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# FMDP SUMMARY REPORT

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Arthur Young
A MEMBER OF ARTHUR [illegible] RNATIONAL

## CONSULTANT REPORT SUMMARIES

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# BELIZE

A Study of the Financial System

Report Author: Jalil Shoraka

Date: May, 1986

## Objective:

Assess the financial system, including relevant legislation, and develop recommendations on how to improve the mobilization of savings, and how to channel those resources to productive sectors.

## Findings:

1. The Central Bank has demonstrated that it can be effective in implementing monetary policy. It successfully curbed credit expansion in the first quarter of 1985 by increasing commercial bank reserve and liquidity requirements, increasing the minimum lending rate and increasing commercial bank savings and time deposit rates.

2. Commercial banks are the main depository institutions. Credit unions exist but are only allowed to accept individual deposits, not commercial deposits. In addition, credit unions do not quote interest rates in advance. The rates are determined at the end of the fiscal year based on the credit union's performance. The interest rates have been competitive with those offered by commercial banks.

3. Assessment indicates that the real obstacle to financial market development is the constrained deployment of funds. The commercial banks are the major source of credit for the private sector (providing approximately 60% of domestic credit). The conservative lending policies of the commercial banks, including restrictive track-record requirements and security requirements of 200%, have resulted in an inadequate supply of credit to fuel business development.

4. There is a shortage of skills and experience in project identification and evaluation services in Belize.

## Recommendations:

1. Sound monetary policies should be adopted to solve the problem of fund deployment. In light of the small size and openness of the Belizean economy, expansion should be supply-led to avoid the possibility of inflation

and/or balance of payments deficit, which could result from demand-led expansion. Thus, monetary policy should be used first to ensure a stable monetary environment, and second to allocate savings to productive investment.

2. The Central Bank should use its powers to allocate credit according to national development priorities. The Central Bank can channel credit to priority sectors by dictating the purpose, maximum maturities, maximum amount of security required, and the volume terms and conditions for all loans, advances, and investment by all financial institutions.

3. Initiate a study of the role of credit unions as financial intermediaries including the areas of organizational support, technical support, funding, and lending and deposit activities.

4. Commercial banks should be re-oriented in the following ways:

   - Since commercial banks are the main depository institutions, their small number has constrained the mobilization of savings. Commercial banks should become more active in encouraging saving, and make a larger presence in the community.

   - Banks should revise track-record and security requirements to encourage the development of new business opportunities. Track-record requirements could be moderated by weighing more heavily the financial and economic feasibility of proposed investments, and security requirements could be lessened by including the future value of the property after investment is made.

   - Commercial banks should provide lease-purchase facilities for new small-scale industrial enterprises to solve the problem of loan security and encourage the development of infant industries.

5. The commercial banks, in conjunction with the Central Bank and other authorities, should develop a money market to facilitate the movement of funds between financial institutions and large trading and industrial firms.

6. The following organizational changes would improve the Development Finance Corporation (DFC):

   - Increase the DFC's role in domestic resource mobilization by making it a depository institution, and by allowing it to resort to the financial market (for example, pension funds, inter-bank borrowing and issuing medium- and long-term instruments such as CDs and bonds).

- Set up a "unit" within DFC or attached to other institutions to perform project identification and evaluation.

- Expand and diversify the operations of the DFC.

- Privatize DFC, allowing it to compete with other financial institutions, and eliminating the influence of the government in determining the feasibility factors of development projects financed by the DFC. Due to the political complications of immediate privatization, a five-year plan of gradual divestiture would be optimal.

7. Alternative financial institutions to the DFC:

   (a) Restructure an existing commercial bank; possibly the Royal Bank of Canada, which has put its Belize operations up for sale;

   (b) Establish a leasing company, which could operate as a subsidiary of the DFC or another financial institution.

8. The international development finance institutions in Belize should coordinate efforts to alleviate duplicative efforts.

## BOLIVIA

Financial Sector Assessment

Report Authors: James Munson and Robert Barbery Ameller

Date: August, 1986

Objective:

Perform an assessment of the financial system of Bolivia and make recommendations to improve the financial system focusing on policy and institutional changes.

Findings:

1. Bolivia's current economic problems include: rapid and radical shifts in government economic policies, a biased tax system which currently penalizes productive enterprise; unbalanced and mis-targeted subsidies combined with expansionary monetary policies that have led to commercial speculation; excessive bureaucracy and nationalization; and a deteriorating terms of trade that has been worsened by expansionary monetary policies and aggressive pursuit of foreign assistance.

2. The financial system of Bolivia has deteriorated since 1981. The number of active banks in the system has declined from 19 to 14 - all major international banks in Bolivia have closed operations. It is highly probable that one or more banks will fail in the near future.

3. The potential for capital formation is constrained by the absence of capital market instruments - there is no active stock exchange and private institutions cannot issue securities. Thus, capital development is limited to large industrial and agricultural concerns with easier access to capital.

4. GOB efforts to control inflation and meet IMF criteria have made near-term internal recapitalization of the existing industrial base virtually impossible. Due to the country foreign private debt burden outstanding, external line of credit financing through private banks is unavailable. Further, USAID line of credit guarantees are currently unavailable.

5. All public and private financial institutions claim major technical and qualitative deficiencies in all levels of management, and the situation is likely to worsen as real salaries decrease. There is currently no formal training mechanism to improve the quality of management.

6. There is a lack of coordination and organization between multi- and bilateral assistance organizations, causing the delivery of rural financing and credit to be inefficient and expensive.

7. Increasingly, public banks are competing with private banks for demand and time deposits. However, the public banks have an unfair advantage because they can write off costs against GOB's budget.

8. Deposits in the financial system are exclusively short-term and the majority are highly speculative.

9. Despite high interest earnings and large commissions, private sector bank revenues don't cover costs.

10. The Central Bank is inefficient because it has too many goals and no clear objectives. It also suffers from rapidly changing staff assignments, staff incompetence, and excessive bureaucracy.

11. High quality timely financial information is simply not available. The Central Bank and other public and private sector organizations do not follow standard accounting practices.

12. The Development Department of the Central Bank has been inefficient in channelling development funds.

13. Operating costs in public and private sector banks are larger than they should be.

14. Bank revenues are larger than they should be given the activity base. Thus it will be difficult to persuade the system to move to longer term loans.

15. There is no security for depositors beyond low leverage ratios and high fixed assets of the banking system.

<u>Recommendations</u>:

1. Focus on stabilization and growth of the economy. Activities suggested for stabilizing and promoting growth in the economy include:

   a) establish an organization to improve the efficiency and use of funds from the Central Bank through intermediate credit institutions to final borrowers;

   b) establish an offshore guarantee facility to improve the access of public and private institutions to external letter-of-credit and other short-term instruments for productive imports;

c) evaluate and implement innovative programs, such as debt swaps, to recapture flight capital in the short-term; and,

d) implement savings stimulation programs, which might include a deposit guarantee program, in the medium-term following economic stabilization.

2. Improve the structure and the operating conditions of the financial sector. The consultants suggest the following activities:

   a) support the evaluation and changes to the Central Bank outlined by the World Bank;

   b) evaluate and modify the roles of state banks, in particular as they compete with private sector institutions and involve themselves in activities dealing with development;

   c) review, and if necessary, reform the banking laws; and,

   d) improve the country's financial information system.

3. Concentrate on improving the operations of financial organizations. This goal can be accomplished by:

   a) using leverage of government and external funds to to rationalize bank operations. This can be accomplished by establishing and enforcing clear operating standards, and reporting and audit criteria.

   b) improving the technical and management capabilities of staff through training. In the short-term, financial sector training can be provided through the USAID sponsored IDEA program, but in the long-term enhanced local training capabilities will need to be developed.

4. Increase the developmental capabilities of the financial sector. Activities within this element include the following:

   a) decentralization of financial operations and decision authority;

   b) implementation of structural changes to enhance the development banking capabilities of public and private sector organizations; and

   c) development and implementation of a broad variety of capital market instruments.

# ECUADOR

Privatization and the Debt Problem

Report Author: Nathaniel McKitterick

Date: July, 1986

Objective:

Determine which parastatals would be appropriate for privatization, the major obstacles to privatization in Ecuador, sources of financing, and whether there are opportunities for direct foreign investment.

Findings:

1. There is no real central control of parastatals, and the consultant was unable to ascertain the number of parastatals in Ecuador today.

2. Obstacles to privatization:

   a. There are no accurate records indicating the financial condition of state-held operations.

   b. It is difficult to determine who the effective government owners are, and to get an agreement to consider an offer from the private sector.

   c. The CFN appears reluctant to offer profitable enterprises for sale since their profits balance CFN's substantial losses. On the other hand, unprofitable enterprises are unattractive to buyers.

   d. Ecuador's economy is plagued by a serious recession and a huge external debt (annual service payments alone amount of US$900 million, more than half of current export earnings). Unless economic growth is restored, recent gains in private sector activity will be lost, further limiting its ability to absorb parastatals.

   e. A major political problem with privatization is how to absorb laid off employees into the economy.

3. Of eight parastatals the consultant identified as prospects for privatization, four posed major obstacles due to problems of valuation, CFN was unwilling to sell two, and one presented a serious labor problem in the event of divestiture.

Recommendations:

1. CFN would be the most important contact for promoting privatization.

2. Assistance is needed most in the areas of auditing and valuation of enterprises.

3. AID should encourage CFN to become a source of management assistance for a broad range of corporate activities.

4. There appears to be some confusion about AID's interest in privatization, as well as confusion and suspicion about the concept in general. Concentrating on valuation and management assistance and avoiding the buzzword "privatization" may eliminate some negative reaction.

5. In light of the unhealthy condition of the economy, and of the private sector in particular, incentives are necessary to encourage the private sector to assume dollar debt in the purchase of public enterprises.

6. Talking points for AID:

   a. Form a Baker Company, an investment bank established by a group of U.S. money-center banks (possibly with other international participation) into which a portion of GOE's annual debt service payments would be placed and invested in Ecuadorian export industries as equity.

   b. Sell early tranches of Ecuador's World Bank loans to U.S. banks, receiving discounted government debt in return and passing some or all of the discount on to the Ecuadorian government. This idea has not been discussed with the World Bank, and there may be problems with U.S. bank regulators.

   c. Project vs. Structural Adjustment in World Bank Loans, as structural adjustment does not appear to bring rapid disbursement as planned.

# ECUADOR

Review of Non-Traditional Agricultural Exports Project

Report Author: David Miller

Date: April, 1986

Objective:

Review issues which must be resolved prior to implementation of the Non-traditional Agricultural Exports Project (Investment Promotion Component), and recommend best alternatives. Consultant's analysis is based on review of the Project Paper Amendment (PPA) and studies performed by Stern, Naranjo & Co. (SN), and on the consultant's experience.

Issues Covered:

1. Promotion of foreign investment in export oriented agribusiness.

   a. Although the project will not increase foreign investment significantly in the short-term due to existing economic conditions, it will promote new foreign investment in the long-term.

   b. It is anticipated that approximately one-fifth to one-third of new capital investment will be in agribusiness.

2. Establishment of Promotion and Support Services Company (PASSC).

   a. Promotion Aspect (PA): involves studies to identify opportunities in a given country and feasibility/market analyses to locate potential investors.

   b. Support Services Aspect (SSA): this aspect of the new company generates revenue and profits. It requires some promotion, but not on the level of PA.

3. Overseas Promotion Service.

   a. The SN report specifies three investor groups: corporate investors, multilateral and bilateral investment agencies, and financial investors.

   b. Two options were presented to attract investors:

a) have overseas contacts working on a broad range of potential investors on an ongoing basis ($250,000 - 500,000 per year); and b) approach targeted investors using selected US contractors ($30,000 - 50,000).

4. Venture Capital Pool (VCP).

   a. As proposed, VCP investments will not be limited to the agribusiness sector, but will include industry, mining and tourism. Land development, banking, and commercial activities in general would be excluded.

   b. Current regulation pertaining to the establishment of new companies lacks the flexibility which would be ideal for the VCP. However, the Superintendent of Companies is not unwilling to revise existing legislation, and the fact that the IFC has expressed interest in participating in a VCP may expedite change.

   c. Both the PPA and the SN study assume AID involvement in the form of equity, on the rationale that AID's promotion of a fund in which they will not invest is a loud message to investors.

Recommendations:

1. Promotion of foreign investment:

   a. Consultant supports project as now proposed, as the mechanisms proposed ((1) promotion and support services company (PASSC), (2) venture capital pool (VCP), and investment credit facility (ICF)) will attract foreign investment to Ecuador.

   b. Overall impact of the mechanisms:

      - attract foreign investment;
      - allow financial sector to provide needed capital;
      - increased professionalism

2. Establishment of PASSC:

   a. AID should focus assistance on PA, leaving SSA under the jurisdiction of the new company. AID should have several options available in the implementation of PA, and the company selected to do the SSA should be required to assume some responsibility for PA.

b. It is likely that there will be significant interest in the PASSC by local companies; the companies should be selected based on competitive proposals.

3. Overseas Promotion Service:

a. The less expensive option to attract investors (b) should be implemented.

b. Funding should be included in the amendment to detail a strategy and then to implement the program, with private sector companies contracted to do the work. This work should be delayed until after the establishment of the PASSC and VCP.

4. Venture Capital Pool (VCP):

a. Investment must be made based on a profit incentive.

b. An employee levy amounting to 15% of all profits is assessed of all companies. VCPs would essentially be double taxed because they would pay the levy out of profits which have already been taxed. This double taxation should be eliminated in order to improve the viability of VCPs.

c. The consultant supports the SN study conclusion that a VCP fund would be financially viable in Ecuador.

d. The draft amendment implies that foreign investors will be heavily involved in the VCP. The consultant, however, predicts that in the initial stages investments will be made primarily in existing enterprises with local entrepreneurs, but that the existence of the VCP will encourage foreign investment in the long-term.

## ECUADOR

Financial Markets Overview

Report Author: John Porges

Date: June, 1986

Objective:

Recommend policy and legal modifications which will stimulate economic growth and development.

Findings:

1. The National Finance Corporation (CFN) plans to sell all its shares in companies through the stock exchange in June.

2. David Gallagher, formerly head of the Latin American Division of Morgan Grenfell, London, was responsible for converting part of Chile's external debt to equity, and is interested in doing the same for Ecuador.

Recommendations:

1. Commercial interest bearing instruments and loans should be on a floating rate basis factoring in the inflation rate in order to encourage savings and deter capital flight.

2. Taxes on dividends should be lowered from the current 55% to 10-15%.

3. The capital gains tax should be lowered from the current 50% to 15-20%.

4. Article 24 of the Andean Pact (limiting foreign investment in local companies to a minority interest) should be abolished because it actually prohibits the return of flight capital.

5. Export tax retentions, prior to import deposits and the advance foreign exchange tax on purchases of exchange, should gradually be reduced because they hamper foreign trade, encourage smuggling, and encourage increased imports by parastatals at the expense of a weakened private sector.

6. Required insurance company investment of reserves should be lowered from 55% to 15% and up to 10% of reserves should be permitted to be invested in commercial operations with favorable tax treatment in order to encourage the growth of the industry.

7. An independent audit and appraisal should be made of the companies prior to the sale of CFN's shares in June to ensure that shares are correctly priced.

8. The sale of shares in general would be improved if the tax on dividends was reduced, the return of flight capital was brought about, and the insurance industry was revitalized.

9. A venture capital fund could be successful, but it must be managed by experienced institutions such as the IFC or IDB.

10. Ecuador should move now to convert foreign debt to equity because economic conditions are favorable.

# ECUADOR

Private Insurance Sector Report

Report Author: D. Reinmuth, A. Lanza, W. Fitzpatrick

Date: August, 1986

Objective:

To produce a profile of the insurance industry in Ecuador, estimating its market penetration, potential for growth, efficiency, and assessing its ability to meet the needs of lower income groups. The study will also examine the capital formation role of the insurance industry in the economy and its investment portfolio.

Findings:

1. The Ecuadorian insurance industry is very small, accounting for one percent of the total assets of financial institutions (U.S. $65.6 million). Within the industry, life insurance plays a modest role with a market share of about seven percent of premium volume. Nominal growth in premiums, assets, capital and profits has been counteracted by inflation and investment restrictions, resulting in negative real rates of growth.

2. The insurance industry is legally restricted in terms of investment options. By law, the companies must invest up to 55% of their capital and reserves in comparatively low yielding government securities. With inflation running at 15 to 35% and a rate of return of 7 to 13% from government securities, the companies face serious decapitalization problems. In an attempt to offset this problem, insurers have invested in real estate which comprises 28% of the portfolio, as compared with 1.2% in the U.S.

3. Even if the government did not impose such requirements, the companies would lack a diversity in their investment portfolio due to the lack of investment opportunities in Ecuador. The capital market consists mostly of long-term bonds. The equity market is virtually non-existent.

4. Minimum capital requirements for insurance companies are too low (currently at U.S. $35 thousand), and although the Director of Insurance has discretionary powers in permitting new insurers to be licensed, various sources have indicated that the Director's decision can be overridden by those with strong political influence.

5. Industry observers believe that some insurance companies rely too heavily on foreign reinsurance, however this does not appear to be the case on the whole. The law does not require national companies to retain any minimum risk.

6. The reasons cited for the lack of development in personal life insurance are high level of inflation, low per capita income, and lack of insurance awareness. Non-life insurance is limited almost exclusively to commercial, industrial and governmental risks because: commercial policies secure larger premiums and can be more profitable; the broker system which is prevalent in Ecuador is better organized to serve large clients; and personal insurance is not a prerequisite to borrowing for homes and automobiles.

7. The economy's high inflation is a deterrent to the development of a private life insurance sector. A potential solution would be variable life insurance, however inflation-indexed securities would be required to back such policies.

8. The compensation law discourages the establishment of independent contractor agent networks.

9. There are no regulations regarding qualifications, training and licensing of brokers.

10. There is no formal training program for insurance company employees and managers.

11. The insurance code is outdated and should be revised.

Recommendations:

1. Investment restrictions should be eradicated, allowing insurers to make investments which pay market rates of return.

2. Revise the entire regulatory system. Specific areas to be revised should include broker qualifications, reinsurance, and minimum capital requirement.

3. There is a large potential personal lines market which is untapped. A follow-up study should be conducting on changing the role of independent contractors and the compensation/benefits system for agents in an effort to mobilize a more aggressive sales force.

4. Develop and implement an industry-wide training program(s) funded, in part, by the insurance companies.

5. Develop and implement training programs for government personnel involved in regulating the industry.

6. Assess the newly instituted government fire insurance program. The evaluation should study the role of the insurance industry in making it a sound and effective program.

7. Investigate the possibility of creating investments such as inflation-indexed securities that can be used by insurers to back indexed policies.

# ECUADOR

Financial Markets Assessment Report

Report Author: John Vanderveen

Date: February, 1986

Objective:

Assess Mission and donor groups' recent activities in financial market development, and review related studies.

Findings:

1. World Bank study findings (April, 1985)

   Ecuador has a serious problem with capital flight, limited resource mobilization, and a lack of interest in capital market development. These problems are due to, among other factors, GOE's interest rate policy, which resulted in negative real interest for savers, and lack of domestic funds resulting in an over dependency on foreign borrowings.

2. Special Study - Industrial Development Finance findings (Nathan and Associates, 1983)

   Although CFN and COFIEC had been relatively successful in promoting industrial development, they failed to mobilize domestic savings significantly, the majority of their loans were for three years or less, and only a small portion of loan portfolios were equity investments. This failure was due to GOE policy measures regarding interest rates, taxation, etc., which hinder free market forces.

3. Trading on the stock market is slow because there is no mass market, there is no tradition of trading, disclosure laws are virtually non-existent, there is no means by which minority shareholders can know the actual position of firms, and taxes on dividends are high relative to other taxes.

4. Activity in the illegal banking system is huge (approximately 3.8% of GDP went through this market in 1984). The huge demand for this service stems from the fact that many small businessmen do not have access to the formal financial markets, which charge 35% or more for short-term loans.

Recommendations:

1. World Bank study recommendations

a. An in-depth study and reform of the banking system is necessary;

b. Legislation should be passed to adopt a variable interest rate;

c. Current laws/regulations regarding capital market development are actually inhibiting growth and should be revised; and

d. Further World Bank/AID cooperation is necessary.

2. Nathan study recommendations

a. Policies, legislation and institutional mechanisms must be developed to improve the mobilization of savings; and

b. Both public and private institutions should be involved in allocating long-term financial resources for development.

3. The bolsas have recommended tax reform, trading in gold and precious metals, the formation of investment clubs and mutual funds, and the establishment of a new classification of corporation ("the open capital company") as ways to stimulate the stock market.

4. Financieras, with the possible exception of CFN and COFIEC, should be merged into the commercial banks because the services they offer are indistinguishable from those of the banks, they suffer serious liquidity problems, and suffer portfolio problems.

5. Price Waterhouse study recommendations (1984):

a. Conduct a capital markets development study covering monetary policy, the institutional development of the entire financial system, and the institutional structure and operations of the Central Bank; and

b. Review the financial and management situation of private banks and financieras.

6. The consultant applauds AID's efforts in promoting investment, but is dissatisfied with the mechanisms chosen, pointing out that the proposed venture capital pool should be headed by someone with thorough local as well as financial knowledge. The notion of the "Baker Company" should be studied in greater depth.

7. The banking system should be made more competitive by consolidating the banks into five to ten larger, more

 

competitive banks, allowing the market to determine the interest rates that financial instruments will bear, and revising banking laws and regulations. Such actions might also diminish activity in the illegal banking system.

8. Agricultural sector credit should be more easily available and at "reasonable" rates; an institutional entity should be established to control rates.

9. Tax codes and regulations pertaining to financial instruments should be amended; a study should be made of all legislation covering the financial system.

10. Ecuador should be included in the financial markets development program.

11. A capital markets workshop should be held in Ecuador.

# GUATEMALA

Study of Financial Markets

Report Author: Stimson Eveleth

Date: July, 1986

Objective:

1. To review the appropriateness of USAID supporting the establishment of a stock market in Guatemala.

2. To review medium- and long-term financial markets in Guatemala.

Findings:

A. The stock market:

1. Current conditions are such that the establishment of a stock market in Guatemala would have little impact on the development of capital markets or medium and long term financing for expansion or development use.

2. An intermediary step before establishing a fully functional stock market is appropriate, given current conditions.

3. Since the Banco de Guatemala is actively studying promulgating laws which would lead to the creation of a stock market and, the target for the passage of such laws is eighteen months, and certain sectors of the private sector actively support the creation of a stock market, USAID should monitor developments closely so as to guide the passage of laws which encourage a free and open market unencumbered by restrictive legislation.

B. Financial Markets:

1. Any changes in market mechanisms should be to encourage the return of flight capital, rather than facilitate flight capital.

2. Commercial Banker's lending policies are traditional and conservative, as such medium and long term lending by commercial bankers is unlikely to develop with out some special stimulus.

3. No medium- or long-term financial instruments exist, except for Government bonds.

4. The financial system is beholden to the banks and banks are beholden to industrial groups.

5. There are few institutional investors and some potential institutional investors are prohibited from investing in the private sector by law.

Recommendations:

1. USAID should work with the Guatemalan Government with the view of implementing legislation which would expand the universe of institutional investors legally permitted to invest in private sector equity and debt issues.

2. USAID should not encourage the establishment of a stock market, in the short-term. However, since there is a movement underway by the central bank to promulgate enabling legislation, USAID should work for the passage of laws which would produce the freest and least encumbered stock market possible. Laws should provide for good government oversight procedures but little direct control.

3. Encourage the establishment of mutual funds, run by banks or financieras, as a first step to encourage the investing public (individual as well as institutional) to use private sector debt and equity investments as a medium for saving/investing.

4. Together with local institutions, USAID should develop training programs for the bankers to encourage them to adopt the more modern methods of balance sheet lending and cash flow lending as opposed to purely asset based lending.

Constraints:

1. Current political and economic conditions mitigate against the return of flight capital.

2. The history of mistrust between the government and the private sector plus the virtual control of the entire economy by a relatively small number of major groups will make the emergence of a free market slow and tedious.

3. Major economic groups are unwilling to dilute control by selling equity out side the holding group.

4. Since corporations are for all practical purposes privately held, published financial statements are not reliable guides against which to judge the condition of a company and to make decision about equity or debt investments. This also makes anything but asset based lending by banks difficult.

5. Given the relatively small volume which would be traded on a stock market, stocks and bonds price movements could easily be subject to forces other than just market forces.

# GUATEMALA

World Council of Credit Unions
Cooperative Strengthening Project:
Capitalization Component

Report Author: Peter Marion

Date: March, 1986

Goal:

To develop innovative approaches to local generation of both paid-in and retained capital while stabilizing and strengthening cooperative balance sheets. Seed money will be supplied through the Trust Unit to qualifying individual cooperatives and credit unions, and to their federations.

Objective:

1. To increase the economically beneficial operations of cooperatives and credit unions.

2. To increase domestic sources of funds for loans and investment (through savings and cooperative shares).

3. To strengthen the balance sheet and earnings of cooperatives and credit unions.

4. To restore the public's confidence in cooperatives and credit unions in terms of their financial soundness and creditworthiness.

5. To establish and enforce operating standards and conditions geared towards maintaining the soundness of the system.

6. To forestall and/or prevent possible intervention or liquidation of delinquent institutions by creditors while the stabilization programs are being implemented.

Findings:

1. Problems facing the cooperative movement:

   - High loan delinquency and weak credit administration;

   - Low profitability and poor operational and pricing policies;

   - Decapitalization due to asset losses, inadequate reserving and earning retention policies, member withdrawals, and debt amortization;

- High level of risk in the system due to insufficient levels of retained earnings and reserves relative to members' shares and liabilities to third parties;

- Market size and membership shrinkage;

- Inadequate training of staff in financial and operational training;

- Inadequate external and internal regulation and control;

- Adjusted book value of seven federation shares indicate negative worth, with the exception FENACOAC;

- Overestimated value of cooperative share capital by federations;

- Underestimated need by federations to build reserves and retained earnings to protect the share capital; and

- The low level of dividends paid by federations on share accounts and the difficulty in withdrawing shares discourage voluntary capitalization by members or affiliates.

2. Strengths of the cooperative movement:

   - Extensive national network of organizations serving both urban and rural constituencies;

   - Strong community identification and in-depth knowledge of their markets and client-members; and

   - A core of successful, sound cooperatives and credit unions.

Recommendations:

1. The cooperative movement should increase the level of reserves and retained earnings to improve its ability to absorb expected and unexpected losses. Towards this end, federations should develop sound cooperative pricing and earning strategies, and implement cost controls and reserving policies.

2. A Savings Protection Program (SPP) should evolve from the operations of the Stabilization Fund in the credit union sector. SPP will function similarly to a deposit

insurance thus increasing depositor confidence in the credit union system and leading to more available capital for lending operations.

Implementation:

Financial stabilization of federations, cooperatives and credit unions will be a joint undertaking of the institutions themselves, the TDU and the Trust Unit. The basic steps will be:

1. Completion of a joint diagnostic study of each institution in terms of their financial, management and marketing positions and their future prospects. A key aspect of such studies will be the classification of the institutions' accounts receivable and loans outstanding.

2. Development of written agreements between the institutions, TDU and the Trust Unit to participate in the project.

3. Preparation of a development plan for each institution specifying activities and investments to improve their performance.

4. Installation of a capitalization system and discipline to increase both share and pure equity capital.

5. Implementation of the agreed-upon development plan.

6. Effect debt rescheduling and non-disturbance agreements.

7. Approval of stabilization investments by the TDU and their disbursement by the Trust. Write-off of non-recoverable assets by the participants.

8. TDU and Trust Unit monitoring and technical support for participants.

9. Annual reviews and renewals of development plan implementation and stabilization investments.

10. Assessment of participants to identify which are qualified for the credit component of project.

11. Preparation of a feasibility and design study for SPP.

12. Policy development by cooperative institutions dealing with capital retains; cash share investments; payment of share withdrawals and system liquidity management to support such payments; dividends paid on share capital; asset/liability management; credit administration and delinquency control; and reserve formation and growth of retained earnings.

13. Specific implementations for credit unions:

- Payment of dividends on share capital;
- Creation of appropriate savings instruments;
- Implementations of mechanisms to assure the liquidity of shares and deposits;
- Improvement of the services offered;
- Development of depositors confidence;
- Implementation of central liquidity facility in FENACOAC to support credit union savings mobilization;
- Improvement of marketing effort to expand clientele.

14. Specific implementations for cooperatives:

- Promotion of the capitalization concept to members;
- Establishment of mechanisms to generate share capital from:
  - Retained earnings;
  - Loan capitalization;
  - Capital retains (discounts) on transactions;
  - Paid-in shares (from new members).
- Improvement of public confidence;
- Declaration of dividends, capitalized in share accounts, not in cash;
- Development of specialized subscriptions of capital shares for specialized needs;
- Improvement of marketing effort to increase clientele.

In addition to the described implementation, the report also details critical issues faced by the TDU, the Guatemalan government and the cooperative movement in the implementation of the project which affect the degree of success achieved.

## GUATEMALA

World Council of Credit Unions
Cooperative Strengthening Project:
Design Documentation

Report Authors: Peter Marion, David Fledderjohn, David Richardson, Alfredo Echegaray

Date: June, 1986

### Goals

To increase rural family incomes and productivity by strengthening the institutional capability of the Guatemalan cooperative system to provide its members and their communities with improved services.

### Implementation:

The project will be implemented incrementally, beginning with the leading federations and their stronger affiliates, and will provide technical and financial resources to them through three key components:

- institutional development component - this component will provide technical assistance and human resource development services to the federations and their affiliates.

- capitalization component - the capitalization component will provide financial stabilization grants and funding for a savings deposit insurance program to a more restricted group of federations and cooperatives which meet specified institutional and economic viability criteria. The design and implementation of improved savings mobilization and capitalization systems is a key element of this component.

- credit component - the credit component will supply wholesale loans to a select group of creditworthy federations and their affiliates to finance income-generating activities primarily at the member level but not exclusing productive investments by federations and cooperatives themselves. The development of improved loan making and collections systems in federation and their affiliates is a central element of this component.

### Organizational Structure:

The project will be implemented through two distinct yet closely related organizational elements: the Technical Development Unit (TDU) and the Funds Management Unit (FMU). TDU will be responsible for implementing institutional development activities in concert with participating federations. FMU will be estabalished to disburse grant, operating and credit funds. Later on, TDU will be disbanded. FMU will absorb the technical elements of TDU and evolve into one or more successor institutions.

Schedule:

The project will be implemented over a 5.25 year period. The first year of the project will involve startup; installation of personnel, establishment of operating systems, development of training methods and materials, preparation of model systmes, implementation of the diagnostic studies of the federations and initiation of their development plans.

Years two through four will involve implementation of the development programs of the federations and their affiliates, with the support and participation of the TDU and FMU staffs. Most development programs will begin in year two. Year five will see a gradual phase-down of TDU activities with primary emphasis on the development of successor institutions to the FMU/Trust account.

Project Finance:

Implementation of the project will require $11 million in USAID/Guatemala funds, $5.7 million for institutional development, $2.5 million for capitalization and $2.8 million for credit. Three basic methods of finance are recommended: direct pay intra-governmental transfer for the PASA Project Manager; Federal Reserve Letter of Credit (FRLC) for international technical assistance provided by CDO; and direct pay for local currency cost incurred by the Guatemalan program operations disbursed through the FMU/Trust account in FENACOAC.

The host country contribution has been defined as the local funding currently provided by the federations for their ongoing administrative costs as well as additional capitalization and personnel costs at the affiliate level attributable to project implementation; the estimated total is $8.7 million. In effect, the counterpart of the participant organizations is the maintenance and operation of the national cooperative system.

## HONDURAS

Review of Honduran Financial Markets

Report Author: Stimson Eveleth

Date: April, 1986

Objective:

To develop both a scope of work for a financial market feasibility study and a strategy for possible AID Mission support of a financial market, and later, a capital market in Honduras

Conclusions:

1. There is currently sufficient information on hand in the AID files in Honduras to provide a basis for choosing among various options open to AID.

2. With the Government being the dominant force in the Honduran financial markets, managing policies to maintain existing fixed exchange rates, and to "stabilize the economy," there is little likelihood that financial markets will develop beyond the short-term money market type operations that currently exist.

3. With a flat to negative yield curve, with returns in near cash investments (tax free government bonds) high in real terms, and with a legislated limit of 20% profit on the return that an investor can get on a business venture that avails itself of government subsidies, there is little probability that a long-term money market or venture capital market will emerge.

4. With no apparent desire on the part of the government to change policies, and with an apparent anti-private sector mindset there is little incentive for the private sector to invest long-term or at risk.

5. Any attempt to create venture capital or a long-term financial market, within the existing system, will fail without continuous subsidy from outside sources. However, a private sector institution could be created which might stimulate the creation of both venture capital and capital markets.

6. Financial institutions and instruments already exist within the market which can accommodate both a long-term and short-term financial market.

Alternatives:

1. Do nothing.

2. Pressure the government to change policies.

3. Create and nurture an institution which will stimulate the long-term markets.

Recommendation:

1. Initiate alternative two and three simultaneously.

Implementation:

1. Form a working party of:

    a. A representative of the Federal Reserve Board familiar with implementing Central Bank and Treasury Policies in underdeveloped countries,

    b. A senior U.S. commercial banker, conversant with banking systems in developing countries as well as the U.S.,

    c. A senior local banker or industrialist, and

    d. An AID economist.

    The purpose of this working party would be to initiate a dialogue with the government and the private sector to liberalize the financial systems. One of the first tasks of the working party would be to review current credit needs and determine if they could be met by current instruments being delivered by the various financial institutions. The second priority would be to convince the government of the need to move toward more stimulative policies.

# INDONESIA

Memorandum on Policy for Capital Market Development

Report Author: Terrence Reilly

Date: July, 1986

Objective:

To help the government of Indonesia decide on the revitalization and further development of the capital market.

Findings:

General

1. In the 1970s, when Indonesia had substantial revenues from oil, the government made credit readily available to domestic businesses in the form of subsidized loans offered by the State commercial banks. Thus, businesses had no incentive to go public. Now, with dropping oil revenues, the government must find alternative ways to finance economic growth. GOI expects the private sector to provide 46% of development funds during the current 1984-1989 Plan period. In order to improve the investment climate, the Investment Board (BKPM) has requested an evaluation of the regional investment climate. Recommendations evolving from this report will greatly help in developing the capital market.

2. The legal business environment is vague, based on a limited number of articles in the 1847 Dutch Commercial Code.

3. Other countries such as Singapore and Malaysia have already started improving their capital markets. If Indonesia does not follow suit it will fall behind in developing its economy.

4. GOI has not indicated that it is interested in the privatization of its parastatals. However, due to the current shortage of funds, the government would like to see the state companies play a larger role in financing their investments.

Supply for Securities

1. Trading has now virtually ceased. Since 1983 only one company has made a public offering, and that was a foreign company that went public to get a license for expansion. Of the 24 companies with shares listed on the exchange, 17 are quoted at below their new issue price and 5 are quoted at below their "nominal value" of

the shares. The share index has fallen from over 100 in 1982 to 60 in 1986. Because government regulations favor state companies in terms of issuing bonds, private companies have not issued them.

2. The securities market has a limited supply of securities. This is partly due to the fact that DANARESKA, the state-owned underwriter and mutual fund, has the right to purchase up to 50% of new issues of shares. DANARESKA can hold these shares in its portfolio or in its mutual fund. The strong presence of DANARESKA along with the underwriting maximum fee of 4% has discouraged the development of the underwriting industry. A further deterrent to the supply of securities is the excessive disincentives to companies in issuing new equity; in fact the debt/equity ratio of most companies in Indonesia has been rising.

3. Offering prices are officially controlled in Indonesia. Some companies have felt that the public offering price was too low for their stock, causing ownership dilution.

4. The government has recently announced that foreign companies which list a substantial percentage of their stock on the Stock Exchange will have access to local finance and distribution. (The exact amount has not been settled on.) The Indonization Plan is still enforced requiring foreign companies to transfer 51% ownership to Indonesians within ten years following receipt of approval to invest in Indonesia.

5. BAPEPAM, the capital market regulatory body, is now evaluating alternatives to improve the supply of securities and remove some of the restrictions impeding trading.

6. The government requires that all companies obtain licenses before they expand their production capacity. Foreign companies feel that they have a difficult time attracting local investors because the licensing procedures favor domestic companies.

<u>Demand for Securities</u>

1. Share prices are not allowed to fluctuate more than 4% per day. In fact, DANARESKA controls the trading prices by buying or selling shares to prevent wide fluctuations. These measures are designed to prevent speculation in the market. Unfortunately, they also severely limit the possibility of capital gains.

2. Currently, savings are mobilized virtually entirely through the banking system. Banks offer high interest

rates, tax-free interest, and are insured by the government. Earnings from investments in the securities market are taxed and the requirements for listing are onerous and tend to discourage companies from going public.

3. Indonesian investors view securities as bank deposits, expecting dividends comparable to interest payments from banks. This discouraged domestic companies from selling shares. In addition, the incentives provided to encourage companies to go public have been insufficient. Lastly, domestic companies are reluctant to publish actual income in a public offering prospectus because tax authorities might suspect the companies of underpaying their taxes and demand a higher payment than is legally owed. In the absence of effective auditing and accounting controls, companies that go public are at a disadvantage to competitors that do not publish financial statements.

4. There are no controls on the deposit rates offered by commercial banks. In addition, the interest from deposits is tax-free. The current return on deposits is 18%. Lending rates run at 18 to 22% depending on the priority of the project.

5. Dividends from common shares is taxable. In order to compete with Bank deposits, companies must guarantee a return of 26 to 28% of the original offering price of the shares. This makes the issue of shares unattractive, so that even businesses prefer depositing in banks over investing in the securities market.

6. The State Pension Funds have an estimated value of $6 billion or more. Currently, it is held in term deposits at the State commercial banks.

7. The government is taking steps to encourage companies to establish pension plans to fund their long-term obligations to employees. Company pensions are typically paid out of current year expenses.

## Recommendations

### General

1. The government must decide to revitalize the capital market. It should be emphasized that bringing the capital market back into action will help the overall financial system of Indonesia. The capital market is inter-related with the money market, with financial institutions such as banks playing active roles in both.

2. The consultant recommends that the government establish a high-level policy making group (Capital Market Development Group) to design and implement an action plan for capital market development. Specific actions would be debated and decided on by policy makers. The group would include private sector representatives as well as outside experts, when appropriate. Specifically, the objectives of this policy making group would be the following:

   - Convince top level officials of the importance of changing policy, particularly regarding the unequal tax-status of Bank and capital market interest.

   - Convince companies to invest in capital assets to expand production.

   - Increase the mobilization of long-term finance through the capital market by (1) removing the rigidities and disincentives of the securities market, and (2) establishing a secondary over-the-counter market without the rigidities of the primary market (as noted, BAPEPAM is already attempting to establish this).

3. Improve legal and regulatory environment for business and securities market activities.

4. Senior officials and private sector representatives should visit other markets (notably Korea, Brazil, Jordan) to study their market development techniques.

5. Provide training in market development, operations, self-regulation and regulation.

6. The Capital Market Development Working Group (with assistance as needed) should design a specific three phase action program for capital market development, including survey of knowledgeable persons and representative companies.

7. Afford an opportunity for discussion with government officials of the above issues and possible actions.

<u>Development Policy</u>

1. Adopt and announce revitalized capital market development policy as part of economic development strategy.

2. Establish a Capital Market Development Working Group of government and private sector representatives, to design and implement a specific action program for capital market development, including evaluation of the areas of

possible action discussed in this memorandum. Merchant banks, institutional investors, and other knowledgeable persons, should participate in the Working Group's evaluation.

3. The capital market development effort should not be limited to public issuance of securities by foreign joint venture companies to meet requirements to transfer ownership to Indonesian investors, but should also encourage public issues of securities by domestic Indoensian companies.

4. Establish a separate Capital Markets Development Commission to focus effort on developing the market, rather than only regulating it; Put management of Stock Exchange in private sector hands, to increase its capacity to pursue market development; Give the Exchange clear self-regulatory duties.

5. The Stock Exchange should have clear duties to pursue development activities in addition to self-regulation, and should have advisory panels and foreign expert advice on market development.

6. Market professionals should provide recommendations for capital market development.

Supply of Securities

1. Encourage business development by more liberal allowance of expansion permits, thereby encouraging increased need for finance and increased potential for raising such finance through the issuance of securities, (pages 14-15); Encourage expansion of small business, which requires increased equity, and small business mutual funds and investment companies; Examine improvements of business climate, to increase prospects for growth and thus use of capital market finance.

2. Adopt requirements for "securitization" of finance, to reduce over-emphasis on Bank borrowing, and encourage (or in some cases require) companies to raise their needed finance through issues of securities, including (a) requiring companies seeking Bank loans to obtain prudent ratios of debt to equity, and reduce short term debt, (b) requiring companies seeking Bank loans to raise parallel public offerings of securities and to offer merchant banks opportunity to raise such finance, (c) allowing companies to issue all kinds of securities, (d) requiring companies that obtain benefits under government investment schemes to raise finance through public offerings of securities, and (e) authorizing the Development Commission to require companies to raise needed finance through public issues of securities.

3. Allow issuance of company bonds, and replace the unduly restrictive existing limitation on bond issues to an amount equal only to paid in capital with more appropriate "debt service" requirements.

4. Reduce tax disincentives to securities supply in favor of Bank debt, and provide incentives as appropriate.

5. Ease listing requirements, to increase the number of companies able to raise finance through securities issues.

6. Encourage securities underwriting, and remove the government limit of 4% on underwriting commissions.

7. Allow free establishment of public offering prices, to encourage companies and controlling shareholders to issue shares (page 24)

8. Restrict insiders loans, which limit the need to raise finance through securities issues.

9. Examine concentration of control of companies, which limits raising of finance through public issues.

Demand for Securities

1. Encourage, and in some cases possibly require, securities investment by institutional investors, including state and private pension funds and insurance companies; Allow establishment of domestic private mutual funds and investment companies.

2. Allow freer price changes in secondary market trading, and thus provide the opportunity for capital gains.

3. Reduce tax disincentives to investment in securities, and provide incentives as appropriate.

4. Improve disclosure of information and investor confidence.

5. Encourage broader sales efforts by securities brokers, to encourage investment in securities, and consider expanding trading facilities in areas of the country outside Jakarta.

6. Provide securities market finance for underwriting, market-making, brokerage and investment.

7. Examine potential for over-the-counter trading outside the Stock Exchange.

8. Examine prospects, over time as market improves, for foreign portfolio investment in Indonesian securities.

9. Consider initiatives for enhancing and providing funding for venture capital.

10. Consider prospects for allowing or incentivating foreign brokerage and market-making firms to operate in th elocal markets to increase demand and opportunities for investment in local securities.

11. Consider eventual prospects for listing Indonesian securities on foreign markets in the region, and for establishing linkages with such markets.

# JORDAN

A Preliminary Assessment

Report Author: Jalil Shoraka

Date: August, 1986

Objective:

Assess the Jordan's financial system and make recommendations to improve the operational efficiency of the financial system.

Findings:

1. The liquidity of the commercial banking community has been increasing in the recent years from 40.5% in 1982 to 48% in 1985 (the legal liquidity asset requirement is 30%).

2. The interest rate is excessively rigid; the real interest rate is high; the spread between deposits and lending rates is too thin (averaging 1.5%), and does not allow for a risk factor. Overall, the interest rate structure is a deterrent to development of the capital market.

3. The development of the Money Market has not kept up with the rapid development of the financial system. Treasury Bills are the only instruments which are traded in the secondary market; other instruments such as trade acceptances, certificates of deposit, and certificates of bonded warehouse, remain with the originating commercial banks and financial companies until maturity. Interbank lending, though practiced on limited and selective basis, is not a common practice among banks. A secondary market for commercial paper is non-existent.

4. There is insufficient corporate finance activity to support the six merchant banks.

5. The parastatal specialized financial institutions have been perceived as sources of subsidized loans with easy payback schedules, financing relatively lower quality projects with high debt/equity ratios. Often these loans are made based more on political motivations than on profitability considerations.

6. The prevailing unstable economic and political conditions of the Middle East have had a dampening effect on the development of the Aman Financial Market (AFM, the stock exchange).

Recommendations:

1. In regards to the banking industry, the consultant recommends that USAID/Aman periodically review the liquidity position of the banking system. Liquidity is a good barometer for measuring the performance of the commercial banks especially with regard to the extent of their participation in Jordan's economic development. The Mission may also want to maintain policy dialogue with the Central Bank on this issue and make suggestions regarding the alternative methods which can be used for putting the excess liquidity to productive use, without undermining the safety and stability of the banking system.

2. The Government of Jordan and the Central Bank are aware of the problems caused by the rigidity of the interest rate structure. Therefore, the role the consultant sees for the Mission in this case is to provide technical assistance, suggesting various methods to deal with the problem of the interest rate structure.

3. The consultant anticipates that within the next two years, some mergers, acquisitions and consolidations will take place among the merchant banks. The consultant believes that the consolidation will be beneficial for the industry and should be encouraged.

4. The consultant sees merchant banking as an excellent vehicle for development of capital market and promotional activities. The cooperation of these institutions should be sought in any privatization project.

5. USAID, in its policy dialogue with the Ministry of Finance and the Central Bank, can also suggest privatization of the government-owned specialized financial institutions, not only with regards to the equity ownership but also the management and the role of free market forces. USAID can provide technical assistance.

6. The Jordanian Parliament will soon consider the proposed new company law which among other issues covers the management of public shareholding companies and the creation of mutual funds. USAID may want to study the proposed law and make suggestions while the bill is debated in parliament.

7. AFM should study and introduce new money market and capital market instruments in order to satisfy the needs of various domestic and foreign prospective investors. The Mission can provide technical assistance for this undertaking.

8. AFM should establish a mechanism for adjusting to variations in supply and demand for securities. This can be accomplished partly by encouraging institutional investors to become more active in the market and by introducing Market Makers.

# MOROCCO

Financial Markets Assessment

Report Author: Stephen Strauss

Date: March, 1986

## Objective

1. Investigate whether Morocco should be selected as one of the countries targeted by the Financial Markets project. Key criteria are:

   - Appropriateness of local environment (problems to be overcome which lend themselves to feasible solutions).

   - Views and support of country USAID Mission.

2. If answer to (1) is affirmative: define the rationale and scope of a Financial Markets project effort in Morocco.

## Findings:

Consultant and USAID Mission agree that Morocco is an appropriate target country for a Financial Markets project (USAID Rabat will recommend that such a project be undertaken at the earliest convenient moment, i.e., late June - early July). This project would provide timely assistance to the USAID Mission in identifying ways to develop financial markets support to two high USAID Rabat priorities: (1) privatization, and (2) credit availability to new projects and target sectors. At present, the lack of effective investment mobilizing institutions, combined with the commercial banks' loaned-up condition, drives the considerable quantities of local liquidity into speculative investments (real estate, etc.) rather than into more productive channels.

## Methodology:

In view of the extensive background thinking done to date by the USAID Mission and the World Bank in this area, the focus was on clarifying which local financial markets issues are appropriate to further effort and targeting the five areas of proposed focus (see below). A number of highly constructive meetings were held with USAID Mission personnel: Director Bob Chase, Deputy Chuck Johnson, plus PRE Officer Ed Clarke and Program Officer Jay Smith (the latter would be most involved in the project as it occurs).

Assessments Which Consultant and USAID Rabat Agree Require Investigation:

1. Capacity of the local financial markets to handle privatization.

2. How to make more effective use of liquidity in the system (which the banks are unable to use given the regulations and limits binding their activity).

3. Identify constraints to the development of capital markets -- especially the issuance of equity instruments -- focusing on:

   - banking laws (restrictions on role of banks vs. possibility of new private-sector investment banking institutions).

   - taxation issues

4. Problem of lack of availability of local medium-term and project financing.

5. Banque Nationale de Development Economique is looking for some guidance which USAID would like to provide. (This institution could play a constructive role in the issues cited above).

Next Steps:

USAID Rabat Director Chase will recommend a Financial Markets project (one or two people, for 2 to 3 weeks) in late June - early July to focus on the five issues cited above.

## PANAMA

Panama Capital Markets Study - Part A

Report Author: Stimson Eveleth

Date: July, 1986

Objective:

To review Panamanian capital markets so as to provide USAID with indications as to the format and probable objectives of a full blown study of capital markets leading to USAID policy recommendations for the Government of Panama.

Findings:

1. Since Panama is a dollars based economy and has no central Bank it has little control over its own fiscal and monetary policy. In many ways, therefore, the Panamanian economy could be viewed as an extension of the United States.

2. The International banks located in Panama are mainly traders and placers and as such do not contribute a great deal, besides employment and taxes, to the local economy. Nevertheless, they lend a sophistication to the market which, if captured could help Panama develop into a major international financial center.

3. The presence of the Panama Canal and the Free Zone are items which, if more closely tied to international finance and trade, could boost the local economy. The local economy itself is probably too small to provide significant economic stability. Therefore, every effort should be made to develop Panama into an international service and financial center.

4. The absence of competing sources of funding puts banks in a priviledged position. Consequently the market is fairly simple and credit is available to only the best risks on very conservative terms.

Recommendation:

1. Engage a contractor to provide USAID - Panama with a 2 to 5 year strategic and tactical plan which would lead to:

   a. The development of local money markets and capital markets.

   b. The integration of the local and international banking systems.

c. The development of Panama into a truly International Financial Services center.

2. The contractor would be expected to make recommendation on such things as:

   a. The desirability of establishing financial institutions which compete with banks (venture capital companies, merchant banks, leasing companies, etc.)

   b. Means of improving the lending procedures of banks in order to provide greater term and project financing to a wider universe than is now the case.

   c. Specific action that USAID can take unilaterally or in cooperation with the financial community to increase the potential number of institutional investors and libralise their investment policies.

   d. Probable oversight requirements on the financial services community.

   e. Whether such innovations as making a market in Latin American debt is a proper function for the Panamanian financial services market.

Constraint:

This is a fairly large and comprehensive task and will require a fairly heavy commitment of individuals with a variety of skills. (The consultant believes that it would take 3 people 4 to 5 weeks of which 2 would be on sight in Panama).

## PANAMA

Panamanian Stock Market - Part B

Report Author: Stimson Eveleth

Date: July, 1986

Objective:

1. To review the appropriateness of establishing a local stock market.

2. To review the appropriateness of establishing an international stock market.

Findings:

1. Very little, if any, enthusiasm exists for establishing a local stock market. Certainly the government opposes.

   a. Economies of scale are such that an efficient market would be hard to sustain.

   b. Because equity is closely held, only corporate debt and public debt would be available for trading plus, possibly, short term money market type instruments.

   c. The current mechanism of private placement seems to adequately serve the issues which would be considered as safe investment by the investing public.

   d. Other than banks, the only other institutional investors are insurance companies. Their holdings are, by preference, cash or cash equivalents.

2. A study made by the Interamerican Institute of Capital lent some support to the idea of the creation of an international stock market. A careful reading of the report provides little substantive support to the supposition that such a market would be a success.

3. The only real justification for an international stock market would be in support of the international banks resident in Panama in their asset management and trust activities. The size of this market is unknown (the Banking Commission has no statistics) however, interview information indicates that no international banks manage client asset portfolios in Panama.

Recommendations

1. Defer any studies or activities which would lead to the creation of a stock market in Panama until Capital Markets are more sophisticated. An international market would only be credible if piggy backed on an operating local market that was efficient and honest as well as well supervised by an independent authority.

Constraints

1. Since Panama is a free dollar based economy, investment funds will flow to the area of greatest safety for the greatest return. It is unlikely that any major international corporation would choose Panama as a location to float an issue. Other issues would be speculative in nature and as such would create an unstable market.

2. Without a clear advantage there is no reason to chose Panama as a trading avenue.

## PANAMA

Secondary Market for Mortgage Paper in Panama - Part C

Report Author: Stimson Eveleth

Date: July, 1986

Objective:

To review the appropriateness of encouraging a secondary market for mortgage paper.

Findings:

1. Due to recently passed legislation (March 85) fixing mortgage interest at subsidized rates for houses upo to $50,000, investments in this mortgage paper is only marginally more attractive than a pass book deposit in a savings Bank and less attractive than a time deposit.

2. However, paper backed by "old" mortgages or mortgages over $50,000 would make an attractive investment for the public.

3. Legislation appears to be in place which supports the formation and development of a secondary mortgage market. Of special mention are:

   a. The tax free nature of investment income managed by the BHN

   b. The government guarantee of the instrument. However, the law still needs clarification.

Recommendation:

Support the formation of this market.

Constraints

1. Banks are extremely liquid and may prefer to be direct holders of mortgages due to improved rate considerations. Since they are the largest generators of mortgages and would probably be the largest institutional buyers of secondary paper any reluctance on their part could doom the market.

2. In a tight money environment, banks could view the secondary mortgage market as a disintermediating force and could resist the formation of the market. (The tax free nature of the investment makes the return better

than that of T.D.'s and the government guarantee makes it safer since there is no insurance of deposits in the banking system in Panama).

# PORTUGAL

## Assessment of the Capital Market

Report Author: George Ferris, Jr.

Date: April, 1986

Objective:

To explore the alternatives for providing technical assistance to GOP in furthering the development of the domestic capital market.

Recommendations:

1. All responsibility and authority for capital market development should be concentrated in a Capital Market Authority/Commission. This Authority/Commission should be established at the cabinet or sub-cabinet level with an adequate staff to assure enforcement of its policies and regulations. The Authority/Commission would sponsor and promote the capital market process as well as be responsible for the regulation of investment banks, distributors and brokers. By consolidating capital market regulations in one entity the disincentive of "going public" will be greatly reduced.

2. The role of the accounting profession needs to be strengthened to provide reliable financial information not only for tax collection purposes but also to increase public confidence, thus encouraging domestic investment.

3. GOP should reevaluate its current method of pricing common stock at an adjusted book value with no consideration of its present market value. This policy discourages successful companies from going public, encourages the practice of free riding and implies a government approval of the posted securities prices. Prices should be determined by the negotiation between the owners and the underwriters.

4. Auditing procedures using international standards should be a business requirement. By standardizing financial information the government could apply effective incentives for companies to "go public."

5. Companies which are traded publicly should be allowed to offer long-term bonds which are tax-free to increase their source of long-term bonds.

6. The government should restrict the business use of short-term Bank credit for long-term capital needs. The

Central Bank could resort to setting credit standards for Bank lending.

7. To further capital market development, interest on corporate bonds and dividends on common shares should receive equivalent tax treatment as do government securities and Bank deposits.

8. The development of mutual funds should be encouraged. The government could provide tax incentives for the general public to participate in the capital market through mutual funds.

9. The government should retain its current policy of not taxing capital gains on securities.

10. GOP must encourage the well-established companies to place shares publicly in order to encourage greater participation of the public. Investors need favorable investment experiences to continue and increase their participation in the capital market.

11. The government should change its present policy of regulating the maximum underwriting fees to setting the minimum underwriting fees so as to preclude predatory competition in this embryonic industry.

12. State-owned commercial banks should not compete as underwriters, but instead, should act as distributors for both underwritings and investment company shares.

Implementation:

1. The Ministry of Finance must determine what priority it will give to capital market development. If a high priority is decided on then plans should be drawn for the creation of the Capital Market Authority/Commission. USAID/Lisbon (the Luso-American Foundation) will consider funding the necessary technical assistance.

# SENEGAL

Financial Markets Assessment

Report Authors: Stephen Strauss
Jean De La Giroday

Date: March, 1986

Objective:

1. Investigate whether Senegal should be selected as one of the countries targeted by the Financial Markets project. Key criteria are:

   - Appropriateness of local environment (problems to be overcome which lend themselves to feasible solutions).

   - Views and support of country USAID Mission.

2. If answer to (1) is affirmative: define the rationale and scope of a Financial Markets project effort in Senegal.

Findings:

Consultants and USAID Mission agree that Senegal is a highly appropriate target country for Financial Markets project (USAID Dakar will recommend that such a project be undertaken at the earliest possible moment). This project would provide timely assistance to USAID Mission in identifying feasible, realistic ways, acceptable to local authorities, to relieve the semi-paralysis of the local financial markets. These markets are currently unable to provide necessary forms of credit to sectors, such as small-to-medium sized enterprises, which USAID (and international donors) wish to see developed. In addition, the need to finance privatization (acquisition by the local private sector of equity parastatal companies and banks) cannot be made unless certain mechanisms can be put into place and certain financial markets bottlenecks overcome.

Methodology:

The current state of Senegal's financial markets, and the identification of problems and possible solutions, were reviewed in depth during interviews with the following three groups of people:

1. USAID Mission:

   This mission began and ended with lengthy, substantive sessions with USAID Director Sarah Jane Littlefield.

Meetings were also held with Deputy Director Carol Tyson and Economist Jackie Damon. Harold Lubell attended many of the outside meetings.

2. A representative cross-section of local commercial/development banks (meetings with senior managers):

   a. Locally-controlled banks (Sofisedit, BSC, Union Senegalaise de Banque).
   b. Foreign-controlled banks, (Citibank, Banque Senegalo-Koweitienne).

3. Relevant government bodies:

   a. Ministry of Finance:
      - Treasury Director-General
      - Money and Credit Director

   b. Central Bank of West African States (Senegal country director).

<u>Assessment of Problems in Local Financial Markets and Their Causes</u>:

There are three fundamental problems that afflict almost all Senegalese banks and have caused a near-breakdown in the credit availability system:

1. An extremely heavy preponderance of the State and of State enterprises in the country's credit markets (most of such enterprises are heavily indebted and have substantial losses).

2. Various forms of pressure exercised in the recent past to induce local banks to lend to such state-sector borrowers.

3. A lack of management competence and of disciplined lending practices in most local banks.

4. Insufficient deposits (deposit rates are unattractive compared to deposit rates available in France, leading to capital flight given the ready convertibility of CFA Francs to French Francs).

5. Heavy losses in most banks resulting from the above four elements.

These five factors led to the present situation in which a large percentage of local Bank assets are tied up in (1) loans to the State; (2) loans to parastatal companies (some of which are bankrupt); and (3) loans to other borrowers who cannot pay because the State or the parastatals owe them money. The result is a situation of illiquidity throughout the local banking system, with many banks undercapitalized, losing money and unable to attract deposits. The consequence is the inability of the local banking system to provide adequate credit to the private sector, especially small-to-medium sized companies. The only credit available, if at all, is short-term overdrafts at an average interest rate of 15%.

This situation is in sharp contrast to other countries sharing the same central Bank such as Ivory Coast or Togo, where banks are healthier and there is adequate liquidity in the system. Therefore this is a problem peculiar to Senegal, not a problem inherent in the West African monetary system (CFA Franc zone).

The lack of liquidity and deposits means that all loans must be funded through the Central Bank rediscount window, which in turn imposes sectoral credit ceilings which are quite restrictive. No more than 3 or 4 local banks can meet a legitimate demand for new credit even for credit-worthy borrowers.

In such a situation, the credit necessary to effect privatization by distributing shares to a broad private-sector group is lacking. The local banking sector itself is heavily government-owned, which most parties interviewed agree has led to many of the present difficulties. Furthermore, there are too many banks which provide the same types of services and credit, doing so inefficiently, at very high cost and without catering to the needs of the market.

Possible Solutions (Meriting Further Close Study):

- Enhance credit availability: an effectively-managed Bank with a source of deposits or other outside funding can lend to borrowers outside credit ceilings provided the rediscount window is not resorted to. Credit reallocation to promising projects and sectors could thereby occur. (If desired, the source of such deposits could have a say on how credit reallocation occurs and how it is managed. For instance, USAID could influence credit allocation of funds it provides toward financing privatization and healthy small-to-medium sized enterprises).

- Financing privatization: banks with the ability to make incremental loans could be induced to do so to finance private-sector purchase of the State's share in various enterprises (the State's equity holdings in local banks themselves could be one of the more obvious places to start, not only because these could be attractive private-sector investments, but because such an effort could be coupled with additional equity-raising to bolster the banks' capital and liquidity).

Such financing would likely require altering credit ceilings. Given the multi-country Central Bank it may be difficult to get agreement on ceiling reallocations; however, it appears possible that the IMF could agree to a special lending ceiling to finance the purchase of equity from the State, since such new credit would retire State debt rather than enter the local economy.

- There is a belief among key local people in banking and government that a local merchant banking entity is needed to perform the following functions among others:

    1. Provide a source of targeted funds to the banking sector to achieve the purposes cited above

    2. Assist in the privatization effort

    3. Coordinate and participate in the share market as it begins to appear, helping the authorities establish an enforce some basic rules to the operation of such a market.

    4. Identify, package and seek financing for worthy new projects in the local economy.

Next Steps:

It is recommended that the Financial Markets project schedule a study of Senegal's banking system and its current problems in order to point the way toward concrete, pragmatic solutions which are supportive of USAID's country goals, including privatization and promotion of smaller businesses. The major problems to be examined include:

- Lack of credit availability to key sectors, and the root causes of this problem such as Bank illiquidity and undercapitalization.

- The need to prepare the ground-work for privatization and the role of financial institutions in raising equity and distributing shares for this purpose.

- The need to explore whether solutions can best be found through existing local entities, or whether the creation of new private-sector financial institutions should be encouraged.

This project is best done in the near future (June) and will require a maximum of 2 weeks for a 2 person team.

# THAILAND

Revies of the Stock Exchange

Report Author: John R. Evans

Date: July, 1986

Objective:

Assess the present situation of capital market development in Thailand with special emphasis on the operations of the Stock Exchange of Thailand (SET). The review has identified a preliminary set of actions to improve the efficiency of SET operations.

Findings:

1. There is a base of Thai professionals and government officials with educational credentials and a practical knowledge of capital markets. There have also been various studies on Thailand's financial markets which have identified the needs of the country's capital markets. Thus, the outside technical assistance that Thailand is expecting is guidance in formulating and implementing revisions to current policies and practices dealing with the markets.

2. The legislation dealing with securities activities is not coordinated. As a consequence, decision-making and administration of capital markets is fragmented, spread over various Ministries and institutions such as the Ministry of Finance, the Ministry of Commerce, the Bank of Thailand and the SET. The situation is further exacerbated by the fact that the current Thai government is a coalition government. Therefore, there is a tendency to make decisions in regards to capital markets that are politically popular but with insufficient regards for their business soundness.

3. Accounting standards are not uniformly applied. For instance, companies listing in the SET, are required to maintain better accounting records of their businesses than businesses which are not listed on the SET.

4. The SET, in its efforts to develop capital markets, is planning or has initiated various programs. A partial listing of the activities include: formulating the requirements for member firms to establish authorized agents; developing an open-ended mutual fund for foreigners; seeking a larger supply of securities for the market by considering privatizing parastatals; allowing a larger group of companies to list in SET; and, considering setting up a share depository center, a

securities information center, and a securities finance corporation.

Recommendations

1. The Thai government should establish a new entity which will be solely responsible for promoting capital market development. This new office will have the authority to supervise and regulate all persons and activities dealing with the securities markets (including those occurring outside the SET). Due to financial and political restraints the new entity can start as a division of the Fiscal Policy Department under the Ministry of Finance. However, it should be elevated to full department status as soon as it is feasible.

2. It is important that uniform accounting requirements apply to companies of similar size regardless of whether they are listed on the SET or not. In addition, the new unit for the promotion and regulation of the capital market should be allowed some input into the decision-making on accounting issues.

3. The Advisory Board to the Minister of Finance pertaining to SET decisions should be abolished, and its review function should be transferred to the new unit.

4. The consultant has provided his opinions on the value of the GOT proposed programs in terms of capital market development.

   - In regards to preventing firms from engaging in both a finance business and a securities business the consultant believes that such a separation would be detrimental to the securities market.

   - The consultant does not see a place for market making in Thailand since currently there are very few active stocks in relation to inactive stocks.

   - The consultant does not believe that considering the expected volume of shares to be traded the cost of setting up a share depository center cannot be offset by the added efficiency resulting from the center.

   - The current stopwatch and surveillance system is adequate. Changes to the present system could be initiated when SET begins automating the trading process.

Implementation:

1. In terms of establishing the new unit the Minister of Finance can partially accomplish this objective through administrative action. The new unit will also require drafting changes to the existing statutes. Thai officials are aware of the necessary changes, and thus, external assistance in this matter should be limited to specific requests from the GOT.