the Borrowers. The purpose of this mechanism would have been to provide security for the A.I.D. Guaranty and to manage the reflow of funds generated by the Program. A trustee would have been responsible for qualifying participating financial institutions, receiving and allocating HG resources, maintaining program collateral, overseeing the establishment and operation of a Liquidity Reserve Fund, receiving loan repayments from the Borrowers (the Mortgage Banks) to be forwarded to the U.S. Lender and reporting to A.I.D. Although the consortium of Mortgage Lending Institutions would have been the Borrowers, the loan funds would have passed through the Trust Fund to the Borrowers upon presentation by the Borrowers of eligible mortgages.

A small fee would have been added to the interest rate charge to create a Trust Fund to serve in the first instance to meet shortfalls in loan repayments to the U.S. Investor as well as to establish a source of additional investment in low-cost housing.

D. Technical Assistance Program.

The $675,000 Development Grant would have been used to complement the HG Loan as follows:

-Provide the services of a long-term Project Manager to oversee and monitor the implementation of the Program, including the TA component;
-Assist in the establishment of the Trust Fund;
-Promote a dialogue between the private sector and public regulatory agencies;
-Train private sector developers in project planning and site design in order to reduce costs; and
-Assist the weaker housing finance institutions to improve operations and procedures to permit participation in this Program.

E. Program Outputs.

1. Physical. The basic physical outputs would have been housing affordable to low-income families in Panama's urban areas. Various assumptions about interest rates and paying capacity were

made to derive what a family earning $585 monthly could afford. The PP analysis showed that a family could afford a unit costing an average of $13,500. It was expected, therefore, that some 3,500 units would have been produced under this Program. This assumed a $25 million Housing Guaranty, $18.4 million in local institution contributions and $4.8 million in beneficiary down payments for a total program of $48.2 million. It was expected that the rollover would have financed the production of an additional 8,000 units over the 30-year life of the loan.

2. Institutional. Listed below are the five institutional outputs which were expected:

-Mortgage Banks would have been involved in low-cost shelter for the first time;
-The weaker housing finance institutions would have been strengthened;
-Resources for low-cost housing would have been mobilized;
-Low-cost housing would have been produced more efficiently; and
-The Trust Fund would have been established as a development tool.

F. Beneficiaries.

Initially 3,500 families would have received new housing. The program was designed to have the mortgage banks and private contractors provide shelter affordable to below median income families. However, it was recognized that the market for such housing is so great that there may have been families with incomes that exceed the median income who would wish to purchase a unit produced under this program

G. Special Program Considerations.

In addition to the Program design as explained above, it was expected that the Program would have achieved the following:

-The S&Ls, Cooperatives and similar financial institutions would have been encouraged to participate because they traditionally cater to lower income families;
-A special line of credit would have been established to finance units costing $6,000 so as to reach the very low-income families;
-An incentive system would have been set up which would have encouraged mortgage banks to provide housing for the lowest income groups;
-No single financial institution would have been able to borrow more than $10 million so as to involve more institutions in the Program as well as to spread the financial risk;
-The Caja de Ahorros would have been encouraged to undertake

an analysis of the feasibility of privatizing the institution;
-It would have been shown that in certain circumstances it is possible to provide Housing Guaranties without the use of a host country guaranty.

## III. Housing Demand

A. Demand for Low-Cost Housing.

The economic crisis of the past few years forced nearly all developers and builders to cease construction of new housing. Moreover, the housing stock continued to deteriorate and, in fact, a considerable number of homes were destroyed or damaged during the Operation Just Cause, many of which housed low-income families. While most of these houses have been repaired (600+) or replaced (over 2,000), housing conditions are considered to be in much worse shape in 1991 than they were prior to 1987. In the meanwhile, because there was essentially no housing construction during the crisis, it is reasonable to assume that the demand for housing, and especially low-cost housing, is even stronger than in 1986 and 1987.

While reliable figures are unavailable to determine the total demand for low-cost housing today, a recent survey (December 1990) of three housing developers demonstrates the pent up demand within the housing market. These three developers alone are currently building or have permits to build 4,520 units, of which 1,950 units will cost less than $13,000 per unit, which classifies them as low-cost housing. Still another developer has 1,800 applications in hand for a large housing project to be built on the outskirts of Panama City. Thus, these three developers alone could fully utilize the $25 million HG.

Since private sector developers first entered the low-cost housing market in 1987, at least seven major developers have planned or initiated low-cost housing projects and see an increasing percentage of their future activities tied to serving the growing market for low- and moderate-income housing. This is because the demand for housing at the upper end of the income scale is tapering off.

In addition, the Chorrillo emergency housing program has shown developers that they can profit by constructing houses that cost as little as $6,500. It is realized that this program did not address the issue of mortgage collection over time as outright grants were made to individual homeowners who paid for the house up front. However, this program has served as a catalyst to encourage the developers and bankers to enter the low-cost housing market. Houses are currently being constructed and financed by Banco General, the largest private mortgage bank in Panama, which cost as little as $9,900. It is expected that the proposed HG program will further serve to develop and expand this market by providing a long-term source of financing.

B. Banking Response.

For many years, the market for middle- and upper-income housing has been saturated, which has prompted developers to refocus their efforts on lower income housing. This is as true today as it was when this Program was originally authorized in 1986. However, private sector financing for long-term mortgages for low-cost housing has been scarce due to a perception on the part of mortgage bankers that the risk is too great and the administrative costs too high to justify serving this market. In addition, bank liabilities consist of relatively short-term funds which increases the risk of lending long term. All these factors have hampered the ability of developers to serve the low-cost market. But as indicated in the paragraph above, the attitude of bankers is beginning to change, in part due to past A.I.D. programs and continuing dialogue between A.I.D. and the private sector. Moreover, construction is an important economic sector in Panama and the health of this industry is important to the banks. For the industry to continue to survive new housing markets need to be explored and developed.

C. Incomes and Affordability.

Incomes have fallen about 18 percent since 1987, which reduces the financial capacity of families to afford housing. This overall decrease in purchasing power and the reduction in the median income to $468 monthly (from $585), means that only housing solutions costing $13,000 or less are affordable by the target group, based on a set of lending assumptions as shown on the next page.

## IV. Revised Program Design

This PP amendment proposes to revise the original HG Program in a minor way. The Program's goal and purpose remain as originally conceived in the Project Paper. The goal remains to improve the quality of life for below median-income urban families through increased access to affordable shelter and employment opportunities in the construction industry. The purpose is to increase the delivery of low-cost shelter financed through private sector institutions, thereby expanding and strengthening the role of the private sector in meeting the shelter needs of Panama's low-income urban population. Financial inputs from the HG Program remain at $25 million, while the local counterpart financing is calculated at 20 percent of the mortgage loan, and beneficiary down payments will be at least 10 percent of the sales price of each unit.

The total amount of resources to be dedicated to this Program has been set at $34.7 million. The decision was made to eliminate the sliding scale formula which called for a larger HG resource input for the least expensive housing being developed and a smaller HG input for more costly housing. This sliding scale was conceived as a way to have banks focus on lower cost units. Subsequent conversations with bankers and developers convinced A.I.D. that this feature of the Program was too unwieldy for effective program management.

In addition, many developers are designing large subdivisions with units ranging in cost from $9,900 to $19,900, with many units being in the $11,000 to $13,000 range. Therefore the sliding scale formula was unnecessary. Finally A.I.D. believed a simpler program design would attract more interest from the banks than had been expressed when the program was authorized. The maximum cost of units eligible for financing under the program is $13,000 which is estimated to be affordable to families earning $468 monthly in 1990. This figure assumes a down payment of 10%, an interest rate of 13% and a term of 20 years on the loan. Since this is a market driven project, it is expected that units will be sold on a first come first served basis regardless of actual income.

Currently Banco General, the largest private mortgage bank, is financing houses that cost as little as $9,900. For these houses, developers are requiring that a family income be at least $435 monthly. For houses costing $13,000, Banco General requires a monthly family income of $565. Although Banco General is currently providing some mortgage loans to families purchasing houses costing less than $13,000, the source of funds for these long-term loans are short-term deposits, which it expects to replace with the long-term HG resources once the HG loan is disbursed. By making this internal swap, the bank will prevent an asset/liability mismatch. It should be pointed out that Banco General decided to begin providing long-term mortgage loans in the expectation that the HG resources would be forthcoming. With the availability of the HG resource, other mortgage and commercial banks are expected to initiate similar mortgage lending programs for low-income families. This Program will encourage the banks to lower their monthly income standards, thereby providing additional financial resources for low-income housing.

Program inputs can be summarized as follows:

| | | |
|---|---|---|
| -HG resources | $25,000,000 | 72% |
| -Local Bank resources | 6,250,000 | 18 |
| -Down payments | 3,472,000 | 10 |
| -Total resources | $34,722,000 | 100% |

The Mortgage Banks will continue to be the principal participating institutions. However, the list of qualified



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participants is being expanded to include Commercial Banks with significant mortgage lending operations, several of whom have expressed an interest in participating in the Program. The original Project Paper contemplated the possible inclusion of the S&L's and Cooperatives at a future date in the Program. But the further weakening of the S&L's makes their participation unlikely until they meet eligibility requirements. However, the housing cooperatives are very solid and have expressed interest in the Program.

The physical output is estimated at 2,900 new housing units to be built with the total Program resources, assuming an estimated average unit cost of $12,000. In addition, the rollover feature of the Program will permit the construction of an additional 6,000 units over the 30-year life of the Program.

In addition to the physical outputs, this Program expects to impact on the number of private sector banks lending to low-income families -- a new market for the majority of the banks. The Caja de Ahorros will not participate in the program due to it's weakened financial condition. It was originally expected to use 40% of the HG loan. As indicated previously, the Program has been streamlined (e.g., the elimination of the sliding scale formula) to attract additional participants. It is expected that five or six banks will participate in the program rather than two or three as originally estimated. In the long run, the Program will result in more private sector banks, with a greater mass of resources, providing long-term financing for low-income housing.

Two of the original five institutional outputs are being eliminated. (1) The concept of the trust mechanism as a development tool is being dropped as will be explained in the next paragraph. (2) Under present circumstances, the savings and loan institutions have been so weakened in the past three years that they could never achieve the financial soundness required to participate in this program.

A. Role of the Administrator.

The trust mechanism has been dropped because of a realization that it would be too complicated and possibly increase overall program costs. There was significant resistance fr
om the Borrowers to surrendering control of their collateral, i.e. the mortgages, to the Trust. The banks also objected to a one percent differential which was to flow to the Liquidity Reserve Fund. This raised substantially the cost of borrowing and the Banks had no real control over those resources.

In its place, a Program Administrator will be contracted to manage and oversee certain aspects of the Program. It will also act to protect A.I.D.'s interests in the event of a default. With fewer complexities than a trust mechanism and at a lower cost, the use of the Administrator will facilitate program implementation. Adequate safeguards for A.I.D. will remain in place.

The Administrator will still be selected by the Borrowers and A.I.D. jointly and in fact three U.S. money center banks, Chase Manhattan, Citibank and Bank of Boston, have expressed a strong interest in being chosen as the Administrator. The role of the Administrator will be to:

-Advise the Borrowers in raising the HG resources;
-Certify Borrowers' qualifications and eligible mortgages;
-Authorize the U.S. Lender, with A.I.D.'s concurrence, to disburse the HG funds to the Borrowers upon presentation of eligible mortgages;
-Receive the loan payments from the Mortgage Lenders and remit same to the U.S. Lenders;
-Monitor the Mortgage Loan Portfolio by ensuring that the loan terms and conditions are met; and
-In the event of any default, manage the loan portfolio of the defaulting institution(s) in accordance with the terms of the Implementing Agreement and the Loan and Guaranty Agreements. (see discussion on A.I.D.'s Security below)

B. Security for A.I.D.'s Guaranty.

Both the original HG as well as this supplement have been designed without a host country guaranty. A host country guaranty essentially insures A.I.D. from losses resulting from changes in the exchange rate and non-payment by the Borrower. In addition there is a commercial risk the Panamanian banks incur in making a mortgage loan. Since Panama uses the U.S. Dollar as the national currency and all loans are denominated in U.S. currency, the exchange risk is non-existent.

The financial risk remains and A.I.D. expects to cover itself from this type of risk by utilizing some of the legal and financial safeguards listed below. The final arrangements for protecting A.I.D.'s interest will be made after further discussions with the borrowers and during preparation of the loan documents.

-The mortgage loans which comprise each mortgage portfolio will be recorded with the Panamanian Recorder of Deeds and each mortgage will state that in the event a Borrower is in default, the Administrator will instruct the Recorder of Deeds to transfer the entire Mortgage portfolio to the Administrator. The Administrator on behalf of A.I.D. will have the legal authority to cure all defaults, should they occur;

-The outstanding value of the mortgage loan portfolio of each Borrower must exceed the amount of the HG loan component by a factor of 1.25 to 1.00;

-In the event a mortgage loan is in arrears by more than 60 days, the Borrower must replace that mortgage in the mortgage portfolio with another eligible performing mortgage, thereby ensuring that the 1.25 to 1.00 ratio is maintained;

-Each Borrower will place on deposit with the Administrator an amount equal to one semi-annual loan payment to the U.S. Lender to provide the Administrator with sufficient funds to cover loan repayments to the U.S. Lender in the event of a default prior to curing that default;

-Prior to borrowing the HG funds, each Borrower must meet the financial institution rating standard known as "CAMEL", (see Section V. of this report for definition) and continue to meet this rating standard for each year the HG loan remains outstanding;

-Each borrower will give A.I.D. a full faith and credit guaranty.

-Each borrower will provide to A.I.D. and the Administrator a quarterly status report on the HG mortgage loan portfolio; and

-Each Borrower will submit to an annual external audit by a U.S. affiliated Panamanian auditing firm and those audits will be made available to A.I.D. and the Administrator. The Banks will cover the commercial risk associated with mortgage lending by employing generally acceptable underwriting criteria, which in turn will enable the Banks to minimize any risk of a mortgagor defaulting. These underwriting criteria include the following:

-The Borrowers (the mortgage or commercial banks) will employ prudent underwriting procedures in part because all mortgages will consist of 20 percent of the Mortgage Lender's own funds;

-The Mortgage Lender will hold a first mortgage on each property mortgaged under this Program;

-All mortgage loans will carry hazard and life insurance; and

-The Loan to Value Ratio will be .72 to 1, meaning that the amount of a mortgage loan will never exceed 72 percent of the original sales price of the unit.

C. Financial Strength of Potential Borrowers.

Several Mortgage and Commercial Banks have expressed a strong interest in participating in the Program. Accordingly they have submitted financial information to A.I.D. to demonstrate their financial strength, thereby laying the groundwork for qualifying as a potential Program participant. This financial information shows that in general the banks have recovered from the previous economic crisis and that they would appear to meet the "CAMEL" rating standards.

One of the key indicators in the "CAMEL" rating system is the financial adequacy of an institution, which is calculated as the percentage of capital and retained earnings to total assets. The standard in the U.S. is set at 6 percent to be met by all U.S. Commercial Banks by the end of 1992. Only two U.S. money center banks meet this standard today. Conversely, all the potential Panamanian Borrowers who have provided A.I.D. with financial information meet this standard, and in fact one Bank has an adequacy rating of 13 percent and another Bank 9 percent.

D. Housing Guaranties in Panama.

Panamanian institutions have participated in the Housing Guaranty Program since the mid 1960's. Until the recent economic crisis, all HG loans to both public and private sector borrowers were current, however each sector's response to the crisis has been different. All HG loans to private sector borrowers are still current or were current until fully paid, and A.I.D. has never filed a claim for non-payment against these borrowers, except for a loan administered by Central de Ahorros, a Saving & Loan Association. In this case, a HG loan was made in 1967 and was current until 1987, when the Panamanian government agency regulating this institution intervened and instructed it not to remit loan payment receipts to the U.S. Lender. Due to this government intervention, A.I.D. has had to file a claim for $900,000 against the Central.

The situation of public sector HG loans is different. The loan to the Caja de Ahorros, a quasi-public institution, was made in 1971 and was current until March 1988 when financial difficulties and frozen funds prevented the Caja from making loan payments. To date, repayments have not resumed and claims by A.I.D. now total $700,000. The situation is similar for the six outstanding HG loans to the public sector. No loan repayments have been made since 1987, and A.I.D. has filed claims totaling $20.0 million.

Before negotiating the new HG-013 loan with the private borrowers, the Mission expects to have completed formal arrangements for repayment of the past Housing Guaranty debts. However, the loan documents for HG-013 will not include conditions linking the new loan to compliance with the repayment of the old debts.

The conclusion to be drawn from this information is that private sector financial institutions are a more reliable and safer borrower than public sector institutions. Furthermore, it should be pointed out that one of the current HG private sector administrators, Primer Banco (PRIBANCO), is expected to be a Borrower under this Program also. The record of PRIBANCO as a HG administrator is impeccable.

E. Construction Financing.

The availability of construction or interim financing is predicated on the availability of long-term or "take out" financing and a predetermined number of units sold prior to initiating construction, usually in the 40 to 50 percent range. Frequently, the construction lender and the long-term lender are one and the same Bank, although some developers use financial companies, called "financieras", which are under their control for construction financing.

To date, some financing has already been made for projects which could be financed under the HG Program. Most of the land has been acquired, site planning and grading has occurred, infrastructure lines have been laid and some low-cost units are actually under construction.

The main issue here is whether there is sufficient liquidity in the banking system to meet the need for construction financing to complete a small portion of the units for these projects and for low-cost housing in the future. While there was a liquidity problem during the economic crisis due to frozen funds and capital flight, the Banks have since replenished their coffers.

F. Borrowing and Contracting Arrangements.

There are several changes in the borrowing arrangements. The trust mechanism and the Trustee are to be replaced by an Administrator. The Administrator will not borrow resources as originally contemplated, nor will it manage a Liquidity Reserve Fund. Under the new arrangements, once a Borrower has accumulated a loan portfolio of eligible mortgages, it will present the portfolio package to the Administrator for certification. If certifiable, the Administrator will inform A.I.D. that the Borrower has met the borrowing terms and conditions, and A.I.D. will notify the U.S. Lender to disburse/lend the funds directly to the Borrower.

The Administrator will not act as a repository of funds that accumulate in a liquidity reserve, since the Trust will not be established. Instead, the Borrower will place on deposit with the Administrator an amount equal to one semi-annual payment to the U.S. Lender. This interest bearing deposit is required in order to trigger the disbursement from the U.S. Lender. Mortgages will not be assigned to the Administrator as they were to have been assigned to the Trust (see Page 10).

All other borrowing and contracting arrangements as described in the original Project Paper remain unchanged.

## V. Qualifying Financial Institutions

A. Conditions for Participation.

The principal criterion for a Panamanian financial institution to participate in the HG Program is meeting the ratings standard using the CAMEL methodology. The acronym, CAMEL, stands for the following:

-Capital adequacy;
-Asset quality;
-Management;
-Earnings; and
-Liquidity.

Four of the five factors are determined objectively through the use of financial information from an institution and it's auditors. Only the management rating is subjective and even this is influenced by the rating in the other areas. Once the supplement to the Project Paper is approved, prospective Borrowers, most of which have already been identified, will be asked to give A.I.D. the necessary information to prepare the CAMEL analysis.

Commercial Banks, along with Mortgage Banks, will be permitted to participate in the Program. They must meet the eligibility requirements as set by Panamanian law which states that Banks, other than Mortgage Banks, operating in the Country, and which receive local savings deposits must invest 50 percent of those deposits in housing mortgage loans with terms of not less than 10 years. Commercial Banks will be permitted to participate along with the Mortgage Banks since they lend for housing and there is no reason to deny their participation.

The CAMEL analysis, in conjunction with Panamanian legal requirements, will permit A.I.D. to qualify an institution for participation in the Program. The eligibility requirements stipulated in the original Project Paper are no longer valid.

B. Description of the Financial Institutions.

Four financial institutions, all of which are licensed as General License Banks, have expressed interest in participating in the Housing Guaranty Program. These banks and the probable amount of loan funds they will initially request are:

| Institution: | Amount: |
|---|---|
| Banco General, S.A. | $5 Million |
| Primer Banco de Ahorros, S.A. | 5 Million |
| Banco del Istmo, S.A. | 3 Million |
| Banco Panamericano, S.A. | 2 Million |

In addition to these Banks, CitiBank, S.A. has expressed an interest in investing $5 Million in mortgages, although it has not yet expressed that interest in writing as have the other Banks. These Banks are either Mortgage Banks or Commercial Banks which invest at least 50 percent of their local savings deposits in housing mortgage loans with terms not less than 10 years. They rank in size from among the largest to the smallest of the 66 licensed banks in Panama. Their ranking in 1989 with respect to total assets and the growth in assets between 1989 and 1990 is as follows:

| Institution | Rank 1989 | Assets 1) 1989 | Assets 1) 1990 | Increase |
|---|---|---|---|---|
| Banco General | 8 | 311.3 | 430.6 | 38% |
| Primer Banco | 11 | 217.1 | 276.6 | 27% |
| Banco del Istmo | 25 | 107.1 | 163.1 | 52% |
| Banco Panamericano | 49 | 26.9 | NA | |

1) in Millions of Dollars

C. Financial Performance.

A preliminary analysis of the Banks using the CAMEL methodology was performed, with financial comparisons made for the calendar years ending in 1988, 1989 and 1990, except for Banco Panamericano in 1990. Details of this analysis are in Annex 1, however the results indicate that at least three of the four will easily meet the CAMEL criteria, while the fourth, Banco Panamericano, may meet the criteria once it submits financial information for 1990. The general results of this analysis are shown below:

-Capital adequacy: As mentioned in an earlier section of this Supplement, the capital adequacy of all four banks is satisfactory especially when compared with U.S. standards as well as standards in other developing countries. The Panamanian Banks show a basic capital ratio of between 7 percent to 13 percent, which indicates that growth in capital funds is keeping pace with asset growth.

-Asset Quality: The four Banks show a reasonable provision for uncollectables. They have experienced no substantial losses in mortgage or commercial loans even during the recent economic crisis. All these institutions comply with Panamanian regulations on qualifying as mortgage lenders, and all are experienced in long-term debt servicing.

-Earnings (Profitability): Overall profitability can be measured by an institution's Return on Assets (ROA) and Return on Equity (ROE). Three of the four Banks show an ROA in excess of 1 percent , which is a satisfactory rating. However, Banco Panamericano, the smallest bank, shows a low ROA due to low profitability (interest earned vs interest paid, and operating expenses not covered by other income), nevertheless, it was profitable in 1989, and is expected to be profitable in 1990 also.

The ROE for three of the four Banks show a satisfactory rating of between 3 percent and 13 percent. Again, Banco Panamericano has a low return due to the reasons enumerated above. But the situation in this Bank is improving, with ROE increasing from a negative 6 percent in 1988 to a positive .3 percent in 1989.

-Liquidity: The Panamanian Banking Law stipulates that commercial banks will maintain not less than 35 percent of deposits in liquid assets, while mortgage banks must maintain 12 percent. In this case, the two mortgage banks have a liquidity ratio of 29 percent and 34 percent, and the two commercial banks have 35 percent and 40 percent. Other measures of liquidity are also favorable. In all four banks the ratio of gross loans to deposits and borrowing showed improvements in 1990 when compared to 1988, while the ratio of liquid assets to total assets showed similar improvements over the same period.

-Management: Once the Supplement is approved, the Banks will provide A.I.D. with additional information to assess the quality of management.

## VI. Technical Assistance

The development issues to be addressed by the technical assistance program include increasing the involvement of the private sector financial institutions in long-term mortgage lending and reducing construction costs. Technical assistance in the form of long- and short-term advisors and training will complement and support the Housing Guaranty Program. More specifically, the TA resources will be used for the following:

A. Long-term Program Management Advisor.

A long-term Program Management Advisor will be funded for eighteen months. In addition to assisting in the Program's start-up and monitoring its outputs, this advisor will coordinate short-term technical assistance activities related to long-term development issues and policies. The advisor will work with contractors and banks to initiate studies in policy reform activities with regard to strengthening the housing finance and production system, particularly for low-cost shelter. The advisor will also be available to work with the Ministry of Planning and Economic Policy, the developers association, commercial banks, the Ministry of Housing, etc., to promote lower costs through more appropriate standards, reduced fees in transferring titles, proposals to mobilize long-term resources for shelter investment, etc. Given the decrease in the credit worthiness of the Government of Panama, the virtual demise of the National Mortgage Bank and continued weaknesses in the Savings & Loan Industry, the private sector will be increasingly relied upon to fill the mortgage financing gap, including mortgages for low-income groups. The cost of a long-term advisor will be $200,000 for eighteen months. Funds for this activity will be provided as a grant to the program.

B. Short-term Technical Assistance.

1) Reducing Production Costs. Emphasis will be given to a dialogue between the private sector and public regulatory agencies to change the shelter and infrastructure norms and standards for different socioeconomic groups and geographic regions, to revise procedures for obtaining project approval, to provide better coordination and to reduce the time required to initiate construction. This will require a series of studies to determine to what degree housing costs may be reduced through revised standards and how project design and development procedures vis-a-vis permits may be streamlined.

Another factor affecting housing production is the cost of building materials. Alternative strategies will be developed to reduce the cost of these primary inputs into housing production. Also, mortgage registry procedures will be reviewed in order to reduce the delay between the time a unit is completed to the time the property is registered and repayments begin.

2) Increasing the Flow of Domestic Funds to Long-term Mortgage Lending. The decrease in the Government's ability to tap long-term credit sources for mortgage lending, coupled with the financial weaknesses in Government and Government regulated financial institutions, puts more pressure on the private sector to increase the flow of funds to long-term mortgage lending. This, in turn, will force the Private Sector Banks to identify and develop new techniques to capture long-term savings so as to prevent a mismatch between savings and lending terms. Technical assistance will be provided to the Banks to assist them to develop these techniques and programs.

Up to $100,000 has been budgeted, subject to availability of funds, to support short-term TA activities for the first two years. These funds will be provided by RHUDO and will be drawn down based on requests and recommendations from the Long-term Advisor.

C. Pre-Project Assistance. Legal assistance will be needed to help prepare various Program documents such as Loan and Administrator Agreements, model mortgage documents and other such legal documents to meet the Program requirements and protect A.I.D.'s interests. The maximum cost will be $50,000 for providing this assistance which will be covered by Mission grant funds.

D. Evaluations and Audits. Mid-term and final Program evaluations will be carried out. These evaluations will document the Program's experience and assess the private sector's continuing role in low-cost shelter. The mid-term evaluation will be conducted at the time of the first disbursement of HG funds and will be submitted to LAC for review. In addition, annual audits will be performed. The cost of evaluating the Program is $50,000 to be funded by grant funds.

SUMMARY OF TECHNICAL ASSISTANCE

| Type of TA | Amount | Source of Funds |
|---|---|---|
| Long-term Advisor | $200,000 | Mission Grant |
| Short-term TA | 100,000 | RHUDO Budget |
| Evaluations & Audits | 50,000 | Mission Grant |
| Pre-Project Assistance | 50,000 | Mission Grant |

Panama 525-HG-013
Highlights of Financial Information
In thousands of U.S. Dollars
As of 12/31/90,89,88

| | BANCO GENERAL, S.A. | | | PRIBANCO, S. A. | | | BANCO DEL ISTMO, S. A. | | | BANCO PANAMERICANO, S. | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 12/31/90 | 12/31/89 | 12/31/88 | 12/31/90 | 12/31/89 | 12/31/88 | 12/31/90 | 12/31/89 | 12/31/88 | 12/31/90 | 12/31/89 | 12/31/88 |
| TOTAL ASSETS | $430,612 | $311,346 | $330,710 | $276,569 | $217,207 | $233,561 | $163,112 | $103,031 | $101,613 | | $26,907 | $27,007 |
| Cash and other liquid assets | 111,413 | 27,302 | 29,661 | 82,385 | 35,538 | 39,310 | 50,573 | 24,617 | 25,334 | | 9,315 | 9,909 |
| Mortgage or other Loan Portfolio-Gross | 264,301 | 242,932 | 262,315 | 161,222 | 157,350 | 170,709 | 104,030 | 69,929 | 70,502 | | 17,285 | 16,952 |
| Provision for doubtful accounts | (3,190) | (3,010) | (2,048) | (703) | (393) | (37) | (773) | (327) | (293) | | (334) | (507) |
| Tax credits | 3,867 | 3,676 | 730 | 2,382 | - | - | - | - | | | - | - |
| Investments - Medium Term | 22,636 | 11,292 | 13,040 | 10,979 | 4,459 | 3,567 | 2,872 | 3,318 | 1,443 | | 25 | - |
| Fixed assets | 15,317 | 14,929 | 15,157 | 14,033 | 10,982 | 12,574 | 2,329 | 2,111 | 2,025 | | 290 | 310 |
| Other assets | 16,268 | 14,225 | 11,855 | 6,271 | 9,271 | 7,438 | 4,081 | 3,383 | 2,602 | | 326 | 343 |
| TOTAL LIABILITIES | $394,132 | $282,340 | $305,050 | $247,741 | $188,352 | $205,172 | $151,811 | $92,762 | $91,612 | | $23,869 | $23,979 |
| Deposits | $381,228 | $263,038 | $284,511 | $243,159 | $184,962 | $199,511 | $144,262 | $90,111 | $87,727 | | $23,319 | $23,145 |
| Savings accounts & Demand Deposits | 107,015 | 84,779 | 86,003 | 62,810 | 48,404 | 53,284 | 26,130 | 16,452 | 15,063 | | 3,126 | 2,842 |
| Term Deposits | 274,213 | 178,259 | 198,508 | 180,349 | 136,558 | 146,227 | 118,132 | 73,659 | 72,664 | | 20,193 | 20,303 |
| Loans Payable to Banks | - | 10,207 | 12,016 | - | - | - | - | - | - | | - | - |
| Mortgage Bonds -12% due 1995 | | | | - | - | - | 2,272 | - | - | | - | |
| Other liabilities | 12,904 | 9,095 | 8,523 | 4,582 | 3,390 | 5,661 | 5,277 | 2,651 | 3,885 | | 550 | 834 |
| NET WORTH | $36,483 | $29,004 | $25,662 | $28,826 | $28,766 | $28,389 | $11,135 | $10,214 | $9,918 | | $3,036 | $3,025 |
| Core Capital | 36,483 | 29,004 | 25,662 | 28,826 | 28,766 | 28,389 | 11,135 | 10,214 | 9,918 | | 3,036 | 3,025 |
| Supplementary capital | - | - | - | - | - | | - | - | - | | - | - |
| Interest Earned on loan portfolio | $26,742 | $26,987 | $31,530 | $19,225 | $19,231 | $21,166 | $10,123 | $8,361 | $11,366 | | $2,747 | $2,544 |
| Other Interest and Commissions Earned | 16,491 | 1,700 | 2,269 | 8,106 | 2,569 | 3,874 | 5,662 | 2,592 | 2,586 | | 583 | 550 |
| Interest Paid | 27,404 | 23,153 | 25,777 | 18,014 | 15,950 | 17,977 | 8,160 | 5,840 | 8,206 | | 2,473 | 2,150 |
| Other Income | - | 9,186 | 7,113 | - | 2,475 | 3,977 | - | - | - | | - | - |
| Operating Expenses | 11,671 | 11,455 | 11,673 | 7,493 | 7,353 | 8,188 | 5,516 | 4,312 | 4,483 | | 848 | 1,115 |
| Net Income - Pre-Tax | 3,901 | 3,265 | 3,462 | 1,824 | 972 | 2,852 | 1,251 | 801 | 1,118 | | 10 | (180) |
| Net Income - After-Tax | 3,152 | 1,909 | 1,923 | 1,560 | 376 | 2,113 | 1,251 | 608 | 1,114 | | 10 | (180) |

Panama 525-HG-013 Private Sector
CAMEL Rating System to Analyze the Financial Condition
of Private Mortgage and Commercial Banks
As of 12/31/90,89,88

| | BANCO GENERAL, S.A. | | | PRIBANCO, S. A. | | | BANCO DEL ISTMO, S. A. | | | BANCO PANAMERICANO, S.A. | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 12/31/90 | 12/31/89 | 12/31/88 | 12/31/90 | 12/31/89 | 12/31/88 | 12/31/90 | 12/31/89 | 12/31/88 | 12/31/90 | 12/31/89 | 12/31/88 |
| Unqualified Opinion | X | X | X | X | X | X | X | X | X | | X | X |
| Qualified Opinion | | | | | | | | | | | | |
| Disclamer of Opinion | | | | | | | | | | | | |
| CAPITAL ADEQUACY | | | | | | | | | | | | |
| Core Capital/Total Assets | 8% | 9% | 8% | 10% | 13% | 12% | 7% | 10% | 10% | | 11% | 11% |
| Total Capital/Total Assets | 8% | 9% | 8% | 10% | 13% | 12% | 7% | 10% | 10% | | 11% | 11% |
| ASSET QUALITY | | | | | | | | | | | | |
| Provision/Gross Loans | 1% | 1% | 1% | 0.40% | 0.20% | 0.02% | 1% | 0.50% | 0.50% | | 2% | 1% |
| Net Loan Losses/Average Loans | - | - | - | - | - | - | - | - | - | | - | - |
| Provision/Net Losses | - | - | - | - | - | - | - | - | - | | - | - |
| EARNINGS (Profitability) | | | | | | | | | | | | |
| Return on average assets | 1% | 1% | 1% | 1% | 0.40% | 1% | 1% | 1% | 1% | | 0.04% | 0.04% |
| Return on Capital | 12% | 12% | 13% | 6% | 3% | 10% | 11% | 6% | 11% | | 0.30% | -6% |
| LIQUIDITY | | | | | | | | | | | | |
| Liquid Assets/Deposits & Borrowings | 29% | 10% | 10% | 34% | 19% | 20% | 35% | 27% | 29% | | 40% | 43% |
| Gross Loans/Deposits & Borrowings | 69% | 92% | 92% | 66% | 85% | 86% | 69% | 78% | 80% | | 74% | 73% |
| Liquid Assets/Total Assets | 26% | 9% | 9% | 30% | 16% | 17% | 29% | 24% | 25% | | 35% | 37% |

| HIGHLIGHTS: 12/31/90 | BANCO GENERAL | PRIBANCO | BANCO DEL ISTMO, S. A. | BANCO PANAMERICANO, S. A. |
|---|---|---|---|---|
| Fixed Term Deposits/Core Deposits | 69% | 74% | 82% | |
| Income Generating Assets/Total Assets | 90% | 90% | 77% | |
| Income Generating Assets/Total Deposits & Borrowings | 102% | 103% | 92% | |
| Debt to Equity | 11:1 | 8.60:1 | 14:1 | |
| Interest Earned/Average Loan Portfolio | 12% | 12% | 12% | |
| Interest Paid/Average Loan Portfolio | 11% | 11% | 10% | |
| Operating Expenses/Average Loan Portfolio | 5% | 5% | 7% | |
| Non-Interest Income/Total Income | 16% | 12% | 22% | |
| Operating Expenses/Net Interest Income | 130% | 125% | 133% | |
| Interest Paid + Profit before Tax/Interest Paid | 1.14 times | 1.10 times | 1.15 times | |