

# **INTERNATIONAL MONETARY FUND**

**Monetary and Exchange Affairs Department**



**PANAMA**

**MODULE 2—BANKING SECTOR ASSESSMENT**

**August 2001**

<b>Contents</b>	<b>Page</b>
I. Executive Summary .....	3
II. Background and Overview.....	6
A. The Banking System.....	6
B. Supervisory and Regulatory Framework.....	8
C. Prior Assessments and Rankings.....	10
D. Non-Bank Financial Sectors.....	11
III. Assessment of Prudential Standards .....	13
A. Compliance with the Basel Core Principles for Effective Banking Supervision....	13
B. Anti-Money Laundering .....	26
 Text Tables	
1. Banking System.....	7
2. Compliance with the Basel Core Principles.....	16
 Boxes	
1. Anti-money laundering legislation—laws 41 and 42 (October 2000) .....	28
 Annex	
I. Principle-by-Principle Assessment .....	32

## I. EXECUTIVE SUMMARY

1. This report contains the findings of the MAE led team, which visited Panama City from April 23 to May 5, 2001.<sup>1</sup> The mission team undertook a stand-alone assessment of Panama's compliance with the Basel Core Principles (BCP) under Module 2 of the IMF's initiative for offshore financial centers, which included the onshore and offshore sectors. The Module 2 assessment is described in the Board paper "Offshore Financial Centers: the Role of the IMF" (SM/00/136 of June 23, 2000).

2. The mission team held extensive discussions with the staff of the Superintendency of Banks (SB), the Superintendent and the SB's board, as well as meeting with several banks, accounting firms, the Ministry of Economy and Finance (MEF), Ministry of Commerce and Industry (MCI), the Superintendency of Insurance and the National Securities Commission. The SB had prepared well for the assessment, having completed a Module 1 self-assessment (with IMF participation) in the fourth quarter 2000.

3. Banking activities represent the most significant component of the financial services sector with bank assets totaling \$38 billion at end-2000, or approximately 3.8 times gross domestic product. The large banking system relative to the economy reflects the confidence in Panama as an international financial center. Experience has been that the government does not rescue failing banks nor is there deposit insurance. Accordingly, market forces play a critical role as the general expectation is that the government will not rescue banks in the future. A review of bank financial factors was not formally a part of the assessment mission; however, the team observed indications of a weakening credit environment that while overall system levels of nonperforming loans are moderate, there are signs of deterioration in asset quality and capital levels among locally-headquartered banks that merit further scrutiny.

4. Though Panama is characterized as an offshore financial center, the substantial majority of banking activities are carried out by general license banks, which are unrestricted in their ability to transact with residents and non-residents. (See Table 1) General license banks have 82 percent of system assets compared to 18 percent for international license banks. International license banks are restricted to business with non-residents.

5. The insurance, securities and other non-bank financial sectors were not included as part of the Module 2 assessment because they are small in relation to the banking system. The mission team observed in its review of two of the sectors—insurance and finance companies—an apparent scarcity of resources for supervision. (Chapter II provides a brief discussion.) Also noted, was that representatives of the financial sector referenced difficulties

---

<sup>1</sup> The assessment was carried out by a team led by Mr. Michael Moore, and included Mr. Alvir Hoffman of the Central Bank of Brazil and Mr. Joseph O'Neill, former head of the Office of the Commissioner of Financial Institutions of Puerto Rico.

with the bankruptcy law, which poses a concern for effective resolution of distressed credits. Several bankers referenced that there is not a formal mechanism for a court administered reorganization.

6. This report consists of three chapters. These include the Executive Summary (Chapter I); background and an overview discussion of the banking system and a description of the supervisory and regulatory environment (Chapter II); and, a discussion of the results of the Module 2 assessment (Chapter III). The mission team reviewed the SB's anti-money laundering efforts with respect to supervisory and regulatory standards, and provides its assessment in Chapter III and a summary below.

### **Module 2 assessment**

7. While the SB still has some work ahead, this module 2 assessment validates that Panama has achieved substantial progress towards putting in place a supervisory and regulatory framework for the banking system that meets most international standards. Since the passage of the 1998 banking law, the SB has issued and is applying a set of regulations that conform to accepted international practices. The regulations include: (i) the requirement that banks and financial groups adopt internationally-accepted standards for accounting and auditing, (ii) introduction of a new capital adequacy framework in line with the Basel Capital Framework, (iii) imposed limits on loans and investments with related parties and single obligors, and (iv) improved internal risk management procedures for liquidity, interest rate and country risk.

8. The mission team's evaluation of Panama's compliance with the Basel Core Principles is favorable. Panama was assessed to be compliant or largely compliant with 23 of the 25 principles. The remaining two principles were considered materially non-compliant, with efforts underway to achieve compliance. As to the two, offsite monitoring (BCP 16) and investment activities (BCP 5) showed shortcomings in analysis of financial factors.

9. There is a strong commitment towards international cooperation. The SB has established good working relationships with foreign supervisory agencies and actively promotes consolidated supervision. The SB's program for ongoing supervision includes the monitoring of foreign activities of Panamanian banks and the SB is conducting onsite inspections of material subsidiaries of banks, both domestic and foreign. Under the SB's program for onsite inspections, the local offices of foreign banks receive similar supervisory treatment as locally headquartered banks, which include banks that hold the international license<sup>2</sup>.

10. In May 2000, the Financial Stability Forum (FSF) published its list of offshore financial centers according to three groupings. The FSF placed Panama along with 24 others in Group III, the lowest ranking group. The FSF's actions prompted the authorities to

---

<sup>2</sup> Six of the 26 International License banks are headquartered in Panama.

undertake this IMF-led assessment. The mission team's largely favorable assessment reflects the commitment by the authorities to address those areas giving rise to the FSF's concerns.

### **Anti-money laundering measures (AML)**

11. The mission reviewed the SB's anti-money laundering efforts in the banking sector, which included banking and trust activities. The mission followed the methodology set out in the Basel Core Principles (BCP), principally BCP 15, and reviewed "know your customer" requirements and suspicious transaction reporting to the appropriate government authority. In this regard, the mission considered the SB to be fully compliant with the AML criteria in the core principles.

12. The SB has in place a well-developed module to verify that banks have implemented fully the requirements of the laws and regulation for anti money laundering. The program includes a regimen of transaction sampling to ensure banks are indeed complying with the "know your customer" requirements, as well as to ensure that there is proper reporting of suspicious transactions to the proper law enforcement agency. Also, the SB interacts with Panama's financial intelligence unit, which is the center of the anti-money laundering program. For 2001, the SB is projected to complete reviews of anti-money laundering compliance in the course of 38 examinations of banks and 17 examinations of trust companies.

13. The level of supervision dedicated to AML is exceptional as 20-30 percent of onsite examiner resources are dedicated to this one area. The resource commitment to anti-money laundering shows in the detailed coverage in inspection reports and inspection work papers.

14. The heightened commitment to AML efforts reflects in large part the adverse listing of Panama as a "non-cooperative" country in the fight against money laundering by the Financial Action Task Force<sup>3</sup> (FATF) in June 2000. Following corrective actions by the authorities and the industry, the FATF reviewed progress in addressing earlier identified deficiencies and subsequently removed Panama from FATF's list of Non-Cooperative Countries or Territories.<sup>4</sup>

---

<sup>3</sup> The Financial Action Task Force on Money Laundering is an inter-governmental body which develops and promotes policies, both nationally and internationally, to combat money laundering. The FATF is made up of 29 member countries and territories, primarily composed of OECD members; the Secretariat is based at the OECD.

<sup>4</sup> See FATF's June 22, 2001 report titled "Review to Identify Non-Cooperative Countries or Territories: Increasing The Worldwide Effectiveness of Anti-Money Laundering Measures".

### **Superintendency's comments regarding this report**

15. An earlier draft of this report was furnished to the SB for their comments. The SB agrees with the observations and recommendations of the report. The SB commented that (i) foreign exchange risk in Panama's banking system is low given the use of the dollar as their currency, which lessens the need for more specific supervisory guidance on foreign exchange exposure to banks; and (ii) a regulation regarding the limitation of holdings in equity securities will be issued shortly to clarify that banks are to limit equity holdings on a cumulative basis to 25 percent of capital<sup>5</sup>. Since the mission team's visit to Panama, the SB has issued for public comment regulations on (i) corporate governance, (ii) licensing procedures and (iii) limitations on investments in equity securities.

## **II. BACKGROUND AND OVERVIEW**

16. The financial sector of Panama consists of the banking system<sup>6</sup>, the stock exchange, insurance companies, finance companies, and public financial institutions. The banking system is by far the most important component. This chapter provides background and overview discussion of the banking system and its supervisory and regulatory environment; experience with past assessments and rankings; and a description of non-bank financial sectors.

### **A. The Banking System**

17. Panama's banking system is comprised of 80 general and international license banks with assets of \$38 billion at end-2000. (Table 1 provides market share information of Panama's banking system by assets, loans and deposits.) Of these banks, 54 were general license (GL) banks—including the publicly-owned National Bank of Panama (BNP), and the Savings Bank (Caja de Ahorros)<sup>7</sup>—and 26 were international license (IL) banks. GL banks may conduct business with both residents and nonresidents, and IL banks may only do business with nonresidents.<sup>8</sup> There are 28 foreign banks, with assets of US\$10 billion that hold a general license and operate as either separately capitalized subsidiaries or as branches.

---

<sup>5</sup> A draft of the regulation was provided to the mission team for comments.

<sup>6</sup> Trust activities are largely conducted by banks. See section on *Supervisory program for trust activities paragraphs* in chapter III part B for further discussion.

<sup>7</sup> Apart from its role as a commercial bank, the BNP functions as the financial agent for the Central Government and the official clearing house for the banking system. It also ensures an adequate supply of U.S. currency to the banking system, and has acted at times to supply liquidity to banks that were in need.

<sup>8</sup> An exception is made to the non-resident rule, as IL banks can participate in Panama's interbank market.

**Table 1. Panama: Banking System**

(In billions of dollars as of December 31, 2000)

Type of Depository Financial Institution (DFI)	Number of DFIs	Percent of total	Assets	Percent of total	Loans	Percent of total	Deposits	Percent of total
General license banks	54	61.4	31	81.6	18	85.8	21	78.8
- Panama headquartered banks	26	29.5	21	55.3	13	59.0	13	46.8
- Branches of foreign banks	18	20.5	7	18.6	4	18.1	6	23.4
- Subsidiaries of foreign banks	10	11.4	3	7.7	2	8.8	2	8.6
International license banks	26	29.5	7	18.4	3	14.2	6	21.2
Representative offices	8	9.1	N/A		N/A		N/A	
Total Banking System	88	100.0	38	100.0	21	100.0	27	100.0

Source: Superintendency of Banks

Besides general and international license banks, there are eight representative offices of foreign banks.

18. Panama's licensing requirements are distinguished from those in many offshore financial centers<sup>9</sup> in two notable ways: (i) banks must establish a physical presence in Panama by maintaining an office with local staff for each of the licensing types, and (ii) eligibility for a general license is open to both local and foreign ownership.

19. Within the scope of the visit, the mission team largely did not review financial factors among banks operating in Panama; however, slowing credit conditions are evident and soundness indicators for some banks are showing deterioration. In the medium term of 12-18 months, profitability of many banks will come under pressure because: (i) the new loan classification regulation comes into full force during the latter part of 2001 requiring larger provisioning for loan losses; (ii) in light of economic climate, the opportunities for prudent

<sup>9</sup> The characteristics frequently associated with OFCs are where the bulk of financial sector transactions on both sides of the balance sheet are with individuals or companies that are not residents of OFCs, where the transactions are initiated elsewhere, and where the majority of the institutions involved are controlled by non-residents. This definition is set out in the June 2000 report to the Executive Board *Offshore Financial Centers: The Role of the IMF*.

loan growth have diminished; and (iii) for many banks—recent merger activity will result in higher operating expenses from the consolidation of activities and staffing.

20. The equity to asset ratio for the system was 9.4 percent and for Panama-headquartered banks was 11.7 percent, well above the regulatory minimum of 8 percent. Nonperforming loans (NPLs) were 2.7 percent of loans compared with 2.4 percent at end-1999. Provisions against loan losses amounted to 74 percent of NPLs, which equals end-1999. The return on average assets for the system was 1.3 percent in 2000 as compared to 1.4 percent in 1999.

## **B. Supervisory and Regulatory Framework**

### **Background**

21. The supervisory and regulatory environment has evolved rapidly following the passage of the 1998 banking law and creation of the Superintendency of Banks. Past concerns about the adequacy of the supervision environment resulted in a multi-year effort to upgrade the quality of the banking supervisory and regulatory framework. As a result of such effort, the SB replaced the National Banking Commission, which was relatively weak and lacked proper independence from the banking industry.

22. The powers of the Superintendency are divided between the Board of Directors and the Superintendent. The board has five members who are appointed by the Executive Branch for a maximum of two eight-year terms. The banking law further imposes the requirement that Board members may not currently be engaged in the banking business. The Board of Directors establishes general policies and norms including establishing banking regulation and interpreting the Banking Law. The Board also approves the SB's budget and resolves any appeal regarding a resolution issued by the Superintendent. The Superintendent engages, in an independent fashion, in all other actions including licensing, supervising and issuing the corresponding orders and resolutions. The Superintendent is a salaried, full-time public official who is appointed by the Executive Branch for a five-year term renewable one time. The term of the Superintendent does not coincide with that of the Executive Branch.

23. The SB has a professional staff of about 100 for onsite and offsite supervision. In addition, there is 20 staff devoted to the legal and administrative duties for regulations and reviewing applications and another 10 for information systems. The onsite inspection program is complemented by offsite surveillance by a bank analysis group that looks at periodic prudential indicators and other managerial reports, placing particular emphasis on related party transactions.

24. In its first two years of operation, the SB issued new regulations dealing with the following activities or areas: (i) accounting and auditing standards, (ii) a Basel-like capital adequacy requirement, (iii) exposure limits on credit to related parties and single obligors, and (iv) risk management requirements for liquidity, interest rate and country risk. The SB recently issued additional regulations for loan classification and provisioning that came into force beginning in the first quarter of 2001.



25. Discussions and observations on financial sector do reflect some difficulties in the effective resolution of distressed credits. The difficult negotiations among creditors following the recent collapse of an important economic group point to weaknesses in Panama's bankruptcy process, which lacks a formal mechanism that allows for reorganization of companies under the direction of a bankruptcy court. Largely, the process is one where liquidation is often the only alternative to resolve a bankruptcy situation, with often a protracted workout, and with a weak outcome.

**Consolidated supervision (including cross-border supervision)**

26. The SB is empowered to supervise economic groups and their bank and nonbank affiliates on a consolidated basis. Its powers include the right to require audited financial statements and other reporting information as appropriate from the bank and nonbank affiliates of economic groups.<sup>10</sup> Although the development of the system for consolidated supervision is largely complete, some policy work is warranted with regard to the types of specialized financial and nonfinancial activities that should be permitted within a bank or a bank subsidiary. The policy should consider the appropriateness of the activity for a bank or bank subsidiary, its relative size, the demand it makes on management and the degree to which its accounts obscure the transparency of the bank's operations.

27. As an important regional banking center, the SB requires that all offices of foreign banks be subject to consolidated supervision by their home country supervisor. In addition, several Panamanian banks have subsidiaries or affiliates in neighboring jurisdictions, primarily in Central America and the Caribbean. To facilitate the cross-border supervision, the SB has pursued memoranda of understanding (MOU) with 16 foreign jurisdictions mostly among Western Hemisphere countries and territories. Of these, four have been agreed and signed, two have been deferred, and all others are under active negotiation.

28. The MOUs are intended for the sharing of information for supervisory purposes, which contrasts with MOUs intended to facilitate information flows for law enforcement or crime prosecution purposes.<sup>11</sup> Though the SB prefers an MOU for information sharing purposes and to allow onsite inspections, it is not a pre-condition to conducting an onsite inspection by a foreign supervisor, which can be arranged on a case-by-case basis. The arrangement will set out guidance on use of information and will stipulate that information obtained be for supervisory purposes only. There is a precedent for allowing an onsite inspection by a foreign supervisor without an MOU being in place. Despite the large number

---

<sup>10</sup> The applicable regulation is Acuerdo 3-99, Consolidated Supervision of the Economic Banking Group.

<sup>11</sup> MOUs for law enforcement purposes, particularly anti-money laundering enforcement, have been negotiated with several jurisdictions by Panama's financial intelligence unit (UAF).

of foreign banks operating in Panama, especially from Europe and North America, the SB has received only a few requests from foreign supervisors to conduct on-site inspections, which Panama has consented to and in most cases engaged in a joint exam with the foreign supervisor.

### **C. Prior Assessments and Rankings**

#### **Financial Stability Forum**

29. Beginning in the first half of 1999, the Financial Stability Forum (FSF) convened a working group to consider the significance of offshore financial centers in relation to financial stability. Based on the results of the working group, the FSF released in May 2000 its rankings of offshore financial centers according to three groupings. Panama along with 24 other countries and territories was categorized in Group III, the lowest ranking group. The FSF characterized countries in Group III as those seen “as having a low quality of supervision, and/or being non-cooperative with onshore supervisors, and with little or no attempt being made to adhere to international standards.”<sup>12</sup>

30. Per the FSF’s report and press release, the groupings were based on a 1999 survey of impressions of supervisors and regulators in 27 onshore jurisdictions that in all considered 42 offshore financial centers. The authorities express disappointment with the FSF’s characterization of the supervisory and regulatory regime, and believe that this view does not give appropriate consideration to important developments that have occurred since 1998.

31. While the SB is continuing to strengthen its supervisory and regulatory framework, the mission team’s view is that it has indeed achieved very favorable results towards meeting international standards for the supervision of its locally and foreign-controlled banks. The team expects that strong commitment to continue. The team observes that the SB has in place an effective program for the supervision of foreign banks operating in Panama, as well as good mechanisms to ensure that foreign supervisors are not inhibited from carrying out consolidated supervision. The SB has demonstrated good cooperation with home country supervisors and is an active participant in the Offshore Group of Bank Supervisors.

32. Advancements in the SB’s inspection program include the receipt of information of the foreign activities of Panamanian banks, as well as the onsite inspections of foreign subsidiaries. The SB publishes on its website monthly and quarterly financial information on a bank-by-bank and system basis, which facilitates monitoring of individual banks and system-wide banking conditions by home country supervisors. While there is still work

---

<sup>12</sup> The other two groupings are: Group I—jurisdictions generally viewed as cooperative, with a high quality of supervision, which largely adhere to international standards and Group II—would be jurisdictions generally seen as having procedures for supervision and cooperation in place, but where actual performance falls below international standards, and there is substantial room for improvement.

ahead, the authorities, and the financial services industry generally, have worked intensively to address the concerns that the FSF earlier had identified as deficient.

### **Financial Action Task Force**

33. In June 2000 the Financial Action Task Force (FATF) criticized the existing anti-money laundering regime, and listed Panama as “non-cooperative” in the fight to combat money laundering. The FATF cited four principal shortcomings: (i) failure to criminalize money laundering for crimes other than drug trafficking; (ii) inefficient reporting of suspicious transaction reports to competent authorities; (iii) overly restrictive rules for international information exchange; and (iv) civil law provisions that impeded the identification of the true beneficial owners of trusts.

34. To address criticisms identified by the FATF, the authorities, with the strong support of the banking industry, quickly enacted new legislation responsive to the FATF criticisms. (See Chapter III-B for fuller discussion of anti-money laundering measures.) New legislation significantly expanded the SB’s ability to examine anti-money laundering compliance by trust companies, which gave the SB the same authority for access to customer information as it had previously for banks. The legislation gives the SB broad authority to use the means necessary to ensure that banks and trust service providers comply with the law, including the authority to issue regulations intended to deter money laundering. The SB (and the entire government) has been very responsive to the concerns raised by the FATF, and is actively working to fully implement the legislation passed in the fourth quarter 2000.

35. In recognition of the achievements, the FATF on June 22, 2001, voted to remove Panama from its list of non-cooperative countries and territories. See chapter III–B for further discussion.

### **Module 1—self-assessment**

36. To take stock of its progress towards meeting international standards for prudential supervision, the SB completed in October 2000 a self-assessment against the Basel Core Principles under Module 1 of the OFC initiative. The self-assessment was assisted by a Fund staff member<sup>13</sup> and considered the compliance with the Basel Core Principles for Effective Banking Supervision (BCP). The self-assessment prepared the groundwork for this Fund-led standalone BCP assessment.

### **D. Non-Bank Financial Sectors**

37. In comparison with the banking sector, the securities, insurance and other non-bank sectors are significantly smaller and their regimes for supervision and regulation less

---

<sup>13</sup> Michael Moore (MAE), the mission head for this assessment, assisted in the self-assessment.

developed. A new securities law was passed in July 1999,<sup>14</sup> creating the National Securities Commission (SC) as an autonomous regulatory agency, with three full-time commissioners and staff. The SC oversees the authorization and supervision of publicly traded securities. In 1999 there were 54 public offerings of securities with a total value of \$851 million, up from \$593 million in 1998. With the exception of \$29 million in equity securities, these were bonds or other debt instruments.

38. The insurance industry, which is supervised by the Superintendency of Insurance (SI), largely serves the domestic market, with most insurance companies offering traditional property, casualty, and life insurance products. At end 1999, there were 24 insurance companies with assets of \$627 million. Under legislation passed in 1996, unlike the banking and securities industries, the SI did not receive the same level of autonomy from the executive branch of government or from industry. The SI remains a bureau of the Ministry of Commerce and Industry (MCI), and is accountable to a nine-member board, which is comprised of five government and four representatives from the insurance industry.

39. The mission notes that the SI's funding resources are constrained because of a fee structure set by the 1996 law. Each insurance company is required to pay only \$2,500 annually per company regardless of size or risk profile. An effort is underway to increase the fees paid by insurance companies to increase the SI's resources, but this effort will require the concurrence of the SI's board of directors. The mission team is of the view that this effort to provide adequate resources to the SI be followed through to create a basis for more effective supervision of the insurance industry.

40. The MCI also has responsibility for the finance companies, which specialize in consumer lending. At end-1999, there were 152 finance companies, with total assets of \$900 million or less than 3 percent of total bank assets.<sup>15</sup> Generally, the risk associated with loans issued by the finance companies is mitigated as they are usually paid by direct payroll deduction and, in the case of retirees, through direct disbursements from the social security system. In addition, it is customary to have (i) cosigners responsible for the obligation, (ii) personal property as collateral and (iii) a life insurance policy to cover the balance of the loan in the event of death. Law prohibits finance companies from accepting deposits. Consequently, funding comes from bank borrowings, shareholder loans, debt offerings, other liabilities and owner equity. The law sets a fixed regulatory fee at \$200 paid annually. Similar to the insurance companies, such fee structure is deemed inadequate to generate sufficient revenue to defray the administrative costs. New legislation for the finance companies is pending that should improve the resources for regulation.

---

<sup>14</sup> Decree Law Number 1-1999

<sup>15</sup> Thirteen finance companies are subsidiaries of banks and subject to supervision by the SB. These thirteen are among the larger finance companies.

41. There are two development banks. The National Mortgage Bank (BHN) provides housing loans, and the Agricultural Development Bank (BDA) provides loans for agriculture. The two banks were created by special legislation for specific social and development objectives. Both are troubled by inefficiency and inconsistent profitability. The authorities are moving to liquidate BHN. BDA is to remain open, but its operations will be rationalized to ensure that its loans benefit the smaller farmers. Supervision of the two development banks is provided by the Panama's Controller's office which primarily audits banks' financial statements. In addition, the Housing Minister and the Finance Minister preside over Boards of BHN and BDA, respectively. Because BHN and BDA do not carry out commercial banking activities and are not empowered to accept deposits, the Superintendency of Banks does not supervise them.

### **III. ASSESSMENT OF PRUDENTIAL STANDARDS**

#### **A. Compliance with the Basel Core Principles for Effective Banking Supervision**

42. The mission team carried out an assessment of Panama's observance and implementation of the Basel Core Principles, using the methodology agreed by the Basel Committee.<sup>16</sup> The mission conducted comprehensive discussions with the authorities at all levels, as well as, private banks, law firms and accounting firms. The assessment focused substantially on a review of the legal and regulatory framework, as well as detailed discussions with the SB's staff to ascertain the thoroughness of the ongoing supervision process.

43. The banking law, which was passed in 1998, provides a good legal base for the SB to carry out supervision. Under the law, the SB has broad authority to draft regulations for banks and their affiliates, including the economic groups that own banks. The SB's enforcement powers are well suited to maintaining appropriate discipline within the banking system. The documents used in conjunction with the assessment included a BCP self-

---

<sup>16</sup> Basel Committee on Banking Supervision, *The Core Principles Methodology*, Basel, October 1999. The methodology was jointly developed between the Basel Committee, the IMF and the World Bank specifically to be used for conducting BCP compliance assessments. The methodology provides detailed criteria for determining compliance in order to achieve a measure of consistency in the assessment process. The primary areas covered by the Basel Core Principles are: (i) licensing and structure, (ii) prudential regulations, (iii) methods of ongoing supervision, (iv) information requirements, (v) formal powers of supervisors, and (vi) cross-border banking.

assessment that was completed by the SB following the Basel Committee's methodology and the Fund's template/questionnaire for offshore financial centers.<sup>17</sup>

44. The mission team's evaluation of the BCP is favorable and found Panama to be compliant or largely compliant with 23 of the 25 principles. The remaining two principles were considered materially non-compliant, with efforts underway to achieve compliance. For the two, offsite monitoring (BCP 16) showed shortcomings in analysis of prudential factors and data quality; and, investment activities (BCP 5) too showed weaknesses in analysis with some adjustment to regulations suggested.

45. For offsite monitoring—BCP 16—the SB has adequate legal powers to require information from banks and affiliated entities and, in practice, collects vast amounts. However, some weakness in the analysis and the quality of the data was apparent, which reflected that the SB was stretched to analyze the information consistently, as well as inadequacies in data collection. The SB has embarked on a comprehensive program to upgrade the information system, which is well underway, with important aspects coming on line by end 2001. Once on line, the SB needs to focus on qualitative analysis of the information.

46. In terms of investment activities—BCP 5—there is scope for strengthening the SB's processes for analyzing and approving bank mergers or other material transactions. In addition to analysis of investments, there is a need for a formal policy/position on the types of non-financial investments that should be permitted within a bank or as bank subsidiaries. The policy should consider the appropriateness of the activity for a bank or bank subsidiary, the relative size, the demand on management and the degree the activity obscures the transparency of the bank's operations.

47. The SB has satisfactory legal power to supervise economic groups and their bank and nonbank affiliates on a consolidated basis. Its powers include the right to require audited financial statements and other reporting information as appropriate from the bank and nonbank affiliates of economic groups.<sup>18</sup> The SB is the consolidated supervisor of 11 banks that have either a branch or subsidiary in a foreign jurisdiction, for which the SB recently has instituted its program of onsite inspections. An inspection by the SB of a significant foreign subsidiary is now in process. The mission noted that many branches and subsidiaries in the foreign jurisdiction were booking vehicles that were controlled from Panama.

48. As Panama is an important regional banking center, the SB works to see that offices of foreign banks are subject to consolidated supervision. In addition, several Panamanian

---

<sup>17</sup> The SB completed the sections of the template that pertain to banking and trust and trust service providers.

<sup>18</sup> The applicable regulation is Acuerdo 3-99, Consolidated Supervision of the Economic Banking Group.

banks have subsidiaries in neighboring jurisdictions, primarily in Central America and the Caribbean. To facilitate the cross-border supervision, the SB has pursued memoranda of understanding (MOU) with 16 foreign jurisdictions in the Western Hemisphere. Of these, four have been agreed and signed, two have been deferred, and all others are under active negotiation.

49. The MOUs are intended for the sharing of information for supervisory purposes only, which contrasts with MOUs intended to facilitate information flows for law enforcement or crime prosecution purposes.<sup>19</sup> Though the SB prefers an MOU, it is not a pre-condition to conducting an onsite inspection by a foreign supervisor, which can be arranged on a case-by-case basis. The arrangement will set out guidance on use of information and will stipulate that information obtained be for supervisory purposes only. There is a precedent for allowing an onsite inspection by a foreign supervisor without an MOU being in place. Despite the large number of foreign banks operating in Panama, especially from Europe and North America, the SB reports that it has only received (and consented to) a few requests from foreign supervisors to conduct on-site inspections.

50. The remaining paragraphs of section A discuss those principles considered to be either largely compliant or materially non-compliant. In both instances, identified shortcomings are described along with recommendations. Table 2 summarizes compliance with each of the principles, and the Annex provides a discussion and assessment of each core principle.

#### **Legal Protection to Supervisor (BCP 1.5)—Largely compliant**

51. Executive Decree 49 of 1998 establishes a veracity presumption in favor of the supervisory personnel as to their declarations.<sup>20</sup> However, the Banking Law does not provide statutory protections for SB personnel or an indemnity against expenses of litigation.

#### ***Recommendation***

49. The Banking Law should provide legal protections against civil suits brought against SB employees (including Board members) for actions taken in their official capacity and in good faith. Any decision to amend the law should also allow the SB to reimburse its

---

<sup>19</sup> Information sharing with foreign authorities for law enforcement purposes, which includes anti-money laundering, is carried out by the UAF, which is authorized by law for this purpose.

<sup>20</sup> Specifically, the executive decree states: "Las actuaciones del personal supervisor de la Superintendencia de Bancos en cumplimiento de sus funciones, hacen fe pública y lo que señalen sus declaraciones será considerado como verdadero, correspondiendo la carga de la prueba a quien asegure lo contrario."

employees for the costs of litigation, including, *inter alia*, the costs of retaining legal counsel for any claim or suit, out of pocket expenses, and the costs of settlement of any claim or litigation. As an interim measure, the SB should consider adopting a policy or obtaining insurance to cover its employees against such costs or expenses. These measures should also cover former employees and Board members.

Table 2. Panama: Compliance with the Basel Core Principles

Assessment as of April-May 2001

Core Principle	C 1/	LC 2/	MNC	NC 4/	Remarks
1.1 Objectives	X				
1.2 Independence	X				
1.3 Legal framework	X				
1.4 Enforcement powers	X				
1.5 Legal protection		X			
1.6 Information sharing	X				
2. Permissible activities	X				
3. Licensing criteria		X			
4. Ownership		X			
5. Investment criteria			X		Shortcomings in analysis of financial factors
6. Capital adequacy	X				
7. Credit policies	X				
8. Loan evaluation		X			
9. Large exposures	X				
10. Connected lending		X			
11. Country risk	X				
12. Market risks		X			
13. Other risks		X			
14. Internal control		X			
15. Money laundering	X				
16. On-site and off-site			X		Offsite analysis is under-developed
17. Bank management contact		X			
18. Off-site data		X			
19. Validation of information		X			
20. Consolidated supervision		X			
21. Accounting	X				
22. Remedial measures		X			
23. Global consolidation		X			
24. Host country supervision	X				
25. Sup/foreign establishments	X				
1/ C: Compliant. 2/ LC: Largely compliant. 3/ MNC: Materially noncompliant. 4/ NC: Noncompliant. Source: Mission team's assessment.					



**Licensing Criteria (BCP 3)—Largely compliant**

52. The Banking Law provides the SB with broad power to issue or deny a banking license. The SB lacks formal internal procedures for evaluating new licenses, and the Regulation regarding licensing is obsolete (Acuerdo 4-81). The SB is cognizant of this issue and already has issued a draft of a new regulation for public comment.

***Recommendation***

53. The mission team encourages the SB to complete and issue its proposed regulation regarding licensing requirements and procedures.

**Ownership (BCP 4)—Largely compliant**

54. The Banking Law requires prior approval of the SB for changes in ownership of banks. However, there are no formal procedures to consider mergers, acquisitions or changes in control of banks.

***Recommendation***

55. Please refer to **BCP 5** below.

**Investment Criteria (BCP 5)—Materially non-compliant**

56. The SB has sufficient authority to review and reject proposals for the creation of new banks, or for the transfer of controlling interest in an existing bank to other parties. The mission team finds that the banking law provides broad powers to establish adequate parameters for granting new licenses or approving acquisitions of existing banks. Moreover, the team notes that there is a project underway (already issued for public comment) to update the SB's regulation for licensing, which dates from January 1981. Such Acuerdo should include, among other provisions, (i) require applicant to submit consolidated financial statements, (ii) detailed financial statement of the applicant's directors officers and large shareholders, (iii) require that effective consolidated supervision is in place in the home country, (iv) discussion of any secrecy laws of the home country and how they may limit the supervisor in obtaining relevant information, (v) source of capital, including from where did the shareholder obtain the funds, (vi) banking experience of the applicant and (vii) control systems to be put in place. While a concise regulation is a necessary part of the licensing requirements to ensure that applicants can determine the licensing requirements, there too is the need for an internal review and analysis procedure that would be used when analyzing an application for a license or an acquisition.

57. Article 67 of the Banking Law establishes that a bank may not invest more than 25 percent of its consolidated capital in any business that is not related to the banking business. Although this limitation requires a diversification of investments in equity securities, it does appear to allow a bank to reinvest its funds in equity securities without an

aggregate limit. Such lack of clear aggregate limitation has had dire consequences in other jurisdictions where the equity markets have been depressed.

### ***Recommendation***

58. The mission team considers the lack of an aggregate limitation on equity security holdings (when there is not control of the underlying enterprise) to be a weakness in the regulatory framework. To the extent that a bank has significant holdings in equity securities, a market downturn could adversely affect capital adequacy. The SB should revisit the treatment of equity investments where there is not control, and consider the application of comparable treatment as is applied to equity investments in non-financial subsidiaries, which per the capital regulation—Acuerdo 5-98—requires that the investment be deducted from capital.<sup>21</sup> Alternatively, the SB could apply a larger risk-weight to equity investments.<sup>22</sup>

59. Furthermore, more in-depth analysis is deemed necessary when a bank purchases other banks. Specifically, the analysis should be similar to the analysis for establishing a new bank which includes (i) effects on prudential indicators—primarily asset quality and capital adequacy, (ii) determination as to management competency given the increase in complexity, (iii) a determination as to whether legal requirements are met, and (iv) market and public interest considerations.

### **Loan Evaluation (BCP 8)—Largely compliant**

60. Acuerdo 6-2000 establishes clear guidelines for classification of loans and minimum reserves requirements. Acuerdo 7-2000 establishes similar requirements for investments in securities. These guidelines are consistent with international standards.

61. The SB is currently in the process of implementing a “Central de Riesgo” (a database similar to a credit bureau), which will include the details of each individual loan in the banking system. Many banks are participating in the pilot tests currently underway. The system is scheduled to be fully operational in the first quarter 2002.

---

<sup>21</sup> It appears that per the legal framework, a bank with the same party may lend to it up to 25 percent of its capital base and hold equity securities of up to 25 percent of its capital base (so long as it does not have a controlling stake). Consequently, it is possible to have a combined exposure of up to 50 percent to a single party. The substantial risk concentration to a single party would be mitigated if under the capital regulation either a larger risk weight were applied or the investment were deducted from capital for risk-based capital computation purposes.

<sup>22</sup> The SB has prepared and issued for public comment a draft Acuerdo clarifying the limitation in equity holdings in non-banking related business is on the aggregate percent of capital.

***Recommendation***

62. Please refer to BCP 16 regarding strengthening the on-site supervisory manual for specialized credit exposures.

63. The team believes that the “Central de Riesgo” will be a very valuable supervisory tool and, accordingly, encourages the SB to take all the corresponding steps to assure its successful implementation. Proper coordination between all the end users and the systems developer is necessary.

64. Once the “Central de Riesgo” is established, the off-site surveillance group should verify the calculation of banks loan loss reserves in accordance with Acuerdo 6-2000. Furthermore, the off-site supervision group should recalculate each bank’s reserves utilizing the worst classification given by any individual bank for all other loans associated with that borrower. Accordingly, the SB would have a worst-case scenario for each bank utilizing as a basis the bank with the most conservative reserving judgment or the individual loan a given borrower has lagged in his/her payment. Any bank whose reserves are substantially below the recalculated worst-case scenario should be reviewed for the appropriate verification. The team emphasizes that this type of worst-case scenario does not imply the need for additional provision as issues such as different collateral held by different institutions have a significant bearing. The worst-case scenario is a useful tool for early detection of problematic situations and analysis thereof.

**Connected Lending (BCP 10)—Largely compliant**

65. Article 64 of the Banking Law establishes clear credit exposure limitations for transactions with related parties. In essence, the Banking Law stipulates a 5 percent of capital limitation for credit exposure to individual related parties and an aggregate limitation of 75 percent of capital for all related parties. The combination of the banking law and regulations adequately define the concept of related party.

***Recommendation***

66. The mission team recommends that the SB evaluate a modification to existing regulation to require that related party transactions be extended at arm’s-length terms<sup>23</sup> and that the bank’s board of directors approve related party transactions (including loans and investments in debt and equity securities) above a certain amount.

---

<sup>23</sup> Arm’s-length terms are considered those under which a transaction in the ordinary course of business would be consummated with an unrelated party. To judge whether a transaction is done at arm’s-length, usually the supervisory authorities would compare the combination of interest rate charged, type and level of collateral required and terms of repayment of a loan to related party with loans to third parties which have similar credit risk profiles.

### **Market Risk (BCP 12)—Largely compliant**

67. The SB has issued guidance as to interest rate risk and other market risk associated with investment securities. The SB recognizes the need to improve its approaches to supervision of interest rate and other market risk more generally and is developing improved guidance.

68. As to foreign exchange, the risk in the Panamanian banking system appears to be quite limited. The SB should obtain periodic information to be able to analyze each bank's exposure and the overall exposure of the financial system.

### ***Recommendation***

69. Through off-site and on-site supervision, any interest rate risk exposure that is considered to be too large should be brought to the attention of the bank's board of directors and management for appropriate action, independent of the trigger mechanism in Resolution 2-2000. As a rule of thumb, a gap exposure in any individual category or on a cumulative basis larger than 50 percent of total capital should be further analyzed. In the analysis of the maturity gap, a portion of the demand deposits should be considered according to historical experience as medium and long term funding, though in principle demand deposits are short term.

70. The mission team supports the development and implementation of guidelines that are flexible and consider the banks' own individual asset-liability characteristics. Guidelines should address the requirement for (i) policies and procedures to control the nature and amount of interest rate risk, specifies risk limits, lines of authority; (ii) requirement for risk measurement and monitoring; and, (iii) a system of internal controls, review and audit. Last, the SB should obtain periodic information to be able to carryout surveillance and analyze bank and system exposures to market risk.

71. Require regulatory information as to financial instruments that result in foreign exchange exposure. Current information will alert the SB of a change in the profile of banks regarding foreign exchange risk.

### **Other Risks (BCP 13)—Largely compliant**

72. The SB has issued standards regarding the responsibilities of boards of directors and management for monitoring most types of risk (credit, interest rate, liquidity and market risks for example). The SB's approach is generally consistent with international practices for putting in place financial and risk control standards and ensuring compliance, though some weaknesses in certain of the risk management regulations remain.

73. Examples of other risk areas are interest rate risk (Resolution 2-2000) and the liquidity risk (Acuerdo 2-2000) standards. The mission notes that the liquidity standard (i) excludes deposits from affiliates and (ii) does not consider bank's undrawn commitments to lend. For banks that are members of a larger economic group, in which a parent bank or

home office does not further enhance their liquidity, the team recommends that the deposits received from affiliates be included in the liquidity formula.

74. Also evident is that there is not a regulation that focuses on corporate governance and internal controls, but the SB plans to issue one by end-2001. Such regulation will encapsulate the concept of obliging the board of directors and management of banks to establish clear systems of risk management to identify, measure, monitor and control risk for the entire banking operations.

***Recommendation***

75. As planned, the SB should implement a Corporate Governance Standard. (Please refer to **BCP 14** and **BCP 16**.)

76. On-site supervision should focus more resources on making sure that the individual institutions are themselves appropriately managing risk on a comprehensive and consolidated basis. These risks include credit, interest rate, liquidity, operational, market, country and foreign exchange.

77. The liquidity standard should be revisited to consider the weakness noted above. The information relating to affiliated transactions should be clearly highlighted and monitored. Liquidity ratios should also be computed for analysis purposes including all funding sources.

78. Any signs of weak liquidity on a **bank only** or on a **consolidated basis** should be thoroughly analyzed and corrective action should be promptly required. Also, as part of the on-site supervision of a bank's liquidity, the SB examiners should review the bank's management of the timing gaps in the maturities of the bank's assets and liabilities. Note that a substantial mismatching may result in future liquidity difficulties.

**Internal Controls (BCP 14)—Largely compliant**

79. The SB currently requires each bank to nominate compliance officers for specific areas of risk, and many Acuerdos relating to specific risk areas incorporate the concept of corporate governance for such individual risk. Accordingly, this principle is, to a large extent, addressed as it relates to the more important types of risk. Nevertheless, a more holistic approach is preferable, clearly defining the responsibilities of each component (Board, Senior Management, Internal Audit, etc...) and how they interrelate. The SB has issued for public comment a draft of the Corporate Governance regulation.

***Recommendation***

80. The mission team supports the SB's efforts to complete and issue its Corporate Governance regulation as planned.

### **On-site and Off-site Supervision (BCP 16)—Materially non-compliant**

81. The on-site program, which is relatively new, covers the following areas: (i) FECCI—a fiscal compliance exam, (ii) anti-money laundering, (iii) safety and soundness and (iv) trust exams. On-site comprehensive examinations covering all risk areas (including money laundering) are done at least once every two years for all banks operating in Panama.

82. The team noted substantial improvement in deployment of resources for on-site exams. The SB is currently revising its on-site examination manual, as the existing manual is quite limited. As the Superintendency has only been in existence three years, there is underway a substantial effort to train the supervision personnel, for which continued efforts will be needed to achieve full effectiveness.

83. Regarding off-site supervision, a substantial amount of information is received and analyzed. However, the analysis showed to be weak, with data quality issues also apparent. The SB is currently implementing a new off-site monitoring information system, which will provide better detail regarding the financial, legal and structure information for regulated institutions. The Directorate of Financial Analysis and Economic Studies (off-site group) intends to develop its operating manual later this year.

### ***Recommendation***

84. See recommendation for **BCP 8**.

85. The mission team recommends the SB to include specific modules within the on-site examination program. In the credit area, for example, these may include (i) commercial real estate lending, (ii) loans to Financieras, (iii) agriculture related loans and (iv) loans to Economic Groups. Modules should also cover the various other general risks such as interest rate risk, liquidity risk, operational risk and market risk. These evaluations of risk management should focus on the reasonableness of the board of directors and management's policies and controls for monitoring compliance with the Banking Law, Acuerdos and Resolutions.

86. The On-site supervisory group should make in-depth supervisory reviews of the banking system's exposure to certain large Economic Groups and large finance companies. It should be more efficient to make periodical assessment (for example once every six months) of the system's exposure to the largest economic groups, rather than make individual analysis during each bank examination. SB should implement its plan to develop specialists to supervise information systems risk. Such risk increases continuously as banks become more dependent on advanced information systems.

87. The SB's off-site supervision group is in the process of significant change, which will enhance its analysis and accordingly off-site supervision. As part of the implementation of a new information system, the SB is developing prudential indicators (capital, asset quality, liquidity, earnings) and peer groups for comparison and analysis. The team strongly encourages the new information systems projects and believes that it will be very beneficial.

88. The mission team promotes, however, that the SB stress **quality** over **quantity** in its collection and analysis of information. Please refer to **BCP 18** below. The team encourages the SB to begin with a rather simple set of peers groups, stressing the quality of a limited number of indicators and peers over complexity and quantity. In addition, the off-site supervision group should focus primarily on consolidated financial indicators of its banks, except the concept of liquidity, which must also be thoroughly analyzed on a solo basis.

89. An area of special significance is the collection of information on the local branches of foreign banks. Given the legal and structural differences between a stand-alone bank and a branch of a foreign bank, activities with affiliates becomes more important. Given the unique structure, the SB may consider specialized reporting to allow for closer monitoring of net exposures owed to or due from affiliates. The ability to monitor activities between a local branch of a foreign bank and its affiliates becomes particularly important to the extent the parent is undergoing stress or financial difficulties.

90. As to composition of subsidiaries, the data submitted should be structured and analyzed consistent with the SB's capital accord. Note that non-financial subsidiaries require a 100% capital haircut. Accordingly, analysis of the data should generally exclude the assets, liabilities and capital of such subsidiary. Notwithstanding, the SB will always have to review the subsidiary operations and make a judgment as to how such subsidiary may affect the bank's safety and soundness in the future.

91. In addition, the team stresses that on a quarterly basis the risk based capital computation submitted by the banks be thoroughly reviewed. Such computation, combined with proper provisions for loans, provides an important indication as to a bank's ability to withstand financial difficulties.

92. The team also encourages the SB to complete its operating manual for off-site supervision, which should include a standard reporting package to each user of the financial information. Users include the Superintendent, the Junta Directiva, the on-site supervision group and the general public.

### **Bank Management Contact (BCP 17)—Largely compliant**

93. Given the relatively limited number of banks operating in the Panamanian system, there is considerable contact between the senior officers of the SB and bank management. Furthermore, during the on-site examinations there is significant contact between the SB and senior management of the banks. The SB expects to examine all banks at least once every two years.

### ***Recommendation***

94. Senior personnel of the SB should consider, in conjunction with key personnel of the examination team, presenting the results of on-site examinations to the board of directors for the larger Panamanian banks and for banks with significant deficiencies. Such meetings are an opportunity to discuss the responsibilities of the members of the bank's board and

communicate directly areas of concern. In addition, it is recommended that the SB establish a policy of high-level contacts for systemically important banks for the discussion of strategic subjects in the context of risk-focused supervision.

#### **Off-site Data (BCP 18)—Largely compliant**

95. The SB has clear authority to obtain information, and does obtain vast amounts. The new system to be implemented later this year will provide additional information. The off-site supervision group analyzes the information received. The team believes that the SB will achieve more effective banking supervision by focusing more on the quality of analysis of critical information, and reducing the emphasis on the quantity of information.

#### ***Recommendation***

96. The SB should consider reducing the frequency of most reporting requirements of many balance sheet items to quarterly, with the exception of liquidity reports which should remain weekly. As circumstances may dictate, reporting frequency may be modified on an individual bank basis. A less frequent reporting would allow for greater depth to the analysis of bank indicators. To the extent that there is a problem institution, a higher frequency of reporting would be warranted, but the higher frequency should be determined on a case-by-case basis.

#### **Validations of Information (BCP 19)—Largely compliant**

97. The on-site examination program includes a step to verify that the information provided to the SB's off-site financial analysis group matches with the information in the accounting records of the bank.

98. The SB ascertains that all banks file audited financial statements within the time period established by law (three months) and verifies that such information is consistent with the regulatory information received.

#### ***Recommendation***

99. Please refer to **BCP 16** above.

#### **Consolidated Supervision (BCP 20)—Largely compliant**

100. Article 17.14 of the banking law authorizes the SB to supervise economic groups that own a bank. Article 54 authorizes the SB to request and obtain any information necessary from any bank or economic group that owns a bank. The on-site inspections now include examinations that consider the economic group on a consolidated basis. The off-site group, starting in latter part of 2000, began to obtain consolidated data and began analyzing the prudential factors on a consolidated basis.



101. The on-site supervision group is currently practicing a consolidated on-site examination that includes an on-site inspection of a bank in Costa Rica that is wholly owned by a Panamanian bank.

***Recommendation***

102. The mission team recommends that consolidated statements become the key tool for supervision, surveillance and the analysis process be oriented for the understanding of the economic group as a single organization and the effects of non-financial activities be considered in the banking system overall assessment.

**Remedial Measures (BCP 22)—Largely compliant**

103. The SB possesses adequate enforcement powers. Given the relative youth of the on-site supervisory program, the SB has had limited experience with their use. Recently, the SB appointed an Advisor to oversee the operations of a bank under distress, which appears to be a well-measured regulatory response given the circumstances.

104. The SB lacks guidelines for working with distressed entities and lacks guidelines for transferring assets and liabilities of an insolvent bank.

***Recommendation***

105. Internal guidelines should be drafted regarding the use of remedial powers. These may include (i) an informal communication to management or the Board of Directors to commit to a certain action recommended by the SB, (ii) a Memorandum of Understanding between the SB and the Board of Directors, (iii) appointing an Advisor, (iv) an Order to Cease and Desist of certain actions and require corrective action, among other. Fines as dictated by the individual circumstances may accompany the above actions. The internal guidelines should not be considered constraints for the SB, as every regulatory action is very unique.

106. Also, guidelines should be established for distressed situations, including bank liquidations. Regarding bank liquidations, the SB may consider mechanisms to immediately transfer deposits up to the \$5,000 preferential amount per depositor and a similar amount of assets to another entity or entities. By making such sale or transfer rapidly, there should be a market calming effect, as a large number of accountholders would not lose access to their funds. However, clarity of the process and legal considerations must be carefully studied as unsecured creditors and depositors (for their amounts above the preferential amount) many times file civil suits against the liquidator.

**Global Consolidation (BCP 23)—Largely compliant**

107. Article 30 of the Banking Law establishes that the SB will supervise the Panamanian banks on a consolidated basis. Article 31 of the Banking Law states that the SB will enter

into agreements with foreign banking supervisors in order to achieve consolidated supervision.

108. To date the SB has signed agreements with Costa Rica, Ecuador, El Salvador and Peru. The SB is currently in the process of negotiating agreements with many jurisdictions including all home countries of any bank with significant presence in Panama.

109. Also see **BCP 20**.

### ***Recommendation***

110. The SB has the necessary powers to oversee on a consolidated basis the foreign activities of Panamanian banks and is working to put in a place a program of consolidated supervision. The SB should consider participating in the examinations of the foreign offices of Panamanian banks conducted by host supervisors.

## **B. Anti-Money Laundering**

111. The authorities and the banking industry are very aware of the prudential risks associated with money laundering and have in place adequate safeguards to deter improper use of the banking system for illegal purposes. While no system is infallible, the mission team concludes that the legal, regulatory and supervisory systems in place in the banking sector compare favorably with internationally accepted prudential supervision practices. The team's review was confined largely to banking and trust activities, which fall under the supervision of the SB. The legal and regulatory requirements are strict and many requirements exceed those in place in industrial countries.

112. The mission team's evaluation of the prudential aspects related to anti-money laundering followed the assessment guidance set out in the Basel Core Principles and the accompanying methodology. Specifically, core principle 15, which draws on the 1988 Basel Committee of Bank Supervisors document: "Prevention of Criminal Use of the Banking System for the Purpose of Money Laundering". The guidance included specific criteria for assessing prudential factors related to "know your customer" requirements, suspicious transaction reporting, and sharing of information with law enforcement agencies, both domestic and foreign.

113. Though the team's primary AML focus was confined to the banking sector, the strong commitment by government and industry toward putting in place an effective anti-money laundering program was evident. The concerted focus by the authorities to put in place its anti-money laundering program came in response to the listing by Financial Action Task Force, which in June 2000 considered Panama to be "non-cooperative" in the fight to combat money laundering.<sup>24</sup> The FATF cited four principal shortcomings: (i) failure to criminalize

---

<sup>24</sup> The Financial Action Task Force is made up of 29 member countries and territories, primarily composed of OECD members; the Secretariat is based at the OECD.

money laundering for crimes other than drug trafficking; (ii) inefficient reporting of suspicious transaction reports to competent authorities; (iii) overly restrictive rules for international information exchange; and (iv) civil law provisions that impeded the identification of the true beneficial owners of trusts.

114. To address the FATF's criticisms, the authorities, with the strong support of the banking industry, quickly acted to enact laws 41 and 42 in October 2000. (See Box 1—anti money laundering legislation.) The new laws criminalized the laundering of proceeds from fraud, extortion, embezzlement, corruption of public officials, kidnapping, terrorism and theft or trafficking in vehicles or weapons. In addition, they streamlined the reporting of suspicious transactions to the competent authorities and facilitated the exchange of information with other governments.<sup>25</sup> Lastly, the laws expanded the SB's ability to examine anti-money laundering compliance by trust companies. The new legislation gives the SB broad authority to use the means necessary to ensure that banks and trust service providers comply with the law, including the authority to issue regulations intended to deter money laundering.<sup>26</sup>

115. At the center of the anti money laundering program is the Financial Analysis Unit (UAF), which is Panama's financial intelligence unit attached to the Council of Public Security and National Defense. The UAF's functions include (i) receiving and analyzing currency transactions and suspicious transactions reports from all financial institutions and other entities covered by Law 42,<sup>27</sup> (ii) communicating the results of such analysis to the Attorney General's Office, (iii) exchanging information with homologous entities from other countries, (iv) exchanging information with the regulators (SB and Comisión Nacional de Valores) and the Attorney General's Office and (iv) assisting the regulators and the Attorney General in providing and analyzing intelligence information in penal or administrative proceedings.<sup>28</sup> The mission team did not review the activities of the UAF, as its purpose is to

---

<sup>25</sup> Executive Decree No. 163 authorizes the government to exchange information regarding suspicious activity with counterparts in foreign jurisdictions so long as there is a Memorandum of Understanding in place.

<sup>26</sup> The SB issued Acuerdo 9–2000 as an implementing regulation for the new law.

<sup>27</sup> Reporting required for (i) deposits or withdrawals of cash larger than 10,000 balboas or structured transactions within a short period of time that in the aggregate exceed 10,000 balboas, (ii) exchanges of bills, lottery tickets, checks, manager checks, traveler's checks or payment orders in low denominations for higher denominated instrument exceeding 10,000 balboas, or vice versa, (iii) money orders issued to bearer or with blank endorsement, individually or that in the aggregate in a short period of time exceed 10,000 balboas.

<sup>28</sup> See Executive Decree No. 163 of October 3, 2000

coordinate information sharing for law enforcement purposes. However, the team reviewed the nature of transaction and suspicious activity reporting to the UAF.

**Box 1. Panama: Anti-money laundering legislation—laws 41 and 42 (October 2000)**

Law 41 and 42 were passed in October 2000. Law 41 criminalized the laundering of proceeds from fraud, extortion, embezzlement, corruption of public officials, kidnapping, terrorism and theft or trafficking in vehicles or weapons. Law 42 required that banks, trust companies, currency exchange offices, money transfer service providers, finance companies, broker/dealers, securities clearing houses, credit unions, among other, to conduct their business with due diligence and care conducive to prevent money laundering. The persons covered by the law must:

- Identify adequately their clients.
- File with UAF the corresponding declarations.
- Communicate to UAF any suspicious transactions.
- Abstain from divulging to clients that a suspicious activity report was filed with UAF.
- Establish internal control procedures to prevent money laundering.
- Take corresponding steps to ensure that their employees understand the requirements of the law, and know how to detect suspicious transactions.
- Conserve for five years related documentation.

Law 42 authorized the SB and other supervisory entities to share information with the UAF and gave special inspection powers to the SB, the Superintendency of Insurance and the National Securities Commission to inspect and verify compliance with laws and regulations. Law 42 also establishes as a precondition for securities to trade on an exchange that they be in book-entry form clearly identifying the beneficial owner.

### **Supervisory program for the banking activities**

116. The SB's anti-money laundering program has two primary focuses: (i) know your customer (KYC) compliance and (ii) suspicious activity reporting. Compliance with laws, regulations and banks' own policies is verified through onsite inspections. KYC requirements apply to individuals and corporations, including bearer share companies. Other areas reviewed by the SB are records retention practices,<sup>29</sup> the adequacy of anti-money laundering training and banks' own internal anti-money laundering policy. The inspection work papers evidenced that the SB's inspectors are reviewing compliance with KYC and other reporting requirements. The reports cite actual violations and mandate corrective action. Instances of noncompliance with Panama's anti-money laundering laws are brought to bank management for prompt correction.

---

<sup>29</sup> By law, banks are required to maintain customer documentation for a minimum of five years. This requirement applies to closed as well as active accounts.

117. The SB has in place a well-developed module to verify that banks have implemented fully the requirements of the laws and regulation for anti money laundering. The program includes a regimen of transaction sampling to ensure banks are indeed complying with the “know your customer” requirements, as well as to ensure that there is proper reporting to the UAF of currency transactions over 10,000 balboas or other suspicious transactions. For the year 2001, the SB is projected to complete reviews of anti-money laundering compliance in the course of 38 examinations of banks and 17 examinations of trust companies

118. The resource commitment by the SB towards anti-money laundering shows in the detailed coverage in inspection reports and inspection work papers. In the mission’s view, the level of supervision dedicated to anti-money laundering is exceptional and under different circumstances disproportionate relative to the risk posed by money laundering.

119. Following the passage of laws 41 and 42, the SB issued Acuerdo 9-2000, which specified the types of transactions that must be reported to the UAF consistent with the law. In addition, the Acuerdo stipulated fines ranging from 5,000 to 1 million balboas for non-compliance with legal requirements.<sup>30</sup> Other important features of 9-2000 require that the banks:

- Reaffirmed the requirement for know your customer and that it include beneficial owners of companies and trusts.
- Establish a profile of their clients where transactions are likely to exceed 10,000 balboas.
- Adopt a “Know your customer” manual for the prevention of money laundering.
- Document the above steps.
- Have policies and procedures which clearly identify counter parties in purchase and sales of securities, including transactions executed on behalf of customers.
- Train personnel in the prevention of money laundering.

120. In December 2000, the SB issued Acuerdo 10-2000, which required that each bank have an anti-money laundering compliance program commensurate with its structure, resources and complexity. The Acuerdo also required all banks to designate at least one compliance officer for anti-money laundering compliance. The SB’s regulations are further augmented by a complementary code of conduct for managing checks, negotiable instruments and money transfers that was prepared and self-imposed on the system’s banks by the two banking associations.

121. Panama is a member of the Caribbean Financial Action Task Force (CFATF) and the Egmont Group. A team from CFATF members has conducted a mutual evaluation of Panama’s compliance with the FATF and CFATF anti-money laundering

---

<sup>30</sup> Executive Decree No. 1 of January 3, 2001 establishes the duty of the supervisory entities with regard to reporting of operations in cash and other means of payment, and the power to impose fines for non-compliance of their duties.

recommendations.<sup>31</sup> The Egmont Group is an association of “financial intelligence units” (FIU). An FIU is responsible for receiving, analyzing and disseminating financial information concerning suspicious transaction reports.

### **Supervisory program for trust activities**

122. The mission team reviewed the newly established program for the onsite inspection and offsite monitoring of trust activities. By law, the SB is responsible for the supervision of trust service providers, which primarily are banks, though other participants include law firms, insurance companies and other non-bank financial institutions. Active supervision of trust activities in Panama got underway in the fourth quarter 2000, following the passage of new legislation that granted the SB requisite legal authority.

123. The new powers include full access to customer information when conducting onsite inspections. Key laws and regulations empowering the SB to undertake inspection of trust activities included the following:

- Executive Decree No. 213 of October 3, 2000 establishes the powers of the SB to carry out inspections and gather documents related to trust activities.
- SB’s circular letter FID No. 3–2000 of December 4, 2000 requires trust companies to comply with the “Know your customer” rules set out by the SB.
- The SB created, during the latter part of year 2000, the specialized Trust Unit to undertake inspections of trust activities. The Trust Unit performs onsite exams of the trust activities.

124. Executive Decree #16 of October 3, 1984 as amended, provides adequate powers to the Superintendency. These include the power to issue fines of up to B/.50,000 (Article 30) and the power to (i) require corrective action, (ii) suspend or (iii) cancel a trust license depending on the severity of the violations (Article 18). The Superintendency may also take control and administer a trust company.

125. To carryout the inspections, the SB established the trust examinations unit and undertook a capacity building/training effort for the new unit’s inspectors. An inspection procedures manual was prepared that set out procedures for (i) pre-inspection planning and analysis, (ii) onsite inspection requirements and (iii) preparation of the inspection report and follow-up. The manual, which was prepared with the assistance of an external advisor, includes a questionnaire, and establishes the internal control requirements. Key considerations to the inspection process are directed to anti-money laundering compliance.

---

<sup>31</sup> The CFATF is a regional anti-money laundering group modeled after the FATF. Their activities include conducting mutual evaluations of members, training activities and technical assistance programs.

126. At end-2000, there were 46 trust administrators, with assets under administration of \$1.1 billion. Trust services are highly concentrated among only a few providers, with the ten largest administrators responsible for 79 percent of the aggregate assets. The largest participant is one European bank that has over 30 percent of total administered assets. In terms of entity types providing trust services, there are 30 banks, five law firms, two insurance companies and nine other non-bank financial institutions.

**FATF's June 2001 updated report on Non-cooperative Countries or Territories**

127. On June 22, 2001 the FATF issued a report titled "Review to Identify Non-Cooperative Countries or Territories: Increasing The Worldwide Effectiveness of Anti-Money Laundering Measures" ("FATF Updated Report"). Paragraphs 33 and 34 of FATF Updated Report state:

"Panama has made important progress in terms of the implementation of its new anti-money laundering regime. It has a well-developed anti-money laundering supervision programme and has significantly increased the human and financial resources dedicated to its Bank Superintendency and financial intelligence unit. It has enhanced its ability to co-operate internationally, and has actively sought to enter into written agreements with FATF members and other countries to provide for international FIU co-operation. Several such written agreements have been signed.

In the future, FATF will pay attention to Panama's continued efforts to enter into written agreements for FIU co-operation, its continued practice of international co-operation and its focus on potential money laundering threats in the Colon Free Zone, the ability of Panamanian prosecutors to effectively pursue money laundering cases and further efforts to enhance compliance by the financial sector with the new anti-money laundering requirements. Additionally, Panama should consider adding additional predicates with its money laundering law."

128. Given Panama's "important progress" and its "well-developed anti-money laundering supervision programme" FATF removed Panama from the list of Non-Cooperative Countries and Territories.

### Principle-by-Principle Assessment

129. This annex provides a principle-by-principle discussion of Panama's compliance with the core principles with regard to the supervision of banks by the Superintendency of Banks. The assessment takes account of the additional criteria.

#### Principle 1 (1): Objectives

130. *An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banks.*

131. **Description:** The Banking Law (Decree law number 9 of February 26, 1998) establishes that the Superintendency of Banks is the sole entity with the authority and responsibility to supervise banks. The Banking Law and the Regulations (Acuerdos and Resolutions) very much consider the key concepts from the Basel Core Principles.

132. The Superintendent has the faculty to intervene banks for orderly resolution of problems, which may range from the ordering early remedial measures to ordering the closure and liquidation of an institution.

133. The Banking Law is considered current as compared to international standards. In addition, the Board of Directors (Junta Directiva) of the SB is vested with the power to issue Acuerdos consistent with the Banking Law. The Junta Directiva has been quite active issuing Acuerdos and, accordingly, the regulatory framework has been updated on a continuous basis.

134. The SB, via its website ([www.superbancos.gob.pa](http://www.superbancos.gob.pa)) publishes industry data, including the balance sheet and income statement of individual banks. The website also includes information on the legal and regulatory framework and other issues of interest relating to the SB.

135. **Assessment:** Compliant. The essential criteria are clearly met. Laws and regulations provide an adequate framework for prudential operation of banks and prudential supervision thereof. The SB is the sole bank supervisor, and the Banking Law clearly establishes the SB's objective. Recently it utilized its authority by designating an Advisor in a bank. The SB has wide authority to adopt new regulations through the issuance of Acuerdos.

#### Principle 1 (2): Independence

136. *Each such agency should possess operational independence and adequate resources.*

137. **Description:** Article 4 of the Banking Law creates the SB as an autonomous entity of the state with its own legal standing and its own fiscal resources.

138. In accordance with Article 9 of the Banking Law, the Superintendent is designated for a five-year term by the Executive Branch, and may not be removed except via an order of the



Supreme Court for due cause as detailed in the statute. The members of the Junta Directiva are nominated for eight year terms, and can only be removed for due cause via the same judicial procedure.

139. There appears to be no interference by the government or industry in the operational independence of the agency. The Junta Directiva oversees certain aspects of the Superintendency, though for supervisory action, the Superintendent is independent.

140. Article 19 of the Banking Law establishes that the banks will pay annual regulation and supervision fees based on the type of license, plus an additional amount based on each bank's total assets. This article establishes a maximum of \$100,000 for the additional portion. Article 19 also provides that the Superintendent may increase or decrease fees to adequate levels in order for the Superintendency to comply with its functions in a reasonable and efficient manner.

141. **Assessment:** Compliant. Essential and Additional Criteria are clearly met. The SB has issued multiple fines and has taken various important regulatory measures without any interference. The SB has adequate financial resources, which has allowed the SB to pay competitive salaries resulting in a very low turnover rate. Also, the SB has adequate facilities and equipment.

142. The SB may consider eliminating the maximum of \$100,000 as the consolidation process in the industry may result in substantial decreases in revenues. In addition, for large and complex institutions, the maximum fee may not be enough to compensate for the direct and indirect costs associated with supervising such institutions, especially as the SB is conducting onsite supervision of Panamanian banks in foreign jurisdictions.

### **Principle 1 (3): Legal Framework**

143. *A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their ongoing supervision.*

144. **Description:** Article 17.1 of the Banking Law stipulates that the Superintendent has the faculty to grant banking licenses for banking operations in Panama. Article 38 states the reasons for which the Superintendent may cancel a banking license.

145. Article 16 of the Banking Law stipulates the faculties of the Junta Directiva. Among such faculties is the power to issue prudential rules (Acuerdos) for the safety and soundness of the banking system.

146. Article 54 empowers the SB to require banks and Economic Groups who own a bank any information regarding their operations and activities.

147. **Assessment:** Compliant. This principle is fully compliant as the necessary legal framework is in place.

#### **Principle 1 (4): Enforcement Powers**

148. *A suitable legal framework for banking supervision is also necessary with regard to powers to address compliance with laws as well as safety and soundness concerns.*

149. **Description:** The Banking Law provides the SB with broad supervisory powers to ascertain compliance with applicable laws and regulations and to ensure that the banks are operated in a safe and sound manner. The SB may apply qualitative judgments as the circumstances dictate. The SB has unfettered access to banks' files in order to review compliance with internal procedures as well as applicable laws and regulations.

150. The SB has broad powers to require a bank to take remedial action and impose sanctions.

151. **Assessment:** Compliant. The Banking Law provides the SB with extensive powers to address compliance with laws and regulations as well as safety and soundness concerns.

#### **Principle 1 (5) Legal Protection for Banking Supervisor**

152. *A suitable legal framework for banking supervision is also necessary, including ... legal protection for supervisors.*

153. **Description:** Executive Decree 49 of 1998 establishes a veracity presumption in favor of the supervisory personnel as to their declarations. Specifically, the executive decree states:

"Las actuaciones del personal supervisor de la Superintendencia de Bancos en cumplimiento de sus funciones, hacen fe pública y lo que señalen sus declaraciones será considerado como verdadero, correspondiendo la carga de la prueba a quien asegure lo contrario."

154. However, neither the Banking Law nor the Executive Decree provide for payment of legal expenditures or explicit protection for personnel of the SB when sued in their official capacity.

155. **Assessment:** Largely complaint—efforts to achieve compliance are underway. The current legal framework does not provide adequate statutory protection to the supervisor, which may cause a chilling effect in the event of future lawsuits filed against the SB.

156. The authorities should consider amending the Banking Law to provide for legal protections against civil suits brought against SB employees (including Board members) for actions taken in their official capacity and in good faith.

#### **Principle 1(6): Sharing Information and Confidentiality**

157. *Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.*

158. **Description:** Article 4 of Law 36 of 1995 authorizes the SB to collaborate with the “Unidad de Analisis Financiero”, which is the central unit that analyzes the currency transactions and suspicious transactions reports.

159. In accordance with Article 264 of Decree Law 1 of 1999, the Comisión Nacional de Valores may solicit assistance to the SB in relation to securities issues of a bank.

160. Article 17.29 of the Banking Law authorizes the SB to establish systems of cooperation with foreign supervisors to strengthen control mechanisms and share useful supervisory information. Article 31 of the Banking Law states that the SB will enter into memoranda of understandings with foreign banking supervisors to allow consolidated supervision based on the principles of reciprocity and confidentiality.

161. **Assessment: Complaint.** The Banking Law provides the adequate authority to share information and requires that both parties maintain the corresponding level of confidentiality. The SB has recently signed memoranda of understanding with four Latin American jurisdictions to share supervisory information, and has been actively seeking to finalize agreements with an additional sixteen jurisdictions where the SB is either a Home or Host supervisor in relation to such foreign supervisor.

## **Principle 2: Permissible Activities**

162. *The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word “bank” in names should be controlled as far as possible.*

163. **Description:** Article 3.3 of the Banking Law defines the term “bank” as any person that engages in the business of banking. “Business of banking” is defined in Article 3.16 as the operation of capturing financial resources from the public or from financial institutions via time or demand deposits, or other mechanism authorized by the Banking Law; and the use of such funds by the bank for loans, investments or other operations authorized by the Banking Law or by the SB.

164. The Panamanian Banking Law is modeled after the “universal banking” concept whereby banks may engage in a relatively wide variety of activities. The Banking Law limits the investments in individual non-banking businesses to 25 percent of the bank’s capital.

165. Article 24 of the Banking Law limits the use of the word “bank” for entities engaged in the business of banking. The word “bank” may also be utilized by national and international institutions that provide humanitarian type assistance or governmental entities that provide social interest type financing.

166. Article 21 of the Banking Law states (with the exception of state banks) that only banks licensed by the SB may engage in the business of banking. Accordingly, the taking of deposits from the public is strictly limited to banks.

167. **Assessment: Complaint.** The Banking Law defines the word bank and the business of banking in accordance with the universal banking model. See related issue regarding banking powers BCP 5. The use of the word “bank” is adequately protected by statute to avoid public confusion.

### **Principle 3: Licensing Criteria**

168. *The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the banking organization’s ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base; where the proposed owner or parent organization is a foreign bank, the prior consent of its home country supervisor should be obtained.*

169. **Description:** In accordance Article 17.1 of the Banking Law, the Banking Superintendent has the authority to approve the issuance of a banking license. Article 33 of the Banking Law provides the general criteria for the analysis of license applications. Acuerdo 4-81 provides more detailed guidance as to licensing, however it is relatively weak as to establishing adequate requirements. The Superintendent has the discretionary faculty to reject any license application. In addition, the SB may cancel a license if, after issuance, it is revealed that false information was included in the application.

170. Article 23 of the Banking Law requires foreign banks to obtain a previous authorization of its home supervisor to establish banking operations in Panama. In addition, when the license applicant is not Panamanian, the applicant must be a bank branch, subsidiary or affiliate of a foreign bank group.

171. Article 42 of the Banking Law establishes the minimum capital requirements for new banks.

172. **Assessment: Largely compliant—efforts to achieve compliance are underway.** The Banking Law provides the SB with adequate power to evaluate a licensing transaction and determine whether to approve or reject the licensing request. The regulation regarding licensing, Acuerdo 4-81 is obsolete. The SB recognizes the need to replace Acuerdo 4-81 with a new Acuerdo detailing the steps to be taken by the entities soliciting a license and the general criteria to be utilized in the analysis. In addition to a new regulation, the SB needs to draft internal procedures to be utilized when analyzing an application for a license or an acquisition. Note that ultimately the SB must have the discretion of rejecting a license request. The SB recently issued for public comment its new Licensing regulation.

173. In reviewing a recent transaction whereby one Panamanian bank purchased another, the transaction resulted in a noticeable reduction of capital as compared to the capital of both entities before the transaction. The SB should, as part of its evaluation of its new procedures for licensing, implement procedures to consider mergers and acquisitions.

#### **Principle 4: Ownership**

174. *Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.*

175. **Description:** Article 17.6 of the Banking Law vests upon the Superintendent the authority of approving the acquisition or transfers of shares of banks, or shares of Economic Groups that control a bank. Acuerdo 3-81 requires Panamanian banks to obtain the SB's approval prior to transferring ownership of shares, independent of the concept of control.

176. For transactions of banks on the stock exchange, the SB requires the banks to communicate the significant ownership transfers to a limited group of persons, in order to determine whether to ratify the transfer or to instruct the bank to purchase the shares that are in a given persons' name.

177. The SB also requires banks to communicate any changes in the ultimate owners of the bank, including when the bank is controlled by a holding company.

178. **Assessment:** Largely complaint—efforts to achieve full compliance are underway. The Banking Law and Acuerdo 3-81 clearly establish the requirement of obtaining approval prior to transferring ownership of shares. The SB has the legal authority to approve or reject the any requests.

179. However, SB lacks a formal process to consider mergers, acquisitions or changes in control. Please refer to BCP 5 below.

180. In addition, SB may consider issuing guidelines as to only requiring approval for transfers of significant ownership of shares.

#### **Principle 5: Investment Criteria**

181. *Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.*

182. **Description:** Acuerdo 7-2000 of July 19, 2000 requires each bank to have a manual for Investments in Securities which must include (i) policies and procedures, (ii) controls to administer the risk, recording and classification of investment securities, (iii) methods and procedures for valuation and (iv) internal controls to monitor and verify compliance with this requirement. Acuerdo 7-2000 establishes that the Board of Directors and management are responsible to formulate and monitor the execution of the policies and procedures. Such policies must include clear guidelines as to maximum levels of exposure to types of financial instruments and approval limits.

183. Article 67 of the Banking Law establishes that a bank may not invest more than 25 percent of its consolidated capital in any business that is not related to the business of

banking. Although this limitation requires a diversification of investments in equity securities, it does allow a bank to reinvest its funds in equity securities without an aggregate limit. Banks may own non-financial subsidiaries, however, such investments are reduced from capital as part of the risk based capital computation. Note that for investments in equity securities, which do not represent a non-financial subsidiary, the risk-based capital required is 8 percent.

184. Credit concentration limits as to lending and investing in debt securities of a single issuer (including Economic Groups) are clearly established. Also, credit concentration limitations regarding loans and investments in debt securities of related parties (directors, officers, affiliate and large shareholders) are clearly established in the Law and Acuerdos.

185. **Assessment:** Materially non-compliant—efforts to achieve compliance are underway.

186. The Law and Acuerdos do not set specific parameters for permissible investments. Accordingly, the investment portfolio of banks may include a wide variety of instruments. Furthermore, there is no aggregate limitation on equity security holdings, as long as the bank's individual investments in an enterprise is within the 25 percent investment limitation. In the event that a bank purchases substantial amounts of highly volatile instruments, it may be unduly exposed to market risk.

187. The SB's Capital Regulation, Acuerdo 5-98, requires banks to deduct from capital their investments in non-financial subsidiaries. However, for all other equity investments, there is no capital haircut requirement. The mission team recommends that the SB consider applying a more consistent treatment for capital haircuts for all types of equity investments. Capital haircuts are not considered necessary for investments in financial subsidiaries and other entities where the value of the investment is guaranteed. In the event that the SB decides to broaden the capital haircut concept, its implementation should allow a gradual transition.

188. Also, the 25 percent single borrower lending limit and the 25 percent limitation on investments in a single enterprise appear to not be inter-related, which would appear to allow a concentration of 50 percent of the bank's equity in one counter party (25 percent in debt and 25 percent in equity). The mission team recommends that the SB analyze this issue in further detail.

189. Regarding mergers and acquisitions, the Banking Law requires the SB's authorization prior to transferring ownership of shares. In a recent transaction, the team noted that as part of a bank acquisition there was a noticeable capital reduction. The team believes that such transactions need to be evaluated more carefully prior to issuing the approval.

### **Principle 6: Capital Adequacy**

190. *Banking supervisors must set minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing*

*in mind its ability to absorb losses. For internationally active banks, these requirements must not be less than those established in the Basel Capital Accord.*

191. **Description:** Article 45 of the Banking Law establishes that general license banks must maintain at least an eight percent risk weighted capital, consistent with internationally accepted standards. Acuerdo 5-98 details the different risk weightings as well as the procedure for the risk based capital computation. It includes a risk weighting for off-balance sheet risks. The methodology and formula are modeled to a large extent after the Basel Capital Accord and compliance is required from a consolidated perspective.

192. The banks operating pursuant to an International license must also comply with the risk-based capital standard, except for branches of foreign banks, which instead are to comply with the capital requirements of their respective Home supervisor.

193. The concept of capital is clearly and adequately defined.

194. The SB may increase the minimum eight percent risk based capital requirement if the SB considers such a change convenient. Furthermore, the SB has broad powers to require banks to take steps to fully comply with the minimum capital requirement. The SB may intervene a bank whose risk-based capital is below the minimum legal requirement.

195. The SB requires banks to report their risk based capital computation (from a consolidated perspective) on a quarterly basis.

196. **Assessment:** Compliant. The capital standards included in the Banking Law and Acuerdos are consistent with the Basel Capital Accord.

### **Principle 7: Credit Policies**

197. *An essential part of any supervisory system is the independent evaluation of a bank's policies, practices and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios.*

198. **Description:** Acuerdo 6-2000 requires each General license bank to adopt an adequate system for credit administration. Banks are required to have a credit manual that includes the process of administration and control of credit risk. Such manual is to address each phase of the credit cycle which includes (i) initial analysis and disbursement, (ii) credit administration and (iii) recovery procedures. These policies for the administration and control of credit risk are to be approved by the Board of Directors and/or management.

199. The SB requires that a unit, independent from the loan origination functions, be responsible for the evaluation and classification of loans. Acuerdo 6-2000 requires banks to classify their loan portfolio within five categories (Normal, Special Mention, Substandard, Doubtful and Loss). Details of such classification are reported to the SB on a quarterly basis.

200. Acuerdo 7–2000 of July 19, 2000 requires each bank to have a manual for Investments in Securities which must include (i) policies and procedures, (ii) controls to administer the risk, recording and classification of investment securities, (iii) methods and procedures for valuation and (iv) internal controls to monitor and verify compliance with this requirement.

201. Acuerdo 7–2000 establishes that the Board of Directors and management are responsible to formulate and monitor the execution of the policies and procedures. Such policies must include clear guidelines as to maximum levels of exposure to types of financial instruments and approval limits.

202. The SB includes as part of its onsite supervision program reviews the banks' Credit and Investment policies and procedures, and verifies compliance therewith.

203. **Assessment:** Compliant. The SB's Acuerdos and onsite supervision program cover the essential requirements of this principle, as the banks must establish credit and investment policies and procedures as well as a structure to ascertain its compliance. As to investments in equity securities, please refer to **BCP 5**. Also, please refer to **BCP 14** regarding recommendations as to Corporate Governance.

### **Principle 8: Loan Evaluation**

204. *Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and reserves.*

205. **Description:** Acuerdo 6-2000 requires all banks to classify their loan portfolio within five categories (Normal, Special Mention, Substandard, Doubtful and Loss). Clear guidelines as to the definition of each category are included in the Acuerdo, as well as specific minimum reserves required for each classification. The classifications are based on (i) the borrower's financial condition and repayment capacity, (ii) the assessment of the borrower's operational cash flow, (iii) the market value of the collateral and its potential realizable value and (iv) delinquency. Special provisions apply to renegotiated loans to ascertain that a renegotiation does not result in an immediate upgrade in classification.

206. Banks are required to have reserves amounting to the higher of (i) the result of categorizing the loans in the five groups and applying the reserves required per group, or (ii) 1 percent of total loans. The SB may require higher reserves as circumstances may dictate. The Banks must review their loan portfolio at least quarterly and report its classification and calculation for reserves for loan losses to the SB within the first ten days following the quarter end.

207. In addition, the Acuerdo provides for the reporting of loans as past due (morosos) and non-performing (vencidos). Furthermore, the Acuerdo establishes guidelines as to when a loan should be placed on non-accrual status.



208. Article 16 of Acuerdo 7–2000 requires each bank to recognize provisions for doubtful accounts on investment securities (i) which are delinquent, (ii) where there is a high probability that the issuer will default, or (iii) where an important deterioration has occurred as to foreign exchange and/or country risk.

209. The SB includes as part of its onsite supervision program reviews the banks' Credit and Investment policies and procedures, and verifies compliance therewith.

210. The SB is currently in the process of implementing a "Central de Riesgos", which will include the details of each individual loan in the banking system. The system is scheduled to be fully operational by the end of the first quarter 2002.

211. **Assessment:** Largely compliant—efforts to achieve full compliance are underway. The Acuerdos established by the SB are generally consistent with international standards. However, the SB lacks examination guidelines for specialized credit risks (commercial real estate, agriculture, finance companies, among other). Also, the Acuerdos do not cover off-balance credit risk such as financial guarantees and undisbursed lines of credit. Please refer to **BCP 16** regarding strengthening on-site supervision.

212. The team believes that the "Central de Riesgo" will be a very powerful supervisory tool and should greatly enhance the credit risk monitoring by the SB.

### **Principle 9: Large Credit Exposure Limits**

213. *Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.*

214. **Description:** Banking Law (DL 9/98–Article 63) and SB regulation (Acuerdo 1/99) establish a credit exposure limit to a single borrower and its related economic group to 25 percent of the consolidated bank capital. The definition of economic group includes individuals or firms whose interests are interrelated in the level that they can be understood as a single entity. The above-cited by-law provides detailed definition, requirements of internal control of the exposures and restrictions.

215. There is a quarterly collection of information of loans to economic groups and related parties for off-site analysis. In addition, the credit portfolio is examined during the onsite inspections.

216. **Assessment:** Compliant. The exposure limit for a single borrower, issuer or a group related borrowers or issuers is appropriate and monitored both offsite and through the on-site inspection process. The definition for related parties to an economic group for purposes of establishing the single borrower is set out by the legal framework, but the SB has further discretion to determine case-by-case instances of when there are additional individuals or firms that should be considered for inclusion within an economic group. The ongoing effort

to put in place the credit risk information center will improve the ability of the SB to monitor large credit exposures to single borrowers and related economic groups.

### **Principle 10: Connected Lending**

217. *In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's-length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risk.*

218. **Description:** Article 64 of the Banking Law establishes clear credit exposure limitations for transactions with related parties, which in essence establishes an individual limit of 5 percent of capital and an aggregate limitation of 75 percent of capital. Related parties include directors, officers, entities where a director of the bank owns more than 5 percent of common shares, shareholders that own 5 percent or more of the bank, spouses of related parties, among other. The SB, via Article 7 of Acuerdo 2-99, may declare the existence of a related party when the substance of the transaction is that the real beneficiary is a related party.

219. The SB requires quarterly reports detailing related party transactions, which includes details of the Economic Groups of the related party.

220. Neither the Banking Law nor the Acuerdos prohibit providing preferential treatment to related parties. The Banking Law does not require that transactions with related parties be subject to approval by the Board of Directors.

221. **Assessment:** Largely compliant- efforts to achieve full compliance are underway. The Banking Law and related Acuerdos clearly establish limitations for extending credit, including investing in debt securities, to a person considered a related party. The SB monitors the related party transactions via a combination of offsite quarterly reporting and onsite inspections.

222. The mission team recommends that the SB consider requiring that all related party transactions be extended on arm's-length terms and requiring Board of Directors to approve related party loans and investments above a certain amount.

### **Principle 11: Country Risk**

223. *Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining appropriate reserves against such risks.*

224. **Description:** The context of the country risk exposure by Panamanian banks is lower because of the type of the exposure, which is largely limited to two forms (i) short-term trade and bank credit, and (ii) exposures by the local office to borrowers in its home country. The

SB by regulation (Resolution 7–2000) requires that banks have effective policies and procedures in place for identifying, managing, quantifying and controlling country risk exposures. The regulation establishes specific responsibilities for banks’ boards of directors and management, who are required to put in place policies for risks regarding deposits, investments in securities and credit exposures placed in other countries. Policies must establish a definition of geographical distribution, levels for credit exposures and criteria for evaluating the country risk, based on international credit risk agencies, and provisioning policies.

225. The framework also establishes a reporting requirement that allows the SB to monitor country exposure information for offsite analysis purposes. Compliance with Resolution 7–2000 is reviewed in conjunction with on-site examinations, with emphasis on analysis of country risk policies and establishment of limits on exposures.

226. **Assessment: Compliant.** The regulation establishes minimum requirements for the establishment of policies and procedures and the onsite inspection process reviews the adequacy of the policies and procedures and their implementation.

### **Principle 12: Market Risks**

227. *Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor and adequately control market risk; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.*

228. **Description:** Market risk represents the risk of loss of value of financial instruments resulting from changes in market prices. Fluctuations in interest rates and foreign exchange rates in most institutions are the most significant factors affecting market risk.

229. The Junta Directiva has the legal authority to require reserves to cover credit and market risk as detailed in article 16 of the Banking Law.

230. Acuerdo 7–2000 of July 19, 2000 requires each bank to have a manual for Investments in Securities which must include (i) policies and procedures, (ii) controls to administer the risk, recording and classification of investment securities, (iii) methods and procedures for valuation and (iv) internal controls to monitor and verify compliance with this requirement.

231. Acuerdo 7–2000 establishes that the Board of Directors and management are responsible to formulate and monitor the execution of the policies and procedures. Such policies must include clear guidelines as to maximum levels of exposure to types of financial instruments and approval limits.

232. General Resolution 2–2000 regulates interest rate risk management utilizing a gapping type method. The Resolution requires each bank to have an Asset Liability Management Committee to manage the institution’s interest rate risk. The gapping method

stipulated subdivides the assets and liabilities in eight categories in accordance with their repricing terms. Banks are required to estimate the effect on net interest income relating to each of the eight categories assuming a 100 and a 200 basis point increase and decrease in interest rates. The Resolution states that if net interest income for one or more of the categories varies, as compared to the prior semester, by more than 10 percent of capital, then the Bank must adopt the corrective measures indicated by the Superintendent.

233. The SB recognizes that the 10 percent trigger in Resolution 2-2000 is focused on historical experience as compared to forward looking. Thus, the SB is in the process of preparing guidance to mandate that banks perform additional analysis employing other risk measurement methods.

234. The new information system, expected to be fully implemented by the first quarter 2002, which will include significant details of each interest generating asset and liability, should enable the Superintendency to have the ability to run multiple interest rate models with the regulatory information received on a quarterly basis.

235. Regarding foreign exchange risk, the Superintendency believes that the exposure of its banks is limited to very small amounts and only in a few banks. Recurring regulatory reporting currently do not require information detailing amount and other characteristics of financial instruments in foreign currencies, and accordingly the Superintendency lacks such information. The Superintendency believes that, given the small amount of foreign currency exposure of its banks, there is not a need for a regulatory standard in this area.

236. During the on-site examination the SB reviews bank's policies and procedures relating to market risk and walk-through procedures are performed. The examinations also verify compliance with the guidance issued by the Superintendency as well as compliance with the bank's internal procedures.

237. **Assessment:** Largely compliant—efforts to achieve full compliance are underway. The SB has issued guidance as to market risk associated with investment securities and interest rate risk. The SB guidance on market risk relating to investment securities covers the most important aspects by mandating each bank to have internal policies and procedures and methods to assure that such policies and procedures are followed.

238. The mission team supports the development and implementation of guidelines that are flexible and consider the banks' own individual asset-liability characteristics. Guidance should address the requirement for (i) policies and procedures to control the nature and amount of interest rate risk, specifies risk limits, lines of authority; (ii) requirement for risk measurement and monitoring; and, (iii) a system of internal controls, review and audit. To achieve compliance, the SB should obtain periodic information to be able to carryout surveillance and analyze bank and system exposures to market risk.

239. Require regulatory information as to financial instruments that result in foreign exchange exposure. Current information will alert the SB of a change in the profile of banks regarding foreign exchange risk.

### **Principle 13: Other Risks**

240. *Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor and control all other material risks and, where appropriate, to hold capital against these risks.*

241. **Description:** The Banking Superintendent has the legal authority to establish operating standards for banks in order for the banks to develop adequate risk parameters. Such authority includes establishing prudent limits that the banks must observe. (See Article 17.32 of the Banking Law)

242. The SB has issued clear parameters that limit and/or require management to actively identify, measure and monitor various types of risk. These include:

- Credit risk—Standards include limitations on credit concentration, exposure to affiliates, classifying and providing reserves for credit exposure and risk based capital. These standards are generally modeled after international standards. (Please refer to Principles 6, 7, 8, 9, 10)
- Liquidity risk—Standard is formula driven whereby generally deposits require a 30 percent in liquid assets that mature within 176 days. See Acuerdo 2-2000
- Interest rate and market risk—Guidance has been issued. (Refer to Principle 12)
- Operational risk—More guidance is required. (Please refer to Principle 14)
- Foreign exchange risk—No guidance has been issued. (Please refer to Principal 12)

243. As part of the on-site supervision the SB verifies compliance with the above standards and performs a limited review and a walk-through of the internal controls of the bank. Furthermore, quarterly verification of compliance with the mathematical standards is performed by the Directorate of Financial Analysis and Economic Studies.

244. Most of the standards detailed above have been put in place relatively recently. These standards represent an important improvement over the previous regulatory scheme and accordingly a very positive step in promoting the safety and soundness of the banking system.

245. However, in addition to complying with generally prudent financial standards of sound banking, the supervisor should concentrate more resources to ensure that the banks have comprehensive management systems to identify, monitor and control all material risks to which the entity is exposed.

246. Acuerdo 2-2000, which establishes the minimum liquidity requirement, currently stipulates that deposits, excluding those from affiliates, require 30 percent in liquid assets.

We believe that the exclusion of deposits from affiliates from the formula should be re-evaluated, or at a minimum special attention should be given to the institutions for which this exclusion applies for additional liquidity analysis.

247. **Assessment:** Largely compliant—efforts to achieve full compliance are underway. The SB is deemed largely compliant with this principle given that most of the important risks are covered by reasonable prudential standards and are monitored via on-site and off-site supervision. The approach utilized by the SB focuses primarily on establishing internationally accepted financial standards and ascertaining their compliance on a piecemeal basis. Such approach is reasonable and expected given the relatively short period of the existence of the Superintendentcy. However, a more holistic approach to comprehensive risk management, combined with detailed prudential requirements is preferable.

248. The SB is cognizant of this issue and intends to issue a regulation on Corporate Governance during the latter part of this year (draft has already been issued for public comment). Such regulation will encapsulate the concept of obliging the Board of Directors and management of banks to establish clear systems of risk management to identify, measure, monitor and control risk. Note that standards regarding the Board of Directors and management's responsibility for managing the most important types of risk (credit, interest rate and market risks) already exist.

#### **Principle 14: Internal Control and Audit**

249. *Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.*

250. **Description:** The SB is in the process of drafting a regulation regarding this subject. Recently implemented on-site examinations and a much-strengthened off-site supervision have identified weaknesses in the internal controls environment of a small number of banks under distress. Specific guidance for Corporate Governance, which SB has already drafted and issued for public comment, will address this important Core Principle. The existence of a clear internal control framework mandated by the SB will provide its supervisory personnel an adequate tool to require an appropriate internal control environment and a basis for corrective action. Furthermore, a clear framework provides explicit guidance to the Board of Directors and management as to their responsibilities, and accordingly, reduces banks' operational risk.

251. According to the Core Principles on Supervision issued by the Basle Committee on Banking Supervision the purpose of internal controls is to ensure that the business of a bank is conducted in a prudent manner in accordance with policies and strategies established by

the bank's board of directors; that transactions are only entered into with appropriate authority; that assets are safeguarded and liabilities controlled; that accounting and other records provide complete, accurate and timely information; and that management is able to identify, assess, manage and control the risks of the business.

252. The SB currently requires each bank to nominate compliance officers for specific areas of risks. Although such requirement is beneficial to the safety and soundness of a bank, it leaves a considerable variety of areas and events that may impair banks' activities unattended. A clear internal control standard will detail the corresponding legal responsibilities of the members of the Board of Directors and of management, and therefore facilitate the identification of liability to individual persons who fail to comply with the standard.

253. **Assessment:** Largely compliant—efforts to achieve compliance are underway. In order to be fully compliant with this Core Principle the SB must require banks to structure and maintain an appropriate framework in order to adequately control their activities, clearly establishing the responsibilities of the Board of Directors and management members, and establishing procedures for independent verification and reporting thereof to the Board of Directors.

### **Principle 15: Money Laundering**

254. *Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.*

255. **Description:** Law No. 42 of 2000 requires banks operating in Panama to implement the corresponding internal controls to prevent money laundering. The Law, as complimented by Acuerdo 9-2000, implements the "know-your-customer" rule, requires reporting of currency transactions and suspicious transactions to the Financial Analysis Unit, requires banks to document the profile of clients in which the business relationship exceed B/.10,000, requires banks to adequately train employees to detect and report transactions covered by Law, among other requirements. Acuerdo 9-2000 stipulates that fines raging from B/.5,000 to B/.1 million may be assessed for non-compliance with its requirements.

256. The SB's Acuerdo 10-2000 issued on December 15, 2000 requires each bank to have an anti-money laundering compliance program commensurate with its structure, resources and complexity. The Acuerdo also requires all banks to designate at least one Compliance Officer with the responsibility to ascertain compliance with the anti-money laundering program.

257. The SB has implemented a very aggressive onsite enforcement program. The Director of onsite supervision represents that 20-30 percent of the examination resources are invested in anti-money laundering compliance exams.

258. **Assessment:** Compliant. The Republic of Panama's statute and the enforcement thereof are consistent with internationally accepted standards.

### **Principle 16: On-site and Off-site Supervision**

259. *An effective banking supervisory system should consist of some form of both on-site and off-site supervision.*

260. **Description:** The on-site and off-site supervision performed by the SB is structured in two specific areas: off-site surveillance where the information collected from banks has been handled and analyzed; and on-site supervision where exams and inspections in banks are carried-out.

261. Banks (and affiliated entities) are required to report to the SB on a weekly, monthly, quarterly, semi-annual and annual basis according to activity type. Information regarding balance sheet and other financial data is used for analysis and understanding of the risks inherent to banking activities. In addition, the SB receives a considerable volume of statistical information with limited supervisory value.

262. Currently the SB lacks an adequate manual for offsite supervision and lacks an early warning system. The analysis process is based on a rough itinerary to be followed by the analysts; the outcome's quality depends on the experience and knowledge of each particular analyst. Within the scope of the developments that has been in process for data information systems, there is a project for implementation of an indicators system, which includes the elaboration of a peer group distribution of banks for comparative analysis.

263. There is a schedule prepared for off-site analysis of banks in order to supply the on-site exam of banks, according to the on-site examination schedule, aiming to identify and to anticipate major risks to be verified and deftly assessed.

264. The off-site supervision area also provides analysis of portfolio growth, credit quality and trends on credit directions. Information on liquidity is received and analyzed on a weekly basis; composition of investments portfolio, connected lending and large exposures are received on a monthly basis; consolidated information including financial and non-financial subsidiaries and compliance with capital requirements is collected on a quarterly basis.

265. The on-site supervision area is adequately structured in terms of staff, budget and skills. The on-site examination process is based on an annual program where banks are examined accordingly to the prior examination date, in order to examine each bank at least once every two years. The program covers basically three kinds of examinations: General Inspection, Money Laundering Procedures Inspection and FECI Examination. *Ad hoc* exams can be scheduled when any relevant issue raised by off-site surveillance is detected.

266. A General Inspection exam of a particular bank may include examining the bank's subsidiaries and obtaining pertinent information of the consolidated economic group to



which the bank belongs. The scope for the examination is defined by the issues raised by the off-site monitoring group, by the findings of the last examination and by other relevant emerging issues. The onsite inspection manual utilized is still rough and, basically, highlights the information forms for information to be collected during the exams and, also, standardizes the work-paper sheets.

267. The reports are oriented to a financial analysis of the recent past performance of the institution and to a confirmation of the information released by the financial statements and other returns provided to the supervisory authority. There isn't specialization of the examiners in terms of examination of the consistency of the information systems of banks and for examination of complex operations as treasury or derivatives. The overall assessment of risks is basically done by utilizing general audit procedures, limited to the confirmation of balances and the corresponding documentation.

268. When identified unsubstantiated assets or deficiencies in provisions, those amounts are not considered in the overall analysis of the institution. The effects of the correction of the findings in the examination will be considered only after corrected by the bank or in the next examination.

269. A rating system of banks has not been implemented yet and there aren't special arrangements for closely monitoring distressed banks.

270. A substantial portion of the on-site supervision activity has been dedicated to inspections for money laundering purposes, due to the international pressure caused by the inclusion of Republic of Panama in the FATF's list as a non-cooperative country with international efforts to combat money laundering. Additionally, the SB also has the responsibility of overseeing and enforcing the collection of a tax called FECI, that is applied upon the interests charged by banks on certain loans.

271. **Assessment:** Materially non-compliant—efforts to achieve compliance are underway. Given the short time that the SB has been established it is remarkable the progress and the level of efficiency and effectiveness that has already been reached. Nevertheless, the developments underway and the implementation of the recommendations brought about, in conjunction with more training and experience of the staff, may be necessary to reach an adequate level of compliance, in terms of off-site supervision, with this Core Principle.

272. The SB's structure of its off-site surveillance group is considered adequate in relation to the complexity and risks of the banking system. The offsite group receives and analyzes significant volume of information. However, the effectiveness of the analysis of such information needs to improve. The SB also receives a considerable amount of statistical information that may have limited or no supervisory value. The mission team recommends that regulatory reporting requirements be reviewed to focus on important risk related information. Efforts are underway to implement an information system that will help standardize and automate the analysis process. These efforts may include definitions and

guidelines for analysis procedures and routines, which should also establish special monitoring actions in case of distressed institutions.

273. In terms of on-site supervision the mission team recommends that the scope of the examination be more oriented towards risk. In this case the outcomes would converge to a forward-looking approach. Supervisors' efforts should look for obtaining concepts upon the perspectives for the bank in terms of continuity, growth, market share, management professionalism and succession.

274. The work done in the field in terms of confirmation of balance, assuming that little or no significant deviations have been detected by this procedure, should be left primarily to the internal and external auditors. The SB should coordinate such type of examination procedures with the accounting firms' and internal auditors, saving time and resources for more in-depth risk analysis.

275. The efforts spent with money laundering and FECI examinations should be planned so as not to detract from general inspections oriented to risk analysis.

276. Improvements of the examination manual are needed and training on specific areas is recommended in order to develop a minimum specialized staff to deal with complex operations and information systems assessments.

### **Principle 17: Bank Management Contact**

277. *Banking supervisors must have regular contact with bank management and thorough understanding of the institution's operations.*

278. **Description:** In practice, the SB has regular contact with the institutions that it supervises through the examination process. At a minimum, the SB's examiners meet at the start of an inspection with senior management to discuss the examination scope and at the close of the examination to present findings. The SB also will initiate a meeting when the off-site surveillance raises points where clarification is required or to communicate some relevant subject or to discuss particular technical issues.

279. **Assessment:** Largely compliant—efforts to achieve full compliance underway. The SB's contact with bank management has been implemented mainly in the technical level of banks and SB staff. Beyond the inspection processes, the approach is oriented for technical discussions regarding interpretation of banking regulation and electronic solutions for the information collecting process done by the SB. However, when relevant issues are presented, SB high-level staff makes the contacts at the appropriate level. Nevertheless, the mission team recommends the SB to establish a policy for regular high-level contacts for discussion of strategic subjects, in the context of risk-focused supervision.

280. In addition, the mission team recommends that senior personnel of the SB, in conjunction with key personnel of the examination team, formally present the results of on-site examinations to the Board of Directors for the larger Panamanian banks and for any bank

with significant deficiencies. Such meetings are an excellent opportunity to communicate directly areas of concern and discuss the role of the Board of Directors, in the event that the policy setting and oversight are not adequate.

### **Principle 18: Offsite Data**

281. *Banking supervisors must have a means of collecting, reviewing and analyzing prudential reports and statistical returns from banks on a solo and consolidated basis.*

282. **Description:** Article 54 of the Banking Law authorizes the Banking Superintendency to request any bank, or any Economic Group of which the bank is part of, all documents and reports relating to their operations and activities. The Banking Law also allows the Superintendency to impose fines for lack of timely compliance with information requests, a power that Superintendency has utilized on various occasions.

283. In accordance with Article 16.10 of the Banking Law, the Junta Directiva may establish the accounting rules that banks are to follow. Acuerdo 3-98 of September 23, 1998 establishes that all banks will utilize International Accounting Standards. Acuerdo 4-99 of November 5, 1999 amends Acuerdo 3-98 allowing the use of U.S. GAAP as an additional accepted accounting standard for banks operating in Panama. Such standards call for consolidated financial statements.

284. The Superintendency requires the banks to submit in substantial detail financial information of their operations on a monthly and quarterly basis. The monthly information is utilized primarily for systemic trend analysis. On a quarterly basis the off-site supervision group analyzes and issues a report on each bank's financial information. For the quarter ended December 31, 2000, the Banking Superintendency began collecting quarterly consolidated financial information. Accordingly, the Superintendency analyzes its banks on a solo and on a consolidated basis.

285. The SB is currently developing a new information system that will include detailed information on each investment security, on each loan and each liability. Accordingly, the Banking Superintendency will have the raw information to perform very sophisticated analysis on an off-site basis.

286. **Assessment:** Largely compliant—efforts to achieve full compliance are underway. The SB has clear authority to obtain information. The new system to be implemented later this year will provide additional information. The mission team observed that large volumes of information are received and analyzed. However, the team believes that more in-depth analysis of only a core group of indicators is necessary to achieve more effective banking supervision.

### **Principle 19: Validation of Information**

287. *Banking supervisors must have a means of independent validations of supervisory information either through on-site examinations or use of external auditors.*

288. **Description:** Step 3.1 of the on-site examination program is to verify that the information provided to the Directorate of Financial Analysis and Economic Studies matches with the information in the accounting records of the bank.

289. The Directorate of Financial Analysis and Economic Studies ascertains that all banks file audited financial statements within the time period established by law (three months) and verifies that such information is consistent with the regulatory information received.

290. In addition, banks are encouraged to have their external auditors review the quarterly consolidated information prior to submittal to the Banking Superintendency.

291. The SB has the legal authority to request and obtain all documents and reports relating to banks and economic groups to which the banks belong. Please refer to Principle 18.

292. **Assessment:** Largely compliant—efforts to achieve full compliance are underway. The personnel of the SB validate the information on a regular basis. We encourage the SB to emphasize more on the qualitative aspects of the information and less on the volume of information.

### **Principle 20: Consolidated Supervision**

293. *An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis.*

294. **Description:** The regulation in place defines adequately the economic groups and requires the financial consolidation of subsidiaries for regulatory (including capital adequacy purposes) and financial reporting purposes. The SB has the power to request any information regarding equity investments in subsidiaries, including non-financial companies. The SB collects on a quarterly basis consolidated financial information concerning the operations of economic groups and the inter-relations among firms in the same group. However, the structure of analysis, monitoring and examination is substantially oriented to monitor banks only on a *solo* basis. The consolidated information is still used as an additional set of data for secondary purposes, as it was observed in the project drafted for the ratios systems, where the consolidated statements had not been considered.

295. **Assessment:** Largely compliant—efforts to achieve full compliance underway. The legal framework is satisfactory and covers the needs for economic group definition and scope of the consolidation. Information is collected on adequate frequency but it is not analyzed as a priority tool in identifying risks of the banking system and its possible risk of contagion caused by adverse performance of business conducted in other fields. Given that the collection of certain information modules just started in the beginning of the current year, receiving and reviewing consolidated data is a relatively new process. The mission team recommends that consolidated statements become the key tool for supervision surveillance and the analysis process be oriented for the understanding of the economic group as a single

organization and the effects of non-financial activities be considered in the banking system overall assessment.

### **Principle 21: Accounting**

296. *Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.*

297. **Description:** In accordance with Article 16.10 of the Banking Law the Junta Directiva may establish the accounting rules that banks are to follow. Acuerdo 3-98 of September 23, 1998 establishes that all banks will utilize International Accounting Standards. Acuerdo 4-99 of November 5, 1999 amends Acuerdo 3-98 allowing the use of U.S. GAAP as an additional accepted accounting standard for banks operating in Panama.

298. The SB performs periodic onsite exams to, among other issues, verify the adequacy of accounting records.

299. Article 55 of the Banking Law requires banks to present to the SB audited financial statements within three months of completion of the bank's fiscal year end. Article 60 of the Banking Law requires that the financial statement be read at the annual shareholders' meeting.

300. Article 56 of the Banking Law requires all banks established in Panama to exhibit their audited financial statements in each branch and to publish their audited financial information in a national newspaper within three months of the closing of the fiscal year.

301. **Assessment:** Compliant. The banks must utilize International Accounting Standards or U.S. GAAP. The banks are subject to yearly audits by independent public accountants, and must publicize financial information. The SB is in compliance with BCP 21.

### **Principle 22: Remedial Measures**

302. *Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirement (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way. In extreme circumstances, this should include the ability to revoke the banking license or recommend its revocation.*

303. **Description:** Article 17.27 of the Banking Law states that the Banking Superintendent may declare an intervention, reorganization or liquidation of a bank. Article 17.9 establishes that the Superintendent may instruct a board of directors to remove directors or executive personnel if such action is merited.

304. Article 137 of the Banking Law establishes the sanctions that the Superintendent may impose in the event of violations to the Banking Law. These range from oral reprimand (private or public) to civil penalties up to \$50,000. Additional sanctions may be imposed for certain specific violations.

305. Article 38 establishes the reasons whereby the Superintendent may cancel a banking license.

306. Article 95 establishes that the SB may intervene (take control) of a bank for various reasons including (i) lack of compliance with capital requirements, (ii) the continuance of operation of the bank endanger the interests of the depositors and (iii) lack of compliance with liquidity requirements.

307. **Assessment:** Largely compliant—efforts to achieve full compliance are underway. The SB has clear legal and regulatory powers. The SB lacks general guidelines for remedial actions and contingency plans in the event of a significant bank failure.

### **Principle 23: Global Consolidated Supervision**

308. *Banking supervisors must practice global consolidated supervision over their internationally-active banking organizations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organizations worldwide, primarily at their foreign branches, joint ventures and subsidiaries.*

309. **Description:** Banking Law (DL 9/98–Article 30) establishes the SB ability to supervise foreign branches and subsidiaries abroad on a consolidated basis. Article 40 of the Banking Law requires banks to obtain authorization from the SB prior to opening or closing an office, branch, or agency. The operations booked in branches and subsidiaries abroad are consolidated and the capital requirements are demanded from a consolidated perspective.

310. Although the operations conducted abroad are consolidated, the SB doesn't collect detailed information that would allow monitoring across the individual branches and subsidiaries located in different countries. Without such off-site reporting, analysis of the repercussions on risks regarding operations carried-out in distressed countries, in jurisdiction with weak banking supervision or less cooperative jurisdictions, would only be possible through on-site examinations at the head-office of the banks. In addition, on-site examinations of branches and subsidiaries abroad are still limited and incipient.

311. **Assessment:** Largely compliant—efforts to achieve full compliance underway. The law in place is satisfactory and enables the SB to supervise banks on a consolidated basis, including overseas activities of locally incorporated banks. In order to properly fulfill this principle the SB should consider collecting data regarding branches and subsidiaries of Panamanian banks operating abroad, subdivided by individual countries. Such information would allow the SB to monitor concentrations or movements to undesired or riskier locations. The analysis of such data may result in an on-site examinations, request for

additional reports or, in extreme case, limiting the volume operations in a given jurisdiction. Furthermore, a program of on-site exams of branches and subsidiaries abroad, followed by a closer contact with host supervisors, is recommendable to ensure the safe and sound environment for operations conducted in other countries.

#### **Principle 24: Cooperation with Host Country Supervisors**

312. *A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.*

313. **Description:** Banking Law (DL 9/98–Article 31) requires the SB to establish memoranda of understanding with host country supervisors for appropriate information sharing on the financial condition and performance of overseas operations in the host country.

314. The SB has dedicated substantial efforts in order to reach consensus for memoranda of understanding with all countries where there is common interest in terms of banks' presence, both as a host and as a home supervisor. The SB has signed memoranda with four countries: Peru, Costa Rica, Equator and El Salvador. The SB is negotiating agreements with sixteen other countries, including the most relevant jurisdictions in terms of assets and operational volume of transactions related to Panama.

315. **Assessment:** Compliant. The SB's attitude has been highly cooperative in terms of implementing memoranda of understanding for supervisory exchange of information and collaboration. In practically all cases, the SB has been the entity promoting the cause of signing the agreements. Completion of formal agreements depends, to a large extent, on the interest of other countries to participate and on the evolution of Panama's reputation relating to anti-money laundering efforts.

#### **Principle 25: Equal treatment of Foreign Banks**

316. *Banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.*

317. **Description:** For banks with General licenses (license required to operate in the local market), Article 28 of the Banking Law stipulates that the foreign banks are to be supervised by their Home supervisors, without prejudice to the complying with the Banking Law. Accordingly, foreign banks are covered by the Panamanian Banking Law in the same manner as local banks.

318. Article 27 of the Banking Law establishes that all foreign banks with International licenses (branches and subsidiaries) are subject to the supervisory authority of the SB and must abide by the Banking Law and applicable regulations. However, for International

license banks operating under a branch structure, such branch will comply with the liquidity, capital adequacy and other technical conditions in accordance with its Home country legislation, and its Home country supervisor will exercise the corresponding consolidated supervision. Also, foreign banks are subject to onsite examination just like the local banks.

319. As a pre-condition to grant a license to any foreign bank, the SB must receive a “no-objection” from its Home supervisor as well as a representation from the Home supervisor that it practices consolidated supervision.

320. The SB, in accordance with Article 29 of the Banking Law may share information with the Home supervisors of foreign banks with an agreement that the foreign supervisor will maintain such information confidential. The SB has been quite aggressive in promoting memoranda of understanding with all jurisdictions that have banks in Panama and all jurisdictions where Panamanian banks have branches or subsidiaries.

321. Home country supervisors of foreign banks may conduct onsite exams of its banks with the prior approval of the SB. The SB represents that in such cases it usually performs a joint examination with the foreign supervisor.

322. The SB represents that it informs the Home supervisor on a systematic basis of substantial corrective measures that are adopted for the bank operating in Panama.

323. **Assessment:** Compliant. The legal framework in place is appropriate. The foreign banks are subject to substantially the same high standards as the domestic banks. The SB has powers to share information with the Home supervisor, and has aggressively pursued the signing of memoranda of understanding with multiple jurisdictions.