Financial Sector Reform in Nicaragua

Final Report

December 28, 1990

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Ms. Janet Ballantyne
USAID Nicaragua
Km. 4½ Carretera Sur.
APO Miami 34021

Dear Ms. Ballantyne:

We are pleased to present five copies of the Final Report, Financial Sector Reform in Nicaragua, prepared by a Price Waterhouse team of Dr. Martin Barrett, Mr. Donn Davis, Mr. René Becerra, and Ms. Margarita Fernández. The objective of this engagement was to develop an agenda for USAID/N assistance to the government of Nicaragua to transform the Nicaraguan financial sector from a state-controlled system to a freely operating system. We present for your review our findings, recommendations and sample scopes of work from which USAID/N may develop a strategy for project development. Our information is based on interviews with USAID Officers, members of international financial institutions, members of the exiled banking community in Miami and leading figures in the private and public sectors in Nicaragua.

We appreciate the opportunity to be of service to you on this important assignment. Please feel free to call us if you require any further assistance.

Sincerely,

J. Richard Breen, Director
Financial Sector Development Project

cc: Ms. Sandra Frydman, AID/PRE/PD
Mr. Russ Anderson, AID/APRE
Ms. Toni Christenson-Wagner, LAC/CEN

December 28, 1990

Sandra Frydman
Project Officer, FSDP
AID/APRE/PD
Department of State
320 21st Street, NW
Room 3208
Washington, D.C. 20523-0018

Dear Sandra:

We are pleased to present five copies of the Final Report, Financial Sector Reform in Nicaragua, prepared by a Price Waterhouse team of Dr. Martin Barrett, Mr. Donn Davis, Mr. René Becerra, and Ms. Margarita Fernández. The objective of this engagement was to develop an agenda for USAID/N assistance to the government of Nicaragua to transform the Nicaraguan financial sector from a state-controlled system to a freely operating system. We present for your review our findings, recommendations and sample scopes of work from which USAID/N may develop a strategy for project development. Our information is based on interviews with USAID Officers, members of international financial institutions, members of the exiled banking community in Miami and leading figures in the private and public sectors in Nicaragua.

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FINANCIAL SECTOR REFORM IN NICARAGUA

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I. EXECUTIVE SUMMARY

A. Background

In July 1990, USAID/Nicaragua contracted a four-person team through the APRE Financial Sector Development Project to assess the Nicaraguan Financial System and outline an agenda for A.I.D. assistance to the Government of Nicaragua. The team was to develop a set of recommendations regarding policy and procedural reforms of the Nicaraguan banking system for potential A.I.D. Mission support as part of its development assistance program. In addition, the team was to design contractible scopes of work for future A.I.D. technical assistance to the Government of Nicaragua to strengthen accounting, management information and financial control systems.

B. Findings

When the Chamorro administration assumed office in April 1990, it inherited an already collapsed "financial system." What had once been the most fully developed financial system in Central America, had become -- by the late eighties -- little more than a mechanically-managed arrangement for the delivery of subsidized credit, funded primarily by the Central Bank.

Heavy government interference during the decade of Sandinista rule distorted the banking system. In some cases government interference took the form of mandated loans to favored borrowers. In other cases, the government essentially converted loans into grants, by forgiving repayment obligations. In effect, the state-owned banks operated as credit departments of the Central Bank of Nicaragua, without any meaningful supervision or surveillance by monetary authorities. As a result, public willingness to hold money virtually evaporated -- and as the demand for money collapsed, so too, did the flow of bank-intermediated credit.

In recent years an hyperinflationary environment has further debilitated Nicaragua's financial system and severely eroded the asset and deposit bases of banking institutions.

The Nicaraguan financial system currently consists of the Central Bank and four lending institutions. They are Banco Nicaraguense de Industria y Comercio (BANIC), Banco Nacional de Desarrollo (BND), Banco Popular and Banco Inmobiliario. Without exception, these four institutions are insolvent; the recoverable value of the assets they hold is less than the face or redemption value of their deposit and non-deposit obligations. If the banks' reported financial statements are taken as credible representations of their performance, then BANIC alone operates as a marginally profitable institution, while all others incur losses. However, the profits that BANIC reports may be misleading, since it does not make meaningful provisions for possible loan losses. Senior management officials at each institution are holdover appointments from the previous government, and despite some staff reductions in recent years, each bank remains overstaffed and operating expenses surpass management control.

In short, what remains of Nicaragua's banking system is in ruins. Routine transfers between cities may take up to a month before payment is finally credited. Inter-institutional competition of any kind -- either in the mobilization of deposits or in the origination of new loans -- has disappeared from the scene. Only the Central Bank is engaged in any international operation. Even the system's "plumbing" -- the mechanics for payment, clearance, and settlement of the transfers of funds -- needs to be re-examined and overhauled

Clearly, there are many problems to be addressed. At this stage a prompt, progressive, and comprehensive overhaul of the system is needed -- both in the practices and policies of those few institutions that are still legally intact, and in the legal and regulatory framework within which they operate. In addition, the reform should provide for the establishment of new financial institutions since the rehabilitation of existing ones is likely to be a long and difficult process.

C. Recommendations

Rebuilding the Nicaraguan financial system will be a monumental feat. It will entail much more than deregulation of interest rates, and certainly require more than marginal adjustments in the management, financial structure, and modus operandi of the few surviving financial institutions. A.I.D. can assist the Government of Nicaragua and strengthen the Nicaraguan financial system through a variety of positive interventions which are summarized below.

1. Support Policy Reform

Macroeconomic stability is of paramount importance and a necessary condition for the reform of the financial system.

Reconstruction of the financial system requires the restoration of confidence that the value of any resources committed to financial intermediaries will not be quickly taxed away through inflation. This is not an easy task in an economy where inflationary expectations are deeply embedded. The problem is compounded by the fact that the current administration does not yet control all levels of government and has experienced some opposition.

A.I.D. should support the Chamorro government in its reform efforts. Through technical assistance, A.I.D. can help policy makers design the content and program the sequence of needed reforms. Such assistance would make a very positive contribution to strengthening the economic foundations of the Nicaraguan economy.

2. Develop Central Bank Audit and Accounting Capabilities

The Central Bank needs immediate technical guidance on building its own accounting and auditing capabilities.

Currently, the Central Bank has only fragmentary information on the condition and performance of the banks. Most of the information is generated by the Office of the Comptroller General, which has assumed many of the auditing functions of the now defunct Office of the Superintendency of Banks. For many policy purposes, much of the information made available to the Central Bank is either incomplete or irrelevant.

A.I.D. assistance in auditing and accounting will enable the Central Bank to monitor compliance with the new regulatory standards, which may be adopted over time.

3. Redesign the Regulatory Framework

Meaningful regulatory standards need to be adopted, and the Office of the Superintendency of Banks needs to be reconstituted, either as a fully independent entity, or as a Department of Bank Regulation and Supervision within the Central Bank. Ideally, these standards should be designed and in place prior to the licensing of new financial institutions. In the absence of adequate prudential regulation and supervision, the development of a more competitive environment could easily degenerate into disorderly competition.

The Central Bank has apparently begun to redesign a regulatory framework, however, a great deal of work still needs to be done as soon as possible. A.I.D. can provide the much needed assistance in this area.

4. Create New Financial Institutions

There is a compelling need to supplement the limited capabilities of the state-owned banks by allowing the formation of non-bank intermediaries. Initially they could be licensed as private finance companies, and later -- when, and if, conversion becomes legally permissible and politically feasible -- converted into banking institutions.

A.I.D. can help design such institutions so that they meet the financing needs not available in the existing system.

5. Rehabilitate BANIC and BND

Each of the state-owned banks needs to be thoroughly rehabilitated in order to respond more adequately to the needs of the banking public -- depositors and borrowers alike. Such efforts will require additional capital which should be generated internally through retained income, rather than externally, through donations from the Central Bank. Simply recapitalizing the banks -- even if their capital requirements turn out to be relatively small, and to do so before the Central Bank or any other regulatory body is in a position to monitor and supervise their performance -- might be interpreted as a policy decision to maintain the status quo.

The provision of technical assistance in bank restructuring and strategic planning, and training in almost every area of bank operations would provide banks the necessary foundation for operating as profit-making, non-subsidized financial institutions.

In short, A.I.D. technical assistance should focus on the following areas:

- o Support the stabilization of the Nicaraguan economy,
- o Develop Central Bank auditing and accounting capabilities,

- Redesign the regulatory framework,
- Create new financial institutions, and
- Rehabilitate BANIC and BND by
  - Assisting with restructuring efforts,
  - Designing and implementing training programs, and
  - Recapitalizing.

II. INTRODUCTION

A. Background

During the 1960s and 1970s the Nicaraguan financial system was composed of a diverse and well-developed group of financial institutions with a high degree of intermediation. With the advent of the Sandinista Government in 1979, however, the financial system began a process of disintegration and de-institutionalization which resulted in financial disarray. In the last decade, a once efficient system of market-directed credit allocation was replaced by a nationalized financial system which allocated credit according to decisions made by the Sandinista Government's central planners.

In an effort to assist the newly-elected Chamorro Administration in its efforts to reestablish normal intermediation in the financial system, USAID/Nicaragua requested assistance through the APRE Financial Sector Development Project (FSDP).

B. Scope

In July 1990, a four-person FSDP team examined the Nicaraguan financial sector. The scope included an assessment of the financial sector and the development of a set of recommendations for A.I.D. intervention regarding the Nicaraguan banking system. The team was also asked to develop contractible scopes of work to strengthen the accounting, management information and financial control systems of the banking sector for future AID technical assistance to the Government of Nicaragua.

C. Staffing and Methodology

The FSDP team which performed this assignment included:

- Dr. Martin Barrett, Team Leader, Financial Economist and Financial Sector Analyst. Dr. Barrett has extensive experience in central banking gained through more than twenty years working with the New York Federal Reserve System and the Savings Banks Association of New York, as well as numerous consulting engagements in developing countries.

- Donn Davis, Commercial Banker and Bank Training Specialist. Mr. Davis' banking career is highlighted by more than 27 years of commercial banking in Latin America and Asia.

- René Becerra, Commercial Banking and Finance Specialist. Mr. Becerra offers 16 years of financial sector experience with particular focus on bank formation, restructuring and management.

- Margarita Fernández, Technical Support and Financial Sector Analyst. Ms. Fernández is an economist thoroughly familiar with Central America.

The information in the study was compiled from a broad range of sources including official GON reports, banking laws, Central Bank memoranda, financial statements and interviews conducted in Washington D.C., Miami and Nicaragua, with banking, public and private sector representatives. The study took place over a three week period beginning July 9, 1990. Following a one week delay due to strikes in Nicaragua, the team travelled to Managua to resume work on July 23 and completed the visit on August 3, 1990.

D. Organization of the Report

This assessment of the Nicaraguan financial sector consists of five chapters and appendices. Chapter I presents an Executive Summary of findings and recommendations. Chapter II, the Introduction, explains the background, scope, staffing and methodology of the analysis. The Nicaraguan Financial Sector is discussed in Chapter III which reviews recent developments such as the creation of the Córdoba de Oro and deficit reduction measures, and explains the composition of the financial sector. Recommendations for U.S.A.I.D. assistance are described in Chapter IV, and Chapter V suggests scopes of work for four of the above areas.

III. THE NICARAGUAN FINANCIAL SECTOR

Between 1963 and 1979, Nicaragua had an excellent banking law in place, which served the needs of private depositors, investors and borrowers, as well as the public sector. During this period the financing requirements of the business community, as well as the agricultural sector, were met. Shortly after the Sandinista government came into power in April 1979, private banks were nationalized and the existing successful banking law was replaced by a series of decrees and regulations periodically issued by the Central Bank. The result is the present banking system which is illiquid, insolvent and inadequate. This section of the Financial Sector Assessment discusses recent financial sector initiatives of the current government and outlines the composition of the financial sector.

A. Recent Developments

When the Chamorro government assumed office last April, it inherited an economy with massive imbalances in the budget, the balance of payments account, and the financial sector. International reserves had fallen to the equivalent of one week's imports; the official exchange rate had become grossly overvalued; public sector prices for telephone services and electricity were well below operating costs; and credit to other government enterprises in the APP (Areas de Producción del Pueblo) remained an uncontrolled source of monetary expansion.[1] To make matters even less manageable, the money supply nearly doubled in April 1990, as a result of a large increase in credit to the Central Government to finance wage increases of public employees. The economy continues to suffer the inflationary effects of that shock.

The new government is pursuing a series of reform measures, including those outlined below, designed to stabilize the currency and to reduce the public deficit.

1. The Córdoba de Oro

At the 1990 Donors Conference in Rome, the Nicaraguan Government outlined a short-run stabilization program to be implemented over the next six months. Although still

[1]. Areas de Producción del Pueblo refers to enterprises and companies confiscated by the Frente Sandinista de Liberación Nacional, managed by the Sandinista Government and considered property of the people of Nicaragua.

evolving, at the time of the team's visit, the short-run plan was clear in its basic outline. The key element of the program is the introduction of a new currency unit, the Córdoba de Oro (CO) to be initially fixed at parity with the US dollar, or its equivalent in old córdobas, at the Central Bank's official selling rate.

Already adopted as a unit of account for newly originated bank loans and time deposits, the government planned to issue the CO in limited amounts of high denomination bills in August, and smaller denominations in September and October. The old and new currencies will coexist for an indeterminate period while the government controls the fiscal deficit, realigns public expenditures, and initiates the process of structural reform, especially tax reform and the privatization of entities in the APP.

In the short-term, the program calls for frequent devaluations of the old Córdoba to protect the export sector, and if all goes well the government plans to retire the old currency and return to a fixed exchange rate at the end of the year.

The development of the new currency holds implications for the financial and export sectors as well as for the domestic market. The financial sector implications of the new currency unit are quite clear. Most importantly, the introduction of the CO has eliminated the inflationary tax now imposed on both loans and time deposits since in both cases the principal amounts are now denominated in the new currency which is, in effect, indexed to the dollar. Depositors' funds are protected in real terms, as long as the official exchange rate is not allowed to get out of line with domestic prices. Similarly, bank claims on borrowers are protected against any inflation-induced erosion in value, and borrowers now carry obligations that are repayable in real terms. A very important downside risk is that the state-owned banks, which are not well equipped to evaluate or monitor credit risks in the first place, may find that delinquencies and loan losses increase very rapidly.

With regard to the export sector, the assumption of dollar-indexed debt need not present serious problems for borrowers whose receipts are in dollars, or for those exporters that sell through the State Marketing Board, ENABAS (Empresa Nacional de Abastecimiento), as long as the prices they receive are realistically related to local currency costs.

For producers of non-tradeable items, however, there can be no assurance that prices in local currency will increase in line with any depreciation of the old currency in terms of dollars, or that borrowers are in a position to absorb any exchange rate risk. Moreover, if the banks experience large loan losses, and they develop more liabilities than assets denominated in the new currency, they will be vulnerable to exchange rate risks as well.

As more loans and deposits are denominated in the new unit of account, the government may be forced to issue new currency, even at the cost of abandoning its objective of maintaining parity with the US dollar. Any such development would come as a critical blow to the credibility of the new government and undermine subsequent efforts to make its policy intentions credible.

The government's declared intention to return to a fixed exchange rate system carries with it an implicit obligation to reduce the public sector deficit to an amount that can be financed externally, and at the same time allow the Central Bank to rebuild its international reserves as the new Córdoba Oro replaces the old Córdoba. There is no assurance that the plan for the issue of the new currency is consistent with the prospective implementation of the budget.

2. Deficit Reduction

Despite economic turmoil, and in the face of a series of strikes by public sector employees in April and July 1990, the new government has adopted a number of measures designed to reduce the overall deficit of the public sector. They include:

- reducing the spread between the official selling rate and the parallel market purchase rate of dollars at the Central Bank. This measure minimizes losses incurred by the Central Bank in its foreign exchange operations; and

- increasing telephone and other public utility rates.

These efforts build on the deficit reduction efforts of the former government. To its credit, the Sandinista government managed to reduce the deficit from more than 25 percent of GDP in 1988 to about 6 percent last year. This was primarily a result of expenditure cuts rather than revenue increases, and most of the reductions reflect deep cuts in capital outlays and repression of salaries, rather than permanent and sustainable reductions in military and other non-productive expenditures. Thus, deficit reduction remains a high priority.

B. Composition of the Financial Sector

The Nicaraguan financial system currently consists of the Central Bank and four lending institutions. They are Banco Nicaraguense de Industria y Comercio (BANIC), Banco Nacional de Desarrollo (BND), Banco Popular and Banco Inmobiliario, and each occupies a slightly different niche in the financial market.

- o Banco Nicaraguense de Industria y Comercio (BANIC) has been oriented, traditionally and primarily, toward the business and commercial borrowing entities, both state-owned and private.

- o Banco Nacional de Desarrollo (BND) has historically limited its lending operations to the agricultural sector.

- o Banco Popular has had much smaller and less reliable access to central bank credit, but when it is liquid the bank has traditionally focussed its lending on small- and medium-size enterprises.

- o Banco Inmobiliario was originally structured as a mortgage-specialized lender. It has not originated any mortgage loans for the past two years.

Without exception, these four institutions are insolvent; the recoverable value of the assets they hold is less than the face or redemption value of their deposit and non-deposit obligations. If the banks' reported financials are taken as credible representations of their performance, then BANIC alone operates as a marginally profitable institution, while all others continue to incur losses. Such profits as BANIC does report may well be misleading, since it makes no meaningful provision for possible loan losses. Senior management at each institution are holdover appointments from the previous government, and despite some staff reductions in recent years each bank is still significantly overstaffed and operating expenses remain beyond their management's ability to control.

In short, the banking system is in ruins. Inter-institutional competition of any kind, either in the mobilization of deposits or in the origination of new loans has simply disappeared from the scene. Only the Central Bank is engaged in any kind of international operations. Even the "plumbing" of the system -- the mechanics for payment, clearance, and settlement of funds transfers -- needs to be re-examined and overhauled, since routine transfers between cities may take up to a month before payments are finally effected.

Undoubtedly the President and other senior officials at the Central Bank are well aware of the fact that the financial system is dysfunctional, and feel a strong sense of urgency about the need to open up the financial sector to allow for the entry of non-bank intermediaries as a necessary step towards the development of a more competitive and resilient financial system. However, this sense of urgency is not fully shared by at least one Ministry, apparently for political reasons. If this interpretation is correct, then at a very early stage the donors and senior representatives from the international organizations should make it clear to all parties in Nicaragua (including the leadership of the Sandinistas) that financial reform is a matter of major importance.

Clearly, there is no shortage of problems to be addressed. What is needed at this stage is a prompt, progressive, and comprehensive overhaul of the system -- both in the practices and policies of those few institutions that are still legally intact, and in the legal and regulatory framework within which they operate. The reform should provide for the formation of new financial institutions because rehabilitation of the existing ones is likely to be a long and difficult process.

The following section of this report recommends six major areas in which support is needed.

IV. RECOMMENDATIONS

A. Support Policy Reform

At a minimum, the Nicaraguan government should produce a coherent macroeconomic stabilization program which assures the consistency of the currency reform with the financing requirements of the public sector. Through its balance of payments and ESF agreements, U.S.A.I.D. should support the Chamorro government's efforts to implement a mix of macroeconomic, social and financial sector policies designed to:

- stabilize the exchange rate,
- implement fiscal reforms,
- rationalize state owned enterprises,
- ensure a social safety net,
- develop Central Bank auditing and accounting capabilities,
- redesign the financial sector regulatory framework,
- create new financial institutions, and
- rehabilitate existing financial institutions.

Macroeconomic reforms are essential to financial sector reforms. Changes in financial sector policies cannot be accomplished without the appropriate accompanying macroeconomic policies. Certainly, any attempt to stabilize the exchange rate, as part of the process of price stabilization, will only be effective if it is accompanied by deep fiscal reforms. Two large drains on the budget are military expenditures and the credit demands of state-owned enterprises. Disarmament agreements and related reductions in military expenditures should be implemented more rapidly than in the past.

At the same time, there is an immediate need for the government to assert control over the credit demands of the state-owned enterprises (SOEs). Many of the SOEs are poorly managed, unable to form a rational investment plan, and lack even a minimally acceptable accounting system. As quickly as possible, USAID and/or the multilateral organizations should work with the government to develop a differentiated approach for the privatization, liquidation, or rehabilitation of those state-owned companies that cannot be transferred to the private sector in their present shape.

The kinds of structural reforms needed in the public sector may be very slow to materialize unless they are accompanied by other programs designed to protect the poor from the costs of stabilization. This was not only an election promise, but it may well be needed to mobilize the political consensus in support of fiscal reform and reform of the financial sector as well.

U.S.A.I.D. support of the above policies and reforms should complement the financial sector policy initiatives recommended below, in order of priority.

B. Develop Central Bank Audit and Accounting Capabilities

There is an immediate need for the Central Bank to reassert its control over the state-owned banks, and to do so on the basis of reliable information on the banks' performance and financial condition, including the quality of their loan portfolios. As matters now stand, senior officials at the Central Bank, along with most government officials, feel as if they are working in an informational vacuum about the use (and misuse) of bank credit. The Central Bank has made it clear that it would welcome technical assistance in building its own accounting and auditing capabilities.

In the short-term, the government must allow the Central Bank to once again control the credit approval process, which had been delegated to the two state banks, Banco Nicaraguense (BANIC) and Banco Nacional de Desarrollo (BND). At this time, the Central Bank has no control over the purpose of loans, nor any of the financing terms. The creation of an audit department in the Central Bank is a necessary step to regain control over the commercial banking system in the country.

A scope of work to build the Central Bank's audit and accounting capabilities is presented in Section V.

C. Redesign the Regulatory Framework

The Central Bank of Nicaragua no longer functions as a traditional Central Bank does in other countries, that is to oversee the activities of commercial banks in order to maintain banking standards on a national level and to function as the lender-of-last-resort. Its primary function in recent years has been to act as a funds-disbursing window or mechanism for the government, via the commercial banks.

The current bank law is almost silent on the regulatory standards to be used by the authorities in the appraisal of a bank's loan portfolio, the minimal standards for an adequately capitalized bank, requirements for external audits by qualified auditors, and on the amount of provisioning required against non-performing loans -- indeed, silent on almost all of the regulatory standards needed to evaluate an institution's capacity to honor its fiduciary responsibilities to depositors. These deficiencies in the regulatory framework need to be addressed, and the government apparently plans to do so before, rather than after, the system is open to private "financieras."

Officials at the Central Bank are well aware of these deficiencies and would welcome technical assistance in developing systems or standards in the following areas.

1. <u>A Loan Classification System</u>

The Nicaraguan banking system needs a loan classification system under which banks and other lending institutions would be required to systematically classify loans as a function of the risk of default. Such a system should differentiate at least three categories of non-performing loans:

- <u>Substandard loans</u>, usually defined as those which are past due for more than 30 but less than 180 days, or as loans in which losses of up to 25 percent are estimated,

- <u>Doubtful loans</u>, or loans that are at least 180 days overdue, but less than 360 days, and not well secured by legally foreclosable collateral in process of collection, and

- <u>Loan losses</u>, usually defined as loans more than 360 days past due, or loans to insolvent companies with no working capital or negative cash flow.

2. <u>Provisioning Requirements</u>

Any regulatory framework, if it is to be at all meaningful, must mandate minimum provisions for non-performing loans as part of the process of maintaining discipline in the credit process. Provisions for possible loan losses are maintained by charges against operating expenses which reduce both income and transfers to capital accounts. Otherwise stated, if a bank's credit policy results in possible loan losses, the risks must be clearly acknowledged and fully reflected in its financial statements. Specific provisions, based on loan classifications, vary from country to country, but usually require a minimum of 25 percent against substandard loans, 50-90 percent of doubtful loans (depending on how long the loan has been overdue), and 100 percent of the outstanding balance of loan losses.

3. Rollover Practices

Specific provisioning requirements can be avoided as long as banks are allowed to refinance or reschedule overdue loans, irrespective of the repayment capability of the borrower. Accordingly, regulatory authorities may limit refinancing altogether by disallowing the capitalization of interest on rescheduled overdue loans, or by requiring at least partial repayment of overdue interest. Either way, the intention is to allow refinancing only if it is based on a realistic assessment of the repayment capability of the borrower.

4. Capital Requirements

Any financial intermediary, because of its fiduciary responsibilities, must maintain some critical amount of capital to allow it to "ride out" or absorb the effects of unanticipated losses (for which no specific provision can be made). As a matter of prudential regulation, banks are typically subject to minimum capital requirements, which may be measured either by reference to their deposit liabilities or expressed as a percentage of their assets. Essentially, the regulatory minimum establishes an upper limit on the degree of financial leverage (or use of borrowed funds) that a bank can exercise.

The main thrust of the regulatory framework is intended to define the boundaries within which bank and non-bank intermediaries can compete for deposits and credits. In effect, the application of provisioning and capital requirements favors the expansion of those institutions that manage to make larger additions to capital by virtue of the fact that their operating expenses, including provisions for possible loan losses, are relatively low. Any institution that consistently fails to make effective use of the funds at its disposal must, sooner or later, cede market occupancy to the competition. In some cases, this may simply call for policies that slow down, or even abort, any growth in deposits, until such time as a bank has lowered its operational costs and managed to reconstitute its capital base. In others, rehabilitation may turn out to be a "mission impossible," in which case, the regulatory framework must also provide for the disposal of the failed institution, either through outright liquidation or a merger with a better managed bank.

An issue that remains to be resolved in Nicaragua today is whether supervisory responsibilities should be entrusted to the Central Bank or placed with a reconstituted Superintendency of Banks. Either way, the entity assigned responsibility would have to be staffed with qualified personnel to carry out both off-site supervision and on-site inspection. The Superintendency of Banks would have to be reconstituted in full, or the Central Bank would have to add qualified personnel or upgrade its own staff. In our view, responsibility for bank supervision should be exercised by the Central Bank of Nicaragua, at least as a transitional arrangement, and possibly on a permanent basis.

A governmental financial supervision program should include systems for setting prudential legal standards, on-site and off-site inspections, and monitoring. These programs could be responsible for licensing new banks and have receivership authority for banks that are bankrupt. The most important medium-term need of the Central Bank with regard to its supervisory responsibility vis-a-vis the financial sector, is to provide for effective on-site inspections of the local banks. As mentioned above, some immediate basic elements such as an understanding of accounting and financial statement analysis needs to be covered. Once this is done, an agenda for the areas to be covered in the examinations can be established.

While it may be difficult for all aspects of the regulatory framework to be in place prior to the full restoration and liberalization of the banking system, there should be a condition precedent that there be established at least a temporary ad hoc legal and regulatory framework for supervision, surveillance and standards of the new institutions, prior to licensing new institutions. A clear, logical set of rules and regulations is very much needed.

The following measures should be part of the liberalization process:

- Authorize a government department or entity to charter, examine, and regulate commercial banks;

- Define procedures for the issuance and backing of bank notes and coinage, and authorize a governmental entity to accomplish this;

- Create systems to improve the national check clearing mechanism and to help prevent the pyramiding of reserve deposits exclusively in the capital city;

- Establish a lender-of-last-resort with appropriate procedures and systems;

- Establish systems for the effective supervision of banks, especially to include an examination process both by the Central Bank and by entities outside of the Central Bank;

- Design internal audits systems to be performed by the individual banks. Such details as frequency of examinations, costs, and disclosure requirements need to be addressed;

- Create a loan classification system describing current performing and non-performing loans. Commercial banks should be required to establish and implement systems for evaluating the financial strength of clients, as well as procedures for adequate risk diversification;

- Determine minimum capital requirements for the establishment of banks and maximum loan ceilings to individual borrowers as a function of capital;

- Address accounting issues such as the need for minimum standards, common definitions and requirements for provisions for loan losses;

- Resurrect the Office of the Superintendency of Banks and clearly define its purpose, basic functions, and responsibilities;

- Establish a system for dealing with banks which are bankrupt, or seriously troubled and determine an entity authorized to liquidate them;

- Resolve the question of re-establishment of foreign banks, or branches, and their authorized functions;

- Address the roles or functions of non-bank financial institutions including appropriate regulations. Such details as purpose, minimum capital, authorized activities and minimum liquidity requirements of finance companies and exchange houses should be defined;

- Establish a warehousing law, or a provision of an existing regulation, which would provide for the bonding of warehouses and the establishment of negotiable warehouse receipts. Clarify the legality of privately-owned warehouses with their ability to extend credit. (While warehouses apparently were not nationalized by the Sandinista government, the financing aspects of warehousing is important in the development of international trade.) Determine minimum capital requirement; and

- Re-examine the legal framework of the insurance industry, which was nationalized under the Sandinista government. The financing system must be able to provide for negotiable bills of lading covering cargoes fully insured by financially responsible insurance companies. Aside from questions about, and procedures for, private ownership, requirements for risk diversification through the use of re-insurance outside Nicaragua deserve prompt attention.

In addition, the Price Waterhouse report entitled Modernization of Regulation and Supervision of LDC Financial Institutions, dated February 8, 1990, provides a useful listing of the key components of an effective on-site supervisory program, including the following:

- a review of the policies, practices and procedures in every area of operation, including corporate and strategic planning activities;
- a determination of the integrity of internal and external controls;
- an evaluation of asset and liability management policies;
- an appraisal of the quality of loans, investments, and other assets;
- a review of the profile and composition of deposits or other liabilities;
- a judgment about adequacy of capital;
- an analysis of other key factors, such as the quality of earnings, liquidity, and interest rate sensitivity;
- an assessment of the capacity and competence of management;
- a determination of the degree of compliance with all laws and regulations; and,
- an identification of changes the institution can make to operate more efficiently and to correct weaknesses.

A recommended scope of work for U.S.A.I.D. support to develop an appropriate legal, regulatory and supervisory framework for the Nicaraguan financial system is located in Section V of this report.

D. Create New Financial Institutions

In the medium-term, the Nicaraguan Government wishes to see new privately-owned finance companies established. The Central Bank is now drafting a law for the operations of finance companies. The plan is for these companies to be able to offer specialized financial services such as construction loans, mortgage loans, production agricultural loans, or export financing. Some finance companies could be established as savings and loan institutions. This would help fill the current absence of financial services provided to the public by companies with a profit orientation.

A condition precedent for USAID assistance with potential programs for enhancing the technical levels of finance and supporting finance companies in other ways ,should be that they are profit-driven entities in order to be self sustaining and not dependant upon government cash flows.

Following the creation of finance companies, and with appropriate legislation, the government intends to authorize finance companies to conduct international financial transactions.

The financial system, as envisioned by officials at the Central Bank, would provide for the creation of new non-banking institutions, which could be converted into all-purpose commercial banks at a later date, when, and if, the constitution permits such conversions. An increase in the number of institutions would intensify, if not create, needed competition within the financial sector. By virtue of competition, each institution's market share would depend upon its ability to respond to the needs of the banking public, and not on its access to central bank credit.

Nicaragua's current banking system needs the active involvement of institutions which are capable of delivering the most basic financial intermediation services. A financial services delivery system has been lacking in Nicaragua for the past ten years. Such a system is surely vital to the restoration and emergance of a free market economy. Without a sound system of financial intermediation, economic growth is dubious.

Before new institutions are licensed to operate, their legal status, rights and responsibilities need to be clearly defined. Indeed, without such clarification would-be investors in the financial sector are likely to remain elusive. In short, the development of a more competitive financial system will require the development of an effective system of supervision and regulation.

The legal parameters, investment sources and the scope of services provided by such institutions are discussed below.

1. Legal Parameters

The flood of legislation put in place by the Sandinista government during the transition period included, inter alia, a constitutional amendment which "reserved" or restricted the banking sector to state-owned organizations. Sandinista representation in the General Assembly is still large enough to block any attempt to undo this amendment.

The restriction does not appear to preclude, however, the formation of privately capitalized non-bank intermediaries. As a legal matter, the only significant difference between the two types of institutions is that the banks are authorized to provide third-party payments facilities through demand or sight deposits, while "financieras" have no such authority and can only offer term accounts. Otherwise, both classes of institutions can offer similar types of banking services. Indeed, in some areas the "financieras" would appear to have somewhat broader capabilities, since at present the state-owned banks are unauthorized to provide international banking services of any kind.

The consensus of legal opinion, at least among the attorneys with whom the team met, was that there are no legal impediments to the formation of non-bank intermediaries. Nonetheless, would-be investors are still uncertain, and would welcome a definitive legal ruling (from the Supreme Court) and/or an unambiguously clear legal mandate before they begin operations. Even after clearing this hurdle, the government will still have to clarify or re-establish the regulations under which both banks and non-bank institutions must operate.

2. Investment Sources

The Central Bank has the authority to license non-bank institutions, subject only to the owners' ability to satisfy initial capital requirements. Such institutions could be fully capitalized by private investors, domestic or foreign. Alternatively, they could be organized as joint ventures capitalized by private investors and the International Finance Corporation (IFC). In principle, the non-bank institutions could conceivably be created with a grant from donor governments.

Conversations with some of the members of the Nicaraguan financial community in Miami suggested that there may be a dozen or more investor groups interested in the formation of private "financieras" in Nicaragua. At this time, however, many would-be investors are reluctant to proceed until the legality of private "financieras" is clearly established. This may involve little more than a technical amendment to the banking law.

3. Services

Under the 1963 Banking Law, non-bank institutions are authorized to offer the same range of credit services as commercial banks, but are denied the authority to offer demand deposits. Thus, the only difference between the two types of institutions is that banks can offer transactions deposits, in the form of checking or demand deposits, while non-bank institutions cannot.

As a practical, rather than legal, matter, this distinction may be unimportant since there appear to be no legal restraints on the authority of non-banks to offer transactions accounts, such as money market funds with check-writing privileges.

If this interpretation is correct, and the banking law places no artificial restrictions on a "financiera's" lending authority, a "financiera" would have considerable discretion -- subject, of course, to appropriate regulatory restraints -- in choosing the specific types and forms of services it wishes to provide.

At present, banks provide only the most limited range of credit services, largely in the form of short-term, self-liquidating agricultural and commercial loans. Among the many gaps in the range of financial services is the conspicuous absence of medium-term credit and long-term financing of any kind. A.I.D. could help the banking institutions develop such mechanisms. (Clearly, workable markets for medium- and long-term financing are not likely to develop until after inflationary expectations are controlled -- and the prospect of this happening soon is remote.)

In addition, commercial lease financing is limited in amount, when available, and there is no lender willing to provide construction or mortgage credit of any kind. On the liability side, time deposits are offered only in non-negotiable form, and only for a limited range of maturities. And, as already noted, the most basic types of international banking services, such as letters of credit, collections, and remittances, are available only through the Central Bank.

Even if the program for the establishment of private finance companies encounters no serious opposition and is successful, and subsequently international operations are authorized in their favor, it is suggested that clear and complete regulations be in effect prior to the establishment of private commercial banks, or a program for the conversion of private finance companies to commercial banks. Rules need to be established for all facets of the financial sector.

E. Rehabilitate BANIC and BND

Among the four state-owned banks in Nicaragua today, only BANIC and BND were operational at the time of the team's visit, and they appear to be the only viable candidates for financial rehabilitation. Exactly how much time and technical assistance might be required for that purpose is difficult to assess, since there is no reliable information on their financial condition or performance. Such information as is assembled by the Comptroller General is incomplete and unreliable. Thus, the first and perhaps most important step that needs to be taken in any program to rehabilitate the banks in question is to fill this void of information -- and the Central Bank is the organization prepared to rectify this situation. Accordingly, assistance should be made available to the Central Bank to develop financial reports, which would be prepared in accordance with Generally Accepted Accounting Principles, as part of the process of building its own accounting and auditing capabilities.

Such information would also provide an early indication of the magnitude of the restructuring problem at each of the state-owned banks. As a matter of policy, there is no reason why state-owned banks should not be held to similar performance standards as privately capitalized institutions.

U.S.A.I.D. can provide both technical assistance and training to further the rehabilitation of the banks. This section suggests technical assistance to design Operations Manuals for the Banks and to elaborate risk management policies. It then describes the basic elements of a training program to strengthen staff capabilities.

1. Provide Technical Assistance

(a) Develop Operating Manuals to Define Procedures and Planning

The team's conversations with the executive directors, at both BANIC and BND, suggest that the banks need assistance in the entire gamut of banking activities and operations. Before any assistance is made available at the operational level, however, senior management should be expected to provide a sense of strategic direction in the formulation of bank policies and procedures.

To begin this process, each of the state-owned banks should develop short- and long-term plans for the restoration of the banks to a satisfactory operational status. These plans should be accompanied by a basic operating manual which would clearly identify risks and management areas, and require periodic reports from all "profit centers" and administrative units. The manual should not only outline operational procedures for the corporation, its subsidiaries and affiliates, but also, it should formalize financial policies within specific areas of activity, and define work-related objectives in terms of measurable results to be achieved.

The manual should outline the bank's fundamental objectives in financial terms, some of which may seem obvious to an outsider but need to be acknowledged explicitly by management if the banks are to become self-sustaining entities. Thus, it should be made clear to all employees that revenues must cover the costs of providing the above-mentioned services at competitive prices. Moreover, the bank's financial policies must clearly recognize that capital is not costless, that a bank must build and maintain capital simply to provide for its own future, and that even in the absence of any need to pay dividends to stockholders, banks must generate returns on capital in the form of additions to net worth. Even before capital requirements are more clearly specified through changes in law and/or regulation, the banks should act as if the need to increase capital to minimally adequate levels were an institutional imperative.

(b) Establish Risk Management Policies

Once a general set of objectives is established, the banks need to elaborate both general and specific policies for the management of both credit and interest rate risks. The control of credit risks for example, means that the banks must have clearly defined credit criteria or standards systems that enable management to monitor compliance with those standards, and control procedures for approval of any credit extensions. In addition, the banks should have procedures for continuing credit examinations of their larger borrowers, and systems for classifying both current and non-performing loans in terms of quality. All of these systems and procedures take on added importance now that loans are denominated in Córdobas Oro, and borrowers' repayment obligations are expressed in real terms.

Interest rate risks would appear to be negligible since both deposit and lending rates are subject to regulation and there are no alternative short-term instruments in which the banking public can invest. However, some depositors may be aware of, and responsive to, rates of interest payable in the informal credit markets and larger depositors are probably well aware of the returns available on short-term investments outside of Nicaragua. Thus, the banks may be vulnerable to deposit withdrawals if the Central Bank fails to maintain the ceilings on deposit interest rates at competitive levels. Or, if the Central Bank does raise the ceilings and the banks are able to avoid disintermediation, they may nevertheless be subject to earnings squeezes since the loan portfolio turns over much more slowly than the deposit base, with the result of banks that are unable to take full advantage of higher lending rates as they arise.

All of this implies that the banks may be vulnerable to interest rate risks, even in the absence of competition through an organized money market. As a practical matter, the only way to manage rate risk exposure is through adjustments in the average maturities of both loans and deposits. Evidently, this calls for information on the remaining term to maturity of assets and liabilities, as well as average returns on assets and interest payable on deposits in each of several clearly defined maturity categories. Absent this kind of information, management will simply not be in the position to monitor its exposure or to take appropriate corrective action.

These then are some of the information systems that should be installed, and for that purpose the banks will almost surely require technical assistance. Likewise, assistance should also be provided in the form of training programs in all of the basic aspects of bank operations and practice.

2. Design A Training Program for BANIC and BND

Middle management at the state-owned banks has had little experience with the policies and procedures that are now part of standard banking practice in other countries. Thus, at the very least, a training program should provide basic instruction in the function and logic of profit-driven, market-oriented financial intermediaries and thorough coverage of accounting principles and practices. Furthermore, BANIC and BND need to build automated information systems that will streamline and accelerate the flow of information. Beyond that, the program should cover:

(a) Principles of Banking or Essentials of Banking

These courses explain the importance of full-service commercial banking as it affects the economy, the community, business, and the individual. Some indoctrination in the idea of profit, as a means of sustaining the life of a banking institution, might be useful.

(b) Credit Training

Includes such fundamental credit areas as financial statement analysis, commercial loan officer development, loan interviewing, agricultural lending, small business lending, construction and mortgage lending, export and medium-term financing, and short-term self-liquidating financing arrangements.

(c) Operations/Administration Training

Includes operational areas such as bank accounting, auditing and bank controls, with special emphasis on interdepartmental accountability for custody and movement of negotiable items.

(d) International Operations

Includes all of the types of documents required to cover the shipment, delivery and payment of goods, as well as issuance of letters of credit, and the mechanics of international collections, foreign exchange, trade finance, remittances and acceptances.

(e) Bank Management

Includes the management of problem loans, fundamentals of administration, performance-related compensation arrangements, and asset/liability management.

The underlying presumption in the introduction of any kind of training program is that sooner or later, the banks will earn their way out of difficulty, with directors and senior management who are committed to that objective. However, this presumption remains to be tested, and should be before any technical resources are allocated for the development of training programs. At the very least, the senior management of the state-owned banks should be required to produce realistic plans (perhaps with the assistance of outside consultants) for the rehabilitation of the institutions they manage. More importantly, management must demonstrate a willingness to translate those plans into a serious effort to contain operating expenses, if necessary, through permanent reductions in the number of employees. Indeed, for the short-term, or until the banks are in a position to mobilize additional deposits and increase their scales of activity, more effective cost controls appear to be virtually the only way for the banks to generate additional earnings. In any event, it would be premature to provide assistance for more than a modest training program unless it is clearly recognized that training is simply part of the larger process of building a more efficient and financially viable institution.

Whether present management of the state-owned banks recognizes this need, and if so to what degree, is difficult to assess. But it is clear that changes in management attitudes are not likely to materialize very quickly, as long as banks enjoy what is, in effect, an exclusive franchise in the markets they serve. Certainly, the Central Bank has made an effort to encourage the two banks to compete in loan markets -- BND by providing credit to the agricultural sector and BANIC by making loans to non-agricultural borrowers. However, these and similar appeals are likely to be in vain, as long as the banks operate on the assumption that they have an indispensable, and presumably permanent role to play, without fear of competition from other sources.

F. Address Construction and Housing Finance Needs.

During the course of the team's interviews and meetings, the need for the financing of construction and housing was mentioned. While this issue was not included in the scope of work, it is discussed here as an area for potential future consideration by USAID/Managua.

There is a critical need for construction and mortgage credit to meet the most minimal housing needs. The most obvious candidate for the delivery of credit is Banco Inmobiliario, although it may not be the most appropriate one. There is a great need for technical assistance in everything from the design of indexed mortgage instruments to the development of operational programs for the management of the mortgage portfolio.

At the present time, Banco Inmobiliario is simply ill-equipped to hedge its exposure to interest rate and credit risks through the development of a more diversified portfolio of non-mortgage loans with shorter maturities. There appears to be minimal confidence in the management of Banco Inmobiliario. If this assessment is correct, and if external financing is made available for construction and/or mortgage loans, then participating institution(s) in the issuance and servicing of loans should be monitored very closely.

V. SUGGESTED SCOPES OF WORK FOR USAID/NICARAGUA

A. Immediate Assistance Activities

The scopes of work suggested below are presented in sequential order according to priority and timing unless otherwise stated. In light of the urgency of the situation, efforts for technical assistance must be implemented in an expedient and intensive manner, without jeopardizing the quality of the assistance, and in close coordination and cooperation with similar assistance efforts by other donor agencies or governments.

1. Develop the Central Bank's Accounting and Auditing Capabilities

Phase One:

The objective of this task is to develop and strengthen the Central Bank's internal accounting and auditing capabilities. This team suggests that a small group of accountants and auditors be asked to conduct a preliminary evaluation of the accounting and auditing systems and personnel at the Central Bank. Upon completion of their evaluation, the accountants would provide a needs-assessment analysis which defines the areas requiring immediate attention and recommend alternatives. The team, consisting of no more than three members, must have extensive combined experience in the central banking field. Team members must have language capability in Spanish. The anticipated duration of this team's assignment would be approximately three to four weeks.

Phase Two:

Once the preliminary evaluation is completed the process of institutional strengthening will begin. A larger group of accountants and auditors (ideally, with the participation of at least one or two members of the first team), would then work closely with Central Bank personnel on a long term basis to establish and develop a modern accounting and auditing unit. This unit will be responsible for the Central Bank's activities in those areas on a continuing basis. The group of consultants must analyze the financial situation of each of the four state-owned banks in order to provide transparent and standardized assessments of the status of each bank. This team must analyze and valuate each banks' loan portfolio, as well as their assets and liabilities.

The depth and magnitude of this task, combined with the circumstances of informational uncertainty, require an experienced team of at least four to six financial accountants. The duration of this engagement is difficult to assess and will depend on the availability of information and support. This assignment is long term and could last for two years.

2. Develop a Legal Framework for the Financial Sector Regulation

An area that requires immediate attention is the development of an appropriate legislative structure to regulate and supervise the Nicaraguan financial system in a manner conducive to competition and fairness. A comprehensive review of the current legislation must be carried out by a group of experts in financial regulation and supervision.

The consulting team must:

- Study the current laws, their applicability and their deficiencies;
- Recommend alternatives for corrective action;
- Provide assistance to the government with regard to the content of the law, addressing factors such as regulatory standards, type and frequency of examinations, reporting systems, etc; and
- Suggest a time-frame for bank compliance and methods of enforcement.

The team would ideally be composed of the following:

- a senior financial supervision and regulation expert,
- a financial regulation specialist,
- a bank examination specialist, and
- an attorney with experience in banking law, preferably from, or thoroughly familiar with, the region and able to interpret current legislation in Spanish.

The first phase of this assignment would produce an initial set of recommended legal standards and regulatory principles. This phase would require approximately four to six weeks of technical assistance. As legislation is drafted within the Government, experience suggests that additional consultations with at least some members of this team will be required.

3. Restructure and Rehabilitate BANIC and BND.

A team of "turnaround specialists" could be hired to restructure each of the banks. This team would work closely with the banks' executives and management to develop a strategic plan for each bank. This trouble-shooting team would also assist management in the development of an operational manual once the strategic planning phase is completed. It is important that the team obtain clear financial data that portrays an accurate picture of the financial situation of each bank. We suggest that four teams, one for each bank, be sent simultaneously. Each team would consist of:

- one or two Commercial Banking Turnaround Specialists,
- a Banking Strategic Planning Expert, and
- two Management Information Systems Specialists with strong accounting backgrounds and a deep understanding of information systems, particularly automated ones as they apply to banking institutions.

The teams would work in close communication with one another and restructure/rehabilitate each bank in accordance with the established legal requirements. This task will entail an organizational streamlining in order to dispose of redundant layers. This implies a reconsideration and/or reorientation of the banks' compensation systems, ideally with a focus on competitive salaries and performance incentives.

B. Longer-Term Technical Assistance Activities: Develop and Provide Bank Training

Bank Training needs are evident in each of the state-owned banks. The team has identified five main areas in which A.I.D. could focus its resources: Principles of Banking, Credit Training, Operations and Administration, International Banking and Bank Management. The timing and applicability of these courses will vary from institution to institution. All of the courses described below can be imparted in a variety of ways and by an array of institutions or independent banking consultants, whether they are taught in English or in Spanish.

1. Principles of Banking

An intensive course on the principles of banking is an essential introductory course which lays the groundwork for more advanced courses. The length of this course varies in relation to the institution teaching it.

2. Credit Training

The Credit Training courses can be divided into two phases. Phase One would cover general topics such as Financial Statement Analysis, Accounting, Commercial Loan Officer Training and Loan Interviewing. The duration of these courses, taught by one instructor at an intensive level, will generally be 12 to 15 days total. Phase Two, composed of more specific topics, would include Agricultural Production Loans, Small Business Lending, Construction Lending, Export Financing and Medium-term Financing. This course can be taught by a two-person team of instructors in approximately 10 to 12 days.

3. Operations and Administration

Courses in this area would encompass subjects such as Bank Accounting (to establish standards), Bank Controls, Internal Auditing and Reporting. These topics could be covered by one instructor in a 10 to 12 day period of intensive instruction.

4. International Banking

The return of international operations to commercial banks and other financial institutions in Nicaragua is necessary. When this takes place, bank and non-bank institutions must be able to conduct these operations smoothly and efficiently. In the event that international operations remain an activity exclusive of the Central Bank, their instruction on this matter would contribute to higher quality service. In either case, this course should, at a minimum, cover the following topics: letters of credit, collections, foreign exchange, remittances and acceptances. This course can generally be taught by one instructor in 10 days.

5. Bank Management

Geared to strengthen management's capabilities, this course would address issues such as Planning, Staffing, and Controlling; Organizational Theory and Leadership; Budgetary

Control; Communications and Management Information Systems. The duration of this course would be approximately one week.

APPENDIX A

Scope of Work

SCOPE OF WORK

NICARAGUA--FINANCIAL SECTOR PROJECT

The Financial Sector Project

a) Objective: To elaborate agenda for USAID/N assistance to the GON to transform the Nicaraguan financial sector from a state-controlled system for creation and distribution of credit to a freely operating system which allows for savings mobilization and rational credit allocation by a variety of autonomously managed financial institutions. Consultants will review the accounting and financial control systems of and for the state-owned banks with a view to developing (a) a set of recommendations to AID about reforms of policies and procedures of the Nicaraguan banking system which can be included in future policy-based assistance programming, and (b) a scope of work for a larger scale program of technical assistance to the Government of Nicaragua for the implementation of improved accounting, management information, and financial control system.

b) **Background:** The Nicaraguan financial system currently is composed of the Central Bank, four state-owned banks, two main exchange houses owned by the Government (and several private licensed exchange houses). The banks include two commercial banks (Banco Nicaraguense de Industria y Comercio (BANIC) and Banco Popular), Banco Nacional de Desarrollo (agriculture sector bank), and Banco Inmobiliario (housing bank). Only BANIC and the Banco National de Desarrollo are really operating. During the 1960s and early 1970s, Nicaragua had a financial system characterized by a high level of financial intermediation and diverse, sophisticated and well-developed financial institutions. During the last ten years, the nature of the Nicaraguan financial system has been fundamentally changed. Privately owned commercial banks were nationalized in the early days of the Sandinista Government, and the previously existing system of market-directed credit allocation was replaced by one in which credit was guided to final users in accordance with the decisions of central planners. A central planning council set Central Bank lending policies and, in turn, the Central Bank directed the lending operations of the commercial banks in great detail, with regard to terms, interest rates and selection of final borrowers.

As inflation accelerated during the 1980s and interest rates became increasingly negative in real terms, the nature of banking in Nicaragua changed in fundamental ways. On the one hand, highly negative real interest rates for deposits led to a drastic erosion of the deposit base. As a result, the commercial banks increasingly assumed the role of retailers of central bank lines of credit. On the other hand, highly negative real loan interest rates converted the entire lending process from one of realistic assessment of the financial and repayment capability of the borrower, to one of a more or less arbitrary distribution of government largesse. This process was accentuated by the frequent practice, particularly on the part of the development bank, of forgiving outstanding loans.

There is an immediate need for the financial system to begin again to carry out its normal intermediation function in order for economic recovery to begin.

One of the first measures of the new, democratic government was the conversion of the loans and term deposits of the banking system into "golden cordobas" defined as equal to one U.S. dollar. The effect of this change is expected to be the restoration of positive real loan and deposit interest rates and the return of autonomy and financial accountability of the individual banks in the system. To achieve this, the operating procedures and management principles of the state banks must be changed fundamentally. This consultancy is intended to provide assistance to AID in developing a program to assist the GON to achieve this objective. The GON also intends to allow private financieras to establish themselves (but not take demand deposits right away). Meanwhile, the GON would like to have the state-owned commercial banks begin to operate as normal banks. This will be complicated by their lack of adequately trained staff (most bank managers left Nicaragua long ago for the US or neighboring countries) and possible politically inspired employee agitation.

At the present time, a team of advisers from the International Monetary Fund is advising the Central Bank on its accounts, operations and procedures. The contract team will have to coordinate its efforts with those of the IMF team in order to provide a consistent set of recommendations to USAID/N for the operations of the financial system as a whole.

c) **Deliverables:**

1. A policy agenda for USAID/N to pursue in conjunction with its balance-of-payments assistance. This should include a list of the measures the GON needs to take to liberalize the financial system with suggested timing and sequencing for each step. The agenda should also indicate whether the measures recommended will require legal action by the Central Bank, the President or the National Assembly (Central Bank lawyers are available to provide legal advice).

2. Recommended changes in the roles the Central Bank (and its bank supervision personnel) vis-a-vis currently operating and future financial institutions in the system.

3. A list of services which new private financial institutions should be allowed to provide, and steps needed to be taken to open the door to their establishment.

4. A technical assistance and training plan for short-term improvements in the operations of the two main banks and for medium-term improvements in those sections of the Central Bank with responsibilities vis-a-vis financial institutions in the system. This plan will be based upon an assessment of the three institutions to receive assistance, which is briefly summarized in the consultants' report. The team will examine the existing

accounting and financial control systems of the state-owned Banco Nicaraguense and the Banco de Desarrollo. The team will prepare recommendations for AID for changes in the policies and procedures of each of the institutions which would be necessary to restore the operations of the financial institutions to sound financial operation. Recommendations should include necessary changes in management information systems to identify increases in loan deliquencies and patterns in branch lending operations which would be indicative of unsound banking practices.

The contract team will prepare a contractable scope of work for a program of technical assistance to the Central Bank of Nicaragua and the state-owned banks to restore the latter to sound commercial operation. The scope should identify types of expertise required and levels of effort. The assistance should contemplate the operational requirements of each Bank's own management as well as the requirements implied by the supervisory responsibilities of the Central Bank of Nicaragua.

5. A list of steps USAID/N should take to initiate an assistance program for financial sector improvement, which includes both assistance activities which should be initiated immediately under buy-in or IQC arrangements and analyses to be completed to develop a financial sector development project. The report will include a contractable scope of work for further work necessary to make the accounts and procedures of the banks adequate for the supervisory and financial management purposes of the Central Bank.

The report will be submitted to the Director, USAID/Nicaragua.

d) **Team Composition:** Three experts will be required--a PhD financial economist with a specialization in LDC financial market issues; a bank supervision expert with prior experience with the US Controller of the Currency, FDIC or Federal Reserve System, and a commercial banker who has managed a bank operating in an LDC. Spanish fluency by at least two of the team members is essential, and the team should have significant prior experience in the Latin American region. Services of the three experts are required for three weeks each.

APPENDIX B

List of Interviews

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LIST OF INDIVIDUALS AND INSTITUTIONS CONTACTED
(in chronological order)

In Washington:

USAID

James Foxx	AID/LAC, Economist
James Vermillion	AID/LAC, Deputy Director Private Sector Office
Robert Asselin, Jr.	AID/PRE/I, Director
James Wesberry, Jr.	AID/LAC, Sr. Financial Management Advisor
Toni Christensen-Wagner	AID/LAC, Head, Nicaragua Working Group
Karen Freeman	AID/LAC, Nicaragua Working Group

International Financial Institutions

Chee Sung Lee	Deputy Division Chief Central America Division IMF
Ricardo Martin	Senior Economist Office of the Vice President Latin America and Caribbean World Bank
Richard Clifford	Acting Nicaragua Desk Officer Latin America and Caribbean World Bank
Margaret Hagen	Nicargua Desk Officer Operations Division IDB

In Miami:

Banking Sector

Esteban Duque Estrada	Vice President Republic National Bank of Miami

CONT. LIST OF INDIVIDUALS AND INSTITUTIONS CONTACTED

Marcella Sevilla-Sacasa	Vice President Pacific Credit Corporation
Harry Brautigam	Latin America Trade Finance Bank of America
Roberto J. Arguello	Vice President Northern Trust Bank of Florida
Ernesto Cruz	Executive Director Popular Bank of Florida
Carlos Pellas Ch.	President and CEO BAC International Financial Group
Roberto Zamora	Managing Director Latin American Financial Services Group
Ernesto Fernández	President Pacific Credit Corporation

Other

William Baez Sacasa	Price Waterhouse/Bolivia
Carlos Ulvert	Insurance/Reinsurance Ulvert & Co.
José Alvarez	retired, former General Manager Banco Nicaraguense

In Managua:

USAID/Managua

Janet Ballantyne	Mission Director
Ken Schofield	Deputy Director
Richard Layton	Comptroller
John Avila	Deputy Comptroller
David Jesse	Private Sector Officer

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CONT. LIST OF INDIVIDUALS AND INSTITUTIONS CONTACTED

Michael Puccetti	Economic Officer U.S. Embassy
Randy Peterson	TDY
Mark Silverman	TDY

Government of Nicaragua

José Félix Sóliz	Central Bank of Nicaragua
Raul Lacayo	First Vice President Central Bank of Nicaragua
Leonel Rodriguez	Vice Minister of Finance Ministry of Finance
Angel Navarro	Executive President Corporación Financiera
Porfirio J. Gómez	Vice President International Operations Central Bank of Nicaragua

Banking Sector

Antonio Medrano	Executive Director Banco Nicaraguense de Industria y Comercio (BANIC)
Luis Angel Montenegro	Executive Director Banco Nacional De Desarrollo (BND)
Alfredo Bustos López	Executive Director Banco Inmobiliario (BIN)
Orlando López Larios	Deputy Director Banco Inmobiliario (BIN)
Jaime García González	Director Banco Popular
Carlos Barahona	Manager/Representative Citibank

CONT. LIST OF INDIVIDUALS AND INSTITUTIONS CONTACTED

International Finance Institution Representatives/Advisors

Christian Will	Representative Inter American Development Bank
Luis Escobar	IMF Financial Systems Advisor Central Bank of Nicaragua
Jorge San Vicente	IMF Accounting Systems Advisor Central Bank of Nicaragua

Private Sector

Gilberto Cuadra	President Consejo Superior de Empresa Privada de Nicaragua (COSEP)
Francisco Lainez	Former President of Centrl Bank

APPENDIX C

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SOURCE LIST

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11. Francisco Mayorga, Nicaragua 1990: An Emergency Program for Peace, Democracy and Recovery, January 1990.

12. Fishlow, Albert. Final Report of Monitoring Group on Nicaragua, Stockholm Meetings, April 24, 1990.

13. Numerous statistical reports were provided by the Central Bank of Nicaragua on the following topics:

    Economy of Nicaragua up to 31/12/90
    Agenda for Economic Restructuring
    Economic Statistics
    Economic Aid to Nicaragua

SOURCE LIST

14. Financial Statements were also provided by the Central Bank of Nicaragua for each of the following banks:

    Banco Nicaraguense de Industria y Comercio
    Banco Nacional de Desarrollo
    Banco Inmobiliario
    Banco Popular