

MULTISECTORIAL CREDIT PROGRAM

(AR-0055)

EXECUTIVE SUMMARY

BORROWER: Argentine Nation
AND GUARANTOR:

EXECUTING AGENCY: Banco de Inversión y Comercio Exterior, S.A.
[External Investment and Trade Bank] (BICE)

AMOUNT AND SOURCE:	IDB: Ordinary Capital	US\$ 300 million
	Local counterpart funding:	
	BICE - Equity Capital	US\$ 100 million
	Financial Intermediaries	US\$ 100 million
	Cofinancing	<u>US\$ 300 million</u>
	Total:	US\$ 800 million

TERMS AND	Amortization period:	15 years
CONDITIONS:	Disbursement period:	4 years
	Commitment period:	3 years
	Interest rate:	variable
	Inspection and supervision:	1% of the amount loan
	Commitment fee:	0.75% per annum of the undisbursed balance of the loan

COFINANCING: The Argentine Government has requested a cofinancing of The Export-Import Bank of Japan.

OBJECTIVES: The Multisectoral Credit Program is designed to enhance the functioning of domestic medium term credit markets, thereby increasing the access to medium and long term credit to the productive sector. By using a newly formed, second tier financial institution that will eventually be privatized, limiting access to funds to the most creditworthy financial institutions, and pricing the funds at market rates, the Program is expected to have a catalytic effect on the development of securities markets (via securitization) reducing the role of the state in the provision of financial services, and providing an incentive for financial institutions to continue efforts aimed at improving their overall financial situation and operating efficiency as a means of gaining access to the program. Linking disbursements to the Government's program of

strengthening bank supervision will help assure that solid advances are made in this area.

DESCRIPTION:

The Multisectoral Credit Facility would provide a unique funding source for long term investment in Argentina. BICE, the executing agency, will operate as a second tier institution and will on lend these funds to a small group of carefully selected, "eligible", financial intermediaries. These, in turn, will on lend funds to support investment projects that require medium or long term financing. Funds can be used for financing investment projects, permanent working capital and export of capital goods. Lending decisions will be made by the eligible banks. The rates charged to eligible banks will be based on market rates for prime Argentine banks who are eligible for the program, while rates to the final borrower will be freely negotiated between the eligible financial institution and the final borrower. BICE will underwrite the risk of the eligible intermediaries while these will be responsible for all risks associated with the final borrowers.

**ENVIRONMENTAL
CLASSIFICATION:**

The Environmental Management Committee in its meeting of May 4, 1992, classified this project as a category III operation. The Environmental Summary was approved on October 29, 1993.

BENEFITS:

The Program will contribute to the overall development of financial markets in Argentina, provide needed investment funds to the private sector, and support the creation of a new, private sector oriented (and eventually owned) second tier financial institution. The funds are particularly needed for modernization and building competitiveness within argentine industry.

RISKS:

There are several risks in undertaking the proposed credit operation in Argentina. First, the supervision of financial institutions is considered weak, and it is therefore difficult to determine the true financial situation of the potentially eligible Argentine banks. Second, the proposed executing agency suffers from a number of organizational weaknesses, in part because it is a new organization with no experience in operating as a second tier institution. Third, there has been a tendency for the Government to attempt to transfer to BICE the responsibility for programs that do not correspond to second tier activities. Fourth, although the Government supports the eventually privatization of

BICE, a successful transfer of ownership to the private sector is not assured.

The program, if implemented as designed, should provide a number of concrete benefits to both the real and financial sectors of Argentina. This will require the commitment on the part of the Argentine Government to manage the Bank according to sound commercial practices.

In order to minimize these risks, the Project Team has established a series of conditions to be met at specified points in time to ensure that progress is being made in areas such as strengthening banking supervision. In addition the project team proposes a very close monitoring of the operation, conducting periodic reviews of BICE's execution of its Business Plan, eligibility requirements for participating financial institutions, and progress towards the privatization of BICE.

**THE BANK'S
COUNTRY AND
SECTOR STRATEGY:**

The Bank's strategy in Argentina has been divided into two stages. The first, recently completed stage, consisted of support for economic stabilization through a series of sector adjustment operations conducted in parallel with the World Bank in the area of public sector reform, promoting the privatization and/or concession of public enterprises and supporting the renegotiation of external debt. The second stage, initiated in 1993, consists of support for the investments necessary to consolidate past progress, investments which had stopped during periods of instability and were given low priority during the economic stabilization process. Such investments include those needed to improve the delivery of services to the social sectors, environmental protection and conservation, and those required both by the public sector and the private sector to improve the country's competitiveness in domestic and international markets.

I. OVERVIEW

A. Macroeconomic Situation

1. Current Economic Situation

- 1.1 The Government of Argentina is continuing the economic reforms (Cavallo Plan) initiated in April 1991. The Convertibility Law, instituted at that time, formally linked the Argentine peso to the U.S. dollar and effectively restricted the role of the central bank to that of a currency board -- linking the creation of base money to foreign exchange reserves. At the same time, the law prohibited the central bank from covering fiscal shortfalls, eliminating the virtually automatic monetization of government deficits that took place previously. As a result, the central government has had to reduce expenditures so that they remain in line with tax revenues (as supplemented by international borrowing and the privatization of state-owned assets). The program resulted in a sharp drop in inflation, improved fiscal accounts, lower domestic interest rates, and sizable capital inflows.
- 1.2 Over the past two years, the economy has experienced robust growth, boosted by a sharp rise in investment and consumption spending while inflation has declined from 1,343 percent in 1990 and to 9 percent in the 12 months to August 1993. The opening of the Argentine economy has led companies to shed workers in an effort to restructure and increase their competitiveness. At the same time, improved economic conditions have boosted labor force participation as previously discouraged workers reentered the labor force. This combination of events has contributed to a sharp increase in unemployment to the highest rate on record: 9.9% in May 1993.
- 1.3 Since the inception of the Convertibility Law, cumulative inflation has reached 43 percent (compared to 6.8 percent in the United States). As the exchange rate remained fixed, this resulted in a growing overvaluation of the Argentine peso that has hurt export competitiveness. In addition, domestic demand for consumer imports has risen sharply, up from five percent of total imports in 1990 to nearly 14 percent in 1991; capital goods imports have also increased. This led to a swing in the current account balance from a surplus of approximately US\$ 1.9 billion in 1990 to a deficit of US\$ 8.6 billion in 1992. Almost a quarter of the deterioration in the trade balance during this period is accounted for by a significant decline in trade with Brazil. However, this trend appears to have reversed, and a trade accord with Brazil in May 1993 will favor Argentine exports of primary and manufactured goods.
- 1.4 The central government has reduced the size of the public sector, undertaken an ambitious privatization program, and successfully negotiated a reduction of foreign debt via a Brady Plan operation supported by the Bank. An improvement in tax collection that has

led to a primary surplus. Nevertheless, excluding privatization receipts, revenues are still below the level of total expenditures (including interest payments on internal and external debt). In the future, as revenues from privatization diminish, the Government will increasingly be forced to rely on external financing, and has plans to float some major issues in international bond markets during the next several months to cover growing fiscal deficits. Meanwhile, the provincial governments, buoyed by an increase in tax revenues under existing revenue sharing arrangements with the central government, have not taken significant steps towards reducing expenditures and remain exposed to downturns in economic activity.

- 1.5 Owing to the perceived problem with exchange rate parity, there is increasing concern regarding the sustainability of the government's restructuring program unless domestic production costs are lowered sufficiently. A recession-induced change in relative prices may be necessary if the exchange rate mechanism cannot be adjusted without undermining the entire economic restructuring program. Under the Convertibility Law such an adjustment could occur if capital outflows led to a contraction in the monetary base thus driving up domestic peso interest rates and slowing economic activity. Although reserves have increased comfortably over the year, the recent sharp drawdown in September indicates the susceptibility of the program to changes in market perceptions of political and economic factors.
- 1.6 The government has already taken significant steps towards lowering domestic costs, and has proposed further labor reforms as well as the establishment of a privately funded pension system (which was approved by Congress in September 1993). These measures are combined with the *Pacto Fiscal* that aims to shift provincial taxes away from productive activities and replace them with local consumption taxes within three years. Steps have also been taken to shore up the agricultural and industrial sectors. In the agricultural sector -- which has suffered from high debt levels, falling commodity prices, and lack of an adequate infrastructure -- measures include lower taxes on imported capital goods and agricultural inputs, a lower tax burden, and proposals for debt relief.^{1/} Measures have also been introduced to protect those industries most affected by import competition. These measures include trade restrictions on textiles and paper products, the suspension of prepayment of asset taxes for some firms, and special incentives for exporters.
- 1.7 Real GDP is expected to grow by four to five percent in 1993, down from 8.7 percent last year. Relatively stable non-food prices

^{1/} A debt refinancing proposal for the agricultural sector would create a system of seven year loans from Banco de la Nación that will be backed by the value of land and carry a 7.9 percent annual interest rate, well below current market levels. Information on how the program will be funded, who will be eligible, and whether current lenders will be forced to bear part of the cost of rescheduling agricultural debts is not yet available.

could result in an inflation rate well below ten percent by year-end. The trade deficit is likely to stabilize around its level a year earlier on the strength of higher exports of primary and manufactured goods, and slower import growth. Lower international interest rates and the impact of the Brady deal may lead to a moderate improvement in the current account from a deficit of 3.8 percent of GDP in 1992. Strong capital inflows, supported by the sale of a majority interest in the state oil company, are expected to lead to an increase in international reserves to nearly one year of import cover.

- 1.8 The most recent IMF mission confirmed that Argentina was in compliance with the targets of their standby program but nonetheless expressed concern regarding the rapid growth of credit in the banking system, the impact of the Government's interest rate subsidy programs, and the lack of progress in dealing with bank supervision and the restructuring of public sector banks.

2. The Financial Sector

- 1.9 The decline in tariff and non-tariff barriers, is forcing many producers to invest in new technologies in order to reduce costs, increase productive capacity, and eliminate the severe production bottlenecks that exist throughout the real sector. Investment in these productive activities, where Argentina has comparative advantages, is essential for long-term economic growth. However, the high cost of credit, and more importantly, the scarcity of term lending facilities is impeding investment in productivity-enhancing plant and equipment. The required investment on the part of the owners of productive assets must be matched by a recapitalization and restructuring of financial intermediaries necessitating investment in the technologies needed to develop efficient, properly functioning markets for financial services.
- 1.10 Policy makers recognize that recent economic progress is at risk if financial sector reform is not achieved. As a result, they have committed to the implementation of policies to shore up the financial sector. These reforms, which were part of the conditions of a recent Investment Sector Loan granted by the Bank, include: (a) improvement in the quality of bank supervision through the development of better information systems and procedures; (b) restructuring of public sector banks, both national and provincial; (c) improvements in the legal and regulatory environment for securities markets; and (d) restructuring of the provincial pension system.
- 1.11 With the support of the Investment Sector Loan some progress has been made. A new Central Bank charter and a new Law of Financial Entities have been approved by the Congress and are being implemented. The Government has begun the process of dismantling several of the national public banks. The Banco Hipotecario Nacional has been converted to a second tier institution, the Banco Nacional de Desarrollo is being liquidated, and the Caja de Ahorros

y Seguros is in the process of being privatized. The Banco de la Nación Argentina has committed to a restructuring program and has begun taking steps to reorganize and downsize its operations. Less progress has been made with the restructuring of the provincial banks, where the central government has less direct control, but the almost automatic rediscounts with the central bank have been eliminated, which to some degree has forced the provincial banks to curtail credits to their governments. Regarding bank supervision, initial steps are being taken, but far greater efforts are needed (see Section I.A.3).

- 1.12 Despite recent improvements, the degree of competition in Argentine financial markets remains low. Due to a combination of high reserve requirements, the incidence of high levels of direct and indirect taxation on financial intermediation, and high staffing levels, the cost of providing banking services in Argentina is high. Charges for maintaining a checking account average US\$54 per month -- for a savings account with access to an automated teller machine, the average reaches almost US\$20 per month.
- 1.13 The high cost of financial services results in a very low degree of monetization in the economy. Only 15% of the adult population of Argentina use checking accounts. Fully 32% of the monetary base is kept in cash compared to 11% in Mexico and 8% in Chile. A significant proportion of savings is kept in dollars. Likewise the amount of money in the economy (as measured by M3) is only 1.9 times the monetary base compared to 9.2 and 7.3 times in Mexico and Chile, respectively. The additional transaction cost imposed on the banking system (and the Central Bank) in processing a large number of cash transactions cannot be ignored.
- 1.14 Due to these problems and a lack of appropriate banking technologies, the operating efficiency of Argentine banks (as measured by deposits per bank employee) is low by international standards. Total bank deposits per employee in Argentina in 1991 were US\$ 47,757, compared to US\$ 67,000 in Bolivia, US\$ 110,000 in Ecuador, and US\$ 196,000 in Chile.^{2/} The inefficiency of Argentine banks is even more marked when compared to countries such as Italy, Spain, France, or Canada, where the comparative figures are well above US\$ 1 million. While this is partially related to the transition from a hyperinflationary economy, the banking system must make greater efforts to adopt better technologies and provide more competitive banking services. The next several years should see considerable changes in how banks operate.
- 1.15 The portfolio quality of the country's financial sector also represents a hindrance to an efficiently functioning system. Irregular loans are very high as a percent both capital and total

^{2/} Source: Argentine Bank Association, 1991. Some improvement is expected to have taken place during the past two years. In addition, while we do not have precise data, the level of efficiency is considered to be far lower in the public sector banks than in the private banks.

loans. This is a particular problem at the public sector banks, although the restructuring efforts undertaken since 1991 appear to have led to some improvements. Table I.1 presents a breakdown by sector.

Table I.1: Argentine Financial Sector Portfolio Quality (Source BCRA: 6/30/93)			
	Total Capital (US\$ Millions)	Irregular Loans: % Capital	Irregular Loans: % Total loans
Banco de la Nación Argentina	1,843.6	50.9	8.8
Provincial Banks	2,396.4	238.5	29.2
Private - Domestic Banks	2,739.0	29.8	4.9
Private - Foreign Owned Banks	819.5	27.8	4.9
Private - Domestic Cooperative Banks	1,487.5	45.2	9.7
Finance Companies and Housing Banks	141.1	44.6	1.6
Credit Unions	45.7	11.4	5.4

- 1.16 The aggregate figures noted above hide a great deal of variation. Some commercial banks are considered to be well managed and efficient with high quality investment portfolios. These are the current targets for the multisectoral credit facility. Others will have to undertake significant restructuring programs (both financial and operational) before they can gain access to the Program funds. Strengthening bank supervision and providing the promise of long-term funding as an incentive should encourage these to undertake a comprehensive restructuring program. Finally, a number of the country's commercial banks may be unable to make the adjustments necessary to remain in business in a more competitive financial environment.

3. Program for Strengthening Bank Supervision

- 1.17 Strong bank supervision is particularly important to the success of this program. Without it, it is difficult to determine the true financial situation of potentially eligible financial intermediaries. The Superintendencia de Entidades Financieras (SEF), a division of the Banco Central de la Republica Argentina (BCRA) is responsible for bank supervision. The SEF faces several weaknesses. Among them are a focus on compliance rather than on portfolio quality and solvency, infrequent bank examinations, lack of follow-up between examinations, lack of coordination with the work of external auditors, outdated management information systems, lack of an adequate training program for supervisory personnel, and low employee morale.

- 1.18 The BCRA and SEF are aware of the problems that exist, and are attempting to deal with them despite lacking adequate resources for the task at hand. The SEF has begun the development of an early warning system based on the CAMEL (Capital-Asset Quality-Management-Earnings-Liquidity) system used in the United States. This is an important step, although the current version likely suffers from poor quality of the information presently available.
- 1.19 The BCRA has well developed plans for the development of modern management information systems across the central bank. The program is expected to cost US\$ 12 million, of which the World Bank is being asked to provide US\$ 5 million. Once finished, this will provide access to the basic information required for supervisory and regulatory systems. The current plans, however, do not go beyond basic access. Plans for the development of examination policies and procedures needed to assure the quality of the data, the creation of training programs, and the development of software required for analysis of available data have not yet been prepared.
- 1.20 Of equal importance, the SEF is being restructured. Several highly qualified individuals are being recruited to serve as deputy superintendents and direct examinations. Each deputy superintendent will have a team working with him/her. Salary levels at this senior level have been improved. Six of the deputy superintendents and their staff will form special teams assigned to work with one large bank (that could impose systemic problems) and a small number of "problem banks." Their work with these institutions will be on a semi-permanent basis, with examinations taking place at least quarterly. The seventh group will be in charge of the rest of the system. The BCRA is in the process of contracting these teams.
- 1.21 The establishment of the groups, the concentration of the critical players in the banking system, and the beginning of the development of information systems are positive steps. Unfortunately, well developed plans for the development of examinations standards and procedures, the adoption of generally accepted accounting and auditing principles, and the recruitment and training of the professional staff are still missing.
- 1.22 In addition, greater emphasis needs to be placed on confronting problems within the provincial and national banks. These are still considered "government" risk by BCRA/SEF regulators and all have been granted the highest risk rating available in the preliminary CAMEL system, despite the fact that most suffer from serious solvency, portfolio quality, efficiency, and profitability problems.^{3/} The BCRA holds, however, that competitive pressures from private banks has, to some extent, already sidelined the provincial banks, and that many will be privatized.

^{3/} It should be noted that none of the provincial banks would currently be considered eligible under the quantitative requirements being developed for this Program.

- 1.23 The diagnostic report on bank supervision presented by the IDB to the BCRA emphasized the need to take a new approach to supervision. In the future, SEF should concentrate its regulatory practices on the evaluation of portfolio quality, prudential practices, control systems or solvency, rather than on compliance with central bank regulations. Systematization of current regulatory practices, improving the quality of bank examiners, and making examinations more often will also help the process. Firm plans or timetables should be prepared for the development of supervisory standards and formal training.
- 1.24 Because of the lingering problems in the financial sector, and the importance of financial reform to the success of the overall economic adjustment plan, this operation will emphasize the need for progress in several important areas, such as bank supervision. Since progress in developing quality supervision is essential to the success of the Program, disbursements under the program will be linked to concrete progress in improving supervision. Since the private commercial banks who are eligible for Program funds will only have access to the extent that bank supervision is improved, these can be expected to provide effective pressure on the Government to implement the agreed upon restructuring programs.

B. Multisectoral Credit Facility: Purpose and Justification

- 1.25 The Multisectoral Credit Facility is proposed as an element in the government's program for the development of medium-term financial markets (and in particular medium-term credit markets) in Argentina. Following the external debt crisis of the early 1980s, two decades of high and variable rates of inflation (several times verging on hyperinflation), and government policies which often resulted in the expropriation of wealth from both depositors and bank shareholders, Argentine financial markets are not yet prepared to take on the critical role of intermediating domestic and international savings into long term investment. For several years, the typical maturity of bank deposits and loans was as short as seven days, and even today, following two years of economic stability, most credit operations are very short term (30-90 days).
- 1.26 This structure creates a dilemma for policy makers who are interested in using financial markets to channel credit to those investment projects that have the highest, on a risk-adjusted basis, economic and financial rates of return.
- 1.27 The proposed operation is designed to play a catalytic role in the development of medium-term financial and credit markets. By providing longer term credits to carefully screened financial intermediaries (at close proxies to market prices), these banks will be able to provide credit to quality investment projects. In addition, the program provides the incentive for banks to improve their financial condition (recapitalization and investment in modern technologies) in order to retain and/or gain access to a unique set of medium-term credit lines. Aside from a limited

access to international markets (Argentine commercial banks have been able to issue some eurobonds with maturities from 2 to 4 years), the proposed Program is the only true source of medium to long term funding for the banking system at the present time.

- 1.28 This program is conceived as transitory in nature, and is properly viewed as necessary only while the domestic markets are developing. High eligibility standards, market prices, and efficient operation of the program are particularly emphasized to encourage the transition from a quasi-public program to a fully functioning private system. The new pension legislation, for example, currently proposes that private pension funds to invest a minimum of 40 percent of assets in bank certificates of deposit. These private flows, once established, will likely preempt the proposed Program as the major provider of medium- and long-term funds to the banking system. While the future development of the private pension funds and the impact on the Program BICE is unknown, the transitional role takes on additional importance in encouraging the development of an infrastructure to manage these larger internal flows. It is thus of particular importance that BICE be efficiently managed.

C. Bank Experience in Argentina.

- 1.29 In 1988 Bank, jointly with the World Bank, granted an agricultural credit loan to the Banco de la Nación Argentina for US\$ 106 million (551/OC-AR). These loans included a requirement for which 20% of the resources should be lent to other financial intermediaries (with the BNA operating as a second tier institution. The final disbursement occurred in 1991 and the program is considered a success.
- 1.30 The Bank granted Argentina an Investment Sector Loan (733-AR/OC) at the end of 1992 intended to support the restructuring efforts of the government. Key financial conditions in the ISL included the points mentioned above. Further progress in implementing these reforms is essential as they were designed to establish a foundation upon which a multisectoral credit operation could function. As a result, progress in meeting those ISL conditions that are most critical to the success of the Program have been also included as conditions of this operation. In addition, a more intensive role of the Bank in the structuring and supervision of the proposed operation is required.

II. THE PROGRAM

A. Objectives

- 2.1 The Multisectorial Credit Program is designed to enhance the functioning of domestic medium-term credit markets, thereby increasing productive sector access to medium- and long-term credit. In addition, it is expected to have a catalytic effect on the development of securities markets (via securitization). This will, in turn, reduce the role of the state in the provision of financial services, and provide an incentive for financial institutions to continue efforts aimed at improving their overall financial situation and operating efficiency as a means of gaining access to program funds. An important and innovative characteristic of the program is its use of a newly-formed second tier financial institution (eventually to be privatized) as the executing agency. The program also limits access to funds to only the most creditworthy financial institutions in Argentina, and prices the funds at market rates based on the secondary market yields of medium-term Eurobonds issued by Argentine financial institutions. Finally, by linking disbursements to the government's program for strengthening bank supervision, it will help assure that solid advances are made in this critical area.

B. Program Components

- 2.2 The Multisectorial Credit Facility would provide a unique source of long term investment in Argentina. The newly formed Banco de Inversión y Comercio Exterior, S.A. (BICE), as executing agency, will operate as a second tier institution and will on lend these funds to a small group of carefully selected, "eligible" financial intermediaries. These, in turn, will on lend funds to support investment projects that require medium- or long-term financing. Funds can be used for financing investment projects, permanent working capital, and capital goods exports. Lending decisions will be made by the eligible banks. The rates charged to eligible banks will be based on market rates for prime Argentine banks, while rates to the final borrower will be freely negotiated between the eligible financial institution and the final borrower. BICE will underwrite the risk of the eligible intermediaries while these will be responsible for all risks associated with the final borrowers.

C. Demand for Program Resources

- 2.3 During the preparation and analysis of the proposed operation, significant demand for long term financing for investment projects was evident in virtually all sectors of the economy. Investment in the maintenance of existing productive capacity, not to mention the adoption of new technologies, has been ignored for a number of years due to volatility in economic and financial markets. In addition, the demand for permanent working capital in both the industrial and agricultural sectors will continue to increase. As

program resources represent less than five percent of total banking system assets, there is little doubt regarding the demand for the funds.

- 2.4 The perceived constraint on the program is the institutional capacity on three levels. First, operating as a private financial institution, BICE will only be able to lend funds to the extent that it has capital to support its lending program within prudential lending limits. The proposed increase in capital and eventual privatization resolves this concern. Second, the set of eligible financial intermediaries is limited to the most solvent and efficient banks in Argentina and their ability to on lend the funds will only increase to the extent that these increase their level of capitalization and/or other financial intermediaries improve their financial situation to the point that they can be considered eligible. This is considered to be the major constraint on the use of program funds. The absorptive institutional capacity is expected to increase as banks develop the risk analysis and monitoring capability needed to operate in term markets, but this will take time.
- 2.5 Third, despite a significant demand of longer term investment funds by the real sector, it is also apparent that many of the investment projects that will be proposed are not bankable. Some are not viable at market interest rates and others do not provide sufficient security as a banking risk. The banks that are currently providing longer term credits note that while they welcome a new source of long-term funds, they will continue to be very careful regarding the placement of these funds. There are few borrowers with whom the banks currently feel comfortable in funding on a long term basis.
- 2.6 Careful analysis of the structure of BICE, its level of capitalization, and the preliminary set of eligible financial intermediaries indicates that the size proposed in the current Program is feasible over the next several years. In addition, BICE as its capital increases will be able expand its lending program to support any increase demand for long term funds via securitization of its asset portfolio and the issuance of bonds in international and domestic financial markets.

D. Cost and Financing

- 2.7 The total cost of the program is estimated at up to the equivalent of US\$ 800 million of which US\$ 300 million would consist of IDB financing, representing 37.5 percent of the total costs of the program. The financing plan of the program would have the following breakdown:

COST AND FINANCING PLAN BY SOURCE OF FUNDS (Equivalent US\$ millions)				
	BANK	LOCAL COUNTERPART		TOTAL
		Cofinancing	Argentina	
Multisectoral Credit Inspection and Supervision	297 3	300	200	797 3
TOTAL PERCENT	300 37.5%	300 37.5%	200 25%	800 100%

- 2.8 The local counterpart commitment is to provide US\$ 500 million in additional financing. This is expected to include a minimum of US\$ 100 million in equity capital invested in BICE by public and private sector sources, and a minimum of US\$ 100 million to be provided by financial institutions. The Argentine Government has requested a co-financing of The Export Import-Bank of Japan up to the equivalent of US\$300 million. If this co-financing is approved, it will also count towards to local counterpart requirement.
- 2.9 The proposed Bank financing is consistent with Bank policy which requires a minimum 50 percent local counterpart. The credit would have an amortization period of 15 years including a grace period of four years. The commitment and disbursement periods will be three and four years respectively. The interest rate on the loan will be variable (based on ordinary capital). A commitment fee of 0.75 percent per annum will be charged on the undisbursed balance of the loan and an inspection and supervision fee of one percent (1%) of the total amount of the loan will also be charged.
- 2.10 Per Bank policy, advances up to ten percent (US\$ 30 million) of the overall credit line can be made at the borrowers request. Additional disbursements will be made upon receipt of evidence that funds have been provided to the sub-borrowers, maintaining the relationship that no more than ten percent can be advanced without evidence.

III. PROGRAM EXECUTION

A. Overview of the Credit Allocation Mechanism

- 3.1 In the past, credit operations in Argentina relied on public sector banks which often worked as both first and second tier institutions within the program. Because of inefficiency, questionable solvency, the inability of these banks to properly evaluate risk, conflicts between their role as first and second tier institutions, and the general problems of public sector lending, these institutions are considered unacceptable by the Bank for managing a second tier operation. The Argentine Government, has been attempting to restrict the activities of public sector banks and proposed the creation of a new entity, the Banco de Inversion y Comercio Exterior, S.A. (BICE), to manage external credit lines obtained by the government for financing medium term investment projects and the import or export of capital goods. Argentine authorities have proposed the eventual privatization of BICE in order to encourage more efficient management and to assure that loans would be limited to the most solvent financial institutions.

B. Participation of Other Lenders

- 3.2 The World Bank has recently shifted its emphasis from a credit operation with some capital market aspects, similar to the approach of the Inter-American Development Bank, to a strict capital market development program. In the process, they increased the amount of their credit from US\$ 300 million to US\$ 500 million. While the details of the World Bank program are still being worked out, the general structure is in place. The technical staff of the IBRD and IDB continue to work closely together to assure that pricing, eligibility requirements, and other critical aspects are consistent between the two programs. The IBRD program consists of following three separate components:

1. Backstop Credit Facility for Privately Issued Bonds

- 3.3 The first component, estimated at up to US\$ 300 million, will be used to guarantee that those banks which issue bonds in private domestic and/or international markets will be able to refinance these at a prespecified interest rate upon maturity. The banks that purchase this commitment will have the option but not the obligation to refinance at the prespecified interest rate. If, for example, a bank had demand for funding an investment over an eight year period, but was able to issue only four year bonds with the interest rate set at LIBOR plus three percent, they could pay a premium for the right to issue another four year bond at maturity at an interest rate no higher than LIBOR plus 3.5 percent. In four years, if interest rates were above LIBOR plus 3.5 percent the bank would be able to borrow the funds at LIBOR plus 3.5 percent. If rates were below LIBOR plus 3.5 percent, the bank would be allowed to borrow funds at the lower market rate.

2. Forward Lending Commitment

- 3.4 The second component, estimated at up to US\$ 200 million, would also be used to refinance privately issued bonds, but with the firm commitment on the part of the bank to refinance the credit at a prespecified interest rate at the maturity of the bond. Using the previous example, the interest rate in the future would be set at LIBOR plus 3.5 percent no matter what happened to market interest rates.

3. Technical Assistance Program

- 3.5 The final component is a technical assistance program designed to (a) assist banks in developing the ability to evaluate and monitor longer term credit risk and/or project finance operations, and (b) assist the Comisión Nacional de Valores in providing capital market oversight. An amount for this component has not yet been determined.
- 3.6 The World Bank, in developing the above structure, is attempting to lever off of the private sector, concentrating their resources on those maturities where the private sector is not yet willing to lend. Critical questions regarding the pricing of these programs (in particular the pricing of the option in the backstop facility) have not fully been explored. The proposed timing of the World Bank operation is similar to that of the IDB. While the loans are separate, the two institutions will continue to coordinate efforts to assure consistency, particularly in pricing, eligibility, and regulatory policies.

C. The Banco de Inversion y Comercio Exterior, S.A. ^{4/}

- 3.7 The following is a summary of the principal points agreed to with Argentine authorities regarding the organizational form and structure of BICE and the overall structure of the operation. These elements have been discussed with and agreed to by representatives of the government and the senior management of BICE.

1. Legal Structure

- 3.8 The Banco de Inversion y Comercio Exterior, S.A. (BICE) is organized as a commercial bank in Argentina. It is under the supervision of the Superintendencia de Entidades Financieras (SEF), is currently audited by Price Waterhouse, and counts on professional outside legal advice.
- 3.9 The Bank has reviewed the proposed bylaws of BICE which provide for its eventual privatization and limit its role to that of a second

^{4/} As these points are critical for the execution of the Program, they are presented here rather than as part of the description of the Executing Agency in Chapter IV.

tier institution providing medium and long term funds to other financial institutions. The bylaws also provide that BICE may act as the financial agent for official multilateral and bilateral financial institutions and for the Argentine Government (national but not provincial) only to the extent that these are closely related to its role as a second tier institution.

- 3.10 As long as government loans and or guarantees (net of any collateral) to BICE exceed its capital, the government, as principal creditor will be able to name one of seven directors. The remaining directors will be elected by the shareholders on a proportional basis. Thus, private sector ownership will need a minimum of 58.4 percent of the shares to control a majority of the Board. Directors representing the public sector must have equivalent rights to the directors representing the public sector. Specific rights reserved to the government are limited to decisions regarding liquidation, merger, migration out of Argentina, a spin off of an important percentage of assets, or change in the underlying objective.

2. Ownership

- 3.11 BICE is currently one hundred percent government owned with paid in capital of US\$ 24 million. The government's stated intention is to sell sixty percent of its participation to the private sector once BICE is fully operational and has established a track record. A precise target date for this privatization has not been set due to government concerns that a prespecified date might influence share value. Nevertheless, it has been agreed that prior to the first disbursement, a tentative privatization plan, with the goal of reaching a majority privatization prior to the disbursement of fifty percent of program funds, will be presented by BICE and the Government (See proposed Resolution).
- 3.12 Based on this tentative plan, the government and the Bank will meet every six months and agree on specific actions to be taken over the next six months which will lead to BICE's eventual privatization. Prior to the 12-month review, the government will test the market via a public offering of approximately ten percent of BICE's shares. Based on the success of this test, a definitive privatization plan will be presented to the Bank. The semi-annual meetings will continue to assure that actions are being taken to comply with the definitive privatization plan (See Recommendations). It is recognized that the privatization requirement is subject to market acceptance.
- 3.13 The relationship between BICE and the government will be restricted such that the future private shareholders, following privatization, will not receive any special benefit nor bear any additional cost beyond a normal commercial return for the risk which they bear. Ownership will neither be a requirement for eligibility nor will it confer automatic eligibility for obtaining credit from BICE.

3. Capitalization

- 3.14 In order for BICE to operate as a second tier institution with a limited number of eligible financial institutions, capital significantly higher than the current level of US\$ 24 million is required. It is estimated that BICE will need between \$150 and \$200 million in equity capital in order to reach the volume of business currently projected.
- 3.15 One of the assets that the government transferred to BICE was a set of OPRACs (long term capital good export credits formerly provided by the BCRA). The government also transferred a liability for the same amount at a slightly lower interest rate. Given that the existing OPRACs are guaranteed by the BCRA, this is equivalent to BICE earning a commission for the administration of the program. BICE has recently proposed that the government cancel the liability (presently at US\$ 200.3 million) and permit BICE to transfer this amount to capital as allowed under Argentine accounting rules.
- 3.16 It has been agreed that if the government canceled the corresponding liability, BICE could use the funds as "accounting capital" in order to meet the minimum requirement of the BCRA, as long as an adequate provision was made to account for the market value of the OPRAC (as determined by an independent group of capital market experts). However, BICE would also have to establish an account of "liquid" or "unincumbered" capital that would include only payments of fresh funds, recoveries of interest and principal, and proceeds from the sale or prepayment of the OPRACs. This account of "liquid capital" would be used to constrain the maximum lending to individual financial institutions (See Annex A of the Loan Contract).

D. Pricing from Government to BICE and Foreign Exchange Risk

- 3.17 The Government of Argentina will borrow from the Bank using the Ordinary Capital Rate based on the Bank's pool of currencies. Funds will be on lent to BICE in U.S. dollars with the government retaining the foreign exchange risk. The Argentine Government will have the option of offering the funds at fixed or floating rates. The difference between the effective calculated cost of IDB funds (the SWAP equivalent) and the rate charged by BICE to eligible financial institutions will be split between the government and BICE. BICE will need to receive sufficient revenue to cover operating costs, risk, and a return on capital. The government will use the remainder as compensation for foreign exchange risk and to cover general financial sector monitoring expenses. It is essential that BICE's portion is sufficient to cover costs, risk and profitability — but not provide unduly high benefits to the future private shareholders. Based on early estimates, it is expected that approximately 75 basis points will be required to cover these costs. The IDB will monitor this split to assure that the economic rent is fairly divided (See Annex A of the Loan Contract).

E. Pricing from BICE to Financial Institutions

- 3.18 BICE will on lend the funds in U.S. dollars to eligible financial institutions at market rates. The rate paid will be based on the yield on Argentine commercial bank bonds (*obligaciones negociables* and eurobond issues in primary and secondary markets). Pricing to eligible banks will be based on their classification (A, B, or C), with lower graded banks paying slightly higher rates (reflecting differences in secondary bond markets). The term and structure (fixed vs. floating) will match that of the loan to the final borrower. A prepayment penalty would be attached to any fixed rate obligation if the Government decided on this option.
- 3.19 Current secondary market yields on the dollar-denominated *obligaciones negociables* and Eurobonds being issued by prime Argentine commercial banks range from 270 to 300 basis points above equivalent maturity U.S. Treasury bonds, or alternatively, with a similar spread over LIBOR. Based on the term structure of early October 1993, this translates to approximately 7.5 percent to 8 percent for a five year fixed rate obligation or initial rates of 6.5 percent to 7 percent for floating LIBOR based loans. The rates would be slightly higher for non-prime rated banks. The Bank will monitor compliance with the agreed upon procedures on at least an annual basis. Bank approval will be required for any modifications to this initial procedure.

F. Pricing from Financial Institutions to Final Borrowers

- 3.20 The terms and conditions of loans between the financial institutions and their final borrowers will be based on market conditions and will not carry any restrictions on interest rate nor favor individual institutions based on the rates they might commit to offer to final borrowers. The government is concerned that some banks may attempt to take advantage of noncompetitive financial markets. Rather than restricting rates, the government has committed to open a dialogue with the eligible banks to discuss the pricing to final borrowers, recognizing that, at a minimum, spreads must cover the cost of funds, operating expenses, risk and a reasonable return to bank shareholders. The government will have the right to propose the exclusion of a bank if it considers pricing to be excessive. Such proposals will be reviewed by the Bank before eligibility is denied.
- 3.21 In an attempt to begin this dialogue with the commercial banks, the Bank and officials from BICE met with representatives of some potentially eligible banks, who indicated that because the longer term credits would be limited to the better risks in the system, the pricing would be far lower than the high rates currently being charged on very short term credits. Most banks indicated an additional spread of 2.5 percent to 4 percent would be added to the rate paid by the eligible bank for the majority of quality medium and large Argentine corporations who do not have direct access to international capital markets. Rates for smaller or riskier

corporations would tend to be higher with spreads ranging upwards from eight or nine percent. Experience in other countries that have undergone a restructuring program indicates that these rates should come down with continued stability as perceptions of risk decline.

G. Interest Rate Subsidies

- 3.22 No interest rates subsidies will be provided by the government or BICE to financial institutions or final borrowers. BICE will not be involved in the promotion of exports via special interest rate programs. Rather, export projects will have to compete on equal terms with loans for investment projects. Borrowers will not be eligible under the government's US\$ 2 billion *Programa Trienal* of interest rate subsidies for small and medium enterprises (four percent of interest subsidized by the government for projects of up to four years using commercial bank funds) nor to the credit insurance subsidies forming part of this same program. The government has agreed to not renew existing or establish new programs of interest rate subsidies (See Proposed Resolution).

H. Allocation and Use of Funds

- 3.23 Funds will be allocated to eligible banks on a first come first served basis within the restriction of the line available to each institution. The loan is designed to be truly multisectoral, open to all sectors of the economy. The major restriction will be that the funds are limited to long-term investments including the purchase of assets, permanent working capital, and financing the export of capital goods. Because of the strict eligibility requirements, very few Argentine commercial banks will have access to BICE's funds. It is estimated that a maximum of 20 to 25 banks, including branches of international banks operating in Argentina, will initially be eligible.

I. Concentration of Risk and Collateral Requirements

- 3.24 In order increase diversification of BICE's risk and allow for a more normal operating leverage without unduly reducing the eligibility standards, a mechanism of assignment of guarantees has been developed by BICE based on technical assistance funded by the Bank. Under this mechanism, participating banks would assign to BICE, as collateral, the underlying credit operations along with corresponding guarantees. The commercial banks would be responsible for the management of the risk and BICE would only take over the sub-loan in the event of the bankruptcy of the commercial bank. In the event of a deterioration of the credit quality of the sub-loan, BICE would have the right to request a substitution of collateral to maintain its position as a preferred creditor.
- 3.25 This collateral requirement will be extended to all banks on an equal basis. Given the small number of eligible banks and the use of collateral, the concentration limit will initially be set at the

minimum of fifty percent of the capital of BICE or 75 percent of the capital of the eligible institution.^{2/} Bank approval would be required for any modification to these limits. Lower limits could be established, at BICE's option based on their internal credit evaluation (See Recommendations).

J. Special Aspects of the Proposed Operation

1. Securities Market Development

- 3.26 While the loan is structured as a traditional credit operation, there are several positive side benefits in the development of Argentine capital markets. The most important of these is the development of asset-backed securities. Since BICE will hold a portfolio consisting of collateralized loans to the best Argentine commercial banks it should be able to securitize the loans and sell portions of its portfolio to pension funds and other institutional investors. By selling the shorter maturities, BICE will be able to achieve some degree of operational leverage and concentrate on longer term maturities where private investors are not yet willing to venture. This should also provide an additional source of funds and profitability to BICE. The government is proposing legislation which allows for securitization.

2. Business Plan and Financial Projections

- 3.27 The latest version of BICE's *Business Plan and Financial Projections* has been reviewed by the Bank. While the financial projections seem somewhat optimistic, both have been professionally prepared. A revised version, agreed to by the Bank will be ratified by BICE's Board prior to the presentation to the Bank's Board of Directors. Essential points of the Business Plan that was presented to the Bank include:

a. Subsidies for Exports or Other Sector Specific Support

- 3.28 BICE will not provide subsidies for any loans (including the export of capital goods) nor be involved in the sectoral allocation of resources.

b. Eligibility Requirements

- 3.29 BICE will use the same eligibility requirements (as established jointly with the Bank) for all lending operations.

^{2/} Lending limits are usually set at ten to fifteen percent of the capital of the lending institution. The higher limit can only be justified since BICE's lending will be concentrated with prime banks and BICE's loans will be collateralized with the underlying sub-loans.

c. Pricing at Market Rates

- 3.30 All loans will be priced at market rates. The only exceptions are the existing lines from Spain, Italy, and France that are tied to exports from these countries. The renewals under these lines will be at market rates.

d. Operation as Second Tier Bank

- 3.31 BICE's operations will be restricted to purely second tier operations, or to acting as financial agent for the government and multilateral or bilateral international lending agencies for a limited set of related operations closely related to this primary objective.

e. Private Sector Orientation

- 3.32 BICE will be operated based on accepted commercial practices, controlling expenses, and managing the quality of lending portfolio with the goal of maximizing the value of equity. All pricing will take account of funding costs, the cost of providing services, risk, and the opportunity cost of capital.

f. Securitization

- 3.33 BICE will, to the extent permitted by law, attempt to securitize and sell assets as a method for increasing operating leverage and generating higher levels of income.

g. Financial Projections

- 3.34 The financial projections presented the Bank are considered overly optimistic in terms of lending volumes and therefore profitability. The technical opinion of the Project Team is that BICE will not be able to reach the lending volumes projected in BICE's Business Plan as this would require lending to a large number of questionably solvent institutions (or the assumption that the financial condition of these would improve dramatically in a short time period). Non-interest income and the level and growth of expenses are also optimistic.
- 3.35 The financial projections result in a return on equity of approximately 15% (in excess of inflation) which is very high given the level of risk to the shareholders. While this high return may not be probable, as a second tier institution, providing a scarce source of long term financing, BICE should have no problem placing Program resources while operating profitably at a fairly low level of risk with a reasonable staffing level and reasonable controls on non-interest expenses. Profitability should be further enhanced via securitization.
- 3.36 The problems with the projections reflect the inexperience of BICE's management in long-term planning and not the viability of

the institution. While there is not a question of viability, the financial projections will have to be reworked at more acceptable levels. A final, more realistic set of projections will have to be included in the privatization plan, and this version will be used in the periodic evaluation of BICE's execution of the program. Profitability and privatization pressures are expected to force a reduction in the future.

K. Institutional Structure

1. Characteristics of Eligible IFIs

- 3.37 The eligible financial institutions are selected on the basis of solvency, portfolio quality, profitability and operating efficiency. BICE's evaluation, in addition will look at non-quantitative aspects such as management quality, credit criteria, and the usage of banking technology. With the exception of the Banco de la Nación Argentina, the currently eligible banks are all private sector institutions. Large, medium, and small banks are all represented. The list of eligible banks is composed of the prime names among the Argentine banking community plus some smaller, less well known, but well regarded banks.

2. Use of Recoveries

- 3.38 Recoveries under the program, in excess of what is needed for debt service can only be used to provide new credits under substantially the same conditions as in the proposed program. Per Bank policy, after five years, the borrower and the Bank can agree to modify these conditions (See Recommendations).

3. Inspection and Supervision

- 3.39 The Bank is committed to undertake periodic inspections and provide a supervision of the execution of the program. Due to the unique characteristics of the program, supervision will, of necessity be more attentive than most Bank operations, and including semi-annual revisions of performance and careful evaluation of program goals. A one percent inspection and supervision fee (US\$ 3,000,000) will be charged to cover this cost.

L. Conditions Prior to First Disbursement

1. Credit Regulation

- 3.40 The government must provide evidence that the Credit Regulation has been placed in force. The most noteworthy provisions of these credit regulations relate to the eligibility criteria for the IFIs, the use of resources, the resource allocation system, the obligations of the IFIs, restrictions on the use of resources, approval and disbursement of the resources and supervision and control of program execution.

2. Transfer of Resources from the Government to BICE

- 3.41 The Government must provide evidence of its agreement to manage the foreign exchange and interest rate risk present in the Bank's Ordinary Capital (pool) rate and to transfer resources to BICE in U.S. dollars at a prespecified margin below the rate BICE will be lending to the highest rated private commercial banks. This margin must be calculated to cover BICE's operating costs, risk, and a normal profit.

3. Strengthening Bank Supervision

- 3.42 The Government must present, to the satisfaction of the Bank, a strategic plan and precise timetable for the strengthening of bank supervision and provide evidence that the BCRA has the human and financial resources to accomplish this plan in accordance with the timetable. The plan presented must be consistent with the agreements reached for the Investment Sector Loan. As a minimum this must include:

a. Management Information Systems

- 3.43 Progress in the concrete plans for completing the development of current management information systems (collection of information from financial institutions), plus the development of action plans for the development of examinations procedures and manuals.

b. Accounting and Auditing Standards

- 3.44 The BCRA must undertake an evaluation of regulatory accounting and disclosure requirements, accounting and auditing standards (and how well they are being implemented) compared to internationally accepted standards for financial institutions. The BCRA must agree with the Bank on an Action Plan and Timetable to move to these international standards.

c. Development of Supervisory Capacity

- 3.45 The six new teams of supervisors included in the supervisory development plan, concentrating on large institutions (systemic risk) and problem banks should be in place before the first disbursement.

d. Establishment of Training Programs

- 3.46 The BCRA/SEF should have committed to a specific timetable for development and implementation of a comprehensive training program.

e. Supervisory Norms and Examination Procedures

- 3.47 The BCRA/SEF should have committed to a specific timetable and plans for the development of standards supervisory norms and

examination procedures (along with necessary MIS support to insure compliance with regulatory actions).

f. International Standards of Disclosure

- 3.48 The BCRA/SEF should have reviewed and have committed to a specific timetable for the establishment of disclosure standards at international levels.

4. Privatization

- 3.49 The government must present, to the satisfaction of the Bank, a tentative privatization plan, consistent with BICE's Business Plan, with the goal of a majority privatization before fifty percent of the program has been disbursed along with specific actions that will be taken during the ensuing six months. The privatization plan will include a satisfactory version of finalized Business Plan, Capitalization Plan, and Financial Projections. These should take into account the pricing of resources from the government; market pricing for all lending (with the exception of the first round of export lines from Spain and Italy); realistic lending limits based on "liquid" or "non-incumbered" capital (excluding the OPRACs transferred to BICE), and a realistic set of eligible banks should be provided; and the pricing agreement between the Government and BICE. These revised projections will be used in the periodic evaluations of the execution of the Program.

5. Eligibility Requirements

- 3.50 The eligibility requirements for the quantitative analysis will be evaluated and reset as necessary with regards to classification and cutoff levels using the most recent financial information available in order to maintain current high standards. In order for the Banco de la Nación to participate, it must demonstrate that it is in compliance with its proposed restructuring program.

6. Interest Rate Policy

- 3.51 The government will provide a letter committing that it will not renew the *Programa Trienal* (interest rate subsidies for small and medium size enterprises) and will not undertake any new interest rate subsidy programs.

7. Participation Agreements with Eligible Financial Intermediaries

- 3.52 BICE must provide evidence that it has signed at least five participation agreements with eligible financial intermediaries.

8. Evidence of Agreement between BICE and SRNAH

- 3.53 Under the Proposed Resolution, the Borrower would be required as a condition precedent to the first disbursement of the Bank financing

under consideration, to submit to the Bank evidence that agreement between BICE and the SRNAH has been signed (see Chapter V.C).

M. Review Process During Execution

- 3.54 In view of the elements described in the previous sections, close supervision and oversight will be required during the early period of execution. This supervision will consist of the following:

1. Interim Semi-annual Reviews -- Privatization Plans and Eligibility Requirements

- 3.55 The Bank, the government and BICE will meet at least every six months to review progress in the execution of the program, to evaluate the need for changes to eligibility requirements, and determine the strategy and timetable for privatization. Prior to the second interim review (12 months following the first disbursement), BICE will undertake a market test by offering a packet (approximately ten percent) of shares to the private sector. Based on the success of this market test and the development of BICE, *vis-a-vis* its Business Plan, a definitive privatization plan will be presented for discussion with and approval by the Bank (See Recommendations).

- 3.56 Prior to each semi-annual review, BICE will provide an evaluation of the degree to which program goals are being met, a evaluation of performance *vis-a-vis* the Business Plan (including proposed modifications to the Business Plan and steps that will be taken to correct any deficiencies), and proposals for any modifications to eligibility requirements. The information provided should form the basis for the Bank's review and discussion (See Recommendations).

2. Comprehensive Review at 20%, 50% and 80% Commitment Levels

- 3.57 Comprehensive evaluations of the overall functioning of the program will take place prior to the time that 20 percent, 50 percent, and 80 percent of the loan has been committed (See Recommendations). To the extent possible, these reviews will correspond with the interim semi-annual reviews. In order for commitments to continue, satisfactory performance and/or adjustments to the operation of the program will be necessary in the following areas:

a. Bank Supervision

- 3.58 Satisfactory progress must be made according to the timetable established in the Investment Sector Loan.

b. Privatization Program

- 3.59 Satisfactory progress must be made according to the timetable established for the privatization of BICE and on the actions established during the semi-annual reviews. During the mid-disbursement reviews, the analysis will focus on the actions the

Government has taken to assure that BICE is privatizable and steadily progressing towards private sector ownership and management control.

c. Interest rate policy

- 3.60 The policy of the Government in phasing out existing and not creating new programs of interest rate subsidies will be evaluated. Satisfactory progress on this commitment will be required for continued lending.

d. Management and Operation of BICE

- 3.61 A comprehensive evaluation of BICE's operating characteristics, financial structure, and overall management quality and independence will be undertaken. Because of the importance of private sector criteria in the management of BICE, it is essential that the general manager (not yet selected) have significant and recent private sector banking experience. Her/his leadership role in setting the strategic direction of BICE and furthering the development of the private banking sector will be carefully evaluated. A parallel evaluation of the roles, experience and capabilities of Board Members will also be included. The evaluation will also focus on the efficiency of bank operations, credit policy and administration, portfolio quality, capital structure, profitability, overall financial management including liquidity and asset-liability management, etc. Agreement and implementation of the plans of action necessary to correct any deficiencies will be established as necessary. The role of BICE in asset securitization will be evaluated to the extent that this is permitted by law.

e. Progress towards meeting program goals

- 3.62 A comprehensive evaluation of the degree to which the goals of the program are being met, long-term credit reaches a wide set of investors, and incentives exist for improving bank quality and bank supervision will be undertaken. Modifications will be designed to correct any deficiencies and will be incorporated into the program.

IV. BORROWER AND EXECUTING AGENCY

A. The Borrower

- 4.1 The Borrower under this Program will be the Government (Nación de Argentina).

B. The Executing Agency

- 4.2 The Banco de Inversion y Comercio Exterior, S.A. (BICE) was established by the Argentine Government as a second tier bank assigned to administer the long term investment and foreign trade lines currently held, or in the process of being contracted by the Argentine Government. In addition to the current operation, BICE will be the executing agency for lines being provided by Spain, France and Italy (at preferential rates, but tied to eligible imports from these two countries) and is administering existing second tier export lines (OPRAC) formerly managed by the Banco Central de la Republica Argentina (BCRA). BICE's role in the related World Bank operation has not yet been determined.
- 4.3 BICE is restricted by its bylaws to operate exclusively as a second tier institution and as financial agent for the Government (plus official bilateral and multilateral financial agencies) when closely related to these second tier activities. Within this Program, BICE will be responsible for the determination of eligibility (based on agreed upon criteria) and the management of the relationship with eligible commercial banks. BICE's responsibilities will be limited to analyzing the credit risk of the participating financial institutions, assuring that they abide by the conditions of the program, and ensuring efficient management of the Program. Neither BICE nor the Government will be involved in the credit granting process of eligible commercial banks nor in the sectoral allocation of funds.
- 4.4 BICE is currently capitalized at a level of US\$24 million. Core staff has been hired and some limited operations (lines transferred from the Central Bank and Spain/Italy export lines) are underway. Current staffing levels are considered adequate for the proposed level of operations. Most mid-level managers and department chiefs come from the private sector, are well regarded and considered capable by the financial community.

C. Eligible financial intermediaries 6/

- 4.5 For the proposed program to be successful, funding must be limited to solvent, prudentially managed financial intermediaries which are willing and able to evaluate the corresponding risks. Thus, only those banks that are able to demonstrate solid financial strength

6/ To the extent possible, eligibility requirements will be coordinated with the World Bank to assure cohesion between the two programs.

and the ability to operate in long term markets will be eligible for participation. In addition to the supervisory requirements, including minimum capital levels vis-a-vis risk adjusted assets ^{7/} and compliance with reserve requirements, participating banks will have to be audited by an acceptable external auditor, and pass both a quantitative and qualitative analysis.

- 4.6 The quantitative analysis is based on measures of solvency, portfolio quality, profitability, and efficiency. Using a methodology developed for BICE by Price Waterhouse, and refined by BICE with technical assistance funded by the Bank, banks will be ranked as A, B, C, or D. Only banks ranked A, B or C will be considered eligible. The parameters for this initial categorization have been developed jointly with the Bank's technical staff and will be reviewed and updated on at least an annual basis to take account of changes in Argentine financial markets (See Annex A of the Loan Contract). A preliminary classification undertaken by BICE of 78 banks (excluding the branches of international banks), placed four in category A, five in B, and six as C. The Bank has agreed to evaluate a moderate lowering of this standard that would raise the number of C banks to 13, if BICE is able to demonstrate that there is no difference in the quality between the additional seven and the pre-classified six banks in category C.
- 4.7 The branches of international banks operating in Argentina will be classified according to their Moodies or Standard and Poor's bond ratings. Branches of banks with an international rating of AAA or AA will automatically be classified as eligible in Category A, while those branches rated A will be placed in category B. Subsidiaries of international banks will have to pass eligibility requirements identical to those of domestic banks unless guaranteed by their AAA, AA or A rated parent.
- 4.8 The qualitative analysis will be based on a formal financial/credit analysis including a professional evaluation of management ability, the quality of information provided, credit policy and administration, overall portfolio quality, solvency, profitability and efficiency, the use of modern banking technologies, and the ability of the bank to analyze and monitor long term credits. This qualitative analysis will be the responsibility of BICE, but will be reviewed by the Bank during execution.

^{7/} The BCRA has established their own version of risk adjusted capital levels, independent of the BIS capital adequacy requirements of 8% of Risk Adjusted assets. Because of the complexity of the formula, and the lack of adequate provisioning requirements, Argentine capital adequacy standards are not comparable with international standards. As of July 1993, commercial banks are required to maintain 8.5% of capital against financial assets (increasing to 11.5% by January 1995) plus 100% of capital against 30% of the real estate owned by commercial banks (to adjust for possible overvaluation of real estate from hyperinflationary accounting treatment in the past). The financial assets are weighted according to risk (based on the underlying interest rate with penalties up to 6 times the amount of the asset) and according to the asset type and underlying guarantee (50% mortgages, 75% automobile loans, 0-50% for Government paper depending on term and whether national or provincial, etc.).

- 4.9 Potential users of funds must pass both the qualitative and quantitative analysis to be considered eligible. In exceptional cases, a bank that is considered to be excellent in the qualitative analysis, but does not pass the quantitative analysis for very specific reasons could be included as an eligible bank upon justification by the BICE analyst and with the prior approval of the IDB. For these exceptional cases, the bank, prior to the granting approval will review the BICE analysis, at least on analysis by a private risk rating agency (a classification of investment grade will be required). ^{g/} If necessary, an independent evaluation may be requested. The qualitative evaluation of BICE, with the approval of the Bank, can also be used to raise the classification of an already eligible bank.
- 4.10 The Government has requested the inclusion of Banco de la Nación Argentina (BNA) because of its national coverage. In some geographic areas BNA is the only bank providing credit services to small and medium enterprises. The inclusion of the BNA will be contingent on its compliance with a restructuring program agreed to in the Investment Sector Loan (773/OC-AR) (See Proposed Resolution and Recommendations). ^{g/} All other public sector banks will have to meet the same eligibility criteria as private banks and will not be able to substitute a provincial or national guarantee for eligibility.
- 4.11 These eligibility requirements will be used for all BICE's lending and not just for funds from the current operation.

^{g/} Private risk rating agencies have recently been established in Argentina and do not yet have a credible track record. Thus they cannot be used to replace the credit analysis of BICE but should form an important secondary control to the analysis. Investment grade ratings by two independent evaluations is required by the Government for the issuance of bonds ("obligaciones negociables").

^{g/} The inclusion of Banco de la Nación Argentina is, at present, the only difference with the eligibility criteria methodology being considered by the World Bank.

V. VIABILITY AND RISKS

A. Viability and Benefits of the Proposed Program

- 5.1 The proposed Program, if properly implemented, will provide important benefits to the Argentine economy at a time of major economic restructuring. The Program will contribute to the overall development of financial markets, provide needed investment funds to the private sector, and support the creation of a new, private sector oriented (and eventually owned) second tier financial institution.
- 5.2 There is a large unsatisfied demand for long-term investment funds in Argentina. The country is recovering from decades of economic mismanagement and needs to invest in rebuilding its productive capacity. By developing the financial sector's ability to evaluate and monitor these investment projects, the Multisectoral Credit Facility has the potential for filling a critical gap, while this transition is taking place.
- 5.3 The multisectoral Program is correctly viewed as a transitory program to assist during the time that domestic markets develop. High eligibility standards, market prices, and efficient operation of the Program are all particularly emphasized due to the need to encourage a transition from a quasi-public program to a fully functioning private system. The new pension legislation, for example, currently requires private pension funds to invest 40% of assets in bank certificates of deposit. These private flows, once established will likely preempt BICE as the major provider of medium and long term funds to the banking system. While the future role of BICE is unknown, the transitional role takes on additional importance in encouraging the development of an infrastructure to manage these larger internal flows.
- 5.4 The structure of the proposed operation satisfies the principle objectives of the Bank in support of financial sector development. In particular, the design 1) forces attention on strengthening bank supervision, providing additional support for meet the conditions of the investment sector loan; 2) sets rigorous eligibility criteria for participating IFIs which are adapted to the specific situation of argentine financial markets; 3) uses a pricing mechanism that provides an appropriate proxy for market rates (while retaining the incentive of financial institutions to seek private sources of long-term funding); and 4) allows for an effective increase in operating leverage via the securitization of BICE's lending portfolio. In addition, the Program should operate as a catalyst, encouraging financial institutions to develop the ability to analyze and monitor medium- and long-term credits -- indirectly developing instruments and infrastructure for channeling credit to the productive sector.

- 5.5 The one objective that is not met directly is that of expanding the access to financial services to smaller customers. Some progress in this area is expected to come automatically with the development of financial markets, the elimination of interest rate controls and the disintermediation of prime credit risks to non-banking financial markets. In 1991, the Bank has supported a US\$ 45 million program for small and microenterprises. In addition, the Bank plans to support these activities via MIF projects aimed at assisting smaller businesses. In addition, the Inter-American Investment Corporation is working on the structuring of a private second-tier cooperative bank that will meet similar needs for a set of banks that work directly with smaller and medium enterprises.

B. Issues and Risks

- 5.6 While there are important benefits from the development of a Multisectoral Credit Facility in Argentina, there are also significant risks involved. The following is a summary of the key issues and risks that face the successful execution of the Program:

1. Quality of Bank Supervision

- 5.7 The supervision of financial institutions is considered weak, and it is therefore difficult to determine the true financial situation of the potentially eligible Argentine banks. The Program will use a second best approach of careful analysis which, of necessity, introduces a degree of arbitrariness into the eligibility criteria.
- 5.8 The problem of weak bank supervision is being address by linking the Program to solid advances in improving bank supervision (see Chapter III).

2. Weakness of Executing Agency

- 5.9 There are a number of organizational weaknesses in the proposed executing agency. BICE is a new organization with no experience in operating as a second tier institution. The ability of BICE to provide leadership in the development of Argentine financial markets will be based on the degree to which it supports and imposes financial discipline on potentially eligible borrowers. Once the Program is functioning the general manager will have to establish and follow the strategic policies needed to provide this leadership position. This is particularly important as few among the current members of the Board, have banking experience and none has recent experience working with the private sector.
- 5.10 The Bank has encouraged the Government to name a general manager with strong private sector experience. Once the private sector has obtained a majority ownership and control, private shareholders will be in the position of naming the general manager and setting overall policies.

- 5.11 Many of the risks of the Program are addressed by its structure. Via its Bylaws, BICE will be prohibited from operating in areas that are not closely related to its principal role as a second tier financial institution. The Program regulates the most critical aspects, including interest rate policy and eligibility requirements. The proposed privatization, the semi-annual reviews of BICE's performance in reaching Program goals and the inability to disburse beyond 20%, 50% and 80% of the overall Program without evidence of progress in each of the major areas provides a critical safeguard.

3. Private Sector Orientation and Eventual Privatization of Ownership and Management Control

- 5.12 Although BICE is to be privatized, there is a tendency for the Government to attempt to transfer responsibilities to BICE for programs that the Banco Central de la Republica Argentina is no longer legally able to provide, even if these do not correspond to second tier activities. While the Government publicly supports its eventually privatization, these activities plus the restrictions placed on the private sector gaining effective control may reduce private sector interest in actively participating.
- 5.13 The uncertainty over the eventual privatization is a risk to the Program. Nevertheless, it is private sector orientation of BICE rather than an actual privatization that is key to the Program's success. Many of the goals of the Program could be attained, even with government ownership. This, however will require continued supervision as described in B.5 below.
- 5.14 The Program has been structured in such a private sector orientation and eventual private sector ownership and control are more likely. Indeed, The requirements that (a) a tentative privatization plan is presented prior to the first disbursement; (b) a public offer of approximately 10% of BICE's shares by 12 months following the first disbursement (followed by agreement to a finalized privatization plan); (c) periodic reviews of BICE operations and steps toward privatization; and (d) assurance that BICE's statutes allow it to be privatizable; are included to help assure that BICE will operate based on the criteria of a private institution.

4. Government Commitment to Financial Sector Reform

- 5.15 The success of this operation, depends on the government's commitment to financial sector reform program, including strengthening bank supervision, enabling of competition in financial markets, continued efforts to reduce the role of the state in the provision of credit and other financial services, and support for market determined interest rates throughout the financial sector. Regarding the latter, although the Government has indicated that the programs of subsidized interest rates for small and medium enterprises will be phased out once this Program

is in place, it is not clear that sectoral (e.g. agriculture) interest rate subsidies will be eschewed in the future.

- 5.16 The conditions of this operation therefore, require that the Government provide evidence that it will not renew the existing program of interest rates subsidies for small- and medium-sized enterprises (*Programa Trienal*), and that new interest rate subsidy programs will not be established. Progress in these areas will be monitored during the execution of the Program.

5. Supervision Requirement

- 5.17 Because of the complexity of financial sector reform in Argentina and the structure of the proposed Program, the degree of supervision by the Bank will be greater than in most programs. While the Bank will not be involved in the management of BICE, it will have to provide an almost continual supervision of the developments related to the principal components of the operation (bank supervision, the operation and privatization plans of BICE, pricing and eligibility requirements). The Bank's commitment to provide this degree of supervision is essential to the viability of the Program.

C. Environmental Issues

- 5.18 The Environmental Management Committee approved the Environmental Brief for the Program on May 4, 1992, classifying it as a category III operation. On October 29, 1993, the Environmental Summary for the Program was approved. It was decided that BICE should sign an agreement with SRNAH to comply the recommendations as indicated below.
- a. Strengthen the ability of the SRNAH's environmental units to effectively address the environmental aspects of projects financed with Program resources during the formulation as well as execution stages. The SRNAH will annually, at the request of BICE, select a representative sample of projects in execution and will review these projects to determine if they are in accordance with the environmental requirements of the credit regulations. The agreement will stipulate the rate to be charged by the SRNAH to cover the cost of these services, which will be charged to the subborrowers.
 - b. Require sub-borrowers under the Program to submit to the SRNAH the environmental studies prepared in conjunction with the feasibility study for each investment project to be included in the Program. The cost of the environmental studies will be recognized as part of the cost of preparing the project and may be financed with program resources.
 - c. Prepare environmental guidelines for investment projects for distribution to potential beneficiaries as well as to the IFIs and BICE.

- d. Maintain within the SRNAH a register of individual consultants and environmental consulting firms which can offer services to the potential beneficiaries of program resources.

5.19 The above mentioned agreement between BICE and SRNAH should be presented to the Bank as condition prior to the first disbursement of the resources of the proposed financing and should be in force at the beginning of the execution of the Program. BICE will evaluate annually the compliance of the beneficiaries of the Program with the dispositions of the agreement. If this evaluation show that the environmental aspects were not correctly treated the corresponding beneficiaries and IFIs will be disqualified as participants of the Program.

D. Impact of Program on Low Income Population

5.20 The benefits of the Program to the low income population are derived from its universal coverage and complementarily with the government's economic restructuring program. Nevertheless, it is important to note that the quantification of any specific impact of a multisectoral credit facility is not possible on an ex-ante basis. The types of beneficiaries and the eventual uses of program funds will depend on the set of final borrowers and their investment decisions.

E. Participation of Women

5.21 The design of the Program does not contemplate specific actions in support of women. Nevertheless, neither the Program nor Argentine legislation discriminates against women in terms of access to credit.

PROPOSED RESOLUTION 1/

ARGENTINA. LOAN /OC-AR TO THE NACION ARGENTINA
(Multisector Global Credit Program)

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with the Nación Argentina, hereinafter referred to as the "Borrower," for the purpose of granting it a loan to cooperate in the execution of a multisector global credit program, hereinafter referred to as the "Program". This Financing shall be subject substantially to the following conditions:

1. Amount and Currencies: Up to US\$300,000,000, or its equivalent in other currencies, except that of Argentina, which are part of the Ordinary Capital resources of the Bank, to pay for goods and services originating in the member countries of the Bank and for such other purposes as may be specified in the loan contract. Payments of amortization and interest shall be made in the currency or currencies specified by the Bank, in a quantity equivalent to the corresponding amount owed, calculated in units of account in terms of dollars of the United States of America, in accordance with provisions to be included in the loan contract.
2. Source of Funds: The Ordinary Capital resources of the Bank.
3. Guarantee: The general responsibility of the Borrower.
4. Credit Fee: 0.75% per annum on the undisbursed portion of the Financing, commencing to accrue 60 days after the date of the loan contract and payable in dollars of the United States of America on the same dates as the interest.
5. Amortization: The Borrower shall amortize the loan in a period of 15 years from the date of the loan contract, by means of semiannual,

1/ The provisions contained in this Appendix I and in Appendices II and III shall become final only when the Board of Executive Directors has approved the loan proposal.

consecutive and, insofar as possible, equal installments. The first installment shall be paid on the first interest payment date, six months after the date scheduled for the last disbursement of the Financing.

6. Interest: The Borrower shall pay interest semiannually on the daily outstanding balances of the loan. The first payment shall be made six months after the date of the loan contract. The Bank shall determine the rates of interest to be applied during the life of the loan, in accordance with the lending-rate policy of the Bank.
7. Commitment and disbursement: The term for commitment of the Financing shall expire 3 years after the effective date of the loan contract, and the term for disbursement of the Financing shall expire 4 years after the same date.
8. Special conditions:
 - (a) The execution of the Program and the utilization of the resources of the loan shall be performed in their entirety by the Borrower, through the Banco de Inversión y Comercio Exterior, S.A. (BICE) (hereinafter referred to interchangeably as the "Executing Agency" or the "BICE"), and with the participation of intermediary financial institutions ("IFIs"). The provisions applicable to the Borrower and the Executing Agency established in Article 5.01(d) of the General Conditions shall also be applicable to these financial institutions.
 - (b) The resources of the loan shall be used to participate in the execution of a Program the total cost of which is estimated at the equivalent of US\$800,000,000. Consequently, the loan contract shall contain the appropriate provisions to ensure that such additional resources as may be necessary, in addition to those of the loan, for the complete execution of the Program shall be duly provided, in an amount estimated at the equivalent of US\$500,000,000, in accordance with a schedule of investments satisfactory to the Bank, which may include a loan from the Export Import Bank of Japan (EXIMBANK), in an amount estimated at the equivalent of up to US\$300,000,000.
 - (c) Prior to the first disbursement of the Financing, the Borrower shall present, to the satisfaction of the Bank:
 - (i) evidence that it has entered into an agreement with the Executing Agency under the terms of which the Borrower transfers to BICE the resources of the financing and the BICE assumes the obligations of Executing Agency of the Program;

- (ii) evidence that the Executing Agency has put into effect the credit regulations of the Program and the eligibility criteria for the IFIs;
 - (iii) evidence that the Executing Agency has entered into agreements, with at least five of the participating IFIs, which set forth the conditions for their participation in the Program based upon in the model previously agreed upon with the Bank;
 - (iv) a plan and timetable for the implementation of the strengthening of the Bank supervision program (audit and accounting norms, management information systems and supervision capacity) and evidence that the Central Bank of the República Argentina has the necessary human and financial resources for the execution of such plan;
 - (v) a plan and timetable for the implementation of the restructuring program of the "Banco de la Nación Argentina";
 - (vi) a tentative plan for the privatization of BICE consistent with its business plan with the purpose of achieving, prior to the disbursement of any amount to exceed 50% of the resources of the Program, a majority participation of the private sector;
 - (vii) evidence of the Borrower's commitment by which it shall not undertake new interest rate subsidy programs nor renew the existing ones; and
 - (viii) evidence that BICE and the Secretaría de Recursos Naturales y Ambiente Humano have entered into an agreement for the fulfillment of the provisions for the environmental protection included in the credit regulations of the Program and in the participation agreements referred to in paragraph 8 (c) (ii) and (iii) respectively.
- (d) The beneficiaries of the credits shall be charged, on account of interest, commissions, insurance, or any other charge, the annual rate or rates which, being consonant with legislation and policies on interest rates of the country, are compatible with the Bank's policy on interest rates for this type of Financing.
- (e) The resources of the Financing shall not be used to grant credits for: (i) general and administrative expenditures of the beneficiaries; (ii) purchase of real estate; (iii) refinancing of debt; or (iv) purchase of shares.

- (f) Funds arising from recoveries under credits granted by the BICE to the IFIs with the resources of the Program may, to the extent they accumulate in excess of the amounts needed for service of the loan, be used only for the granting of new credits conforming substantially to conditions established in the loan contract and in the credit regulations. Five years after the date of the last disbursement, the Bank and the Borrower may agree upon another use for recoveries that does not depart from the basic objectives of the Financing, or agree to reduce the period of validity of this obligation.
- (g) The Bank shall establish such inspection procedures as it deems necessary to assure the satisfactory execution of the Program, and the Borrower shall extend all cooperation which is required for the most effective accomplishment of this purpose. From the amount of the Financing the sum of US\$3,000,000 shall be allocated for credit to the general income accounts of the Bank to meet expenses of general inspection and supervision.

RECOMMENDATIONS:

- A. It is recommended that the following conditions, to be fulfilled to the Bank's satisfaction, be included in the loan contract in addition to those set forth in the proposed resolution:
1. The outstanding balances of a single beneficiary on subloans granted with resources of the Program, shall not exceed the equivalent of US\$30,000,000.
 2. The accumulative amount of subloans granted by BICE with resources of the Program to a single financial intermediary shall not exceed 50% of the liquid capital of BICE or 75% of the capital of the IFI, whichever is less.
 3. During the execution of the Program, the Borrower and the Executing Agency, on the one hand, and the Bank, on the other hand, shall periodically review the interest rates applied to subloans. If necessary, the Borrower and the Executing Agency would take appropriate measures, consistent with the economic policies of the country, in order to harmonize the interest rates on subloans with the policy objectives sought by the Bank.
 4. During the execution of the Program, the Borrower, the Executing Agency and the Bank shall meet semiannually for the purpose of reviewing the execution of the Program and determining whether conditions have arisen which warrant modifications in the structure or operating rules of the Program, and in the eligibility requirements of IFIs. The first meeting shall take place six months after the date of the first disbursement. Two months prior to each meeting, the Borrower shall present to the Bank progress reports on: (i) the credit operations granted; (ii) the restructuring of the BNA and the execution of the Business Plan of BICE; (iii) the financial situation of the IFIs and an evaluation of the goals accomplished in the execution of the Program; (iv) the privatization program of BICE; and (v) the Bank supervision program.
 5. Within 12 months after the date of the first disbursement of the financing, the Executing Agency shall undertake a public offer for the selling of approximately 10% of its shares to the private sector. Based on the result of this offer and the execution of its Business Plan, the Executing Agency shall present, to the satisfaction of the Bank, a definitive privatization plan and its timetable.

6. The Borrower, the Executing Agency and the Bank shall carry out a review of the results achieved by the Program in the strengthening of the Bank supervision program referred to in paragraph 8 (c)(iv) of Appendix I, the tentative privatization program of BICE, referred to in paragraph 8 (c)(vi) of Appendix I, the interest rate policy, referred to in paragraph 8 (c)(vii) of Appendix I, the plan for restructuring the "Banco de la Nación Argentina", referred to in paragraph 8 (c)(vi) of Appendix I, and the execution of the Business Plan of BICE, and assess the extent to which its objectives have been accomplished when 20%, 50% and 80% of the resources of the financing have been committed. If it is considered that the Program has not substantially achieved its objectives, the Bank, the Borrower and the Executing Agency shall agree in the measures to be taken in order to resolve the deficiencies, prior to any further commitment of the resources of the Financing.
 7. The financial statements of the Program and of BICE during its execution and for five years following the date of the last disbursement of the financing, shall be presented annually to the Bank audited by an independent public accounting firm acceptable to the Bank.
- B. The loan contract shall include an annex substantially similar to Appendix III ("The Program"), which follows.

THE PROGRAM

Annex A to the Loan Contract

I. Objective

- 1.01 The objectives of the Multisectoral Credit Facility include: i) providing short- and medium-term funding for financing private sector investment projects which are judged to be technically, financially and economically viable; ii) contributing to the development of capital markets; and iii) contributing to the efficient operation of the banking system by restricting access to program resources to the more financially solvent banks of the system.

II. Description

- 2.01 To reach these objectives, the Multisectoral Credit Facility would provide a unique funding source for long term investment in Argentina. The executing agency, operating exclusively as a second tier institution, shall transfer these funds to those financial intermediaries which meet the eligibility requirements of the program. The inclusion of the Banco de la Nación Argentina as an eligible intermediary shall be subject to its fulfillment of the restructuring program referred to in paragraph 8 (c) (v) of Appendix I. The financial resources shall be used in the financing of investment projects, permanent working capital and the export of capital goods.

III. Cost and Financing

- 3.01 The estimated cost of the Program is the equivalent of US\$800,000,000 in accordance with the following categories and sources of financing.

Cost and Financing (in US\$ millions)

<u>INVESTMENT CATEGORY</u>	<u>BANK</u>	<u>LOCAL COUNTERPART</u>	<u>TOTAL</u>
1. Credits	297	500	797
2. Inspection and Supervision	3		3
TOTAL	300	500	800
PERCENTAGE	37.5%	62.5%	100.0%

IV. Liquid Capital

- 4.01 For the effects of what is established in paragraph A.(2) of Appendix II, Liquid Capital of BICE is understood as the capital paid in cash plus the recoveries, prepayments and/or third party sales of the OPRAC letters once the liability associated with these has been converted to capital. BICE may use the OPRAC letters as accounting capital for compliance with technical requirements established by the Banco Central de la República Argentina as long as an adequate provision is made to reflect the market value of these letters.

V. Eligibility Requirements for IFIs

- 5.01 In order to be considered eligible under the Program, an IFI shall have to pass the requirements established in a ratio analysis with minimum levels previously agreed with the Bank ("quantitative analysis") and an analysis of the financial condition and management ability undertaken by BICE ("qualitative analysis"). In the quantitative analysis the following weights and cut-off levels shall be used:

<i>Eligibility Factors</i>	<i>A</i>	<i>B</i>	<i>C</i>	<i>D</i>	<i>Weight</i>
<i>Solvency - Coverage of portfolio with liquid net capital (%)</i>	≤ 33	≤ 67	≤ 100	> 100	6.5
<i>Solvency - Coverage of risk with net capital (%)</i>	≤ 5	≤ 10	≤ 15	> 15	12.0
<i>Solvency - Coverage of risk with liquid net capital (%)</i>	≤ 10	≤ 20	≤ 30	> 30	6.5
<i>Portfolio quality - Percent of portfolio classified as irregular (%)</i>	≤ 4	≤ 6	≤ 8	> 8	21.0
<i>Earnings - Annual return on net Capital (%)</i>	≥ 18	≥ 12	≥ 6	> 6	7.0
<i>Efficiency - Coverage of structural costs with earnings (%)</i>	≤ 80	≤ 90	≤ 100	> 100	10.0
<i>Portfolio quality - Portfolio concentration (%)</i>	≤ 20	≤ 30	≤ 40	> 40	7.0
<i>Portfolio quality - Interest received over interest earned (%)</i>	≥ 95	≥ 90	≥ 85	< 85	7.0
<i>Final Return on Capital for semester (%)</i>	≥ 9	≥ 6	≥ 3	< 3	5.0
<i>Ordinary Return on Capital for month (%)</i>	$\geq 1,5$	≥ 1	$\geq 0,5$	$< 0,5$	5.0
<i>Ordinary Return on Assets (%)</i>	$\geq 0,45$	$\geq 0,30$	$\geq 0,15$	$< 0,15$	3.0
<i>Size - Net Worth (in millions of Argentine pesos)</i>	≥ 90	≥ 60	≥ 30	< 30	10.0

To be considered as an eligible financial institution, a bank must pass four of the first five indicators with a minimum classification of "C". The final classification shall be determined by the weighted average of all the indicators (calculated with the weights established, taking an indicator "A" as 1.00, one of "B" as .67, one of "C" as .33 and one of "D" as 0.00). A cut-off level shall be applied to this final indicator of 80% for "A" banks, 70% for "B" banks, and 60% for "C" banks. The limit of 60% for "C" banks may be lowered to 50% upon the presentation by BICE, to the satisfaction of the Bank, of an analysis which demonstrates that the risk of those banks classified between 50% and 60% does not differ from that of the banks classified between 60% and 70%. This system (including the individual cut-off limits and weights) shall be reviewed together with the Bank at least one time each year, based on the information available, such that these limits reflect the current situation of the Argentine banking system at the time of the review.

The qualitative evaluation, undertaken by BICE, shall concentrate on the financial analysis of the banks, management quality and capacity to evaluate and monitor long-term investment projects. BICE may use this qualitative analysis to eliminate a bank, to lower the classification of a bank as well as limiting amounts or establishing maximum terms. To include a bank form category "D" among the eligible banks or to raise the category of a bank, BICE should present a copy of their evaluation together with that of a private risk-rating agency (showing at least a result of "Investment Grade") to the Bank for its approval.

The cited evaluation system shall not be applied to the case of branches of international banks whose debt obligations have been classified as AAA or AA by Standard and Poors or Moodies in the understanding that these branches shall be classified as "A". Those branches whose debt obligations have been classified as A by these agencies shall be classified as "B" in the program.

VI. Determination of interest rate for the transfer of funds to BICE and from BICE to the IFIs

- 6.01 The loans from BICE to the eligible financial intermediaries shall be based on the conditions of Argentine financial markets. To this effect the Borrower shall transfer the funds (denominated in US Dollars) under the following conditions:
- a. The Borrower shall have the option of either offering funds at a floating rate over LIBOR or at a fixed rate based on a margin over the yield curve of U.S. Treasury Bonds, or a combination of both rates.
 - b. BICE, based on the classification assigned to each IFI, shall establish a margin above the base rate at which it has received the funds according to point (a) above. This margin shall be established in the following manner:

- i. Classification "A": BICE shall take the average yield in the secondary market for the longest term eurobonds and "obligaciones negociables" which have been issued by the private financial institutions classified as category "A" and compare this to the base rate for a similar term as established in point (a) above.

The difference among the two yields shall set the supplementary margin to be added to the base rate (whether it be over LIBOR or over Treasury Bonds) of a similar term.

- ii. Classification "B": The same as group "A" except taking the average yields on bonds issues by private financial institutions of Category B.

In the event that secondary markets do not exist or BICE considers these to be of insufficient liquidity, the difference in yields at the date of issue and the corresponding base rate (following point (a) above) at that same date shall be used.

- iii. Classification "B": The same as groups "A" and "B" except taking the average yields on bonds issues by private financial institutions of Category C.

In the event that less than 50% of the financial institutions classified as category "C" have issued "obligaciones negociables", and it would therefore not be possible to apply in a coherent fashion a comparison of these yields with the yield on the base interest rate, the margin shall be based on the margin applicable to category "B" IFIs plus an addition margin equal to the difference between the margins established for the IFIs in categories "A" and "B" respectively.

- c. The Borrower shall transfer funds to BICE at a rate that allows BICE to cover operating costs, credit risk, and an acceptable income level. To establish this rate, the Borrower and BICE shall agree on a profit margin which shall be subtracted from the rate calculated for the IFIs of category "A".

The commercial banks, in turn, shall transfer funds to their clients at the rates and financial conditions freely agreed between the two parties.