The Panamanian Banking Sector

Investigation of the Panamanian Banking Sector and its attractiveness for Dutch Banks

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We hereby declare that this work has not been accepted yet, in whole or in part, for any degree but is concurrently being submitted in candidature for the degree Master of Science in Financial Management at Nyenrode Business Universiteit.
We also declare that this report is the result of our own investigation and that the indebtedness is indicated in the bibliography and elsewhere in the text.

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December 2006

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Preface

We are very glad to present our thesis report, prepared in order to graduate for the Master of Science degree in Financial Management at Nyenrode Business Universiteit.
The last three months were really interesting and challenging. Especially the two months we spent in the Central American region, where we experienced a completely different culture, language and way of life. It was amazing to see the many developments that are taking place in Panama, which not only affect the Banking Sector. Skyscrapers are being built everywhere, one even bigger and more beautiful than the other. Also the developments with regard to the expansion and modernization of the Panama Canal and the expansion of the Colon Free Trade Zone were interesting.

Although a lot of positive things are happening right now, we also see that the country still has to face some big challenges in the near future, like the problem of income disparity, the problems with the infrastructure and the poor education program.
Nevertheless, it was very interesting and a great experience to investigate and assess the Panamanian Banking Sector on its performance and attractiveness for Dutch Banks.

This research would not be complete without the help of many, which we would like to thank. First of all would we like to thank our sponsoring company, the Dutch Embassy in San Jose (Costa Rica), for providing us with this interesting project and giving us the opportunity to conduct the research in Costa Rica and Panama. We especially want to thank the ambassador, Mrs. Blankhart and our supervisors Mr. Grijns and Mr. Buhrs for their advice and support.
The research benefited enormously from the practical advice and the network of the Dutch honorary consul in Panama, Mr. De Wolf. We are also very grateful to him and to the Towerbank for providing us with office space and all other facilities in Panama City.
Following this we would like to thank all the people we have interviewed for their openness and interesting, interactive conversations.
Furthermore, we would like to thank our supervisor Prof. A. Thibeault for his advice, suggestions and constructive criticism and Prof. Reijniers for being second reader.

Last-but-not least would we like to thank our family and friends for their dedication and support towards us and our work.

We hope you will enjoy reading this report as much as we have enjoyed writing it.

Summary

The economy is currently booming in Panama and a lot of investors are studying the country. Within the banking sector this has led to many mergers and acquisitions.
It is in the line of business of the Dutch Embassy to inform Dutch investors, companies and banks about the country. This has led to the project of investigating the Panamanian banking sector.
There is no model available in the literature that can be used for this project. Therefore a model is developed for the assessment of banking sectors, based on important conclusions and factors found in academic articles.

The central research which has been derived is:

Is it attractive, looking at current market conditions and performance indicators of the market and banks, for Dutch banks to enter the Panamanian banking sector, and if so, what is the best way to do this?

This question is divided into the following sub-questions:

- *What are the characteristics of the Panamanian banking sector?*
- *What are important factors for a bank entry in a certain country?*
- *What are important factors for a bank to choose a target bank to merge with or to acquire?*
- *Which banks can be presumed attractive targets based on the scores on these factors?*
- *Is it attractive for banks to enter Panama based on the previous assessments?*
- *What is the best way to enter the market based on the various results?*

A theoretical and empirical analysis has been used for this research.
First is investigated what the characteristics of the market and players are and how the market is structured. The second step in this research was to find out which factors are important for banks in their assessment to enter a foreign banking sector.
An empirical research has been added to detect trends, the opinions on various matters and to get an idea about expectations within the sector.
The empirical analysis required a two month presence in the Central American region. The theoretical and empirical analysis together forms the assessment of the banking sector. This assessment has led to the answers of the research questions.

Panama has many attractive characteristics, but the country is very small and the banking is sector crowded and competitive. Next to this are there a few banks with a lot of market power, like the two global banks HSBC and Citibank. The best way to enter the market is through mergers and acquisitions. Due to the M&A-history of the sector and the expected M&A activities are the prices paid by banks based on high multiples.
This leads to the conclusion that solely Panama is not attractive for Dutch banks to enter. However, there are 40 million people living in a region that is currently doing economically very well. Therefore, it can be attractive to diversify regionally following the banks strategy. Currently are there only a few takeover candidates that operate regionally, the possibility of choice is therefore limited. It is however more costly to buy local banks in every country, next to this does it take more time to incorporate them.
The device is therefore to act rapidly because there are only a few opportunities left to enter the region and now is the time that the region is flourishing.

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More tables and figures can be found in the Appendix supplement.

1. Introduction

This chapter discusses the rationale for the research, the Dutch Embassy which is the sponsoring company, the problem definition, the research question and sub-questions, the research model, the limitations of research, the code of ethics and how the report is structured.

1.1. Rationale

This year, 2006, Panama remembers and celebrates its 103 years of independence.
After the historic handover of the Panama Canal in 1999 and the closure of the American military bases, Panama could build its own future. Although this looked like the beginning of a bright future, Panama struggled with this freedom. The pullout of the Americans happened too fast and the loss of US revenue influenced the Panamanian economy. The budget deficit was growing fast, unemployment rates were high and the social security almost reached bankruptcy. Mireya Moscoso, the first female president after the Noriega regime, was linked to scandals of corruption and new elections were necessary in 2004. Under the current government of Torrijos, the Panamanian economy started to grow rapidly and it looks like it keeps on growing for the coming years.

One of the pillars of the economy is the financial sector, as a main contributor in its services industry. The financial sector of Panama is modern, innovative and well-regulated compared to other countries in the Central American region. The banking sector consists of 76 banks with total assets of US $ 41.5 billion (September 2006). There are a lot of Mergers & Acquisitions (M&A) activities in the banking sector, implying that banks are entering, expanding or leaving the market. M&A can provide direct access in Panama and different countries in the Central American region for Dutch banks. The departure of ABN AMRO in 2002 might imply a decreasing interest for Dutch Banks in the Panamanian financial sector. Developments with regard to mergers and acquisitions in the market could prove this. The trend that banks will try to regionalize their activities is expected to accelerate, due to among others the start of the commercial treaty between the US and Central America (DR-CAFTA) and higher multiples. The economic growth in the Central American region, large investments in infrastructure and energy market, a growing population, an increase in tourism and trade will lead to a larger demand of financing activities. There are great opportunities for foreign banks to fulfill these needs.

When looking at the history of Panama, the current economic growth, economic and regulatory climate, the M&A activity, the trends and developments and interesting investment opportunities, it is important to find out whether entering the Panamanian banking sector is attractive and whether there are any opportunities for Dutch banks or not. The Embassy would like to provide Dutch banks with an assessment of the Panamanian banking sector, to inform them about its structure and attractiveness.

1.2 The Dutch Embassy in Costa Rica

The sponsoring company is the Dutch Embassy in San Jose, Costa Rica, which is supervised by the Dutch Ministry of Foreign Affairs. The Dutch Embassy in Costa Rica covers the countries Panama, Costa Rica, El Salvador and Honduras.
The Embassy takes care of consular activities, like the distribution of passports, visa and other documents, as well as the legislation of these documents. The Embassy also assists Dutch people that are in trouble.

One of the other tasks of the Embassy is to assist companies that want to trade with or in one of the mentioned countries. They also help investors making proper investment decisions by providing them with market information or contacts. Problems with local authorities or companies can be avoided or solved with the help of the trade department of the Embassy.

1.3 Problem Definition

The research focuses on the Panamanian banking sector in general and the opportunities for Dutch banks to enter Panama. An analysis has to be made, to point out the attractiveness of the financial market of Panama and ways to enter the market. It might even be possible to detect opportunities to enter the market. It is important to know the relevant factors that banks use in their assessment of markets. To detect trends and expectations is it necessary to interview people for an empirical analysis.

No model could be found in the literature which could be used for this project. Therefore a model has been developed based on important conclusions and factors of academic articles.
This model can be seen as the first phase for a bank in the evaluation of a banking sector.

The analysis starts with a description of the current situation and structure, after which it assesses the performance, based on the factors pointed out in the literature. It assesses whether there are attractive target banks for Dutch banks to acquire and finally there is an empirical analysis that indicates trends, opinions and expectations of local experts.

1.4 Research questions

The central research question that can be derived out of the problem definition is:

Is it attractive, looking at current market conditions and performance indicators of the market and banks, for Dutch banks to enter the Panamanian banking sector, and if so, what is the best way to do this?

The central research question is divided into the following sub-questions:

- *What are the characteristics of the Panamanian banking sector?*
- *What are important factors for a bank entry in a certain country?*
- *What are important factors for a bank to choose a target bank to merge with or to acquire?*
- *Which banks can be presumed to be attractive targets based on the scores on the precious mentioned factors?*
- *Is it attractive for banks to enter Panama based on the previous assessments?*
- *What is the best way to enter the market based on the various results?*

1.5 Research Model

In this paragraph a research model is introduced. A research model is a schematic and strongly visualized model in which the different steps during the research process are described to reach the final goal (Verschuren and Doorewaard, 2000, p.18).
The research model consists of different parts of the goal of the research project and can be adjusted during the project. The research model is visualized below:

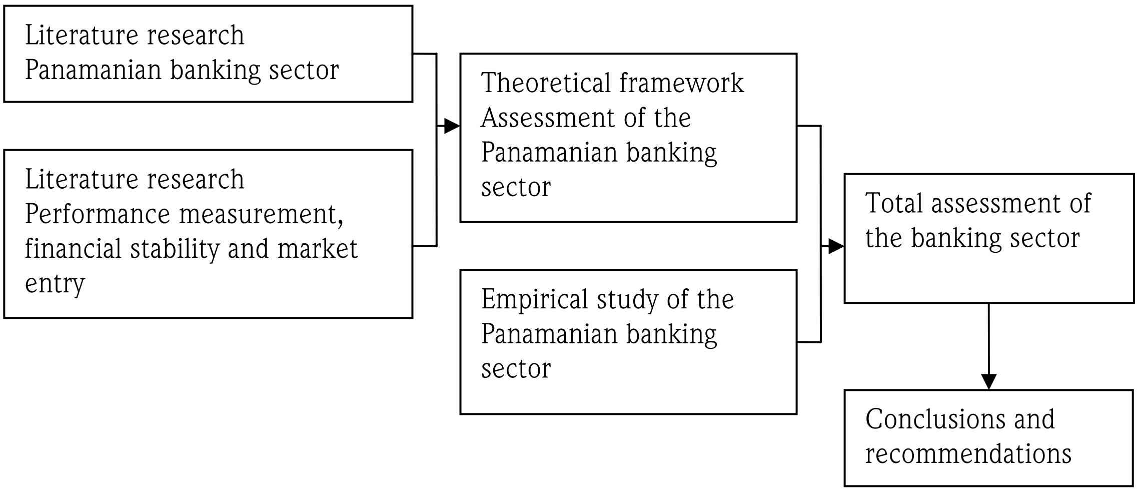


Figure 1: Research model of the project

The research model consists of two parts of literature research. The literature is being examined to give an overview of the Panamanian banking sector, with all its rules, regulations and fundamentals. This is literature examined to give an overview of important aspects concerning the performance of financial institutions, factors that determine financial stability and factors affecting the entry of a bank in a foreign market. These two literature studies form the theoretical framework of the assessment of the Panamanian banking sector. Interviews are done, which are an important part of the empirical study of the Panamanian banking sector.

The theoretical framework and the empirical framework are both used to make the assessment of the banking sector complete. The theoretical framework provides hard data whereas the empirical framework will provide soft information like opinions and expectations. Both are important for a good assessment.
Last-but-not-least, conclusions and recommendations are formulated for Dutch banks, whether the Panamanian banking sector is attractive to enter and how this can be accomplished best.

The contribution of this thesis report to the academic literature is the development of the model and the application on the Panamanian banking sector.

1.6 Limitations of the research

The research is limited by the fact that no country selection model has been developed or used, because the sponsoring company had already chosen Panama as the country for investigation. However, this paper does assess Panama on specific factors or criteria found in the literature to define its attractiveness that can be used in a country selection model. It was beyond the scope of the project to assess the neighboring countries and compare them with Panama.
Furthermore, the theoretical part is not exhaustive as it merely provides a model for a basic analysis of the market. Banks with a sincere interest in Panama should conduct an additional analysis tailored to their needs. Next to that has an indication been made of possible attractive takeover candidates that need further investigation linked to the strategy of the bank.

The research period consisted of three months of which only two months were on site in Panama, which is very limited for such an extensive research. Therefore there were limitations in available amount of time.
Because of the fact that the mother tongue in Central America is Spanish, some translation difficulties occurred. This was a minor problem, because all the respondents were skilled in the English language and Spanish literature is not used frequently.

The financial data is retrieved from the website of the Superintendencia, with the presumption that the data is correctly published. The financial data used is from 1999 till 30 September 2006. As can be seen in table d in appendix 9, there are some ratios missing because some information was not available. All ratios are calculated on a basis before tax has been subtracted.
The presumption is made that banks want to exploit private banking operations in the country, therefore no analysis has been conducted for banks with a Representation License.

1.7 Ethical code

The interviewees allowed to state their names and functions in this thesis report if it is used for the University. However, the respondents prefer to stay anonymous with regard to published information outside the University. Confidentiality is guaranteed by not stating names or references on published materials.

1.8 Structure of the report

A summary of relevant academic articles can be found in chapter two, together with a summary of the selected factors relevant for the assessment of the performance of the market and banks and factors that are relevant for the selection of banks as takeover targets. This is visualized with a conceptual model, which can be found as the final part of chapter two.

In chapter three the methodology of the project is discussed, to point out how the research is designed and the way of data collection. Chapter four discusses the development and situation of the Panamanian banking sector. In chapter five a performance analysis is made of the banking sector as a whole and the different banks individually. Chapter six discusses the assessment of the banking sector. The results of the empirical research can be found in chapter seven. The conclusion, which gives answer to the research questions and therefore summarizes the main results of the research, can be found after chapter seven. The references and appendices follow the conclusions.

2 Theory

This chapter presents the results of a literature research. The first two paragraphs focuses on factors that influence the financial stability of a banking sector and the performance measurement of banks. The third paragraph discusses the drivers for banks to do cross-border investments and the factors that play an important role in the success of a merger or acquisitions in the banking sector. After this a summary can be found and a conceptual model gives a good visualization of the theory.

2.1 Financial Stability of the country

To assess a countries financial stability, one should look at specific internal and external factors, supervision and regulation and the business cycle according to the academic literature. The following paragraphs discuss the mentioned criteria.

2.1.1 Internal

Bruinshoofd, Candelon and Raabe suggest that the strength of the banking sector helps to explain the transmission of currency crises, next to the existing trade and financial linkages. They argue that the strength of the banking sector positively affects the extent to which countries can absorb external shocks. In a strong banking sector, loans are only granted when all the risks are covered by the interest revenues. Key for a bank is the necessity to correctly price the risk and this is reflected in a low share of non-performing loans and in high levels of profits, efficiency, capital and liquidity (Bruinshoofd, Candelon and Raabe, 2005, p.4).
The average share of bad loans increases by credit expansion and this deteriorates the quality of the banks' loan portfolio. The failure of a large number of bad projects funded during a credit boom could set off a downward spiral. Borrowers, unable to repay their debt (credit risk), see their collateral seized and sold by banks, which could trigger asset price declines, lower net worth and further loan recalls.
If loan losses exceed the reserves of a bank and their equity cushion, the bank is technically insolvent. Even in the absence of a rise in loan losses, banks are exposed to higher solvency risk if asset price declines set off. The variables share of non-performing loans, overall cost efficiency, profitability and liquidity, define the exposure of banks to shocks and determine their ability to absorb for instance contagion or bank runs (Bruinshoofd, Candelon and Raabe, 2005, p.5).

It seems that the share of non-performing loans decreases with the cost efficiency of banks (DeYoung and Whalen, 1994, p.4). Some authors suggest that lending booms are a leading indicator for banking crises, especially in emerging markets (Kaminsky and Reinhart, 1999, p.475; Ottens, Lambrechts and Poelhekke, 2005, p.1).
Bruinshoofd, Candelon and Raabe suggest using different measures to indicate the strength of the banking sector. These variables are the bank assets compared to GDP and the private credit provided by banks compared to GDP (Bruinshoofd, Candelon and Raabe, 2005, p.9). Next to this, a lending boom index is presented which reflects the speed of credit expansion (Sachs, Tornell and Velasco, 1996, p.10; Tornell, 1999, p.12-14). This index is a representation of the real percentage change in loans that banks grant to the private sector and to state-owned enterprises over a four-year period. It is possible that credit growth is higher than GDP, because of investments in working capital and a deepening of the financial system. This can improve investment opportunities that benefit the economy and eventually results in growth (Ottens, Lambrechts and Poelhekke, 2005, p.1).

Lambrechts and Ottens suggest that the stability of banking sectors in emerging economies is at risk; not only in an environment of rapid lending growth, but with high inflation and rising real interest rates as well. They think that there are four categories that give indicators for banking crises: macroeconomic, external, financial and institutional variables (Lambrechts and Ottens, 2006, p.2)
It seems that the risk of a banking crisis is linked to the economic growth and real interest rates (Demirgüc-Kunt and Detragiache, 1998, p.3). Higher fiscal deficits will increase the probability of banking crises (Eichengreen and Arteta, 2000, p.14).

2.1.2 External

The literature identifies two important channels of crisis transmission like trade and financial linkages, whereas fundamental macroeconomic variables play only a minor role. Glick and Rose found empirical support that the role of trade linkages is built on competitive devaluation (Glick and Rose, 1999, p.604). The role of financial linkages is based on the common banker lender effect, which builds on risk management techniques used by banks (Van Rijckeghem and Weder, 2001, p.306). The common bank lender effect states that a bank which has exposure in a country that is hit by a currency crisis will reduce its investments in related markets, causing a credit crunch.

External factors like higher world interest rates and slower world growth are suggested as indicators of an increase in probability of crises in emerging markets (Eichengreen and Rose, 1998, p.30). Other indicators can be a stop or reversal of capital inflows (Calvo, Izquierdo and Talvi, 2003, p.11-13) and a deterioration of a country's terms of trade (Caprio and Klingebiel, 1996, p.11-14). Demirgüc-Kunt and Detragiache suggest a positive relationship between an explicit deposit insurance scheme and financial sector problems and that a country with weak law enforcement is more prone to banking crises (Demirgüc-Kunt and Detragiache, 1998, p.1).

2.1.3 Supervision and regulation

Periods of bank lending booms are caused by bad loans (Sachs, Tornell and Velasco, 1996, p.28; Tornell, 1999, p.14). This comes along with poor mechanisms of prudential supervision and regulation. First of all, banks are more willing and able to grant loans and second of all, the terms are improved under which debtors can obtain funds from banks.
Foreign banks can have a positive impact on banking practices, regulation and supervision. Governments need to impose policies like power decentralization, democratizations, privatization, structural policies aiming to improve inefficient bureaucracies, tackle corruption and enhancements in the legal system (De Haas and Van Lelyveld, 2004, p.6; Peek and Rosengren, 2000, p.45-47).

Politics like protectionism and lobbying play an important role in financial developments. The combination of improving corporate transparency and implementing advanced accounting standards reduce information costs and efficiency in bureaucracy and legislation reduces agency costs (Rajan and Zingales, 2003, p.19). Berger and De Young agree that prudential regulation and supervision can reduce the risk of failure of banks and make them more resistant to external shocks. Examples of policies could be the limits on loan concentrations, allowing interregional diversification, encouraging low loan-to-asset ratios or requiring high levels of capital (Berger and De Young, 1997, p.867-868).
It is said that sound institutions and a high degree of governance play an important role for the competitiveness of an economy, as well as a country's credibility. This will enhance transparency and the protection against fraud due to a sound legal and political system. That's

why freedom and democratic values, or civil liberties, have influence on savings and investment decisions and can reduce the cost of capital (De Santis and Lührmann, 2006, p.14).

Daude and Fratzscher suggest in their empirical analysis that information frictions reduce the volume of capital inflows and that portfolio investment is substantially more sensitive to the degree of market openness and development as well as to the quality of host country institutions than to FDI or loans. They also suggest that the quality of economic and political institutions has a substantial impact on cross-border investments (Daude and Fratzscher, 2006, p.5). Important driving forces for growth in the medium to longer term are the quality of domestic institutions, the size of FDI inflows and the sequencing of the liberalization process (Fratzscher and Bussiere, 2004, p.4).

2.1.4 Business Cycle

The motion of economic activity, visible by looking at patterns of fluctuations of macroeconomic variables such as output, production, interest rates, unemployment and prices can be summarized as a business cycle. The business cycle consists of a peak in economic activity; a period of recession followed by a trough and a period of expansion, but does not show this in regular periods. The duration can be seen has the time gone by between two peaks or troughs. Harding and Pagan think that one should consider the fluctuation of the level of economic activity. A boom can be seen as an absolute increase in the level of economic activity, while a recession shows the opposite behavior. The literature mostly discusses the estimators that give a good estimation of the business cycle. Several macroeconomic variables and not only fluctuations in GDP should be monitored (Harding and Pagan, 2002, p.367).

Factors that affect Current Account Balances (CAB) and net portfolio flows are for example a countries demographic profile, the quality of the institutions, monetary aggregates and initial foreign asset positions. The balance on the financial account is given by the sum of net foreign direct investment, net portfolio flows, net flows in other investment, net financial derivatives and changes in official reserves (De Santis and Lührmann, 2006, p.7).
There are incentives to invest in younger economies which are characterized by higher capital demand and higher expected asset returns and in older economies, if they offer a higher premium. Income growth has an important positive effect on private savings. A growing income results in an increase in consumption. Countries in the early stages of development tend to have current account deficits, arising from building the infrastructure and expanding domestic markets (Farrell, 1970, p.873-876; Summers, 1981, p.535; Tobin, 1967, p.250-256). As an indication for the depth and sophistication of the financial system, the money stock to GDP ratio is often used. The rationale behind this is that well-developed financial systems allow households to increase the savings rate (Edwards, 1996, p.33).

2.2 Performance measurement

According to the academic literature, performance can be measured with help of specific ratios and the structure of the market. The following paragraphs discuss the results of the mentioned factors in more detail.

2.2.1 Ratios

To evaluate the performance of financial institutions, a separation needs to be made between well-performing and poor-performing banks. Research shows that the average institutions compared to the institutions on the *best-practice* efficient frontier incur high costs and low profits (DeYoung and Whalen, 1994, p.6; Wheelock and Wilson, 1995, p.9-15).
Bos et al. state that financial institutions too often rely on comparatively simple ratios like return on assets (ROA) and return on equity (ROE), while measuring bank performance. It is important that the performance of domestic banks can be compared with the performance of competitors from other geographical areas. When comparing banks on profitability, one investigates significant information about past performance, but it provides little information on the future performance (Bos et al., 2006, p.7-8).
Bos et al. suggest a broader definition of performance. They present a scorecard where banks performance is measured based on four criteria, namely the profitability, risk, market power and efficiency. For the profitability they have chosen the ratios ROE, ROA, average cost to income ratio, interest income margin and non-interest income margin. For risk they measure the risk adjusted return on income. For measuring credit risk, it is suggested to use the ratios of capital adequacy, leverage and provisioning. To measure the liquidity risk the ratio of liquid assets to demand deposits should be used and for valuation purposes one should compare the price to book values (Bos et al., 2006, p.12-21). The assessment of market power is discussed in the following paragraph.

The question is to how make a distinction between the well-performing and poor-performing banks, or in other words, between weak and strong banks.
Banks approaching failure tend to have low cost efficiency next to having high ratios of problem loans. Contradictory, Kwan and Eisenbeis (1994) found negative relationships between efficiency and problem loans, even among banks that do not fail. A reason for loan performance problems could be the poor senior management that has problems in monitoring both their costs and their loan customers. It is also possible that regional economic downturns result in loan quality problems. Because of this, extra expenses arise due to the non-performing loans, e.g. monitoring, seizing and disposing of collateral (Kwan and Eisenbeis, 1994, p.25).
Berger and De Young suggest that increases in non-performing loans tend to be followed by decreases in measured cost efficiency, resulting in an increase in costs on monitoring, working out and/or selling off these loans. Before increases in non-performing loans for banks with low capital ratios arise, a decrease in bank capital ratios precedes (Berger and De Young, 1997, p.2).

2.2.2 Market structure

One of the principal factors governing the performance of the banks is the market.
That is why the structure of the market plays an important role and can be viewed in various ways. Any measure of the structure of a market is concerned with the degree of aggregation and the weighting of the firms operating in the market (Bos et al., 2006, p.31).
Another indicator is the degree of market concentration; a high concentration ratio is expected to correspond with less competition and more market power and vice versa (Bikker and Haaf, 2002, p.78). With regard to the structure of the market this paper presents an overview of the Mergers and Acquisitions history within the market and the rumors about possible M&A activity that is expected to take place in the near future. Also an overview is presented of licenses granted by the Superintendencia.

2.3 Foreign bank entry

The likelihood of success and consequences of foreign bank entry should be assessed by looking at the most attractive way to enter the market, the impact on the market after entry and specific success factors for mergers and acquisitions. The following paragraphs discuss the mentioned topics.

2.3.1 Impact on the market

There is horizontal and vertical Foreign Direct Investment (FDI). Horizontal FDI is characterized by the willingness to be close to the customers markets due to high trade costs or, in other words, doing the same in different countries. Vertical FDI is when firms split up its activities and locates them over different countries on the basis of cost efficiency.
Foreign banks are more profitable and more efficient than domestic banks in emerging markets (Bonin, Hasan and Wachtel, 2005, p.2158; Demirgüc-Kunt and Huizinga, 1999, p.380-382; Martinez Peria and Mody, 2004, p.513). Bank entry will lead to more competition, which will help borrowers. Presence of foreign banks in emerging countries increases access to loans (Giannetti and Ongena, 2005, p.6; Mian, 2003, p.4).

The crucial difference between foreign and domestic banks is the information collection. Domestic banks have an advantage with regard to historic credit market information, but foreign banks have better screening skills. The information problem can be overcome by entering the market through acquisition. A Greenfield investment should only be done by a foreign bank when its advantage in screening new applicants for loans is greater than the disadvantage of having less or no information (Claeys and Hainz, 2006, p.6).
A foreign bank will charge a lower lending rate than a domestic bank when entering the market and the competition will become fiercer when a foreign bank enters through a Greenfield operation (Claeys and Hainz, 2006, p.6).
It is interesting to know what the driving forces behind and possible barriers for the internationalization of banks are. A driving force can be that international diversification help banks to decrease their exposure to systematic risks (Buch, Driscoll and Ostergaard, 2005, p.7). As banks have a considerable degree of non-diversifiable economic risks, international extensions of credit can improve the diversification of the systematic risks. International lending is also connected to higher returns, which can improve the risk-return trade-off of the bank in general. There are two ways in the internationalization of the banking industry, namely through direct cross-border lending to a foreign counter-party, or through the ownership of foreign branches or subsidiaries.

Giannetti and Ongena (2005) state several advantages of foreign banks presence in a country. These banks have fewer connections to local families and politicians and can bring expertise and practices, foster competition, efficiency (Giannetti and Ongena, 2005, p.6). This will stimulate bank lending and may stabilize the financial system (Crystal, Dages and Goldberg, 2002, p.1-2). It is mostly because foreign banks have probably sounder lending practices and accumulate fewer bad loans and may be more resilient to negative shocks because of their direct access to foreign savings.
On the other hand, foreign banks have an informational disadvantage and may increase the volatility because they can more easily find alternative investment opportunities or transfer shocks from their home countries (Martinez Peria, Powell and Vladkova Hollar, 2003, p.19-22; Morgan, Rime and Strahan, 2002, p.7). The presence of foreign banks has influence on the stability of the banking sector. If they are more efficient that the domestic banks they could stabilize the performance of the domestic banking system. Cross-border diversification and the

exploitation of associated cost-saving scope and/or economies of scale can result in efficiency gains. Foreign bank management practices and information technologies can also improve the quality and efficiency of banking services and lower the costs of funds intermediation (De Haas and Van Lelyveld, 2004, p.6; Peek and Rosengren, 2000, p.47-50).

2.3.2 Success factors

The strategic focus of banks is important and domestic and cross-border mergers are very different in terms of whether dissimilar or similar banks succeed in mergers. Consistency on the efficiency and deposits strategies of merging partners are performance enhancing both for domestic and cross-border mergers and acquisitions. Performance was improved when differences between the merging institutions with regard to the capitalization and investment in technology and financial innovation were demonstrable. Diversity in loan and credit risk strategies improves performance for merging banks for cross-border Mergers and Acquisitions. Integrating institutions with widely different strategic orientation often have difficulties (Altunbas and Ibáñez, 2004, p.6).

Different studies state that banks' mergers could create shareholder value only for the target institution shareholders and at the expense of the bidding institution (Berger, Demsetz and Strahan, 1999, p.10-15).
In contrary, Cybo-Ottone and Murgia (2000) state, that mergers and acquisitions of banks result in significant market valuation gains for both the target and the bidder (Cybo-Ottone and Murgia, 2000, p.842).
The main conclusion of several studies is that mergers among banks with geographical or product relatedness create value and that dissimilarities tend to destroy shareholder value (Amihud, De Long and Saunders, 2002, p.873). Therefore, the strategic fit is an important element in determining the success or failure.

A strategy could be the earnings diversification strategy, implying a broad product strategy with the emphasis on other sources of income apart from the traditional net interest revenues. This strategy of maximization of non-interest revenue is measured by the ratio of other operational revenue to total assets.
It is important that banks maintain their asset quality profile, which could be measured as the ratio of loan loss provisions divided by interest revenues.
When banks with very different asset quality and overall portfolio strategies merge, this will show bad post-merger performance. Cross-border mergers with the goal to improve revenues by including new portfolio strategies or to reduce the risk profile may result in better performance. Another strategy can be to minimize cost, which can be measured by calculating the total cost-to-total income ratio. Firms competing on the basis of low-cost and operating efficiency are expected to benefit as a result of economies of scale and scope (Altunbas and Ibáñez, 2004, p.17).

Another important factor is the capital adequacy level, giving an overview of the capital structure of the bank and is measured by the ratio of equity divided by total assets. Banks with larger capital ratios probably have a better balance between capital and earnings. Especially in Panama, as there is no lender of last resort, it is very important for a bank to have larger capital ratios.
The liquidity risk strategy is measured by the ratio of liquid assets to customer and short-term funding and gives an indication of the way to handle liquidity risk.
A high liquidity ratio is expensive and merging with banks with better liquidity management would improve performance.

Differences in technology are expected to improve the performance as both parties may benefit from returns resulting from the implementation of new technologies.
In the case of cross-border mergers is it possible that technologies are incompatible and this will result in a drop of performance (Harrison, Hall and Nargundkar, 1993, p.1031).
In domestic mergers, the post-merger performance is lower when the target bank is larger in size than the bidder. For cross-border mergers, the post-merger performance will be better when the relative size of the target is larger than the bidder. It is also suggested that when the target is a good performing bank, the bidder will not benefit as much from a merger than when the bank would be performing less. In cross-border Mergers and Acquisitions a larger difference in credit risk and loan-to assets position leads to a better average improvement of performance (Altunbas and Ibáñez, 2004, p.24).
Foreign banks invest in countries that have the characteristics like uncorrupt bureaucracies, high-quality legal system and a non-government controlled banking system. Papaioannou (2005) shows four important results. The first is the connection of a countries size which is inversely related to their distance. The second is the institutions and political risk. As a third result are the sound policies and well-functioning of the institutions, without corruption and inefficiencies, with good investor protection and swift judicial process and where the government does not own and control the domestic banking system. The fourth result concerns some patterns like the elimination of exchange rate risk, the effect of quantitatively large institutions and politics and the asset and liability flows (Papaioannou, 2005, p.6).
Cultural characteristics like religion, societal composition and language perform better than legislation in explaining financial flow in the world (Stulz and Williamson, 2003, p.346-347).
A measure of how expensive the stock market is relatively to the ability of firms to earn profits is the price-earnings ratio.

2.4 Conceptual Model

The conceptual model is an abstract model, in which supposed relations or connections between variables are visualized. This visualization leads to a simplified image of a part of reality. The model can be based on an existing model in the literature or can be developed by the authors themselves (Vennix, 2002). For this research, no suitable model has been found in literature; therefore the following conceptual model is developed, see figure2.

The main parts of the conceptual model are the characteristics of the Panamanian banking sector, the assessment of the banking sector and the opportunities for Dutch Banks. This line leads to the conclusions that answers the problem statement and research questions.
The characteristics of the Panamanian banking sector consists of a description of the economic climate, investment opportunities, political stability, mergers & acquisitions history, structure of the banking sector and the supervision and regulation of the banking sector.

The assessment of the banking sector consists of an analysis based on the factors found in the literature for performance measurement, consisting of profitability, risk, market power and efficiency. The other part of the assessment is the analysis of the financial stability, consisting of supervision and regulation, internal factors, external factors and the business cycle.

The assessment and description of the banking sector leads to possible opportunities for Dutch banks. This is followed with an analysis of foreign bank entry, consisting of an analysis of the impact on the market and success factors for mergers and acquisitions. Possible target banks are spotted and compared with the M&A-expectations of the market.

This is a model that combines theoretical and empirical results in assessing a banking sector.

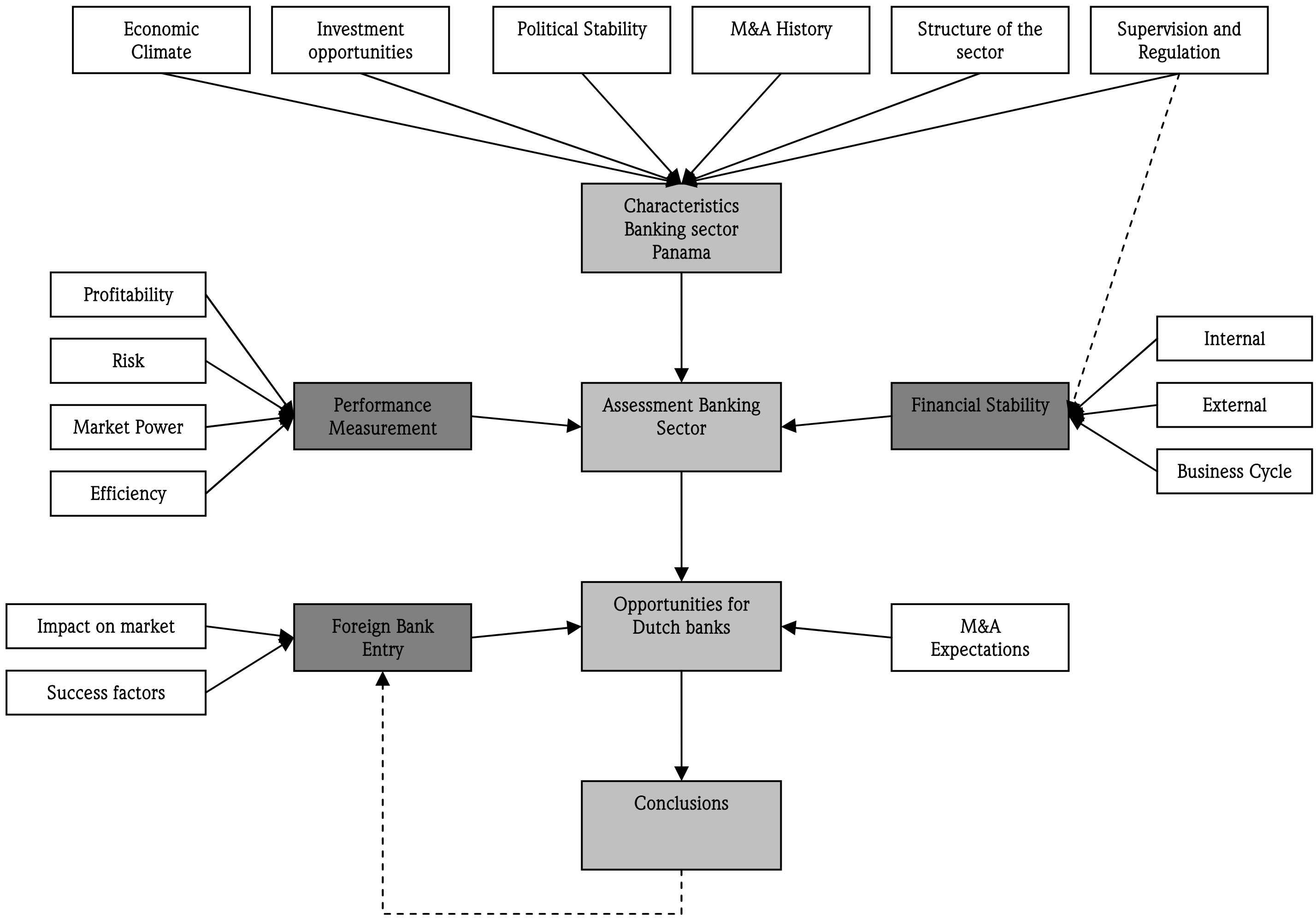


Figure 2: Conceptual model of the project

2.5 Summary

This paragraph provides a short summary of the factors that are previously discussed and used in the rest of the report. The conceptual model gives a good overview and can be found in the next paragraph. This is a model developed for banks to assess banking sectors.

Financial stability of the country

The assessment of the financial stability of Panama is based on several factors, namely: internal factors, external factors, supervision and regulation and the position in the business cycle.
The internal factor deals with overall cost efficiency, profitability and liquidity. Some other aspects that are discussed are bank assets, private credit and percentage change in loans compared to GDP, but also inflation and fiscal deficits.
The external factor is analyzed by looking at trade and financial linkages and the law enforcement.

With regard to supervision and regulation, an analysis is made of the structure and enforcement of the market, the presence of foreign banks, transparency of the market, advancements to accounting standards and the quality of economic and political institutions. This report also gives an indication of the current position in the business cycle based on the GDP and a descriptive view on the important developments within the country with regard to investment opportunities, like the expansion of the Panama Canal, the Colon Free Zone and others.

Performance

The performance of the market and banks is measured by looking at profitability, risk, market power and efficiency. With regard to profitability, an analysis is made of ROE, ROA, Leverage, Profit Margin and Asset Yield (Course: Management of Financial Institutions).
With regard to risk, an assessment is made of the capital adequacy ratio, leverage, provision to loans ratio and liquid assets to demand deposits ratio.
Market power is analyzed by looking at the market concentration or, in other words, by looking at the number and sizes of the players in the market.
Efficiency is analyzed with help of the ratios operational cost to income and non-operational cost to income.

Foreign bank entry

The impact of the market is assessed by looking at the competitive environment and stability of the financial market. An analysis is made, based on the strategic focus of a bank about diversification or cost-benefits. Banks with potential to improve performance are pointed out as well.
Success-factors are examined, like the strategic focus, political risk, sound policies and institutions, exchange risk and language.

3 Methodology

This chapter discusses the methodology of the research. It first elaborates on the interview guides that have structured the interviews. Then it continues with the research design and data collection

3.1 Interview Guide

The research questions as defined in the first chapter fund this project. For the empirical part of the project these questions need to be adjusted to more empirical questions. The empirical questions that have guided the interviews are:

- *What are the opinions about the performance, structure and regulation and supervision of the banking sector?*
- *What is the view on the consolidation wave?*
- *Which investment opportunities can be expected that are attractive for banks?*
- *What are the expectations about the banking sector with regard to performance and competition?*
- *Which trends and/or developments can be expected in the near future with regard to products or merger and acquisition activities?*

In chapter seven these questions are answered. This chapter continues with the research design and data collection.

3.2 The research design

This paragraph discusses the type of study that is conducted in two sub-paragraphs namely: case study and different case studies.

3.2.1 Case study

A research design is the strategy or a plan of action, to get from the research questions to their solutions or conclusions. It depends on the research, the data that need to be gathered and the conditions to conduct the research, which research design suits best to the specific research.
When a research is conducted, there are different options for its design. The research can be done following one of the three basic designs: the experiment, a survey or a case study. In the case of this particular research the case study suits best. With an experiment and a survey, one moment is being assessed, while at a case study different moments of assessment are being held. Essential for a case study is that one subject, in this case the Panamanian banking sector, is studied very thoroughly and from different angles. A case study is therefore very suitable to ask questions to interviewees about how and why some processes are the way they are.

3.2.2 Different case studies

There are different kinds of case studies, like the explorative, the descriptive and the causal case study. An explorative case study is used, when the researcher has relatively little information about different factors of the study. When the researcher wants to describe a certain subject, he makes use of a descriptive case study. A causal research is used, when a researcher want to give reasons for situations or a certain subject.
In this research a descriptive case study is conducted, as the banking sector of Panama and the different opportunities within this sector are described. The research can also be seen as a

field research. This is a more empirical approach to detect trends, opinions and expectations in the market.
Cross-sectional research is used to investigate the current situation and demographics of banks in the market. Longitudinal research is used to investigate the economy, how it has evolved over the past few years and if possible what can be expected for the coming years.

3.3 Data collection

In this research, different kinds of data are gathered. Next to the theoretical analysis, a financial analysis is made. Interviews are held to get descriptive information and insights, to complement the theoretical part of the research. See the references for more detailed information about the information sources used.

3.3.1 Theoretical analysis

In order to build a theoretical framework, different sources are used for data and information. Different academic articles, papers and relevant studies are reviewed to found the theoretical and empirical analysis. Next to this, news providers like newspapers, magazines and internet sources are screened for useful and interesting information concerning the country and the banking sector.
The theoretical analysis is not only descriptive, but also assess it on a developed model. This attractiveness is determined by the financial stability, the performance of the market and possibility versus success of entering the market. Academic articles are used to found factors that describe these factors.

3.3.2 Financial analysis

To indicate and assess the market, data for the financial analysis is gathered, like the financial statements of the banks. A performance analysis of the Panamanian banking sector is made, to discuss the performance and to detect trends and developments. Next to this, annual data of the years 1999-2006 of all banks in the sector are used to calculate key financial ratios in order to assess the performance of the banks. This thorough financial analysis describes, compares and classifies the financial situation of the different banks that are active in Panama.
In total, the analysis is based on about 76 Balance Sheets and Income Statements for a period of 1999 till the third quarter of 2006. For this analysis the non-consolidated financial statements are used.

3.3.3 Interviews

The empirical part of the research required a two month period presence in the Central American region.
Field research is done by interviewing people from various banks. The banks are selected on their local, regional or international operations, the size of the bank, the merger or acquisition activities the bank has experienced or is presumed to do. The respondents have given an overview of their bank, the sector and the expected future of their bank and banking sector. Furthermore, some respondents were confronted with more in-depth questions about specific topics.
Also local auditors, governmental departments, investors and other experts are visited for in-depth interviews concerning corporate government, compliance, fraud, money laundering, investment opportunities, trends and risk management issues.

4 The banking sector of Panama City

This chapter starts with a short overview of the Panamanian economy in general. After this the discussion continues with the fundamentals of the banking sector, the present situation of the banking sector and ends with a summary.

4.2 The Panamanian economy

This paragraph discusses the Panamanian economy by elaborating on the monetary system, economic growth, trade relations, investing climate and a risk analysis of Panama.

4.2.1 Monetary system

The Panamanian monetary system is unique and very important for the development of the country and their economy. The official currency of the country is the Balboa, which is at par with the United States Dollar (US $), due to the monetary treaty with the US of 1904. So since 1904, the US Dollar is a legal tender and a medium of exchange in Panama. This was very efficient during the realization of the Canal, where workers were paid in dollars.

The services, commercial and financial activities in the economy flourish due to the Dollarization of the Panamanian economy.
Panama does not have a Central Bank or an independent monetary policy, independent interest rates or money supply. All these things are determined by the commercial banking system. Banco Nacional de Panama operates as a commercial bank, but carriers out some central bank functions. Banco Nacional is the fiscal agent for the government; it serves as the principal depository and has Panama's drawing right in the International Monetary Fund (IMF).

The growth of the regional economy will increase the credits and the bank deposits. Lending rates are at their lowest levels the last years, namely 9%. This is still quite high compared to the US, because of the risk premiums reflecting the weak Panamanian economy and the high level of public debt. Interest rates are expected to increase as the interest rates in the United States are increasing and international monetary conditions get tighter.
The liquidity position of Panama mainly depends on their ability to attract dollar deposits, their export of services and goods and their ability to maintain an inflow of dollars.

Panama is seen as a financial centre of the region. This centre also handles billions of dollars of remittances every year from the United States to countries in the Central and Latin American region.

4.2.2 Economic growth

The market of Panama is small with its 3.2 million inhabitants. The region however has around 40 million inhabitants. Furthermore, Panama has a unique geographical position connecting North America with Latin America.

In the period of 1980 to 1999 the average annual Gross Domestic Product (GDP) growth rose from 0.9% to 4.2%. The services sector was the main driver of the growth, representing 80% of GDP. This includes the commercial activities at the Colon Free Trade Zone. The growth slowed down in the early years of the 21st century, which was in line with the global economic

growth. But recent years show strong growth, which is a result of the favorable external economic environment.
The current government needs to put some effort in narrowing the fiscal deficit, as it intends to reduce the public-sector debt from 71.7% of GDP in 2004 to 60.0% by the year 2009, while maintaining a primary fiscal deficit not higher than 1.0% of GDP.

	2001	2002	2003	2004	2005
Real GDP (% Change)	0.6	2.2	4.1	7.6	6.4
Nominal GDP (US $ billion)	11.8	12.2	12.9	14.2	15.5
Nominal GDP Per Capita (US $)	3,927	3,987	4,130	4,455	4,793
Consumer Price Index (% change)	0.3	1.0	1.4	1.7	2.8
Short-term Interest Rate (%)		2.22	1.50	1.90	3.13
Fiscal Balance (% of GDP)	-0.7	-2.0	-4.8	-4.9	-4.5
Current Account Balance (US $ billion)	-0.2	-0.1	-0.4	-1.1	-1.3
Current Account Balance (% of GDP)	-1.4	-0.8	-3.4	-7..8	-8.4
Trade Balance (US $ billion)	-2.2	-2.3	-2.3	-2.7	-3.2
Trade Balance (% of GDP)	-18.2	-18.9	-18.0	-19.1	-20.6
Exchange Rate (LCU/US $, end of period)	1.00	1.00	1.00	1.00	1.00
Exchange Rate (LCU/Euro, end of period)	0.88	1.05	1.26	1.36	1.18

Source: Global Insight

Table 1: Development GDP and macroeconomic indicators for Panama 2001-2005

Economic growth per sector

The export sector, the rising activity in the Colón Free Trade Zone and the construction boom drive the economic growth of Panama. The growth per sector is presented in the table below.

	Q1 2005	*Q2 2005*	*Q1 2006*	*Q2 2006*
GDP	7.7	7.7	8.3	7.9
Individual sectors				
Agriculture	9.7	3.5	10.6	6.5
Fishery	17.4	32.4	-7.9	-24.1
Mine Extraction	4.6	-17.1	14.8	29.6
Manufacture Production	2.2	3.3	6.1	5.3
Utilities	4.1	4.8	1.6	1.2
Construction	5.1	-16.1	15.9	30.2
Retail	8.7	8.2	17	14.1
Lodging and Hospitality	7.6	11.9	11.7	9.8
Transport, Haulage and Communications	11.9	11.7	12	11.6
Financial Services	12.4	17.7	12.5	12.8
Education	2.2	2.2	4.2	4.2
Health	3.1	3.8	2.5	1.8
Government Services	-1.5	-0.5	0.7	1.2

Source: Global Insight

Table 2: Economic growth per sector for first two quarters of 2005 and 2006

The growth in the second quarter of 2006 is down from 8.3% year-on-year (y/y) to 7.9% y/y compared to the previous quarter. Compared to the second quarter of 2005 is the growth up from 7.7% y/y to 7.9% y/y. It is expected that the Panamanian economy will grow at high rates in 2006, unless external shocks appear.

The GDP growth in the second quarter of 2006 is due to a strong demand for exports of fresh fruit abroad, strong activity in the Colón Free Trade Zone, occupation of the hotels, the Panama Canal and a small growth in ports activity. When looking at the domestic drivers, there is growth in the manufacturing industry, construction, haulage and banking services. The agricultural sector benefited from the good weather and realized a growth of 6.5% y/y. This can be explained by a rise in production of 9.2% y/y of bananas, a rise in production of non-traditional fresh fruits of 34.9% y/y and a rise in production of meat and cattle of 3.0%.

The mines benefited from the growth in the construction area, as there is more demand for basic materials like cement, up with 20.3% y/y, and concrete, up with 40.6% y/y, and realized a growth of 29.6% y/y in the second quarter of 2006. The growth of 29.9% in the construction industry is mainly due to the residential and non-residential construction projects such as high-rise luxury residential buildings, but also the projects involving the expansion of main ports in Panama and the investments made by the Panama Canal Authority (ACP) towards the improvement of the Canal.

When looking more closely at the manufacturing industries which increased with 5.3% y/y, one can see that especially sugar went up with 73.2% in the food and beverages sector. The expansions also resulted in an increase in the electric energy consumption, which resulted in an increase of 1.2% y/y in production of the utilities sector. The increased consumption of goods like food, cars, gasoline and textiles resulted in a growth of 14.1% for the retail sector. The Colón Free Trade Zone showed a growth of 19.6% y/y, resulting from an increasing demand from countries like Venezuela, Colombia and Ecuador. The growth in the transport, haulage and communications sector is due to the higher volumes of traffic, up with 8.0% y/y, through the Panama Canal and the increased air transportation. The telecommunications grew with 13.7% y/y due to an increase in the mobile-phone-services sector. The financial services sector grew with 12.8% y/y. This is because more foreign investors are active in the country and the earnings of the Colón FTZ earnings are reinvested in the area. Foreign capital invested went up with 77.5% y/y to an amount of US $491 million in the first half of 2006.

It is expected that the Panamanian economy will continue to grow at high rates.
But one should be aware of external shocks, like a faster-than-expected slowdown of the world economy. This would reduce the global trade, the transportation volumes through the Panama Canal and the activity in the Colón Free Trade Zone (Global Insight, 2006).

The consumer price index

The consumer prices in Panama rose with 1.1% on average during 2000-2004. In august 2006 it showed an increase of 0.1% month-on-month.
The inflation in Panama is normally very low, because of the dollarized economy and therefore its dependence on the US Federal Reserve for its monetary policy. End 2005, inflation figures were 3.4%. In the meantime inflation decreased a bit to 3.2% in June 2006. Main driver of these high inflation rates is the oil price, just like the high energy prices, which are feeding through in different goods and services. This leads to an increase in the general price index, although the government has tried to regulate this, due to a lower import tariff for diesel and petrol.

It is expected that inflation will ease in 2006, but high oil prices will keep the inflation high. Lower oil prices and lower demand will lower the inflation in 2007. As the oil price is the main factor for the inflation, it is possible that these figures might change rapidly (The Economist, 2006b). The inflation in Panama has been consistently lower than the inflation in the US.

4.2.3 Trade relations in the region

The export increases

The export from Panama has increased with 35% to US $ 325 million in the second quarter of 2006. The most important sector for export is the agribusiness. Panama is also exporting more and more to Europe, especially food. Although there is a growth, the trade volume with Europe is rather small. The Benelux imported for US $37 million from Panama during the first quarter of 2006. To compare: the Netherlands imported for US $ 1.5 billion from Costa Rica in 2005. The table below shows the most important import and export markets for Panama in 2004.

Export to	Total Export	Import from	Total Import
USA	11.6%	Japan	31.2%
Nigeria	10%	China	10.6%
South Korea	8.1%	US	9.4%
Japan	8.0%	South Korea	8.5%

Source: Website Dutch Embassy San José (Costa Rica)

Table 3: Import and Export to and from the most important markets for Panama in 2004

The following table gives an overview of the trade between The Netherlands and Panama for the period 2001 to 2004.

Year	Import	Export	Net
2001	9.6	37.7	28.1
2002	13.0	28.9	15.9
2003	56.4	12.4	44
2004	16.6	28.5	11.9

Source: CBS 2005, 2006, Website Dutch Embassy San José (Costa Rica)

Table 4: Trade Nederland-Panama period 2001-2004 (in millions of Euros)

International Agreements

Panama is a member of all major international organizations, including the World Trade Organization (WTO) since 1997, and the Organization of American States (OAS). The government is also interested in joining the Central American Free Trade Agreement with the US and the Dominican Republic (CAFTA-DR). However, the country is more focused now on sealing such a deal with the US only.

Furthermore, Panama has signed the following major international agreements:

- Washington Convention (International Centre for the Settlement of Investment Disputes, ICSID);
- Panama Convention (Inter-American Convention on International Commercial Arbitration);
- Montevideo Convention (Inter-American Convention on Extraterritorial Validity of Foreign Judgments and Arbitral Awards);
- New York Convention (Convention on the Recognition and Enforcement of Foreign Arbitral Awards).

Trade Agreements

The United States is Panama's main trading partner. Many Central American neighbors, like Costa Rica and El Salvador, but also Japan and some Latin American and European countries are among its main trade partners.
In Central America, Panama only has a Fair Trade Agreement (FTA) with El Salvador, but has recently signed a pact with Chile. This pact will affect most traded products, as around 90% of the Panamanian exports will now enter Chile free of barriers. The reverse will apply to 62% of Chilean goods (Global Insight, 2006).
Panama is pursuing a parallel FTA with Costa Rica and Honduras. Free-trade talks between the Panama and Costa Rica began in 2002 but were delayed, because Panama did not take part in the regional negotiations of a free-trade pact with the United States (CAFTA-DR). Issues that were addressed were, amongst others, market access, financial services and procurement practices (Global Insight, 2006). Panama and Costa Rica resumed free-trade talks in August, entering into their fourth negotiating round.

Also Guatemala and Panama want to conclude an accord on a Free Trade Agreement (FTA) at the end of November. Main focus is the industrial arena, in particular the textile, plastics, wood and cement sectors. There is also a focus on the agricultural arena, as advancements are noted in the milk and processed food sectors. Market access, government procurement, rules over origin naming and services and investment regulations are the top priorities (Global Insight, 2006).
Both Panama and Guatemala maintain relations with Taiwan, sharing an FTA with the Asian nation. Panama and Taiwan wants to intensify their trading. The main objective of Panama is to reduce poverty in the country with help of cooperative projects, ranging from agricultural and fishery cooperation to educational and training courses. Taiwan has helped Panama raise its productivity in tropical fruit plantation, fish culture and poultry farming. As one of the major users of the Canal, Taiwan is determined to take part in the expansion (Financial Times, August 15 2006).

Doubtful relations

Venezuela offered Panama to build a refinery and signed a deal to supply oil at discounted prices under the Petrocaribe initiative. Reason for Venezuela is the diversification of its export markets (Global Insight, 2006). However, critics see it as an attempt to win political allies and influence against the US. For Panama, the energy deal is an attempt to use oil to compete for influence in Central America against Mexico, which is backing a project to build a new heavy oil refinery in Central America.
The Panamanian government faced some difficulties in the past regarding the bilateral relations. Especially with Cuba, as Moscoso pardoned four Cubans that were accused of attempting to murder Fidel Castro in 2000. President Torrijos strengthened the relationship in 2005.

The relation with Colombia is also distorted, due to illegal Colombian armed groups operating in the border zones. In April 2006, Panama took Colombia to the World Trade Organization for undermining the appeal of the Free Trade Zone of Colon. Panama accuses Colombia of restraining the flow of the re-export from the zone by imposing new restrictions and taxes in Colombian ports, by which goods from Colon transit. Panama estimates losses of US $240 million for the country since this restriction and tax scheme were established. The Panamanian Minister of Commerce, Alejandro Ferrer, and Colombia's Minister of Industry, Jorge Humberto Botero, will meet in an attempt to settle the countries' differences regarding Colombia's port restriction applied to products coming from Panama's Colon Free-Trade Zone (Global Insight, 2006).

4.2.4 Investment climate

In general
The country has a positive attitude towards foreign investors, resulting in no notable expropriation lately. The Multilateral Investment Guarantee Agency (MIGI) is an institution that aims to create a stable environment, favorable for business activities in order to attract (foreign) investors. The institution offers protection against loss of property and assets due to governmental actions. A privatization wave occurred in the 1990s, which did not discriminate between domestic and foreign investors.
The government of Panama has a liberal approach and gives freedom to do business. There are almost no restrictions on foreign participation in the economic sectors. The only restrictions that do exist concern some areas of retailing, the media and the utilities. Franchise can be obtained in the retail industry though.

A new public contract law is approved, which provides for the use of new technologies in the bidding process that restrict opportunities for corruption. Information gets available to everyone; this promotes transparency and therefore a barrier to bad practices.

The amount of foreign direct investment is doubled this year. Growth figures get higher and higher. The first quarter of 2006 showed a growth of 77.7% of foreign investment. The record of 1997 (US $ 1.3 billion) is broken. The increase in the Real Estate sector and the dynamics of the Free Trade Zone are the main drivers of this growth, together with the acquisitions of the Panamanian banks. The Ministry of Trade and Industry expects that the total foreign investments will be US $ 2 to 3 billion this year.

The Canal
Over the second quarter of 2006, 75 million tons of shipping passed through the Canal, which is an increase of 5.7% compared to the same period last year. As ships larger (post-Panamax) than the standard 'Panamax' (which just fit through the Canal's locks) are being produced, the Canal needs to expand to accept these larger vessels. It is a choice to expand or to loose business. The main users of the Canal are the United States, major South American economies and China. When the plans are finished, the capacity of the canal will be doubled. Stakeholders look forward to the modernization of the Canal and the decline in waiting time.
The upgrading of current infrastructure, like canal locks and telecommunications, as well as the expansion are the two main features behind the modernization process. The project costs approximately US $5.25 billion and would involve the building of a third set of locks which should be completed in 2014.

The main opposition to the expansion of the Canal comes from local farmers and environmentalists that fear flooding and being displaced as a result of the expansion.
Many contingency mechanisms will be put in place to avoid the flooding of the land in the near of the Canal and to recycle the water used by the locks.
Foreign investments are crucial to finance the expansion. Critics fear the social impact and the debt burden that this the project implies. The tolls of the Canal will be increased, as the government will try to avoid the financial burden for its citizens.

The 22nd of October the referendum about the Canal expansion has been held in Panama. A big majority of 78% voted in favor of the expansion of the Canal. This is a higher percentage than the polls had expected.

A couple of weeks before the referendum, the Nicaraguan government revealed that Nicaragua was planning to build a Canal as well. With the results of the referendum, it is very unsure if these plans are being executed because it seems that there is no market for more than one Canal. The Panamanians are very competitive as the infrastructure is already there and prices are not high. The figure below shows a comparison of the Panama Canal and a Nicaragua Canal.

Comparison of the two Canals		
	Panama	Nicaragua
Cost	$ 5,250 million	$ 18,000 million
Project period	8 to 9 years	12 years
Depth	13.8 meters	22 meters
Length	80 km	286 km
Expansion return	3% yearly	5.5%
Traffic	15,000 transits *	3,820 transits*
Maximum Capacity	More than 600 million tones 'cpsuab'**	1,222 million tones TM*
Total Income	$ 6,000 million*	$ 7,457 million*
Employment	250,000***	40,000****
* For the fiscal year 2025		
** Referring to the cubic capacity of a vessel with cargo		
*** Result of increased economic activity		
**** Direct labor force needed for construction		

Source: ACP, Gobierno de Nicaragua, Published in La Prensa by Daniel González

Table 5: Comparison expansion of Panama Canal and construction of Canal in Nicaragua

According to the ACP and its expansion plans, the Canal is going to be a success story. Sales are expected to increase from US $ 1.2 billion in 2005 to US $ 6.2 billion in 2025. The net profit is expected to grow from US $ 484 million in 2005 to US $ 4.31 billion in 2025, which implies an average increase of 11.6% year-on-year. Expectations are that the ACP supplies the State with more than US $ 37 billion the next twenty years.
In 2014 the new set of locks will be operational, which will have a profit margin of 12% after inflation.

The expansion of the Canal is one of the most important drivers of an expected growth of GDP with a minimum of 5% a year for the next 20 years. GDP will be around US $ 31.7 billion in 2025 which is more or less double the GDP now.
The project needs between 35000 and 40000 workers. It is expected that in 2010 6750 workers are needed at the same time. The Canal will be deepened and the locks placed at that point in time.
The project has expected costs of US $ 5.2 billion. The placement of the new sets of locks will cost US $ 2.7 billion, dredging will be US $ 870 million and the placement of the basins will be US $ 620 million.

Chances for Dutch companies

- Dredging: the ACP thinks that there will be dredging activities needed for approximately US $ 870 million. It is expected that a division of the ACP will dredge for an amount of US $ 370 million and to do this a ship needs to be designed, for which a tender is made by IHC Holland (US $ 100 million). The other US $ 500 million will be for the commercial dredging companies, like Royal Boskalis (NL), Jan de Nul (B), International Dredging (B), Van Oord (NL) en Great Lakes (VS).
- Ships are needed in different sorts and sizes. Chances for De Dongen Scheepswerven, IHC Holland and Damen Scheepswerven.
- ACP needs new locks. Specialized knowledge is needed and Dutch companies might provide the knowledge or specialized products, like hydraulic techniques.
- The financial sector will also be part of this project. Sales of the Canal will have an expected growth of 3% year-on-year and the fee to pass the Canal will be raised with 3.5% year-on-year. The ACP will finance the expansion with the revenue increase and the ACP will stop raising the amount of money that is paid to the government. A commercial loan is needed for an amount of US $ 2.3 billion for the period 2009-2011 and this loan will be repaid in eight years against an expected interest rate of 6.25%, which is rather low due to the fact that the rating of the Canal is better than the rating of the government. Dutch banks can participate in this loan.
- Ports. The bigger ports of Panama are operated by commercial Port companies like Hutchison Whampoa (Balboa: 664000 TEU and Cristobal), Evergreen (Colon: 2 million TEU) and Maerks since 1999 for the next 25 and 50 years. The increase in the transportation by sea and the expansion of the Canal leads to an expected investment of US $ 1.5 billion. The government also wants to build a Megaport of 115 Ha on the Westside of the Canal entry at the Pacific. It is expected that this project is an investment of US $ 600 million.

Dutch companies already doing business with the Canal

- *WL Delft Hydraulics.* The Netherlands Waterloopkundig Laboratorium did different studies for Panama and the Canal to check the water quality, morphology and the water flow. They did a study about the influence of salt on the Canal and there will be more research to be done in the future.
- *Boskalis.* Boskalis is a partner of the Canal for many years now. They did a lot of projects for the Panama Canal Commission and the ACP later. Boskalis is also active in the Panamanian private sector.
- *Smit.* Smit International is a worldwide player for 160 years now in the ports-business and was part of the development of the Balboa and the Cristobal ports. Smit is also the provider of the ships that guide the Containerships through the Canal.
- *TNO Bouw en Ondergrond.* They did a study in 2004 to assess the quality of the sand at the Canal.
- *Van Oord Dredging and Marine.* Van Oord did a couple of dredging projects in Panama lately.
- *IHC Holland.* IHC supplied Panamanian companies with (technical) parts for the Canal.
- *De Dongen.* De Dongen is a builder of ships from Vlissingen, which supplied parts of the Drill Barge in the Canal.
- *IHE/Unesco Delft.* An institute where two workers of the ACP are studying to obtain their Masters degree. It is expected that another five ACP workers will start their studies in 2007.

The Colon Free Trade Zone

The Colon Free Trade Zone (CFTZ) is established in 1948 at the Atlantic entrance of the Panama Canal. The CFTZ is the largest trade zone in Latin America and second of the world, just after Hong Kong. It is located in Colon, next to the Manzanillo international terminal on the Atlantic side of Panama and 90 km from Panama City.
Goods may be imported, stored, modified, repacked and re-exported without being subject to any customs regulations.

Companies operating in the CFTZ may engage in four types of sales operations:

- Re-exportation of goods from CFTZ warehouses;
- Sales to clients located within Panama’s customs territory;
- Direct sales to foreign clients in which goods are shipped from a third country manufacturer without physically arriving in the CFTZ;
- Transfers in which sales are made to other CFTZ firms.

There are four basic ways of doing business in the CFTZ:

- Leasing lots on which the firm builds a warehouse or other facilities as designed by the firm. Land leases are granted for a 20 year period;
- Purchasing an existing facility from the Zone Administration;
- Entering into an agreement with a company already established in the CFTZ as the operator’s representative. The cost of this service is set by mutual agreement between the parties involved;
- Leasing a public warehouse operated by the Zone Administration. The firm receives its goods and stores them like any other company of the zone. There are no fixed costs and payment is based on the weight or volume of the goods stored.

Companies located in areas considered as Free Trade Zones are not subject to income tax payment on their overseas operations. Overseas operations are exportation and re-exportation operations from a Free Trade Zone to a foreign country.
Services operations carried out within the Free Trade Zones are not considered as overseas operations, thus these are subject to income tax. If the above described services take their effect abroad, these will be considered as overseas and exportation operations.
Dividends and profits from overseas operations which are distributed by companies established in the CFTZ receive the same treatment.

The oil refinery

The oil refinery is an investment of US $ 4 to 6 billion and there are eight companies very interested in investing: Chevron, Conoco-Philips, Occidental Petroleum, Valero Energy, Shell, Global Resources, Marubeni en Mitsubishi. The refinery will be placed in Puerto Quetzal (Guatemala) or in Puerto Armuelles (Panama). The investors will decide where the refinery will be placed.

The Minister of Trade and Industry of Panama, Mr. Ferrer, wants to build a refinery in Panama, paid by a private investor, when Guatemala wins the opportunity to build a refinery that takes care of the energy production for the region. Panama is busy with the plans for the refinery for a couple of years already and had talks with American Occidental Petroleum. A lot of analysts think that there is room for more than one refinery plus a petrochemical centre.
When Panama gets the refinery it will have a capacity of 350000 to 450000 barrels of oil and Occidental Petroleum wants to build a connection to the transatlantic pipeline and the electricity network.

Maintenance airplanes

Panama Aerospace Engineering, a division of Singapore Technologies Aerospace will start a centre for maintaining and repairing airplanes at the former military basis Howard. Main customer will be the Panamanian carrier COPA. The centre will attract a lot of workers and will be a first step in the change of Howard to a logistic centre and an economical development site at the Pacific.

Call centers

The telecommunication sector is booming in Panama. The last months the industry of call centers in Panama has a growth of 40 to 50%. The Ministry of Trade registered 16 new companies with more than 10000 workers. The capacity in this branch is doubled herewith.

Distribution hub

Panama has the ideal geographical characteristics to be the international distribution hub for the American continent of the future. Multinationals like Catterpillar, Toyota and Wal-Mart are checking the opportunity to use Panama as a distribution centre. The port of Colon and its container terminal is getting busier with cars and machinery.

4.2.5 Risk analysis

Concluding from the theoretical part of this paper and the different aspects as can be found in chapter 4 and appendix 1, concerning the political, legal, tax, operational and security situation in Panama, risk ratings can been awarded to the different aspects. These are summarized in the following table:

Nature of risk	***Rating***
Political	2.50
Economic	2.50
Legal	2.50
Tax	1.50
Operational	2.50
Security	3.25
Overall	2.47

Source: Global Insight

Table 6: Rating per category for Panama

Overall, Panama has a risk rating of 2.47. This rating show a declining trend, as it was 2.57 in 1998, with a peak of 2.63 in 2001 and a score of 2.47 nowadays. The risk reduction is mainly due to a reduction of risk in the economic climate of Panama.

Internationally, Panama is placed 81st, regarding the overall risk ratings for countries. This rating represents a moderate risk.

When looking at Latin America and the Caribbean, Panama is placed on the 21st place, just below Costa Rica and Cayman Islands. Panama is less risky than Mexico, Guatamala, El Salvador, Honduras, Nicaragua, Venezuela and Colombia (Global Insight, 2006).

4.3 The fundamentals of the Banking Sector

This paragraph consists of an elaboration on the licenses granted by the Superintendencia de Bancos. Furthermore, a description of the Associacion Bancaria and the Superintendencia de Bancos can be found, who are responsible for the supervision and regulation in the banking sector.

4.3.1 Licenses

The banking sector of Panama is characterized by the system of granting licenses. The granted license by the Superintendencia de Bancos de Panama, immediately show the activities a bank is in.

There are three types of licenses:

- *General license:* This authorizes the operation of a bank to do business in any part of Panama and transactions which are made, used or take effect abroad;
- *International license:* It authorizes the management of transactions which are made, used or take effect abroad, throughout an office in Panama;
- *Representation license:* This license only authorizes the establishment of one or more offices of representation in Panama, for operations which are executed abroad.

There are also an Official Licenses, but these are only granted to state-owned banks, of which there are currently two. The Official License gives the same authorizations as a General License.
The banks that are granted a general license are authorized to offer different banking services within the country, but abroad (offshore) as well. To obtain a general license, the bank needs to comply with certain rules. They must maintain a minimum capital requirement, contingent credit and legal reserves on domestic funds, and must observe liquidity ratios. On offshore deposits there are no requirements for legal reserves.
There are some limitations on the different kinds of business a bank can do with this particular license and the Banking Law is very clear in this. Especially the limitations that concern the granting of loans and the acquisition and possession of shares in another company are necessary.
Banks with a general license can transfer deposits between themselves freely and can accept deposits from banks with an international license.

The international license obliges a bank to operate in offshore business only. The inter-bank market is an exception, as they can place and receive deposits in the inter-bank market from other banks (both the banks with a general license and the banks with an international license). The funds need to have an offshore origin though. The interest rate at the inter-bank market is determined by demand and supply in the market.
Banks with an International License are not paying Panamanian taxes and subject to liquidity ratios and legal reserves requirements. The main difference with the banks that hold a General License is that they are not that restricted in doing business.
An offshore bank is actually a bank that gets funds from and re-lends it to non-residents of the country. A place, country of city where domestic operations are carried out separately from international financial business, is defined as an offshore financial centre. This separation can be created, when this centre lacks certain restrictions to domestic business, or when these restrictions are eased. Mainly these restrictions are fiscally or have to do with foreign exchange controls. But also restrictions upon operations such as reserves ratios and banking regulations

are important. Mostly the fiscal incentives are the reason for banks to undertake offshore activities.
Offshore centers are either classified as *paper* or *functional*. A paper offshore centre is a centre for recording transactions, in which little or no actual banking is carried out. It can be seen as a booking centre. Financial institutions can prefer to do business in a country where taxes and regulations are lacking or nominal, and are therewith able to minimize their overall costs. A paper offshore centre can be a solution, as paper centers do not require own offices or staff on the site. Mostly trust companies or established banks service these paper centers (McCarthy, 1979).
A functional centre is the place where financial services and transactions are actually provided and executed. At this place deposits are taken, the lending is done, etcetera. The banks in a functional centre can compete locally and/or internationally. This depends on the kind of license the financial institution has. A functional centre generates employment and income for the host country (McCarthy, 1979).

The banks under license of representation concerns foreign banks that have a representative office in Panama. These offices do not do the banking business themselves, but are there in order to have contact with their customers everywhere. So the representation license is not very functional license, but more symbolic.

4.3.2 Superintendencia de Bancos de Panamá

The banking sector is supervised and regulated by the Superintendencia de Bancos (The Superintendence of Banks). This public institution is in charge of granting the banking licenses and is also in charge of the system inspection.
The Superintendence has a manager, the Superintendent, chosen by the president and the board of directors of the Superintendence. The Superintendent manages the Superintendence together with the board of directors. The current Superintendent is Mr. Barrelier who has replaced Mrs. Cardenas lately.
The Superintendent has the right and the power to grant and withdraw bank licenses. The policy of entry for foreign banks that are authorized to deal in the offshore market is highly selective.

The main objectives of the Superintendence:

- To promulgate banking policy;
- To maintain the solidity, liquidity and efficiency of the banking system,
- To promote monetary and credit conditions for the stability, growth and development of the national economy;
- To strengthen and promote the proper conditions for the development of Panama as an international financial centre.

As can be seen from the previous, the Superintendence has similar functions as a central bank, but it does not issue or print money, nor does it hold the official national reserves of Panama. Banco Nacional de Panama helps the Superintendence with some other central bank functions.

During the year, a copy of the last balance sheet needs to be published on the premises. The bank needs to provide the Superintendence with a monthly update, in which the bank shows the total of their assets and liabilities of their establishments in Panama. Every three months (at the close of operations of each quarter) the bank furnishes the Superintendence with the status of their credit facilities and other assets at the disposal of their establishments in Panama. Every bank is required to submit its balance sheet and profit and loss statements,

together with all the notes and other relevant information within a period of three months after closing of a fiscal year.
The Superintendence regulates the branching for both domestic and commercial banks, as it wants to have full insight of the new opened establishments in the system. When the banks want to close or move a branch, they also need permission of the Superintendence. The Superintendence tries to protect the interests of the depositors, by ensuring that everything happens in an orderly fashion.

4.3.3 Asociacion Bancaria de Panamá

The Asociacion Bancaria de Panamá, the Panama Banking Association, was founded by the private commercial banks and the Banco Nacional de Panama in February 1962.

The purpose of founding this organization was:

- Defending the legitimate interests of the banking industry;
- Promoting the exchange of opinions and information among member banks;
- Promoting the development and technology of the national banking system;
- Collaborating with the authorities in the improvement of the country's economy.

The Association acts in according with this mission and fulfils its objectives and purposes in providing services to its members and represents them in matters that have to do with domestic issues, but in international authorities and institutions.

One of those international institutes is the FELABAN, the Latin American Federation of Banks, of which Juan Antonio Niño, former president of the Association, is president. The FELABAN consists of all the national Banking Associations of the Latin American countries and the Florida International Bankers Association. The FELABAN discusses issues like foreign trade, bank security, the prevention of money laundering, banking law, technology and marketing.
One of the most important activities the Association has participated in, was during the Political crisis in the late eighties. Panama was never confronted with a more serious issue in the Banking sector and the Association was able, with help of other actors, to get the banks and their clients through this crisis without casualties.
Nowadays the Association faces the fight against money laundering, or asset laundering. With respect to the publication and transparency of the banks' financial information, the Association tries to clear the image of Panama.
Besides this the Association provides their members with seminars, workshops and other training programs about recent developments and issues in the banking sector (Asociacion Bancaria, 2003).

4.4 The banking sector now

This paragraph discusses some characteristics and trends of the banking sector. It discusses the competition, consolidation wave and the reasons for this consolidation wave.

4.4.1 Competition

The Panamanian banking sector continues to attract new players. During 2004 and 2005 for example, 16 banks received operating licenses from the Superintendence. This development of the Panamanian banking sector seems to be a good thing, but it leads to a severe competition and reducing margins. Thirty to forty banks that offer local services in a country with 3.2 million inhabitants, indicates that the market is crowded and rather competitive. It is very hard for banks to make money, because of this situation.

A decade ago, international banks focused on the commercial consumer and the high-end corporate business and the local banks focused on the retail market. Now the market segmentation is changing rapidly as international banks focus on the retail market and big local banks are changing in regional banks.
Most banks want to grow their profits with a multiple of yearly GDP growth, which is difficult when margins are declining. Banks try to increase their market share by attracting the customers of the other banks, which will lead to lower margins and lower profits. Higher loan volumes are accepted to make up for lower profit margins.
Foreign banks with international networks do not have a competitive edge, as they also have to compete on pricing and service. Although having an international network can be very beneficial for doing business in the Colon Free Trade Zone.
Local banks are not always concerned when foreign banks enter the market, as these banks mostly operate under international license or focus on a specific market niche. The market is especially concentrated around a dozen banks. Foreign banks get a more and more important position in the banking sector because they buy local banks. One of the first movements was the acquisition of Panabank by Banco Cuscatlán, as part of their regional expansion strategy. A lot of acquisitions and consolidations followed (LatinFinance, March 1 2006). The next paragraph discusses the consolidation wave.

4.4.2 Consolidation wave

Until now, most of the Latin American banks have been owned locally and are slowly starting to expand regionally. The result of this regionalization is a wave of consolidations, which can offer foreign banks the opportunity to enter the whole Central American market with one relatively simple acquisition of a regional bank.
The Central and South American banking sector has proven to be increasingly attractive because of its greater stability and high returns, for foreign banks.
HSBC, for example, bought the Panamanian consumer finance firm Financomer, a major bank in Mexico in 2002 with wide interests in Brazil and Argentina.
Regional banks are also expanding rapidly. Banco Industrial from Guatemala is the fourth largest in Central America and is in the running to acquire Banco de Occidente, Guatemala's fifth-biggest bank (The Banker, March 6 2006). The strategy is to grow, to remain competitive especially because foreign banks show interest in the country and region. The banks can profit from the billions of dollars remitted from for instance Guatemalans living in the US to their relatives back home. It seems that the banking sector of Guatamala is going in the direction of Mexico: only a handful of strong players.

Other regional and foreign players are studying Guatamala for possible acquisition targets. Grupo Banistmo showed their interest in the country. Scotiabank, which bought El Salvador's Banco de Comercio for US $178 million last year, and HSBC and General Electric are also studying Guatemala.
Local banks that can be acquired want a right price for their shareholders. In 2004, attempts by El Salvador's Grupo Cuscatlán to acquire Banco del Café, Guatemala's third-largest bank, failed because the price was too high. It is expected that CAFTA will generate more foreign investment and more opportunities for banks.
The sale of Banco Atlantico Panama to Banco Continental has been approved by the banking regulator of Panama, Superintendencia de Bancos de Panama. It is suggested that the owner of Banco Atlantico Panama, the Spanish banking group Banco Sabadell, has received US $96 million, but the exact sum of the deal was not disclosed.

The last year, three of the six largest local banks were bought by foreign investors or banks. These important acquisitions, which account for more than US $ 3.5 billion in total, are explained shortly in the following.

General Electric Consumer Finance buys stake in BAC

The consumer finance subsidiary of General Electric Company paid US $500 million in 2005 for a 49.9% stake in Panama's BAC International Bank to increase its presence in financial services in Central America. GE has options to acquire a further stake in the bank if they want so. The stake marks the entry of GE into consumer loans and retail banking in the region.

BAC International Bank operates throughout Central America and has 178 branches. The Credomatic unit of BAC is the leading credit-card issuer in the region, with about US $1.7 billion in credit card loans, mortgages and other assets. Besides this Credomatic has BAC about US $1.9 billion in deposits.

BAC International Bank still continues running the operations of the bank. GE only brought some additional workers to prepare new offerings, like private-label credit cards for the retail sector.

Mark Begor, chief executive and president of GE Consumer Finance-Americas, said that they have been looking at the region for more than four years, waiting for the right investment. Begor said Central America is "a sizable place to play. It's an attractive place to grow." (The Wall Street Journal, May 12 2005).

HSBC acquires Banistmo

HSBC has bought recently all shares of Banistmo for a price of US $1.77 billion. The deal is conducted in a cash-only transaction and HSBC paid the Grupo Banistmo shareholders US $52.63 per share. This was a 25% premium.

HSBC is the world's biggest bank in assets and this deal further boosts their presence in the Latin American market. They also own Mexico's fourth-largest bank and one of Brazil's biggest banks. The total assets of HSBC situated in Central America amounts US $11 billion after this acquisition. Grupo Banistmo also had branches and offices in Costa Rica, Nicaragua, El Salvador, Honduras and Colombia.

Grupo Banistmo owns 99.39 per cent of 'Primer Banco del Istmo' (Banistmo), which offers a full range of personal, commercial and investment banking services through 42 branches. It also owns one of the country's largest insurance company, Compania Nacional de Seguros (Conase). These operations in Panama will complement HSBC's existing presence in the country, as HSBC's wholly owned subsidiary, HSBC Bank (Panama) S.A., provides services to personal and corporate customers through 19 branches. In February 2006, Banistmo completed the acquisition of a 56 per cent stake in Inversiones Financieras Bancosal SA, the holding company for Banco Salvadoreno which operates through 72 branches in El Salvador.

HSBC had little overlap with Banistmo, except for Panama. HSBC expect to benefit from the scale and knowledge that Banistmo brings from operating in the region. The completion of the transaction is expected during the fourth quarter of 2006.

Stephen Green, HSBC's chairman, said: "This exciting development will give HSBC a strong presence across a fast-growing economic region which, with the ratification of the Central American Free Trade Agreement (CAFTA), has encouraging prospects. It will allow us to expand into new markets, in a region of 83 million people, including Colombia, and in which large sections of the population do not currently have bank accounts." (The Independent, July 22 2006).

Citigroup acquires Grupo Financiero Uno (Banco Uno)
Citigroup, the largest bank in the world by market capitalization, agreed to acquire Group Financiero Uno on October 27th. Citigroup said that the acquisition of Banco Uno (US $ 2.1 billion in assets) strengthens their platform in the Central American region, in both the sectors of retail and consumer financing. In the first quarter of 2007 the transaction will take place and the financial terms of the transaction will be disclosed. There are rumors that the acquisition of Grupo Financiero Uno costs Citigroup US $ 1.4 billion.
The acquisition expands the presence in the Central American region especially in the field of credit cards. Grupo Financiero Uno was market leader in credit cards, representing 1.1 million credit card accounts (La Prensa, October 27 2006).

4.4.3 Reasons for this consolidation wave

In the previous paragraph, different mergers and acquisitions are discussed. Every merger and acquisition has its own story. This paragraph deals with several reasons for the recent consolidations in the banking sector. The first reason is the banking sector itself. The banks in the area have modernized, with better controls and more transparency and the competitive environment moves from a local one to a regional one. The banking sector has grown steadily in recent years, thanks to post-war economic stabilization, a more modern regulatory environment and consumer activity. Asset levels are climbing steadily and interest rates are down, fuelling demand for loans and credit cards.
Other reasons are investment opportunities, remittances and the upcoming DR-CAFTA.

Investments
The consolidation wave is mainly started because of the economic growth and the fact that there are numerous investment opportunities in Panama and the rest of the Central American region. The banks are very eager to finance these investments. Because many banks want to participate in the bidding process and want to have a larger market share, a lot of banks are being acquired or are in a merging process.

The main investment opportunity is the expansion of the Canal and the development of activities around the Canal. Other opportunities are:

- The real estate sector (offices and apartments);
- Bus transportation system;
- Highways (Panama City-Colon and the Northern and Southern corridor;
- Ports and especially the Megaport;
- Improvement Panama railroad;
- Tourism sector, improvement of beaches;
- Energy projects;
- Oil refinery;
- The production of Biodiesel from seeds;
- Modernization and expansion of the sewer system.

More elaboration on the investment opportunities can be found in paragraph 4.2.4 and paragraph 7.3.

Remittances
In Central America, *remittances* play an important role in the economy. Remittances are the transfers of money to their home country by foreign workers. In some countries, the amount of remittances has overtaken the sum of Foreign Direct Investment (FDI) and development aid. Remittances normally account for more than 10% of GDP in these countries, so it contributes

to economic growth. More interesting for banks, it leads to a higher demand for financial services.

The vice-president of Lafise Securities, Mr. Michael Schnabel, said that the remittances are one of the most important reasons for attractive investment opportunities for large foreign banks. Annual remittances of the US exceed US $7 billion. This in combination with relatively stable governments and upcoming Free Trade Agreements gives excellent opportunities in Central America (The Wall Street Journal, May 12 2005).

DR-CAFTA
The Dominican Republic - Central American Free Trade Agreement (CAFTA or DR-CAFTA) is an important reason for the consolidation wave as well. The Central American Free Trade Agreement (CAFTA) is an agreement between the United States and five Central American countries: Guatemala, El Salvador, Honduras, Nicaragua and Costa Rica about free trade. The negotiations for the terms concluded in December 2003. The Dominican Republic was added to the agreement in March 2004. Panama might be added to these agreements in December.
Free trade agreements for the Central American region provide trade opportunities for companies and financing opportunities for banks. The whole region will regionalize, which will lead to a bigger consumer market.

The US warns Panama to hurry with the Free Trade Agreements as the window of opportunity is closing. If Panama wants to be part of the fast track initiative in the Congress, an agreement has to be made before the end of December 2006.

The FTA between Panama and Costa Rica is very near. In August 2006 the countries started their fourth round of discussions. The subject of the meeting is the access to the markets, rules of origin, services, investments, financial services and governmental expenses.

4.4 Summary

The factors that contribute to the Panamanian financial centre are the cross-road to Latin-America, the stable government, the dollarized economy and the lack of natural disasters (hurricanes and earthquakes). The positive internal factors are the taxation, the reserve ratios, the Panamanian regulation, the infrastructure (Panamanians know the English language, IT, telecommunication, transport, mail, services and the supervision and regulation of the system) and the general climate/attitude of the Panamanians.

The economy of Panama is dollarized and is therefore dependent on the commercial banking system, with regard to monetary policy and money supply. There is no lender of last resort but there are good credit lines and Banco Nacional de Panama and the Superintendent perform some central bank functions. The country however is relatively small and has a large fiscal deficit, which needs to be reduced.
The economy, with the Panama Canal, Colon Free Trade Zone and the services sector as it main drivers show good growth rates in all sectors, but one should be aware for external shocks.
The inflation is normally low; currently it is higher than usual because of high oil prices. The price index is rising on average with 0.1% month-on-month.
The US is the main trading partner of Panama. Other main trading partners are Nigeria, South Korea, China, Costa Rica, El Salvador, Japan, Chile, Honduras, Guatamala and Taiwan.

There is no discrimination between domestic and foreign investors, and there are almost no restrictions on foreign participation in the economic sectors. Transparency is promoted and corruption restricted with elicitations via the internet.
Looking at the international risk rating has Panama the 81st place, one of the highest compared to the neighboring countries. The expectations are, that conditions will change for the better and that Panama will go up some places on the international risk rating list.

The Superintendencia de Bancos grants three different licenses for banks who want to operate in Panama, namely the General License, International License and Representation License.
A general license gives authorization for operations of a bank to do business in any part of Panama and transactions which are made, used or take effect abroad. An international license authorizes the management to do transactions, which are made, used or take effect abroad, throughout an office in Panama. The representation license only authorizes the establishment of one or more offices of representation in Panama, for operations which are executed abroad.
The Superintendencia de Bancos supervises and regulates the banking sector. It can issues bank licenses and has the objective to promulgate banking policy, maintain solidity, liquidity and efficiency of the banking system, promotion of monetary and credit conditions and strengthen and promote the proper conditions for the development of Panama as an international centre.

The Banking Association has the objectives of defending the legitimate interests of the banking industry, promoting the exchange of opinions and information, promoting the development and technology of the banking system and collaborates with the authorities in the improvement of the country's economy.
There are 40 banks offering services and products in a country with 3.2 million inhabitants. The market is therefore very competitive and almost no competitive advantage for foreign banks.

Recent mergers & acquisitions resulted in a bigger presence of foreign banks. Most important developments are the 50% stake of GE capital in BAC International Bank, the acquisition of Primer Banco del Istmo (Banistmo) by HSBC for 1.77 billion and the acquisition of Banco Uno by Citibank for '1.4 billion'. It is clear that the multiples that are paid for these banks are high and are increasing as there are fewer targets that are attractive to acquire.
There are many interesting investment opportunities that need to be financed. Especially because of the Canal Expansion, remittances and DR-CAFTA is it attractive to operate in the region.

5 Financial analysis of Panamanian banks

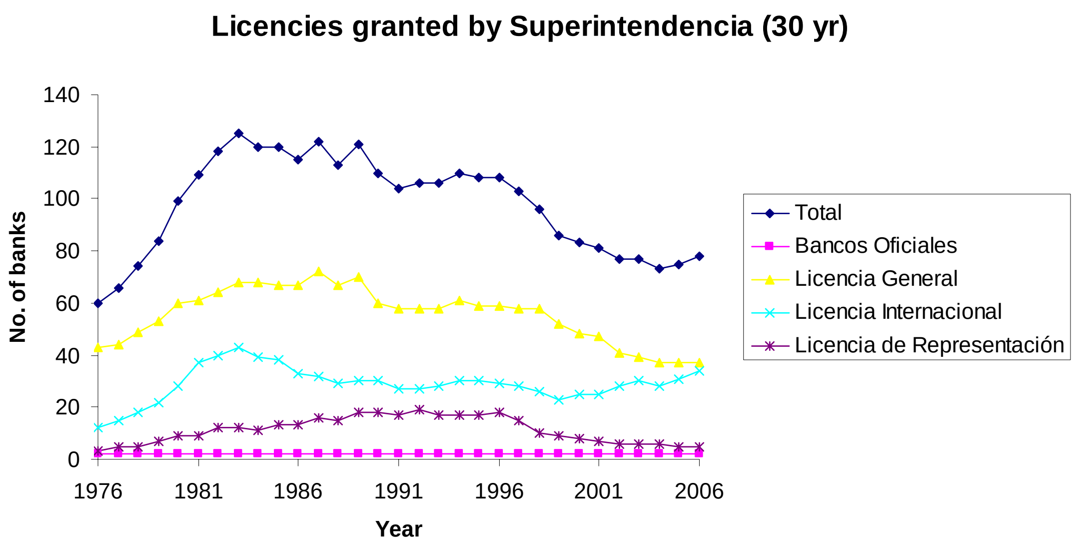
This paragraph provides a financial analysis of the banking sector. It first concentrates on the current situation (30th of September 2006) and continues with the development over the years (1999-2006) with regard to balance sheet and income statement items for the different licenses. The final part of this chapter concentrates on the performance of the market by means of a ratio analysis. The conclusions, graphs and tables are based on the data from the website of the Superintendencia de Bancos de Panamá. The graphs used in this analysis are figures a-k, which can be found in appendix 5.

5.1 *Current situation of the banking sector*

First, this paragraph gives a general overview of the banking sector, consisting of an analysis of the development of licenses over the years, an analysis of Balance Sheet and Income Statement Items, an analysis of banks that are listed on the stock exchange and an analysis of banks that have a Fitch rating. Then the analysis will focus more on the situation and developments of the different licenses.

5.1.1 General overview

Table d can be found in Appendix 9, containing the results of the analysis of all the different banks present in the market in Panama. The analysis is based on data from the Superintendencia de Bancos de Panama. This table presents balance sheet items, income statement items and ratios. Also, the results have a score for each item in a decreasing order.
The Superintendencia de Bancos de Panamá grants licenses to banks to operate in Panama. As stated in paragraph 4.3.1, there are three licenses, the Official License, General License and International License. Figure a in appendix 4 gives a representation of the number of licenses over the years ranging from 1904 to 2006. The following graph gives an overview of the development of the number of different licenses granted by the Superintendencia. The graph presented, focuses on the last thirty years, respectively the period 1976 to 2006.



Source: Based on data from website Superintendencia de Bancos de Panamá

Figure 3: Number of licenses granted per type of license over 30 year period

A large increase in the number of banks obtaining a license occurred during the years 1964 to 1984. During this period there was an increase in number of all licenses, except for the licenses for Official banks, which is obvious because these are state-owned banks. After 1984, the numbers of licenses show a decreasing trend till 2006. Only the amount of International Licenses has increased from 1998 to 2006.
The amount of banks with a General License follow a cyclical trend the last thirty years. The different licenses show an increase in numbers as of 1976, there is a peak in the 80s and then there is a decrease in the number of licenses till 2006. The number of International Licenses increases as of 1998 and the number of banks with an Official License stays the same.

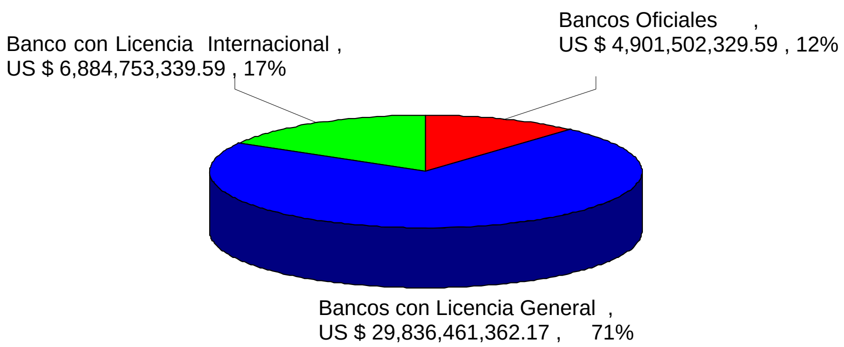
It is expected that the number of licenses will fluctuate around the 75 banks or even increase a bit. The rationale for this is that M&A activities will compensate the number of entering banks.
The following table gives a short overview of Total Assets, Net Income, ROE and ROA for the different licenses but also their market shares.

License	Total Assets	%	Net Income over 3 Quarters	Net Income Annualized	%	ROA	ROE
Banks with Official License	US $ 4,901,502,329.59	11.78%	US $ 106,046,645.41	US $ 141,395,527.21	15.86%	2.88%	17.28%
Banks with General License	US $ 29,836,461,362.17	71.68%	US $ 463,073,984.14	US $ 617,431,978.85	69.26%	2.07%	13.30%
Banks with International License	US $ 6,884,753,339.59	16.54%	US $ 99,503,028.78	US $ 132,670,705.04	14.88%	1.93%	16.18%
Totals	US $ 41,622,717,031.34	100.00%	US $ 668,623,658.32	US $ 891,498,211.10	100.00%	2.14%	

Source: Data from website Superintendencia de Bancos de Panamá

Figure 4: Overview ROE, ROA and market share Total Assets, Net Income for different licenses

The total banking sector represents around US $ 41.5 billion in total assets and US $ 670 million in total net income, as can be seen in the table above. About 71% of Total Assets is allocated to banks with a General License, the other 29% is allocated to banks with other licenses.
Banks with an Official License show the highest average ROE and ROA, whereas banks with a General License show the lowest average ROE and banks with an International License the lowest ROA.
The largest bank in the banking sector is Primer Banco del Istmo with about US $ 5.2 billion in total assets. The following figure shows the market share in Total Assets for each License.



Source: Data from website Superintendencia de Bancos de Panamá

Figure 5: Overview market shares Total Assets per License type

Next to Total Assets, Net Income, ROA and ROE, there are more important factors which need to be briefly touched upon. These are the market for loans, investments and deposits, but also interest revenues from loans, interest revenues from deposits, interest revenues from investments and equity. Graphs can be found for all these variables in appendix 5, figures a-k.

Loans

Banco Latinoamericano de Exportaciones (Bladex) is the largest player in this segment with a total of around US $ 2.7 billion or a market share of 11%. The top five players represent a market share of 45% in this segment. The total market for loans is US $ 25.5 billion currently.
US $ 1.4 billion is earned in interest revenues from loans in total. Primer Banco del Istmo shows again the best results, with US $ 147 million in revenues which represents 11% of the total. The top five banks attracted 46% of all the revenues from loans.

Investments

Primer Banco del Istmo is the largest player in the market for investments representing around US $ 1.5 billion or a market share of 20%. The top five players represent a market share of 55% in this segment. The total market for investments is currently around US $ 7.5 billion.
In total, the banks have earned US $ 226 million on interest revenues from investments. Banco General realized the largest part, namely US $ 32 million or 14%. The top 5 banks account for 51% of the total amount.

Deposits

In total is the market for deposits US $ 29 billion worth. Primer Banco del Istmo is also here the market player with a market share of 11% or around US $ 3.3 billion. The top five possess 41% of all the deposits. The total revenues from deposits were US $ 230 million. Banco Nacional de Panamá earned the most, namely US $ 43 million, which is 19% of the total. The top five banks account for 40% of the revenues in this segment.

Equity

Total equity is US $ 5.3 billion. Banco Primer del Istmo has the largest amount of equity, namely US $ 756 million, or 14% of the total. The top five banks represent 51% of the equity part.

Listed on stock exchange

The following banks are listed at the stock exchange, the Bolsa de Valores de Panamá. Most banks have only issued bonds and preferred shares. There is no data available on Beta's or on the development of share prices. A price-to-book value analysis is therefore not possible.

Banco Aliado
Banco Continental de Panama
Banco Cuscatlan-Panabank
Banco Delta
Banco General
Banco Panameno de la Vivienda
Banco Universal
Global Bank Corporation
Multi Credit Bank
Primer Banco Del Istmo

Source: Website from Bolsa de Valores de Panamá

Table 7: Banks listed at the Bolsa de Valores de Panamá

The next part will discuss the results of banks with different licenses in more detail. More information about the specifics of the different licenses can be found in paragraph 4.3.1.

Rating of the banks
Several banks are rated by Fitch. Table a in appendix 2 gives an overview of the ratings of the different banks. The Fitch rating is chosen, because more banks are rated by Fitch than Moody's and Standard & Poor's, which facilitates the comparison.

There are more foreign banks with a higher rating. The first rating for a Panamanian branch of a bank is Banco Cuscatlán. Other Panamanian banks have rating ranging from BBB to BB. So it can be assumed that there are more foreign banks that benefit from cheaper funding, because of these ratings.

5.1.2 Banks with an Official License (State-owned banks)

The banking sector in Panama has two state-owned banks, which therefore have an Official License. The largest state-owned bank is Banco Nacional de Panamá, which offers different kinds of products and is one of the most profitable banks, in terms of ROA, and one of the largest banks in terms of asset size in the market. The other state-owned bank is Caja de Ahorros. It is expected that in the future only one state-owned bank will remain. This means that a merger can be expected between these two banks, resulting in a bank with total assets of US $ 4.9 billion.
The following table gives a short overview of the banks with an Official License.

Bank	Total assets	Net income	Net Income annualized	ROA
Banco Nacional de Panamá	US $ 3,800,217,906.11	US $ 90,267,321.90	US $ 120,356,429.20	3.17%
Caja de Ahorros	US $ 1,101,284,423.48	US $ 15,779,323.51	US $ 21,039,098.01	1.91%
Total	US $ 4,901,502,329.59	US $ 106,046,645.41	US $ 141,395,527.21	2.88%

Source: Data from website Superintendencia de Bancos de Panamá

Table 8: Overview banks with an Official License

5.1.3 Banks with a General License

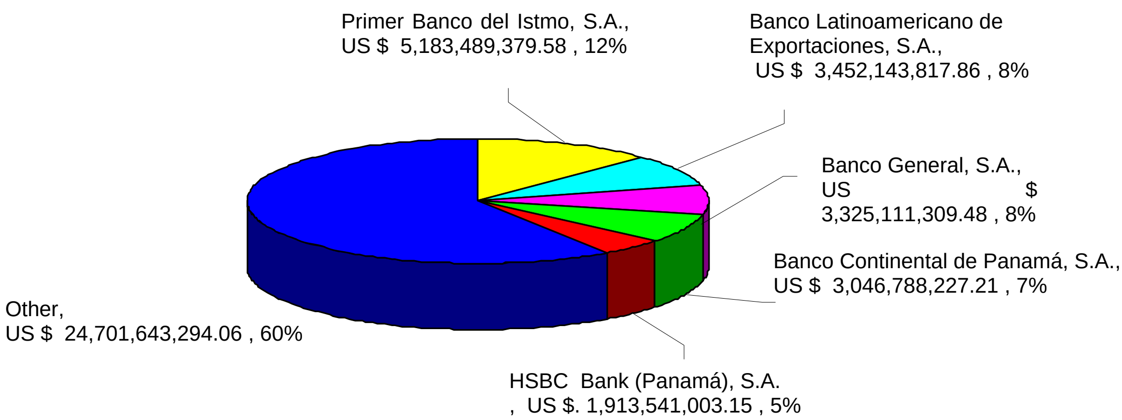
This subparagraph discusses the banks with a General License. The banks with this license represent by far the largest amount of Total Assets and share of Net Income.

No	Bank	Amount total assets	Bank	Amount of Net Income
1	Primer Banco del Istmo, S.A.	US $ 5,183,489,379.58	BAC International Bank, Inc.	US $ 86,310,008.67
2	Banco Latinoamericano de Exportaciones, S.A.	US $ 3,452,143,817.86	Primer Banco del Istmo, S.A.	US $ 84,129,722.85
3	Banco General, S.A.	US $ 3,325,111,309.48	Banco General, S.A.	US $ 59,073,536.72
4	Banco Continental de Panamá, S.A.	US $ 3,046,788,227.21	Banco Latinoamericano de Exportaciones	US $ 39,370,813.68
5	HSBC Bank (Panamá), S.A.	US $ 1,913,541,003.15	Banco Continental de Panamá, S.A.	US $ 30,192,646.35
	Total of 5 banks	US $ 16,921,073,737.28	Total of 5 banks	US $ 299,076,728.27
	Total of license class	US $ 29,836,461,362.17	Total of license class	US $ 463,073,984.14
	Total of all banks	US $ 41,622,717,031.34	Total of all banks	US $ 668,623,658.32
	% Assets compared to the License class	56.71%	% Assets compared to the License class	64.59%
	% Assets compared to all Assets	40.65%	% Assets compared to all Assets	44.73%

Source: Data from website Superintendencia de Bancos de Panamá

Table 9: Five largest banks with a General License in terms of Total Assets and Net Income

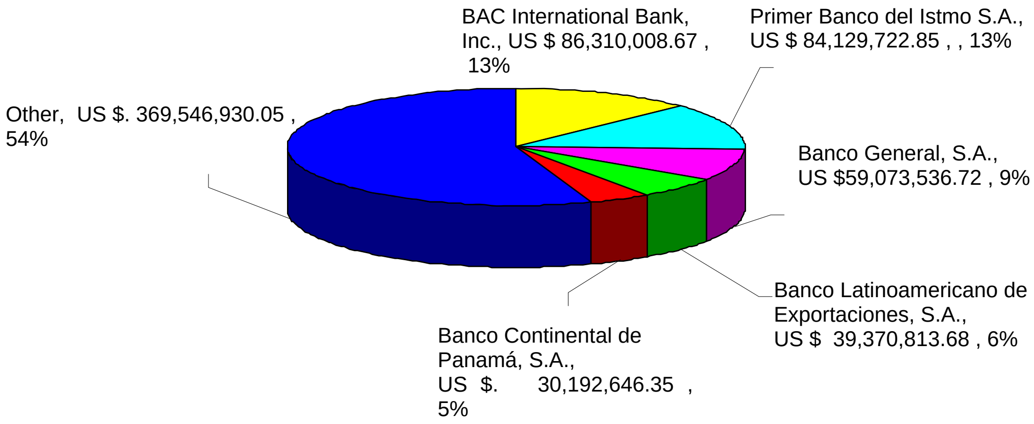
The largest bank in Total Assets with a General License is Primer Banco del Istmo, which scores second best with regard to the total amount of Net Income, just after BAC International Bank. Because HSBC bought Primer Banco del Istmo, their market share of total assets will grow to 17%. The top five players with a General License represent for about 57% of the total assets within its license and for 41% in the total market. See also figure 6.
Looking at Net Income, 65% is realized by the top five banks holding a General License. 45% of Net Income is allocated to these banks when looking at the total market. See also figure 7.
These figures give an indication of market concentration. The market is getting concentrated and it is expected, with upcoming M&A-activities in mind, that it will get even more concentrated. The following graph shows the market shares of the five banks, with regard to Total Assets for all banks with different licenses.



Source: Data from website Superintendencia de Bancos de Panamá

Figure 6: Market Shares Total Assets in the market for five largest banks with a General License

The following graph shows the allocation of realized Net Income of the banks, compared to all the banks with different licenses.



Source: Data from website Superintendencia de Bancos de Panamá

Figure 7: Market shares Net Income for five largest banks with a General License

5.1.4 Banks with an International License

This subparagraph discusses the results for the banks holding an International License.
The table below shows main results like Total Assets and Net income for the top five banks with an International License.

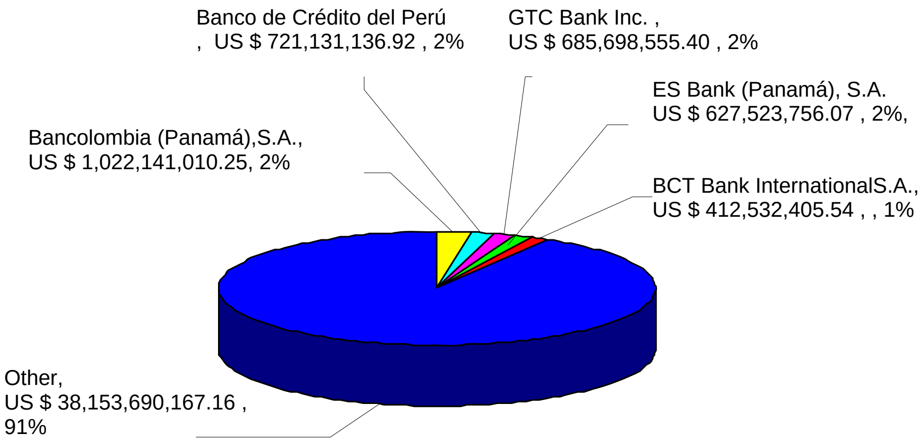
No.	Banks	Amount of total assets	Banks	Amount of Net Income
1	Bancolombia (Panamá), S.A.	US $ 1,022,141,010.25	Bancolombia (Panamá), S.A.	US $ 19,856,954.87
2	Banco de Crédito del Perú	US $ 721,131,136.92	Banesco International Bank, Inc.	US $ 15,415,800.63
3	GTC Bank Inc.	US $ 685,698,555.40	GTC Bank Inc.	US $ 6,407,612.40
4	ES Bank (Panamá), S.A.	US $ 627,523,756.07	Popular Bank, Ltd. Inc.	US $ 6,299,687.02
5	BCT Bank International, S.A.	US $ 412,532,405.54	Banco de la Provincia de Buenos Aries, S.A.*	US $ 5,691,235.36
	Total of 5 banks	US $ 3,469,026,864.18	Total of 5 banks	US $ 53,671,290.28
	Total of license class	US $ 6,884,753,339.59	Total of license class	US $ 99,503,028.78
	Total of all banks	US $ 41,622,717,031.34	Total of all banks	US $ 668,623,658.32
	% Net Income compared to the License class	50.39%	% Net Income compared to the License class	53.94%
	% Net Income compared to all Assets	8.33%	% Net Income compared to all Assets	8.03%

Source: Data from website Superintendencia de Bancos de Panamá

Table 10: Five largest banks with an International License in terms of Total Assets and Net Income

As can be seen in the table, Bancolombia is the largest bank with an International License, with around US $ 1 billion in Total Assets. The five banks represent 50% of Total Assets for banks with an International License and only 8% in the total market.
The five banks realized 54% of the Net Income of banks with an International License and again only 8% of all banks with different licenses.

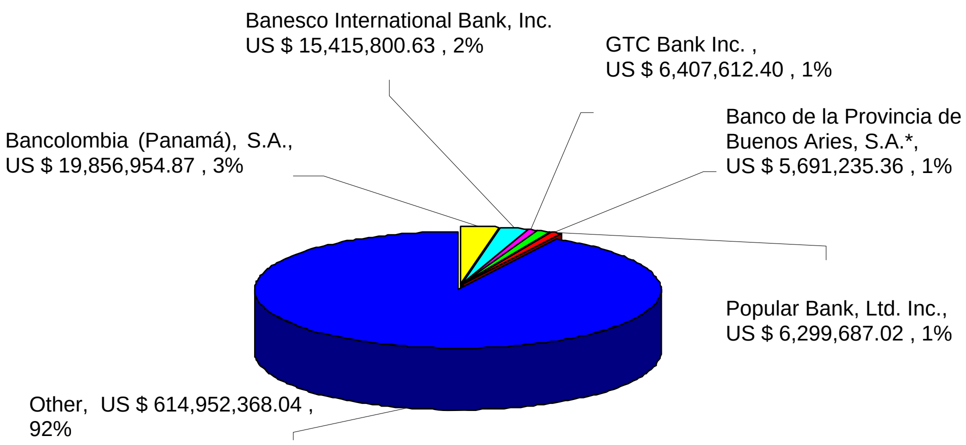
The following graph shows the market shares of the different banks with an International License compared to all banks.



Source: Data from website Superintendencia de Bancos de Panamá

Figure 8: Market shares Total Assets for five largest banks with an International License

The following graph shows the Net Income realized by the top five banks with an International License and its 8% share of the market.



Source: Data from website Superintendencia de Bancos de Panamá

Figure 9: Market Share Net Income in the market for five largest banks with International License

5.2 Time-series analysis of the banking sector

The goal of the time-series analysis is to retrieve information about the performance of the market and to figure out which direction the market is heading. The analysis focuses on Balance Sheet items like Assets, Liabilities and Equity and on Income Statement items, like Interest revenues, Non Interest revenues, Operational Cost, Other Cost and Net income. It tries to indicate segments in the market that are growing or shrinking.
The graphs are based on financial figures from the Superintendencia. The analysis is based on *the figures l-aa*, which can be found in *appendix 6*.

5.2.1 The development of the market

When looking at all the banks and the development of Assets, Liabilities and Equity over time, it can be said that the market is growing. After a low at the end of 2004, the market shows high growth nowadays. This high growth is particularly due to growth in Loans from US $ 1.7 billion to US $ 2.95 billion or 74% (9.5% year-on-year (y/y)). But also Investments and Other Assets have grown over time with respectively 131% (16.9% y/y) and 99% (12.8% y/y). Liquid assets on the other side have decreased in amount over time from US $ 2.1 billion to US $ 1.2 billion or 43% (5.5% y/y).

The liability side is mainly composed of Deposits, which has grown over time from US $ 3.1 billion to US $ 3.8 billion or 22.5% (2.9% y/y). Other Liabilities, Equity and Senior Debt have stayed more or less constant during the period 1999-2006 at levels of respectively US $ 1.5 billion, US $ 3.1 billion and US $ 5.1 billion.
When looking at the development of income, a sharp decline from US $ 3 billion to US $ 1.6 billion, can be seen in the years 2003 and 2004, which is mainly due to a decline in interest revenues from loans (-42%) and deposits (-83%). Other non-interest assets have grown over the years with 137% (17.7% y/y), mainly due to growth in revenues from commissions (86%, 11.1% y/y) and dividends (342%, 44.1% y/y).

The operational cost has decreased till the year 2004 with 44% (5.68% y/y), after which it increased again with 130% (16.8% y/y). Only the other costs, like administrative costs, show a small increase during the total period.
Net results have increased over the years from US $ 550 million to US $ 903 million or 65% (8.4% y/y), with a large negative result in the second quarter of 2002 after which it increased rapidly again.

5.2.2 The development of banks with an Official License

When looking at the development of Assets during the years 1999-2006, it seems that Total Assets do not grow much, only 18% (2.3% y/y). The main asset class is Loans, which has grown substantially with 71.3% (9.2% y/y). The Liquidity is reduced in this period meaning that the money is probably invested in more profitable projects. The amount of Investments has increased with 131% (16.9% y/y) and Other Assets have grown with 99% (12.7% y/y), but both are not really significant in size.
At the Liabilities and Equity side, is Deposits the main contributor of the total. The amount of Deposits has grown over the years with 22% (2.8% y/y) and it looks like it will continue growing. Equity (23%) and Other Liabilities (20%) have increased over time. It can be said that the growth in loans is mainly financed by the increase in deposits.

When looking at the interest revenues, two peaks can be seen, one in the 4th quarter of 2002 and one in the 2nd quarter of 2006. Main drivers of the peaks are other revenues in November 2002 and interest revenues form loans in June 2006.
This is possible because there are only two banks with an Official License. When one bank shows large fluctuations, it has a major influence on the averages.
The total revenues from interests are moving around an average of US $ 2.7 billion, due to an increase in revenues from loans and a decrease in revenues from deposits. The operational cost also seems to be moving around an average of US $ 1.1 billion, whereas the other costs show an increase over the years of 67% (8.65% y/y), which is small in total compared to operational cost. The rise in these costs is mainly due to a rise in administrative costs. When looking at other income, it can be stated that it is fluctuating very much and the fluctuations have increased over the years.

5.2.3 The development of banks with a General License

The total assets in the market for this particular License shows cyclical behavior over time, but has increased with 25% (3.23% y/y) over the period 1999-2006. After a low at the end of 2003, it increased rapidly. The amount of Loans shows a similar behavior over time. Investments and Other Assets have grown with respectively 176% (22.7% y/y) and 49% (6.3% y/y) over time. Liquid Assets have decreased over the years with 24% (3.1% y/y).
At the liabilities side, it is Deposits again that takes the lion share of the total. It shows strong growth as of the end of the year 2003 and grows 24% (3.1% y/y)over the total period. Other Liabilities (-1.1%, -0.14% y/y) and Senior Debt (+9.8%, +1.26 y/y) stay more or less constant, whereas Equity show a constant growth of 74% in total (9.6% y/y).

The average net income from interest revenues shows a cyclical movement. After increases from 1999 to 2001 to a maximum of US $ 2.13 billion, it decreased to US $ 1.09 billion at the end of 2004. After 2004, it is increasing again to an amount of US $ 1.94 billion in the third quarter of 2006. The main drivers of net income are the interest revenues from loans that show a similar development over time.
The interest revenues from deposits have increased with 47% (6.1% y/y) and interest revenues from investments have decreased with 21% (-2.71% y/y) over the years. Other cost and other non-interest income shows a constant increase over the years of respectively 154% (19.9% y/y) and 129% (16.6% y/y). The operational costs are showing a similar development as income from interest revenues. Net income shows a constant development till 2001, but after that is it getting more volatile with a negative point in the second quarter of 2002 of US $ 1 billion; nevertheless has it grown with 83% (10.7%) over time.

When looking closer at other costs, it can be seen that administrative costs is the main cost driver in this class. Administrative cost and general cost showed a constant increase over the years with respectively 33% (4.26% y/y) and 53% (6.84% y/y). Other cost shows large fluctuations during the years and has increased with 158% (20.3% y/y).
Commissions have gradually increased over the years with a total growth of 72% (9.3% y/y). Other income and dividends increases over the years with respectively 267% (34.4% y/y) and 340% (43.9% y/y), but these items show more fluctuations over this period.

5.2.4 The development of banks with an International License

The banks with an International License show a higher liquidity compared to banks with other Licenses. Liquidity decreases over time with 31% (-4% y/y). The assets are mainly composed of Loans and Liquid Assets. Looking at the graph, the amount of Loans and Other Assets seems to be decreased with 20% (2.6% y/y) and the amount of investments increased with 81% (10.5% y/y).
At the liabilities side is the main contributor to the total the Deposits item, although it shows a decreasing trend, with a negative growth of 29% (-3.7% y/y) over the years. Equity and Senior Debt have grown over time with respectively 169% (21.8% y/y) and 133% (17.2% y/y), whereas Other Liabilities have decreased with 34% (4.4% y/y).
Operational interest income shows a similar trend as can be seen at analysis of the General License. It increased till 2001 and decreased to 2004, after which it increased again till the 3rd quarter of 2006.

Interest revenues from loans is the major driver of total revenues, but has decreased with 21% (2.7% y/y). Interest income from investment has grown with 103% (13.4% y/y). Interest income from dividends increased till the fourth quarter of 2000 after which it decreases. As of the beginning of 2005 is there a small sign of recovery, which in total led to a decrease of 26.7% (3.45% y/y). The operational costs seem to be linked to operational income and show similar developments over the years. Operational cost decreased with 28.3% (-3.65% y/y) over the years. Net income shows a volatile trend and fluctuates, but increased with 26.6% (3.43% y/y) over the years, although the results are decreasing as of 2005. The amount of general costs is volatile during the period, ranging from the second quarter of 2001 till the beginning of 2005. As of 2005, it is stabilizing till the end of 2006.
Looking at other costs, their volatility from 2001 to 2005 can be clearly seen. Administrative cost increases and general cost and depreciation decreased respectively with 14.4% (1.86% y/y), -44.2% (-5.7% y/y), -9.5% (-1.23% y/y).
Income from commissions decreased with -33.3% (-4.3% y/y), whereas revenues from other income increased with respectively 150% (19.35% y/y). Other income increased over the years with 53% (6.8% y/y).

5.2.5 Ratio analysis

The following analysis is based on the figures bb to nn in appendix 7.

ROE
No clear trend can be discovered when looking at the development of the ROE over the years 1999-2006. The results fluctuate from positive ROEs to negative ones.
The ROE of the total market and banks with a General License are comparable. Both have negative ROEs in December 2001 and September 2002. Banks with an Official License show a more stabilized development of their ROE, with a negative point in March 2005. Banks with an International License show a very volatile ROE over the years, but also the highest in absolute and average terms.

ROA
The development of the ROA shows a similar pattern as can be seen for the ROE of the market, of the banks with an Official License and of banks with a General License. The results for banks with an International License are less volatile compared to the results for ROE.

Profit Margin
When looking more closely to the profit margin, it is clear that it also show a similar trend like ROE and ROA for the total market and for banks with the different Licenses.

Asset Yield
Asset Yield shows a constant development over the years. It is moving around an average without really de- or increasing much. Only a slight increase for banks with an Official License can be seen.

Average cost to income
This ratio is also moving around an average of 70%, without significant in- or decreases. The ratio decreased slightly after March 2004 for the whole market, the banks with a General License and the banks with an International Licenses, but increased in June 2006 again.

Interest income margin
The ratio interest income margin show a decrease over the years for banks with different licenses and the market. It can be concluded that more revenues are generated from non-interest income.

Non-interest income margin
After the previous analysis for the interest income margin, it can be concluded from the graph that the non-interest income margin has increased over the years. It can be expected that this increasing trend will continue.

Leverage
It is obvious that leverage has reduced over the years for the market and for banks with a General and an International License. The results converge towards banks with an Official License at an average of around 7.5. Leverage decreased sharply for banks with an International License. This might be due to increased transparency and number of regulations with regard to capital requirements.

Liquid Assets to Deposits
This ratio has decreased slightly over the years. For banks with an Official License, the Liquid assets to deposits ratio has decreased more than for the banks with the other Licenses.

Equity to Assets
The ratio equity to assets has increased over the years. This is obvious as it is the inverse of leverage. Banks with an International License increased their equity stake more than banks with a General License. The ratio stays more or less the same for banks with an Official license and that the results of the other Licenses move towards this average.

Loan loss provisions to Revenues
There is no clear trend with regard to this ratio. Strange peaks can be seen for banks with a General License in June 2004 and for banks with an Official License in December 2004.

Operational Cost to Income
The operational cost to income ratio has decreased over the years, especially for banks with a General and International License. The ratio is going up again at the end of 2005.

Other cost to income

The other cost to income ratio stays more or less constant over time for the market. Banks with an International License show a decreasing trend till the end of 2004 but then it is rising again. A small increase of this ratio can be seen for banks with an Official and General License.

Loans to customer deposits

A clear increase in loans to customer deposits for the market and the banks with the different licenses. This increase is especially for banks with an International and General License. This can be the result that banks with Official Licenses are better in attracting deposits.

5.3 Summary

Currently are there two Official Licenses, 40 General Licenses and 34 International Licenses issued. These licenses represent for respectively 12%, 71% and 17% of the market for Total Assets, which accounts for $ 41.5 billion.
Banks with an Official License have the largest ROA and ROE; banks with a General License have the lowest profitability ratios.

The largest bank in Total Assets is Primer Banco del Istmo (Banistmo) with $ 5.2 billion. After the acquisition is HSBC the largest bank with a market share of 17% in Total Assets. Banco Latinoamericano de Exportaciones (Bladex) has the largest part of the loans in the market namely 11% or US $ 2.7 billion. Banistmo has the largest market share in Investments, Deposits and Equity, which are respectively US $ 1.5 billion (20%), US $ 3.3 billion (11%) and US $ 756 million (14%).
Twelve banks are listed on the Panamanian Stock Exchange (Bolsa de Valores), but have only issued bonds or preferred shares. There are 31 banks operating in the Panamanian market that are rated by Fitch. In general, foreign banks have a better rating, which results in cheaper funding.

The largest bank in Total Assets with an Official, General and International License are respectively Banco Nacional de Panama (US $ 3.8 billion), Primer Banco del Istmo (US $ 5.2 billion) and Bancolombia (US $ 1 billion).
The market is growing since the end of 2003. The largest part of assets and liabilities consist of respectively Loans and Deposits. Other non-interest revenues are increasing more rapidly, but remain small compared to interest revenues.
Net results have increased over the years from US $ 550 million to US $ 903 million or 65% (8.4% year-on-year), with a large negative result in the second quarter of 2002, after which it increased rapidly again.
No trend can be detected with regard to ROE, ROA and the loan-loss provisions to revenues ratio. The ratios Asset Yield, Average cost to income and other cost to income have stayed more or less constant over time. An increase can be seen with the ratios non interest income, equity to assets and loans to customer deposits. The ratios that show a decreasing trend over the period are interest income margin, leverage, liquid assets to deposits and operational cost to income.

6. Financial Assessment Results

This chapter discusses the results for the analysis of the financial stability, performance measurement and entering the market.

6.1 *Financial Stability*

Internal

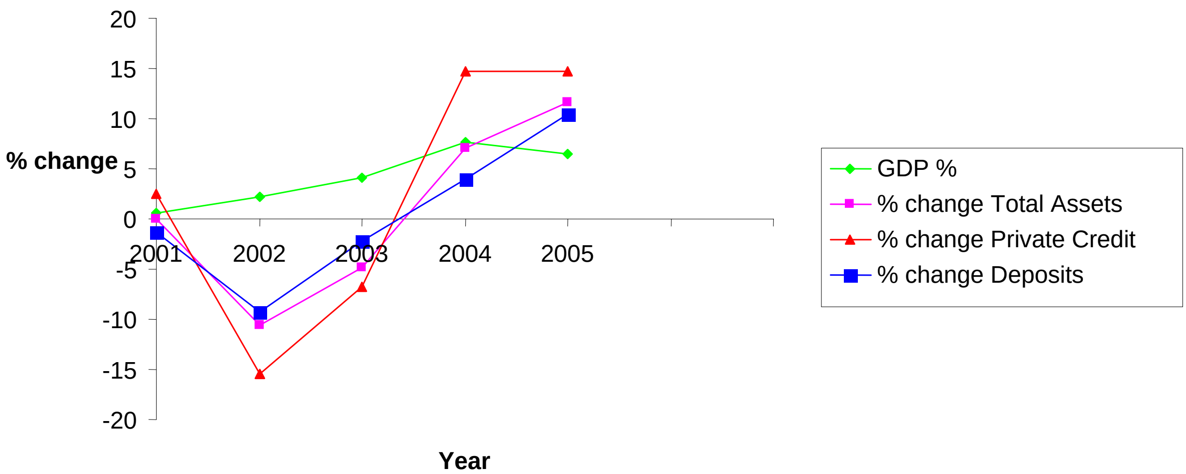
A description of the economical, political, regulatory and supervisory situation of Panama is made and can be found in chapter four. Together with results from the empirical analysis, conclusions will be drawn with regard to the financial stability.

One can conclude that the internal factors have improved remarkably over the years. And it's the banking sector can be seen as the most sophisticated in the region. Panama is a democracy, politically stable and it is doing very well economically. When looking at the regulatory and supervisory situation it can be concluded that foreign and domestic banks or investors are very well protected by law. About 25% of the banks are still Panamanian the rest is foreign. One can have some doubts with the law enforcement.

The following research focuses on the analysis of GDP with regard to different variables. These variables are the bank assets compared to GDP and the private credit provided by banks compared to GDP.

As an indication for the depth and sophistication of the financial system, the money stock (deposits) to GDP ratio is used. The rationale behind this is that well-developed financial systems allow households to increase their savings rate (Edwards, 1996).

The following graph gives an indication of the market with regard to the mentioned variables.



Source: Global Insight & Data from website Superintendencia de Bancos de Panamá

Figure 10: Development GDP compared to Total Assets, Private Credit and Deposits (2001-2005)

As can be seen from the graph, GDP grew to 7.6% in 2004 and has decreased in 2005. It is expected that the GDP growth is around 7% for 2006 (Global Insight) and that GDP will grow to approximately 8% for the next 3 to 5 years (empirical analysis), after which it is possible that it will decline.
Total assets, private credit and deposits all show negative growth in 2002 and 2003. In 2004, was the growth positive again, especially the amount of private credit. This shows that growth was stabilizing. Total Assets and Deposits do not show any signs of stabilization and it is expected that these items will continue to grow.

The fact that private credit grows faster than GDP may seem worrying, but in the case of Panama it is expected that this is due to the deepening and development of the financial system. Total Assets and Deposits also beat GDP, which indicates the liquidity of the market. Total Assets grows faster than Deposits, investment opportunities are easily spot and financed. The results indicate that more attractive investment opportunities can be expected.

External
An overview of the trade agreements and regional trends of Panama has been presented in paragraph 4.2.3. Information on macroeconomic indicators, interest rates and inflation can be found in paragraph 4.2.2. The law is discussed in the appendices and opinions about it in the empirical analysis chapter 7.
Taking all this into account, one can conclude that Panama is very dependent on the USA. The dependency is decreasing, because of trade agreements with other countries. The macroeconomic indicators are very good, there is for instance a low inflation and no exchange risk because of the dollar, but there is a high fiscal deficit which can cause some worries.
The law of Panama is very developed which is also the result of the change in 1998. Foreign investors and especially banks in this case are well protected by the law. There are only some doubts with regard to the law enforcement.

Supervision and regulation
The structure of supervision and regulation looks very sophisticated, see also paragraph 4.3. A lot of improvements have been made to increase transparency like the adoption of Know-your-Customer, publication of financial information and the upcoming Basel II compliance. The Superintendencia and the Asociacion Bancaria are very capable and have the resources for good supervision and regulation. The Superintendencia is independent, capable and authorized to efficiently supervise and regulate the banking sector.

Business cycle
The economy of Panama is currently doing very well as can be seen in paragraph 4.2.2. Currently is there a high GDP growth and it is expected that it will maintain its high growth for the coming years. Main driver of the GDP growth for the coming years will be the expansion and modernization of the Panama Canal. The export and production has increased and the unemployment rate is going down.

6.2 Performance Measurement

This paragraph discusses the different performance measurement criteria. Each criterion analyses different ratios. The analysis is based on the data from the table d in appendix 9.

6.2.1 Profitability

The profitability of the banks is determined by using the following ratios: average cost to income, interest income margin, non-interest income margin and ROE.
ROE is further divided into ROA and Leverage. ROA is further subdivided into Profit Margin and Asset Yield. This will result in a thorough profitability analysis.

Cost to income	%	Interest income margin	%	Non-interest income margin	%
BAC International Bank	24.06	Banco de Crédito del Perú	98.87	BAC International Bank	75.72
Banco Nacional de Panamá	50.44	The bank of Nova Scotia	96.08	Banesco International Bank	59.88
Banco Uno	57.54	Banco Latinoamericano de Exportaciones	95.29	Banco de Bogotá	50.17
Banesco International Bank	59.66	GTC bank	95.13	Banco Atlántico	42.55
Popular Bank	60.95	Banco de Occidente	94.71	Bancafé	41.03

Source : Data from website Superintendencia de Bancos de Panamá

Table 11: Top five banks on profitability ratios

The following table gives a summary concerning these items based on the 35 largest banks concerning Total Assets.

ROE	%	ROA	%	Profit Margin	%	Asset Yield	%	Leverage	%
The bank of Nova Scotia	58.35	BAC International Bank	11.08	BAC International Bank	74.96	Banco Uno	22.77	BNP Paribas Sucursal	101.39
Citibank	45.46	Banesco International Bank	6.03	Banco Nacional de Panamá	47.79	Banesco International bank	14.96	Banco de Crédito del Perú	66.51
BNP Paribas Sucursal	37.66	Banco Atlántico	4.65	Banesco International Bank	40.34	BAC International Bank	14.78	The bank of Nova Scotia	48.72
Banco Uno	33.34	Banco Uno	4.1	Banco Atlántico	36.1	Banco Atlántico	12.89	BNP Paribas Private bank	22.74
Banesco Banco International bank	32.19	Banco Nacional de Panamá	3.17	Bancolombia	34.09	Citibank	10.69	HSBC Bank USA	21.23

Source: Data from website Superintendencia de Bancos de Panamá

Table 12: Top five banks on ROE, ROA, Profit Margin, Asset Yield and Leverage

Different banks have a high score for a specific ratio. BAC International Bank is the most profitable bank, by far. Banco Uno is also scoring very well with regard to profitability. This is because both have operations in Credit Cards where there are high margins. BAC International scores this high, as it is probably because of their efficiency and resulting low cost-to-income ratio. The other banks are not that specialized and offer several or all financial services, which results in a lower profitability.

6.2.2 Risk

Risk is measured by analyzing the risk adjusted return on income, the credit and liquidity risk. The risk adjusted return on income is not assessed because no indication could be found on the amount of loan losses. Nevertheless, the credit and liquidity risk are assessed.
The credit risk is assessed by looking at the capital adequacy, leverage and provisioning. Liquidity risk is assessed by investigating the ratio of liquid assets to demand deposits.

Capital adequacy	%	Provisioning	%	Liquid assets to demand deposits	%
BAC International Bank	41.58	The bank of Nova Scotia	94.24	HSBC Bank USA	95.51
Banesco International Bank	18.74	Banco Agricola	94.12	BNP Paribas Private Bank	71.43
Banco Latino Americano de exportaciones	16.58	Caja de Ahorros	81.77	Banesco International Bank	63.16
Banco Bilbao Vizcaya Argentaria	16.47	Banco Universal	80.26	Banco de Occidente	43.65
Banco Atlántico	15.78	Bancolombia	75.14	Banco De Bogotá	36.66

Source: Data from website Superintendencia de Bancos de Panamá

Table 13: Top five banks on Capital adequacy, Provisioning and Liquid Assets to Demand Deposits

BAC has a high capital adequacy ratio, probably because of the risky credit cards. With regard to the ratios of Provisioning and Liquid assets to demand deposits is some specific information for banks not available. When looking at provisioning, Bank of Nova Scotia has a high ratio, namely 94.24%.
HSBC Bank has probably a high percentage of liquid assets to demand deposits, because of funds needed for the acquisition of Banistmo.
Capital adequacy, Provisioning and Liquid-assets to demand deposits ratios are at a sufficient level and therefore low credit and liquidity risk is expected.

6.2.3 Market power

Market power is measured by looking at the concentration. This analysis is based on the results of paragraph 4.5.
There is a strong concentration for banks with a General License, because the top 5 players have a total market share in Total Assets of 56% when comparing with banks with the same License and 40% when looking at the total market. Banks with an International License have a market share of 50% when a comparison is made within its License and a market share of 9% with regard to the market.

When looking at net income, the top 5 players with a general license have a market share of 66% within their class and 46% of the total market. When looking at banks with an International License the top 5 players only a have 53% market share within their class and an 8% market share within the total market. HSBC has a big market share of 17% now it acquired Banistmo. It is expected that the market will concentrate further.
There is a high market power for a few banks and this will increase. It is especially difficult to become a significant player in the market, now two global banks, HSBC and Citibank, are active at the Panamanian market and have completed large acquisitions. It can be expected that they will expand in the market and region and use their market power and resources to fight off other banks and entrants in gaining market share.

6.2.4 Efficiency

Efficiency is investigated by looking at cost to income. This ratio is split in two other ratios namely operational cost to income and non-operational cost to income.

Cost to income	%	Operational Cost to income	%	Non-operational cost to income	%
BAC International Bank	24.06	BAC International Bank	13.23	Banco de Crédito Perú	1.07
Banco Nacional de Panamá	50.44	Banesco International Bank	14.08	Banco del Pichincha Limited Panama	8.49
Banco Uno	57.54	Banco Uno	19.61	HSBC Bank USA	8.55
Banesco International Bank	59.66	Banco Nacional de Panamá	28.16	BCT Bank International	10.06
Popular Bank	60.95	BBVA	28.99	BAC International Bank	10.83

Source: Data from website Superintendencia de Bancos de Panamá

Table 14: Top five banks Efficiency ratios

It is obvious that BAC International Bank is the most efficient bank in the market. The ratios of the other banks are much higher. It can be stated that most banks are far away from the best practices frontier and that there is room for improvement. The averages of ratios for the market are respectively 76.66%, 45.24% and 34.11%.

6.3 Entering the market

This paragraph analyses the possibilities for banks to enter the market. First it concentrates on the rationale for entering the market. Second it analyzes a possible entry strategy. When talking about Mergers and Acquisitions (M&A) strategy it tries to indicate possible targets.

6.3.1 Rationale for entering the market

Attractive Market
In chapter 4 is already stated that Panama is an attractive market to enter because of the political and economical situation of the country. It has a strong banking sector, no exchange risk because of the dollarization, very low probability on natural disasters and has an excellent geographical position, connecting Northern and Latin America. Furthermore, the country shows strong economic growth and interesting investment opportunities.
However are there also negative characteristics that make the market not that attractive, like the competitive market, the small country and the high multiples that need to be paid for a target. Nevertheless, this research will assess the Panamanian market on the developed model to indicate takeover targets.

Strategic fit
For a bank is it important to find a strategic fit with the target bank in the market. This strategic fit can be different. In this part there is only focus on the strategy of Differentiation and Cost-benefit. The choice has to be made by the acquiring bank as all banks have different strategies.

6.3.2 Green field

Opening a new branch has advantages but also disadvantages. As have been seen in the theoretical framework, chapter 2, is it likely that opening a new branch will lead to increased competition and the competition is fierce already. Furthermore, there will be an informational disadvantage compared to the players in the market.

An advantage is that opening a new branch does not require a bank to pay a premium. But as real estate prices climb really fast and the buying opportunities for office space are very limited, this advantage will be less important than the disadvantages. This research therefore suggests obtaining a position in the market is best done by acquiring a target bank.

6.3.3 Mergers and Acquisitions

When looking at possible targets, then there are not many left. As has been seen in the analysis of the M&A activities, paragraph 4.4.2 , there has been many consolidations in the recent past. The following table presents a list of the most attractive banks that could be possible takeover candidates. See also table c in appendix 8 for more information about these banks.

Bank	Total Assets	Position assets
Banco General, S.A.	US $ 3,325,111,309.48	4
Banco Continental de Panamá, S.A.	US $ 3,046,788,227.21	5
BNP Paribas Sucursal (Panamá), S.A.	US $ 1,750,647,772.35	7
Global Bank Corporation	US $ 1,018,018,724.95	11
Banco Cuscatlán de Panamá, S.A.	US $ 856,438,339.98	13
Banco Internacional de Costa Rica, S. A.	US $ 730,786,792.29	14
Multicredit Bank, Inc.	US $ 682,829,557.73	17
Banco Aliado, S.A.	US $ 584,207,234.94	20
Banco Panameño de la Vivienda, S.A.	US $ 328,727,533.07	28
Towerbank International, Inc.	US $ 326,664,659.11	29
BNP Paribas Privatel Bank, Sucursal Panamá	US $ 298,062,597.65	30
Banco del Pichincha Limited Panamá, S.A.	US $ 237,646,343.80	32
Bancafé (Panamá), S.A.	US $ 232,790,915.41	33

Source: Data from website Superintendencia de Bancos de Panamá

Table 15: Possible takeover candidate banks ranked to Total Assets

In this list Citibank, HSBC, Primer Banco Del Istmo, Banco Uno, Banco Atlántico, the bank of Nova Scotia, Banco Bilbao de Vizcaya Argentaria and BAC International can not be found. That is because these banks have already been acquired or are global banks that will not sell their operations. It also excludes banks with an International License, as it is assumed that the banks that want to enter the market wants to exploit private banking activities. Nevertheless, the banks will sell for the right price, but this will be a high multiple over the current book value.
No further research has been done on the success-factors.

Diversification
To indicate diversification in income, this research relies on interest income ratio and non-interest income ratio. When looking at diversification on a geographical level, it focuses on whether operations are local or regional.
Banks that score well on diversification and have a high non-interest income ratio are Bancafé, Banco del Pinchincha Limited and Global Bank. Unfortunately, there is no indication on the various financial products or services that the banks sell.
When looking at diversification on a geographical level, Banco Cuscatlán looks attractive with its many branches in the region. Other banks that operate regionally are Proamerica and Lafise. These banks however have very small operations in Panama.

Cost-minimization

To give an indication about best practices of cost minimization in the market this research use cost to income ratio, operational-cost to income ratio and non-operational cost to income.
An analysis of these ratios has already been made in paragraph 6.2, performance measurement. As can be seen in this chapter and in the table in the appendices, BAC International Bank is best performing with regard to these ratios. GE Capital has bought a 50% interest in BAC recently and is it very unlikely that they will sell their interest to another party.

The first serious target company is Banco General, after various other banks have passed the list, that have already merged, acquired or are state-owned. Looking at the worst performing banks, there is a lot of improvement possible at Banco de Cuscatlán and Banco International de Costa Rica. These banks are suitable for takeover, but also show potential synergy gains when merging with a bank that is operationally more efficient.

Other criteria

Other important criteria to investigate before acquiring a bank are the asset quality profile, total loans to total customer deposits, liquidity risk, size, technology and capital adequacy.
The asset quality profile is measured by dividing loan loss provisions by interest revenues. Table c in appendix 7 gives a fast overview of the criteria for the takeover candidates. It is impossible to continue the research, because specific financial information of a Dutch bank is needed for the strategic fit. This chapter is just for informational purposes and it beyond the scope of the research to compare the results between Dutch and Panamanian banks.

6.4 Summary

The financial stability is assessed by looking at the internal factors, external factors, supervision and regulation and business cycle. The internal factors look very promising. The country is political stable, has a well developed law system and is economically booming. When looking at the external factors, it can be seen that Panama is very dependent on the USA with regard to trade. Other and upcoming Free Trade Agreements will reduce this dependency.
The macroeconomic indicators look good; The only thing is that Panama has a high fiscal deficit. Furthermore, there is low inflation and no exchange risk because of the dollarization.

The financial system of Panama is very well developed and sophisticated. Loans are increasing at a higher rate than GDP, but this is not seen as a dangerous development merely because it is invested in promising investment projects.
The supervision and regulation is getting better in Panama. The authorities have enough independency and resources to do their job. It is strengthened with the sophisticated law system.

The economy is currently booming which is expected to last for the coming years. Panama has a good financial stability. The market is profitable, liquidity and credit risks are at acceptable levels, the efficiency is however low. The market power is strong especially because two global banks, HSBC and Citibank, have considerable market shares.
So with regard to performance is the market not that attractive, especially because of the market power of some banks and the low margins in the market.
When entering the market it is important to have a strategic fit and to assess other ratios. Because of informational advantages it is recommended to enter the market by means of Mergers and Acquisitions. There are around 13 banks left in the market to acquire.

The following banks look attractive as a candidate for a takeover based on a specific strategy:

- Differentiation: Bancafé, Banco del Pinchincha Limited and Global Bank
- Geographical diversification: Banco Cuscatlán
- Regional operations: Proamerica and Lafise, have only small operations in Panama
- Reputation and market share in Panama: Banco Continental and Banco General. Banco General is attractive based on its good cost-minimization strategy.
- Improvement benefits: Banco Cuscatlán and Banco International de Costa Rica.

Other criteria are only indicative so a specific Dutch bank can compare its performance with the takeover candidates.

7. Empirical focus on the sector

The questions that guide the empirical part of this project are already stated in paragraph 3.1. The following paragraphs will discuss the opinions and expectations of the respondents.

7.1 Panama and the Banking sector

This paragraph discusses the opinions of interviewees on the political system, the economy, the banking sector and the departure of International banks from the banking sector.

7.1.1 Political system

The current government is in office for two years now and will be in power for another three years. After these three years another government might take over. A respondent thinks that a lot of positions change when there is a change of government. This is not a problem, but some positions, like the Superintendent should not be changed. The Superintendent should be autonomous. A government change, mess up with some positions but contracts are respected. So the plans the government makes, are not all wiped away when a new government is installed. Delays can be expected though.

One of the main campaigns of the current government, the Torrijos government, is the fight against corruption. According to several respondents, the Moscoso government was linked to several affairs of corruption and scandals. A respondent mentions that Torrijos did four important things:

- He changed the tax system. More strict tax payments are required and people need to sign a declaration that they promise to pay taxes. As a result the Panamanians were obliged to pay more taxes.
- He changed the social security system, which was actually bankrupt. He increased the number of years to pay social security in a progressively way. The social security system should last for at least 30 years now, but it led to a lot of annoyance in the country.
- He changed the minimum wage structure.
- Last-but-not-least he wants to expand the Canal. The Canal is the best company in the world: cash payment upfront and they have a monopoly. The plans of Nicaragua to build their own Canal are unlikely and based on promises of Hugo Chavez, the president of Venezuela.

The unemployment rate is going down and this pleases the Panamanians.

There is a high possibility that the current government will be reelected. The referendum was a big ‘yes’ and gives the government a lot of credit. Continuation can be expected, because of the fact that he thinks that the opposition is weak.
There is a general opinion that the government does a good job, just a couple of respondents are more critical. It is acclaimed that Torrijos took a couple of very unpopular decisions. Torrijos is a weak leader, according to some respondents, but a lot of people are happy with Torrijos, because of the fact that he does not interfere with their business.
People think that the Torrijos government is not as refrained from corruption as they like the people to see it. The PRD party is always looking for the big things, that their reference. PRD used to be the political arm of the Noriega dictatorship.

7.1.2 Economy

One of the fundamentals of the Panamanian economy is the Dollarization in 1904, because of the Canal. Other fundamental issues are the legal and commercial structure, like the laws, the free transferability of the US Dollar and the fact that Panama has no Central Bank.
A big driver of the economy is the Canal and its expansion. There will be many other (new) activities around the Canal. The FTA and the Canal expansion are complementary. The ACP is looking for the cheapest way of realizing the project. When the Canal gets a better rating, Panama gets a better rating. Moody's rated Panama BB, while BBB is investment worthy, resulting in lower borrowing cost. The FTA will imply certain rules of conduct like transparency, regulation, supervision, and so on. This will eventually lead to a better credit rating.

It is expected that the Canal, the Real Estate sector, the telecommunication sector and the ports will lead to a continuation of high growth of GDP for the next years. A yearly GDP growth rate of 6 to 8% for the next ten years can be seen, because of the planned expansion of the Canal. Other respondents expect this growth to last for three to five years.
The external investment for the Canal is not that large as expected, probably US $ 2.5 billion is needed from financial institutions and the other US $ 3 billion is invested by the Canal itself. Transport companies will also invest, as well as the different providers of maritime services and products around the Canal.
Banks have to participate as well. There are not that many deals like this in the world and the Panama Canal has a high investment grade, higher than the investment grade of the government.

Panama is an open economy, so everyone (from everywhere) can start a business in the country and it has always been like this. Panama is competing in the Banking World with Miami to be the main financial center of the region. The US has initiated a new law lately, The Patriot Act, which actually helps Panama to outperform Miami. Due to the amount of rules, restrictions and costs are many companies moving their business to Panama. Iberia, for example, wants a hub in Panama because of the situation at Miami Airport. Copa Air, a Panamanian airline, is doing very well because, also because of their ability to offer alternatives for traveling via Miami.
Panama is the financial centre of the Central American region, but not of Latin America. Business is booming in Central America and because of some populist governments (like in Venezuela for example) corporations move to Panama. Doing business in Panama has many advantages: geographical, political and economical. Companies are more and more differentiating their different activities over different countries. El Salvador is well known for its production facilities, as labor is cheap. Many headquarters and finance divisions are situated in Panama.

7.1.3 Banking sector

The international banks (mainly regional banks) account for 75% and the other 25% are Panamanian banks in the banking sector. In September 2006 the total amount of assets amounted to almost US $ 50 billion of which 50% is international and 50% is domestic. It is expected that this 50/50 distribution will be maintained in future.

The total amount of assets is comparable to the total amount of assets in 1982, but at that moment there were 110 banks compared to 81 banks now. A lot of the respondents expect

that the number of banks will rise, but a lot of others expect stabilization. Few respondents think the number of bank will decrease.
During the last two to three years, the amount of foreign assets increased due to a better performance of the Panamanian banking sector and the (Latin-American) economy as a whole. There was a high increase in consumer loans (especially mortgages) and corporate loans during this period.

Image of the Banking sector

Panama has a special banking system, due to the country's monetary and economical system and the fact that it does not have a Central Bank. Most of the banks that are situated in Panama are foreign. The banking sector of Panama got interesting for foreign banks as of the 70s, when the banking sector was really founded by law.

Looking at the history, it is clear that Panama had a bad reputation during the 80s, because of the Noriega dictatorship, money laundering and drugs problems.
In 1982, Mexico could not pay their debts anymore and this caused some problems. It was impossible for the Central American banks to lend money, so it was very difficult to get credits or money at that time. Banks were closed for a month.
During the late 80s, Latin America got more stabilized and a process of refinancing started. In the 90s everything was refinanced, so things could only get better. The banking systems were opened and foreign banks went to Latin America again.

Panama has taken several measures to stop money laundering, like the Know Your Client (KYC) regulations. Special compliance officers and authorities that investigate these matters were appointed. These measures will lead to a situation that banks are really strict on accepting deposits. It also improves the communication with various authorities, like the Drug Enforcement Administration (DEA). In the Colon Free Zone for example, a lot of Colombian checks are not accepted, issuers are told to go to Miami.
It is more difficult in Panama to open an account than in Miami. Banks are also looking for ways to check current accounts.

According to a couple of respondents, money laundering is more an issue in the US than in Panama. The Superintendencia requests for direct communication in case of (expected) money laundering issues. Foreign investors, especially from the US and Colombia, are checked on money laundering issues, as these people are most often violating these rules.

That Panama has a bad image due to their rating is a misperception. People mix up the political and the economical system. The top banks have good ratings, as Fitch rates BAC, Banco General and Banco Continental at least B++. Banco General and Banistmo are heading for BBB and A- ratings.

Most respondents praise the banking sector because of one or more of the following reasons.

- The Panamanians have the biggest chunk of the national reserve in their own pockets or on a bank account;
- Banks ask for lines of credit with foreign banks when money is needed;
- When there is a great demand for deposits withdrawal, could this lead to a bank run, but this can easily be solved with the current structure;
- Panama does not need the foreign banks in their system for as a form of insurance, they only need access to lines of credit.

Auditors

KPMG Panama is the largest auditing firm of Panama. Around 75% of the total assets in the banking sector are under their supervision. KPMG has a market share of 42% in Panama and therewith they are the No.1. (2nd PWC, 3rd Deloitte, 4th E&Y). The procedures and policies of KPMG are the same all over the world. They have KAM, the KPMG Auditing Model, a worldwide methodology, which has to be the same.
Besides this they have to comply with the IAS, the International Accounting Standards.
The objective of KPMG is to give an opinion about the firmness of the balance. Banks are under the regulations of the Superintendencia. All banks have to hand in their financial statements at March 31st. And all the banks that are active in Panama are being audited, by one of the big four.

Asociacion Bancaria

Important for the Panamanian Banking Sector are the intermediary activities of the Asociacion Bancaria. They communicate with the banks, the Superintendence and the authorities like the IMF and Inter-American Development Bank (IDB).
There is a good relationship between the Asociacion Bancaria and the Superintendencia. Every month they meet to discuss current topics and issues and they are even situated in the same building. When there is a draft for a new regulation, the Superintendencia sends it to the Asociacion Bancaria to get feedback. The Asociacion Bancaria will discuss the draft with the financial institutions and if a draft needs further discussion a technical meeting is held with the Superintendencia.
At this moment, the Superintendencia has just sent a draft regulation for a new municipal tax regulation to the Asociacion Bancaria. The Asociacion Bancaria will study it and consult the plan with the banks. This consult consists of an assessment whether the draft has a positive impact on the banking sector. New regulations need to be adapted to the current regulations and education needs to be developed for a proper implementation.

Superintendencia de Bancos de Panama

The Superintendencia is an independent authority that supervises and regulates the banking sector with regular feedback of the banks and the Asociacion Bancaria. The Superintendencia communicates with the Asociacion Bancaria and with the banks directly. A meeting is held five to six times a year, in which regulatory issues and trends are being discussed.
The 1998 law provides the Superintendencia with a legal framework for its activities. This law did not change many things, the same licenses are granted for example. Before the Superintendencia was founded, this authority was financed by governmental budget, now it is financed by the Banking System. Banks started to adopt transparency rules (about information disclosure: Balance Sheet and Profit and Loss statements) voluntarily, even before the law of 1998 was taken into effect. After 1998 all banks gave complete insight in all financial statements with notes and audit reports.

It is not the intention to separate the supervisory and regulatory activities of the Superintendencia. There was a discussion in the Government to create one body that supervises the banking sector, the insurance sector and the capital markets. But the Government decided that this is not a good thing. The banking system should be treated separately as it is very important for the economy of the country (7 to 8% of GDP). Other sectors need to improve their supervision though.
The banks need to report to the Superintendencia weekly about their liquidity risk, monthly about their balance sheet and income statements and quarterly about their consolidated balance sheets and income statements. The Superintendencia wants to be transparent, so they place everything on their website and provide BIS and IMF quarterly with the information. If

there are other entities that need information, the Superintendencia will provide them with this information.

The regulations of the Superintendencia are very effective. Besides this, 23 of the 25 Basel principles are implied. The compliance with Basel II will move slowly. It is expected that 12 banks will comply with the Advanced System; other banks might work towards a Basel Ia situation first. It is expected that the system is ready to comply with Basel II in 2010. In Panama the international banks need to comply with the regulations in their home country, for example with Basle II. Latin American banks need to comply with the Panamanian regulations, as long as the banks home countries regulations are not more stringent. The competitiveness of the Latin American banks might be affected by the earlier compliance of the international banks with Basel II.
The Superintendencia conducted two quantitative impact studies in the banking system, which indicate that banks are very solid. Two other studies are needed to assess the possible compliance to the standardized approach.

Upcoming regulations are:

- Stability and fundamentals for capital requirements.
- Loan classification.
- International Accounting Standards (IAS).
- Capital/Market/Operational risk.
- Liquidity regulations, more division on liquid assets. Now there are only inter-banking deposits. In the future notes, government bonds and agency bonds need to be added.

In the first quarter of 2007 new regulations of warrants will be introduced for risk mitigation.

The Superintendencia has implemented a lot of changes the last years. Next to becoming legally and financially autonomous, they changed the capacity of the supervisory and regulatory activities, which have improved considerably since 1998.
Their challenge for the future is to change the vision from a supervision framework to risk supervision. On-going business needs on-going supervision. Nowadays the Superintendencia has an emphasis on historical information, key indicators, asset quality and the quality of provisions.
The Superintendencia wants to maintain the good performance of the system and thinks to achieve this with another kind of supervision. A more specialized, tailor-made, specific supervision is requested.

Almost every respondent was surprised of the resignation of Delia Cardenas as a Superintendent. Most respondents think that she was very capable; others doubted her capability. She managed to get Panama from the black list and implemented KYC and compliance. Her management of the Superintendencia led to more transparence in the Banking sector.
The successor of Cardenas is Barrelier, a former manager at Chase Manhattan. He has been a liquidator of banks (like Banco Disa) and has a lot of experience in the Banking Sector. He is a supporter of the Torrijos campaign. The board of directors and the president appoint the Superintendent. The resignation of Delia Cardenas has therefore nothing to do with economical independency.
Politically seen, the independency of the Superintendencia is another discussion. Cardenas resignation was a mistake, according to many respondents. Some people think that Cardenas was the opposition to the government and she was not a friend of the president. Other respondents say that Cardenas left for personal reasons.

Some respondents think that the current Superintendent will not stay for more than two years. The new president wants to put people from his party in key positions.

The Superintendencia had two major economic problems in 2001. Local banks had a problem of US $ 120 million and a foreign trade group in Colon could not account for US $ 70 to 80 million.

7.1.4 Departure international banks

It is a remarkable fact that many international banks left the Panamanian banking sector the last years. Deutsche Bank, Lloyds, Dresdner Bank, Bank of America and ABN-AMRO are just a couple of examples.

Lloyds is a very large bank in the UK and they left Panama because they changed their business approach. Strategically the UK was enough. The Brazilian market was also large, but they closed it for strategically reasons as well. They sold their offices in Guatemala, Honduras and Panama to Banco Cuscatlan (which has its head office in El Salvador). Banistmo bought their operations in Colombia.
They sold everything because of a complete strategy change. There were too many problems; the market was too volatile and not big enough. It was a global strategy to close down all their foreign subsidiaries. Lloyds is acclaimed to be too passive, because of the fact that they still not operate globally. Now they are hammered by the market: they have a lot of money, but still do not know what to do it.

Bank of America was a really aggressive bank, which had a lot of bad loans those days. This led to a high volatility for the bank. The Panama business was very profitable for Bank of America, but problems in the real estate sector in 1982 made them to reduce their assets to improve their ratios. Of course the Noriega crisis in 1987-1988 made things worse. But it was unexpected that Bank of America would leave the country.
Not only the Panama business was closed, but the Chile, Argentinean, Peruvian and the Venezuelan business were closed as well. Actually there was a moment that they wanted to stay in Panama only, but there were too much problems to do so.
When Panama rose economically, there were no intentions at Bank of America to go back to Panama. The bank merged with Nationsbank 10 years ago and as Nationsbank has no international view, there was no intention to expand internationally.
Through the merger of Nationsbank and Bank of America, Bank Boston became part of Bank of America (after being acquired by Fleetbank). Bank of America is expected to come back sooner or later. Same counts for Dresdner bank that left four years ago, after the Argentinean crisis.

ABN-AMRO bank entered the Panamanian market in the seventies. At that moment the local banks started to grow and ABN-AMRO was operating in a small niche. ABN-AMRO tried to serve their clients the best way they could and they had to, because it were upper class customers, that ask for a personalized treatment. ABN-AMRO acted like all clients were special and clients stayed loyal over the years. The operations were small compared to the competition. ABN-AMRO had US $ 200 million in assets; whereas an amount of US $ 500 million would be the average.
ABN-AMRO is a financial monster that could have acquired every bank, if they wanted so. If they had invested those days, they could have been as big as HSBC now. But they had a conservative policy. Head office had strong control over the management here. There was fierce competition with an amount of 86 banks.

During 1997 and 1998 ABN-AMRO was very strong in Latin America. In 2000, ABN-AMRO changed of CEO and the new CEO only wanted to concentrate on big markets, like Brazil. Panama was an offshore bank for ABN-AMRO, which acted mainly as a booking center. According to former employees and managers, ABN-AMRO left Panama because of this strategic change at the Amsterdam head office. It was definitely not an issue of profitability. ABN-AMRO must have had another reason than strategy only.
For ABN-AMRO, Panama was the smallest branch in Latin America and they decided to leave all the countries in September 2002, except for Brazil.
ABN-AMRO might have left too early as they could have had a nice niche in Panama now. ABN-AMRO has the ability to survive in the market, but they should not think locally, but regionally.

7.2 Consolidation

The recent consolidation wave in the banking sector is not very strange. It is a global wave that not only affects the banks, but other industries as well. The biggest cement factory of the country was sold to Simex. Lately two breweries were sold to foreign breweries. Carrefour has the intention to buy supermarkets in the region.
Despite this consolidation wave, Panamanian banks will always be there.
This paragraph discusses the opinions and views on the acquisitions that have taken place in the banking sector. But it also provides the opinions on foreign bank entry, differences and competitive advantages of international banks versus local banks and competition and margins.

7.2.1 Acquisitions

General Electric (GE) bought a 49.9% stake in BAC a couple of years ago. GE is very large in Europe in consumer lending (pay products later) and leasing (like jet engines to Boeing for example). They financed all equipment in a hospital in Panama (which is leased). Their focus is on the D-segment in Mexico (average salary US $ 200 to 300 a month).
GE wants to expand their banking business in Brazil, Argentina and Mexico and in Central America. They focused on acquiring a group of regional banks. HSBC also was in the bidding process for BAC, but their bid was less than GE. Because Pellais (owner of BAC) wanted to stay in control of the company, GE only was able to buy a maximum stake of 49.9%.
But in practice it seems that GE is more in control. They are implementing their operating systems in the bank. BAC can learn a lot from GE. But on the practice of consumer loans, GE can learn from BAC. BAC also knows a lot about the region. Some things that works in Central America, does not work in Panama. GE is very eager to grow; their objective is that BACs assets are doubled in the next three to five years.

The acquisition of Banistmo by HSBC is a planned one. HSBC is a global bank and active in 76 countries. They wanted to have a bigger presence in the Latin American area. They were only active in Panama, Brazil, Argentina, Chili (small market) and in Venezuela (representative office). HSBC started looking for business in Peru, Paraguay and Uruguay and the Central American region.
HSBC did not have branches in Central America, except for Panama and Mexico. There was a missing link from Panama to Mexico. November last year HSBC reached a preliminary agreement with Banistmo (after conversations with BAC and Banco Uno as well). The 7th of November the transaction will be completed and HSBC increases its operations from 76 to 81 countries (as they added Colombia, Costa Rica, Honduras, Nicaragua and El Salvador). They still have no branch in Guatemala, but it will not take long before a branch is opened here. HSBC wants to add Venezuela and Ecuador to their Latin American list later.

HSBC wants to have a presence in every country, offering a complete product range. Citibank is the biggest competitor of HSBC worldwide. That is because Citibank and HSBC are the only two global players in the Panamanian market. Other banks diversify locally, regionally, in various emerging markets or put themselves into niches.
HSBC Panama was a US $ 2 billion bank and wanted to be in the top 20 operations of HSBC worldwide. That is because internal investments are made first in the top operations and than it goes downhill.

HSBC Latin America will have a headquarters in Mexico. Sandy Flockhart, the former CEO of the Mexican department, is in charge of the whole HSBC Latin America now. It is the idea that the HSBC Latin American sector is going to be consolidated and Mexico will be the platform to do this. Every client needs to have the opportunity to find the same products in all the Latin American branches, accompanied with the same level of service. But every country has its own needs. The global presence of HSBC facilitates the rapid spread of new products all over the world, technological innovation for example and the economies of scale when developing them.

Citibank bought Banco Uno in November. This acquisition is part of their business, part of their strategy. In history Citibank changed of strategy a lot. Now with the acquisition of Banco Uno it might be the case again. Citibank wants the profitable credit card business of Banco Uno and a bigger market share.
Citibank is definitely not following HSBC in the things they do. There are not many things known about the acquisition of Banco Uno, as there are no numbers revealed yet (probably the first quarter of 2007).
Citibank already had a presence in every country that Banco Uno was in. So it is an increase in market share in the different countries. The product range of Citibank will be expanded again, so all operations of Banco Uno will be added to Citibank and not only credit cards. So Demand Deposits Accounts (DDA), savings and checking accounts will be part of Citibanks business soon. Banco Uno will be transformed in Citibank in the coming period.
The future of Citibank is difficult to predict at this moment. As they just have bought Banco Uno, which take some time for incorporation. They will check the opportunities at the Canal, and want to stay focused on the consumer banking and the corporate loans.

Future consolidation
The future of the banking system in Panama will show further consolidation. In the banking sector there will be a movement towards a situation that the International banks buy the regional banks. Some people think that there is no bank that can or will buy banks like Banco General and Banco Continental and that all other regional banks are targets. Other people think that Banco General and Banco Continental might merge or eventually might be acquired by another (foreign) bank.
It is widely acclaimed that Scotiabank wants to buy a bank (probably Global Bank) after their acquisitions of banks in Costa Rica and El Salvador lately. Some people think that Citibank will buy Banco Cuscatlan. GE/BAC International Bank is looking to expand their business. The big banks will stay in the market and so will the specialized banks that are in a niche. A merger of some Jewish banks, like Towerbank and Banco Aliado is also expected by many observers.
Very well informed people think that Global Bank will be bought in the coming three years. It will definitely be a bank from outside Panama that buys Global Bank.

7.2.2 Foreign bank entry

It is expected that banks from Europe and Asia will enter the Panamanian banking system. A revival from banks that have left the system during the eighties is expected. The Canal is very attractive and will be an incentive for banks to come back for. A Japanese bank will enter soon, just like a couple of Latin American banks and Caixa Galicia (Spain). Some think that Credit Suisse and Julius Bär will enter the market, to focus on personal banking for people with great wealth. Others expect some banks from Brazil and Colombia, and two or three banks from Guatemala. Central American banks might like to come to Panama for their dollar deposits.

There are currently eight applications at the Superintendence for obtaining a license, of which four from European banks. European banks are closing their Miami branches, because of the fact that it is very costly there and there are a lot of regulatory issues, like the Patriot Act.
The new director of the Federal Reserve confirmed in his first speech lately that the Miami banking sector was getting too expensive. The cost-benefit evaluation showed that there was no proper balance. The director of the Federal Reserve promised to eliminate some costs. Until that time is Panama a good alternative for banks to run their operations.
Banks are moving to Panama because Panama has very favorable conditions, especially the monetary system and the lack of a Central Bank.

There is still room for banks to enter the market. Especially in the consumer banking business there is room for more banks. The strategic purpose of the bank should be a mixture of corporate banking activities, services and consumer banking (with a lot of branches and very aggressive in margins).
A new bank can not just open their doors from scratch, buying an existing bank will be better.

7.2.3 International banks vs. local banks

Panama is by far the most competitive banking sector in the region. At this moment the competition increases between local and the international banks. The international banks used to be more interested in the corporate side of the business, but due to small margins they saw that they also have to be in the consumer side of the business. Banco Continental and Banco General both have the size to stay competitive. They have a reputation good and brand name.
But the region gets more and more competitive, best practices are imported. The international banks are staying for the long term, as is proven by the acquisition of Banistmo by HSBC. This will not inevitably affect the local banks. People want to do business with the local banks or the international banks. They choose for the local banks if they want to have a relationship with the bank and care about a personal approach. The Panamanians want customer service and a more flexible and personal style of doing business. Foreign banks are stricter as they have international policies and not a personal relationship that influences business like local banks can have.
Local/regional players need to be in all the niches, because they will never know which niche is going to be profitable. Citibank for example can destroy a whole niche by entering it.

But also on the corporate side there is this knowledge. International banks can pull out of Latin America when they change their strategy. This happened with Chase for example. Clients are aware that this can happen with International banks.
Panama might be doing great, but if one emerging market is doing badly, they might pull out everywhere. International banks are more interested in big economies. But a country like Panama can be interesting for banks, because of the interesting investing opportunities and a financial centre of the region. International banks want partnerships to participate with the big

deals, and they do not need to be in Panama themselves to start these partnerships (it is widely acclaimed that Credit Suisse and ABN AMRO might want to do some underwriting). If they want to be in some niches as well, the banks need to be present in Panama.

7.2.4 Competition and margins

The Panamanian banking sector will be smaller in terms of competition: first there were 20, 12, 6 and now only 4 big banks. It is a competitive atmosphere, 6 banks would be better, according to a respondent.
Due to the large amount of banks, the banking sector is very competitive. The margins are small; People think that the net interest margin is 2.9% to 3% on average and do not see potential problems with these small margins. The acquisition of Banco Uno by Citibank for example gives Citibank opportunities to gain a lot of profits by their margins. The credit card-business of Banco Uno has huge margins and Citibank has cheap funding (LIBOR), which creates high margins.
A respondent said: At the loans-side, bank employees hear: "You cannot charge me 9% when the bank next door charges me 8%." And on the asset-side, they hear: "Another bank pays me 5% while you only pay 4% on my savings deposit."

The international banks can get their dollars cheaper than the local banks, because of their credit rating and LIBOR-rate. But local banks drop their margins to the level of the International banks. Some banks even can manage to have lower credit rates than international banks. They can do this because of the fact that they offer a lower interest rate to their depositors. It also happens that the requirements for a loan are lowered by for example reduce the amount of collateral.

7.3 Investment opportunities

This paragraph discusses the opinions and views about various investment opportunities in Panama that could be attractive for banks. It discusses investment opportunities of the canal, real estate and a summary of various other opportunities.

7.3.1 The Canal

The expansion and modernization of the Canal will have a great impact on the Panamanian economy. Financial institutions will respond directly after the referendum. A lot of non-Panamanian players will knock on the door of the ACP. Some companies will do that because they want to establish a presence in Panama, which is a big advantage for doing business there. They want to be close to the action to see the developments, have access to information and establish a social network.
The Canal doesn't need local banks to sell their investment. There might be some contractors and subcontractors. It is a good investment, as it has relatively low risk. The Canal expansion is very diligent, as the ACP is very familiar with this; they have quite some knowledge about this expansion. There is even a 30% cushion in the investment, and the investment has a really aggressive repayment schedule of 8 years. When this would be 15 years, there would be much more room for redemption. But maybe they will increase the toll revenues as well.

Dredging activities
To expand the Canal, three dredging projects are forecasted:
The entrance waterway of the Canal at the Pacific side, with high tides, need to be deepened. So, dredging from the Pacific Ocean to the Miraflores and Pedro Miguel locks is the first

project. The second project is the entrance waterway of the Canal at the Atlantic side, almost without tides. There is a third project which is the deepening of the Canal through Panama itself, from 14.2 meters to 18 meters. This is not really a dredging project, as this is dry sand that needs to be moved.
As the ACP will probably do the third project themselves, there are two dredging projects available for public dredging companies like Koninklijke Boskalis and Van Oord, both Dutch companies. Koninklijke Boskalis and Van Oord are leading companies in the world for dredging services. They have a couple of competitors, like De Nul and Deme from Belgium. The world number five is Great Lakes from the USA.
The Panama Canal costs US $5.25 billion. There is an amount of 100 million m3 that needs to be done; of which half are dredging activities. Half of the dredging activities are planned by the ACP to do themselves. ING plans that the dredging activities will cost US $ 500 million in total. SNS Securities think it will be US $ 1 billion. ING is more in the right direction. This is because of the fact that 50 million m3 for US $ 1 billion is equal to US $ 20 per m3, and this is ridiculous.
Koninklijke Boskalis will probably not ask more than US $ 10 per m3 (but this is different per side of the Canal: the Pacific side is really tough rock, as the Atlantic side is softer). When the ACP accepts an offer of US $ 125 million for a project of 12.5 million m3, Koninklijke Boskalis can be satisfied.

The ACP only asks for the price of mobilization and demobilization of equipment and a price per m3, in a bidding process. All contestants can be part of the bidding process and the cheapest wins. This is very transparent and not corrupt at all.
When Koninklijke Boskalis gets the project a price is made for this project. When Koninklijke Boskalis has more costs than expected, this is their problem. Koninklijke Boskalis already had some problems with the composition of the ground. During one project they had the expectations that they had to dredge 2.5 million m3 mud and 50,000 m3 of basalt rock. But it turned out to be, that is was 250,000 m3 basalt rocks, which is a lot more laborious and therefore expensive.

Other activities around the Canal expansion

An extra lock will be added on each side of the Canal. The new locks will be a lot wider than the old ones (55 meters compared to 30 meters). Other activities are modernizing the Canal and adding more lights to make it easier to get through the Canal.

The Dutch organizations that might have opportunities are:

- The Water Laboratory in Delft, which is specialized in the differences between sweet and salt water;
- Consultancy companies (giving advice);
- A Dutch company that produces the cylinders for the lock gates;
- Alcyon/Lieverse, which is a producer of lock gates;
- Banks that take care of the investment (ABN-AMRO, ING);
- IHC, that wants to sell new ships for dredging for example;
- Den Dongen which has already supplied the ACP with floating draglines
- Trade finance. Especially the Dutch have always been very good at this. US $12 billion goes in and out every year (ABN-AMRO and Credit Suisse are experts in this).

7.3.2 Real estate

A lot of well informed respondents think that there is a speculative real estate bubble. Prices go up, but that's not strange. The real estate needs to be diversified. The bubble will last for a couple of more years and than a few segments will collapse. The prices of the skyscrapers can not be maintained, when they are built in these amounts and for these prices. Last years a price of US $ 900/m2 was very reasonable, nowadays it is US $ 1500/m2 and sometimes even more. Maintenance cost needs to be paid as well, of which the costs are around US $ 250-750 per month. The price of real estate is going up rapidly and it will diminish the low cost of living.

Normally the presales have to be 50%, signed with down payment before it is financed by a bank. Or the buildings need to be financed privately. Although everything that is being built is already sold, there are investors that want to buy whole stories in apartment buildings, to sell these apartments later against higher prices (so there is a lot of speculation). Panama is not a country where houses are rented, everyone buys a house.
The Real Estate projects the next five years, account for US $ 5 to 6 billion. Six or seven buildings are being built at the Avenida Balboa that are 50 or more stories high. In Costa del Este there are two big projects as well.

Some respondents think that there is some speculation, but now everything is sold. Look at Punta Patillo, which is finished in 2008. A lot of retirees from the US, Mexico, Canada, Spain and France will live there. A lot of these projects are financed by these countries as well. Investment companies from Spain are building two big projects now: Palacio de Bahia and Los Fallos de Panama. The real estate sector goes fast.

7.3.3 Other investment opportunities

The project of an *oil refinery* will be started next year (possible in cooperation with Occidental Petroleum) and will cost around $ 6 billion. It is build to serve US (east coast) and Mexico and both Panama and Guatemala are fighting for the deal. Panama will be most likely. There will not be two refineries.
Panama is attractive because of the fact that Panama already has a pipeline from Chiriqui to Bocas del Toro and that the Ocean at the Pacific side is very deep. Vopak or Shell might be interested to participate.

Biodiesel can be produced from sugar cane or palm oil. In August 2006 the Dutch company VI-effect (Stimac) visited the Panamanian Ministry of Commerce to talk about this investment.

A *Megaport* is needed and will be realized on the Pacific side and will be financed internationally. Seven other ports will be established, in which millions of US $ are invested.

The *Tourism* sector has numerous projects and probably exceeds investments of US $ 10 billion. Those projects are in the interior (Boquete, Chiriqui) and the several beaches (Bocas del Toro, Coronado). It is a more risky sector as it is dependent on the preferences of the people and the world economy. People can easily go to Costa Rica for example.
It is important that beaches are improved.

The *Energy* sector requires solar-, hydro- and wind energy. Guillermo Viloria foresees no problem with water, as there is enough capacity. These energy projects account for over $ 1 billion in total.

Consultants will be necessary in the coming future. CH2MHill, a large consultancy firm specialized in water treatment and cleaning is planning to establish a branch in Panama.

In the *transportation* sector especially more public transportation is needed, like Millennium busses (the harmonica type as we know them in Holland). But next to the busses the transportation capacity of trains/railways also need to be increased. The Panama railroad will be improved (also because of the Canal).
A subway in Panama City can be the answer, but this is the subject of several studies now. This seems very expensive, but Panama has to better their sewer system, as waste water pollutes the ocean and the bay. The water needs to be cleaned before it ends up in the ocean. As this sewer system will be placed 50 m deep, maybe a subway is not that impossible anymore and can these projects be combined.
The infrastructure need to be improved by a Highway to Colon and the Northern and Southern corridor and a belt way around Panama City (in total US $ 1 billion), which need to be financed by private investments.

The *communication* sector is also very interesting, as call centers are operated in Panama to cover the whole world. Panama is connected to four optic cables lying in the oceans, which connect the country with the rest of the world. Panamanians speak good English and are very service oriented. A company like Dell, but also other US and Argentinean organizations are moving their call centers to Panama. Besides this the sub marine optic cables provide Panama with an excellent connectivity network throughout whole Panama.

Facilities for training people are needed. Panama lacks the specific knowledge for the different projects. Panama is small and needs people from abroad. It also needs expertise in different areas. The Government of Panama is working on this. A lot of money is transferred to institutions that train people and commitment with the private sector is established. For example, 6 big hotels are being built. The ministry took care of the workers: 2500 people are being educated one month ago on the 40 universities. Worldwide universities are planning to open a branch in Panama.

7.4 Summary

Looking at the political system of Panama, there are good circumstances for banks. The Torrijos Government has changed a lot of things lately and many respondents are happy with the current government. After the positive outcome of the referendum, it is very likely that the PRD party will be the winner of the next elections.
The economical situation is flourishing as the expansion of the Canal will lead to a GDP growth for the next years. Other sectors are also growing and offering huge investment opportunities. The FTA will offer more trade opportunities and lead to more income.

The banking system is supervised and regulated by the Superintendencia. Most respondents think that this authority is doing a good job and creates more transparency in the system. The former Superintendent, Cardenas, is succeeded by Barrelier, a change that some respondents can not understand. The reason is probably even more unclear.
The Asociacion Bancaria represents the banks in conversation with the Superintendencia, IMF and others. This system is working fine according to the respondents.

Many movements are going on in the banking sector. First of all, a lot of International banks are leaving Panama, due to mergers or acquisitions that lead to a different focus or a strategy

change at the headquarters in the banks homeland. Examples of these banks are Lloyds, Bank of America, Dresdner Bank and ABN-AMRO.
Second of all, there is a consolidation process in the Central American banking market going on. Banks are merging, acquisitioning or being acquired. Three large banks are being acquired the last years, which represent an amount of total assets of more than US $ 3 billion. The expectations of the respondents are that this consolidation trend will last for the next years.
Last of all, foreign banks are willing and planning to enter the Panamanian market. The regionalization, FTAs and huge investment opportunities are important points for banks to be part of. Eight banks are on the list of the Superintendencia currently, to enter the market. This increases the amount of international banks in the system. Panamanian and international banks are different in doing business and therefore both needed in the system.
Due to the large amount of banks, the competition is fierce and the margins low.

The respondents see a lot of investment opportunities for both banks and companies. It is obvious that the Canal project and all other projects around the Canal ask for a lot of financing. Besides this, the Real Estate business is booming, but it is expected that there is a lot of speculation in this sector. Other investment opportunities the respondents see are an oil refinery, biodiesel, energy projects, tourism/beaches, transportation, infrastructure and many others. It is said about the tourism sector that there is speculation in this investment as well.

Conclusions

A new model has been developed for the assessment of a banking sector. This model uses a theoretical and an empirical framework and has been applied on the Panamanian banking sector. The frameworks are based on conclusions and factors found in the academic literature.

The central research question that has been derived from the problem definition is:

Is it attractive, looking at current market conditions and performance indicators of the market and banks, for Dutch banks to enter the Panamanian banking sector, and if so, what is the best way to do this?

This question will be answered at the end. First will the answers on the sub-question will be presented.

- *What are the characteristics of the Panamanian banking sector?*

Panama has a stable political system and is technologically sophisticated, especially compared to its neighboring countries. Panama is currently enjoying high economic growth, most sectors are flourishing. The economy is dollarized, which lead to low inflation and no exchange risk. There is no Central Bank, but some of the Central Bank tasks are exercised by Banco Nacional de Panama. Furthermore, Panama is geographically situated between North and Latin America. A lot of transport and transactions are done via Panama. Main drivers of the economy are the Panama Canal, the (financial) services sector and the Colon Free Trade Zone. Former US influence is the reason that the Panamanians speak English and are open/friendly to foreigners. Panama shows very interesting investment opportunities for investors and financing opportunities for banks.

Panama is a small country with only 3.2 million inhabitants, but the region is more interesting with its 40 million inhabitants. There is income-disparity, the education system needs modernization and the country has a large fiscal deficit. There have been some scandals of corruption and money laundering in the past, which resulted in a bad reputation and a new government.
The Superintendent has supervisory and regulatory duties. The Asociacion Bancaria is stimulating developments within the sector and is the intermediary between the Superintendencia and banks. Banks are granted three types of licenses, namely the General, International and Representation License. Auditors check the annual reports of banks according to international standards.
Currently are there 76 banks in the sector with total asset of US $41.5 billion. There are 2 banks operating with an Official License, 40 banks with a General License and 34 with an International License. Around 25% of the banks are domestic and the rest are foreign banks.
The sector show a lot of Mergers & Acquisitions activities lately. Grupo Banistmo is acquired by HSBC, Banco Uno by Citibank and bought GE a 50% stake in BAC International Bank.

The Know-Your-Customer policy has been implemented successfully in the sector and advances have been made towards the compliance of Basel II. No due date has been set for the compliance of Basel II, but expected is the year 2010.
Leverage has been decreasing over the years but is stabilizing. No trend could be detected for the profitability of the market, but it is getting more efficient when looking at operational

costs. Non-interest revenues are growing more rapidly than interest-revenues. When looking at Loans, the corporate, consumer and mortgage loans have grown a lot over time.

- *What are important factors for a bank entry in a certain country?*

Analyzing a country on the opportunities for entry is based on financial stability and performance. Financial stability is assessed based on internal factors, external factors, supervision and regulation and on the current position in the business cycle.
The performance is assessed by investigating the profitability, risk, market power and efficiency.

Performance
The performance of the market and banks is measured by looking at profitability, risk, market power and efficiency. With regard to profitability an analysis is made of ROE, ROA, Leverage, Profit Margin and Asset Yield.
With regard to risk, an assessment is made of the capital adequacy ratio, leverage, provision to loans ratio and liquid assets to demand deposits ratio.
Market power is analyzed by looking at the market concentration or, in other words, at the number and size of the players in the market.
Efficiency is analyzed with help of the ratios operational cost to income and non-operational cost to income.

A banking crisis is not caused by one indicator, but depends on multiple imbalances. More insight with regard to trade linkages is presented in this paper by looking at Free Trade Agreements, bilateral agreements and to the origins of the biggest countries in the import and export sector.

Financial stability of the country
The assessment of the financial stability of Panama is based on several factors, namely; internal, external, supervision and regulation and business cycle.
The internal factor deals with overall cost efficiency, profitability and liquidity. Some other aspects that are discussed are bank assets, private credit and percentage change in loans compared to GDP, but also inflation and fiscal deficits.
The external factor is analyzed by looking at trade and financial linkages and the law enforcement.
With regard to supervision and regulation, an analysis is made of the structure and enforcement of the market, the presence of foreign banks, transparency of the market, advancements to accounting standards and the quality of economic and political institutions.
This report also gives an indication of the current position in the business cycle based on the GDP and a descriptive view on the important developments within the country with regard to investment opportunities, like the expansion of the Panama Canal, the Colon Free Zone and others.

- *What are important factors for a bank to choose a target bank to merge with or to acquire?*

For mergers and acquisitions is it important that there is a strategic fit. Next to this, there other important factors like asset quality, success factors and the impact on the market.
The impact of the market is assessed by looking at the competitive environment and stability of the financial market. An analysis is made based on the strategic focus of a bank about

diversification or cost-benefits. Banks with potential to improve performance are pointed out as well.
Success-factors are examined, like the strategic focus, political risk, sound policies and institutions, exchange risk and language.

- *Which banks can be presumed attractive targets based on the scores on these factors?*

It seems that the most attractive takeover candidates in the market already have been bought. This results in 13 banks that could be attractive to acquire. This attractiveness is based on the factors mentioned in the previous and whether there is a possibility to buy the bank.
The following banks look attractive as a candidate for a takeover based on a specific strategy:

- Differentiation: Bancafé, Banco del Pinchincha Limited and Global Bank
- Geographical diversification: Banco Cuscatlán
- Regional operations: Proamerica and Lafise, have only small operations in Panama
- Reputation and market share in Panama: Banco Continental and Banco General. Banco General is attractive based on its good cost-minimization strategy.
- Improvement benefits: Banco Cuscatlán and Banco International de Costa Rica.

However, banks like BBVA, Citibank and Bank of Nova Scotia are actively searching for targets to expand in the region and their market shares in Panama by means of acquisition.
Other criteria are only indicative so a specific Dutch bank can compare its performance and strategy with the takeover candidates.

- *What is the best way to enter the market based on the various results?*

The best way to enter the market is through Mergers & Acquisitions, because the cost of a lack on credit information is higher than the cost of screening applicants more efficient. However, due to the recent acquisitions and expected acquisitions are prices for banks based on high multiples.

- *Is it attractive for banks to enter Panama based on the previous assessments?*

Panama has many attractive characteristics, but the country is very small and the banking sector is crowded and very competitive. Next to this, there are a few banks with a lot of market power of which two are the global banks HSBC and Citibank. As been said, the best way to enter the market is through mergers and acquisitions. Due to the M&A-history of the sector and the expected M&A activities, the prices paid by banks are based on high multiples.

This leads to the conclusion that Panama as a market on its own, is not attractive for Dutch banks to enter. However, there are 40 million people living in a region that is currently doing economically very well. Therefore, it might be attractive to diversify regionally and implementing it in the banks strategy. Currently are there only a few takeover candidates that operate regionally, the possibility of choice is therefore limited. It is however more costly to buy local banks in every country and it takes more time to incorporate them.
The device is to act rapidly because there are only a few opportunities left to enter the market and now is the time that the region is flourishing.

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Appendices