Report Number : ICRR12753

IEG ICR Review
Independent Evaluation Group

1. Project Data:		Date Posted :	09/20/2007	
PROJ ID :	P039994		Appraisal	Actual
Project Name :	Programmatic Financial Sector Adjustment Loan I	Project Costs (US$M):	15.0	15.0
Country:	Paraguay	Loan/Credit (US$M):	15.0	15.0
Sector Board :	FSP	Cofinancing (US$M):	0	0
Sector(s):	Banking (53%) General finance sector (28%) Central government administration (13%) Law and justice (6%)			
Theme(s):	Standards and financial reporting (23% - P) Regulation and competition policy (22% - P) Legal institutions for a market economy (22% - P) State enterprise/bank restructuring and privatization (22% - P) Debt management and fiscal sustainability (11% - S)			
L/C Number:	L7288			
		Board Approval Date :		04/05/2005
Partners involved :		Closing Date :	09/30/2006	12/31/2006

Evaluator :	Panel Reviewer :	Group Manager :	Group :
Khalid Siraj	Ismail Arslan	Jaime Jaramillo	IEGCR

2. Project Objectives and Components:

a. Objectives:

The objective of the first Programmatic Financial Sector Adjustment Loan (PFSAL I) was to strengthen the Government's capacity to manage weaknesses and stresses in the financial system and to prevent crisis contagion effects, by utilizing early corrective actions and market risk -sharing mechanisms to transfer and sell good loan assets of failed institutions, while reducing losses to the State . This was to be achieved by modernizing the bank restructuring and deposit insurance systems and improving the banking legal, regulatory and institutional framework.

b.Were the project objectives/key associated outcome targets revised during implementation?

No

c. Components (or Key Conditions in the case of DPLs, as appropriate):

The PFSAL I was the first of three planned loans ($15 million each for the first two and $30 million for the third) for reforming and strengthening of Paraguay's financial sector. The conditions for the first PFSAL related to three broad areas:

1. Adequate macroeconomic policy framework. The Government was required to maintain an adequate macroeconomic framework as agreed with the Bank, covering fiscal, monetary, exchange and financial sector policies.

2. Modernization of the Bank Restructuring and Deposit Insurance System: (a) The Board of Directors of Banco Central del Paraguay (BCP) issue resolutions establishing specific technical criteria for troubled financial institutions to improve their financial condition and prohibiting all financial institutions from pledging their assets as security for deposits held by individuals and/or legal entities; and (b) The Government and banks agree to renegotiate public bonds through an exchange of New Bonds for Old Bonds and that Congress approve the law authorizing such exchange of bonds.

3. Banking Legal, Regulatory and Institutional Framework: (a) BCP issue a resolution establishing new prudential norms (asset classification, loan loss reserves, etc.); (b) The submission to Congress of draft Banking and Anti-Money Laundering Laws; and (c) BCP approve the Superintendency of the Bank's (SB) Strategic Plan.

The conditions under the second and third PFSALs were aimed at further strengthening the actions taken under first PFSAL and restructuring of the state-owned banks. The Bank did not proceed with these two loans.

d. Comments on Project Cost, Financing, Borrower Contribution, and Dates:

There was a long delay in the approval of the PFSAL I by Congress. As a result, the loan effectiveness date was extended several times from September 12, 2005, the original date, to December 31, 2006. Three of the extensions were approved retroactively by the Regional management although the Bank policy (OP 13.00) required MDO's approval to such extensions. However, after this inconsistency with Bank policy was pointed out by the VP for OPCS, the Region obtained the required approval. The loan became effective on November 21, 2006 and was fully disbursed on November 27, 2006. The Bank in early 2007, decided not to continue with the second and third PFSAL because of political uncertainties related to the Congressional approval of new laws and some back-tracking by BCP on the application of new prudential norms.

3. Relevance of Objectives & Design:

The Program objective was relevant at the time of approval, and continues to remain so, to the country conditions and Bank's country strategy. Between 1995 and 2004, the country experienced major banking crises resulting in: (a) closure of 41 financial institutions (35 percent of financial system); (b)14 percent reduction (as percent of GDP) in credit to the private sector between 2002 and 2004; and (c) heavy cost to the Government and BCP (about 12 percent of GDP). Therefore, the first of the four pillars of the Bank's country strategy aims at strengthening the Government's core economic reforms including the financial sector. The CAS (November 2003) envisaged an FSAL with objectives similar to PFSAL. All program components were clearly priority areas for strengthening the financial condition of the banking sector to reduce its vulnerability to future shocks and increasing the flow of credit for domestic investment. The logical framework for the program had a strong direct causal relationship between actions and expected outcome. However, the design was over-ambitious and failed to correctly assess the feasibility of the proposed reforms in the context of the country's political climate.

4. Achievement of Objectives (Efficacy):

Performance of banks improved significantly in 2005-06 (moderate recovery in capitalization, strong earnings growth and a dramatic decline in past-due loans, from 14.5 percent in 2002 to 2.1 percent in 2006). As was envisaged, there was some progress towards consolidation of banks (number of banks reduced from 14 in 2004 to 13 in 2006). This positive performance is attributable partly to favorable economic developments in the country emanating from a good macroeconomic framework and, partly, to the reforms under the Program. However, finance companies have been lagging behind the banks as their capitalization has slipped further, but their consolidation has progressed as targeted (their number declined from 20 to 14). A disturbing recent development is the emergence of cooperatives as a major part of the financial sector (25 percent of assets of the financial system) and given that| they face a lighter regulatory requirements, they could take a greater market share from banks and finance companies, thereby enhancing the vulnerability of the financial sector, as a whole to possible shocks. Moreover, the expected Program benefit of increasing the availability of financing to the productive sector has not materialized yet as the banking sector loans to private sectors have fallen from 25 per cent of GDP in 2002 to 15 percent in 2006. This ratio might improve in future once banks have adjusted to the new regulatory regime

Rating: *Modest*

5. Efficiency (not applicable to DPLs):

Not applicable

a. If available, enter the Economic Rate of Return (ERR)/Financial Rate of Return (FRR) at appraisal and the re-estimated value at evaluation :

	Rate Available?	Point Value	Coverage/Scope*
Appraisal		%	%
ICR estimate		%	%

* Refers to percent of total project cost for which ERR/FRR was calculated.

6. Outcome:

In comparison to the Program objectives, there were a few positive outcome under the first PFSAL loan (improvement in the performance of banks, banks restructuring and deposit insurance system, and restructuring of state-owned banks). However, there were major shortfalls in the areas of the legal and regulatory banking frameworks (particularly failure with respect to adoption of new laws, institutional development of SB, and the building of a regulatory framework for cooperatives). The most critical shortfall was with respect to two core Program objectives, i.e., the financial sectors vulnerability to future shocks has not been alleviated significantly and increasing the financing to the productive sectors has not materialized .

a. Outcome Rating : Moderately Unsatisfactory

7. Rationale for Risk to Development Outcome Rating:

The modest development outcomes so far are susceptible to major political, economic, institutional, and governance risks. The country's economy is vulnerable to external shocks, there is an absence of a broad political support to major financial sector reforms and, institutional weaknesses persist in critically important institutions, i.e., BCP and SB.

a. Risk to Development Outcome Rating : High

8. Assessment of Bank Performance:

Quality at entry . The PFPAL I design was based on extensive sector analysis and close consultation with major donors, IMF and IDB. Generally, it covered all the major areas of financial sector. However, the design was over-ambitious and did not assess fully the efficacy and feasibility of the proposed reforms in terms of the political climate and institutional capacity in the country. This resulted in new laws required by the Program not being approved and the lack of progress on many institutional areas. Also, the downstream implications of the new prudential norms were neither fully considered nor an appropriate strategy developed. The reform of the cooperative sector was not given adequate priority in the design of the first loan, resulting in the growth of this sector under a weak supervisory framework and enhanced risks to the vulnerability of Paraguay's financial sector to shocks.

Quality of Supervision . The Bank's supervision of the Program was helpful to the borrower as it provided strong support during the partial implementation of the Program. The frequency of supervision and its coverage was adequate as was the reporting. The outcome targets were regularly monitored and comprehensively reported. Initially, retroactive extensions in loan effectiveness dates were approved by the Regional management, but once VP for OPCS pointed that Bank policy required such extensions to be approved by MDO, the required approvals were obtained.

a. Ensuring Quality -at-Entry: Moderately Unsatisfactory

b. Quality of Supervision : Moderately Satisfactory

c. Overall Bank Performance : Moderately Unsatisfactory

9. Assessment of Borrower Performance:

The Government maintained a satisfactory macroeconomic framework, a requirement of the Program which generated noticeable improvement in the performance of banks. It also remained committed to the overall financial sector reform process taking steps to implement some of the components of the Program (banks restructuring and deposit insurance, restructuring of state-owned banks). However, it was not able to develop broader political support to the reforms planned under the Program, and ensuring a strong governance of BCP.

The two implementing agencies, BCP and SB, supported the reform program by making efforts to implement it, but BCP was hampered by its own governance problems (lack of quorum in its Board of Directors and change in its President) and, as a result, the implementation of the Program suffered. SB implemented only a part of the Program relating to its activities.

a. Government Performance : Moderately Unsatisfactory

b. Implementing Agency Performance : Moderately Unsatisfactory

c. Overall Borrower Performance : Moderately Unsatisfactory

10. M&E Design, Implementation, & Utilization:

The expected Program results and outcomes stated in the policy matrix were expressed mostly in terms of change (growth of deposit fund, approval of new laws, compliance with new prudential norms, completion of specific tasks, etc.) but were adequate. There were no intermediate outcome indicators and the triggers for the second and third loans were to serve as intermediate targets. During the implementation period, the Bank staff regularly monitored the developments in the financial sector. Just prior to the delayed loan disbursement, an in depth assessment of the Program and its relevance was carried out. Bank's monitoring provided extensive data on the developments in the financial sector with baseline comparisons.

a. M&E Quality Rating : Substantial

11. Other Issues (Safeguards, Fiduciary, Unintended Positive and Negative Impacts):

Not applicable

12. Ratings:	ICR	IEG Review	Reason for Disagreement /Comments
Outcome:	Moderately Unsatisfactory	Moderately Unsatisfactory	
Risk to Development Outcome:	High	High	
Bank Performance :	Moderately	Moderately	See Section 8 above.

	Satisfactory	Unsatisfactory	
Borrower Performance :	Moderately Unsatisfactory	Moderately Unsatisfactory	
Quality of ICR :		Satisfactory	

NOTES:
- When insufficient information is provided by the Bank for IEG to arrive at a clear rating, IEG will downgrade the relevant ratings as warranted beginning July 1, 2006.
- The "Reason for Disagreement/Comments" column could cross-reference other sections of the ICR Review, as appropriate.

13. Lessons:

1. Design of projects particularly those supporting major structural and legal changes should strike a balance between what is needed to be done and what can be delivered given the capacity of the country. In assessing capacity and in addition to institutional capacity, the country's political economy should be given more weight.
2. For operations requiring major new legislation and where political support is weak, it would be advisable to design and launch the operation after the required legislation has been approved.
3. Financial sector reform programs aimed at reducing systemic vulnerability need to be inclusive of all important sectors. In this case, lack of fuller attention to the cooperative sector resulted in enhanced vulnerability of the financial sector to possible shocks.
4. When designing reform programs, the downstream implications of reform should be recognized and an appropriate strategy should be developed to deal with them. In this case, given the track record of banks and finance companies in Paraguay, it should have been recognized that new prudential norms would have major implications in terms of the quality of portfolio, provisioning requirements and capital adequacy ratios, and most likely, there would be resistance from banks and finance companies. A well-conceived strategy to handle such an eventuality could have ensured a smoother implementation of the new prudential norms.

14. Assessment Recommended? ○ Yes ● No

15. Comments on Quality of ICR:

The quality of ICR is satisfactory. It is comprehensive with succinct and relevant details of all major aspects. Its main strength is its candor with respect to the quality at entry, achievement or lack thereof so far, and the prospects for future financial sector reforms in Paraguay.

a.Quality of ICR Rating : Satisfactory