INFORME DE ESTABILIDAD FINANCIERA

SBP
Superintendencia de Bancos de Panamá

I semestre de 2022

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Foreword

The Financial Stability Report (IEF, for its acronym in Spanish) published today, under the Superintendency of Banks of Panama's approach, presents a macro financial point of view, with an analysis of all the socio-economic variables that affected the results of the National Banking System (NBS). We developed this survey taking into consideration that the Republic of Panama was one of the countries with the strictest lockdown measures due to the COVID-19 pandemic, which in turn, caused a significant impact on economic aggregates, such as GDP decline, unemployment rate growth, FDIs cuts, among others.

The best economic performance presented at the end of 2021 and the growth outlook expected in the medium-term were dissipating, because of the Russia-Ukraine war, which has caused an international economic impact, as well as inflationary expectations and interest rate hikes set by the Fed. However, we must consider the capacity of the Panamanian productive sector to overcome adverse times, which will help to obtain reasonable economic growth figures, although not at the levels projected in late 2021.

This paper reveals, in turn, the indebtedness performance, both at the corporate and household levels. As for the Panamanian case, we observe a prominent level if compared to the GDP-to-debt ratio.

In addition, we present an analysis of the impact of interest rate hikes in our market and the performance of the entities that make up the NBS, the performance of the real estate sector, and the impact of macroeconomic variables on the solvency ratio. The survey shows that the financial system, at the aggregate level, would remain resilient, at the face of an unexpected economic scenario, as well as at the face of potential severe domestic and international shocks. The NBS has demonstrated its robustness despite of the impact triggered by the pandemic, however, when facing these disturbances, we observe a difference in the financial capacity of entities with better financial soundness indicators.

Remarkably, the capital regulatory framework adopted in 2016 addresses the recommendations on higher quality capital elements, as established by international standards, such as Basel III.

As for the results of the sensitivity analysis conducted on liquidity, we observe that the NBS maintains adequate resilience levels to face deposit outflows, which would occur in severe scenarios, where excess availability [of resources] would make it possible to absorb a significant outflow of deposits. The resistance to liquidity shocks in most entities is based on an adequate distribution of assets and liabilities by maturity terms, on the sufficiently diversified funding structure, and on high-quality liquid assets that were set to comply with the liquidity coverage ratio (LCR) requirement.

I. National & International Economic Performance

A. International Environment

The most recent data shows that the world faces a much more complicated environment this year compared to what happened in 2021, considering that the pandemic risk remains, coupled with a war in Eastern Europe, an international monetary policy set by major central banks stringent than originally anticipated, and greater volatility in global financial markets that already warn of the possibility of a recession in several developed countries.

These elements would lead to rate and risk premium hikes, above that observed, and a potential widespread of financial volatility that will be instrumental to slowdown global economic activity, which could undoubtedly influence the domestic market.

According to the International Monetary Fund (IMF), various risks to the outlook point to the downside. The war in Ukraine could cripple Russian gas imports into Europe; inflation could be more difficult to reduce than expected, either because labor markets are tighter than expected, or because inflation expectations become unanchored; tightening global financial conditions could cause over indebtedness in emerging markets and developing economies; new COVID-19 outbreaks and lockdowns. Meanwhile, the deepening crisis in the real estate sector could further inhibit growth in China, while geopolitical fragmentation could hamper global trade and cooperation. In turn, we foresee a feasible alternative scenario, in which the risks materialize, inflation increases even more, and global growth falls to 2.6% in 2022 and 2.0% in 2023.

In accordance with the IMF baseline, growth will fall from 6.1% in 2021 to 3.6% in 2022, which would also represent a decline of 0.8 basis points compared to the previous edition of the World Economic Outlook (**see Table I.1**). The lower domestic growth recorded at the beginning of the year, the loss of households' purchasing power, and a stringent monetary policy triggered the downward revision of 1.4 basis points in the United States. In China, the new lockdowns and the worsening of the real estate crisis have forced the downgrading of growth by 0.4 basis points, with important global repercussions. On the other hand, in Europe, the significant declines reflect the Ukrainian war repercussions and the tightening of the monetary policy. Global inflation was up because of food and energy prices and persistent supply-demand imbalances, and we expect that this year it will stand at 6.6% in developed economies and 9.5% in emerging markets and developing economies, i.e., upward revisions of 0.9 and 0.8 basis points, respectively.

Table I.1: GDP Growth Forecasts
Annual difference in %

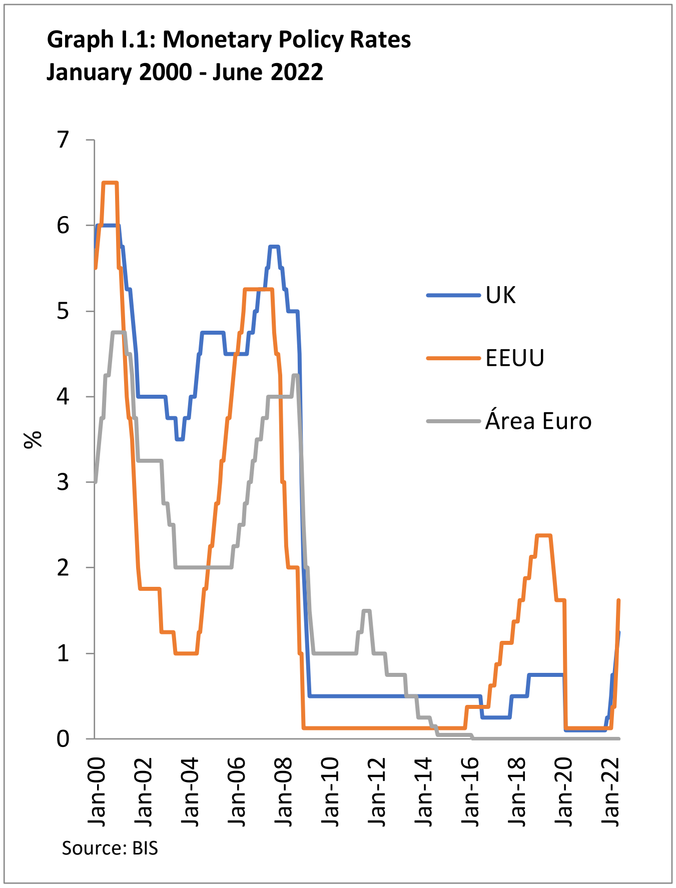
	2021 (IMF)	Projections Apr 2022		Projections Diff. Jan 2022	
		2022	2023	2022	2023
Global GDP	**6.1**	**3.6**	**3.6**	**-0.8**	**-0.2**
Developed economies	**5.2**	**3.3**	**2.4**	**-0.6**	**-0.2**
United States	5.7	3.7	2.3	-0.3	-0.3
Euro Zone	5.3	2.8	2.3	-1.1	-0.2
Japan	1.6	2.4	2.3	-0.9	0.5
United Kingdom	7.5	3.7	1.2	-1	-1.1
Emerging economies	**6.8**	**3.8**	**4.4**	**-1**	**-0.3**
China	8.1	4.4	5.1	-0.4	-0.1
India	8.9	8.2	6.9	-0.8	-0.2
LATAM	6.8	2.5	2.5	0.1	-0.1
Brazil	4.6	0.8	1.4	0.5	-0.2
Mexico	4.8	2	2.5	-0.8	-0.2
Panama	**15.3**	**7.5**	**5**		
Emerging Europe	**6.7**	**-2.9**	**1.3**	**-6.4**	**-1.6**
Russia	4.7	-13	-2.3	-11.3	-4.4
Ukraine	3.4	-35			

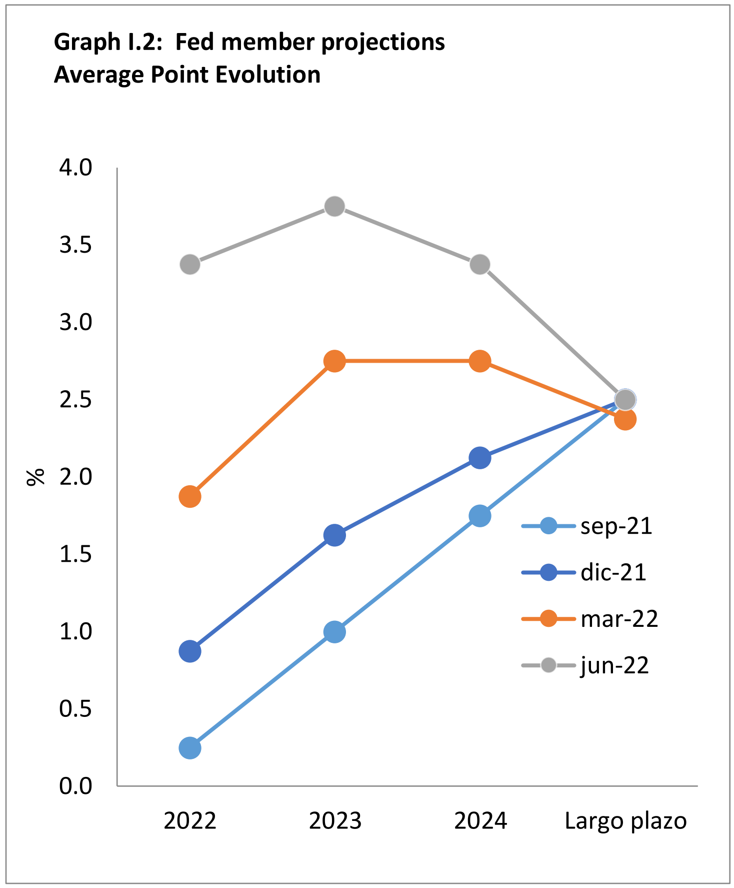
Source: WEO, IMF

Despite this less encouraging scenario, as for Panama, the economic growth for the IQ2022 was 13.6%, exceeding market expectations. The foregoing led to a revision of the economic growth forecast for 2022 and places it in 7.5% more than a basis point above the original forecasts. However, the slowdown in the global economic recovery described above and the protests developed at the beginning of IIQ2022 will undoubtedly affect the forecasts for the year that will be subject to a high decree of uncertainty and downward risks.

Price hikes continue to be the main problem in all the economies, for which the economic authorities' top priority has been controlling inflation. An important part of developed economies has initiated a significant monetary policy interest rate hike (**see Graph I.1**). As for the United States, the stronger stance in its objective of controlling inflationary expectations and reversing part of the stimulus is creating an important market change. In any case, the slowdown debate will gain relevance in 2022.

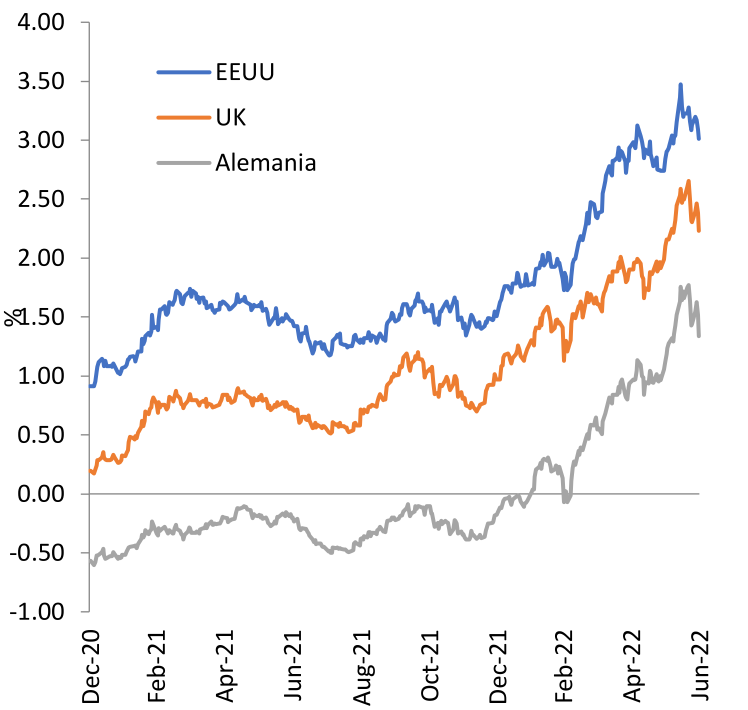
Notably, the forecast and effective hikes in the United States have been more aggressive than originally stated in the minutes of the Federal Reserve (**see Graph I.2**). No meeting has recorded interest rate hikes since 1994. The 2022 scenario would imply that the Fed could end the year at 3.4%, a level that will more actively limit economic activity. Most members believe that a "restrictive" policy should reduce demand to a price restriction.





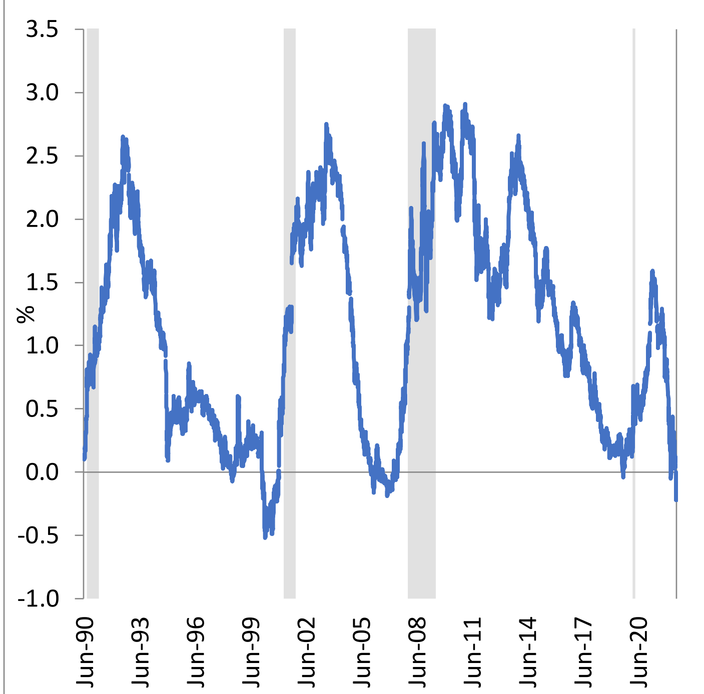
This environment has led the fixed-income markets to begin anticipating a slight growth, i.e., a flattening of the yield curves (**see Graph I.3**). In this framework, financial assets prices showed asymmetrical performances by segments and markets, reflecting a significant depreciation of financial assets. With growing inflationary pressures in developed economies, there has been an increase in public securities yields in recent months. As for the United States, starting in September, it confirmed to have an environment of greater volatility and a rise in short- and long-term yields in the Treasury bonds market (that at the beginning implied a certain flattening of the yield curve) (**see Graph I.4**). The inverted yield curve is associated with greater risk in the short-term, therefore, it will precede recessions. In the current case for the United States, the inverted curve could suggest an expectation that the Fed will continue to raise its rate given the strength of the labor market and the inflationary process that could begin to weaken in the second half, but above the 2% range.

Graph I.3: 10-Year Government Bond Interest Rates
December 2020 - June 2022



Source: Board of Governors of the Federal Reserve System (US)/FRED

Graph I.4: Yield Curve
June 1990 - June 2022

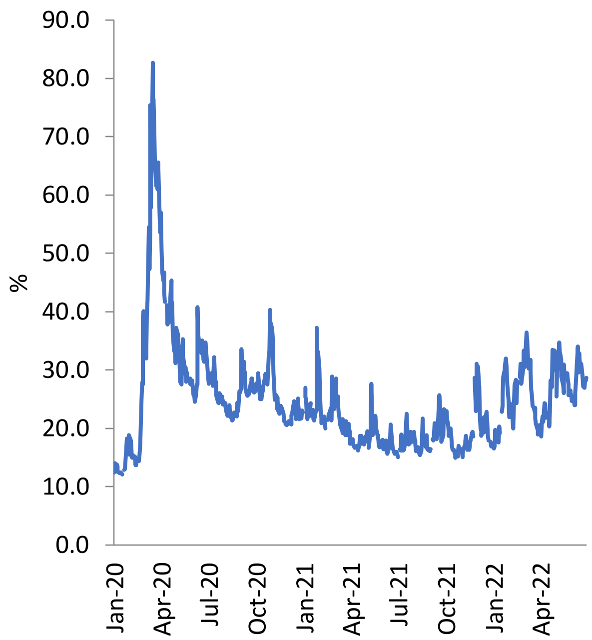


Source: Federal Reserve Bank of St. Louis

In addition to the foregoing, it has been possible to observe a tightening of financial conditions because of greater risk aversion derived from the war. Since late 2021, there has been an increase in long rates worldwide and in market risk indicators, such as VIX on the rise (**see Graph I.5**). This has occurred in a scenario where, overall, stock markets have gone down. As for emerging economies, sovereign risk premiums have increased (**see Graph I.6**), because of the incorporation of factors such as higher risk premium, higher inflation premium, higher monetary policy rates expectations.

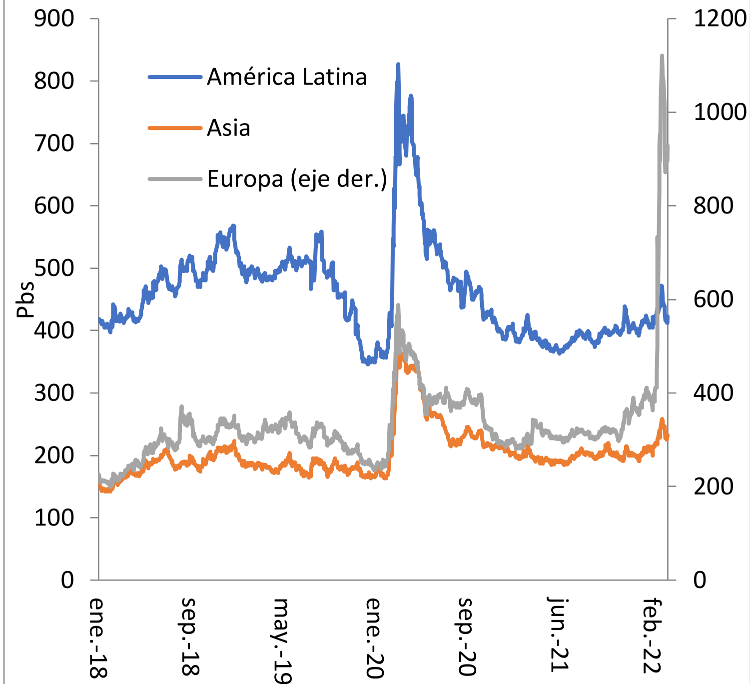
About emerging economies markets, in the second half of the year there were increases in the margins required for secondary sovereign debt markets (EMBI), something that has also occurred in Panama. However, we do not expect any impact on the country's credit rating in the medium-term.

Graph I.5: VIX Index
Jan. 2020 - Jun. 2022



Source: Chicago Board Options Exchange

Graph I.6: Risk premiums
Jan. 2018 - Jun. 2022



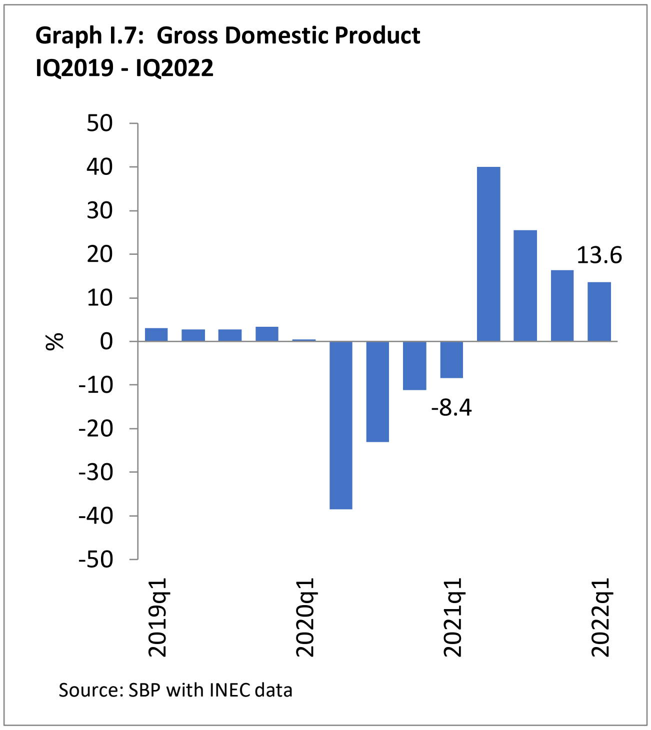
Source: JP Morgan

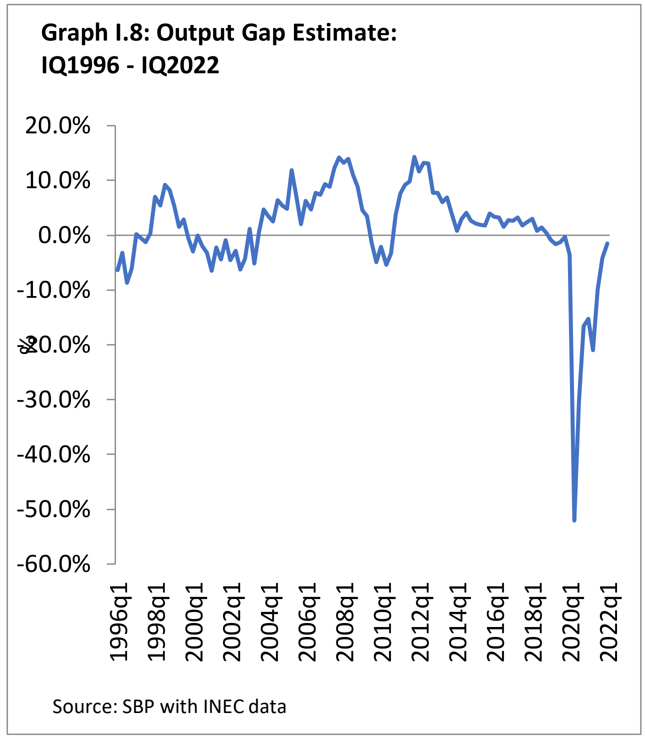
B. Domestic Environment

1. Economic activity and employment

During IQ2022, economic activity continued to consolidate the reactivation and economic growth process that began in 2021, after the progressive normalization of social mobility and remained running operations at levels higher than those of the pre-pandemic era. This growth took place even in a new COVID-19 infection wave in the country, with limited and temporary influence on the activity level thanks to an ongoing vaccination process. Economic activity improvement came along with total employment recovery but continued to show sectoral asymmetry.

In IQ2022, the GDP increased 1.8% quarterly s.a. (13.6% year-on-year, **see Graph I.7**) and stood at 3.7% s.a. above its level in IVQ2019. The growth trend, and its upward outlook, maintains an output gap that will be down during the first half of the year, which, together with employment market improvement, suggests that demand pressures on prices will continue for the remainder of the year.





Although the overall post-pandemic recovery of the productive sectors, a great asymmetry persists regarding the level of activity of each. Among the sectors producing goods and services, commerce, construction, and transportation, storage and telecommunications were the most dynamic, recording a year-on-year increase of 22.4%, 21.7%, and 11.9%, respectively. The joint contribution of these sectors to annual growth was of two (2) bp. Among services, commerce stands out rising to 12.1% s.a. in the same period and contributed another 8.4 bp and account for 61% of growth in IQ2022.

However, to date, there are still lags in the recovery of services that are more sensitive to social distancing, such as recreational or accommodation services, given the restrictions and low demand they still face. Hotels and restaurants are the services furthest behind: they would have to grow thirty-seven (37) bp to reach the numbers of IVQ2019.

Table I.2: Sectorial GDP Performance
IQ2020 = 100

Market Production	2019	2020				2021				2022
	IV	I	II	III	IV	I	II	III	IV	I
Primary sector										
Fishing										
Mining and quarrying										
Industry										
Basic services										
Construction										75
Commerce										
Hotels and restaurants										66
Transportation and storage										
Financial intermediation										
Real estate										
Private education										85
Private healthcare										
Other communities										
Government										
Total GDP										

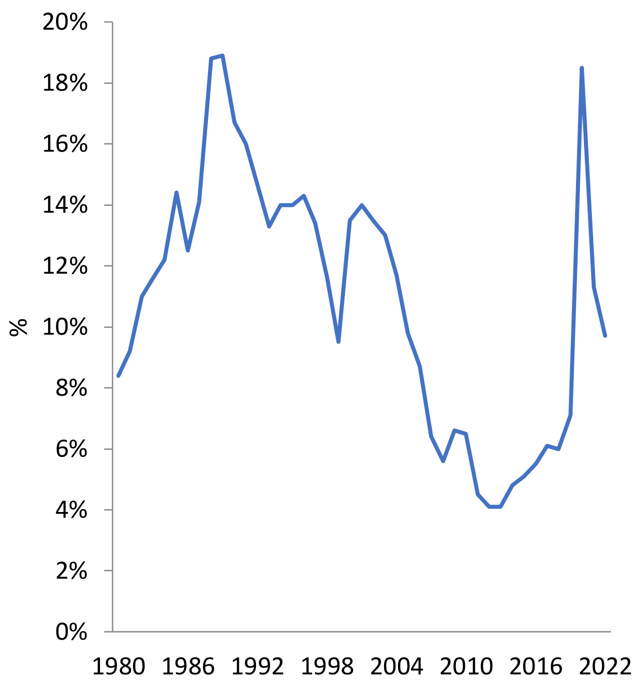
Source: with INEC data.

In April 2022, unemployment showed signs of recovery and reached a 9.9% rate. With this result, unemployment decreased 1.4 points, i.e., it went from 11.3%, in October 2021, to 9.9%, according to the latest data (**see Graph I.9**). This would be the lowest unemployment rate since the start of the health crisis in the country when the indicator rose to 18.5%. Looking at the performance of the first half, given the best time of the local economy, we believe that the return of inactive people to the labor market would continue, in such a way that the employment rate could keep improving.

The recent performance of private sector employees makes it possible to distinguish different developments at the sector level, but most still show a significant lag. However, considering pre-pandemic levels, hotels, and restaurants; financial; and construction sectors still have room for recovery both in activity and new recruitments (**see Graph I.10**).

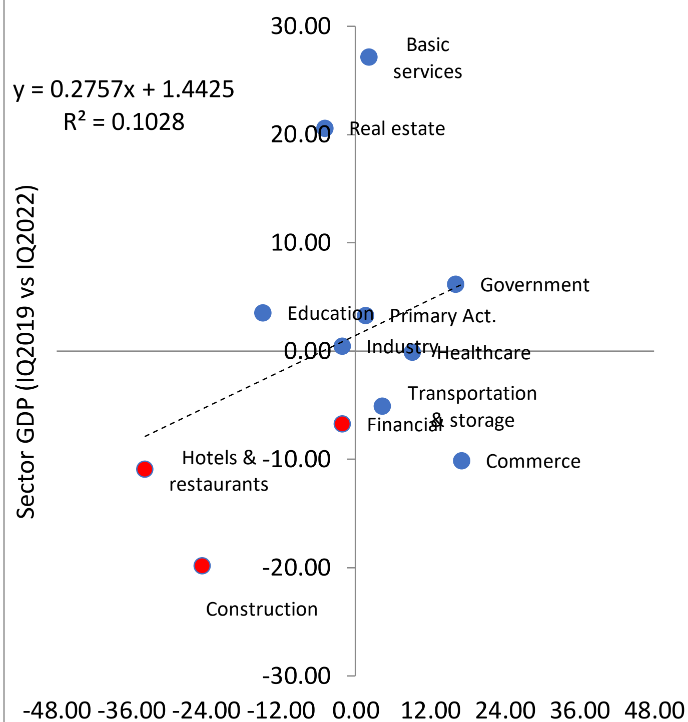
Although, it is expected that economy will continue to recover its employment level and the people who were laid-off will be rehired, the evidence of a decrease in the employed people and the difficulty of recovering the people who were laid-off because of the pandemic trigger red flags regarding the economy's ability to resume the employment recovery rate for the second half of the year, and therefore, continue observing significant improvements in the unemployment and employment rate.

Graph I.9: Unemployment Rate 1980 - 2022



Source: SBP with INEC data

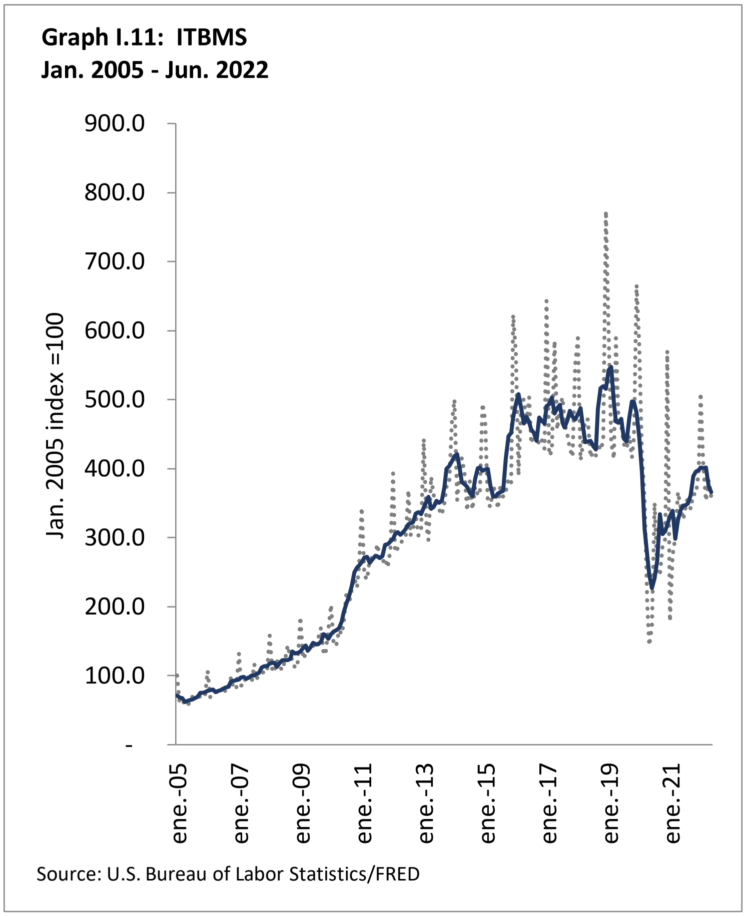
Graph I.10: Activity and Employment IQ2019 vs IQ2022

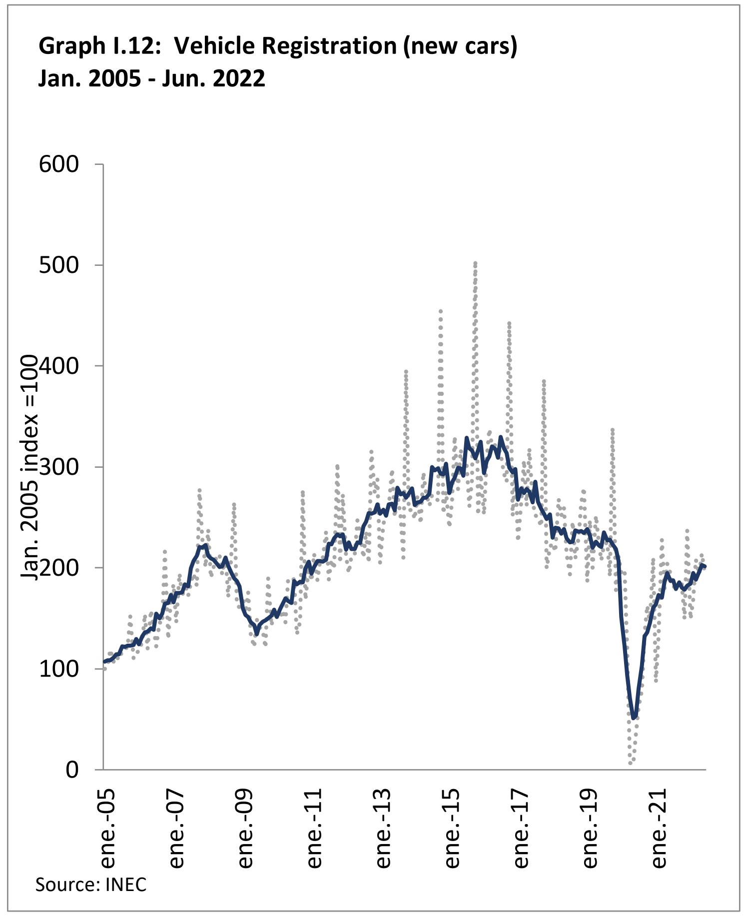


Source: SBP with INEC data

Regarding consumption indicators, overall, they continued to recover gradually. Thus, during the first half of 2022, private consumption maintained its recovery; the consumption of goods showed a favorable performance and remained, in some cases, at levels like that of pre-pandemic ones. Therefore, for example, the recovery in automobile sales has allowed sales volumes to resume (**see Graph I.12**). In addition, companies have made the decision of purchasing new models to boost their businesses and strengthen the planning chain.

For their part, consumption taxes indicators are still below 2019 levels (**see Graph I.11**). The foregoing would indicate that consumption recovery is still partial and asymmetrical, but it is progressing.





It is necessary to mention that it is possible that consumption exhibits a greater performance than other private spending components. We mention this because of the performance of external accounts that have had a strong increase in imported goods. This could put pressure on the checking account balance.

2. Recent Inflationary Evolution

In the first half of 2022, global inflation has continued to accelerate because of the effect of unresolved epidemic shocks and the increasing tensions caused by the Russia-Ukraine conflict, among others.

It is worth remembering that we came from a tight raw materials market with few frictions and multiple supply restrictions, and the Russia-Ukraine conflict becomes a catalyst of these price movements, since there is a high dependence on Russian and other countries' raw materials (energy, grains, fertilizers, among others). In this juncture, the prices of various raw materials have increased sharply, in net terms, and fluctuated drastically in response to geopolitical events (**see Table I.3**).

Table I.3: Heatmap: Raw Materials Prices
Dec. 2019 – Jun. 2022

Source: with World Bank data

The result of all the above has led to the continued imbalance between supply and demand in different markets, which persists because of slow distribution channels restoration and low production flexibility. Although all commodities peaked weeks ago after Russia's invasion of Ukraine, we are still at significantly higher price levels than at the beginning of the year.

The fact that raw materials are in a cycle in which prices are rising and, at the same time, volatility is higher, is also beginning to generate credit issues and working capital needs issues. These price movements could create a potential channel that could expose financial institutions to contagion, from a stability perspective.

In Panama, as of June 2022, the CPI increased 1.1% per month, bringing annual inflation to 5.2%, the highest score since October 20013 (**see Graph I.13**). Food and fuel were once again the main determinants of inflation.

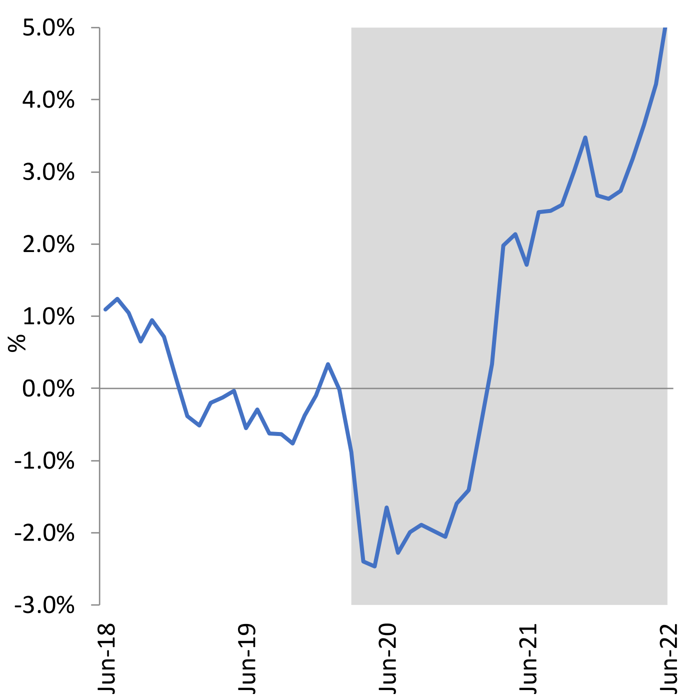
Although 90% of the difference during the first half of 2022 originated in supply components (food and energy), the truth is that these factors have proven to be less transitory than initially expected.

This performance, added to the pressure to close the output gap [and] continuous disruptions in the global supply chain, will cause inflation to remain above record average throughout 2022.

Inflation in all CPI components increased, which would show that the current inflationary phenomenon does not respond only to a supply shock, but rather that demand has also been pushing up prices in an economic growth context.

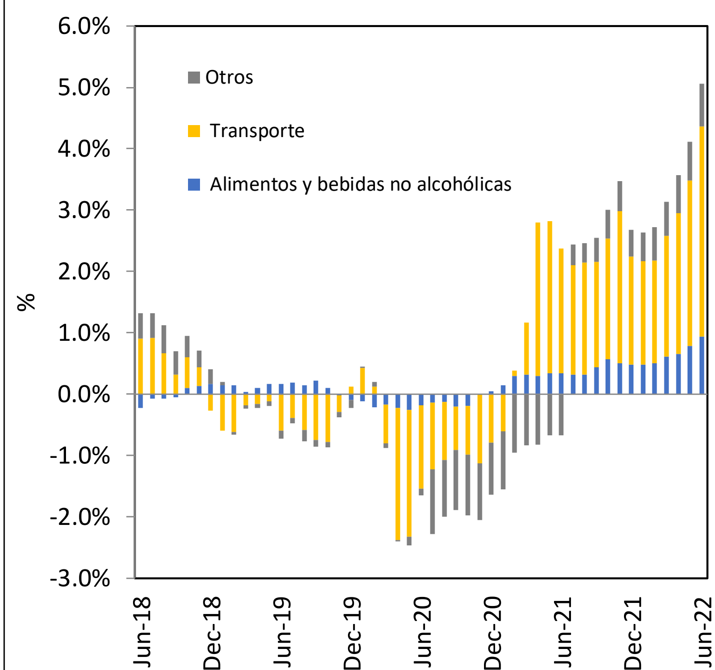
Regarding the volatile component, fuels have continued to drive annual inflation, with a combination of effective price hikes in recent months. Fuel price hikes, within transportation, explains more than half of the increase (**see Graph I.14**).

Graph I.13: Price Consumer Index
Jun. 2018 - Jun. 2022



Source: SBP with INEC data

Graph I.14: CPI Incidence by Groups
Jun. 2018 - Jun 2022



Source: SBP with INEC data

The inflation outlook for 2022 is challenging. We anticipate that inflation will remain above the record average throughout the year, because of factors such as closing the output gap during the first half, the transfer of costs on final prices, and nominal rigidities.

In addition, given the fact that the greatest inflationary pressure comes from energy prices in a net fuel importer country, such as Panama, we expect that an increase in fuel prices will reduce activity. From a conceptual point of view, an increase in fuel prices affects economy in two ways: consumption and production. For the former, an oil price hike, and because of energy cost, reduces purchasing power and, therefore, due to the income effect, reduces the demand for consumer goods. On the production side, marginal costs increase and the demand for productive factors shorten, cutting back the local aggregate supply and rising prices. And even when it is not a direct factor, crude oil price fluctuations can influence, through the expectation effects, the determination of wages and business margins.

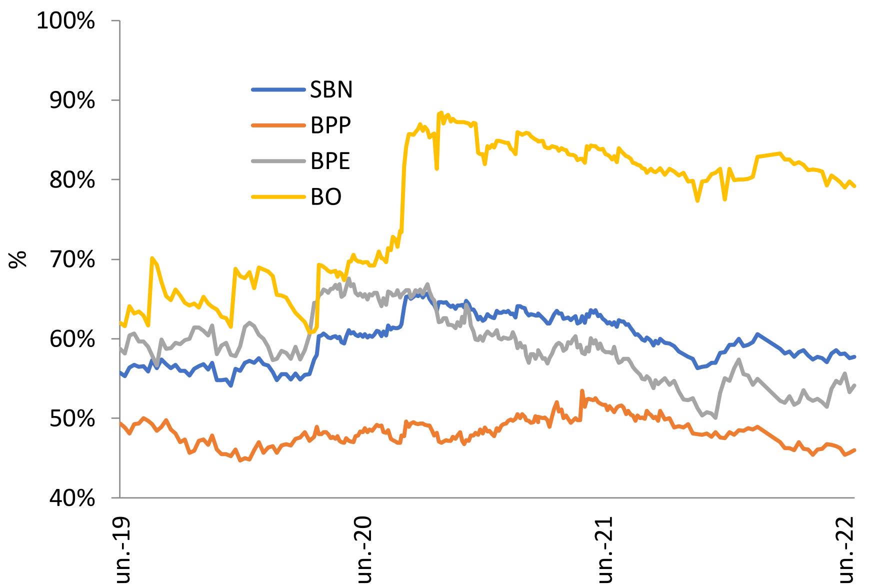
II. IBC Performance

A. Liquidity

As of June, the liquidity of the Banking System reached 57.9%, which easily exceeds the regulatory minimums. The domestic banking system has a recorded a more well-heeled liquidity position since March 2020 (**see Graph II.1**), because of the accumulation of short-term assets in a high uncertainty environment, which responds to the comprehensive strategy of caring for the quality of assets, provisioning, and expanding liquidity, guided by prudential principles promoted by the Superintendency.

In relation to liquidity to date, although there has been a certain decrease in ratios versus the levels reached in 2021, the financial system maintains adequate liquidity ratios at the aggregate level, with sufficient resources to meet its short-term financing needs and which, in turn, will make it easier to resume credit growth. The decreases recorded reflect greater loan disbursement.

Graph II.1: Weekly average liquidity ratio
Jun. 2019 - Jun. 2022

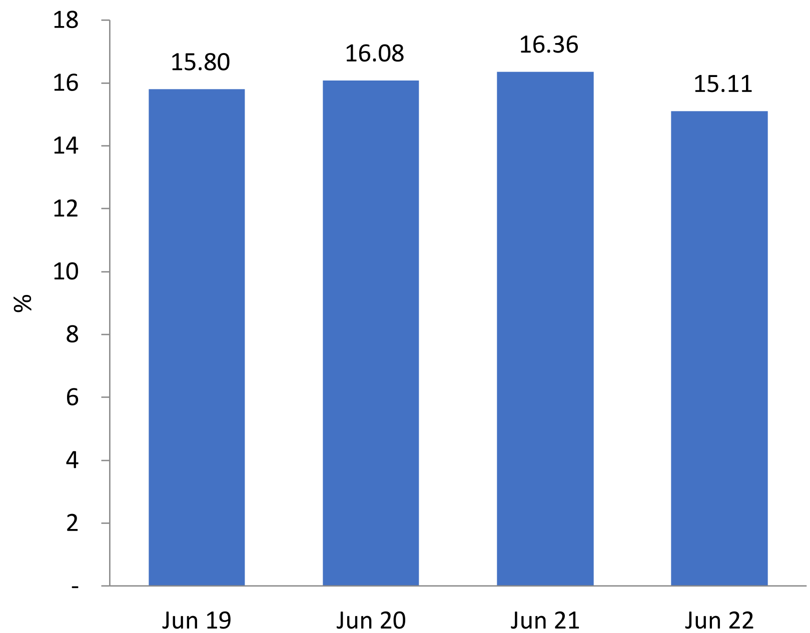


Source: SBP with General License Banks data

B. Solvency

At the end of IQ2022, the International Banking Center's (IBC) aggregate solvency ratios remained high. The capital adequacy ratio on risk-weighted assets (RWA) was 15.1% at the end of IQ2022 (**see Graph II.2**). The capital compliance of the group of banks did not record significant changes compared to IVQ2021. Currently, all banks running operations satisfactorily comply with the new bank capital regulatory standards.

Graph II.2: Capital Adequacy Ratio
Jun. 2018 - Jun. 2021



Source: General and International License banks

C. Income Statement

At the end of the first half of 2022, the banks that make up the IBC obtained profits for USD 946.6 million, which is equivalent to a USD 340 million increase and a growth of over 56% compared to the first half of 2021 (January to June), which shows a boost in the profits obtained by banks. A significant decrease in preventive estimates for credit risks, lower interest expenses, higher results from intermediation and other income, particularly those related to the financial services provision, influenced the results of the first half of 2022. The extraordinary income from a banking group favored these results. Remarkably, gross profits during the period responded significantly to the increase in other income (+36.1%) and net interest income (+14.6%) in its portfolio interest income (+3.5%), deposits income (+27.8%), and securities (+9.5%) components. In addition, income from financial services provision (commissions) increased up to 7.7% during this period. General expenses amounted to USD 1.46 billion, a year-on-year growth of 27.2%. This increase responds, in part, to digitalization, innovation, and sustainability initiatives undertaken by banks, which, although they will save costs, entail high initial investments. Even though provisions for USD 310.3 million were set, they decreased by 26%, when compared with that of June 2021. We estimate that provisioning expenses should remain above pre-pandemic levels as banks continue to write off exposures to borrowers that were unable to resume payments in the context of COVID-19. In addition, the new stress scenarios in Europe and the global monetary policy adjustment processes required prudent behavior and careful risk monitoring, which could evolve and lead to new stress scenarios.

Table II.1: International Banking Center
Accumulated Income Statement
(In millions of USD)

International Banking Center	Jan.-Jun. 2021	Jan.-Jun. 2022	Difference %	Difference USD
Net interest income	1,125.0	1,289.7	14.6%	164.6
Other income	1,044.2	1,421.6	36.1%	377.4
Operating income	*2,169.2*	*2,711.3*	*25.0%*	*542.1*
General expenses	*1,143.0*	*1,454.3*	*27.2%*	*311.3*
Profit before provisions	1,026.3	1,257.0	22.5%	230.7
Provisioning expenses	419.6	310.3	-26.0%	-109.3
Profit for the period	**606.6**	**946.7**	**56.0%**	**340.0**

Source: General and International License banks.

The National Banking System recorded accumulated net profits, as of June 2022, of USD 739.7 million, 41.5% more than that of June 2021. Like what happened in the IBC, greater credit activity and lower provisioning had positively impacted the sector's profits.

Table II.2: National Banking System
Accumulated Income Statement
(In millions of USD)

National Banking System	Jan.-Jun. 2021	Jan.-Jun. 2022	Difference %	Difference USD
Net interest income	1,070.2	1,203.8	12.5%	133.7
Other income	914.8	1,179.7	29.0%	264.9
Operating income	*1,985.0*	*2,383.5*	*20.1%*	*398.5*
General expenses	*1,042.8*	*1,342.5*	*28.7%*	*299.7*
Profit before provisions	942.2	1,041.0	10.5%	98.8
Provisioning expenses	419.2	301.2	-28.1%	-118.0
Profit for the period	**523.0**	**739.7**	**41.5%**	**216.8**

Source: General License banks.

We expect that banks in the system will continue with cost control and operational efficiency strategies. Currently, IBC efficiency levels are around 54%.

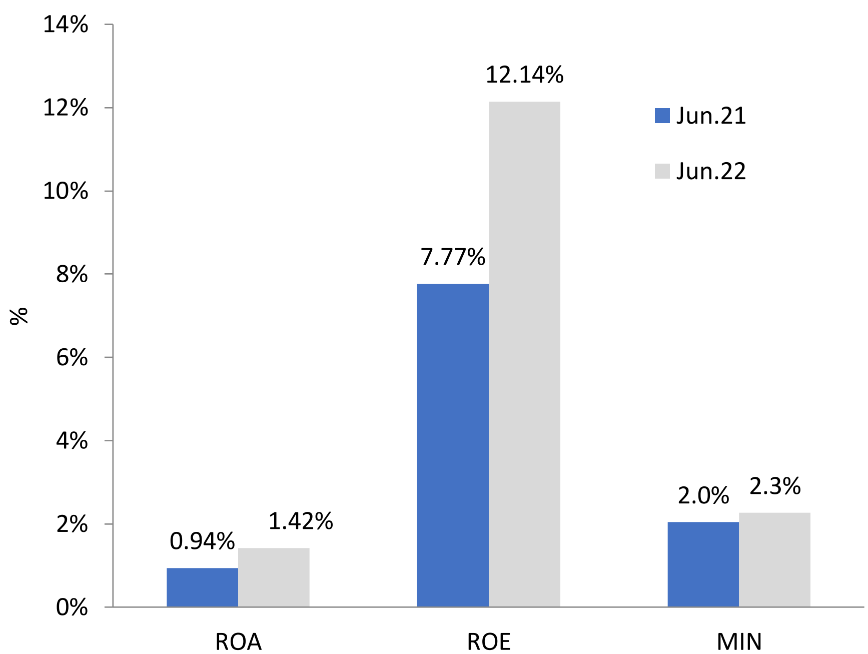
D. Profitability Indicators

At the end of the first half of 2022, the profitability indicators of the group of banks were at positive levels and above those recorded in the same period in 2021 (**see Graph II.3**). In the accumulated through June, the total IBC result reached 1.42% (ROA) and 12.14% (ROE), i.e., a 0.48 bp and 4.37 bp growth, respectively. This increase occurred in a context of higher income from financial intermediation and financial services provision, among others.

Regarding the intermediation margin, it stood at 2.26 bp, 0.22 bp more than a year ago. It is noteworthy to explain that the margin increase is in part because of consumer loans, which are more onerous, increasingly have a greater weighting in the balance sheet of entities, as well as the greater share of available deposits whose cost is cheaper.

Although this result is positive, it is asymmetrical among credit entities, and challenges are yet to face, among which are to finish recognizing the impairment of modified loans, maintaining the capitalization of profits to have capital strength, and continuing with the process of phasing out temporary regulatory flexibilities.

Graph II.3: Profitability Indicators - IBC
Jun. 2021 - Jun. 2022



Source: SBP with General and International License Banks data

E. Balance Sheet

The assets of the International Banking Center, as of June 2022, totaled USD 137.30 billion, an USD 8.33 billion rise versus June 2021, a year-on-year increase of 6.5%, which was the result of growths in the net loan portfolio (12.3%) and the securities portfolio (13.8%) that keeps growing but at a slower pace. On the liquid assets' side, although they fell short (-15.8%), the banking system has high-quality instruments fully available to face stressed financial market conditions.

At the end of the first half of 2022, the banks' portfolio saw a significant boost in its nominal value, reporting a hike of USD 8.77 billion or a 12.3% growth annually. In this context, the portfolio reached USD 79.91 billion. The sustained increase in the loan portfolio responds to the push given by entities to the placement of productive loans and preferential interest rate mortgages. On the performance of the external loan portfolio, it increased by 34.8%.

The securities portfolio recorded a year-on-year growth of USD 3.55 billion (13.8% y/y). To date, the investment portfolio's brief period mitigates the volatility effects of the financial markets. However, the SBP will be monitoring them closely given that corporate bonds and "other non-government securities" account for a significant share of liquid resources and could be less liquid in volatile periods.

Regarding the sources of bank financing, at the end of the first half of 2022, IBC deposits totaled USD 98.83 billion, a year-on-year rise of USD 3.53 billion, which represents 81% of total funding base, which provides great stability to its funding sources and has allowed the IBC to mitigate external shocks and reduce its exposure to global financial stress conditions. External deposits have maintained the upward trend of recent months and account for 30% of total deposits. Stable public deposit-taking is that both domestic and external depositors have remained confident on the banking system's stability. Notably, during the first half of 2022, deposits increased by 3.7%, compared to the 12.3% growth of the net loan portfolio, with which we expect that, in the medium-term, they will return to the pre-pandemic trend in which loans grew at a slightly higher rate than that of deposits.

Panamanian banks' debt (including subordinated debt) represents around 15%, where Obligations, for their part, presented increases of 32.8% versus June 2021. It is worth noting that, although bank deposits are on a record high and are the core component of the loan portfolio, the income collected by these instruments is more focused on investing in physical assets and capital goods, the integration of working capital, the refinancing of liabilities, and the integration of capital contributions in controlled or related ventures.

Table II.3: International Banking Center.
Balance Sheet
(In millions of USD)

Breakdown	2021	2022	Jun. 22 /Jun. 21 Difference	
	June	June	Total	%
Liquid assets	25,063.1	21,105.3	-3,957.9	-15.8%
Net loan portfolio	71,135.8	79,904.8	8,769.0	12.3%
Domestic	*52,146.2*	*54,300.6*	*2,154.5*	*4.1%*
External	*18,989.6*	*25,604.1*	*6,614.6*	*34.8%*
Securities	25,821.9	29,376.9	3,555.0	13.8%
Other assets	6,953.1	6,908.0	-45.1	-0.6%
Total Assets	**128,973.9**	**137,294.9**	**8,321.1**	**6.5%**
Deposits	95,300.5	98,824.4	3,523.9	3.7%
Domestic	*63,185.6*	*63,235.7*	*50.0*	*0.1%*
External	*32,114.9*	*35,588.7*	*3,473.8*	*10.8%*
Obligations	14,337.0	19,034.3	4,697.3	32.8%
Other liabilities	3,698.3	3,893.5	195.2	5.3%
Capital	15,638.0	15,542.7	-95.3	-0.6%

Source: General and International License Banks.

The assets of the Banking System (general license banks only) totaled USD 120.54 billion, USD 5.58 billion or 4.8% more than that of June 2021. The net loan portfolio of the National Banking System showed a USD 6.57 billion (10.0%) increase amounting to USD 72.37 billion.

Net external loans grew by 32.3%, while the domestic portfolio had a performance of 4.1%.

On the other hand, total deposits placed in the NBS amounted to USD 85.91 billion, a 1.0% rise, which is the result of customer deposits.

Table II.4: National Banking System
Balance Sheet
(In millions of USD)

Breakdown	2021 June	2022 June	Jun. 22 /Jun. 21 Difference Total	%
Liquid assets	20,308.5	17,247.6	-3,060.9	-15.1%
Net loan portfolio	65,803.7	72,367.2	6,563.4	10.0%
Domestic	*52,146.2*	*54,303.2*	*2,157.0*	*4.1%*
External	*13,657.5*	*18,063.9*	*4,406.4*	*32.3%*
Securities	22,157.2	24,368.1	2,210.8	10.0%
Other assets	6,698.0	6,555.9	-142.1	-2.1%
Total Assets	**114,967.4**	**120,538.7**	**5,571.3**	**4.8%**
Deposits	85,030.6	85,901.0	870.5	1.0%
Domestic	*63,100.6*	*63,054.5*	*-46.1*	*-0.1%*
External	*21,930.0*	*22,846.5*	*916.5*	*4.2%*
Obligations	14,200.7	18,936.2	4,735.5	33.3%
Other liabilities	3,530.0	3,725.9	195.9	5.6%
Capital	12,206.2	11,975.5	-230.7	-1.9%

Source: General License Banks.

F. Loans

As of June 2022, the domestic loan portfolio amounted to USD 56.59 billion, a USD 2.37 billion or 4.4% increase. At the sector level, the loan performance has had a significant improvement compared to that of June 2021. This would be a sign that banks continue to increase their risk appetite, maintaining a path of profitable growth, while developing and implementing expansion initiatives for certain lines of business.

At the end of the first half of 2022, the loans for nonfinancial business activities increased to USD 11.37 [billion] or 8.4% y/y. As for the corporate portfolio, overall, all productive activities showed positive performances, except for loans to Mining and Quarrying (-8.3%) and Construction (-9.4%).

The balance of household loans grew by 4.8% until the first half of 2022 because of the performance of loans for home purchases, whose balance is above pre-pandemic levels. In June 2022, the balance of loans for this purpose increased a year-on-year rate of 5.5%, being higher than that of the previous quarter. For household loans, the data for IIQ2022 shows the continuation of the expansionary trend.

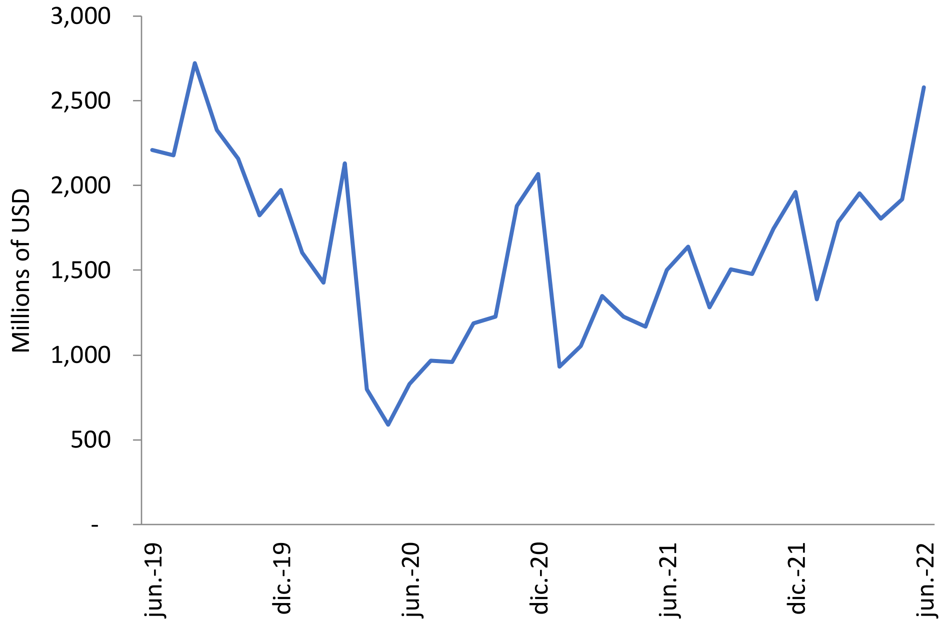
Table II.5: National Banking System
Balance of Domestic Loan Portfolio by Economic Sectors
(In millions of USD)

Sectors	2021	2022	June 22/21 Difference	
	June	June	Total	%
TOTAL	**54,226.0**	**56,590.0**	**2,364.0**	**4.4%**
Public sector	**1,436.00**	**1,470.00**	**34.00**	**2.4%**
Private sector	**52,790.00**	**55,120.00**	**2,330.00**	**4.4%**
Financial & insurance activities	*1,254.0*	*1,383.0*	*128.0*	*10.2%*
Agriculture	*415.0*	*467.0*	*52.0*	*12.6%*
Livestock	1,359.0	1,401.0	42.0	3.1%
Fishing	86.0	87.0	1.0	0.7%
Mining & Quarrying	57.0	52.0	-5.0	-8.3%
Commerce	10,477.0	11,362.0	885.0	8.4%
Industry	*2,717.0*	*3,155.0*	*437.0*	*16.1%*
Mortgages	*18,396.0*	*19,204.0*	*808.0*	*4.4%*
Construction	5,555.0	5,035.0	-520.0	-9.4%
Personal consumption	12,474.0	12,975.0	501.0	4.0%

Source: General License Banks.

The flow of new loans to the domestic component, granted during the first half of 2022, was 57.4%, higher than that granted in the same period a year earlier, but it continues under the influence of a comparison base effect. The advance of monthly data in IIQ2022 shows an even greater increase with respect to the previous quarter, confirming the expansion of placements. The data shows that financial system disbursements have already reached pre-pandemic levels (**see Graph II.4**).

Graph II.4 New Loans
Jun. 2019 - Jun. 2022



Source: SBP with General License banks data

As for new loans, the commercial sector is one of the activities that grew the most during the first half of 2022. On the other hand, consumer portfolio continues to provide new credit cards and personal and car loans.

In relation to data on granting new home mortgage loans (including new and second-hand homes), approximately 68% of new loans correspond to the preferential [interest rate] segment. The foregoing implies that the performance of the housing market relies heavily on the subsidy regime. It is worth noting that from the balance perspective, the largest component of the portfolio corresponds to non-preferential loans (54.2% of the total home mortgage portfolio).

Table II.6: National Banking System
New domestic loans by sectors and activities
(In millions of USD)

Sectors	2021	2022	June 22/21 Difference	
	June	June	Total	%
Public entity	99.4	596.9	497.4	500.2%
Financial companies	329.9	683.3	353.4	107.1%
Agriculture (incl. forestry)	*89.1*	*147.5*	*58.4*	*65.5%*
Livestock	*254.8*	*396.6*	*141.8*	*55.7%*
Fishing	18.0	13.1	-4.9	-27.1%
Mining & Quarrying	5.7	9.8	4.1	71.3%
Commerce (incl. Services)	3,162.4	5,434.8	2,272.3	71.9%
Industry	1,009.6	1,236.5	226.9	22.5%
Mortgages	*813.5*	*995.4*	*181.9*	*22.4%*
Construction	*531.8*	*749.1*	*217.3*	*40.9%*
Personal consumption	912.0	1,112.5	200.5	22.0%
Total	**7,226.4**	**11,375.4**	**4,149.0**	**57.4%**

Source: General License Banks.

G. Credit Risk

At the end of June 2022, the delinquency ratio for the IBC is 4%, while for the NBS is 4.4%. We observe a stable performance before and during the pandemic which, in certain way, is because of regulatory changes that allowed financial [relief] measures where bearing conditions did not apply to the impaired categories, and which are gradually returning to normal.

Breaking down the delinquency of the portfolio by its main activities, we observe a similar trend over the surveyed periods that comprise June 2020 to June 2022. For the months between June and August 2021, there is an increase in terms of portfolio quality ratio, in part this was due to the application of Article 4 of Rule 2-2021, which dictates the general conditions to restore modified loans according to Rule 4-2013.

Nonperforming loans were at levels like pre-pandemic ones at the end of the first half. This would be consistent with the debtors' strong payment culture, with which banks have traditionally had a history of low nonperforming assets and loan losses. However, it is foreseeable that the removal of the financial relief program and the nonperforming loan ratios will weaken and could show future increases, but we expect them to remain manageable. As of June 2022, the NBS recorded a delinquency ratio of 1.7% and overdue loans of 2.7%.

For the household sector, made up of mortgages and personal consumption, as of the end of the first half of 2022, the delinquency ratio is 7.5% and 6.7%, respectively. While for agricultural activities, the delinquency is 7.9%; construction, which has also been one of the most affected sectors during this period, has a delinquency [rate] of 5.1%; meanwhile, commerce has a default rate of 3.5%.

Despite the better aggregate performance of loan quality for the first half of 2022, the impairment of the domestic and global macro financial context (due to increasing inflationary pressures and geopolitical tension) and the exhaustion of financial relief measures could imply prospective impairment risks in credit quality. We expect that loan losses and nonperforming assets will increase as the financial relief programs end. Currently, the SBP closely follows these ratios and their evolution.

H. Performance of the Modified [Loan] Portfolio of the National Banking System

The modified [loan] portfolio as of June 2022 totaled USD 4.72 billion. The issuance of prudential regulations encouraged banks to reach agreements with their clients, with which, as of the second half of the year, there is an important shifting towards the unmodified [loan] portfolio. This represented USD 9 billion or 68% [less] than that of June 2021. The sectors with the greatest shifting towards the regular portfolio under Rule 4-2013 are the household segment and the real estate sector. On the other hand, in the context of the classification established by Board of Directors' General Resolution SBP-GJD-0003-2021, as of the end of IQ2022, the portfolios that could entail the greatest risk would be the modified doubtful and modified loss that together amount to USD 1.09 billion. All these performances connect to the improvement in monthly installments, however, the portfolio classified in this category is still higher and could entail greater provisioning.

Table II.7: Modified loans of the National Banking System by economic activity
(In millions of USD)

Sectors	Jun-21	Jun-22	Total Difference	% Difference
Mortgages	6,675	2,320	-4,355	-65%
Consumer	2,888	1,172	-1,716	-59%
Construction	2,011	438	-1,573	-78%
Services	1,788	480	-1,308	-73%
Commerce	876	182	-694	-79%
Industry	213	32	-181	-85%
Others	255	90	-165	-65%
TOTAL	14,706	4,714	-9,992	-68%

I. Deposits

The performance of IBC deposits increased by 3.7% during the first six months of the year versus 2021. This difference responds to increases in both domestic and external deposits, having in common that both relevantly react to customer deposits growth. Deposits represent 83% of the total funding base during 2021 and have historically remained at similar levels.

Remarkably, deposits account for a greater share of funding for the entire system and finance its loan operations, which results in low dependence on funding market debt issuances. The high share of customer deposits in bank funding represents a stable source of financing that has allowed the expansion of long-term loans under favorable financing conditions, both for households and companies, with limited risks.

Deposits placed in the market, as of the first half of 2022, recorded a total of USD 98.83 billion, USD 3.53 billion more than that of June 2021 (**see Table II.8**). If we focus on the domestic deposits analysis, as of June 2022, there is an increase of USD 63.24 billion or 0.1% versus June 2021. On the other hand, external deposits recorded an increase of USD 3.48 billion, amounting to USD 35.59 billion. It is worth noting that the increase in global inflation, as well as the expectation that major central banks will fix interest rate hikes in the future, in addition to exchange rate uncertainty, have affected the demand for domestic financial assets and liabilities in the past.

Table II.8: National Banking System
Total Deposits
(In millions of USD)

	2021	2022	June 22/21 Difference	
	June	June	Total	%
Deposits	**95,301.0**	**98,824.0**	**3,524.0**	**3.7%**
Domestic	**63,186.0**	**63,236.0**	**50.0**	**0.1%**
Government	*12,474.0*	*11,884.0*	*(590.0)*	*-4.7%*
Customer	*47,117.0*	*47,994.0*	*878.0*	*1.9%*
Banks	3,595.0	3,357.0	(238.0)	-6.6%
External	**32,115.0**	**35,589.0**	**3,474.0**	**10.8%**
Government	*165.0*	*428.0*	*263.0*	*158.9%*
Customer	*24,375.0*	*28,054.0*	*3,679.0*	*15.1%*
Banks	7,574.0	7,107.0	(468.0)	-6.2%

Source: General and International License banks.

In the case of the National Banking System banks, there is a trend like that of the IBC, recording a balance of USD 85.91 billion, a 1.0% increase versus June 2021, driven by external deposits and remarking that domestically only customer deposits maintained an increase compared to June 2021 (**see Table II.9**).

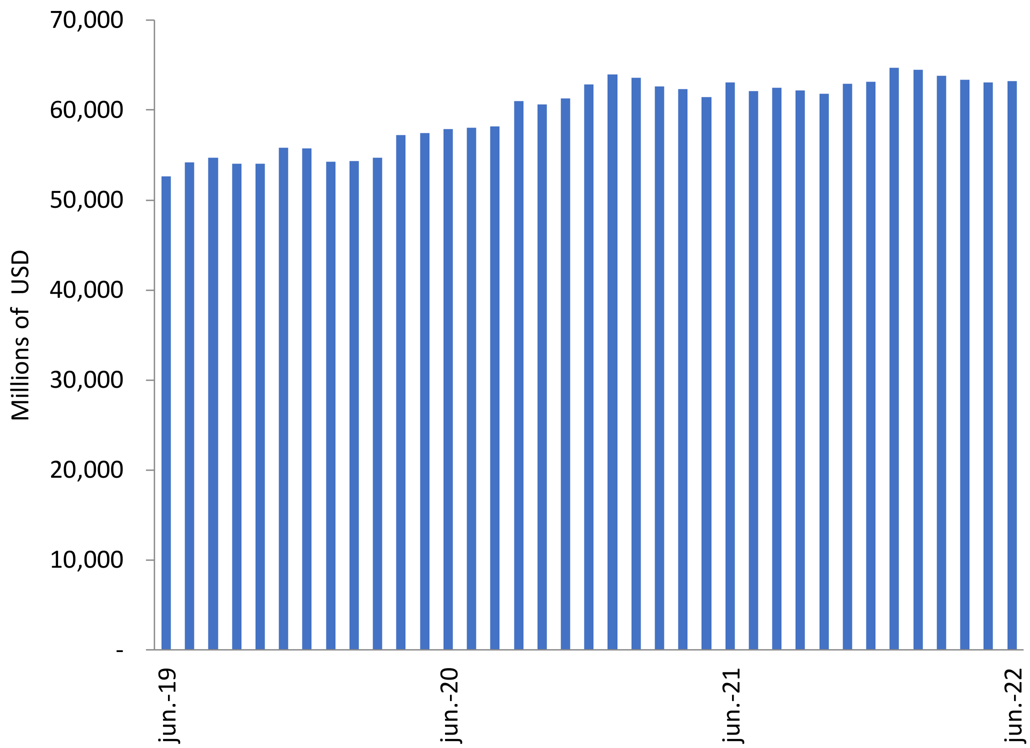
Table II.9: National Banking System
Total Deposits
(In millions of USD)

Accounts	2021 June	2022 June	June 22/21 Difference Total	June 22/21 Difference June
Deposits	**85,031.0**	**85,901.0**	**870.0**	**1.0%**
Domestic	**63,101.0**	**63,055.0**	**-46.0**	**-0.1%**
Government	*12,474.0*	*11,884.0*	*(590.0)*	*-4.7%*
Customer	*47,117.0*	*47,994.0*	*878.0*	*1.9%*
Banks	3,510.0	3,176.0	(334.0)	-9.5%
External	**21,930.0**	**22,847.0**	**917.0**	**4.2%**
Government	*165.0*	*426.0*	*261.0*	*157.6%*
Customer	*14,709.0*	*15,803.0*	*1,094.0*	*7.4%*
Banks	7,056.0	6,617.0	(438.0)	-6.2%

Source: General License banks

The structure of the IBC deposits is based on collecting customers and corporate deposits, and the remaining are interbank positions. Remarkably, the National Banking System domestic deposits account for 74.1% of total NBS deposits. To date, customer deposits have shown resilience and there are no short-term reductions that could indicate that there could be a situation that exposes the group of banks. **Graph II.5** shows the evolution of domestic deposit balances.

Graph II.5: Total Domestic Deposits
Jun. 2019 - Jun. 2022

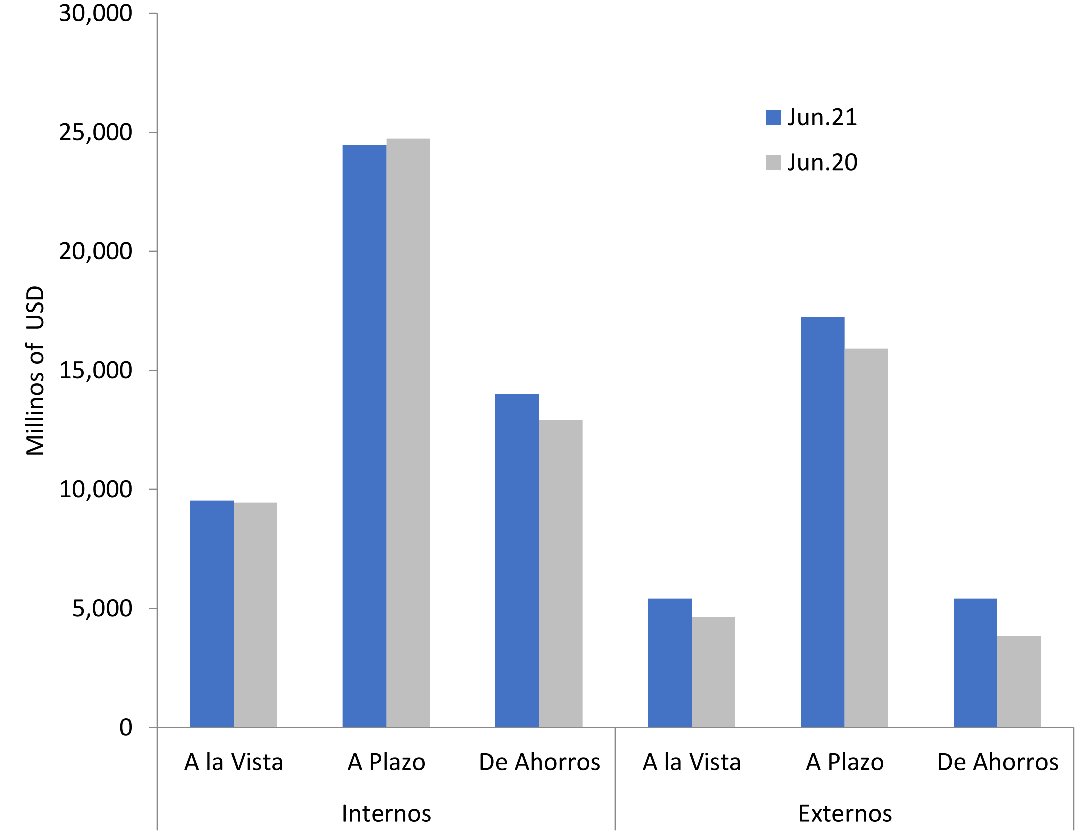


Source: General License banks

Regarding the structure of customer liabilities by maturity, time deposits continue to be the most important savings instrument. In the Banking Center, as of June 2022, domestic customer time deposits amounted to USD 24.46 billion, followed by savings rising to USD 14.02 billion, and demand deposits totaling USD 9.52 billion.

Domestic customer demand deposits (+0.9%) and savings deposits (+8.4%) kept in the financial system increased during the surveyed period (**see Graph II.6**). In this way, we continue to record a rearrangement of bank deposits, as immediate demand deposits increased since depositors sought to have greater availability and liquidity of their resources. The reactivation of economic activity, which favored a greater flow of income from the sale of goods and services, as well as the substitution of part of term resources, could explain the increase observed in the performance of demand deposits.

Graph II.6: Customer Deposits
Dec. 2020 - Dec. 2021



Source: General and International License banks.

III. Macro financial Threats

As of the end of the first half of 2022, the world is facing a much more complicated situation than 2021, since to the risk of the pandemic, which is not over yet, has been added the conflict in Eastern Europe, an international monetary policy set by major central banks stringent than originally anticipated, and greater volatility in global financial markets that already warn of the possibility of a recession in several developed countries.

Breaking down the different risks identified, the first one would be the reputational risk Panama will face if not delisted from the FATF Gray list. This continues to be a great challenge for Panama as a country, we have certainly taken actions, and all financial sector players and the superintendencies have had important progress.

In financial terms, the main external threats come from potential reactions to changes in Fed's monetary policy, which we expect to continue in the future, which could generate increases in long-term rates or higher risk premiums for emerging economies, among others.

Similarly, an escalation of geopolitical tensions in Eastern Europe would sharpen uncertainty in international financial markets. These elements would lead to rate and risk premium hikes, above what we have already seen, and a possible widespread of financial volatility, contributing to worsen the slowdown of global economic activity, which could undoubtedly have an effect in the domestic market.

Finally, the socio-economic risk derived from the health threat is still latent. Although the pandemic, which has begun to subside because of the inoculation process, is still wreaking havoc on the global economy, and a clear example is what is recently happening in China, where the "Zero COVID" policy has been affecting nearly 40% of all economic activity, putting pressure on bottlenecks in the great global supply chain and continuing to generate frictions that increase inflation risks, which have started to cause protests globally, and we have already seen those in Panama. The recent protests and agreements reached will put greater pressure on the public (nonfinancial) sector deficit goals set for this year at 4% of GDP.

These risks could have effects such as termination of correspondent relationships, funding cost hikes, a slowdown of new loans, an increase in loan arrears, a reduction in profitability, and at medium-term they could put greater pressure on the country risk and keeping the investment grade, among others.

Historical data and analysis results suggest that monetary policy hikes in the United States could compress banks' profit margins (given that cost increases cannot be passed through in the short-term), but also, we can observe an increase in loan arrears. A quicker pass-through of these increases could lead to further deterioration of loan portfolios.

Additionally, shocks due to lower growth of one of the main trading partners could have negative effects that would affect the quality of banks' portfolio, which implies that the rise could trigger new vulnerabilities that must under monitoring.

Figure 1. Macro financial risk matrix and Credit risk impact

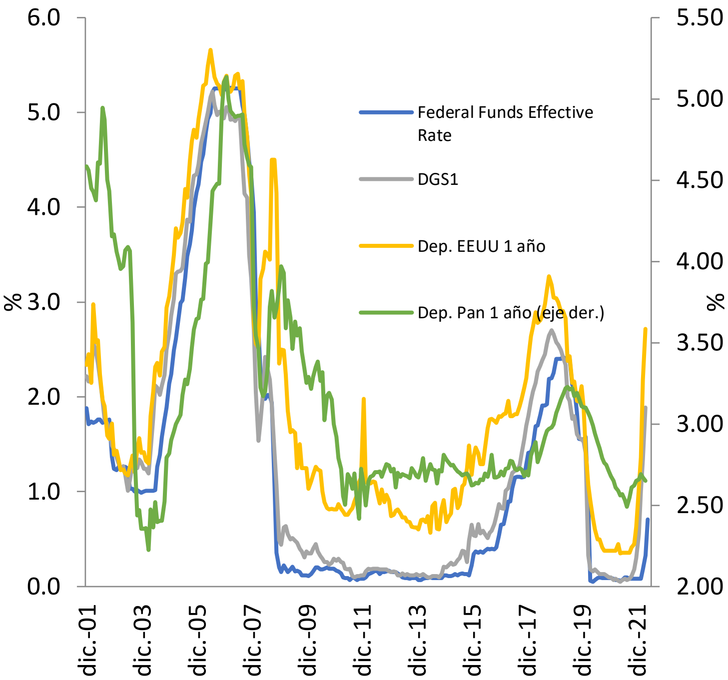
Bearing these risks, we will describe few elements associated to Credit Risk related to:

- Interest rate hikes
- Household debt
- Performance of the construction and real estate sector

A. Interest Rate Hikes

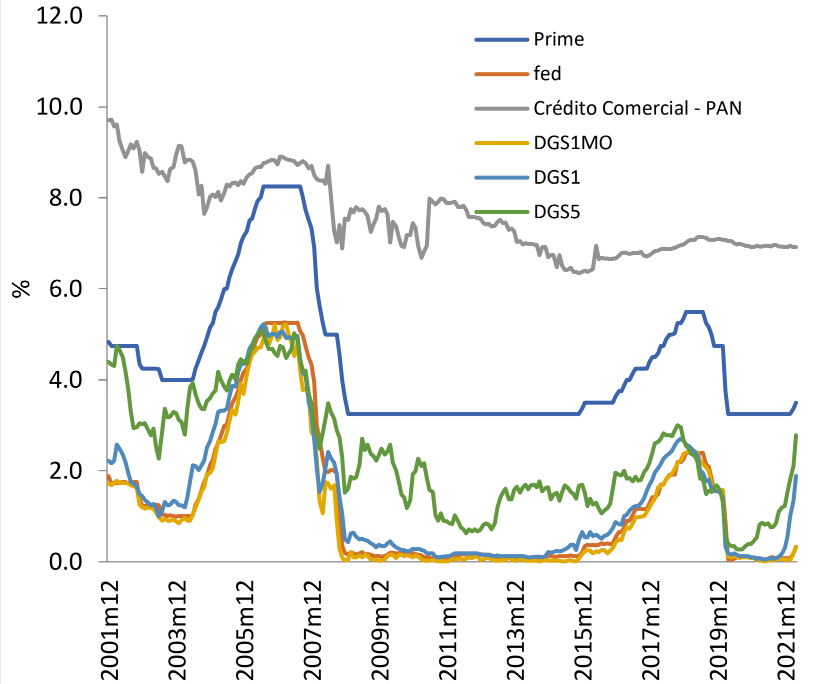
Historically, Panama has had low rates, compared to other countries, thanks to the use of the United States dollar as legal tender and the free flow of capitals, but it has also been favored because of the competition between banks and that entities have satisfactory funding structures and adequate liquidity positions that have allowed them to maintain lower rates, which has been benefited by the prudent management of their activities and which has ultimately reduced their volatility. Banks have a funding cost different from the Fed rate, which includes, among others, the cost of deposit-taking (the greatest share of their liabilities) and the cost of their issued obligations (including their financing through issuances). In this section, we will analyze the interest rate effect for both lending and deposit rates, but before going deeper, it is relevant to make a little digression on the analysis. One-year time deposits represent the greatest share of deposits, while loans are in that the commercial sector. The econometric analysis between the Panamanian and the U.S. interest rates with the same maturity show that the pass-through of United States rates is less than 1, typically in the range of 0.6 to 0.8 for deposit rates. As of loans, this pass-through effect is even lower than deposit rates. The pass-through from U.S. rates to lending rates is less than 1, typically in the range of 0.3 to 0.5.

Graph III.A.1: Deposits and Lending Rates in the U.S. Dec. 2001 - Apr. 2022



Source: Fed and SBP

Graph III.A.2: Commercial Loans: Panama vs USA Dec. 2001 - Apr. 2022



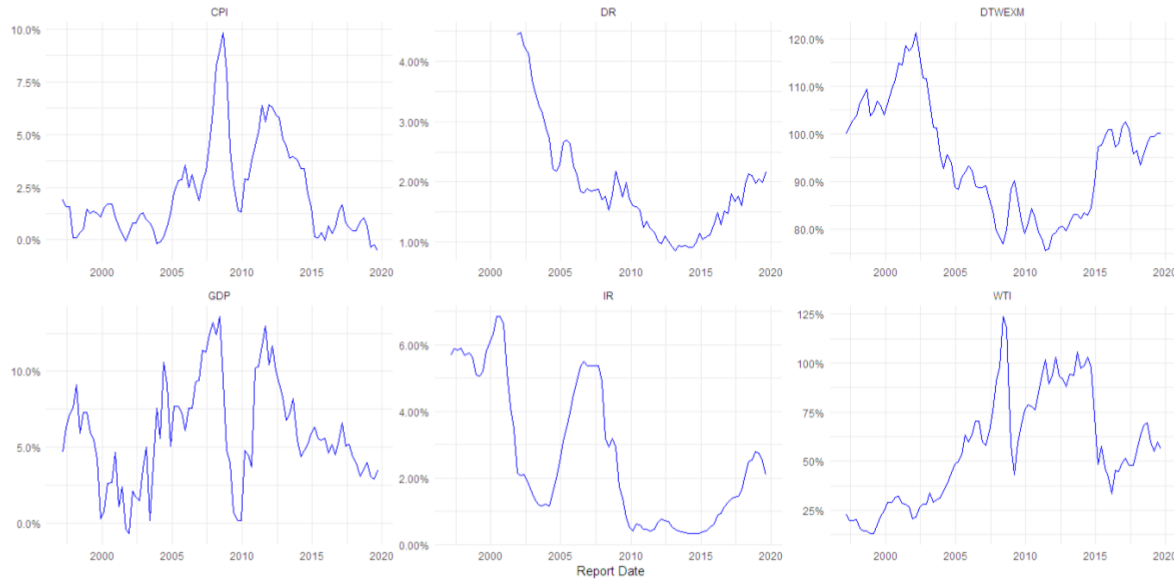
Source: SBP and Fed

The previous results would suggest that, at the face of external rates hikes, as we have saw in the past, these changes could lead to reductions in the intermediation margin since the increases in the cost of liabilities have been greater.

In this way, it is possible to conclude that on previous occasions the pass-through of interest rates in the United States has been lower for lending rates compared to deposit rates, which implies a negative relationship between the U.S. Fed interest rates and the lending and deposit spreads of Panamanian banks.

Historical data and the results of the analysis suggest that monetary policy hikes in the United States, in addition to being able to compress the banks' profit margins (given that cost increases cannot be passed through in the short-term) can also lead to an increase in loan arrears. A quicker pass-through of these increases could lead to further deterioration of loan portfolios.

Graph III.A.3: Portfolio Quality and Macroeconomic Variables
Jan. 2000 – Feb. 2020



Additionally, shocks due to lower growth of one of the main trading partners could have negative effects that would affect the quality of banks' portfolio, which implies that the rise could trigger new vulnerabilities that must under monitoring.

Summary

The recent hike of Fed rates could have repercussions locally later, however, it is remarkable that the Panamanian rate market responds with a lag and usually has a smaller difference that the change recorded in the United States.

The analysis conducted in this paper show that in the past the pass-through of United States interest rates has been lower for lending rates compared to deposits rates, which implies a negative relationship between interest rates and spreads between Panamanian banks' loans and deposits, without this necessarily affecting the total profitability of banks.

Although market conditions, such as higher risk premiums and an environment of greater inflation suggest that hikes could take place in the future, it is an issue that we are closely monitoring.

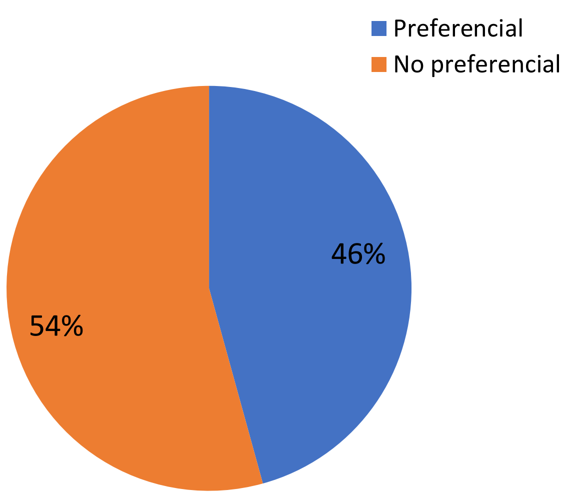
Until now, the system's lending rate hikes are not on placement rates, which has reduced the intermediation margin at a time when the system's loan portfolio has been accelerating its growth significantly. Furthermore, to date, we observe that lending and deposit rates have remained stable despite the rate hikes observed in other countries.

B. Household debt

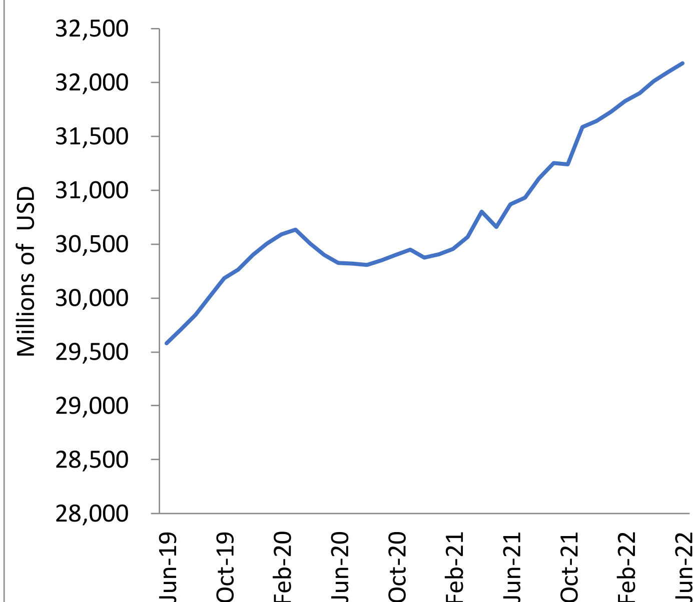
Household debt (defined as the total home mortgage and consumer loans granted by bank credit establishments) in Panama represents an important share of the banking loan portfolio. As of June 2022, home mortgage and consumer loans reached 58% of loans to the private sector (**see Graph III.B.1**). Evidence from developed countries show that household loans represent around 63% of placements[1].

In nominal terms, household bank indebtedness amounted to USD 32.18 billion, as of June 2022, and consists of consumer loans (40.3%) and home mortgage loans (59.7%). After the last IEF, household indebtedness has continued with the upward trend already remarked in the previous report (**see Graph III.B.2**).

Graph III.B.1: Household Loan Composition
Jun. 2022



Graph III.B.2: Balance of Household Loans
Jun. 2019 - Jun. 2022



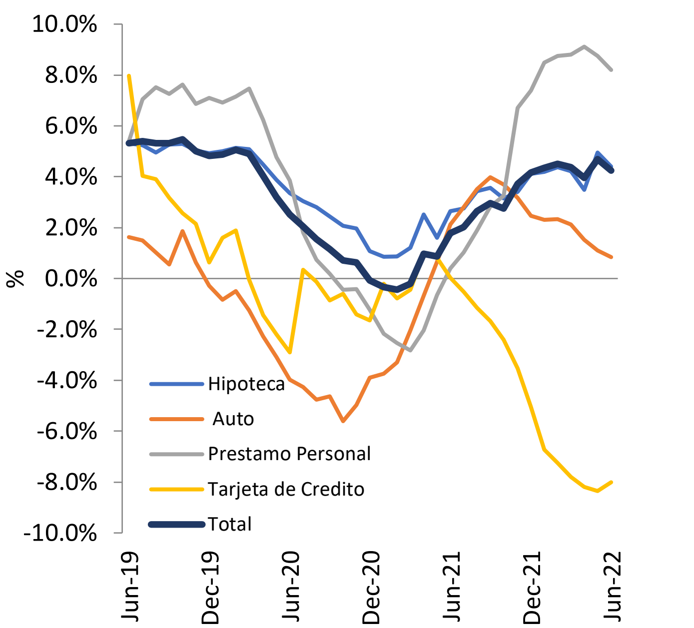
Source: General License banks.

In fact, in the last twelve months, household debt showed an increase of 4.2% as of June 2022, above the rate reported in 2021 (1.8%) and in 2020 (3.7%). At the onset of the pandemic, there was a lower boost in household loans, confirming single-digit growth rates. However, as of the IIIQ2021, household indebtedness has recovered its performance, like the nominal growth recorded before the pandemic (**see Graph III.B.3**).

[1] This responds to the fact that, to the extent that there are more developed financial systems, companies tend to finance themselves through issuances.

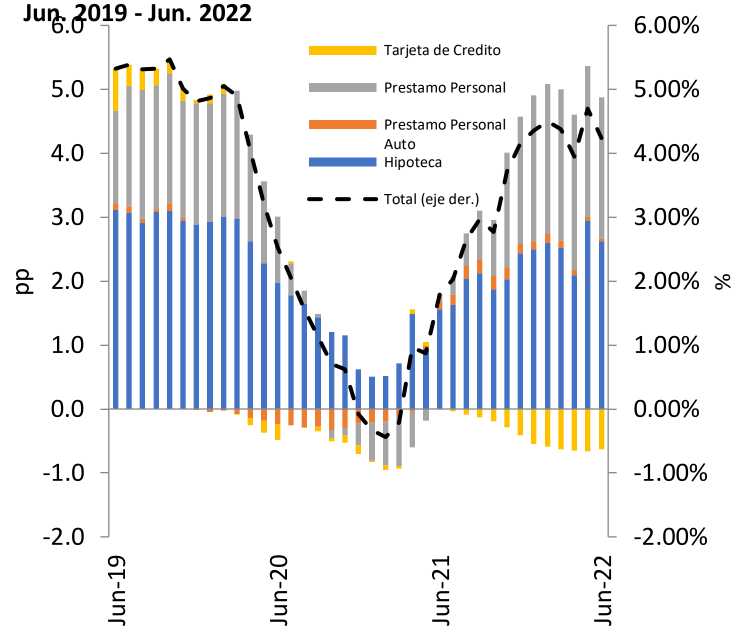
Thus, the year-on-year growth of household loans happened because of its main components, home loans and personal consumer loans, which contributed 2.6 bp and 2.1 bp with the year-on-year difference, respectively (**see Graph III.B.4**).

Graph III.B3: Household Debt
Jun. 2019 - Jun. 2022



Source: SBP with General License banks data

Graph III.B.4: Impact on the growth of the household portfolio
Jun. 2019 - Jun. 2022



Source: SBP with General License banks data

The most important product in retail banking is mortgage loans, which accounts for 59.7% of the total lent, however, in terms of number of loans, the most substantial sub-item is personal loans, which amount to around 607K personal loans granted and represents 40% of total credits issued, which amount to USD 1.74 billion (**see Table III.B.1**).

Table III.B.1: Portfolios granted to Individuals by the NBS
June 2022

Type of loan	Banking System (Millions of USD)	Banking System (quantity)	Average Debt (USD)
Mortgages	19,204	281,767	68,155
Personal car loans	1,755	153,342	11,446
Personal loans	8,985	694,758	12,933
Credit cards	2,235	607,590	3,678
Total	**32,179**	**1,737,457**	**18,521**

Source: SBP

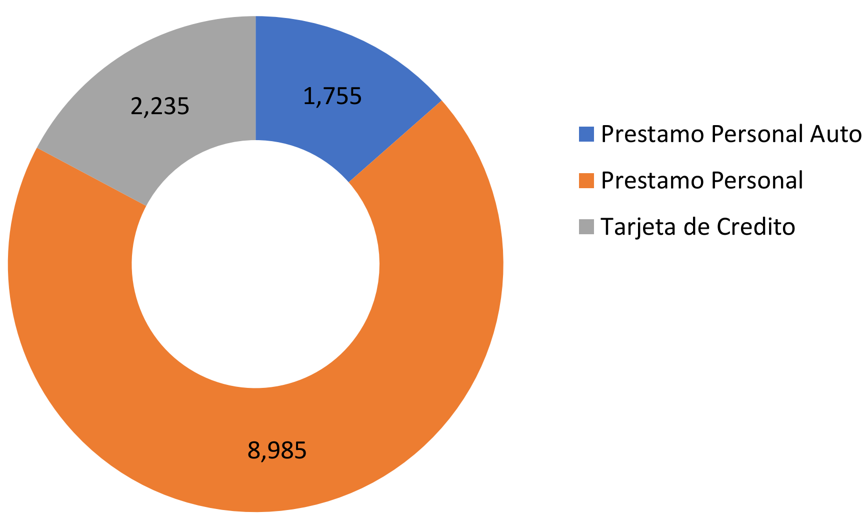
1. Consumer loans

In the consumer loan component (credit cards, personal loans, and car loans) this represents 40.3% of the household portfolio balance. This portfolio showed a balance of USD 12.98 [billion], where personal loans have the largest share (**see Graph III.B.5**). Although decreases in specific segments within the portfolio, these respond to different situations.

In the case of car loans, it increased by just 0.8%, unlike portfolios such as personal loans and mortgages loans, which responds to a decrease in car dealers' inventories, related to the shortage of semiconductor chips and supply chain disruptions.

Between June 2021 and June 2022, there was a general reduction in the credit card balance; in particular, it decreased 8% in nominal terms, being the type of loan with the most evident decline in this period. Loans in this item represented, in June 2021, 17% of the total consumer loan portfolio. It is worth noting that said decrease has also occurred in the number of active credit cards that fell by 6.8%. The foregoing could be the reflection of families prioritizing expenses, consolidating products, and, overall, deleveraging more expensive loans.

Graph III.B.5: Consumer loans
Jun. 2022

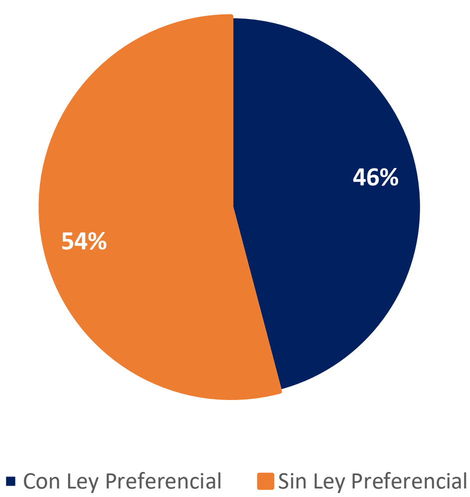


2. Home mortgage loans

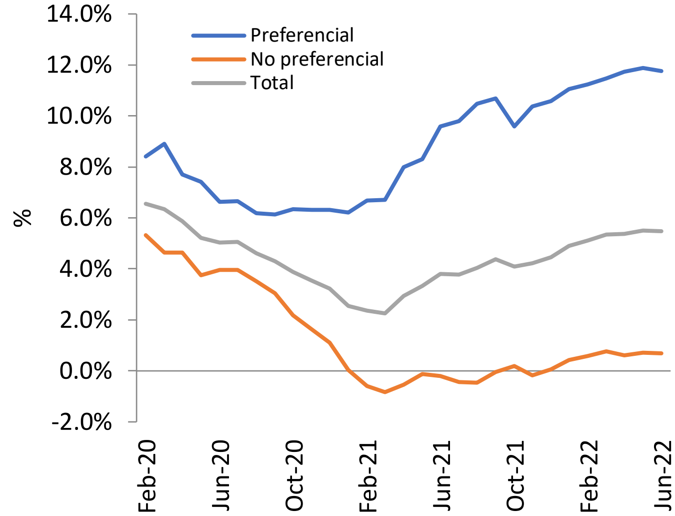
The balance in terms of mortgage loans is positive. Banking has been growing its placement significantly, by 3.9%, in terms of number of loans, and by 4.4%, in terms of amount placed; the balance of the portfolio as of June 2022 reached USD 19.21 billion.

Regarding the data on granting new home mortgage loans (inc. new homes and second-hand homes), it shows that approximately 68% of the number of new loans belong to the preferential interest rate segment. The foregoing implies that the performance of the housing market relies heavily on the subsidy regime. Notably, from the balance side, the largest component in the portfolio corresponds to the non-preferential interest rate segment (54.2% of total home mortgage portfolio, **see, Graph III.B.6**).

Graph III:B6: Home Mortgage Loan Composition
Jun. 2022



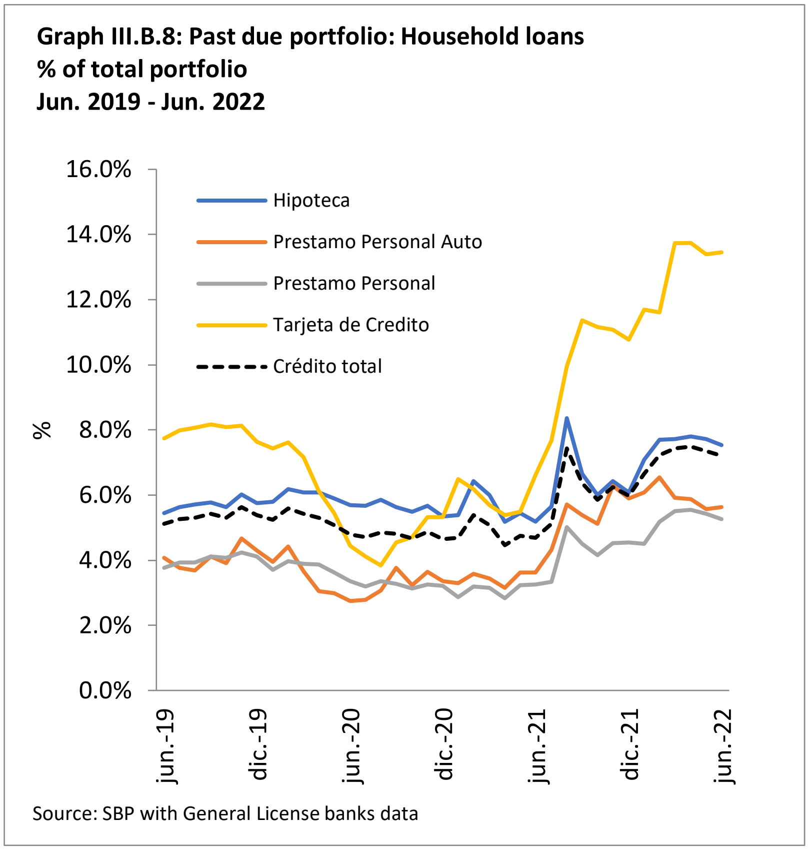
Graph III.B.7: Preferntial and Non-preferential Interest Rate Loans
Feb. 2020 - Jun. 2022

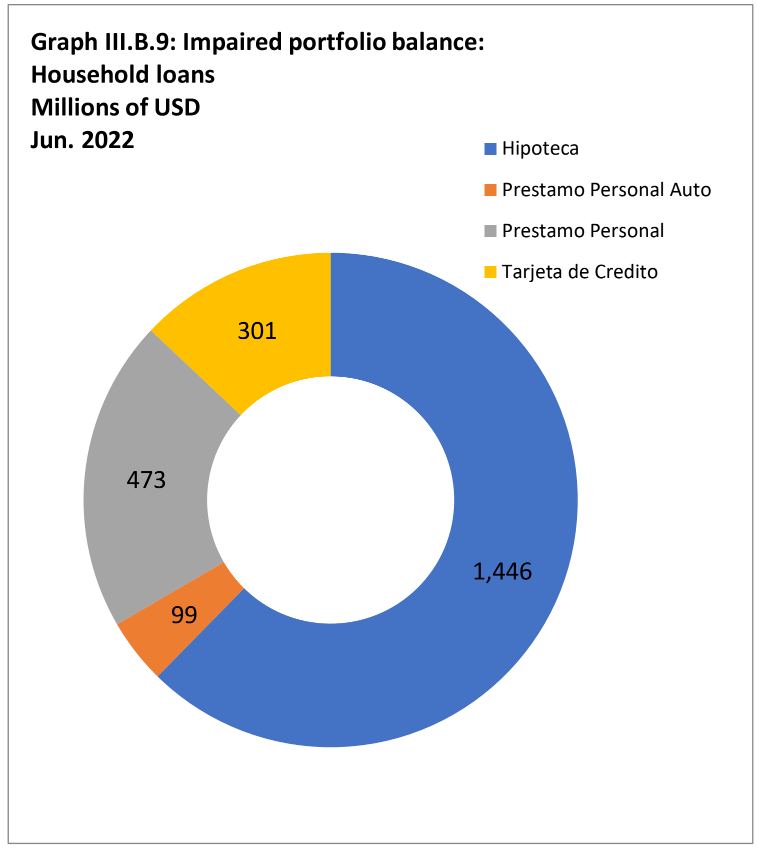


Source: SBP with General License banks data

A. Quality of Household Loan Portfolio and Modified Loans

According to the data reported in the last IEF, the quality household loans granted has deteriorated slightly, reflected in a delinquency rate of 7.2% as of June 2022 (**see Graph III.B.8**). This figure stood above the December 2021 figure (6.0%) and at levels above those observed in June 2021 (4.7%). Credit card delinquency (13.5% in June 2022) is the highest among consumer loans. The delinquency trend at the consumer level in this category was quite different from the rest of activities and could be partly the result of product originations by risk profile. The remainder of activities have maintained constant or have even shown improvements in most recently.





Regarding the household modified [loan] portfolio as of June 2022, it amounts to USD 3.35 billion and accounts for 71.1% of the modified [loan] portfolio. The issuance of prudential regulations promoted banks to reach agreements with their clients, with which as of the second half of the year, there is an important shifting towards the unmodified [loan] portfolio. The sectors with the greatest shifting to the traditional portfolio, under Rule 4-2013, are the household and real estate sector segments, even though they continue to be the ones with the largest share in the portfolio.

Table III.B.2: Portfolios granted to individuals by the NBS
January 2022 - June 2022

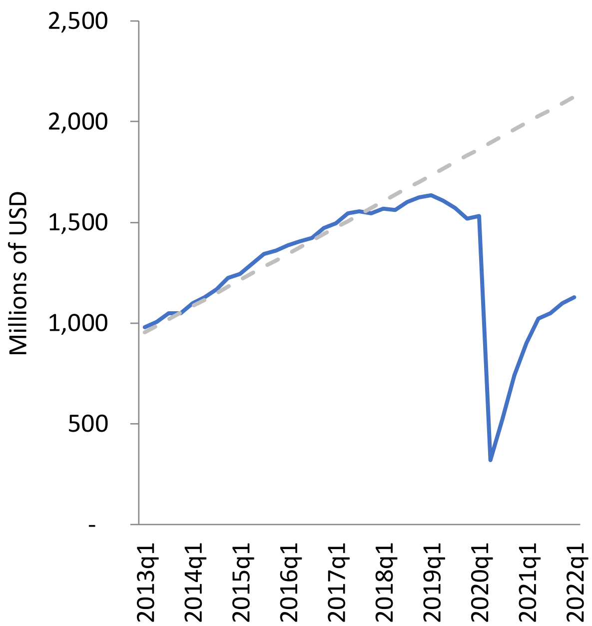
Type of Loans	Jan-22	Feb-22	Mar-22	Apr-22	May-22	Jun-22
Home mortgage	3,392.6	3,205.2	2,862.4	2,676.6	2,461.3	2,177.3
Car	346.2	321.0	276.8	250.5	207.4	169.9
Personal loan	876.4	834.1	757.9	708.7	642.9	562.3
Credit card	642.2	593.7	549.3	521.2	472.5	440.3
Household loans	**5,257.3**	**4,954.1**	**4,446.3**	**4,157.1**	**3,784.1**	**3,349.8**

Source: SBP

C. Performance of the Construction and Real Estate sector

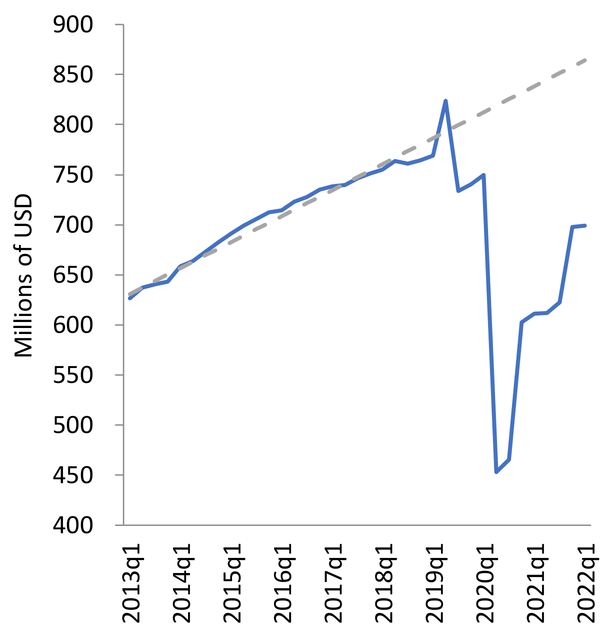
The National Accounts data prepared by INEC show that during IQ2022, the real estate sector's GDP maintains a positive performance (12.6%), while that of construction and other works recorded a lower performance during the period when compared to previous quarters (21.7%). However, in both cases there is still a gap compared to the pre-pandemic trend level (**see Graphs III.C.1 and III.C.2**). These results imply that the recovery of construction and real estate activities continues without the pre-pandemic drive but shows signs of an upward trend.

Graph III.C1: Construction GDP IQ2013 - IQ2022



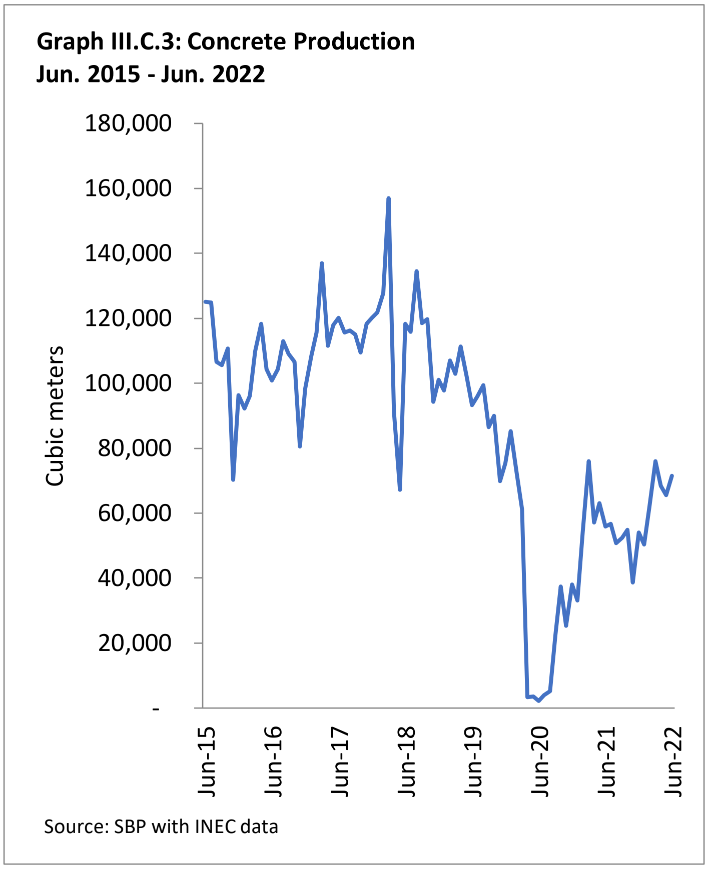
Source: SBP calculations with INEC data

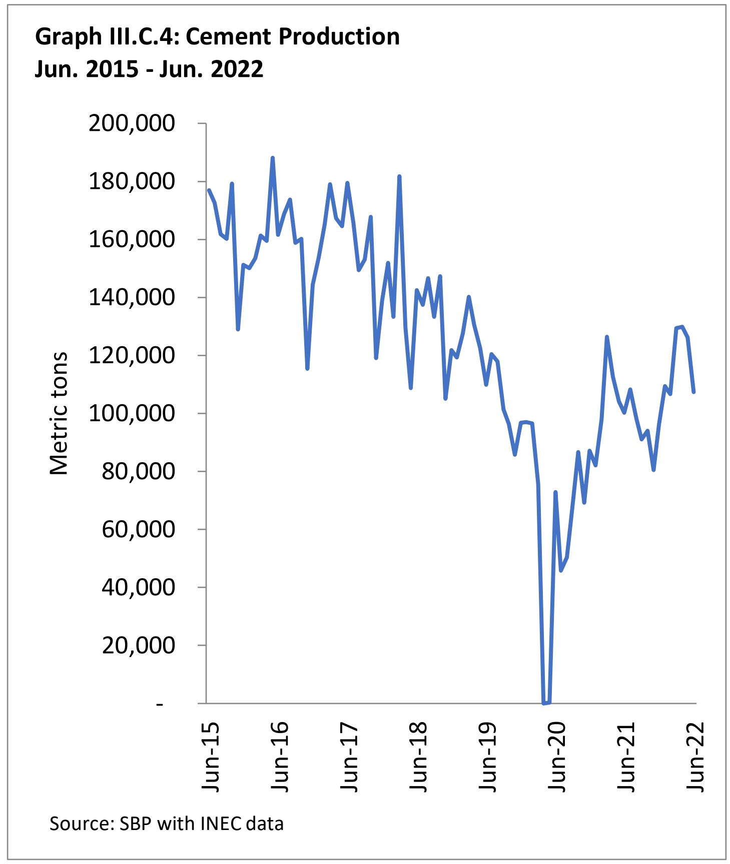
Graph III.C.2: Real Estate GDP IQ2013 - IQ2022



Source: SBP calculations with INEC data

Even though the sales of construction materials remain active compared to the pandemic, they are still below their recent record performance (**see Graphs 3 and 4**), while the municipal record of new permits continues to lag as it is expected that the works that suffered the postponement of their timeframes will continue to be executed, which is why new permits will continue to show low growth. Therefore, the investment outlook for the second half of 2022 includes the uncertainty associated with the drop in expectations, the increase in construction material prices, the hikes in long-term interest rates, and the new wage conditions. Based on the foregoing, we anticipate a less dynamic investment performance in private construction and gross fixed capital formation (GFCF).





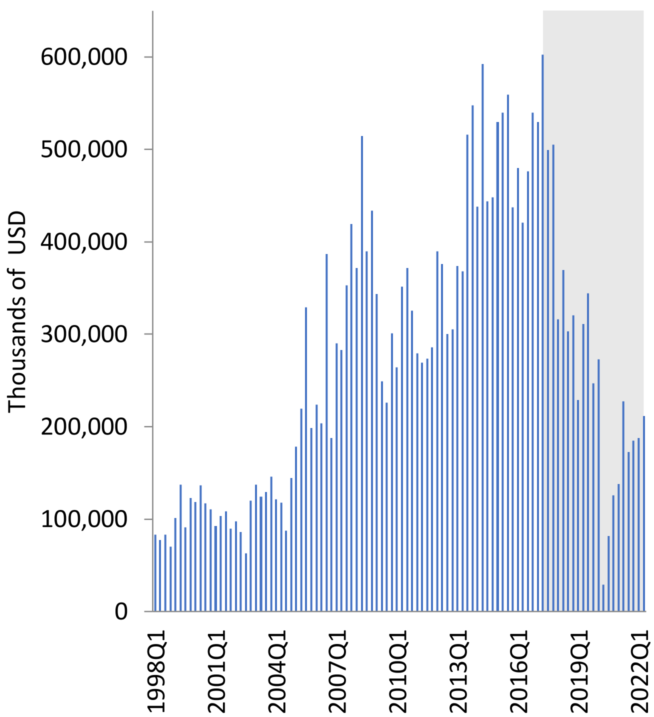
For their part, overall, the price indicators for construction materials continue to accentuate their rises. Construction materials and supplies prices have continued their upward trend since the publication of the previous report, consistent with the persistent problem in the global supply chain, and the higher price of fuel. This has limited the supply capacity of materials and supplies in the local market. As a result, there is an increase in the producer price indexes related to construction and civil works activities.

Construction costs at levels above those recorded in previous years, given the rise in raw materials, affect the possibility of starting new real estate projects. Therefore, a limitation in the supply of new real estate projects for the coming months will put pressure on the apartments that are under construction and those available for sale.

According to INEC, among the items that increased are stranded electric wire No. 12 (foot), 36.6%; galvanized corrugated zinc No. 26 (foot), 33%; PVC plastic pipe (10-foot section), 27.2%; purling No. 4 (foot), 21.6%; clay block No. 4 (one hundred), 5.1%; unbrushed espavel wood (foot), 3.3%; to a lesser extent, ½ inch steel rod (30-foot section) increased 2.7%; and outlet for polarized box, 2% (each).

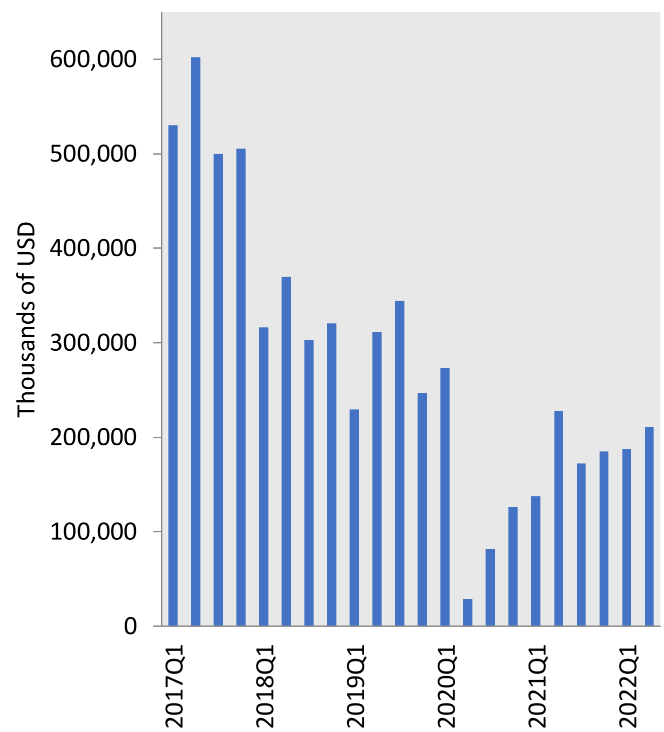
Added to this is the excessive cost of spare parts, equipment, and machinery. Thus, one of the relevant risks continues to be the upward trend of construction material prices. In relation to the local costs faced by sector producers, the producer price index (PPI) of specialized activities related to the construction sector show an annual growth rate above two digits. It is noteworthy that the annual growth rate of the different indices is well above the annual CPI growth for the same period, and even though they are temporary in principle, it is not clear when they will end.

Graph III.C.5: Construction Permits
1998QI - 2022QII



Source: SBP with INEC data

Graph III.C. 6: Construction Permits
2017QI - 2022QII2



Source: SBP with INEC data

So far this year, the approval of new works records a 13.5% increase versus 2021; this is how, between January and June, constructions nationwide registered permits with a total approved area of 709,905 square meters. In terms of monetary investment, the narrative has been similar. Most recently, the latest figures available show a scenario that is still slow in terms of authorization.

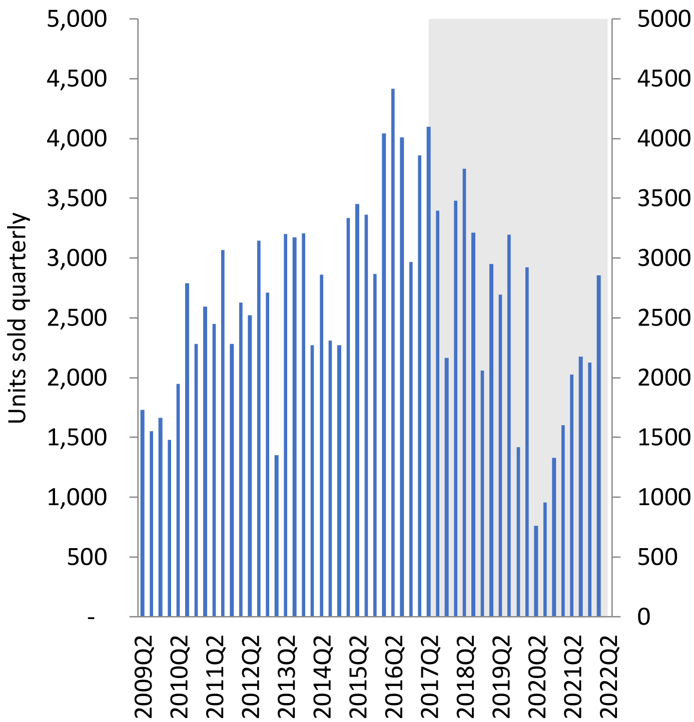
On the supply side, recently, there has been a decrease in stock available for sale due to the lower entry of new real estate projects. Part of the construction firms' behavior happened because of the increase of construction costs, given the high supply prices, affected by the increase in raw materials, such as steel, as well as by freight costs on account of fuel price rises (intensive sector in the use of heavy equipment).

Real estate market performance

The demand for housing has cemented a rapid recovery in late 2021, reaching in the second quarter to a sales level like that of other positive periods for the sector. This recovery in housing demand has continued to consolidate during the first half of this year, once again recording sales levels near the averages of 2018. In fact, between January and June, we estimate sales of over 6,200 housing units, which means an annual increase of 71.4%.

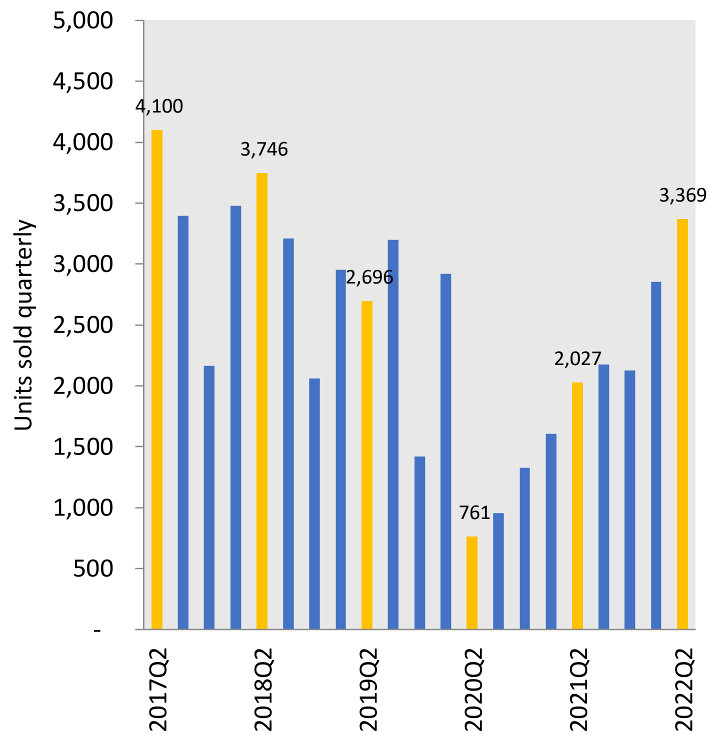
Although salesrooms have remained closed due to lockdowns, thus making it difficult to sign the sales promises, the real estate sector has exhaustively use virtual sales channels and, in this way, it has been able to grow marketing levels better than expected.

Graph III.C.7: Quarterly Home Sales IIQ2009 - IIQ2022



Source: SBP with Galería Inmobiliaria data

Graph III.C.8: Quarterly Home Sales IIQ2017 - IIQ2022



Source: SBP with Galería Inmobiliaria data

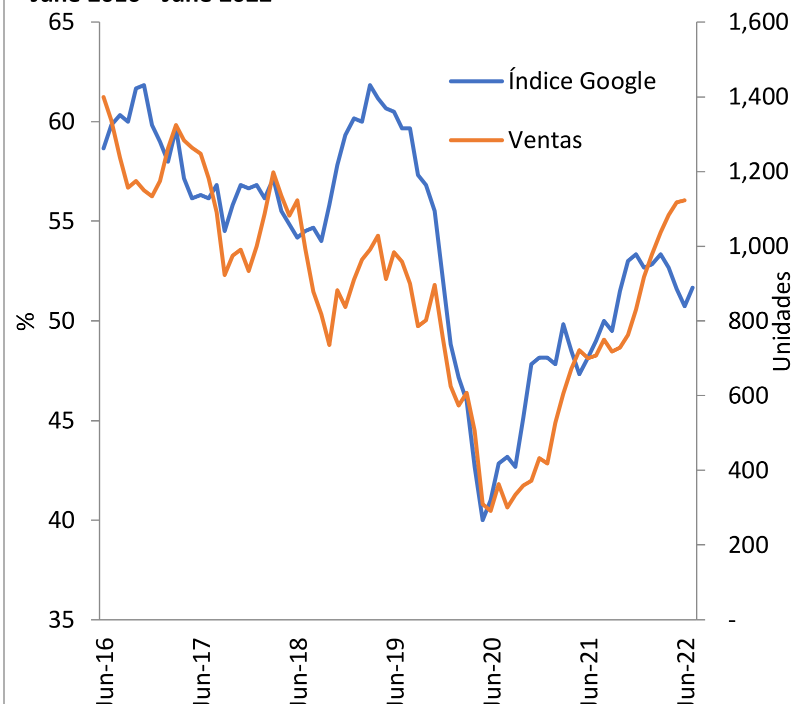
New home prices have exhibited an evolution consistent with the demand and supply dynamics analyzed in previous reports. Thus, the deceleration trend in annual hikes in both apartment and home prices continued.

Despite a specific hike, home prices continued their adjustment process at the face of a significantly depressed demand. However, there are no price corrections. Although sales levels have been incredibly positive in recent months, the higher uncertainty levels could reduce buyers' interest, and in the future, delay the decision to purchase a new home in the coming months, which would affect the speed of sale, even affecting the start of new real estate development projects.

Graph III.C.9: New home price index - % Difference
June 2014 - June 2022

Source: SBP with Galería Inmobiliaria data

Graph III.C.10: Home sales and Google Index
June 2016 - June 2022



Source: Galería Inmobiliaria and Google data

While there has been no stimulation in housing prices, the higher cost of materials undoubtedly has a direct impact on construction costs, since there are maximum increases that exceed two digits in the annual comparison. In the most probable scenario, we expect negative differences in construction investment where demand that has not yet fully recovered.

Summary

The degree of recovery of the real estate and construction market activities will depend on the extent to which the economic and financial effects of this disturbance are persistent once the health crisis is over.

IV. Credit Stress-testing

The SBP has a macro prudential stress test with the following objectives:

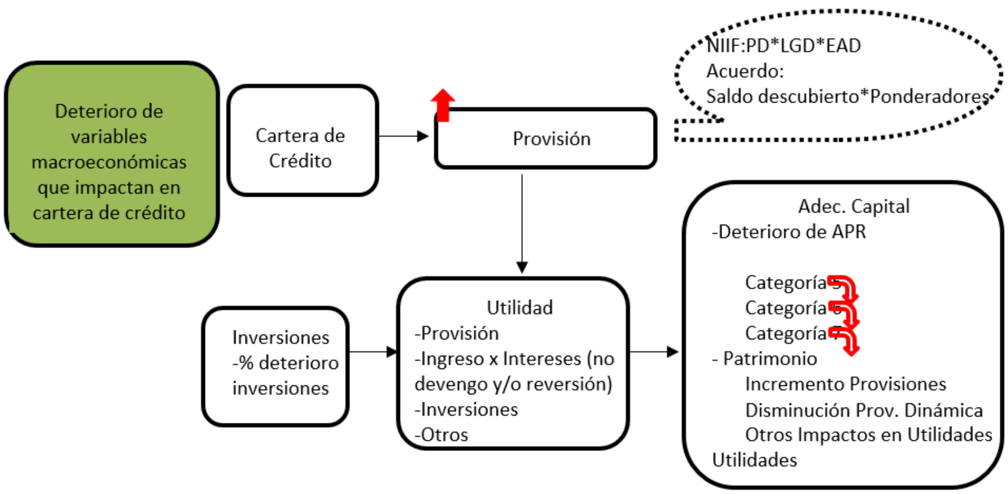
- Assess the impact of internal or external macroeconomic shocks on the banking system's stability
- Identify structural vulnerabilities and global risk exposures in the system.

This test is for all general license banks reporting capital adequacy. The results obtained are based on extreme scenarios with a low occurrence probability.

The test allows projecting the loan portfolio and its provision for a 2-year period (half-year results), considering the deterioration of macroeconomic variables, such as GDP and unemployment rate.

We developed models to calculate the loan impairment of the main activities (construction, industry, service, commerce, primary sector, mortgage, car, and consumption).

As a result of the test, we obtained net gains/losses which affect equity. The calculation of stressed-capital adequacy ratio considers the payment of loans and the deterioration of RWAs.



For this test, with a June 2022 cutoff, the macroeconomic variables considered were a -2% decrease in GDP and an 18% unemployment rate. The calculation for the provision (considering the IFRS) uses an in-house model developed jointly with the Bank of Spain.

For this, we segmented the portfolio as follows:

Stage 1:

- Modified and unmodified pass loans

Stage 2:

- Unmodified special mention
- Modified special mention (with less than 120 days past due)

- Modified substandard

Stage 3:

- Unmodified substandard
- Doubtful and loss (both modified and unmodified)
- Modified special mention (with over 120 days past due)

The provision increase for the stressed scenario is USD 2.04 billion (96% increase compared to the current provisions) being the most affected activities service, construction, and mortgage.

The difference of the National Banking System's capital adequacy ratio is 2.3%, going from 14.9% to 12.6%.

V. Liquidity Stress-testing

Article 73 of the Banking Law establishes that general license banks and international license banks that are subject to the home supervision of the SBP must always maintain a legal liquidity ratio of 30%, i.e., a minimum amount of liquid assets equivalent to 30% of total gross deposits.

The liquid assets that banks must maintain to make up a basket of liquid assets include:

- Gold or legal currency in Panama,
- Net balances in the Panama Clearing House,
- Net balances deposited in any bank in Panama, whether demand deposits or time deposits whose maturity does not exceed 186 days from the date of the liquidity report in Panama or foreign banks, which the SBP must approve in advance,
- Treasury bills issued by the National Treasury and other securities issued by the State with maturities not greater than one year, at market value,
- Debt instruments issued by foreign governments or by international financial organizations, approved by the SBP actively traded in stock markets,
- Debt instruments issued by domestic or foreign private entities approved by the SBP actively traded in a stock market and accorded investment grade,
- Debt instruments issued by domestic private entities and guaranteed by a general license bank, if the issuer and the guarantor bank do not belong to the same economic group,
- Loan payments due within 186 days from the date of the liquidity report,
- Other assets the Superintendency may authorize.

In addition to the monitoring conducted on each bank, the SBP has analyzed a series of sensitivity scenarios including the withdrawal of deposits, a decrease in the payment of obligations paid within 186 days, and the deterioration in investment value.

The results below consider the following scenario:

Two percent (2%) monthly withdrawal of nonbanking deposits

Five percent (5%) monthly deterioration of investments

Fifteen percent (15%) decrease in the payments of obligations paid within the next 186 days.

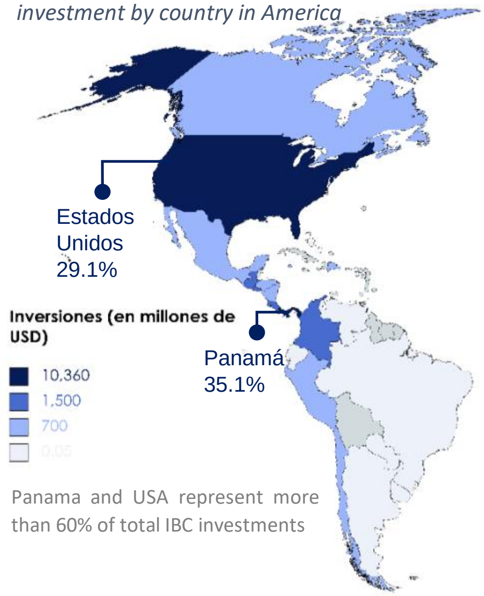
Range	Liquidity reported 01 July 2022	Stressed liquidity		
		1 month later	2 months later	3 months later
Below 30%	0	0	0	0
30% - 35%	0	1	6	9
35% - 40%	3	8	6	3
40% - 45%	8	3	4	7
45% - 50%	3	6	8	7
Over 50%	26	22	16	14
TOTAL	**40**	**40**	**40**	**40**

VI. Evolution of the International Banking Center's Securities Portfolio

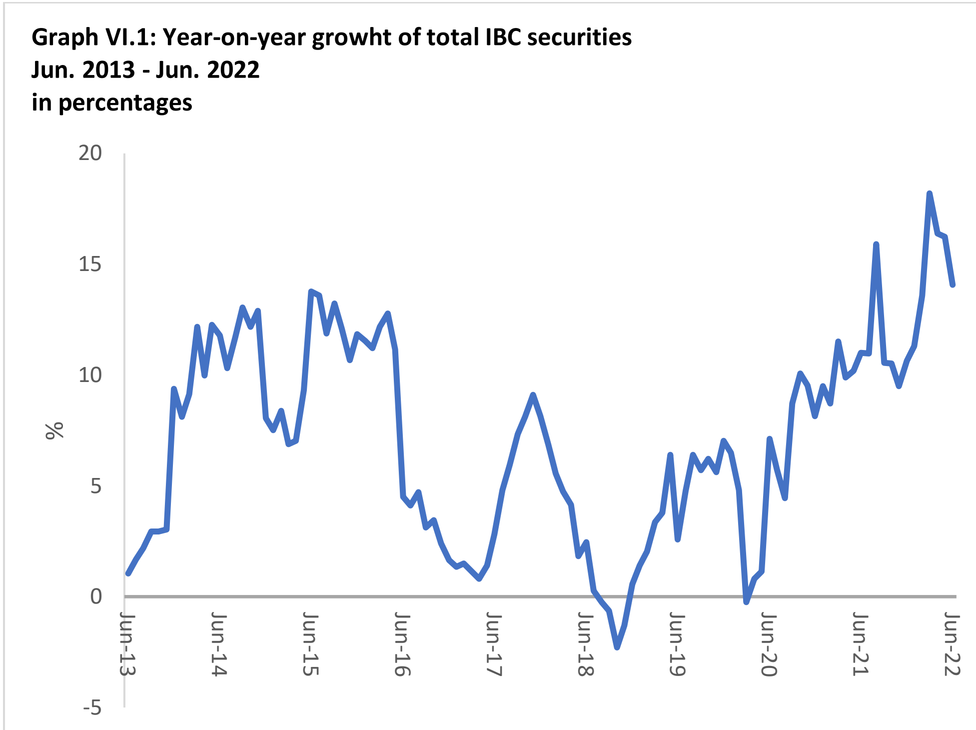
A. Latest performance

The total investments of the International Banking Center as of June 2022 represent 21.4% of total assets and have presented a sustained growth in the last couple of years, 14% of year-on-year growth (**Graph I-I**), around a USD 3.64 billion increase.

Illustration 1. *Concentration of investment by country in America*

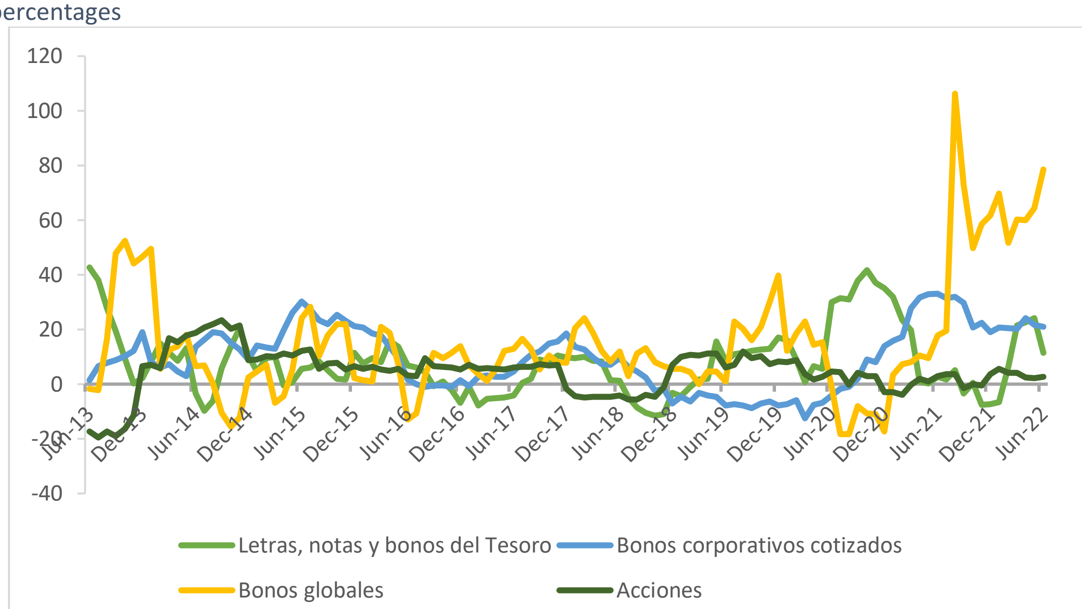


However, if the growth by type of security is observed (**Graph I-II**), global bonds are those that show the greatest growth, being August 2021 the one with the greatest increase (representing 9% of the securities portfolio), in mid-June 2020 these securities showed a decrease, but in 2021 they began to recover rapidly, influenced in part by the introduction of new banks, followed by corporate bonds listed on an organized market with a year-on-year increase of 21%; it is worth noting that these bonds represent 30% of the total amount of securities. Although since late 2018 and mid-2020 listed bonds showed a decrease because banks preferred to invest in state bonds and various IBC entities were winded down.



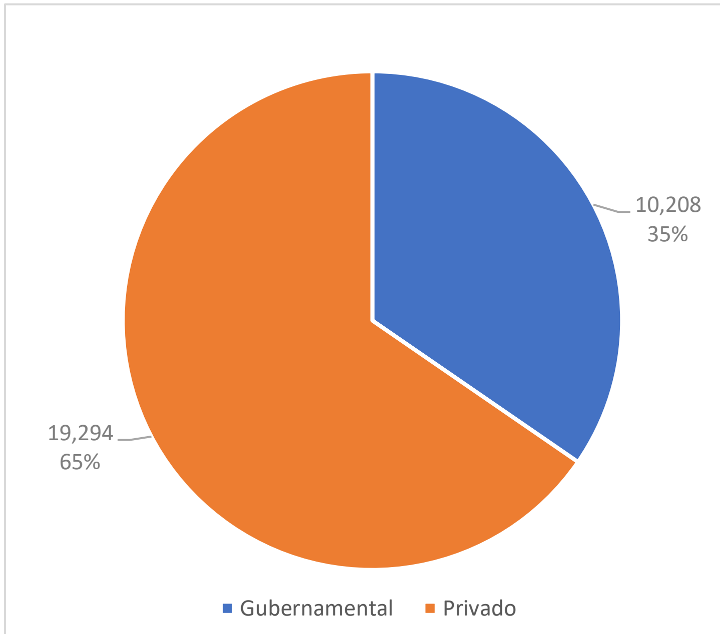
On the other hand, treasury bonds maintain their growth, although to a lesser extent, influenced by interest rate and inflation hikes in the United States, although after securities in Panama (35% of the total), followed by those of the United States with almost 30% of total securities (**see Graph VI.1**). Stocks have shown the least growth and have sometimes decreased; however, stocks represent 21% of total IBC securities.

Graph VI.2 **Year-on-year growth of IBC securities by type**
June 2013 - June 2022
In percentages

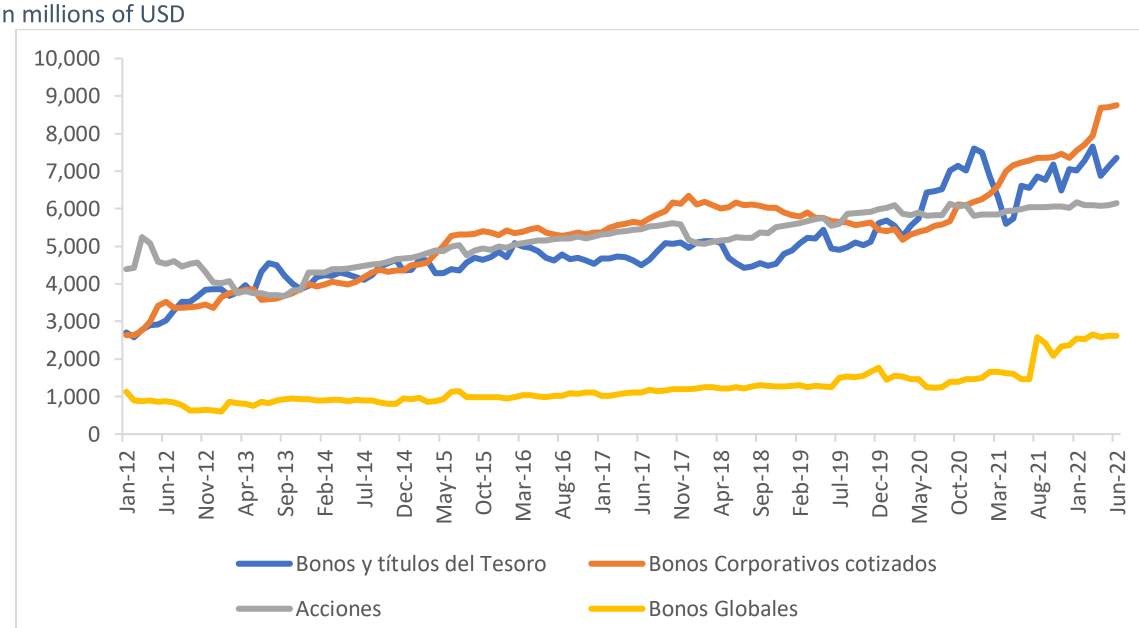


It is important to mention that private securities represent 65% of total securities, about USD 19.30 billion as of June 2022, and government securities, 35%.

Graph VI.3. Share of securities by sector
as of June 2022, in millions of USD and percentages



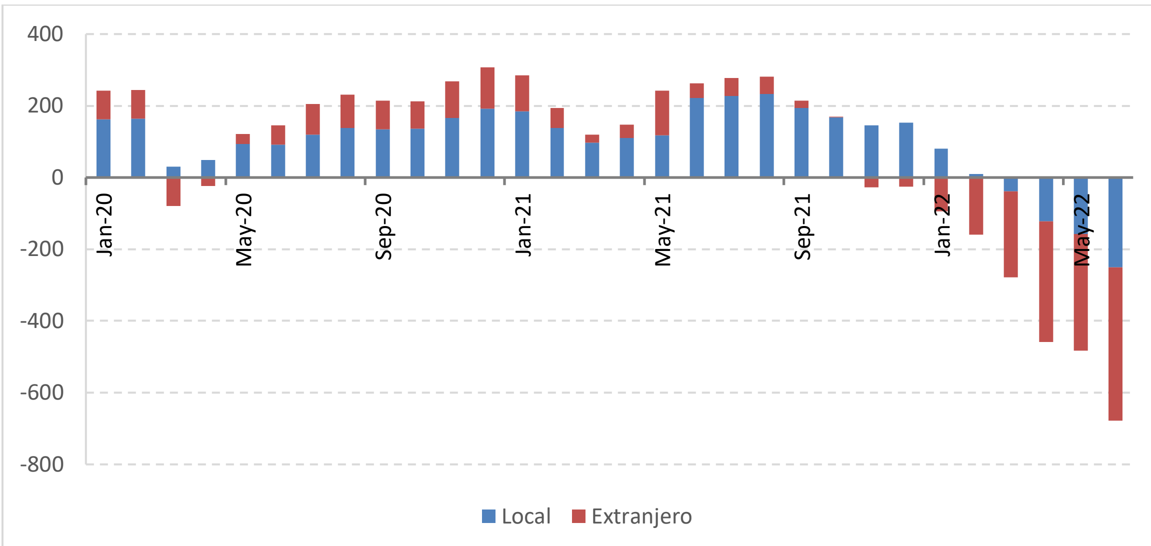
Graph VI.4: **Investment by IBC securities**
January 2012 - June 2022
In millions of USD



B. Market Risk

Since January 2022, financial instruments at fair value with changes in other comprehensive income present losses both domestically and abroad, with June 2022 being the highest lost recorded with USD 679 million.

Graph VI.5. **Profit and Losses in Financial instruments at fair value with changes in other comprehensive income**
January 2020 – June 2022
In millions of USD



The indicated losses can be explained by the change in the Federal Reserve's monetary policy that presented interest rate hikes, inflation rises, sociopolitical problems that occurred in Panama, and that some entities changed their securities portfolio in which bond duration was increased, which makes them sensitive to changes in market conditions, however, by June 2022, long-term positions have decreased, especially in private securities. The observed losses represent 4.4% of IBC's assets.

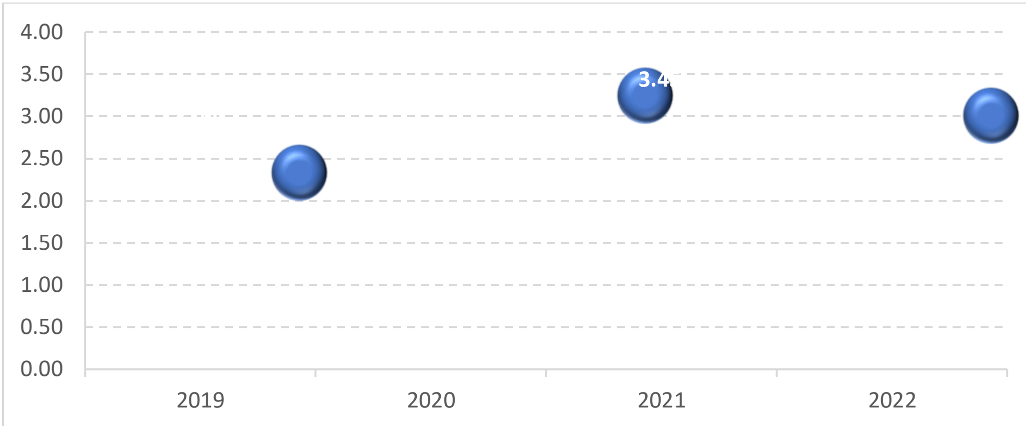
1. Conditional Value at Risk (CVaR)

CVaR, "also known as the expected shortfall, is a risk assessment measure that quantifies the amount of tail risk an investment portfolio has."

The average CVaR of the Banking System's tradeable investments went from 3.45%, in December 2021, to 3.25%, in June 2022. The decrease is because banks have adjusted their securities portfolio, reduced the duration of instruments, and invested in private securities.[2]

[2] CVaR was calculated with historical observations, so the indicator showed is only a reference and not a forecast regarding the potential losses that could be observed in the securities portfolio, taking into consideration the current situation (interest rate hikes, inflation rises, Russian invasion of Ukraine).

Graph VI.6: **Average Conditional Value at Risk (CVaR) at 99.9% for the Banking System's market risk**
In percentages



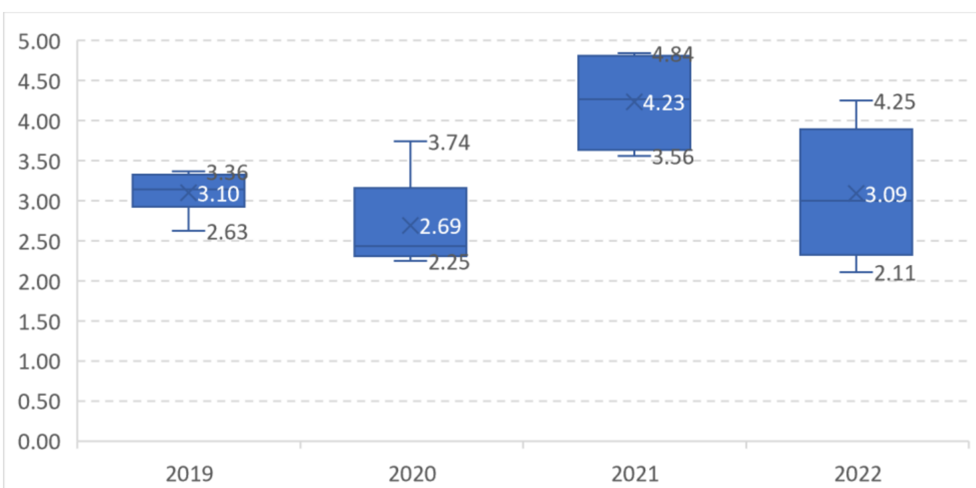
2. Sensitivity

We measure the sensitivity of bonds to interest rates changes of the portfolio of banks that make up the Banking System through duration. Duration allows us to approximate the change in the value of a bond when an interest rate change occurs, the higher the duration of a bond the higher will be its sensitivity to interest rate changes.

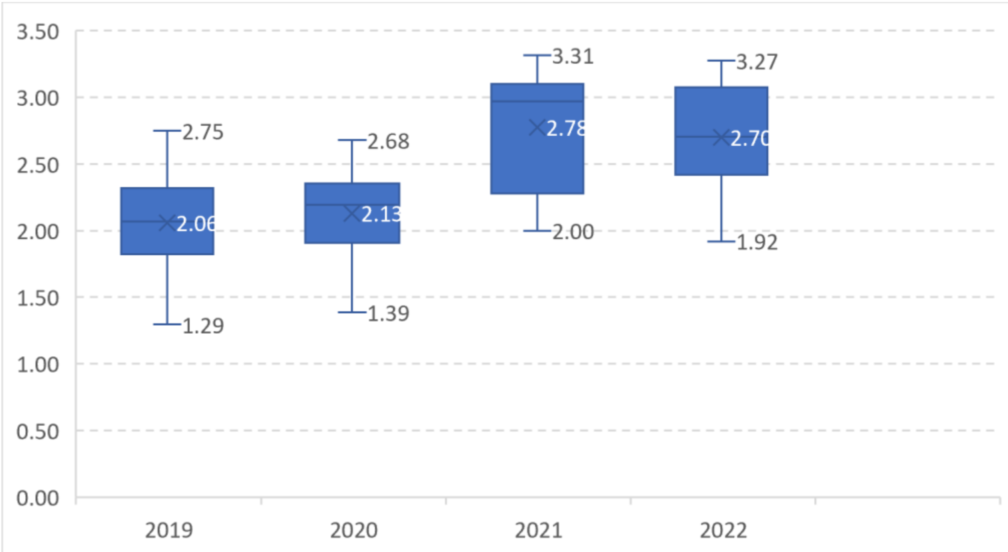
The average duration of government bonds, as of June 2022, was 3.09 years, below than that calculated in 2021 of 4.49 years, as of December, and 4.23, as of June. In relation to the duration in years of private bonds, as of June 2022, it was 2.70 years, a figure below than that of government bonds as well as a decrease to that of 2021.

As of June 2022, of the total bonds recorded in the securities portfolio by entities, 70% are investment-grade bonds, and 80% of these securities are in Panama and the United States.

Graph VI.7. **Average duration of the National Banking System's Government bonds as of June 2022**



Graph VI.8. **Annual average duration of the National Banking System's Private Bonds**



VII. Operational Risk Performance

The Basel Core Principles for Effective Banking Supervision establish that banks must have a comprehensive risk management process, including surveillance by the Board of Directors and top management, to identify, quantify, evaluate, monitor, report, and control or mitigate all significant risks in a timely manner. Within the range of risks banks face is the "operational risk," defined as the possibility of incurring losses due to inadequate or failed internal processes, people, and systems or from external events. This definition includes legal risk but excludes loss of profits, strategic and reputational risk.

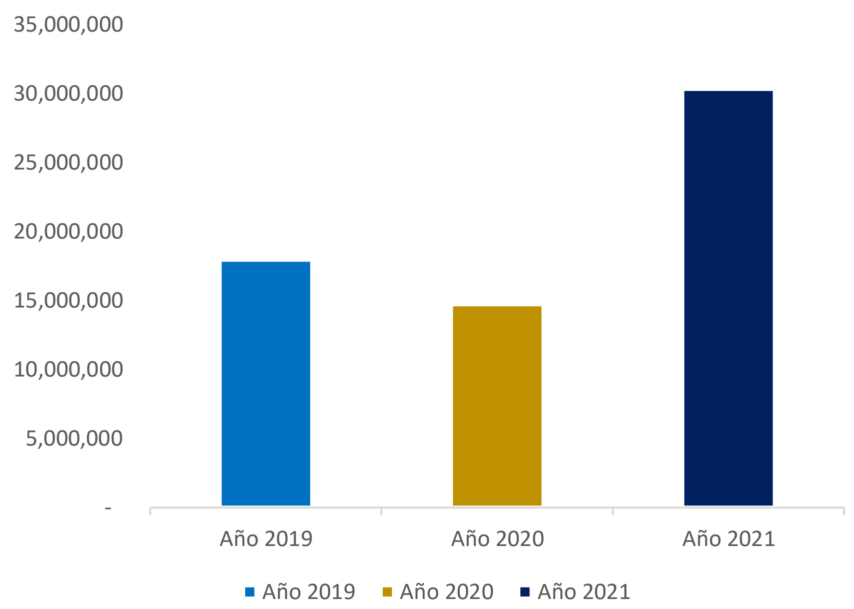
At the face of these threats (risks) that may affect financial entities, the Superintendency of Banks, fulfilling its objectives of ensuring the soundness and efficiency of the banking system and strengthening and fostering favorable conditions for the development of the Republic of Panama as an international financial center, on 20 December 2011, enacted Rule 7-2011 that established operational risk guidelines – that were later updated by Rule 11-2018, dated 11 September 2018 – which included new provisions to be complied with by banks for operational risk management.

The Superintendency of Banks constantly checks the financial entities' faithful compliance with regulations, ensuring that they have designed and implemented operational risk policies, manuals, and procedures, including as a minimum: the functions and responsibilities of the board of directors, top management, risk committee and risk management unit; the detailed description of the operational risk management process (identification, measurement, mitigation, monitoring, control, and reporting), and the detail of measurement tools to assess the behavior of these risks.

The results of operational risk management conducted by banks reveal that such risks are effectively managed. Entities have created organizational structures with clear functions, described in their manuals and procedures, aimed at reducing the possibility of incurring losses due to this type of risk. Banks recorded operational risk losses from 2019 to 2021, for a total of USD 63.06 million with a higher proportion for 2021. However, these losses do not jeopardize the solvency of financial entities in any way.

Below is the breakdown of losses for 2019 to 2021:

Graph VII.1: Total losses incurred by operational risk from 2019 to 2021



We categorize business activities for financial system into "business lines," each with a sub-category. Business lines are:

Line name	Meaning	
Corporate finance	Corporate finance, public administration finance, investment banking, advisory services	Performance of structured financing operations and participation in securitization processes; underwriting; financial advice to corporations, large and medium-size companies, as well as central government and public sector entities, among other similar activities.
Trading and sales	Sales, market creation, own positions, Treasury	Treasury operations, purchase and sale of securities, currency, and commodities on their own account; among other similar activities.
Retail banking	Retail banking, private banking, card services. Loans and deposits from retail clients, banking, trusts, and testamentary services	Individual loans and deposits, banking, trust, and testamentary services, and investment advice. Retail and non-governmental business/ commercial cards.
Commercial banking	Commercial banking	Financing to non-retail clients, including real estate, export financing, commercial financing, loans, guarantees, bills of exchange, financial leasing, among others.
Payment and settlement	External clients	Activities related to payments and collections, interbank transfer of funds, clearing and settlement, among other similar activities.

Line name		Meaning
Other services	Custody, agency for companies, corporate trusts, other services	Custody services, trusts Issuers and payment agents.
Asset management	Discretionary fund management, non-discretionary fund management	Pooled, segregated, retail, institutional, closed, open, shareholdings.
Retail brokerage	Retail brokerage	Execution and full service.

The total of USD 63.06 million in operational risk losses accounted for by banks from 2019 to 2021 is in the following lines of business, of which retail banking recorded a USD 46.13 million loss, which represents 73%.

Operational risk management entails identifying the threats to which the entity is expose and group them according to their nature into the following types:

- Internal fraud. Potential losses derived from any type of action, in which bank employees are involved, aimed at defrauding, embezzling, or failing to comply with regulations, laws, or internal policies.
- External fraud. Potential losses derived from any type of action by a third party aimed at defrauding, embezzling, or failing to comply with the law.
- Labor relations and safety in the workplace. Potential losses derived from actions incompatible with labor law or agreements, with safety and hygiene at the workplace, with the settlement of claims for personal injuries or cases related to discrimination, as well as breaches to the code of ethics.
- Practices related to clients, products, and business. Potential losses caused by failing to comply with an obligation with the customer or derived from the nature and design of a product or service. In addition, practices related to customers: breach of trust, misuse of customer's confidential information, fraudulent trading in bank accounts, money laundering, sale of unauthorized products.
- Damages to physical assets. Potential losses derived from damages or losses to material assets because of natural disasters or other events.
- Business interruption and information technology failures. Potential losses derived from business interruptions and information technology failures.
- Deficiencies in process execution, delivery, and management. Potential losses derived from errors in operations processing or management, as well as from relationships with counterparties (suppliers, clients, depositors, etc.).
- Legal deficiencies. Potential losses derived from sanctions imposed for failing to comply with laws and regulations. Also, because of lawsuits against the bank and for defects in design or formalization of contracts of the different financial instruments.

- Deficiencies in management information systems. Potential losses derived from the discrepancy between the analysis that supports decision-making and the underlying reality.

- Model deficiencies. Potential losses derived from inadequacy in certain models, in the areas of financial instruments valuation and risk identification and measurement, caused by inappropriate assumptions, biased estimation of certain parameters, non-inclusion of relevant variables, errors in the databases used, and event model tampering.

The operational risk events that produced losses for a total of USD 63.06 million from 2019 to 2021 are "Deficiencies in process execution, delivery, and management," with USD 28.3 million (represents 45% of the total) and "External fraud," with USD 17.0 million (represents 27% of the total).

Legal risk. Is the possibility of incurring losses as a result of noncompliance with standards, laws, regulations, or procedures with potential legal consequences; instructions from competent authorities; of adverse judicial or administrative resolutions, judicial or extrajudicial agreements, arbitral awards; as well as, because of the effect of poor drafting of acts, contracts or transactions, even different from those of its ordinary course of business; or because the rights and obligations of the contracting parties have not been correctly stipulated.

In the most frequent losses between 2019 and 2021, within the "Deficiencies in process execution, delivery, and management" operational risk type, are the "data entry errors" and the "client record errors." Due to these two causes, banks incurred losses for a total of USD 19.82 million.

Risk exposure is the amount of the maximum possible loss due to the occurrence of an operational risk event, without considering the reduction caused by hedging or recoveries.

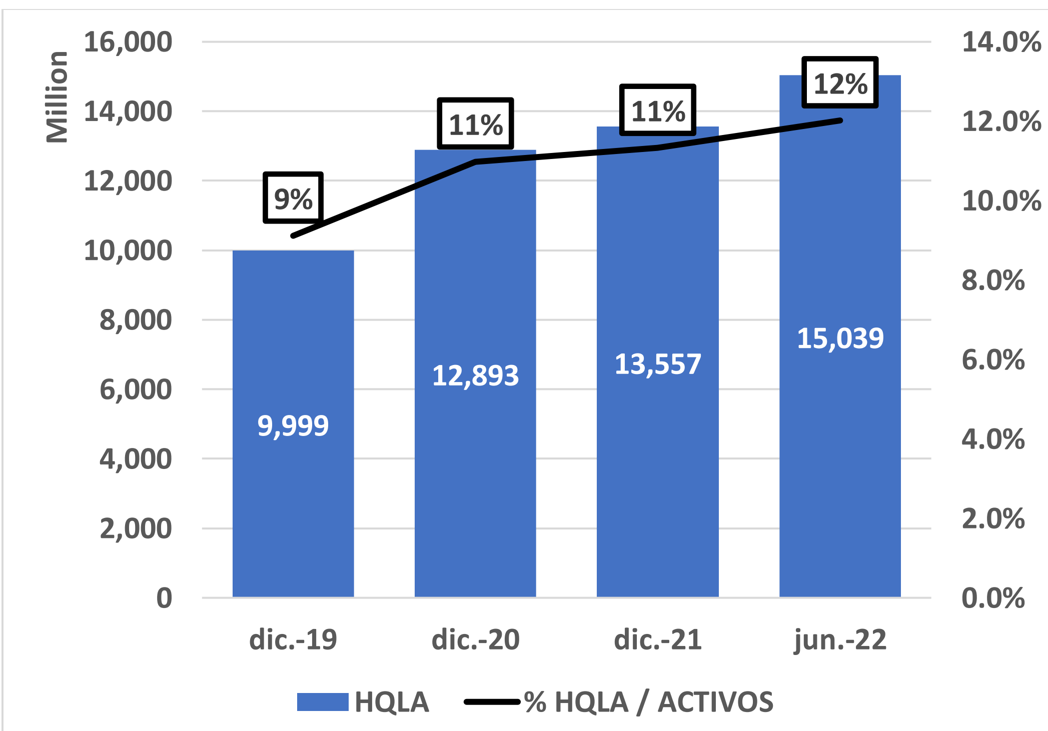
The losses recorded from 2019 to 2021 of USD 19.82 million because of "data entry errors" and "client record errors" represent 7% of total exposure in this cause for the same period, which was USD 271.52 million.

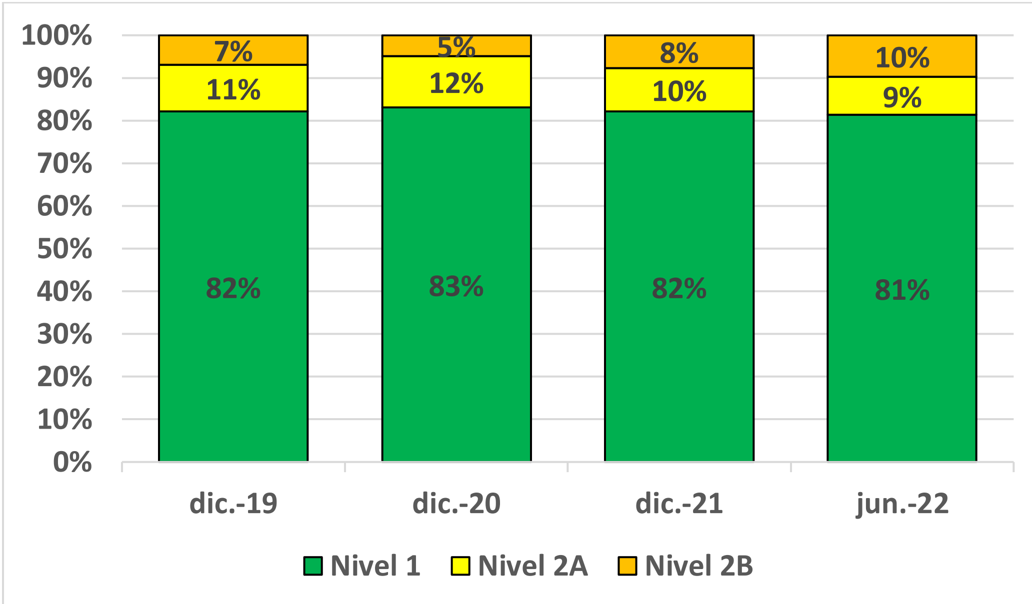
VIII. Liquidity Coverage Ratio (LCR)

Rule 2-2018 "Whereby the provisions on liquidity risk management and the liquidity coverage ratio are established" states that banks must ensure they have a liquidity position made up of High-quality liquid assets (HQLA) that can be easily converted in the market. Four years after its entry into force, banks have increased this pool of liquid assets and their relative importance over total assets.

As of June 2022, banks' high-quality liquid assets have reached USD 15.04 billion, which represents 12% of total assets. This proves that the quality and the liquidity of the assets that make up the securities portfolio of IBC banks have improved because of the good corporate governance and solid liquidity risk management practices.

It is also important to highlight that over 80% of these liquid assets are of very high quality, i.e., tier 1, which have mainly been placed in deposits with authorized entities, such as the Bank for International Settlements (BIS) and the United States Federal Reserve Banks; and invested in debt of authorized issuers rated between AAA and AA-, which are mostly representative of sovereign debt and debt of some multilateral development organizations approved by the Superintendency of Banks. The regulations defined an adaptation period to comply with the LCR established in the rule. The deadline to comply with these minimum percentages ends in December 2022. With satisfaction, we can point out that, as of June 2022, 96% of the banks have met the minimum required.

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