Overview and Background

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Although Central American countries are individually relatively small, they are large as a group and confront many common policy challenges. With about 40 million people, Central America's population is as large as Spain's or Argentina's. Besides geographic proximity and a common language, the region shares a dependence on raw material exports, close economic ties to the United States, and vulnerabilities to natural disasters and terms-of-trade shocks. Several of the countries have also suffered from long periods of civil strife, which slowed economic growth generally, and hampered the development of legal and judicial systems.

Banking is the most developed component of the region's financial system, and intraregional financial activity has increased substantially in recent years following macroeconomic stabilization and rapid financial liberalization in the 1990s. In this period, several countries upgraded financial legislation, introduced pension reforms, removed interest rate controls, provided for the diversification of financial instruments, and enhanced central bank independence. Liberalization in other areas was also significant.[1]

While there are important similarities and economic linkages among Central American countries, the analysis of regional issues must take into account the heterogeneity of countries as well. Information is sometimes not available for all countries, and data are often not fully comparable. Thus, regional analysis will always need to be adapted carefully to an individual country's circumstances.

Across the region, although financial sector openness is high (absence of or negligible capital controls; free entry of foreign banks), overall institutional quality needs considerable development. Weak governance, connected lending, and uncertain property rights pose particular problems in much of the region for financial intermediation and economic growth, notwithstanding initiatives to combat these problems. All six countries have strengthened the quality of regulatory governance and reforms are ongoing, but they are incomplete. Among other areas, it is crucial to improve the independence of financial oversight agencies and provide adequate legal protection for supervisors. This is needed to ensure that supervisory laws and prudential regulations are applied in an even-handed manner, free from interference by vested interests.

Regional financial groups are a distinctive feature of the Central American financial sector. These groups have expanded their activities, and at present account for a larger share (about one-third) of banking assets in Central America than do foreign banks (about one-sixth). Contributing factors to this development, besides the history of economic and political instability in several countries of the region (which may have discouraged entry by foreign banks), include increased regional trade linkages; the benefits from economies of scale and scope; the proximity of Panama as an international and regional financial center; reputation improve-

[1]Progress in establishing a regional common market and on the Central American–Dominican Republic Free Trade Agreement (CAFTA-DR) with the United States show the authorities' commitment to openness and market-oriented regional economic integration.

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ments as regional financial groups survived crisis episodes; and declining intermediation costs, apparently associated with increasing dollarization in the region. There may also be cases where intragroup cross-border transactions are designed to take advantage of regulatory arbitrage.

The success of regional financial groups holds promise for supporting economic development in the region while, at the same time, presenting increased vulnerabilities and risks. In particular, the authorities face challenges in supervising cross-border operations of financial groups and containing the risk of regional contagion. The countries have established the Central American Council of Superintendents of Banks, Insurance, and Other Financial Institutions (CCS) as a regional forum for facilitating cross-border supervision of financial institutions. Harmonization of countries' financial supervisory frameworks would discourage regulatory arbitrage. At the same time, this would reduce the costs of regulatory compliance and make the regional financial groups more competitive.

Dollarization, another common feature of the financial landscape, is also a mixed blessing for financial sector development and stability. The earlier outright prohibition of financial intermediation in foreign currency in some countries in the region helped to motivate the establishment of banks offshore, many of them in Panama, where the economy has been dollarized since the beginning of the twentieth century. Official dollarization in El Salvador in 2001 has accompanied an ongoing trend toward dollarization elsewhere in the region. Dollarization has been associated with lower interest rate spreads and increased domestic financial intermediation. At the same time, credit risk has increased in some countries because of lending in dollars to clients who do not have dollar earnings. The officially dollarized economies, however, have largely eliminated exchange rate risk.[2]

The underdeveloped insurance sector constrains the development of the whole financial sector. The sector is small and fragmented in much of the region. While better-off households and larger firms can obtain most insurance products, much of the population (e.g., in the agricultural sector) does without them. The scarcity of insurance affects welfare directly, reduces the availability of financing or increases its cost, and constrains insurance companies' role in deepening financial markets.

Most indicators of the soundness and performance of the insurance sector do not raise immediate, systemic concerns, particularly because heavy use is made of reinsurance from the large international reinsurers. Companies' investment portfolios are typically not very diversified; investment abroad is modest and constrained by regulations.

Positive and innovative developments in some countries, such as the successful bundling of an insurance component in small agricultural loans in El Salvador, might be replicated in other countries. In several countries, insurance supervisors lack resources and are constrained by outdated laws. Regulations need to be adapted to a more risk-based approach, with a greater role played by actuarial calculation of risks, as is done in Costa Rica. In particular, technical reserves need to be related to the expected value of losses, their variances and covariances, and other risks, especially reinsurance risk.

More effort is needed to bring national payments and securities settlement systems in line with international standards and best practices. Most countries in Central America have launched reforms in their payment and securities settlement systems in recent years with a view to strengthening their financial infrastructure. These countries should seek to harmonize those systems toward establishing the microfoundations of more developed national, and potentially regional, capital markets.

As national systems converge toward international standards, there is a growing interest in the region in the efficiency gains that could be achieved by adopting integrated frameworks for regional payments and securities settlement. Projects on regional clearance and settlement of large-value transactions and on integrated regional large-value, real-time gross settlement (RTGS) payment systems have been launched by Central American governments, the Central American Monetary Council, and the Inter-American Development Bank. Ongoing reforms at the national level provide an opportunity for further harmonization at the regional level and the eventual integration of payment and securities settlement frameworks.

Efforts are needed in all six countries to improve the legal framework for payments and securities settlement, for example, as regards the irrevocability of final settlement; protection of the systems against the effects of bankruptcy procedures; and legal basis or

[2]There remains exchange rate risk vis-à-vis third-country currencies; this risk is relatively contained since the United States is the most important trading partner of each of the Central American countries.

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Box 1.1. Summary of Recommendations

Banking Supervision and Regulation

- Improve the independence of financial oversight agencies and provide adequate legal protection for supervisors.
- Develop a regional approach to cross-border consolidated supervision:
  - enhance cross-border cooperation and exchange of information;
  - incorporate parallel banks and booking offices into the scope of consolidated supervision;
  - clarify the legal definition of a financial group;
  - strengthen legal powers to regulate financial groups; and
  - address a minimum set of priority risks in the first stage, notably risks associated with connected lending and loan concentration, loan classification and provisioning, and capital requirements.
- Develop a regional approach to dealing with potential stress of financial conglomerates:
  - set specific rules and procedures applicable to cross-border bank bankruptcy proceedings; and
  - increase harmonization in resolution procedures, notably as regards triggers and duration of bank intervention, and treatment of bank managers and shareholders.

Development of the Insurance Sector

- Upgrade the legal and regulatory framework for the insurance sector, with a view to moving toward harmonization of regulations:
  - better relate technical reserves to actuarial calculations of risk;
  - gradually ease investment restrictions on insurance firms;
  - ease remaining restrictions on foreign entry in the insurance industry; and
  - strengthen regulation and supervision of operational risk.
- Launch regional efforts in related areas, including:
  - jointly collect and disseminate demographic, meteorological, agronomic, and other information; and
  - jointly develop catastrophe insurance programs.

Harmonization of Payment and Securities Settlement Systems

- Continue ongoing efforts to bring national payment and securities settlement systems in line with international standards:
  - upgrade the legal framework governing the operation and oversight of the payment system;
  - introduce, or finalize introduction of, real-time gross settlement (RTGS) systems;
  - modernize public sector payments, including through enhanced coordination among relevant agencies;
  - upgrade clearing and settlement processes in securities settlement systems, notably by eliminating physical handling of securities and reducing custody risk; and
  - devote adequate resources to securities settlement oversight, and enhance cooperation in this area among the central bank, self-regulatory organizations, and the private sector.
- As part of these efforts, lay the groundwork for further harmonization and integration through the interlinking of the different systems.

definitions for custody arrangements, repurchase operations, multilateral netting arrangements, immobilization and dematerialization of securities, pledge of collateral and securities lending, and oversight powers, which are typically the responsibility of the central bank. The adoption of a comprehensive payment system law, as is well advanced in Honduras and Guatemala, would help address many of these issues.

International migrant remittances are a significant portion of cross-border payments in the region and the largest single source of foreign exchange in El Salvador, Guatemala, Honduras, and Nicaragua. Remittances to several countries have continued to increase much faster than export receipts in the past few years. Remittances also seem to have an automatic stabilizer effect, because they typically rise in the face of natural disasters or during periods of economic slowdown in the recipient country.

Fees for sending cross-border remittances are high and regressive. Remittance costs can be reduced by encouraging competition, introducing new remittance instruments, harmonizing payment systems, and increasing access to banking services to remittance senders and recipients. If a larger proportion of remittance flows were channeled through financial institutions, it might encourage saving and would also help alleviate concerns related to anti-money laundering and combating the financing of terrorism (AML/CFT) (see Box 1.1 for a summary of recommendations).

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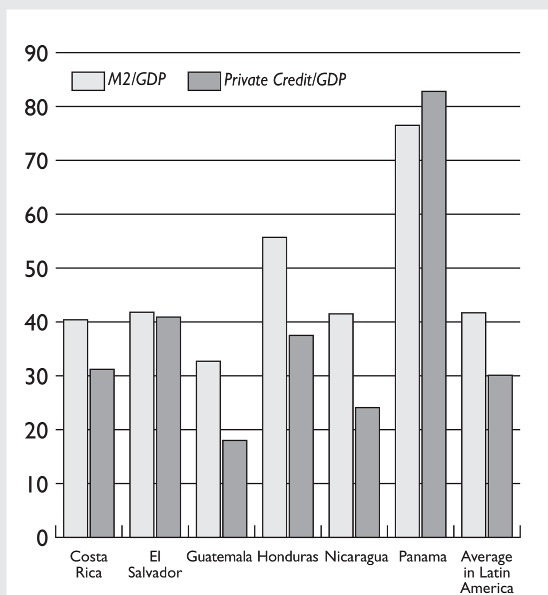
An Overview of Financial Intermediation in Central America

Financial Soundness and Development

Central America's financial sector has grown substantially in the last decade. The average credit-to-GDP ratio rose from 26 percent in 1993 to 39 percent in 2003, while average M2 to GDP in Central America rose from 32 percent to 48 percent. Financial intermediation in Central America, excluding Panama that exhibits substantially above-average ratios, is similar to the average in Latin America, although financial depth varies significantly from one country to another (Figure 1.1).

Although financial sector openness in the region is high, overall institutional quality is relatively low. There is free entry of foreign banks and there are no restrictions in any of the countries on foreign currency purchases by residents. At the same time, according to cross-country databases such as the Heritage Foundation's Index of Economic Freedom and the PRS Group's International Country Risk Guide, in much of the region, weak corporate governance and corruption reportedly pose problems and property rights are not well established.

Figure 1.1. Indicators of Financial Deepening, 2003
(In percent)



Sources: IMF, *International Financial Statisitics*; and national authorities.

Some countries in Central America have concentrated banking systems. In Costa Rica and El Salvador, the financial system can be characterized as moderately concentrated (three banks account for more than 60 percent of total assets), whereas Nicaragua's banking sector is highly concentrated (three banks account for more than 70 percent of total assets). Government-owned banks account for only a small share of total assets in the banking sector in most countries in the region. Only in Costa Rica is the public share of banking assets significant—around 60 percent—whereas for the others it is 15 percent or less.

Banking systems exhibit significant cross-country variations (Table 1.1). Financial soundness indicators show that the ratios of liquid assets to total assets range from about 14 percent in Costa Rica to 32 percent in El Salvador. The ratio of capital to unweighted assets are reported as between 7.3 percent for Honduras and 12.9 percent for Panama. Profitability, measured by return on assets, varies between 1 percent in El Salvador and 2.1 percent in Nicaragua and Panama. The ratios of nonperforming loans (NPLs) to total loans range between 1.8 percent for Costa Rica and 9.6 percent for Honduras.

All of the countries have strengthened the quality of banking supervision during the past few years and are in the process of bringing their systems further in line with the Basel Core Principles. Laws governing the financial sector have been revised, new regulations that strengthen loan classification and provisioning have been issued, and efforts to enforce capital adequacy ratios have been undertaken. Limits on large exposure and related-party lending have also been tightened.

Among other areas, cross-border supervision activities need to be made more effective (see Chapter 2), and there is room to improve the independence of banking supervisory agencies. International experience has shown that operational and financial autonomy and adequate legal protection for supervisors are essential if they are to carry out effective oversight of financial institutions free from intervention by vested interests. In El Salvador, specifying in the law the conditions for dismissal of the head of the banking supervisory agency as well as providing adequate legal protection to all supervisors would be im-

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TABLE 1.1
Financial Soundness Indicators for the Banking Sector, June 2004[1]
(In percent; as of June 2004, unless stated otherwise)

	Costa Rica	El Salvador[2]	Guatemala[3]	Honduras	Nicaragua	Panama
Capital/assets	9.7	10.1	8.2	7.3	8.1	12.9
Nonperforming loans (NPLs)/total loans	1.8	2.1	5.3	9.6	2.7	2.0
ROA	1.9	1.0	1.3	1.4	2.1	2.1
Liquid assets/total assets	14.4	31.6	29.1	27.6	23.5	20.5

Sources: Central American Monetary Council; country authorities; and IMF staff estimates.
[1]Unless stated otherwise.
[2]Data on return on assets (ROA), liquid assets as of September 2004.
[3]Data on return on assets (ROA), liquid assets as of July 2004.

portant measures to increase the independence of supervisory authorities. Increasing legal protection is also an issue in Panama. In Honduras, protecting the budgeting process of the supervisory agency from political interference would enhance independence. In Nicaragua, frequent judicial decisions overturning supervisors' actions raise concerns about the banking authorities' autonomy.

Increasing Dollarization

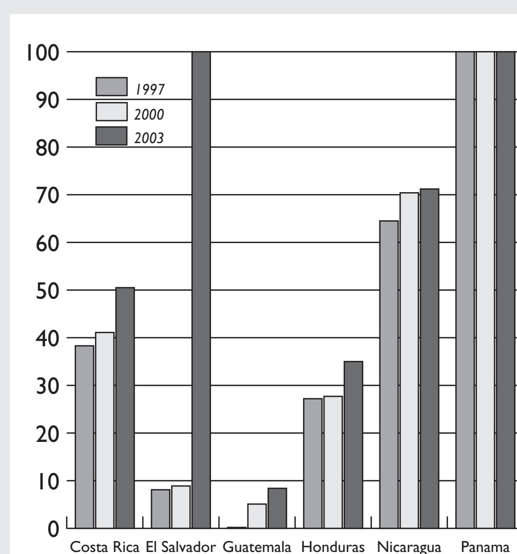
Dollarization in the region is high and increasing. With the exception of Panama, which was already dollarized, dollarization became entrenched in the region as inflation accelerated during the 1990s. Following a long period of a virtually fixed exchange rate, El Salvador decided to adopt the U.S. dollar as a domestic currency in 2001. The proportion of foreign currency deposits to total deposits increased in all five Central American countries (excluding Panama as a dollarized economy) from 1997 to 2003 (Figure 1.2). The measure of dollarization would be even higher if deposits indexed to the exchange rate in Nicaragua were included, and if all the foreign currency deposits in offshore banks in Costa Rica and Guatemala were accounted for.

Salvadoran and Panamanian banks operate in foreign currency throughout the region taking advantage of their foreign currency deposit base. Nicaraguan banks also operate in foreign currency, with domestic loans in national currency indexed to the exchange rate against the U.S. dollar. Domestic banks in the region must offer the same services to prime customers, even if those customers do not generate foreign currency revenue. It appears that offshore operations stimulated by the prohibition of foreign currency deposits and loans in some countries (Costa Rica and Guatemala) have not been fully brought back onshore following the removal of those restrictions.

Migrant Remittances

Remittances are a large and stable source of external financing in Central America, especially for the poorer countries. In addition to officially recorded remittance receipts, flows through informal (unmeasured) channels are significant, and some remittances are misclassified, for instance, as export revenue or

Figure 1.2. Foreign Currency Deposits to Total Deposits
(In percent)



Source: Central American Monetary Council (2003).

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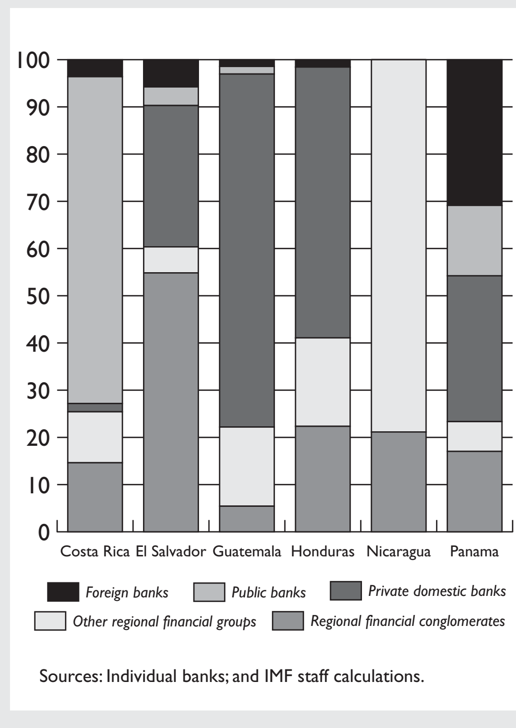
tourism receipts. Formal remittances to Central American countries are largely originated by money transfer operators (MTOs) and banks in the source countries, channeled using mostly private proprietary payment systems, and distributed through banks and agents of the MTOs.

Remittance costs, typically paid by senders to the remittance agent at the time of sending, range from a fixed $3–$5 per transaction to as high as 20 percent in the case of some MTOs. The average remittance cost seems to be around 4–6 percent in Honduras, 5–7 percent in El Salvador, 6–8 percent in Guatemala, and 6–9 percent in Nicaragua. On top of that, remittance agencies charge a 1–3 percent foreign exchange commission (except when funds are delivered in U.S. dollars). Remittance costs are significantly higher for smaller remittance transactions used by poorer migrants. Conservative estimates suggest that the true cost of transactions—labor, technology, setting up networks, and rent—add up to only about $5 (or less) per transaction. These high mark-ups reflect market phenomena (e.g., large sunk costs that impede entry to the market), regulatory measures that restrict competition or raise compliance costs, the lack of access to public infrastructure (e.g., payment systems), and use of outdated remittance technology. Improving transparency in remittance transactions would raise consumer awareness, and reduce unfair remittance practices, and might have a significant effect on costs.[3] Efforts to reduce costs, however, will have to be carefully balanced with those to fight money laundering and the financing of terrorism.

Figure 1.3. Bank Assets by Type of Bank, 2003
(In percent)



Sources: Individual banks; and IMF staff calculations.

Cross-Border Financial Intermediation and Consolidated Supervision

Trends

In recent years, cross-border financial intermediation activity in Central America has increased, mostly through regional financial conglomerates. The share of regional banks in deposits and loans in Central America has increased in parallel with consolidation in recent years, in some cases associated with the absorption of failed financial institutions following crisis episodes. Although banks are dominant within financial conglomerates, such conglomerates may also conduct nonbank operations.[4] They are normally part of larger corporate groups. Some other groups do not consolidate operations and operate through *parallel banks*—separate institutions operating in different jurisdictions with almost the same ownership structure. Other banks operate through booking offices that basically record operations not reported to the home supervisor, and where the underlying operations may be carried out offshore.

Four regional financial conglomerates operate in the region, whose countries of origin are El Salvador, Nicaragua, and Panama (Figure 1.3).[5] Each holds an international license to operate from Panama, where they consolidate operations of their subsidiaries. Three Nicaraguan groups are parallel

[3]The World Bank and the Bank for International Settlements (BIS) Committee on Payment and Settlement Systems (CPSS) have set up a task force, with IMF participation, to develop voluntary principles that service providers, regulators, and supervisors should adopt for improving transparency in the market.

[4]A financial conglomerate is defined in this book as a group of companies under unified control, primarily engaged in financial services in at least two of the banking, insurance, and securities sectors, showing significant cross-border operations in the region.

[5]These are Cuscatlán and Agrícola (of Salvadoran origin); Banco de América Central (Nicaraguan); and Primer Banco del Istmo (Panamanian).

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bank–based. There are other banks with links to other regional financial institutions operating in the region, some of which were originally created to circumvent limitations regarding operations with sight deposits and/or foreign currency deposits (Costa Rica and Guatemala).

Regional financial groups account for about one-third of assets of the regional financial system. Foreign bank branches account for only 3 percent of the system (this does not include operations from financial hubs such as Miami). Domestic banks represent one half of the regional financial system. The share of public banks (about one-sixth) largely reflects their high share of the financial market in Costa Rica.

Regional financial conglomerates appear to have higher profitability, measured by return on assets, relative to other groups of banks. The conglomerates' higher capitalization and profitability seem to reflect their success in servicing prime customers. Domestic private banks have a larger share of deposits on-lent to borrowers as they concentrate on local clients. Foreign banks show overall lower profitability that may be partly related to more strict accounting guidelines required by their parent offices.

A trend toward consolidation in the regional financial system has been taking place. Between 1998 and 2003, 24 banks were closed and 31 mergers took place, more than offsetting the number of new banks (8 banks started operations in the region in the same period).[6] Total assets denominated in U.S. dollars increased by 38 percent between 1998 and 2002 for Central American countries (excluding Panama, which experienced a slight decline). Concentration, measured by the share of assets of the five largest banks, increased to 73 percent in 2002 for the region. At the country level, this phenomenon is observed in all countries except Costa Rica, with Nicaragua showing the highest concentration (96 percent). Banks maintain a dominant position in the region, holding 80 percent of financial sector assets.

Regional financial groups have consolidated their position in regional financial markets.[7] In addition to the expansion of Salvadoran and Nicaraguan groups, Primer Banco del Istmo (Panamanian) has participation in Honduras and Costa Rica, and Cuscatlán (Salvadoran) acquired the regional banks formerly owned by the British bank Lloyds. Banks belonging to regional groups acquired selected assets of failed banks, including through cross-border acquisitions: Banex (Panamanian) in Costa Rica absorbed four banks between 1998 and 2001; Lafisse and Promérica (Nicaraguan) absorbed assets and liabilities of failed banks in Nicaragua and El Salvador; and Cuscatlán and Agrícola (both Salvadoran) in Costa Rica and Guatemala.

Factors contributing toward integration through the activity of regional financial conglomerates include

- increased cross-border economic linkages. Trade within the region has expanded gradually and represents a significant share of total international trade for El Salvador and Nicaragua (where most regional financial conglomerates have emerged);
- political uncertainty in some countries. In several countries, particularly El Salvador and Nicaragua, a long period of social unrest and political uncertainty led major corporate groups to diversify their operations across the region. These concerns may also have discouraged foreign banks from aggressive entry into the regional markets, leaving space for large regional financial groups;
- improved reputation of large domestic banks. Depositor confidence in large banks belonging to regional groups improved after these institutions survived crises and, in some cases, absorbed assets and liabilities of failed banks. Also, some groups have been able to obtain credit ratings, which opens access to international capital markets;
- contribution of dollarization to achieving economies of scale. Full dollarization in El Salvador and Panama, and high dollarization in Nicaragua, have helped lower operating and intermediation costs in the region. The adoption of official dollarization by El Salvador in 2001 may have helped level the playing field between foreign banks and regional groups that originated locally; and
- facilities provided by Panama, an international financial center in the region. Most regional financial groups have active offices in Panama using an international license to conduct operations throughout the region. Easy access from their home countries provides an opportunity to put in place significant managerial capabilities in Panama.

[6]Central American Monetary Council (2003).
[7]Barraza (2003).

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Vulnerabilities Associated with Regional Financial Integration

While financial integration in Central America has contributed to the diversification of financial operations and thus reduced risks, increased vulnerabilities may have emerged at the same time. Regional cooperation and coordination is required for adequate detection of these vulnerabilities. International experience with cooperation between home and host country regulators, however, is generally inadequate worldwide. Moreover, effective financial supervision at the home country level may be constrained by institutional weaknesses, insufficient market discipline, and lack of independence of and legal protection for supervisors.

The main challenges associated with the supervision of cross-border financial intermediation are

- assessing the capitalization of regional financial groups. Accurate assessment and proper monitoring is complicated by differences in the definitions and calculations of both actual and required capital across borders, differences in accounting standards, and lack of proper financial and auditing consolidation. Despite similar requirements, effective capitalization varies significantly across countries;
- detecting undue intragroup transactions. Undetected intragroup transactions may result in (1) capital or income inappropriately transferred from a regulated entity to an unregulated entity; (2) terms disadvantageous to a regulated entity; (3) an impact on solvency, liquidity, and/or profitability of individual entities; or (4) circumvention of regulatory requirements;
- anticipating contagion within groups and across borders. Asset dumping—transfer of nonperforming assets to a more lenient jurisdiction—may hide overall credit risk and cross-border transfer of deposits may magnify liquidity risk. Regulatory treatment of the sale of loan portfolio bundles varies among countries; and
- minimizing the risk of regulatory arbitrage. Regulation of large credit exposures is uneven in Central America, with El Salvador imposing the most stringent regulations overall. Regulation on related lending is relatively strict in El Salvador and Panama, but several countries do not have an aggregate limit on overall lending to related parties. Differences in loan classification and the treatment of collateral make asset transfers a likely means for achieving regulatory arbitrage, including between different subsidiaries in a conglomerate.

Individual Country and Regional Responses

To implement consolidated supervision, supervisors in the region need to overcome the hurdle of adapting the legal framework for financial activities. Legislation in Costa Rica and Panama includes longstanding provisions for consolidated supervision, but only Panama has been able to effectively combine, to some extent, supervision of domestic financial conglomerates and of cross-border intermediation (including of regional financial conglomerates). El Salvador approved amendments to its banking law in 2002 defining financial conglomerates, and financial institutions have already formed conglomerates. However, the Salvadoran superintendency does not conduct supervision of cross-border financial activities because the two Salvadoran conglomerates consolidate their international operations in Panama. Guatemala and Honduras recently approved modifications to the legal framework, and the process of implementation has yet to be completed. Changes in the legal framework for financial activities are pending approval by congress in Nicaragua, where the supervisory authority has relied on isolated legal provisions and ring fences (more strict prudential regulation for entities presumably belonging to a group and not submitting consolidated financial statements to any supervisory authority) to control cross-border transactions within financial groups.

The main problems with the legal framework for effective consolidated supervision include the lack of a clear definition of a financial group and the lack of enforcement of legal powers to regulate such groups. Heterogeneous and unclear definitions across countries hinder conduct consolidated supervision. Weak legal powers of supervisors to regulate financial groups prevent imposing effective limits on intragroup operations or requiring corrective actions when dubious transactions are observed. Implementation of legal modifications is also made difficult by the limited exchange of information, with more sensitive information not being shared among supervisors in the region.

Ring fences have been put in place but are difficult to implement because of institutional limitations. In light of the importance of cross-border operations by parallel banks of Nicaraguan origin, the superinten-

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dency has put in place ring fences on the operations of the domestic bank to limit opportunities to circumvent regulation, including limits to investment in financial institutions and special accounting rules; higher capital adequacy requirements; regulation of deposits and investments; 100 percent provisioning on sales of loan portfolio bundles; and restrictions on the use of a common name. However, recent attempts to expand certain powers of the superintendency based on ring fences have been subject to court injunctions.

In some countries, only partial progress has been achieved in the incorporation of booking offices into the scope of consolidated supervision. In Costa Rica, reluctance to report continues despite higher capital adequacy requirements (20 percent for non-reporting groups and 10 percent for groups allowing full access). In Guatemala, the superintendency has completed a first round of on-site inspections of all offshore entities. However, reporting deficiencies result in the unreliability of financial statements of banks and groups.

Panama is the only jurisdiction where consolidated supervision is conducted consistently. Regional financial conglomerates have chosen to consolidate in Panama as a recognized international financial center. Upgrades of financial legislation in El Salvador pertaining to such conglomerates and supervisory procedures in Nicaragua have not yet been tested since groups have decided not to consolidate in those countries despite significant mind-and-management presence.

Individual country measures will not be fully effective in the absence of a regional approach that leads financial groups to consolidate their financial reporting. A regional approach is just starting to be developed. Despite a long-standing overall framework for memoranda of understanding sponsored by the CCS and signed in 1998, the lack of a central authority, legal restrictions in some cases (e.g., secrecy provisions in several countries), unclear focus on what information is to be exchanged and reported, and reluctance of supervisors to provide timely and detailed information have conspired against a smooth exchange of information.

The CCS has been instrumental in promoting an open exchange of views among regional supervisors on the need for cross-border consolidated supervision. The CCS was founded in 1976, with the goals of encouraging cooperation and exchanging information between regional superintendencies, and facilitating the implementation of regional agreements. Discussions on plans to harmonize regulation across countries in the region have taken place with the Inter-American Development Bank (IDB), with the main goal of identifying the gaps for the application of international standards for banking supervision. Coordination to implement International Financial Reporting System (IFRS) criteria was assisted by the Central American Bank for Economic Integration (CABEI). Specific steps to improve regional banking supervision include the preparation of assessments and action plans. The CCS is at a crucial juncture to define a roadmap and lay out the priorities in improving consolidated supervision of regional financial institutions.

In the context of internal discussions, the CCS has prepared a regional initiative for consolidated and cross-border supervision. The main objectives are to (1) eliminate opportunities to elude supervision; (2) use adequate prudential standards; (3) define the structure, ownership, and management of conglomerates; (4) establish adequate capital requirements; (5) assess asset and liability management, including credit management; (6) identify global risks of conglomerates; (7) ensure transparency of information; (8) establish links to transmit risks; (9) determine contagion risks; and (10) verify compliance with the legal framework. The proposed arrangement among supervisors has the following main features:

- The host supervisor would notify the home supervisor of requests to obtain licenses, and the home country would report on compliance with laws and regulations in the home country of the requesting financial group.
- Information exchange would be open, with the exception of the identification of depositors.
- Supervisors would commit to provide assistance to on-site inspections of other country supervisors.
- Cooperation would be promoted, especially on AML/CFT issues.

Systemic Risk Considerations

The growth of cross-border banking activities poses significant challenges for banking resolution. In the event of failure, regional financial groups may be split into their national legal entities, each subject to different bankruptcy proceedings. In the absence of internationally recognized insolvency rules,

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equitable banking resolution may therefore be hampered if creditors in one jurisdiction receive higher compensation than creditors in other locations.[8]

Continuous coordination and communication between regulators is critical to ensure orderly resolution. A decision to intervene or close a domestic bank with operations abroad or a subsidiary of a foreign bank could have unintended, but significant, consequences for other countries. Thus, bank supervisors should coordinate their actions, including to ensure that insider creditors do not exit prior to the commencement of a liquidation.

Further harmonization in the legal and regulatory framework for bank exit would also help to ensure orderly resolution. Progress in upgrading processes and procedures for banking resolution in Central America has already been substantial. For instance, many countries have introduced a system of prompt corrective actions, specified triggers for intervention in case of bank insolvency, and broadened the range of available resolution tools. Areas where further efforts are needed include the following:

- *Triggers for bank intervention*. A uniform definition of insolvency—currently ranging from 2 to 8 percent of risk-weighted assets—would allow the authorities to coordinate the timing of intervention of members of a financial group across countries, thereby minimizing the risk of contagion and asset stripping.
- *Duration of bank intervention*. Compulsory bank intervention prior to possible liquidation varies in length, and in some countries is not well defined. This can pose problems for orderly liquidation.
- *Treatment of bank managers*. Bank managers should be prevented from participating in key bank resolution decisions to ensure fairness, but that is not always the case in all Central American countries.
- *Rights of shareholders*. Similarly, shareholders' rights should be suspended as part of bank intervention, but the law in this respect is unclear in a number of Central American countries.

[8]In contrast, in jurisdictions following a single-entity approach there is only one set of insolvency proceedings in which the financial institution is treated as one entity, and its assets, no matter where they are located, will be included in a single liquidation or reorganization process. There is no "best practice" as to which approach should be followed in the legislation governing bank insolvencies.

Although the six Central American countries are signatories to a regional convention on cross-border bankruptcy proceedings, further efforts are needed. The 1928 Convention on International Private Law (the "Bustamante Code" or "Havana Convention") only sets certain principles applicable to cross-border bankruptcy proceedings as to the extraterritoriality of a bankruptcy order. In the absence of an international agreement specifically governing cross-border bank insolvency, the authorities may want to consider entering into a regional treaty that would set specific rules and procedures applicable to cross-border bank insolvency proceedings, particularly aimed at dealing with regional banking problems to help ensure fair, timely, and transparent treatment of claims of depositors and other creditors.

Policy Recommendations

The minimum standards for the supervision of international banking groups established by the Basel Committee on Banking Supervision stipulate that (1) all international banks should be supervised by a home country authority that capably performs consolidated supervision; (2) the creation of a cross-border banking establishment should receive the prior consent of both the host country and the home country authorities; (3) the home country authority should possess the right to gather information from cross-border banking establishments subject to their oversight; and (4) if the host country authority determines that any of these three standards is not being met, it could impose restrictive measures or prohibit the establishment of banking offices.

Given the significance of existing cross-border intermediation, it may not be possible to implement these standards within a short time frame. Moreover, the presence of banks that do not consolidate financial statements in the international banking center and the likely substantial mind and management in the home country of shareholders are areas to be addressed within the framework of a regional approach. Also, some phasing-in may be required for bank operations in different jurisdictions authorized long ago and for most already well-established regional financial groups. In addition, host supervisors in locations with significant "mind and management" presence perceive that information should flow also from home to host supervisors.

The proposal for regional supervision by the CCS described above is a step in the right direction. It

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would benefit from the definition of a road map with appropriate sequencing and a clear prioritization of goals. Moreover, it appears that more forceful action could be called for in several areas, for example, (1) a no-objection letter from the home regulator would be required to grant licenses in another country in the region; (2) information on depositors could be made available to the home supervisors on an exceptional basis, for example, to identify group exposures and concentration; and (3) cooperation on AML/CFT issues should allow for specific gateways such as for testing compliance with the applicable group requirements and in relation to suspicious activity reports.

Elements to be considered for prioritization and sequencing of a common strategy include

- take as a starting point the decision of financial groups to consolidate in Panama. Rather than "fighting against the wind," the strategy to be devised should aim at maximizing the potential benefits that consolidating in a jurisdiction within the region may bring, while reinforcing the mechanisms that would allow more effective identification, monitoring, and mitigation of risks in each country;
- commit to a plan to require parallel banks and booking offices to report on a consolidated basis, with regional ring fences facilitating enforcement;
- strengthen the role of host supervisors in the process of consolidated supervision. The strategy to be followed should be mindful of the strong "mind and management" presence in the country of origin of shareholders of financial groups. Consideration should be given to a two-way exchange of information;
- address a minimum set of risks considered priority in the first stage. Risks associated with related-party lending and loan concentrations, loan classification and provisioning, and capital requirements seem to be candidates to be addressed in the first instance, by establishing minimum standards and a time table to make them more in line with international standards and best practice. Later on, AML/CFT and country risks could be addressed;
- enhance cross-border cooperation. Central America has a history of formal Memoranda of Understanding (MOUs) that lack effective implementation. Discussions at the CCS should highlight examples when implementation of MOUs has proven effective. Further needed improvements include clarifying the nature of information to be exchanged and reported, with firmer commitments to provide timely and detailed information on more specific areas. Secrecy laws or other limitations on sharing information may need to be modified in some countries; and
- put in place transitional arrangements. More stringent requirements for opening new offices in the region while consolidation of large groups is completed could be considered. Working toward a clear common definition of financial groups among Central American countries should also be a priority.

Development of the Insurance Sector

Structure and Performance

The insurance sector remains small in most of Central America. The market for insurance products in most Central American countries is modest by any measure, but in line with what is seen in countries at a comparable level of development.[9] The number of policies is low relative to the population. Larger firms and more affluent households can obtain most forms of insurance, but the poor are generally lacking in insurance services. Agricultural insurance has only recently been introduced through a number of pilot projects.

The scarcity of insurance affects welfare directly, and may also reduce the availability of financing or increase its costs, because lenders are discouraged when they must bear both the economic risks associated with a project to be financed and also insurable risks from damages. In addition, the limited assets of insurance companies imply that they cannot be major players in domestic financial markets. Hence, measures to promote the insurance industry could yield multiple benefits if they are well targeted. Some of these measures would be more effective if undertaken on a regional basis, and at a minimum the countries can learn from one another in this area.

The prevalence of non–term life insurance, that is, life insurance with an important savings element,

[9]It should be borne in mind that data are sometimes not fully comparable across countries.

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depends on whether or not other savings vehicles are available. Given the heterogeneity of fiscal, distributional, and demographic factors affecting non–term life insurance, this report concentrates on non–life insurance.

The insurance sector in most of the region is highly fragmented, and many insurance companies tend to be relatively small affiliates of banks. Thus, the average company is small (Costa Rica, which has a unique state monopolist insurer, is an exception). Some insurance companies are linked to broader industrial-financial conglomerates. The numerous small companies almost certainly operate well below efficient size, and in many cases their revenues are insufficient to support the employment of their own actuary or the development of a fully computerized system for record keeping, data analysis, and claims processing. Their portfolios of investments may also be too small to achieve full diversification.

Most indicators of soundness and performance display stability and do not raise immediate, systemic concerns.[10] There have been no major failures in recent years, but the occasional failure of small companies has been widespread. Recent experience with heavy losses from both Hurricane Mitch in most of the region and two earthquakes in El Salvador in 2001 indicates that, in all affected countries, the insurance sector as a whole was capable of covering its liabilities, largely because it was properly reinsured. Heavy use is made of reinsurance from the large international reinsurers, although the Panamanian reinsurers also accept risks in the region.

Companies' investment portfolios are typically not very diversified, at least by type of investment. Most companies place assets in bank accounts or, in some cases, in securities issued by their respective national governments. Investment abroad is modest and in all countries is severely constrained by regulations. For non–term life insurance business, companies are often severely constrained by the lack of securities with a maturity approaching that of liabilities to policyholders.

Legal and Regulatory Framework

All countries have a law on insurance. Supervisors and market participants are generally aware that certain legal provisions may unnecessarily hamper the development of the sector, but enacting the necessary amendments is not high on the legislative agenda. The Honduran Law was substantially amended in 2001, and, in other countries, legislative amendments are being prepared. Many firms choose to establish internal financial policies that are much stricter than what regulations require.[11] The supervisors generally monitor the condition of their insurance industries closely, and are aware of regulatory developments elsewhere. However, in several countries, they acknowledge that they lack the budgetary resources to retain as many well-trained staff as they would prefer.

Certain common features can be identified in the regulations of many (if not always all) of the countries of the region. Some potentially problematic features include the following:

- Minimum required technical reserves (also called provisions) for non–life insurance policies are defined as a proportion of premiums net of the amount ceded to reinsurers, rather than related to the actuarial value of expected losses, which is a company's true exposure. Furthermore, this specification of minimum reserves may create an incentive for companies to increase risk by competing via lower premiums because by doing so they both gain market share and reduce the expense of holding reserves. If the proportionality factor is too high, the affected products will be needlessly expensive.
- On a connected point, the treatment of insurance premiums ceded to reinsurers does not differentiate sufficiently according to the specifics of the reinsurance contract, which might give the reinsurer more or less scope to limit reinsurance payouts in case of loss. If the regulations do not allow for this possibility, primary insurers can have an incentive to reinsure as cheaply as possible while also reducing the expense of holding reserves.
- All countries established solvency requirements ("solvency margins"). A few supervisors suggested that the minimum solvency requirements may be too low.
- Investment by insurance companies is restricted in various ways. While these restrictions are

[10]However, the insurance business is inherently vulnerable to rare but large risks; performance can be satisfactory for many years, but the true soundness of the system is often apparent only after a major event such as an earthquake.

[11]In Panama and Guatemala, the insurance sectors have five times and three times the required level of capital and reserves, respectively.

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mainly intended to preserve the solvency and liquidity of companies, some may be counterproductive or inefficient. Certain restrictions strongly favor investment in securities issued by the national government. Additionally, in all countries, investment abroad is severely limited, and in some countries returns on foreign investment are taxed much more heavily than returns on domestic investments. Given the limited size and development of regional capital markets, restrictions on foreign investment depress investment yields and increase risk by limiting diversification.

- Entry by foreign firms is generally permitted, subject to standard licensing procedures (except in Costa Rica). However, there are restrictions on the form in which a company can be incorporated, and branching is prohibited. All countries prohibit the purchase of most forms of insurance from abroad. These restrictions constrain regional integration.
- In most countries, presumably because of the recent nature of the service, specific regulations regarding bancassurance are weak. When banks sell insurance products through their branches, the scope for bundling financial products—such as a loan with an insurance requirement—gives rise to issues of consumer protection and the definition of fiduciary responsibilities.
- Few countries have extensive requirements on companies to prepare and publish regular reports on their actuarial situation (Nicaragua is an exception). Regulations for and supervision of information management systems, computer systems, and other forms of operational risk are very limited. The lack of requirements in these areas, where effective systems are characterized by high fixed cost, helps smaller companies to survive.
- The tax treatment of insurance differs across countries. In some, but not all, countries, premiums for life insurance and certain other categories of insurance are deductible from income tax. Sometimes certain insurance expenses are exempt from sales or value-added taxes. The treatment of insurance payouts also varies.

The weaknesses noted above suggest an agenda for regulatory modernization. The authorities hope to move toward a more risk-based approach to regulation and supervision, with a greater role played by actuarial calculation of risks. In particular, technical reserves need to be related to the expected value of losses, their variance and covariances, and other risks (such as reinsurance risk). Also, companies need more scope to manage their portfolios to match underwriting risks. Many measures needed for prudential purposes, such as introducing more risk-based reserve requirements, mandating the production of actuarial reports, and introducing modern information management systems, would likely have a greater impact on smaller companies, and could spur consolidation. However, while the regulatory and supervisory framework can be improved, it will be important to allow room for less sophisticated products aimed at providing basic coverage at low cost.

Insurance Sector Development and Regional Issues

Besides the regulatory issues raised above, the authorities may have a role in providing other support services. There may be a role for direct subsidies or administrative support for crop insurance, provided that the cost is made transparent in the budget. Insofar as farmers are poor, there may be distributional reasons for these types of support. Moreover, the availability of crop insurance may be held back by fixed costs, such as centralized information processing; government action may be needed to reduce the substantial start-up costs.

Governments could also contribute to the development of the insurance sector by insuring more of their own risks instead of relying on implicit self-insurance. Greater insurance volumes by the government could help in creating critical mass and economies of scale for the sector. Taking out insurance policies on important assets, such as roads and bridges, as is done in many countries,[12] could add to explicit planned expenses, but it would also allow for an improved budgetary process and less need for costly last-minute reallocations of budget revenues to attend unforeseen reconstruction expenses and other losses.

Another potential area for government action is general catastrophe insurance. A large volume of private sector assets in Central America are uninsured

[12]In Bahrain, for example, government or quasi-government agencies insure petroleum-related facilities and other infrastructure, and premiums from government insurance constitute about half of all property-related premiums.

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and the potential losses from a major event, such as an earthquake, can create a negative macroeconomic shock that multiplies the direct losses from the event. To the extent that governments typically assume some responsibility for disaster recovery and reconstruction in the case of catastrophes, there is an implicit public sector liability. Recognizing these potential liabilities and dealing with them through appropriate insurance contracts may reduce the associated costs.[13] The government would be involved by making insurance compulsory for specified catastrophes, conducting risk analysis, and selecting one or more providers. (In the United States, for example, there are several earthquake, flood, and hurricane insurance and relief arrangements.)

Insurance sector development offers scope for regional cooperation and the exploitation of economies of scale. One set of measures might be directed at the harmonization of regulations, in line with international best practice. The authorities could coordinate the introduction of risk-based regulations, and eventually there could be a presumption that a company operating in one jurisdiction would be free to offer insurance products and to open a branch or subsidiary in another country of the region. In this way, competition could be preserved even as the sector consolidates within individual countries. This type of effort appears particularly relevant given the expected results of the CAFTA-DR and Free Trade for the Americas negotiations.

Regional efforts could be worthwhile in other areas, including (1) the collection and dissemination of demographic, meteorological, agronomic, and other statistics needed for actuarial calculations that underlie insurance pricing, notably but not exclusively in relation to crop insurance; and (2) joint development of catastrophe insurance programs, especially where geographic or climatic regions with similar risk characteristics extend across borders.

Harmonization of Payment and Securities Settlement Systems

There is a high degree of heterogeneity in payment and securities settlement systems in Central America. Most countries in the region have launched substantial reforms in their national systems in recent years, with assistance from the international financial institutions (IFIs), but significant differences remain from one country to another. Overall, more is needed to bring national payment and securities settlement systems in line with international standards. The proper design and functioning of national systems should be pursued with a view to contributing to the overall soundness and stability of the financial system, a further deepening of financial markets, and preventing systemic risk.

In parallel with the development of national systems, there is growing interest in the region in the efficiency gains that could be achieved by adopting integrated frameworks for regional payments and securities settlement. Projects on regional clearance and settlement of large-value financial transactions and on integrated regional large-value, RTGS payment systems have been launched by Central American governments, the Central American Monetary Council (CAMC), and the Inter-American Development Bank. The ongoing reforms at the national level provide an opportunity for further harmonization at the regional level and the eventual integration of payment and securities settlement frameworks.

Current Situation

There are serious deficiencies in the legal framework governing national payment and securities settlement systems in Central America. Legal provisions are either lacking or have not resulted in adequate regulation in a number of key areas, such as central bank oversight powers, irrevocability of final settlement, protection of the systems against the effects of bankruptcy procedures, custody arrangements, repurchase (repo) operations, multilateral netting arrangements, and immobilization and dematerialization of securities (notably public securities). Weaknesses in the legal framework create uncertainty about the systems' and participants' risk exposures, and create impediments to financial market development.

Most countries in the region already operate or have launched RTGS systems, but manual or semimanual systems remain prominent. Costa Rica has a safe and efficient RTGS system, and new systems more in line with the CPSS Core Principles for Systemically Important Payment Systems (CPSIPS)[14]

[13]Turkey has established a catastrophe insurance pool for damage to dwellings from earthquakes. Initiatives to develop catastrophe insurance are under way in several other countries, with the assistance of the World Bank, the Inter-American Development Bank, and the International Finance Corporation.

[14]See Bank for International Settlements (2001).

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are being launched in El Salvador, Honduras, and Guatemala. Overall, however, checks represent a significant portion of large-value interbank payments, thereby maintaining a "systemically important" status. In some countries, checks are the predominant or the only system available to channel interbank payment transactions. Slow progress in the full adoption of RTGS systems has come at a cost in terms of efficiency and vulnerability to credit and systemic risks.

Cashless instruments for retail payments are little used in the region despite recent efforts. New applications to process retail electronic credit and debit instruments have been a major element of efforts to modernize national payment systems. Automated clearinghouses (ACHs) have been launched in some countries (Costa Rica, El Salvador, Guatemala, and Honduras). In most countries, however, ACH projects are either too slow to keep pace with customer needs or too limited in scope (e.g., the project only focuses on improvement of check-clearing procedures). Moreover, countries have often failed to fully integrate government-related payments (tax collection, salaries, purchase of goods and services, and so on) into the national payment systems, despite the fact that public sector institutions are major players in the system.

There is room to improve the safety and efficiency of clearance and settlement mechanisms for foreign exchange transactions. These transactions—whether domestic or cross-border—are typically not settled on a payment-versus-payment (PvP) basis, which generates significant credit and liquidity risk. Risks related to cross-border transactions are also relevant in view of the important flow of remittances to countries in the region. In particular, a large share of remittances is still channeled through nonregulated specialized institutions, for which there are no standards for aspects such as transparency of fees and other charges or the timing of accreditation of funds to end-beneficiaries.

The underdevelopment of the interbank market has been a key obstacle to the smooth functioning of payment and securities settlement systems in the region. Interbank money markets are not very active in most Central American countries, with the notable exception of Costa Rica. This has hampered liquidity management by financial intermediaries, in addition to impeding monetary policy transmission.

Significant shortcomings remain in the securities settlement process across countries in the region. Manual handling of securities is common and creates inefficiencies and risks that limit the development of the markets. Settlement cycles tend not to be standardized, and automatic securities lending and borrowing facilities are not available, which hampers effective risk management. In most countries in the region, securities transactions are not settled on a delivery-versus-payment (DvP) basis, and full dematerialization and immobilization of securities have not been achieved. In addition, overall there is an absence of risk management tools used to cover settlement failures.

In general, there is scope for improving the oversight of payment and securities settlement systems. Central American central banks do not fully observe the main responsibilities of the Core Principles for Systemically Important Payment Systems regarding payment system oversight. Specifically, central banks in the region lack explicit oversight authority over the securities settlement system and full transparency on major policies affecting the payment system; progress toward compliance of the systems with international standards has been slow, as noted; and cooperation with other relevant authorities, both at the national level (i.e., the ministry of finance, the banking supervisor, the securities commission, and other relevant regulators) and across the region, remains weak.

Policy Recommendations

Central American countries should continue in their efforts to bring their national payment systems in line with international standards. By adopting a comprehensive approach based on international standards and best practices, each country would move toward a set of payment arrangements, services, and circuits able to serve the needs of all users in the economy. Not only should the scope of reform be broadened in terms of systems (to include, for instance, retail and government payments in addition to large-value payments), but it should incorporate an upgrading of the underlying legal, regulatory, and oversight environments. In conducting the reform, the logical sequencing process would be (1) diagnostic analysis; (2) vision development; (3) conceptual design and implementation planning; (4) user requirement specifications; and (5) acquisition, procurement, development, testing, and implementation.

As the authorities prepare for the next stage of reforms, they should lay the groundwork for further regional integration among the different payment sys-

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tems. Appropriately reforming each national payment system in the region will create the conditions for further harmonization and integration through the interlinking of the different systems. Central banks should, therefore, work in parallel in reforming as a first priority their national payments systems and, at the same time, work toward closer integration within the region by discussing and preparing minimum common features and a realistic timetable.

A number of improvements are needed to bring national payment and securities settlement systems in line with international standards and best practices:

- All countries in the region should move toward an appropriately designed RTGS system. The design of the system should include (1) a robust and efficient communications network to reduce and eventually eliminate the use of manual and paper-based procedures; (2) strict security measures for physical and electronic access to the system; (3) contingency plans and disaster recovery mechanisms, including the setting-up of a secondary site; and (4) measures for business continuity and resilience.
- Central banks have a role to play in ensuring that the existing retail circuits support customers' needs and are safe, convenient, and efficient for the economy as a whole. Central banks should (1) ensure that the legal and regulatory framework keeps pace with market developments; (2) monitor competitive market conditions and behaviors and take appropriate actions to foster such conditions; (3) support the development of effective standards and infrastructure arrangements; and (4) adapt as necessary its provisions of settlement services for systems operated by other entities to contribute to efficient and safe outcomes, allowing all such systems to settle in central bank money.
- Central banks and relevant government agencies should foster coordination to ensure that collection and disbursements of public sector institutions that are major players in the payment system be processed electronically and timely through an appropriate system, such as an automated clearinghouse for retail electronic payment instruments.
- Central banks should monitor trading and settlement platforms and procedures for foreign currency and cross-border transactions, notably remittances, to ensure that the principles of safety and efficiency can be applied to clearance and settlement.
- The interbank money market should be developed further to ensure the smooth functioning of the payment and securities settlement systems. A key element would be to create a special system for large-value payments. This should provide secure electronic interbank transfers with immediate settlement, connected to an electronic book-entry securities registration system.
- Clearing and settlement processes in securities settlement systems should be upgraded. The main aspects to be improved are achieving full dematerialization and immobilization of securities; establishing DvP procedures; upgrading risk management tools; mitigating credit and liquidity risk in the cash leg settlement (including eliminating the use of checks as a cash asset); providing better access to liquidity for system participants; and developing a comprehensive strategic approach to the reform of systems, as opposed to technology-driven and purely operational reform projects.
- There is room for efficiency gains in the securities settlement infrastructure. Physical handling of securities should be eliminated to increase safety and efficiency. Clearing and settlement should aim at achieving straight-through processing. Plans for backup sites and disaster recovery facilities should be accelerated or established when they are nonexistent. External audits of the systems should be undertaken, especially when they were developed in house and/or oversight is weak.
- The legal framework needs to be strengthened to reduce custody risk—that is, to guarantee the protection of customers' assets in the event of bankruptcy of the depository or the custodian. The country authorities should ensure that the segregation of accounts for securities and funds under custody has a clear legal basis; that all customer assets are appropriately accounted for under their beneficial owners in the depository or in the custodian's omnibus accounts; and that customer assets are protected against the insolvency of custodians.
- The securities depository should be well capitalized, autonomous, and capable of expediting settlement of transactions and accessory rights.

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This is crucial for the development of the securities markets.

- The authorities should analyze the risks associated with cross-border links among securities depositories. At the international level, the legal framework governing the cross-border pledge of securities as collateral should be improved. In this respect, some depositories and securities regulators participate in the Hague Convention efforts to develop internationally accepted principles in this area, but they believe that market participants have not been sufficiently involved.
- There is scope for improving the oversight of payment and securities settlement systems. Legislation should clarify in detail the responsibility and enforcement authority of the central bank as payment system overseer. In addition, adequate resources should be devoted to securities settlement oversight and an effective cooperative framework established with other agencies, self-regulatory organizations (SROs), and the private sector. In performing the oversight function and as system operators, central banks and securities regulators should ensure transparency in their policies and conditions for services offered.

Conclusions

Central American countries share the bonds of geographic proximity, a common language, and similar histories. Country authorities have seen the mutual advantages of cooperating in areas critical to economic growth and development, including promoting financial sector development and stability. There appear to be significant economies of scale and scope that can be exploited by serving a sizable regional market.

The private banking sector has already expanded throughout the region, contributing to an increase in financial intermediation in line with that observed elsewhere in Latin America. At this stage, prudential regulation and supervision need to catch up with the activities of financial conglomerates, to reduce the potential risks arising from regulatory arbitrage and cross-border contagion. Several countries need to increase the financial and operational independence of financial sector supervisors because international experience has shown that this is crucial to ensuring the implementation of prudential regulation free from intervention by vested interests. Continuous upgrading of the technical capacity to conduct consolidated supervision of financial institutions in all of the countries is also advisable.

To back up efforts by the Central American council of financial sector regulators to improve supervision of regional financial groups, recommendations include the sharing of information by supervisors in countries where regional financial groups have significant activity; consideration of joint on-site inspections; and establishing a regional timetable to address irregular arrangements such as parallel banks and offshore institutions. With the relaxation or elimination of restrictions on domestic financial institutions to conduct operations in foreign currency, there should be less legitimate incentive for offshore operations. In addition, supervisors in the region could benefit from an exchange of views on necessary changes to the respective legal frameworks for achieving an effective regime for cross-border bank insolvency.

Insurance and capital markets in Central America are much less developed than the banking sector. The development of these sectors seems to be constrained by legal restrictions (cross-border sale of insurance products is generally closely controlled or prohibited), and there are limits on the investment of insurance assets abroad. Furthermore, payment and securities settlement arrangements are country based with no regional trading platform. The countries are encouraged to increase the technical resources and strengthen legal frameworks for oversight of insurance and payment and securities settlement arrangements. This would be a precondition for the development of individual country insurance and capital markets and, eventually, of a regional stock market.

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