T R A N S L A T I O N

Bill amending the current Banking System (Decree Law 9 of 1998)

Explanatory Memorandum

The Panamanian Banking System is a key element to the stability of the Panamanian economy. Its global integration, combined with the monetary system, provides balance to the economy, fostering a secure and reliable intermediation system. This allows the collection of domestic savings and the efficient allocation of credit to various sectors of the economy, in response to market mechanisms and principles. The development of the International Banking Center is mostly because the special legislation that rules its activity and the emphasis given to the creation and execution of an effective, specialized regulation. The banking sector currently represents 77.4% of all financial activities and contributes, by itself, with 6.1% to the Gross Domestic Product. The current banking deepening level the country has is only comparable to that of developed countries, well above the rest of the continent.

In this regard, the Superintendency of Banks considers prudent to recommend to the Executive Branch, to maintain the independence of this Institution and of the banking legal framework. Aware of its institutional strength, its supervisory and regulatory experience and its high-degree of competence, it is convenient to recommend that those sectors raising funds from the public and that are not supervised or regulated according to the risks they represent to the stability of the economy, be supervised by this Institution through direct amendments to their special legal frameworks, as the successful example of trust companies.

I. Background:

The Banking System, as it is known today, was born in the 70's, when a legal framework developed in this era fostered the creation of a Banking Center with important banks worldwide, e.g. from the United States, Europe, Asia, and Latin America. In the early 80's more than 120 banks started operations in Panama with assets above B/.49,000 MM.

The Latin American external debt crisis, the risks derived from money laundering, the changes to the United States banking legislation, and the growth strategies of international banking, reduced the competitiveness of the banking business done from Panama: raising international funds at low financial cost to be allocated preferably on Latin American markets.

In 1998, a new legal framework based on concepts and principles according to the reality of a more integrated, sophisticated but especially regulated financial market was aimed to avoid the

undesirable effects of different international financial crises that occurred during the last two decades, amended the 1970's legislation.

II. The New Regulator:

The international unanimous consensus, which is reflected in the Basel Committee's 25 Core Principles for Effective Supervision, was to have technical supervisory bodies, independent from the political sphere, to ensure the best allocation of resources and technical talent supervising and regulating the banking systems.

This would be a way to mitigate the negative effects of the financial crises in the economic systems and thus, the people's access to credit facilities that enable growth and creation of value in the economy.

Decree Law 9 of February 1998, which creates the Superintendency of Banks as an independent state agency with the primary responsibility for supervising the banking system, is the initial step towards that direction. The subsequent regulation developed by the Superintendency of Banks has allowed having a regulatory framework in line with the main recommendations of the Basel Committee.

This has been ratified by independent assessments made by Multilateral Organizations, such as the International Monetary Fund (IMF) on the level of compliance and adherence to our legal and regulatory framework to the 25 Basel Core Principles, and the recommendations of the Financial Action Task Force (FATF) on the implementation of the 40 + 9 recommendations against money laundering and financing of terrorism.

In assessments made from 2001 to 2005 our level of compliance is between the highest of the world (23 of 25 principles) and with the third best evaluation international in regards to the prevention of money laundering and financing of terrorism.

III. Performance of Banking Industry

The realities and characteristics of the banking and financial market are in constant change. The international banking system undergoes a profound transformation focused in at least two paths.

The first one is a growing specialization that allows diversifying operations in regards to integral risk management assessment. Increasingly, large international banking corporations are looking for the consolidation and increasingly sophistication of their operations to maximize benefits by means of a professional risk assessment and management.

On the second one, contrary to the experience of earlier decades, the banking system operates, most often, in increasingly regulated environments thus ensuring both the independent risk management assessment assumed by banks and the adequate protection of customers who do not have a decisive power in the complex banking relationships.

International recommendation on the Core Principles for Effective Supervision have been revised and improved. On the other hand, a new methodology for capital management and allocation in terms of risks assumed by banks has been implemented since mid-2007 by major banking centers of Europe, Asia, and the United States.

The last recommendation compiled by the Basel Committee on the Revised Framework for International Convergence of Capital Measurement and Capital Standards (Basel II) represents an important opportunity to improve banking supervision on the basis of effective risk management.

IV. Legal Update Need:

It is clear that the magnitude of the banking business taking place in and from Panama has grown both in nature and sophistication. In 2007, our Banking Center has consolidated assets (including banking subsidiaries of banks headquartered and consolidated in Panama) of about B/.68,000 MM, with 86 licensed banks directly employing 16,617 people.

Therefore, the legal framework governing the Banking System requires an updated.

The banking business has changed substantially; the realities of regulation and supervision are increasing; in order to maintain the stability and the institutional framework for addressing these challenges it requires to be strengthened.

The Bill that is subject to evaluation and consideration of the responsible government agencies is based on four (4) pillars that seek strengthening the competency of the Superintendency of Banks to supervise and regulate the banking system and to update the legal framework to new challenges and issues faced by the international banking system.

V. Regulatory and Supervisory Competency/:

The new legal framework reinforces the regulatory and supervisory competency of the Superintendency of Banks to broaden its authority to regulate not only banks but companies which, together with Banks, compose the Banking Group, which includes bank holding companies.

This principle follows the concept of regulating and supervising, on a consolidated basis, all activities that in one way or another may represent a risk to third-party resources entrusted to banks. Even the competency of supervising the activities of non-banking companies, which may represent a contagion risk for the Banking Group, has been broaden.

On the other hand, the powers to establish an appropriate balance between banks and costumers without relevant decision power in banking operations are highlighted. The principles on access to information in the customer/bank relationship seek to create a more competitive environment that favors efficient banking intermediation.

Finally, the extension of powers to hear and decide administratively the claims of banking consumers, as they have been defined in the Bill, up to an amount of twenty thousand Balboas (B/.20,000), is a step in the right direction to protect users with less access to information and bargaining power. Likewise, were established banking services arbitration as an alternative method of resolving disputes between banks and bank consumers, when the parties submit those to the Superintendency's jurisdiction.

Another aspect of strengthening prudential supervision and the regulatory environment is the requirement of capital adequacy of banks according to risk-weighted assets.

New standards for measuring capital requirements are established, in order to allow banks to emphasize more on the economic capital measurement, depending on their risk-weighted assets and thus, have a minimum base of capital allocation management on their growth strategies.

The Superintendency recognizes that a better measurement of capital requirements, together with the strengthening of risk management, internal controls, implementation of internal boundaries, and reinforcement of provisions and reserve policies, are key elements to further enhance the strength and soundness of the solvency of the Banking Center.

Following the recommendations and international banking practices, the Superintendency of Banks will be empowered of having a supervisory response and demand for corrective actions, in case the capital adequacy is below the minimum required, depending on the risk profile of any bank in particular.

VI. International License Banks Regulation:

Another aspect that establishes a banking legal framework update, is the regulation of international license banks over which the

Superintendency of Banks is home supervisor, this means, integral inspection to banking business consolidating their operations in Panama.

Given the tendency of regional conglomerates to consolidate their banking and financial operations in Panama through international license banks, it is necessary to broaden the powers of the Superintendency of Banks not only to supervise but also to implement a coherent and comprehensive regulatory framework.

This regulation focuses on the legal capacity to require capital against risk-weighted assets, to maintain adequate liquidity and also to set limits both to related parties risk exposure as well as to one obligor or those who are part of a particular economic group risk exposure.

VII. Banks Reorganization and Liquidation:

A third area of reform is to amend the process to address situations of banks in trouble focusing on perfecting a faster process to ensure to private depositors with less resources the possibility of recovering their savings.

This is in order to increase the reliability and stability of the system and to protect small savers, without creating mechanisms to increase the moral risk of the Banking System and without costs whatsoever to Banks, depositors or the Treasury.

VIII. Institutional Strengthening of the Superintendency:

Finally, the fourth area of reform is related to improving the institutional image of the Superintendency of Banks as an autonomous and independent agency with its own administrative and budgetary management.

A particularly important aspect is the creation of the Banking Supervisor Civil Service Career to optimize the Human Resources Management through a specialized administrative career. The purpose of this reform is to strengthen the independence of the Superintendency of Banks, and lay the conditions for the staff to have sufficient incentives and compensation that would enable them to expand their technical skills to supervise an increasingly complex and sophisticated market in order to maintain and strengthen the stability of the banking system. It should be emphasized, also, that this amendment gives to the Superintendency a regime that may allow it to retain its staff despite of the high personnel rotation caused by officials migrating to private sector because of better compensation.

Other aspects of this institutional reform focus on the Superintendency's financial resources management, with appropriate

internal and oversight controls, to ensure corporate governance responding quickly, efficiently, effectively, with a high degree of international competitiveness to its responsibilities.

After ten years of experience under the current legal framework, the Superintendency of Banks – Panama considers that this reform package is an upgrade and modernization necessary to keep both the competitiveness of the banking center and its supervision as a guarantee of stability to the Panamanian economy.

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