

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

URUGUAY

SECTOR PROGRAM TO STRENGTHEN THE BANKING SYSTEM

(UR-0150)

LOAN PROPOSAL

This document was prepared by the project team consisting of: Guillermo J. Collich (RE1/FI1), Team Leader; Ximena Morey (RE1/OD1); Karina Azzinnari (RE1/FI1); Fernando De Mergelina (RE1/FI1); Carlos Sampaio-Costa (LEG); Alfredo Echegaray (COF/CUR), and Haydemar Cova (RE1/FI1) who helped produce the document.

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BASIC SOCIOECONOMIC DATA

For basic socioeconomic data, including public debt information, please refer to the following address:

<http://www.iadb.org/RES/index.cfm?fuseaction=externallinks.countrydata>

INFORMATION AVAILABLE IN RE1/FI1 FILES

PREPARATION:

Law 17,643/01 Asset laundering

Law 17,523/02 Strengthening of the banking system

Law 17,613/02 Financial system reform

Central Bank of Uruguay Statistical Bulletin

Financial statements of financial institutions, December 2002 – SIIF

Draft resolutions on SIIF regulatory changes

Draft resolutions on SIIF organizational and bank examination procedure changes

Policy letter agreed on with the IMF (2002)

Program Document for proposed structural adjustment loans to the Republic of Uruguay.

World Bank report 25012-UR, March 2003

Strengthening Uruguay's regulatory framework. Technical report. Sara Ordóñez, RE1/FI1 consultant, June 2003

Strengthening the Superintendency of Financial Institutions. Technical report. Alberto De Nigris, RE1/FI1 consultant, June 2003

Law 17,613 and its implications for Uruguayan bankruptcy provisions. Technical legal report. Camilo Martínez Blanco, RE1/FI1 consultant, January 2003

Exit mechanisms for nonviable financial institutions. Technical legal report. Silvio Lisoprawski, RE1/FI1 consultant, September 2002

Availability of crisis management mechanisms and instruments in Uruguay: The legal context. Technical legal report. Noris Aguirre, RE1/FI1 consultant

The 2002 economic crisis in Uruguay: causes, consequences, and prospects for a return to normal. Economic-financial report. Michelle Santo, RE1/FI1 consultant

Basle Committee recommendations I and II. Various documents. Bank for International Settlements, Basle, Switzerland

Conditionality monitoring matrix

Policy letter

ABBREVIATIONS

AFAPs	Administradoras de Fondos de Ahorro Previsional [pension fund management companies]
BCU	Central Bank of Uruguay
BHU	Banco Hipotecario del Uruguay [Uruguayan Mortgage Bank]
BROU	Banco de la República Oriental del Uruguay
FIs	financial institutions
FRP(s)	Recovery Trust Fund(s)
GDP	gross domestic product
IDB	Inter-American Development Bank
IMF	International Monetary Fund
LFSB	Bank System Strengthening Law
LRSF	Financial System Reform Law
MEF	Ministry of Economic Affairs and Finance
MIF	Multilateral Investment Fund
NBC	Nuevo Banco Comercial
NGO	nongovernmental organization
SIIF	Superintendency of Financial Institutions



Inter-American Development Bank
Regional Operations Support Office
Operational Information Unit

Uruguay

Tentative Lending Program

2003

Project Number	Project Name	IDB US\$ Millions	Status
UR0131	Municipal Development and Management	60.0	
UR0150	Banking System Strengthening Sector Loan	200.0	
Total - A : 2 Projects		260.0	
*UR0152	ABN Amro Uruguay TFF	12.5	
Total - B : 1 Projects		12.5	
TOTAL 2003 : 3 Projects		272.5	

2004

Project Number	Project Name	IDB US\$ Millions	Status
UR0141	Cattle Development Program	25.0	
Total - A : 1 Projects		25.0	
UR1001	Highway Infrastructure Program	70.0	
UR1002	Program to Support Employment Generation	N/A	
Total - B : 2 Projects		70.0	
TOTAL - 2004 : 3 Projects		95.0	
Total Private Sector 2003 - 2004		12.5	
Total Regular Program 2003 - 2004		355.0	

* Private Sector Project



URUGUAY

IDB LOANS

APPROVED AS OF AUGUST 31, 2003

	US\$Thousand	Percent
TOTAL APPROVED	3,339,701	
DISBURSED	2,928,770	87.69 %
UNDISBURSED BALANCE	410,931	12.30 %
CANCELATIONS	316,023	9.46 %
PRINCIPAL COLLECTED	779,527	23.34 %
APPROVED BY FUND		
ORDINARY CAPITAL	3,193,786	95.63 %
FUND FOR SPECIAL OPERATIONS	104,079	3.11 %
OTHER FUNDS	41,836	1.25 %
OUTSTANDING DEBT BALANCE	2,149,244	
ORDINARY CAPITAL	2,120,580	98.66 %
FUND FOR SPECIAL OPERATIONS	28,663	1.33 %
OTHER FUNDS	0	0.00 %
APPROVED BY SECTOR		
AGRICULTURE AND FISHERY	265,652	7.95 %
INDUSTRY, TOURISM, SCIENCE AND TECHNOLOGY	425,245	12.73 %
ENERGY	116,984	3.50 %
TRANSPORTATION AND COMMUNICATIONS	343,084	10.27 %
EDUCATION	147,131	4.40 %
HEALTH AND SANITATION	403,694	12.08 %
ENVIRONMENT	0	0.00 %
URBAN DEVELOPMENT	235,676	7.05 %
SOCIAL INVESTMENT AND MICROENTERPRISE	624,578	18.70 %
REFORM AND PUBLIC SECTOR MODERNIZATION	658,496	19.71 %
EXPORT FINANCING	8,940	0.26 %
PREINVESTMENT AND OTHER	110,221	3.30 %

* Net of cancellations with monetary adjustments and export financing loan collections.



URUGUAY

STATUS OF LOANS IN EXECUTION AS OF AUGUST 31, 2003

(Amount in US\$ thousands)

APPROVAL PERIOD	NUMBER OF PROYECTS	AMOUNT APPROVED*	AMOUNT DISBURSED	% DISBURSED
<u>REGULAR PROGRAM</u>				
Before 1997	2	207,300	160,108	77.23 %
1997 - 1998	7	410,355	378,190	92.16 %
1999 - 2000	4	90,825	17,718	19.51 %
2001 - 2002	7	526,600	274,225	52.07 %
<u>PRIVATE SECTOR</u>				
2001 - 2002	1	10,500	6,000	57.14 %
TOTAL	21	\$1,245,580	\$836,241	67.14 %

* Net of cancellations. Excludes export financing loans.

SECTOR PROGRAM TO STRENGTHEN THE BANKING SYSTEM

(UR-0150)

EXECUTIVE SUMMARY

Borrower and guarantor:	Eastern Republic of Uruguay	
Executing agency:	Ministry of Economic Affairs and Finance in coordination with the Central Bank of Uruguay	
Amount and source:	IDB (Ordinary Capital):	US\$200 million
	Local:	N/A
	Total:	US\$200 million
Financial terms and conditions:	Amortization period:	20 years
	Grace period:	5 years
	Disbursement period:	2 years (minimum of 18 months)
	Interest rate:	LIBOR
	Inspection and supervision:	1%
	Credit fee:	0.75%
	Currency:	U.S. dollars
Objectives:	<p>The objective of the proposed program is to assist in implementing reforms launched by the Uruguayan government to stabilize bank liquidity and solvency and rebuild depositor confidence in the country's banking system. The program will assist in the following: (i) preserving a macroeconomic environment consistent with achieving the objectives of the proposed program; (ii) stabilizing banks' financial condition; and (iii) strengthening of bank regulation and supervision.</p>	
Description:	<p>The Bank would disburse the proposed sector loan over a span of not less than 18 months counted from the loan contract signature date. The loan proceeds would be disbursed in three tranches, the first in the amount of US\$80 million and the second and third for US\$60 million each, after verifying that the respective tranche release conditions had been fulfilled. The disbursement arrangement is front-loaded because of the importance of the measures already adopted as part of this program (see paragraphs 1.21-1.28) and because the conditions for release of the first tranche form the critical mass of the operation.</p>	

The significant changes in banking industry operations called for in the reform package attest to the importance the government has accorded to strengthening the banking system, as evidenced in a number of substantive and costly initiatives since August 2002 in the framework of the present program, namely: (i) enactment of the Bank System Strengthening Law (Law 17,523) (LFSB) thanks to which depositors were able to access money in their sight and savings accounts despite the unfolding crisis; (ii) enactment of the Financial System Reform Law (Law 17,613) (LRSF) which among other measures modified bank exit mechanisms to enable the authorities to deal more expeditiously with foundering banks; (iii) liquidation of Banco Comercial, Banco Montevideo/Caja Obrera, and Banco de Crédito (see paragraphs 1.21-1.28); and (iv) the self-imposed decision to limit banks' public-sector exposure and provide for financial institutions to rate government financial assets just as they do for other borrowers. The following sections outline the rationale and scope of the planned measures in each action area. The first-tranche conditions must be fulfilled in their entirety and a special account opened for loan proceeds before the proposed operation will be submitted to the Bank's Board of Executive Directors for approval.

The Bank will support the planned Central Bank actions in the areas of regulation and supervision through technical cooperation funded with resources available in the multisector credit operation, which will be partially financed with Bank resources. The Central Bank has requested approximately US\$4 million for this technical cooperation. For this purpose, Uruguay asked the Bank to make the pertinent changes to the contract; once the Board approves this sector operation, Management will prepare the corresponding amendatory contract.

The macroeconomy

Faced with the need to stabilize and begin revitalizing the economy the Uruguayan government launched an economic adjustment and macroeconomic reform program that has the backing of the International Monetary Fund, the World Bank, and the IDB. The program is set out in the policy letter, as are the government's undertakings to the Bank in this regard. The measures envisaged in the financial sector operation proposed here are considered crucial to remedy the crisis that has buffeted the financial sector and to correct institutional weaknesses spotlighted in the process, in order to minimize the risk of recurrence of such episodes.

Banking sector stability and strengthening

When a financial crisis erupted in 2002 the government had to step in with a series of actions (see paragraphs 1.21-1.28) for which the program described here would provide support. Prompt and thorough

implementation of these measures is an essential step in restabilizing the nation's banking system and restoring depositor and investor confidence; this, in turn, is a sine qua non for the economy to rebound and return to a steady long-range growth path. One of the program conditions devised to that end is that government-owned banks fulfill the reprogrammed-deposit commitment.

The crisis also severely weakened financial institutions, prompting the suspension of operations and/or liquidation of some of the country's leading domestic banks. Now that the authorities have adopted a new regulatory structure to make the financial system more resilient (see paragraphs 1.21-1.28), one requirement for enduring post-crisis stability of the system will be to craft and institute a strict timetable for currently noncompliant FIs to adopt the new structure. There is provision in the proposed program for monitoring official and private commercial banks' strict adherence to that timetable.

Strengthening of bank regulation and supervision

a. Legislation

In order to bolster the financial system's legal framework (see paragraph 1.51) the government, as part of its reform package, amended the laws governing banking activity (see paragraphs 1.21-1.28). The rewritten legislation gives the Central Bank of Uruguay added bank prudential regulation powers and spells out procedures for resolving the situation of distressed banks, including institutions that have had their operations suspended.

b. Prudential regulation

Just as the crisis had pointed out weaknesses in the country's banking legislation it brought to the surface weaknesses in bank prudential regulation (see paragraph 1.50), which are being perceived as a significant risk for Uruguayan financial-market clients. As part of the sector reform program targeted for support by the operation proposed here, the government and Central Bank plan to introduce and implement a plan to align these prudential rules to international best practices and standards in this sphere. Among the specific issues the plan will address are: (i) risk concentration; (ii) risk classification and loss provisioning; (iii) minimum capital rules; (iv) liquidity requirements; (v) consolidated supervision; (vi) transparency; and (vii) comprehensive risk management.

c. Bank system supervision

In order for the measures being adopted to improve Uruguay's bank legislation and prudential regulation to work, the Superintendency of

Financial Institutions (SIIF) will need to be strengthened, notably to improve its organizational structure, procedures, and operating capacity. One facet of the proposed program is a specific action plan for the SIIF to institute the required changes and be equipped with the technical and human resources it needs to discharge the added responsibilities falling to it by virtue of reforms brought in via the program described here, including external reviews (compliance audits) of the technical caliber of SIIF bank examinations. Among the planned functional and procedural reforms are: (i) creation of a Market Risk Unit; (ii) creation of a Methods Unit; (iii) creation of a Nonbank Institutions Unit; (iv) creation of a Credit Risk Unit; (v) creation of a Technological Risk Unit; (vi) new procedures for the use of electronic supervision tools; and (vii) development of a database on financial conglomerates and operational coordination of bank supervision with insurance and securities exchange regulators.

The SIIF also will add to its internal control procedures a program for quality control of its regular inspections of financial institutions. This will include checks to ascertain whether all inspection procedures were followed and reports produced, with the requisite scope, and a review of the technical caliber of the examinations. The reviews will be done using large samples of the total bank inspections conducted the immediately preceding year. From these audit findings, recommendations will be made to the Superintendent (see paragraph 2.14).

**The Bank's
country
strategy:**

The overarching objective of the Bank's strategy with Uruguay¹ is to provide support for government policies and development programs pursuing sustained GDP growth with enhanced social equity while maintaining macroeconomic stability. Priority Bank strategy focuses on the operations side are: (i) initiatives to enhance the regional and global competitiveness of Uruguayan output and spur private investment, looking to the country's comparative advantages and to modern technology to position it more solidly in regional and world markets; (ii) reform and modernization of the State to lessen the official sector's role in the economy, increase its efficiency, rationalize and target its interventions, and reduce its incidence on the cost of producing goods and services in the country, and (iii) moves to improve societal welfare and enhance equity, bringing the most vulnerable segments of the population into the development mainstream and improving their quality of life.

¹ Country paper, document GN-2119-1 of 27 September 2000.

The proposed program fits with this strategy inasmuch as it will help achieve the first of the objectives outlined above, the aim being to assure lasting stability of the financial system so that it can once again become the premier avenue for domestic saving mobilization and thereby spur private investment and help revive the economy.

Environmental and social review:

Since all the planned activities involve institutional and legal reforms in the financial sector, this operation will have no direct impact on the environment. It was reviewed by the Committee on Environment and Social Impact on 20 June 2003. This proposal incorporates the Committee's recommendations.

Interagency coordination:

The proposed program has been formulated in the context of Uruguay's Standby Arrangement with the IMF to restore basic macroeconomic balances. Activities are being and will be closely coordinated with the IMF to ensure pursuit of the macroeconomic environment envisaged in that IMF accord (see paragraphs 1.5, 1.6, 1.63-1.65, and 2.4).

This program also complements the World Bank's US\$151.5 million Special Structural Adjustment Loan, whose chief financial-sector objective is to assist with the restructuring of Banco Hipotecario del Uruguay (Uruguayan Mortgage Bank—BHU). Likewise, the proposed program complements IMF actions in that sector under the terms of the current Standby Arrangement, the centerpiece of which is the restructuring of Banco de la República Oriental del Uruguay (see paragraphs 1.64-1.69).

Benefits:

The most important benefits that are expected to ensue from achieving the program's objectives by way of the measures and reforms targeted for support will be the program's contribution to: (i) solidifying bank liquidity and solvency and (ii) bolstering bank system regulation and supervision capacity by way of the system's policy-maker and regulator, the Central Bank.

Risks:

The operation's chief risk would be a weakening of the Uruguayan authorities' resolve to implement the proposed reforms effectively and quickly enough and to sustain them. In view of the authorities' actions to date and their unfaltering decision to proceed with such sensitive, costly measures as liquidating banks whose operations had been suspended, the project team considers such a risk to be low and acceptable.

Another significant risk would be that government banks might not be able to comply fully and on schedule with technical-ratio requirements in the additional prudential regulations the program would help bring in, or would be unable to keep to the LFSB timetable for release of reprogrammed deposits. However, from all indications the authorities are working very actively with the IMF (see paragraph 1.63) to attenuate this risk, the serious consequences of such a scenario being clearly understood.

Special contractual clauses:

The program will be implemented in accordance with the loan contract terms and conditions. Disbursement of each tranche will be contingent on: (i) preserving a macroeconomic environment consistent with achieving the program's objectives; (ii) fulfillment of the policy actions decided on for each tranche, which are set forth in Section II and Annex I of this document. In addition, the following are conditions precedent to the first disbursement: (i) a special account must be opened for loan proceeds; and (ii) the Ministry of Economic Affairs and Finance and Central Bank must sign an agreement in which: (a) the Central Bank pledges to fulfill all the conditions incumbent on it, as provided for in the loan contract; and (b) the borrower agrees to provide the Central Bank with the necessary material, technical, and human resources to fulfill those conditions.

Poverty-targeting and social sector classification:

This operation does not qualify as a social equity enhancing project, as described in the indicative targets mandated by the Bank's Eighth Replenishment (document AB-1704), nor does it qualify as a poverty-targeted investment (PTI).

Exceptions to Bank policy:

None.

Procurement:

The quick-disbursing funds from the financial sector loan may be used to finance the aggregate cost, in foreign currency, of eligible imports from IDB member countries. In this case, Bank procedures on sector loans would apply, which do not require international competitive bidding.

I. FRAME OF REFERENCE

A. Macroeconomic setting

1. Background

- 1.1 Throughout the 1990s the Uruguayan economy grew at an acceptable pace with declining inflation. With the combination of an anti-inflation policy using the exchange rate as a nominal price-system anchor and tight controls over the public finances the country was able to slash annual consumer price increases from the triple digits in 1990 to a single digit in 1998. Thanks to prudent management of the public accounts and a favorable external environment Uruguay posted real annual GDP growth rates averaging 3.9% over those years. However, the effective real appreciation of the peso during that interval meant lower earnings for the productive sectors in an increasingly open economy. The result was a steady deterioration in the trade balance, with mounting trade deficits throughout that period (see Table 1.1). On the fiscal management side, moves to control spending and put through reforms of the State and of the social security system promise to benefit the treasury in the medium and long run but have created financial pressures in the short term. Outlays for these reforms put added strain on the public finances and, despite positive economic growth rates in recent years, the ratio of public sector deficit to GDP held in the range of 1% to 1.6%.
- 1.2 From 1999 onward the economy slid into a recessionary phase. The main reason for the worsening of the public finances was the recession's impact on tax revenues, the overall public sector deficit having climbed to around 4% of GDP in 1999-2001. Factors in this protracted recession were: (i) deteriorating terms of trade (increases in world prices for Uruguay's main commodity imports, notably oil, and falling world prices for its leading export commodities); (ii) the "exchange-rate lag" that made the country's traditional exports less competitive; (iii) the 1999 depreciation of the Brazilian real, which hurt Uruguay's trade with Brazil; and (iv) the flattening of Argentine demand for Uruguayan goods and slowing of Argentine tourism flows because of the recession and sharp devaluation of the Argentine peso following that country's decision to end the "convertibility" scheme. As the deep depression persisted Uruguay's unemployment rate climbed from 10.1% in 1998 to 15.3% in 2001.

2. Recent developments

- 1.3 The nation's economic problems worsened in 2002. Real GDP dropped 10.8%, making for a cumulative 17.5% decline in the last four years. The urban unemployment rate hit 16.9% at year-end 2002 and edged up to 17.5% in the moving quarter April-June 2003. Real wages fell 10.7% in 2002 and 18.3% in January-June 2003. In the last 12 months (to May 2003) as the treasury continued to feel the tax-revenue effects of the recession the fiscal deficit stood at US\$619 million, roughly 5% of GDP. Included in these figures is the impact of

interest payouts for the late-May 2003 debt exchange (see paragraph 1.7). Inflation began to climb in July 2002 following the decision to let the peso float freely, though inflation increases trailed the ensuing sharp devaluation because of the protracted recession at home and deflationary pressures from the region (in the 12-month period ended in June 2003, inflation rose 25% while the peso lost 50% of its value). A further 1% contraction in GDP is forecast for 2003. However, there are signs that the economy is rallying: according to the most recent figures available, seasonally adjusted first-quarter 2003 GDP was up 2.2% over the fourth quarter of 2002 and up 3.3% between April and June compared to the first quarter of 2003. Nevertheless, real GDP declined 6.8% in the first half of 2003 compared to the same period the previous year.

- 1.4 Compounding these adverse economic developments was a deep liquidity and solvency crisis in the financial system in 2002 which slashed the credit supply and lost Uruguay its investment grade (nonspeculative) sovereign debt rating, the result of chronic consolidated public-sector deficits and the government's mounting foreign-currency debts to fund them. Because of the sharp devaluation in the Uruguayan peso (causing dollar GDP declines that outpaced the real-term decline in economic activity), heavy external borrowing to come up with funds to manage the bank system liquidity crisis from July onward, and the public sector's borrowing requirements, the public debt stock soared from 34.4% of GDP in December 1998 (US\$7.694 billion, US\$1.619 billion of it owed to multilateral lenders) to 92.1% of GDP in December 2002 (US\$11.345 billion, of which US\$4.494 billion was multilateral debt). By way of the mid-May 2003 debt exchange the government was able to defer a considerable volume of sovereign debt maturities (see paragraph 1.7), thereby scaling back the projected short- and medium-term public sector borrowing requirement.

Table 1.1
Principal economic-financial indicators, 1998-2003

	1998	1999	2000	2001	2002	2003
Real GDP	4.5	(2.8)	(1.4)	(3.1)	(10.8)	(6.8) ¹
Prices, wages and employment (%)						
- Inflation (Dec.-Dec. change)	8.6	4.2	5.1	3.6	25.9	19.5 ²
- Devaluation (Dec.-Dec. average change)	8.3	7.6	7.3	12.9	93.7	19.0 ²
- Real wage (average annual change)	1.8	1.6	(1.3)	(0.3)	(10.7)	(12.5)
- Unemployment rate (annual average)	10.1	11.3	13.6	15.3	16.9	17.5
External indicators (US\$ million)						
- Merchandise exports f.o.b.	2,829	2,291	2,384	2,144	1,931	1,013 ³
- Merchandise imports f.o.b.	3,601	3,186	3,311	2,914	1,871	934.4 ³
Public finances (% of GDP)						
- Consolidated public sector deficit (-)	(0.9)	(4.0)	(4.1)	(4.2)	(4.2)	(4.7) ⁴
- Gross public sector debt	33.9	40.8	45.3	54.1	92.4	108.7 ⁵

Source: Central Bank of Uruguay

(1) January-June 2003/January-June 2002.

(2) 12 months to July 2003.

(3) January-June 2003.

(4) 12 months to April 2003.

(5) IMF estimate.

3. Agreements with the International Monetary Fund (IMF)

- 1.5 The government's near-term economic policy focus in 2002 was to narrow the fiscal deficit and undo the crisis of confidence that hurt the economy, and particularly the banking sector, throughout most of the year. The government's strategy, combining moves to revive the economy and keep prices stable, has been supported by IMF standby credits. The March 2002 arrangement for 594.1 million Special Drawing Rights (SDR), about US\$745 million, was to run through 31 March 2004. In May 2002 the government asked the IMF to augment the current arrangement by SDR 1.16 billion (about US\$1.5 billion) to assist with measures being adopted to shield the nation's banking system from spillovers from financial crises in the region. Agreement was reached on the 2003 program upon completion of the IMF's second review on 22 February 2003, extending the current arrangement for one year, to March 2005.
- 1.6 The standby accord enabled the immediate disbursement of US\$300 million and cleared the way for Uruguay to access additional IDB and World Bank funding. The following are the central features of the program: (i) a primary fiscal surplus of 3.2% of GDP (fiscal deficit to be narrowed to 3.1% of GDP); (ii) 25%-27% inflation in 2003; (iii) continuation of the floating exchange-rate policy with an estimated devaluation rate similar to inflation; and (iv) deeper structural measures to bolster the public finances in the medium term (essentially, 2003 enactment of reforms of the tax system and of police and military pension plans).
- 1.7 The Uruguayan authorities also completed the voluntary public-debt exchange program, an important element of their plan to remedy immediate liquidity problems and solidify the fiscal accounts in the medium term. Ninety-nine percent of holders of locally issued government securities agreed to the exchange as did 89.2% of foreign bondholders. On 29 May 2003 the government paid out more than US\$100 million in interest on the swapped paper and began delivering the new bonds.¹ This high investor participation helped brighten local and global financial market perceptions of the country's economic outlook, as evidenced in the decline in its "country risk" to less than half the 1,700-basis-point spread its sovereign external debt had carried before the debt exchange was formalized. By early August 2003 the risk spread on Uruguayan sovereign debt, measured on the mean market price of the most widely traded new global bonds, was about 800 basis points over U.S. Treasury bonds of like tenor.

¹ The government offered two options: (i) the "extension option" that would exchange current paper for securities on identical rate and currency terms but extending the maturities by five years; and (ii) the "liquidity option," which offered more stretched-out maturities and concentration in a few larger global bond issues and thus greater liquidity. This second option included changes in interest rate parameters and, in some instances, in the face value of the bonds to be exchanged.

B. The Uruguayan financial system

1. The financial services sector

- 1.8 Practically speaking, Uruguay's financial system is its banking system, particularly since investment funds all but disappeared in the wake of the 1998 Russian crisis. At their height, local investment funds had amassed somewhere between US\$450 million and US\$500 million in funds under management; today their total holdings come to less than US\$5 million. Virtually every fund established in the 1990s is gone. Citibank, Bank of Boston, Banco Santander, and Algemene Bank Nederlands exited the market, as did a number of currency exchanges that had launched investment funds.
- 1.9 The country's economic troubles and problems with some corporate negotiable-bond issuers (notably the Granja Moro fraud) wiped out the private debt market. The failure of Banco Comercial and Banco Montevideo, heavy eurobond issuers on both the local and global markets, was the final blow.
- 1.10 Since the two institutional investors left in the market—pension fund management companies (AFAPs) and insurance companies—are relatively modest players, the country's banking industry is still the mainstay of its financial system even after the massive outflow of deposits during the 2002 crisis. The AFAPs currently manage about US\$1 billion and insurance companies have roughly US\$200 million in technical reserves, compared to the year-end 2002 bank deposit base topping US\$7.5 billion.
- 1.11 In December 2002 Uruguay's banking system consisted of 17 private commercial banks with US\$5.62 billion in assets and two official banks—Banco de la República Oriental del Uruguay and the Banco Hipotecario del Uruguay [Uruguayan Mortgage Bank]—with total assets of US\$4.436 billion and US\$1.361 billion, respectively. Also in operation were seven finance corporations, six savings and loan associations, and seven offshore banks. The Superintendency of Financial Institutions (SIIF) regulates and supervises all banking activity on behalf of the Central Bank, the system's sole regulator.²
- 1.12 For decades Uruguay's bank system offered nonresident investors a safe haven from the periodic ups and downs of other economies in the region. The 1972 legalization of foreign-currency deposits, strict bank and tax secrecy, and the protection of depositors' rights when the system was plunged into crisis in the 1980s earned Uruguay credibility as a financial market in which the value of capital on deposit would be preserved.

² The Uruguayan banking system does not have institutions that fit the regular definition of "full-service banks." Financial institutions cannot invest in companies, sell securities or directly organize and administer pension or investment funds. However, most bank groups, through their subsidiaries, conduct a variety of nonbank activities (particularly pension fund administration and capital market transactions).

- 1.13 Those features of the banking system had to be adapted to international regulations on money laundering prevention, which call for proactive cooperation between financial institutions (FIs) and agencies that investigate laundering, namely, the reporting of suspicious transactions, customer identification, and recording transactions. Extensive international cooperation is also needed to control offenses that, due to their nature, transcend political borders.
- 1.14 Since 2000, Uruguay has been adopting stringent measures to prevent and combat asset laundering, among them Law 17,343 and Circulars 1,712, 1,713, 1,722 and 1,737 issued in 2000 and 2001. The Central Bank set up a Financial Information and Analysis Unit in the SIIF with a centralized database to record transactions by parties required to report them. In March 2001 the Center for Training in Asset Laundering Prevention was set up under the aegis of the National Drug Council, and at the second meeting of the South American Financial Action Task Force it was decided that the training center would coordinate training regionwide for all the member countries.³
- 1.15 Uruguay's compliance with international money-laundering prevention standards was examined in 2002 during the first round of mutual evaluations by the South American Financial Action Task Force. All the recommendations made in the evaluation report have been incorporated into a new bill to be presented to parliament in October 2003, rounding out the current laws on this matter. The bill proposes, *inter alia*, to lengthen the list of parties in the financial sector who are required to report suspicious transactions, while underscoring that "professional secrecy" (which includes the banking sector in Uruguay) is not at odds with fulfillment of these legal obligations. The private sector, too, has developed self-regulating measures to prevent asset laundering, such as Codes of Conduct adopted in 1997 by the Uruguayan Banking Association and the Association of Financial Institutions and subsequently by the Association of Currency Exchanges and the Securities Exchange in 2002.
- 1.16 In 1992, with IMF backing and support from IDB sector program UR-0031, Law 15,322 of 1982 governing financial intermediaries was amended, expressly empowering the Central Bank to take over and liquidate financial institutions (FIs). Regulatory Directive 381/989 required FIs to be single-purpose businesses and prescribed rules for the creation and operation of offshore FIs, which were permitted to do business only with nonresidents. Directive 614/992 required FIs established in Uruguay to consolidate their financial statements with those of their offshore branches. One chapter of Law 16,327 enacted in 1992 specifically addressed the FI crisis and the subject of preventive measures and administrative liquidation. It mandated the Central Bank to adopt preventive measures (which may include takeover of operations, suspension, dissolution, and liquidation of a failing FI) and to serve as lender of last resort.

³ Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Paraguay, Peru, and Uruguay.

2. Recent financial system developments

- 1.17 Toward the end of 2001 over US\$1 billion poured into Uruguayan banks from Argentina in the wake of financial turmoil in that country. The deposit base of Uruguay's financial system skyrocketed: as Table 1.2 illustrates, total resident and nonresident deposits at 31 December 2001 stood at US\$17.077 billion. This massive inflow of nonresident deposits began to reverse direction early in 2002 when the market set out on a course that, by year-end, would plunge Uruguay's banking system into its worst crisis ever. In January 2002 Banco Comercial, the country's leading private commercial bank, was in disarray following the liquidation of Banco General de Negocios in Argentina, whose principal shareholder was also Banco Comercial's controlling shareholder, and the discovery of irregularities in the bank's asset and liability management. To manage this situation the Uruguayan government and the other three foreign shareholders (Chase Manhattan, Dresdner Bank, and Credit Suisse First Boston) came up with an emergency capital infusion.

Table 1.2
Bank system deposits
(US\$ million)

	Dec. 99	Dec. 00	Dec. 01	Dec. 02	June 03
Total deposits	14,798	14,536	17,077	9,612	9,020
Foreign currency	12,699	12,552	15,373	8,781	8,041
- Residents	7,567	7,823	8,311	6,328	5,824
- Nonresidents	5,132	4,729	7,062	2,453	2,218
Pesos	2,099	1,984	1,704	831	979
- Residents	2,092	1,978	1,697	829	978
- Nonresidents	7	6	7	2	1

Source: Central Bank of Uruguay

Note: Excludes Nuevo Banco Comercial and banks taken over by the authorities except Banco Galicia.

- 1.18 In February 2002, as a result of macroeconomic imbalances since 1999, Uruguay lost its investment grade rating. That same month, with Argentina's financial system in trouble and ensuing restrictions on capital movements out of that country, Banco de Galicia Buenos Aires-Uruguay, subsidiary of the Argentine institution of the same name and Uruguay's second-largest private commercial bank by deposit base, found itself unable to honor its deposit obligations, whereupon the Central Bank stepped in and suspended its operations. Though these twin events dealt a severe psychological blow the authorities were able to keep satisfactory control of the situation, and bank system liquidity held more or less at historical levels.
- 1.19 By late June 2002 the system's worsening liquidity problems reached crisis proportions, fueled by yet more bad news. The Central Bank had taken control of Banco de Montevideo, which had recently subsumed Banco de la Caja Obrera (privatized in 2001), following revelations of irregularities involving the finances of Banco Montevideo's controlling shareholder which had ties to the majority Argentine-owned Velox Financial Group.

- 1.20 The ensuing run on deposits in July 2002 prompted the Central Bank to suspend the business and financial operations of Banco Comercial, Banco Montevideo/Caja Obrera, and Banco de Crédito which was also experiencing a liquidity crunch. At the time these three banks accounted for about 46% of aggregate private-sector financial system assets.

3. Government moves to manage the crisis

- 1.21 By late July, as the deposit hemorrhage continued, the two State-owned banks—Banco de la República Oriental del Uruguay (BROU) and the Uruguayan Mortgage Bank (BHU)—began to experience liquidity problems as well. By way of Law 17,523 of August 2002 (the Bank System Strengthening Law), the government directed those two official banks to reprogram approximately US\$2.237 billion in foreign-currency time deposits⁴ and set up a Bank System Stabilization Fund that would supply liquidity for withdrawals of sight and savings deposits from the banking system. As part of the BHU restructuring under way with World Bank assistance (see paragraph 1.68) the government ordered that bank to transfer its reprogrammed deposits to BROU. The quarterly payout timetable for the two banks' reprogrammed deposits is phased—25% to be paid the first year, 35% the second year, and 40% the third year, with 6% annual interest. The initial 25% installment is to be paid out starting in August 2003.⁵
- 1.22 Direct and indirect government assistance delivered to the three suspended banks via the Central Bank, Economic Affairs and Finance Ministry, and National Development Corporation came to US\$1.051 billion (US\$351 million for Banco Comercial, US\$412 million for Banco Montevideo/Caja

Box 1
Recovery Trust Funds
Management of Residual Assets
of Liquidated Banks

Pursuant to the Financial System Reform Law (LRSF), responsibility for liquidating a financial institution, from the liquidation order through to ultimate disposition of assets, rests solely with the Central Bank (BCU), which is to conduct the process administratively (out of court). According to procedural requirements in the LRSF, when a liquidation order is given, a Recovery Trust Fund (FRP) will be automatically set up and all the liquidated bank's assets and liabilities of any nature must be transferred to the Fund. The management of this Fund and the ultimate disposition of assets (likewise the responsibility of the BCU alone) constitutes the sum total of the liquidation process. As general and sole administrator the BCU may elect to exercise its authority direct or indirectly (outsourcing asset disposal) and may order the disposition of Fund holdings whether through asset distributions or collections or sales, its primary obligation being to safeguard the rights of the liquidated bank's depositors.

At this writing the Central Bank is administering FRPs for the four banks liquidated in 2002 and early 2003. Current Banco Comercial and Banco Montevideo/Caja Obrera FRP holdings consist of Nuevo Banco Comercial (NBC) certificates of deposit (CDs) delivered as payment of the unacquired assets, to which eventually will be added the assets and/or loans returned by NBC if it exercises its option (see footnote 5).

The respective FRPs' liabilities will be progressively discharged using these funds, beginning with payouts to small depositors. Payments can be in cash (from the proceeds of asset collections or sales) or in the form of NBC CDs or other assets. The swift, efficient disposition of these FRPs is one of the planned action areas in the program the Uruguayan government worked out with the IMF for the financial sector as part of the current Standby Arrangement (see paragraph 1.63).

⁴ This reprogramming applies to deposits made before 30 July 2002. The terms are calculated based on equal maturities for each deposit.

⁵ In fact, on 23 June 2003 BROU began to pay out part of the first installment and in August decided to release the entire first payment.

Obrera, US\$288 million for Banco de Crédito). Multilateral organizations supplied a total of US\$1.422 billion to set up the Bank System Stabilization Fund—US\$640 million of which was used for the official banks and US\$346 million for the banks whose operations had been suspended. This brought the bill for the 2002 banking crisis to about US\$1.051 billion.⁶ If US\$1.319 billion in 2002 operating losses of the government-owned banks (BHU US\$1.078 billion, BROU US\$241 million) are factored in, the December 2002 tally of State aid to FIs comes to US\$2.37 billion, equivalent to roughly 19% of the nation's gross output.

- 1.23 In view of the weight of Banco Comercial and Banco Montevideo/Caja Obrera in the country's financial system, particularly in terms of lending to the nonfinancial sector (accounting for 21.9% of overall system lending to that sector at 31 July) the Uruguayan authorities decided that liquidation of the institutions should be avoided. Instead they explored the possibility of opening a new bank formed from the two banks' healthy portfolios, with a viable business plan meeting all SIIF liquidity and capital strength requirements. The authorities engaged ING Consulting to assess the state of the two banks and the viability of creating a new institution.
- 1.24 On 27 December 2002 the legislature unanimously passed Law 17,613, the Financial System Reform Law (LRSF). The new legislation: (i) gave the Central Bank (BCU) special powers, notably to pursue, by way of the Executive Branch, disciplinary action against any State-owned financial institution that was not in compliance with SIIF bank regulations, and (ii) ordered the liquidation of Banco Comercial and Banco Montevideo/Caja Obrera and the creation of Nuevo Banco Comercial (NBC). The liquidated banks' assets and liabilities were transferred to BCU-administered Recovery Trust Funds.⁷ On 28 February 2003, following a succession of failed attempts by the government and Banco de Crédito's private shareholders to put together a capital increase that would raise the bank's capital to the statutory minimum, the Central Bank ordered that institution liquidated under the terms of the new Financial System Reform Law.
- 1.25 NBC is a commercial bank established under private law. Though its initial capital of US\$100 million is 100% government-held, the bank will be privately run. Factors driving the decision to create NBC included the following: (i) the closed banks' heavy weight in the local financial market, particularly as providers of credit to small and medium-sized local businesses and for the agriculture sector; (ii) the key role of those banks and their physical networks outside the country's capital, where BROU would be left as the only alternative; it was felt that a de facto BROU

⁶ Estimated cost of direct government aid to the suspended banks, assuming the government recovers 100% of money advanced to the official banks and those taken over by the authorities so they could honor deposit obligations.

⁷ Assets in these Funds were auctioned off on 20 February 2003. NBC, the sole bidder, paid US\$830 million to acquire the bulk of Fund assets at an average 94% of their face value. NBC has the option until December 2003 to return to the respective Funds any of the acquired loans classed in risk categories 4 and 5.

monopoly on bank services outside the capital was not desirable; (iii) the desire to save at least some of the jobs that were going to be lost in the aftermath of the 2002 systemic crisis; and (iv) the authorities' wish to take advantage of the fact that depositors of the banks taken over were agreeing to have part of their deposits capitalized and the rest reprogrammed with longer maturities, to be able to manage assets more efficiently and thereby minimize potentially larger losses for the parties involved (depositors and the State)—that being a typical scenario when a bank is liquidated outright. Creating NBC meant that loans would not have to be auctioned off at a critical economic and financial-system juncture and the government would not have to limit collateral foreclosures, a move that would have undermined the country's legal framework.

- 1.26 From the outset the government made clear that NBC would be a private commercial bank entitled to no special treatment under the regulatory framework that governed all the nation's financial institutions. In point of fact, NBC's opening was deferred until it could be fully compliant with SIIF commercial banking regulations. If NBC was not immediately privatized it was essentially for two reasons, one political and one economic. In order to win back depositor and investor confidence following a crisis as severe as the 2002 events it was essential that there be as broad a consensus as possible across the political base to secure passage of the laws and rules that had been developed to bring an end to the crisis. Since some major political groups were opposed to a firm privatization date being set for NBC the government elected not to specify a date in the Financial System Reform Law, to make sure the privatization would be supported by all political quarters—as indeed occurred.
- 1.27 Additionally, the thinking was that the economic and financial crisis and the sharp falloff in bank business in the wake of the 2002 turbulence made it highly unlikely in the short run that a bank could be sold on reasonable terms. Consequently, it was decided to put off the sale of NBC until the economy had rallied and depositors had regained trust in the banking system. In the end, this approach is expected to recoup more of the funds paid out to aid banks that the authorities took over during the 2002 upheaval.
- 1.28 An important consideration here is that NBC is run under management contracts with private-sector bankers and is bound by exactly the same rules as other private commercial banks in Uruguay. The sole difference is that its shares are temporarily owned by the State, awaiting better conditions for its sale to a top international bank.

4. State of the banking system

- 1.29 Table 1.3 shows total deposits in foreign and local currency in Uruguay's banking system as of 30 June 2003.

Table 1.3
Total financial system deposits
(US\$ million)

	Dec. 99	Dec. 00	Dec. 01	Mar. 02	July 02	Dec. 02	June 03
Total deposits	14,798	14,536	17,077	14,983	10,652	9,612	9,021
Total official banks	5,298	5,411	5,606	5,509	3,911	3,915	4,154
- BROU	3,893	3,851	3,954	3,921	2,717	3,618	3,802
- BHU	1,404	1,560	1,653	1,587	1,194	297	352
Total banks under govt. control	3,857	3,211	4,695	3,746	3,270	2,795	954
- Caja Obrera	370	379	384	335	211	156	(1)
- Banco Comercial	1,186	1,466	1,640	1,122	1,014	851	(1)
- Banco de Crédito	703	822	756	646	473	380	(1)
- Banco Montevideo	526	544	589	545	512	442	(1)
- Banco Galicia	1,072	1,272	1,326	1,099	1,061	966	954
Nuevo Banco Comercial							801
Rest of private banks	4,393	4,603	5,619	4,504	2,308	2,538	2,750
Savings and loan institutions	322	347	394	357	260	262	285
Other financial institutions	928	964	763	867	902	101	77

Source: Central Bank of Uruguay.

(1) Banks liquidated before June 2003.

NA: Not available.

- 1.30 Massive deposit withdrawals between July 2002 and March 2003 had a negative impact on bank lending to the nonfinancial sector. Table 1.4 shows the changes in aggregate lending to the nonfinancial sector in the past few years.

Table 1.4
Total lending to the nonfinancial sector
(US\$ million)

	Dec. 99	Dec. 00	Dec. 01	Mar. 02	July 02	Dec. 02	June 03
Total lending	10,568	9,514	9,595	8,499	6,230	4,041	2,906
Total official banks	4,736	3,521	2,795	2,659	2,039	1,654	1,248
- BROU	2,630	2,155	1,865	1,796	1,538	1,292	912
- BHU	2,106	1,366	930	863	501	362	336
Total banks under govt. control	2,427	2,542	3,313	2,641	1,941	817	191
- Caja Obrera	224	231	183	176	148	46	(1)
- Banco Comercial	880	967	1,295	1,137	859	229	(1)
- Banco de Crédito	503	478	441	441	384	211	(1)
- Banco Montevideo	338	368	394	368	359	165	(1)
- Banco Galicia	483	507	999	520	192	166	191
Nuevo Banco Comercial							92
Rest of private banks	2,873	2,879	2,688	2,469	1,879	1,288	1,140
Savings and loan institutions	279	315	321	295	229	200	170
Other financial institutions	252	258	478	434	141	82	65

Source: Central Bank of Uruguay.

(1) Banks liquidated before June 2003.

NA: Not available.

Liquidity

- 1.31 There was enough money in the Bank System Stabilization Fund to remedy the liquidity problems of the official banks and those being managed by the authorities, covering all sight and savings deposit withdrawals from these institutions. This took approximately US\$986 million of the Fund's holdings—US\$640 million for BROU and BHU demand and savings deposits and US\$346 million to help pay out Banco Comercial and Banco de Montevideo/Caja Obrera sight and savings deposits.
- 1.32 The other offshore banks used funds of their own to pay depositors, either by cutting back on lending or tapping credit lines or securing capital from their parent companies. In capital injections alone, local subsidiaries of international banks received the equivalent of US\$68 million in 2002, which gave this group of banks needed liquidity and also bolstered their capital position.
- 1.33 Since depositors were so wary, most banks opted to keep their liquidity high to be able to withstand any new deposit runs, and their profits suffered accordingly. Table 1.5 charts bank system liquidity over the past several years, using a liquidity ratio constructed to measure the relationship between banks' liquid resources and under-30-day deposits.

Table 1.5
Financial system liquidity

Date	BROU	BHU	Offic. banks	Caja Obrera	Comercio	Crédito	Montev.	Galicia	Susp banks.	Private banks	FIs	Coop.
Dec. 00	0.28	0.16	0.26	0.22	0.22	0.20	0.33	0.06	0.22	0.21	0.44	0.21
Dec. 01	0.49	0.22	0.44	0.19	0.27	0.29	0.31	0.19	0.26	0.22	0.38	0.30
Mar. 02	0.28	0.11	0.25	0.20	0.18	0.26	0.23	0.57	0.26	0.19	0.44	0.28
July 02	0.22	0.09	0.20	0.15	0.13	0.13	0.06	0.49	0.18	0.27	1.08	0.28
Dec. 02	0.24	0.08	0.23	1.82	0.33	0.29	1.18	0.57	0.55	0.31	0.65	0.28
Mar. 03	0.49	0.08	0.46					1.11		0.33	0.79	0.33
June 03	NA	0.08						1.14		0.38	1.15	0.29

Source: Central Bank of Uruguay.
NA: Not available.

- 1.34 Between December 2001 and December 2002 the government banks' liquidity ratios dropped by half (BROU) or close to two thirds (BHU) since declines in their liquid resources far exceeded the drop in short-term (under 30 day) deposits. In the banks taken over by the authorities the liquidity ratio improved over the course of 2002, from 0.26% at year-end 2001 to 0.55% at the end of 2002—but the reason for the improvement was the huge (76%) reduction in these banks' short-term deposits compared to the 49.5% drop in liquid resources over that 12-month interval.
- 1.35 Liquidity ratios in the rest of the country's private commercial banks improved from 0.19% coverage in March 2002 to 0.38% in June 2003, since their liquid resources increased over that period while deposits shrunk. Clearly, these other private-sector institutions have tightly managed their liquidity, apart from any

backing they may have received from their parent companies. System-wide bank profits naturally suffered when banks were obliged to keep such high levels of liquidity.

- 1.36 Overall bank system liquidity has improved thus far in 2003, largely because of the increase in deposits. The official banks report a US\$54 million increase in foreign-currency deposits between January and May, the private commercial banks a rise of US\$250 million. The largest increase was in May, when deposits were up US\$220 million—US\$61 million in government-owned banks and US\$159 million in private commercial banks.
- 1.37 In May 2003, roughly 60% of total private bank deposits (not counting NBC) are sight deposits, which makes it very difficult for banks to boost their lending. All together, the loan books of the group of private commercial banks still doing business normally in the market were down the equivalent of US\$164 million in the first four months of this year, a drop of just over 9% from year-end 2002.
- 1.38 Though there still are no official figures for the NBC, the bank's new authorities indicate that they have captured over US\$70 million in new deposits and the bank has launched a press campaign offering individuals and businesses a menu of credit line options.

Capital strength

- 1.39 Since banks had to come up with money to pay depositors who were pulling out their funds (which usually meant calling in the most liquid, highest-quality loans and not renewing them) and global economic conditions were worsening, the ratio of nonperforming loans (more than two months past due) to performing loans rose considerably, especially in the official banks and those taken over by the authorities. In December 2002, category 4 and 5 loans (doubtful or loss)⁸ made up 59.6% of BROU's total portfolio, 52.5% of outstanding loans of the banks under government control, 28.7% of other private commercial bank loan books, and 17.9% of the portfolios of other financial institutions (see Table 1.6).

⁸ The SIIF classifies bank loans in five categories: 1 (pass, 0.5% provisioning); 2 (watch, 5% provisioning); 3 (substandard, 20% provisioning); 4 (doubtful, 50% provisioning), and 5 (loss, 100% provisioning).

Table 1.6
Percentage of outstanding loans by risk category

Institutions	2000					2001					2002				
Category	1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
BROU	26.8	22.6	30.0	19.3	1.3	14.7	15.8	20.2	27.3	22.0	9.6	15.9	14.9	31.9	27.7
Total banks under mgt.	76.9	7.7	5.4	3.4	6.6	67.1	8.7	8.5	5.1	10.6	17.7	8.7	21.1	22.7	29.8
Caja Obrera	66.6	13.6	7.5	4.6	7.7	51.4	15.0	12.7	7.7	13.2	10.5	5.8	19.8	34.6	29.3
Comercial	73.0	11.7	5.2	4.3	5.8	68.5	9.5	7.6	5.2	9.2	21.2	10.5	25.0	19.9	23.4
Crédito	63.7	5.7	11.1	3.8	15.7	59.1	5.9	12.0	4.3	18.7	20.3	5.9	21.6	23.3	28.9
Montevideo	84.8	6.0	2.9	4.2	2.1	83.0	6.1	4.0	4.2	2.7	9.3	9.7	11.9	22.7	46.4
Galicía	99.8				0.2										
Other private banks	76.9	6.2	5.3	5.6	5.9	71.2	9.2	6.1	6.3	7.2	48.7	12.2	10.3	11.3	17.4
Other financial institutions	70.5	12.2	6.7	7.3	3.3	82.6	7.8	3.0	5.0	1.6	61.7	5.0	15.4	11.1	6.8
Sav.&loan inst.	72.4	8.5	5.7	4.3	9.1	69.3	10.0	6.5	4.0	10.2	48.7	17.4	8.8	8.3	16.8

Source: Central Bank of Uruguay.
Information available on an annual basis only.

- 1.40 The quality of bank lending portfolios generally, and the loan books of the official banks and institutions under government control in particular, declined dramatically in 2002. In the second half of the year the SIIF took steps to strengthen local bank balance sheets, notably an increase, effective 31 December 2002, in the minimum capital required for an institution to operate as a bank, finance corporation, or savings and loan association to 190 million Uruguayan pesos (about US\$6.7 million), and an increase from US\$0.5 million to US\$4.5 million in the minimum capital required for an institution to transact with nonresidents. Equally important, the SIIF directed banks to restate their loan collateral values to reflect the impact of the peso devaluation and decline in value of the collateral, and to provision for any collateral shortfall. The provisions thus created by the banks in the last quarter of 2002 were one reason for the losses posted by the majority of institutions that year.
- 1.41 The government also has taken steps to make it easier for borrowers to honor their obligations. An arrangement worked out with the private commercial banks provides for voluntary refinancing of their loans to private-sector clients. The accord covers foreign-currency-denominated loans approved before June 2002 and being duly serviced at that date which currently are classed as past-due. Eligible loans are those made to “physical persons” (individuals, families, or microenterprises, small or mid-sized businesses).⁹ The agreement envisages mutually agreed interest-rate reductions, maturity extensions, and remission of penalty interest by the financial institutions. The State also offers tax relief for borrowers—for instance, Law 17,671 waives payment of VAT (23% base rate) on mortgage loan interest.

⁹ Though large companies are not expressly excluded, confining this initiative to “physical persons” in effect leaves out large firms, which are always legal persons.

- 1.42 At 31 December 2002 all private FIs (except the banks taken over by the authorities) reported equity/risk-adjusted assets ratios of 20.5%, on average, just over double the 10% required by the Central Bank in accordance with the Basle principles. At that same date all the private commercial banks and BROU were in compliance with SIIF capital requirements; only three system institutions (accounting for less than 4% of total system assets) asked to be given until December 2003 to complete their capitalization programs.
- 1.43 In the first four months of 2003, roughly 70% of loans made by private commercial banks that are operating normally in the market were being repaid on schedule (comparable to the 2002 year-end percentage), but nonperforming loans—more than eight months' overdue, borrowers rated insolvent—made up a higher share of loan books, having risen from 12.7% of the total outstanding in December 2002 to 16.8% by the end of April 2003. Difficulties in the real sector of the economy are the main reason for the mounting percentage of nonperforming loans.

Bank earnings

- 1.44 The complicated global macroeconomic panorama in 2002 and resulting deterioration in bank loan portfolios, the slide in overall financial intermediation volumes and the need for banks to hold high levels of liquidity to prepare themselves for deposit runs created considerable losses system-wide that year, as Table 1.7 illustrates. Other factors that eroded commercial banks' bottom lines were losses from fraud in some of the banks subsequently taken over by the authorities, overexposure to the Argentine market, the devaluation's impact on institutions with strong sold positions, and the restatement of asset and loan collateral values ordered by the Central Bank at the end of 2002 (see paragraph 1.39).

Table 1.7
Financial system earnings (US\$ million)

	Dec. 96	Dec. 97	Dec. 98	Dec. 99	Dec. 00	Dec. 01	Dec. 02
<i>Total earnings</i>	132.3	52.2	65.1	195.6	(90.4)	(445.0)	(3,099.3)
Total official banks	67.8	(24.7)	87.0	56.8	(205.5)	(412.6)	(1,318.5)
- BROU	32.1	13.1	50.1	52.7	9.8	6.5	(240.5)
- BHU	35.7	(37.8)	36.9	4.1	(215.3)	(419.1)	(1,078.0)
Total banks under govt. control	22.5	31.4	(29.0)	65.5	67.7	(101.3)	(1,542.9)
- Caja Obrera	1.6	3.7	1.4	1.8	0.3	(16.2)	(47.0)
- Banco Comercial	17.0	21.0	20.3	25.7	21.3	(171.8)	(709.4)
- Banco de Crédito	0.3	0.5	(58.7)	(0.7)	(1.9)	1.2	(110.0)
- Banco Montevideo	3.5	6.2	8.0	10.3	9.3	11.8	(676.5)
- Banco Galicia				28.4	38.7	73.7	-
Rest of private banks	21.8	28.5	(8.6)	53.5	35.5	59.3	(240.5)
Savings and loan inst.	10.9	7.8	4.2	0.2	1.3	1.8	(35.9)
Other financ. institutions	9.4	9.3	11.4	19.6	10.6	7.7	2.5

Source: Central Bank of Uruguay.
Information available on an annual basis only.

- 1.45 In 2002 cumulative banking system losses hit US\$3,099.3 million. They were particularly heavy in the official banks (US\$240.4 million for BROU, US\$1.078 billion for BHU) and the banks subsequently taken over by the authorities (Banco Comercial US\$709.4 million, Banco Montevideo US\$676.5 million, Banco de Crédito US\$110 million, and Banco Caja Obrera US\$47 million). BHU's large 2002 loss stemmed mainly from the impact of the late-June devaluation, since that bank's loans are denominated in "indexation units" that move with the mean wage index and the bulk of its liabilities were in dollars. The other private commercial banks posted accumulated losses of US\$204.5 million in 2002, the bulk of them incurred in the final quarter when banks had to substantially boost their loss provisions to comply with the new SIIF requirements.
- 1.46 The persistence of recessionary conditions until at least mid-2003 and, above all, the sharp downturn in bank business system-wide will continue to squeeze bank profits this year, forcing most institutions to restructure to some degree to adjust their cost structures to the anticipated new market realities in the short and medium term. This may well prompt some of the smaller institutions to exit the market, given the slim prospects for breaking even in a reasonable timeframe.
- 1.47 Only three banks earned a profit between January and May of this year: ABN-AMRO (US\$5.25 million), Banco Galicia (US\$47.8 million), and Creditanstalt (US\$1.6 million). Lloyds Bank broke even; the other banks posted losses. As a group, then, the private commercial banks will come out even at the end of May 2003 as far as earnings are concerned. However, the profits reported by Banco Galicia (which is still under government control) came from restatements—exchange differences and inflation adjustments. In the current global macroeconomic climate it is reasonable to view as normal the approach taken by the banks that have continued to operate as usual and are still restructuring (for example Banco ACAC, S.A.-Credit Agricole, Citibank, Banco Bilbao Vizcaya Argentaria Uruguay, S.A., Banco Santander, and Bank of Boston), which reported losses of varying magnitudes, and to assume that these losses will slow toward the end of this year once the bank restructurings are complete.
- 1.48 Regarding State-owned banks, both BROU and BHU continued to run losses in early 2003. BHU reported US\$123 million in first-quarter losses, leaving it with a capital deficiency of US\$36 million at the end of March. BROU lost US\$2 million in January 2003 (most recent data available). The government thus is looking at a US\$250 million capital infusion for BHU (funded mostly with the World Bank loan proceeds) and for BROU (in the context of the IMF accords) using money left in the Bank System Stabilization Fund (see paragraph 1.22).
- 1.49 One positive element in this otherwise clouded picture of bank system profitability is that the devaluation since mid-2002 has helped sharply drive down the system's dollar costs (principally wages), which indubitably will help boost bank earnings.

5. Bank regulation in Uruguay: the main issues

- 1.50 The 2002 developments described above spotlighted weak points in the banking laws as to avenues for resolving the situation of faltering banks as well as gaps in prudential regulation of such matters as kinds of risk addressed, risk concentration and classification, and the inadequate safeguards in place to deal with distressed banks. For instance, under the existing regulations, interbank lending was not treated as carrying any risk, nor was lending to the public sector; consequently, there were no exposure limits in either case. The collateral offered by a prospective borrower carried heavy weight in the appraisal process; however loan officers looked only at credit risk, ignoring other contingencies such as country risk and price risk or exchange risk in the borrowing company. There were weaknesses as well in prudential rules governing loan concentration limits, nonresident deposits, and related-party lending. It was largely because of these shortcomings that FI liquidity and solvency problems escalated so quickly when the crisis erupted.
- 1.51 The mounting numbers of troubled banks as the crisis unfolded also pointed out weaknesses in the SIIF's organizational structure and operating capacity, which were keeping it from discharging its full supervision mandate. One serious constraint was the agency's outdated functional structure, which needed revamping to be able to keep up with rapidly evolving international bank oversight practices. In its analysis, the Bank found that the SIIF did not segregate certain supervision tasks that were so numerous and specialized as to require skilled personnel assigned full-time (risk analysis, nonbank supervision, etc.). Furthermore, because of a huge increase in workload the SIIF has been unable to conduct comprehensive preventive examinations on a regular and frequent-enough schedule; instead, it has had to confine itself almost exclusively to precautionary inspections of noncompliant banks. Likewise, given the transaction volumes and complexity of today's fast-moving banking industry it is essential that the SIIF bolster information-technology support for its supervision work, adopting tools with which to optimize offsite surveillance tasks and to evaluate more closely the workings of information technology in financial institutions.

C. The Bank's strategy and participation

1. The Bank's country strategy

- 1.52 The overarching objective of the Bank's strategy with Uruguay (country paper, document GN-2119-1 of 27 September 2000) is to provide support for government policies and development programs pursuing sustained GDP growth with enhanced social equity while maintaining macroeconomic stability. Priority focuses of Bank operations support are: (i) initiatives to make Uruguayan output more competitive regionally and globally and spur private investment, looking to the country's comparative advantages and to modern technology to position it more solidly in regional and world markets; (ii) reform and modernization of the State to lessen the official sector's role in the economy, increase its efficiency, rationalize and target

its interventions, and reduce its incidence on the cost of producing goods and services in the country, and (iii) moves to improve societal welfare and enhance equity, bringing the most vulnerable segments of the population into the development mainstream and improving their quality of life.

- 1.53 The proposed program fits with this strategy inasmuch as it will help achieve the first of the objectives outlined above. The aim is to assure lasting stability of the financial system so that it can once again become the premier vehicle for mobilizing domestic savings and thereby spur private investment and help revive the economy.

2. Previous Bank support for the financial sector and lessons learned

- 1.54 Since the early 1990s the Bank has provided support for a number of major financial-sector operations in Uruguay. Overall, their purpose was to help stabilize the financial system, with a specific focus on financial-market deepening. In 1991 the Bank approved loans 626/OC-UR and 664/OC-UR for a finance sector program which pursued the following objectives: (i) help maintain a pro-growth macroeconomic environment with price stability; (ii) assist in external debt reduction and restructuring initiatives; (iii) improve financial institution (FI) efficiency and competitiveness; and (iv) create a regulatory framework that would assure adequate FI solvency and liquidity levels. Substantive amendments to the Central Bank's charter as a result of the program gave that agency more managerial independence and created a bank supervision line with a Superintendency of Financial Institutions (SIIF) independent of Central Bank senior management. A new financial intermediation law broadened the scope of commercial bank activity and introduced the principle of consolidated, centralized supervision of the various financial-system markets, giving the Central Bank sole regulatory authority over them all. A number of Central Bank rules were rewritten in order to safeguard financial-intermediary solvency; a uniform chart of accounts was brought in for banks; progress was made on bringing government-owned banks into compliance with regulations governing banks in general; and steps were taken to reorganize the official banks' functional structure and procedures to make them more efficient and competitive.
- 1.55 Also in 1991 the Bank approved a global credit program for microenterprise and small business (loan 614/OC-UR) designed to make credit more readily available to such businesses. In a parallel technical cooperation operation (ATN/SF-3601-UR) the Bank provided support to the National Development Corporation, the program's executing agency, for delivery of technical assistance and training to microenterprises and small businesses and to promote and coordinate the credit program with financial intermediaries and the Central Bank, the program's fiscal agent. This program was successfully completed and, as of the end of 2002, the US\$7 million in original loan recoveries had been relent to microenterprises and small businesses in credits totaling US\$35.4 million and averaging US\$10,219.

- 1.56 In 1992 the Bank approved the first multisector global credit program (loan 705/OC-UR) for US\$90 million; the final disbursement was released in 1998. The last disbursement for the US\$155 million second multisector program (1155/OC-UR) approved at the end of that year was made in 2003. The third multisector operation (1407/OC-UR) for US\$180 million approved in 2002 is already over half disbursed. The object of these programs is to help supply private businesses' medium- and long-term finance needs, helping to make up for insufficient medium- and long-term savings mobilization in the domestic financial market. To that end, such programs help deepen financial markets by encouraging financial intermediaries to get into the business of lending at medium and long term for private-sector productive investment projects, and spur the creation of new financial products institutionally suited for that purpose. The financing facility for private enterprise created in the Central Bank to be able to implement these global credit programs has introduced new products with each successive operation. To the first multisector program menu of investment and housing loans the second program added leasing and a maturity mismatch credit facility in financial intermediaries. More recent enhancements to the product list are export finance at terms longer than one year—a 2002 addition under the third multisector global credit program—and short-term export financing under the Foreign Trade Facility, approved by the Bank's Board of Executive Directors in December 2002. Thanks to these operations, 40% of Uruguay's financial institutions are now dealing in medium- and long-term investment finance for private companies—a marked change from the early 1990s when BROU had a virtual monopoly on investment lending.
- 1.57 The technical-assistance component of the social security reform sector support program (loan 921/OC-UR) approved by the Bank in 1996 funded, among other activities, technical assistance to create República AFAP (the first pension fund management company—AFAP) and the Central Bank's AFAP Oversight Office and to design and set up the AFAP regulatory and supervision apparatus. Today AFAPs are the leading institutional investors in Uruguay's capital market, with the equivalent of 10% of GDP in worker pension savings under management.
- 1.58 Several other operations have been funded with Multilateral Investment Fund (MIF) resources. Technical-cooperation operation ATN/MT-6098-UR approved in 1998 provided support for the regulatory and supervision functions of the Superintendency of Insurance and of the Securities Market, which operate within the Central Bank. This MIF operation was crucial to enable these areas responsible for nonbank oversight to improve their procedures, train staff, and introduce new products to aid their work. Through that operation, the Bank supported the design of a financial stress evaluation model for banks, for preventive supervision. The SIIF is already applying that model in its regular offsite control procedures.
- 1.59 That same year saw the approval of a subordinated loan (10/MS-UR) to the financial cooperative Federación Uruguaya de Cooperativas de Ahorro y Crédito (FUCAC) which specializes in lending to microenterprises and small businesses, so

it could expand its credit lines to this business segment. Approved in tandem was technical-cooperation operation ATN/ME-6243-UR to improve FUCAC's microenterprise and small-business lending techniques and its overall operation. In 1999 the MIF approved operation ATN/ME-6741-UR for institutional strengthening of the nonregulated NGO Fundación Uruguay de Apoyo y Asistencia a la Mujer (FUAMM), followed by another in 2000 (ATN/ME-7312-UR) for Cooperativas Nacional de Ahorro y Crédito (COFAC), the country's leading financial cooperative. Implementation progress on these two ongoing operations is satisfactory.

- 1.60 In 2002 approval was given for the MIF to participate in the formation of Uruguay's first venture capital fund for small and mid-sized businesses, a joint enterprise with the National Development Corporation and Pegasus Venture Capital. The Fund has yet to be formally established but is expected to take shape shortly. Uruguay also was actively involved in two regional technical-cooperation operations approved in 2002 which provided support for creation and development of a financial investigations unit in the Central Bank and for training in South American Financial Action Task Force (GAFISUD) mutual evaluations (see paragraph 1.13), the aim being to develop institutional mechanisms to curb money laundering and other illicit financial practices.
- 1.61 Measures adopted with support from the above-described operations did a great deal to bolster Uruguay's financial institutions and deepen its financial system. However, considering the weaknesses the crisis brought to light and the fresh set of problems it triggered, it is the view of the government and the Bank that the system still has a way to go. The events of 2002 were not just a heavy drain on the treasury; they were serious enough to threaten the stability of the financial system and undermine confidence in the system at large.
- 1.62 The most important lesson the Bank has learned in its experience with finance-sector operations is that since these reform programs are complex exercises that take time to come together, support is best delivered via a succession of operations, each with its own specific, delineated objectives and with limited conditionality in terms of number of requirements but significant impact and content conditions. Those lessons have informed the operation proposed here, which focuses on a handful of interventions designed to deepen and cement bank regulatory reforms needed to improve crisis prevention and resolution.

D. IMF and World Bank activities in the financial sector

- 1.63 The program described here is part of a support package that the multilateral organizations pledged to deliver to Uruguay after the magnitude of its financial crisis became clear in mid-2002. Since the crux of the problem was bank system liquidity, the IMF took the leadership role in multilateral financial assistance to the country and the World Bank and IDB augmented their programs with new loans to supply additional financing and help further financial-sector structural reforms.

- 1.64 In June 2002 the IMF approved a US\$1.5 billion enhancement (still in effect) to the US\$745 million standby credit it had approved the previous March to help Uruguay restore its basic macroeconomic balances. The IDB operation proposed here is formulated within the framework of the Standby Arrangement.
- 1.65 Another facet of the IMF accord is a financial-sector structural reform program with the restructuring of Banco de la República Oriental del Uruguay (BROU) as its centerpiece. The authorities are committed to producing a plan for the restructuring of BROU's finances, which is expected to be ready at the end of this year (this being part of the IMF structural conditionality). One piece of the restructuring plan will be a business plan spelling out measures to strengthen the bank's financial statements, tackle the problem of nonperforming loans (about 60% of outstanding loans), and bring down the institution's operating costs. Two issues targeted for review are the interest rates paid on reprogrammed deposits, to align these with the lower rates being paid by the rest of the banking system, and the question of payroll reductions, for instance the issue of early retirements. The restructuring plan also is to describe how key aspects of BROU governance will be improved.
- 1.66 The World Bank has approved two operations for Uruguay's financial sector: a Special Structural Adjustment Loan (SSAL) for US\$101.2 million and a US\$151.5 million Structural Adjustment Loan. Disbursements of these two operations were tied to compliance with policy and reform conditionalities. Fiscal and debt-sustainability issues were the focus of the SSAL conditionality, including requirements to: (i) cut public spending, particularly the wage bill; (ii) raise taxes on wages and pensions; and (iii) curtail wage benefits in public enterprises.
- 1.67 The object of the Structural Adjustment Loan is to assist with the restructuring of the Uruguayan Mortgage Bank (BHU). The loan proceeds are to be disbursed in two tranches of US\$100 million and US\$51.2 million. The first tranche has already been released; conditions for release of the second tranche are as follows: (i) approval of a new BHU charter; (ii) due-diligence valuation of BHU's loan and investment portfolios; (iii) BHU board approval of a divestment plan with semiannual targets; (iv) approval of a new credit manual; (v) implementation of a new integrated information system; (vi) a BHU resolution on the phaseout of deposits; and (vii) development of a mechanism for Central Bank supervision and disciplining of State-owned banks.
- 1.68 The foregoing list points up the breadth and depth of the World Bank conditionality. A few setbacks notwithstanding, major progress has been achieved toward these conditions. The matrix called for a law to amend the BHU's charter; Law 17,596 to that end was passed on 13 December 2002. Another requirement (also in the IMF conditionality) was that the Central Bank be given disciplinary powers over the rest of the official banks; Law 17,613 of 27 December 2002 brought in that change. The BHU's deposit base on the tranche release date, not counting money on deposit under the advance-saving scheme, was not to exceed

US\$750 million; in late July 2003 BHU deposits totaled US\$141 million, including about US\$45 million in advance-saving deposits. The BHU restructuring plan—another matrix condition—has been approved and is being implemented, as is the strategic plan. Branches across the country have been closed and the BHU has launched the first stage of a reduction in force affecting 500 of its 1,350 employees.

- 1.69 By late August 2003 the following conditions had yet to be satisfied: (i) adoption of a new credit manual (condition IV): the manual was produced and approved, as planned, but is being revised because the World Bank found it to be insufficient; (ii) a due diligence process to assess the market value of BHU assets (loans and investments) (condition II): this condition is being fulfilled; and (iii) as a consequence of the status of condition II, the divestment plan (condition III) has not yet been implemented. In short: by the end of August 2003 conditions II, III, and IV either had not been fulfilled or had been fulfilled in part. The government expects to fully perform these conditions and secure release of the second tranche before the end of 2003.

II. THE PROGRAM

A. Objective

- 2.1 The objective of the proposed program is to assist in implementing reforms launched by the Uruguayan government to stabilize bank liquidity and solvency and rebuild depositor confidence in the country's banking system. The program will assist in the following: (i) preserving a macroeconomic environment consistent with achieving the objectives of the proposed program; (ii) stabilizing banks' financial condition; and (iii) strengthening of bank regulation and supervision.

B. Action areas

- 2.2 The Bank would disburse the proposed sector loan over a span of not less than 18 months counted from the loan contract signature date. The loan proceeds would be disbursed in three tranches, the first in the amount of US\$80 million and the second and third for US\$60 million each, after verifying that the respective tranche release conditions had been fulfilled. The disbursement arrangement is front-loaded because of the importance of the measures already adopted as part of this program (see paragraphs 1.21-1.28) and because the first-tranche conditions form the critical mass of the operation.
- 2.3 The significant changes in banking industry operations called for in the reform package attest to the importance the government has accorded to strengthening the banking system, as evidenced in a number of substantive and costly initiatives since August 2002 in the framework of the present program, namely: (i) enactment of the Bank System Strengthening Law (LFSB) thanks to which depositors were able to access money in their sight and savings accounts despite the unfolding crisis; (ii) enactment of the Financial System Reform Law (LRSF) which among other measures modified bank exit mechanisms to enable the authorities to deal more expeditiously with foundering banks;¹⁰ (iii) liquidation of Banco Comercial, Banco Montevideo/Caja Obrera, and Banco de Crédito (see paragraphs 1.21-1.28); and (iv) the self-imposed decision to limit banks' public-sector exposure and provide for financial institutions to rate government financial assets just as they do for other borrowers. The following paragraphs outline the rationale and scope of the planned measures in each action area. The first-tranche conditions must be fulfilled in their entirety and a special account opened for loan proceeds before the proposed operation will be submitted to the Bank's Board of Executive Directors for approval.

¹⁰ The project team reviewed both laws and found them satisfactory.

1. The macroeconomy

- 2.4 Faced with the need to stabilize and begin revitalizing the economy the Uruguayan government launched an economic adjustment and macroeconomic reform program that has the backing of the IMF and the other multilateral agencies. The program is set out in the policy letter, as are the government's undertakings in this regard. The measures envisaged in the financial sector operation proposed here are considered crucial to remedy the crisis that has buffeted the financial sector and to correct institutional weaknesses that have been spotlighted in the process, in order to minimize the risk of recurrence of such episodes.

2. Banking sector stability and strengthening

- 2.5 When a financial crisis erupted in 2002 the government had to step in with a series of actions (see paragraphs 1.21-1.28) for which the program described here would provide support. Prompt and complete implementation of these measures is essential to restabilize and restore trust in the nation's banking system; this, in turn, is a sine qua non for the economy to rally and return to a steady long-range growth path. One of the program conditions devised to that end is that government-owned banks fulfill the reprogrammed-deposit commitment.
- 2.6 The crisis also severely weakened Uruguay's financial institutions, prompting the suspension of operations and/or liquidation of some of the country's leading banks. Now that the authorities have revamped the regulatory structure to make the financial system more resilient,¹¹ one requirement for enduring post-crisis stability of the system will be to devise and implement a strict compliance timetable for FIs that have not yet adopted the new structure. There is provision in the proposed program for monitoring official and private commercial banks' strict adherence to this timetable.

3. Strengthening of bank regulation and supervision

a. Legislation

- 2.7 In order to fill in gaps in financial system legislation (see paragraph 1.50) the government, as one piece of the reform package, amended the laws governing banking activity (see paragraphs 1.21 and 1.28). The rewritten legislation gives the Central Bank of Uruguay added bank prudential regulation powers and spells out procedures for resolving the situation of troubled banks, including institutions whose operations are taken over by the authorities.

¹¹ It will take a major effort to bring the official banks (BROU and BHU) into full compliance with the new system-wide regulatory framework that the proposed program will institute. Because those banks make up such a large part of the system their regulatory alignment is critical to achieve the program's objective of stabilizing bank-system solvency and creating a level playing field in the marketplace.

b. Prudential regulation

2.8 Just as the crisis drew attention to weak points in the country's banking legislation it brought to the surface weaknesses in bank prudential regulation (see paragraph 1.50), which are being perceived as a significant risk for Uruguayan financial-market clients. As part of the sector reform program targeted for support in the proposed operation the government and Central Bank plan to introduce and implement a plan to align these prudential rules to international best practices and standards in this sphere. Among the specific issues the plan will address are the following:

- a. Risk concentration: (i) country-concentration ceilings to limit an FI's total exposure in any one country. This limit, which applies both to loans to and investments in the country, will vary depending on the country's investment grade or rating; (ii) lowering of the current ceiling on loans that may be made to a single nonpublic, nonfinancial sector borrower, with provision for raising that limit for borrowers who have solid credit ratings or furnish adequate security; (iii) a limit on lending to any single financial sector or national government borrower. Previously there was no set limit for those sectors, so this ceiling is considered a major step toward uniform treatment of different financial-sector borrowers and is in itself a clear acknowledgment by the government of the need to strengthen the sector and rebuild confidence at home and abroad in the system's financial intermediaries; and (iv) lowering of credit-concentration limits for physical or legal persons having connections to the financial institution, differentiating (as always) for highly rated borrowers or those who can put up prime collateral.
- b. Credit rating and loss provisioning: (i) adoption of a new borrower rating methodology featuring improved criteria for banks to rate borrowers as good risks or poor risks;¹² (ii) a change in the weight given to loan collateral for provisioning purposes, the idea being that banks should create provisions for any loan not being repaid on time regardless of the security the borrower may have furnished; (iii) a new rule requiring all system banks to downgrade a borrower who is in arrears on a loan to any bank, to make for uniform treatment of high-risk debtors even if they are current on payments to one bank or another; (iv) setting of standards for implicit foreign exchange risk appraisal and provisioning; at the moment, Uruguayan banks are not rating this risk, which is widespread in the country's highly dollarized banking system, even though some borrowers do not generate foreign currency with which to repay obligations contracted for in U.S. dollars; (v) setting of country exposure ceilings to limit exposure in any one country depending on its rating, as noted earlier; and (vi) increased provisioning to reflect a decline in the realization value of collateral. This increase is the natural corollary of reducing the weight given to

¹² Pursuant to a new rule adopted in December 2002 banks began rating government borrowers, which previously had not been considered to entail any risk.

collateral and the time that elapses before banks re-provision for past-due collateralized loans.

- c. Minimum capital requirements: (i) a new requirement to calculate asset inflation adjustments (annual comparison of the inflation-adjusted value of real property and its market value) in order to mark assets to market, to be able to demand capitalization when such prices are substantively different from book inflation adjustments; (ii) consideration of price risk, to ascertain whether capital leverage is adequate for market fluctuations relative to investment in tradable securities; (iii) consideration of foreign exchange risk; and (iv) consideration of interest rate risk, for the purpose noted in point (ii).
 - d. Liquidity requirements: (i) higher requirements than the current ones for nonresident deposits in view of their demonstrated volatility, and (ii) review of the asset and liability matching rule for operations over three years.
 - e. Consolidated supervision: (i) mandatory consolidated exposure limits; and (ii) creation of a database of information on nonbanks having connections to the financial institution.
 - f. Transparency: (i) financial information disclosure (speedier and more detailed reporting); (ii) disclosure of solvency, profitability and performance ratios and other indicators, and (iii) publication of names of financial institutions' shareholders and senior officers.
 - g. Comprehensive risk management: setting of minimum comprehensive risk management standards (not necessarily by adopting Basle II) to equip the sector for integrated management of its activities and so that the SIIF can institute management standards once criteria and measurement methods for these have been developed.
- 2.9 As discussed earlier, the aim of most of the proposed reforms is to align Uruguayan bank prudential regulation to international best practices and standards in this sphere. Some of the other reforms target specific problems in Uruguay's financial sector which came to light mostly following the 2002 crisis and heightened the upheaval. For instance, there were no reserve requirements on offshore nonresident deposits, so in practice there were no liquidity requirements for these deposits even though, as was noted earlier, they were known to be very volatile especially when market conditions shift. Since Uruguay receives substantial inflows of nonresident savings and does not want to discourage this influx by increasing operating costs, it opted for minimum liquidity requirements for aggregate nonresident deposits, directing that 30% of such deposits be invested in a menu of safe, liquid income vehicles.
- 2.10 The heavy element of Argentine exposure (whether direct or via a financial group) in the assets of many Uruguayan banks also helped spark and stoke the crisis. This

came into play particularly in Banco Galicia, Banco Comercial, and Banco Montevideo/Caja Obrera. Virtually all of Banco Galicia's assets were in Argentina; Banco Comercial had a very large exposure in Argentine government securities, and Banco Montevideo/Caja Obrera had high exposure to the nonresident financial sector in the Cayman Islands in a bank belonging to the same financial group, from which loans were triangulated to Argentina. This overexposure to Argentine risk was abetted by the absence of regulation governing not just borrowers' country of residence but also risk concentration limits specifically for government debt securities and lending to the financial sector. Accordingly, one facet of the program proposed here is a plan to limit country exposure and risk concentration in government securities and loans to the financial sector.

- 2.11 Uruguayan banking regulations require financial institutions to create loss provisions only for the uncollateralized portion of a loan. The financial crisis brought home not just the sharp declines in dollar value of collateral, especially real estate, but also how difficult it is for banks, both politically and practically, to foreclose on collateral during episodes of crisis. Consequently, the present program proposes to boost loss provisioning through steps to lower the realization value calculated for eligible collateral.
- 2.12 Lastly, because Uruguay's banking system is so heavily dollarized, with the concomitant effects and risks for bank lending to the nontradable sectors (which take in revenues in Uruguayan pesos), criteria would be set via the proposed program for FI appraisal and provisioning for implicit foreign exchange risk for foreign-currency-denominated loans.

c. Bank system supervision

- 2.13 If the measures being adopted to bolster Uruguay's banking laws and prudential regulation are to work, the Superintendency of Financial Institutions (SIIF) will need to be strengthened, notably to improve its organizational structure, procedures, and operating capacity. One part of the proposed program is a specific action plan for the SIIF to effect the required changes and be given the technical and human resources it needs to discharge the added responsibilities falling to it by virtue of reforms brought in via the program proposed here, including checks of the technical caliber of that work. Among the planned functional and procedural reforms are:
 - a. Creation of a Market Risk Unit, which will decide which risks need to be analyzed in the supervision exercise, with procedures designed for these appraisals. The idea is to assess the impact of relative price changes on the economic value of an FI's capital, assets, liabilities, and earnings.
 - b. Creation of a Methods Unit to develop and systematize supervision procedures and align them to current international standards.

- c. Creation of a Nonbank Institutions Unit to handle supervision of currency exchanges, nonbank credit card issuers, advance-saving circle administrators, and agents.
 - d. Creation of a Credit Risk Unit to perform offsite surveillance functions and assist bank examiners in their onsite work.
 - e. Creation of a Technological Risk Unit to entrench the use of Control Objectives for Information and Related Technology (COBIT) standards in the SIIF's information-technology assessments.
 - f. Institution of procedures for the use of electronic supervision tools, training supervisors to use Advanced Computational Languages (ACL) in their monitoring and data management work in bank inspections.
 - g. Development of a database of financial conglomerates and operational coordination of bank supervision with the work of insurance and securities regulators. This will include information on nonbanks having ties to financial institutions.
- 2.14 The SIIF will add to its internal control procedures a program for quality-control reviews (compliance audits) of its regular FI examinations, which are to be conducted of every institution at least every 18 months. This will include checks to ascertain whether all examination procedures were followed and reports produced pursuant to the respective terms of reference, with the requisite scope, and a review of their technical quality. The checks will be done on large samples of total inspections performed the immediately preceding year. The review findings will be accompanied, where applicable, by recommendations to the Superintendent on corrective measures considered necessary. In the proposed program, all externally reviewed bank inspections must have been found to be satisfactory by the Bank. An exception of a single bank will be permitted, but it cannot be one of the State-owned banks. A further aim here is to subdue the State's inherent conflict of interest as both owner of the official banks and their regulator (via the SIIF), since the quality of examinations performed of official banks must be audited by independent external reviewers.

C. Conditionalities

1. Measures already taken within the framework of the program

- 2.15 **Stabilization of bank finances:** (i) enactment of Law 17,523 (Bank System Strengthening Law—LFSB) (see paragraph 1.21), and (ii) liquidation of Banco de Crédito, Banco Comercial, and Banco de Montevideo/Caja Obrera and assumption of the latter two banks' residual assets and liabilities by Nuevo Banco Comercial (NBC), which has been in full compliance with current prudential regulations since it began operating (see paragraphs 1.23-1.26).

- 2.16 **Strengthening bank regulation and supervision:** enactment of Law 17,613 (Financial System Reform Law—LRSF) which updated banking legislation in accordance with the program targets in this area (see paragraph 1.24).

2. First-tranche conditions

- 2.17 **The macroeconomy:** macroeconomic performance conducive to achieving the proposed program's objectives.

- 2.18 **Stabilization of bank finances:** (i) payment of interest and of reprogrammed deposits adhering strictly to the LFSB compliance timetable, and (ii) Central Bank report on FIs targeted for the alignment program because they are not yet in compliance with new prudential rules.

- 2.19 **Strengthening bank regulation and supervision:**

- a. **Prudential regulation:** entry into force of changes agreed on with the Bank regarding prudential regulation of FIs, pertaining to: (i) risk concentration, (ii) minimum capital requirements, (iii) liquidity requirements, (iv) consolidated supervision, (v) credit registry, (vi) information technology issues, and (vii) borrowers' financial reporting.
- b. **Banking supervision:** (i) approval and launch of a work plan agreed on with the Bank for organizational adjustments of SIIF inspection and audit procedures and for institutional strengthening of the agency, and (ii) Central Bank approval and launch of an FI audit and inspection plan calling for regular examinations of every FI and independent external quality reviews of a significant sample of the examinations conducted (compliance audits).¹³

3. Second-tranche conditions

- 2.20 **The macroeconomy:** macroeconomic performance conducive to achieving the proposed program's objectives.

- 2.21 **Stabilization of bank finances:** (i) payment of interest and release of reprogrammed deposits adhering strictly to the LFSB compliance timetable; (ii) submittal to the Bank of December 2003 audited financial statements of the Recovery Trust Funds, and (iii) Central Bank approval of an alignment program for FIs that have yet to comply with the new prudential regulations, and a compliance timetable.

¹³ A "significant sample" is considered to be no fewer than 30% of the financial institutions holding at least 75% of total assets in the system. The sample must include BROU and NBC.

2.22 **Strengthening of bank regulation and supervision:**

- a. **Prudential regulation:** full enforceability of the first-tranche FI prudential regulation changes and entry into effect of changes regarding: (i) credit rating and loss provisioning; (ii) transparency, and (iii) comprehensive risk management standards.
- b. **Banking supervision:** (i) SIIF work-plan timetable adhered to and audit and examination manuals updated accordingly, and (ii) periodic inspections conducted of FIs accounting for the equivalent of 75% of financial system assets. Inspections of BROU, NBC and two other banks are to have been externally reviewed for quality. All the examinations evaluated but one (which cannot be BROU or NBC) must have been found to be satisfactory to the Bank.

4. Third-tranche conditions

2.23 **The macroeconomy:** macroeconomic performance conducive to achieving the proposed program's objectives.

2.24 **Stabilization of bank finances:** (i) payment of interest and release of reprogrammed deposits adhering strictly to the LFSB compliance timetable; (ii) submittal to the Bank of December 2004 audited financial statements of the Recovery Trust Funds, and (iii) satisfactory completion of the alignment program for FIs that were not yet in compliance with the new prudential standards, and adherence to the compliance timetable.

2.25 **Strengthening of bank regulation and supervision:**

- a. **Prudential regulation:** maintenance and enforceability of the first- and second-tranche FI prudential regulation changes.
- b. **Banking supervision:** (i) SIIF work-plan timetable adhered to and pertinent manuals in use, and (ii) periodic inspections conducted of FIs accounting for the equivalent of 100% of bank system assets. Inspections of BROU, NBC and three other banks (not the institutions considered for the second tranche) must have been externally reviewed for quality control purposes. All the examinations evaluated, for both the second and the third tranches, but one (which cannot be BROU or NBC) must have been found to be satisfactory to the Bank.

D. Cost and financing

2.26 The Bank would provide US\$200 million in funding for the proposed program, to be disbursed in three tranches of US\$80 million, US\$60 million, and US\$60 million. The approximate tranche release dates would be November 2003 for the first tranche, May 2004 for the second tranche, and one year later (but at least 18 months after signature of the loan contract) for the third tranche. The Bank will release the funds for each tranche when the government has fulfilled the

conditions outlined in this proposal and its annexes and prescribed in the loan contract. The total loan amount was arrived at by consensus between the Uruguayan government and the Bank in light of the country's requirements and the Bank resources available for policy-based loans.

- 2.27 The Bank will support the planned Central Bank actions in the areas of regulation and supervision through technical cooperation funded with resources available in the multisector credit operation, which will be partially financed with Bank resources. The Central Bank has requested approximately US\$4 million for this technical cooperation. For this purpose, Uruguay asked the Bank to make the pertinent changes to the contract; once the Board approves this sector operation, Management will prepare the corresponding amendatory contract.

III. PROGRAM IMPLEMENTATION

A. Borrower, guarantor, and executing agency

- 3.1 The borrower and guarantor for the operation would be the Eastern Republic of Uruguay. The executing agency would be the Ministry of Economic Affairs and Finance (MEF) which would work in coordination with the Central Bank. The Central Bank, whose activities are the object of most of the measures and reforms called for in the program, would head up technical elements in the program, while the Ministry would be responsible for the macroeconomy and operational aspects of the project.

B. Program implementation and administration

- 3.2 The Minister of Economic Affairs and Finance, as head of the program's executing agency, would be responsible for: (i) depositing loan proceeds in separate, specific accounts, which cannot be used to procure goods on the negative list in the loan contract or goods from countries that are not members of the IDB; (ii) supervising execution of program activities; (iii) preparing progress reports for submittal to the Bank; (iv) submitting tranche release requests and disbursement requests providing, as applicable in each case, the documentation required to verify that the respective tranche conditions have been satisfied; and (v) creating and keeping accounting and operations records on the program in areas for which the MEF has responsibility. The Central Bank's formal acceptance of these responsibilities will be evidenced in a letter of agreement to be signed by the Central Bank and the MEF.

C. Procurement

- 3.3 The quick-disbursing funds from the financial sector loan may be used to finance the aggregate cost, in foreign currency, of eligible imports from IDB member countries. In this case, Bank procedures on sector loans would apply, which do not require international competitive bidding.

D. Implementation timeframe and disbursement timetable

- 3.4 The timeframe for disbursement of this sector loan will be not less than 18 months counted from the loan contract signature date, as mandated by the Board of Governors for policy-based loans (AG-1/02).

E. Monitoring and evaluation

- 3.5 The operation will be monitored by way of progress reports delivered to the Bank by the MEF on ongoing program activities. In addition, with each tranche release request the MEF will provide the Bank with a special report and documentation demonstrating that each of the conditions precedent agreed upon with the Bank for

that tranche has been satisfied. The project team will review the information and reports to ascertain whether the conditions have been performed and will prepare tranche release reports for the Bank's Board of Executive Directors.

- 3.6 In addition to the above requirement, the project team is of the view that an impact evaluation of the program should be conducted six years after its completion, focusing on an analysis of the stability and performance of the reforms instituted through the program and achievement of the impact indicators devised when the operation was designed. Inputs for the evaluation would be: (i) program progress reports; (ii) tranche release reports; (iii) project completion report; (iv) Central Bank financial system statistics; and (v) any ad hoc studies on specific issues that were produced in the course of the operation. The Uruguayan authorities have indicated that they are prepared to keep the necessary technical records and collaborate in the technical aspects of the evaluation. It is recommended that the Office of Evaluation and Oversight (OVE) add this evaluation to its work plan, at an estimated cost of US\$250,000.

F. Inspection and supervision

- 3.7 The Bank will establish the inspection procedures needed to assure satisfactory implementation of the program. The Bank reserves the right to request financial reports on the program's accounting records, audited by the Office of the Auditor General. The borrower will cooperate fully with inspection requirements and will assist the auditors and provide them with information needed for their work.

G. Policy letter

- 3.8 The Bank and the Uruguayan government are agreed on the macroeconomic and sector policies set out in the policy letter (Annex III) sent by the government to the Bank, which describes the central focuses of the strategy and policies the government is pursuing in the banking sector and contains the government's undertaking to address itself to the reforms and measures agreed on with the Bank.

IV. VIABILITY AND RISKS

A. Viability of the program

- 4.1 In the project team's assessment, the requisite economic and financial conditions are in place for execution of the program activities as envisaged, and the institutions responsible for their implementation have sufficient financial and technical capacity to carry them out as and when planned.

B. Environmental and social review

- 4.2 Since all the proposed activities involve institutional and legal reforms for the financial system, this operation will have no direct impact on the environment. It is neither a poverty-targeted investment nor a social equity enhancing project. The operation was reviewed by the Committee on Environment and Social Impact on 20 June 2003. This loan proposal incorporates the Committee's recommendations.

C. Benefits and risks

- 4.3 The most important benefits that are expected to ensue from achieving the program's objectives through the measures and reforms targeted for support will be the program's contribution to: (i) solidifying bank liquidity and solvency and (ii) bolstering bank system regulation and supervision capacity through the system's policy-maker and regulator, the Central Bank.
- 4.4 The operation's chief risk would be any weakening of the Uruguayan authorities' resolve to bring in the proposed reforms effectively and quickly enough and to sustain them. In view of the authorities' actions to date and their unfaltering decision to put through such sensitive, costly measures as liquidating banks whose operations had been suspended, the project team considers such a risk to be low and acceptable.
- 4.5 Another significant risk would be that government-owned banks might be unable to satisfy in full and on schedule the technical-ratio requirements in the additional prudential rules the program would bring in, or might not keep to the LFSB timetable for release of reprogrammed deposits. However, from all indications the authorities are working very actively with the IMF (see paragraph 1.63) to attenuate this risk, the serious consequences of such a scenario being clearly understood.

D. Poverty and social equity classification

- 4.6 This operation does not qualify as a social equity enhancing project, as described in the indicative targets mandated by the Bank's Eighth Replenishment (document AB-1704), nor does it qualify as a poverty-targeted investment.

**SECTOR PROGRAM TO STRENGTHEN THE BANKING SYSTEM
(UR-0150)
CONDITIONALITY MATRIX**

ACTION AREA	PROBLEM	PROGRAM ACTION TARGETS	IMPACT	MEASURES ADOPTED	TRANCHES		
					I	II	III
1. Macroeconomy	A three-year recession and the aftermath of the 2002 financial crisis have hurt the country's basic macroeconomic balances.	Maintenance of the enabling macro-economic environment laid out in the policy letter.	Restore macroeconomic balance.		1. Macroeconomic environment conducive to achieving the proposed program's objectives.	7. Macroeconomic environment conducive to achieving the proposed program's objectives.	13. Macroeconomic environment conducive to achieving the proposed program's objectives.
2. Stabilization of bank finances	The recent financial crisis triggered a severe liquidity crunch and impaired bank asset quality, seriously eroding depositor confidence and making it difficult for the productive sector to secure financing.	Release on schedule of reprogrammed deposits.	Help stabilize bank liquidity and solvency.	Passage and entry into force of Law 17,523 (Bank System Strengthening Law—LFSB).	2. Payment of interest and release of the reprogrammed deposits adhering strictly to LFSB timetable.	8. Payment of interest and release of reprogrammed deposits adhering strictly to LFSB timetable.	14. Payment of interest and release of the reprogrammed deposits adhering strictly to LFSB timetable.

ACTION AREA	PROBLEM	PROGRAM ACTION TARGETS	IMPACT	MEASURES ADOPTED	TRANCHES		
					I	II	III
	The presence of suspended banks could create situations of moral hazard and foster a culture of default.	Resolution of situation of suspended banks (Banco Comercial, Banco Montevideo/Caja Obrera, Banco de Crédito).		Liquidation of Banco de Crédito, Banco Comercial, and Banco de Montevideo/Caja Obrera and assumption of the latter two banks' residual assets and liabilities by Nuevo Banco Comercial, which from the outset has been fully compliant with current prudential regulations.			
2. Stabilization of bank finances	Some institutions not in compliance with a regulatory framework strictly aligned to international standards in this sphere.	Alignment of all system banks to new, up-to-date prudential regulation that is concordant with international standards in this sphere.	Progressive strengthening of bank system liquidity and solvency.		3. Central Bank report on FIs targeted for the alignment program because they are not in compliance with the new prudential regulations.	9. Central Bank approval of alignment program for FIs that have yet to comply with the new prudential regulations, and a compliance timetable.	15. Satisfactory completion of the program to align still-noncompliant FIs with the new prudential regulations, and adherence to the compliance timetable.
3. Strengthening of bank regulation and supervision	Inefficiencies in banking legislation created significant delays in resolving the situation of foundering FIs, at a high cost to the treasury and depositors and consequently increasing the perception of legal uncertainty of the system.	Updating of legislation governing exits of financial institutions (FIs) generally.	Strengthening of mechanisms for resolving the situation of problem banks.	Passage and entry into force of Law 17,613 (Financial System Reform Law-LRSF) which updated banking legislation in accordance with the program targets in this area.			

ACTION AREA	PROBLEM	PROGRAM ACTION TARGETS	IMPACT	MEASURES ADOPTED	TRANCHES		
					I	II	III
	Weak prudential regulation, only partly aligned to international standards.	Alignment of prudential regulation with the most advanced international standards in this sphere.	Institution of a regulatory framework concordant with international standards (Basle Committee recommendations).		4. Entry into force of changes agreed on with the Bank regarding prudential regulation of FIs. See paragraph 2.19.	10. Full enforceability of tranche I changes regarding prudential regulation of FIs and entry into force of the new changes. See paragraph 2.22.	16. Tranche I and II changes regarding prudential regulation of FIs still in effect and enforceable.
3. Strengthening of bank regulation and supervision	Insufficient Superintendency of Financial Institutions (SIIF) rules and procedures for purposes of the new regulatory framework to be implemented via the operation proposed here and insufficient operational capacity for the SIIF's supervision tasks.	Institutional reorganization of the SIIF and strengthening of its supervision rules and procedures.	Strengthening of the SIIF's operational capacity to equip it to manage the new regulatory requirements.		5. Approval and launch of a work plan agreed on with the Bank to strengthen SIIF bank examination and audit procedures and for institutional strengthening of the agency.	11. Work-plan timetable adhered to and audit and inspection manuals updated accordingly.	17. Work-plan timetable adhered to and pertinent manuals in use.

ACTION AREA	PROBLEM	PROGRAM ACTION TARGETS	IMPACT	MEASURES ADOPTED	TRANCHES		
					I	II	III
			Improvement in quality of onsite supervision (bank inspections).		6. Central Bank approval and launch of an FI examination and audit plan calling for regular inspections of every FI (at least every 18 months) and independent external reviews of examination quality (compliance audits) for a significant sample of bank examinations conducted. ¹	12. Periodic inspections conducted of FIs accounting for the equivalent of 75% of bank system assets. External reviews are to be conducted to assess quality of examinations of BROU, NBC and two other banks. All inspections evaluated but one (which cannot be BROU or NBC) must have been found to be satisfactory to the Bank.	18. Periodic inspections conducted of FIs accounting for 100% of bank system assets. External reviews must have been done to check quality of examinations of BROU, NBC and three additional banks other than those considered in tranche II. All the inspections evaluated for both the second and third tranches but one (which cannot be BROU or NBC) must have been found to be satisfactory to the Bank.

¹ A “significant sample” is considered to be no fewer than 30% of the financial institutions holding at least 75% of total assets in the system. The sample must include BROU and NBC.

SECTOR PROGRAM TO STRENGTHEN THE BANKING SYSTEM (UR-0150)
IMPACT INDICATORS

Areas of activity		Proposed measures		Impact indicators	
Problem	Cause	Objective	Measures	Interim	Final
The recent financial crisis triggered a severe liquidity crunch and impaired the quality of banking system assets, seriously eroding depositor confidence and making it difficult for the productive sector to secure financing.	A crisis of confidence in bank system liquidity driven by: (i) the regional financial climate (Argentine crisis) and (ii) suspension of operations of the country's four leading private commercial banks because of liquidity and solvency problems.	Stabilize bank system liquidity and regain depositor confidence in financial institutions (FIs).	Passage and entry into force of Law 17,523 (Bank System Strengthening Law—LFSB).	Cumulative real annual increase in M3 of at least 3%, as a mark of restored confidence in the system.	M3 has continued to expand at least in line with GDP growth at current prices.
The presence of suspended banks could create situations of moral hazard and foster a culture of default.	Forbearance of banks' noncompliance with capital standards triggered, by association, a sharp decline in portfolio quality in the faltering banks.	Urgently resolve the situation of problem banks.	Liquidation of Banco de Crédito, Banco Comercial, and Banco Montevideo/ Caja Obrera and assumption of the latter two banks' residual assets and liabilities by Nuevo Banco Comercial (NBC), temporarily State-owned but privately run, which from the outset has been fully compliant with current bank prudential regulations.	Disposition of 30% of Recovery Trust Funds of the liquidated banks.	Disposition of 100% of Recovery Trust Funds of the liquidated banks.
Some institutions not in compliance with a regulatory framework strictly in line with international standards in this sphere.	The 2002 turbulence in the system weakened the financial condition of banks overall.	Progressive alignment of the country's State-owned and private commercial FIs with a regulatory framework tightly aligned to international standards in this sphere.	Timetable to bring all system FIs (BROU, BHU, NBC, private commercial banks) into compliance with new prudential regulations agreed on for this program with the Bank.	All institutions (including State-owned banks) are in full compliance with current prudential regulation (which includes all the measures introduced via the operation proposed here).	Significant (3% to 7%) improvement in the following indicators: <i>Capital strength:</i> Provision accrual/ Nonperforming loans (baseline 12/02: 43.4%);

Areas of activity		Proposed measures		Impact indicators	
Problem	Cause	Objective	Measures	Interim	Final
					<p>Nonperforming loans (gross and net)/Total outstanding loans (baseline 12/02: 28.2% and 18.4% respectively); and Provisions + realizable collateral/Total loans (baseline 12/02: 39.1%).</p> <p><i>Profitability:</i> ROA (baseline 12/02: -13.4%) and ROE (baseline 12/02: -186.9%).</p> <p><i>Efficiency:</i> Operating expenses/Assets (baseline 12/02: 4.9%).</p>
Inefficiencies in bank legislation created lengthy delays in resolving the situation of foundering FIs, at great cost to the treasury and depositors and creating the perception that the system did not afford full legal certainty.	Legislation then in force did not clearly spell out: (i) bank exit mechanisms; (ii) the scope of the Central Bank's authority for that task; or (iii) liability of government bank and private commercial bank officers and staff for the conduct of FI business.	Remedy weaknesses observed in the system's legal framework in order to minimize the social cost of resolving the situation of troubled FIs, thereby bolstering perceptions of the system's legal certainty.	Passage and entry into force of Law 17,613 (Financial System Restructuring Law—LRSF) which updated bank legislation in accordance with the program's targets in this area. This law: (i) defines the personal liability of bank executives and staff in the conduct of FI business; (ii) makes clear and broadens the scope of the regulator's authority to resolve the situation of foundering FIs; and (iii) spells out and adds to the mechanisms available to it for that purpose.	Consistent implementation of changes made in the situation of banks that experienced difficulties in 2002 (Banco de Crédito, Banco Comercial, Banco Montevideo/Caja Obrera, Banco Galicia y Buenos Aires and Cooperativa Financiera Caycu).	Reduction, from six to three months, of the time it takes to resolve the situation of institutions experiencing financial problems or not complying with the regulations.

Areas of activity		Proposed measures		Impact indicators	
Problem	Cause	Objective	Measures	Interim	Final
Weak prudential regulation, only partly aligned to international standards.	Weak prudential regulation enabled the system's institutions to become much more financially vulnerable.	Progressive strengthening of prudential regulation to align with international standards and best practices in this sphere (Basle Committee recommendations).	Changes to prudential regulation governing: (i) risk concentration; (ii) risk classification and loss provisioning; (iii) minimum capital requirements; (iv) liquidity requirements; (v) consolidated supervision; (vi) transparency, and (vii) comprehensive risk management.	All the new regulations are in force.	Fully implemented, more stringent prudential regulation creates significant (3% to 7%) improvements in the following ratios: <i>Liquidity</i> : Current assets/Current liabilities (baseline 12/02: 63.6%). <i>Capital strength</i> : capital adequacy ratio (baseline 12/02: 14.42%).
Insufficient Superintendency of Financial Institutions (SIIF) rules and procedures for purposes of the new regulatory framework to be implemented via the operation proposed here and insufficient operational capacity for the SIIF's supervision tasks.	In recent years the SIIF's operating capacity has not been strengthened sufficiently to equip it for the added responsibilities that will fall to it with the new regulatory framework.	Strengthen the SIIF's operational capacity to equip it to discharge the responsibilities falling to it under the new regulatory framework.	(i) Creation of the: (a) Market Risk Analysis Unit; (b) Supervision Procedures Unit; (c) Foreign Exchange Compliance Department, and (d) Credit Risk Unit. Development of a database on financial conglomerates and operational coordination of supervision work. Adoption of procedures for use of electronic supervision tools; (ii) implementation of a system to monitor number and quality of SIIF examinations of FIs through reviews, using sampling, of bank examination quality conducted by independent external experts (compliance audits).	Findings of 80% of a sample of external reviews conducted of at least 25% of bank examinations performed (following the new procedures approved via this operation) in the three years following release of the last tranche are satisfactory.	External reviews to monitor bank examination quality are now part of SIIF standard procedures and regular (every-18-month) inspections; findings of 95% of compliance audits of 25% of those inspections are satisfactory.