Public Disclosure Authorized

Public Disclosure Authorized

Document of
THE WORLD BANK

For Official Use Only

Report No. 23996-PA

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT

FOR A PROPOSED PROGRAMMATIC FINANCIAL SECTOR ADJUSTMENT LOAN

IN THE AMOUNT OF US$15 MILLION

TO THE

REPUBLIC OF PARAGUAY

March 7, 2005

Finance, Private Sector and Infrastructure Department
Country Department for Argentina, Chile, Paraguay and Uruguay
Latin America and the Caribbean Regional Office

This document has a restricted distribution and may be used by recipients only in the performance of their official duties. Its contents may not otherwise be disclosed without World Bank authorization.

CURRENCY AND EXCHANGE RATE
(As of February 28, 2005)

Currency Unit = Guaraní G/.
US$1.00 = G/. 6,275

FISCAL YEAR
January 1 – December 31

ABBREVIATIONS AND ACRONYMS

AML	Anti Money Laundering
BANAVI	Banco Nacional de la Vivienda (National Housing Bank)
BCP	Banco Central del Paraguay (Central Bank)
BNF	Banco Nacional de Fomento (National Development Bank)
CADEF	Calificación de Entidades Financieras (local bank rating system)
CAH	Crédito Agrícola de Habilitación (Agricultural Credit Fund)
CAMEL	Capital/Assets/Management/Earnings/Liquidity
CAR	Capital Asset Ratio
CFAA	Country Financial Accountability Assessment
CONAVI	Consejo Nacional para la Vivienda (National Housing Council)
CNV	Comisión Nacional de Valores (National Securities Commission)
DGCP	Directorate General for Public Procurement
ESW	Economic and Sector Work
FDI	Fondo de Desarrollo Industrial (Industrial Development Fund)
FDC	Fondo de Desarrollo Campesino (Rural Development Fund)
FG	Fondo Ganadero (Cattle Industry Fund)
FSAP	Financial Sector Assessment Program
GAFISUD	Financial Action Group of South America
GDP/GNI	Gross Domestic Product/Gross National Income
GOP	Government of Paraguay
IDB	Inter American Development Bank
IDP	Institutional Development Plan
IMF	International Monetary Fund
INCOOP	Instituto Nacional de Cooperativismo (National Cooperatives Institute)
IOU	Invoice of Understanding (or "I owe you")
IPS	Instituto de Previsión Social (Social Security Institute)
LIBOR	London Interbank Offer Rate
LOLR	Lender of Last Resort
MERCOSUR	Mercado Común del Sur (Southern Common Market)
MIC	Ministerio de Industria y Comercio (Ministry of Industry and Commerce)
MOF	Ministry of Finance
NIR	Net International Reserves
NPL	Non-Performing Loan
OAS	Organization of American States
PFSAL	Programmatic Financial Sector Adjustment Loan
PETROPAR	Petroleos Paraguayos (Paraguayan Petroleum Company)
RWA	Risk Weighted Assets
SB	Superintendency of Banks
SBA	Stand-By Arrangement
SIAF	System for Integrated Financial Administration
UTEP	Unidad Técnica Ejecutora de Programas (2nd Tier Financing Facility)
WOCCU	World Council of Credit Unions

Vice President:	Pamela Cox
Country Director:	Axel van Trotsenburg
Acting Sector Director:	John Henry Stein
Acting Sector Manager:	Susan Goldmark
Sector Leader:	Juan Gaviria
Lead Economist:	James Parks
Country Manager:	Peter Hansen
Task Team Leader:	John Pollner

FOR OFFICIAL USE ONLY

REPUBLIC OF PARAGUAY

PROGRAMMATIC FINANCIAL SECTOR ADJUSTMENT LOAN

TABLE OF CONTENTS

Update to the Board of Executive Directors i

Loan Summary ii

PART I. Recent Economic Developments and Prospects 1

A. Economic Context 1

B. Recent Economic Developments 3

C. Economic Prospects and Financing Needs 6

D. Multilateral Coordination 7

PART II. Financial Sector Context and the Reform Program 9

A. Overview 9

B. The Banking System 13

C. The Government Reform Agenda for the Banking System 24

The First Operation Under the Program 24

The Second Operation Under the Program 32

The Third Operation Under the Program 35

PART III. THE PROPOSED LOAN 38

A. Loan Description: Objective and Rationale for Bank Involvement 38

B. Conditionality 41

C. Disbursement and Auditing 45

D. Environmental Aspects 45

E. Program Objective Categories 45

F. Benefits and Risks 46

Annex 1: Policy Matrix 49

Annex 2: Letter of Financial Sector Development Policy 54

This document has a restricted distribution and may be used by recipients only in the performance of their official duties. Its contents may not otherwise be disclosed without World Bank authorization.

Annex 3: Background and Diagnostics of the Paraguayan Banking Regulatory and Resolution Framework and Technical Issues in the Reform 75

Annex 4: Timetable of Key Processing Events 91

Annex 5: Paraguay – IMF/Fund Relations 92

Annex 6: Paraguay – Status of World Bank Operations 95

Annex 7: Paraguay at a Glance 96

TABLES, BOXES AND FIGURES

Box 1: Progress To-Date on 'Political Agreement' and CAS Benchmarks 4
Box 2: Donor Technical Assistance Coordination 8
Box 3: Financial Soundness of BNF 22

Figure 1: Financing Structure for Proposed Deposit Insurance Fund 25
Figure 2: Summary of Bank Resolution Regime....27
Figure 3: Structure of Loan Portfolio Securitization Scheme 88

Table 1: Selected Economic Indicators 3
Table 2: Public Sector Debt Sustainability.... 7
Table 3: Estimated Public Sector Financing Needs.... 7
Table 4: Percent Coverage of Currency & Short Term Liquidity by International Reserves....10
Table 5: Monetary Components of Ratio 3 10
Table 6: The Paraguayan Banking System....13
Table 7: Non Performing Loan Ratios in the Banking System 14
Table 8: Accumulated Cost to date of Central Bank Rescue Measures 15
Table 9: Estimation of Deposit Insurance Funding Requirements....16
Table 10: Public (State owned) Financial Institutions in Paraguay....20
Table 11: Distribution of BNF's Deposit Liabilities....21
Table 12: External Financing Requirements 40
Table 13: Sequence of Adjustment Measures to 'Stress Test' Banking System Capital Adequacy ..82

Bank staff who worked on the Programmatic FSAL included: John D. Pollner (Lead Financial Sector Specialist / Task Team Leader, LCSFF), Joaquin Gutierrez (Lead Financial Sector Specialist, OPD), Jose Antonio Alepuz (Senior Counsel, LEGPS), Modibo Camara (Sr. Financial Economist, LCSFF), Peter Hansen (Country Manager, LCCPY), Susana Sanchez (Senior Financial Economist, LCSFF), Luz Meza Bartrina (Senior Counsel, LEGLA), Reynaldo Pastor (Senior Counsel, LEGLA), Zeinab Partow (Country Economist, LCSPE), James Parks (Lead Economist, LCC7A), Juan Gaviria (Sector Leader, LCSFP), Peter Hansen (Country Manager, LCCPY), and Javier Bolzico (Consultant). The Financial Sector reform program was developed based on the findings from a Financial Sector Review conducted in September 2002, and which included the following team: John Pollner (LCSFF), Modibo Camara (LCSFF), Mario Guadamillas (LCSFF), Joaquin Gutierrez (BFR) and Sergio Lleras (Consultant, LCSFF).

UPDATE TO THE BOARD OF EXECUTIVE DIRECTORS

The original Paraguay Financial Sector Adjustment Reform Loan (FSAL) was distributed to the Board of Executive Directors in August 2004 and subsequently withdrawn at the Government's request given a pending Board presentation condition. The pending condition was the submission of a new Banking Law to the Congress. A draft Banking Law, evaluated as satisfactory by the Bank, was submitted to Congress on December 10, 2004, thus meeting the pending condition.

Board presentation of the FSAL was also conditioned on progress with the restructuring and consolidation of the state owned financial institutions. In this context, a draft law was submitted to Congress in mid-2004 covering the consolidation of the first tier and second tier public financial institutions. This draft law was not taken up by the Congress and was subsequently replaced by another draft law covering the consolidation of the second tier public financial institutions only. While the Administration has reaffirmed its commitment to the full scope of the reform of the public financial institutions, these events reflect the challenging political environment in Congress. This was further reflected in the recent approval by Congress of expanded credit limits for the largest first tier public bank (*Banco National de Fomento*) which had been reduced earlier as a policy action endorsed by the Bank. These developments have increased the perceived risks to the program.

Despite the challenges, the Government has made important progress in implementing reform of the regulatory framework for the banking system. The Government's macroeconomic policies and performance remain satisfactory and Paraguay continues to meet the poverty, governance, structural, and portfolio triggers for the CAS base case lending program. On December 20, 2004, the IMF approved the third review of the Stand-By Arrangement and a six month extension of the program to September 30, 2005 to accommodate the authorities' modified strategy for the financial sector. The Inter-American Development Bank has postponed its policy loan which focused on the state banking reforms, and is proceeding with a credit line project to support the operation of the planned consolidated second tier bank, including implementation of financial operating rules and risk management policies.

In light of developments, the Bank and Government have agreed to proceed with a programmatic approach to Bank support for Paraguay's financial sector reform. Under this approach, Bank support is proposed through a sequence of three single tranche programmatic financial sector loans, the first a Financial Sector Adjustment Loan followed by two Financial Sector Development Policy Loans, to be presented to the Board as the reform program achieves sufficient, measurable progress. All of the elements of the original financial sector reform remain within the scope of the program as described in this Program Document for the first PFSAL, including the agreed triggers for the subsequent two PFSAL operations. While providing up-front support for reform actions already taken, the proposed loan amounts under the new programmatic approach incorporate a back-loading of Bank support to reflect the increased risks.

REPUBLIC OF PARAGUAY

PROGRAMMATIC FINANCIAL SECTOR ADJUSTMENT LOAN

LOAN SUMMARY

Borrower:	The Republic of Paraguay
Implementing Agencies:	Ministry of Finance with the assistance of the Central Bank
Objectives:	To strengthen the financial condition of the private and public banking sector in order to reduce vulnerability to future shocks and negative impacts on economic growth and increase the flow of credit for domestic investement.
Description:	Financial support to the Borrower for the formulation and approval of key financial sector laws and regulations including implementation of the recently approved deposit insurance and banking resolution law, new loan loss provisioning regulations, revision of the general banking law, and approval of a new anti-money laundering law.
Beneficiaries:	Enterprises of all sizes requiring improved access to financial services and credit, savers and depositors of the banking system, taxpayers, banking sector regulatory and supervisory agencies, and the Treasury of Paraguay.
Poverty Issues:	For the banking system as a whole, the implementation of bank resolution and deposit insurance schemes will, as a priority, protect the smallest depositors with the least economic assets, and assure prompt repayment of their deposits in the event of bank failures while reducing costly bank bail-outs at taxpayers' expense.
Risks:	Main risks pertain to political, macroeconomic, governance and institutional capacity. The main risk is that Congress may not approve in full some of the key legislation supported by this operation such as the banking law which would undermine the adjustment program. Stricter capital and provisioning regulations may initially lead to further contraction in commercial bank credit available to the private sector, especially if the macroeconomic environment is less conducive towards improvement in banks' financial condition. A public information campaign and consultation with the banking industry will help to encourage participation in the reforms, as well as a gradual phasing in of some of the tougher reforms such as the increase in base capital and loan loss provisioning requirements. Institutional capacity

constraints are being mitigated with the support of an accompanying Technical Assistance project.
Governance risks are being addressed through the implementation of audits of the reforms, continuation of the Government's public transparency campaign, and implementation of the new anti-money laundering legislation to prevent the flow of illicit funds under more effective institutional arrangements.

Amount:	US$15 million, to be disbursed in a single tranche.
Terms:	LIBOR-based fixed spread US Dollar loan with a grace period of 5 years, a final maturity of 23 years, and level repayment of principal, at the Bank's standard variable interest rate.
Commitment Fee:	0.35 percent (net of waiver) on undisbursed loan balances, beginning 60 days after Loan signing.
Front-end Fee:	0.50 percent of the loan amount payable upon effectiveness.
Schedule of Disbursements:	To be disbursed upon Board approval and compliance with standard effectiveness conditions. Policy conditions met prior to Board presentation.
Economic Rate of Return:	Not applicable.
Project Identification No.:	PE-P039994-LEN-BB

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
PROGRAM DOCUMENT
FOR A PROGRAMMATIC FINANCIAL SECTOR ADJUSTMENT LOAN
TO THE
REPUBLIC OF PARAGUAY

1. This memorandum proposes a Programmatic Financial Sector Adjustment Loan to the Republic of Paraguay in the amount of US$15 million to support the reform of the banking system through a new framework for banking legislation, and supervision and resolution of distressed banks. The program would be implemented jointly by the Ministry of Finance with the assistance of the Central Bank. The Loan would be fixed spread LIBOR-based, US Dollar denominated, with a grace period of five years, a final maturity of twenty three years, and level repayment of principal at the Bank's standard variable interest rate.

PART I. RECENT ECONOMIC DEVELOPMENTS AND PROSPECTS

A. Economic Context

2. Following several years of economic stagnation and decline, exacerbated by political stalemates that prevented advances on important policy reforms, a new Paraguayan administration came to power in August 2003. Enjoying substantial political support, the Government has since achieved important advances in its program of economic reforms. Economic performance has also been positive in 2003 and 2004, following several years of deteriorating GDP and fiscal indicators. The Government has reached agreement on a precautionary Stand-By Arrangement (SBA) with the IMF and re-activated the lending program with the Bank.

3. The shift in performance and outlook came on the heels of a major economic crisis in 2002, which was the culmination of several years of fiscal mismanagement and inability to undertake needed policy reforms. A small open economy, with an estimated GDP of US$6.6 billion (2004), Paraguay is one of the poorest countries in the region with a per capita income of about US$1100[1]. Heavily dependent on agriculture (cotton, cattle, timber, and recently, soybeans) and on regional conditions, the economy has been aided in recent decades by an open trading environment which fostered significant contraband trade with neighbors Brazil and Argentina. While Paraguay enjoyed economic booms during the construction of the Itaipu and Yacyretá hydropower projects between the late 1970s and the early 1990s, the prosperity proved to be transitory.

4. Although economic management was gradualist and fairly prudent in the years following the end of the military dictatorship in 1989, with balanced fiscal accounts, small current account deficits and declining inflation, growth performance was disappointing. Protracted slow growth which went negative in recent years, reflected a decline in total factor productivity associated with a shrinking investment ratio, little progress in structural reform, fiscal deficits, and widespread corruption.

5. Poor policy performance was exacerbated by a series of external and domestic events. Major banking crises in 1995 and in 1997-98 led to the closure of a number of domestic banks, the reduction of credit to the private sector, and a sharp drop in private investment. Paraguay's terms of trade

[1] Gross National Income per capita for 2003, Atlas method.

deteriorated significantly after the mid-1990s and the country suffered droughts in 1999, 2000, and most recently in 2002. The economy was battered by adverse developments in its main trading partners, namely the Brazilian devaluation of 1999 and the recession and financial turmoil in Argentina in 2001-2002.

6. The combination of external vulnerability and a poor policy environment resulted in exceptionally poor growth performance, particularly since the mid-1990s. While GDP growth averaged 1 percent per year, annual population growth stood at 2.5 percent. The outcome has been a secular decline in per capita GDP to pre-1990 levels. Poverty was estimated at 41 percent in 2003 with the extreme poor making up 20 percent of the population. Poverty is concentrated in the rural areas where half of Paraguay's population lives, and is exacerbated by polarized income and land distribution.

7. In 2002, worsening economic conditions came to a head as GDP fell by 2.3 percent, leading to an over 4 percent contraction in per capita income. Inflation rose to double digits, the guaraní depreciated by nearly 40 percent, and the public sector's fiscal situation deteriorated sharply, recording a deficit of 3.1 percent of GDP. As a result of the depreciation, public external debt climbed to nearly 50 percent of GDP from 33 percent a year earlier. Given Paraguay's lack of access to financing, either internal or in the international capital markets, the fiscal gap was financed by a combination of delays in public sector salary payments, postponement of public investment expenditures, the drawing down of deposits at the Central Bank and the accumulation of arrears to creditors and suppliers. At the end of 2002, arrears on debt service amounted to almost 3 percent of GDP.

8. *Financial Sector Problems.* The Government and Central Bank intervened in four banking crises between the mid 1990s and early 2000s during which a number of financial institutions accounting for approximately 35 percent of the financial system were liquidated. The currency suffered a loss of confidence as the Central Bank used its reserves to rescue insolvent banks (via long term credits, deposit guarantees, lender of last resort facilities and other instruments). Overall outlays amounted to almost 12 percent of GDP with only 5 percent having been recuperated to date by the Central Bank. The additional liquidity injected into various banks ultimately failed, and there was an additional cost to the Central Bank in terms of the interest paid on open market operations to mop up excess liquidity. In 2002, a run on Banco Alemán – which itself was healthy but suffered contagion from the failure and dissolution of a mutual fund affiliate – eventually required its closure. Since then and through 2004, an additional four banks closed down, some voluntarily, due to the rising share of non-performing loans.

9. The result of the financial sector problems has been a reduction in bank credit to the private sector by about a 14 percent at the end of 2004 compared to two years earlier, although credit began to grow in the second half of the year. The banking system is highly dollarized, and remains vulnerable to shocks. Another major problem is the critical condition of the public development bank, the *Banco Nacional de Fomento* (BNF), which suffers from both illiquidity and insolvency with non-performing loans constituting more than half of its portfolio. Other serious issues include weak bank resolution and supervision processes and institutions, accounting practices and norms that do not comply with international standards and that over-estimate local bank solvency, a deposit guarantee system that relies on direct financial support from the State, an antiquated banking law lacking modern resolution procedures[2], and vulnerability of the Central Bank to interference and pressure from the Executive.

[2] A modern banking resolution law including a private sector deposit insurance scheme was approved in December 2003.

B. Recent Economic Developments

10. Economic performance improved markedly in 2003 and 2004 with GDP expanding by an estimated 2.6 and 2.9 percent respectively (Table 1). The increased growth in 2003 was the result of a 12 percent expansion in the agriculture sector thanks to exceptionally high international prices of soybeans and cotton. Rising agricultural exports bolstered the guaraní which appreciated by close to 15 percent with respect to the US dollar over the year allowing inflation to return to single digits and international reserves to rise by 50 percent. After several years of deficits, tight spending policies and improved tax administration resulted in primary surpluses. These trends strengthened in 2004, as economic growth continued despite a drought, supported by favorable regional and global conditions. Unlike 2003, growth was more balanced across sectors, with nearly all areas contributing to the economic expansion. Thanks to a 36 percent rise in tax revenues and to constrained public spending, the Central Government achieved an estimated primary surplus of 2.7 percent of GDP. The guaraní remained stable, depreciating by 5 percent with respect to the US dollar, and CPI inflation ended the year at 2.8 percent.

Table 1: Selected Economic Indicators

	1996-2001	2002	2003*e*	2004*e*	2005*p*
GDP (% growth)	1.0	-2.3	2.6	2.9	3.2
Central Gov. Balance (% of GDP)	-2.1	-3.2	-0.2	1.9	-0.3
Central Gov. Primary Balance (% of GDP)	-1.2	-1.7	0.9	2.7	1.0
Public Sector External Debt (% of GDP)	24.0	48.4	44.7	39.0	38.1
Current Account Balance (% of GDP)	-3.3	1.7	2.4	0.7	-0.4
CPI Inflation (e-o-p, %)	8.6	14.6	9.3	2.8	5.0
Depreciation (avg, %, - =depreciation)	-13.3	-39.0	-12.6	-5.1	-6.0
Imports (US$, % growth)	-13.1	-13.5	11.0	30.7	6.2
Exports (US$, % growth)	-7.8	0.0	12.6	29.7	3.0

Source: Ministry of Finance, IMF and Bank Staff estimates   *e* = estimate; *p* = projection

11. Registered exports grew by nearly 30 percent in part due to strong soy prices and access to new export markets for meat. Imports also expanded by 30 percent in the same period, reflecting both the economic recovery and higher petroleum prices. As a result, the current account surplus declined to 0.7 percent of GDP in 2004, from 2.4 percent in 2003. Net central bank purchases of foreign exchange have offset upward pressures on the currency from buoyant export earning and large private capital inflows, moderating the growth of the money supply, and increasing international reserves to US$1.2 billion at the end of 2004.

12. Despite Paraguay's lack of access to international markets, total external debt, mostly public sector, is estimated to have reached 49 percent of GDP in 2002, declining to about 45 percent in 2003 as a result of GDP growth and the appreciation of the guaraní[3]. The debt-to-GDP ratio is estimated to have declined to 39 percent by the end of 2004 due to economic expansion and a primary surplus, and helped by low international interest rates and the depreciation of the dollar. For the medium term, and barring a further major depreciation of the guaraní, debt service payments are not projected to increase dramatically as debt is mainly long-run and concessional. The on-going and projected improvement in the public finances should also ease concerns about debt sustainability.

[3] The 2003 debt ratio reflects an increase of over 10 percentage points with respect to its 2001 level, largely the result of the depreciation of the guaraní and poor growth performance, rather than a significant amount of new debt.

13. *Policy reforms.* The Administration took advantage of the incipient recovery and strong political support to quickly launch an economic adjustment and reform program. By the end of 2003, notable advances on a package of core economic laws had enabled the Administration to reach an agreement with the IMF for a precautionary 15-month Stand-By Arrangement (now extended by six months) and led to the support in lending for financial sector programs, totaling a combined US$45 million from the Bank and the IDB. Together with the Administration's agreement with commercial banks to reschedule over US$100 million in domestic debt which was complemented by accords with bilateral creditors to reschedule debt service arrears, this facilitated a significant reduction in arrears.

14. The Administration's economic program aims to stabilize Paraguay's macroeconomic situation and begin a process of structural reform, with priority placed on addressing the country's long-standing governance problems and improving the efficiency and transparency of government operations. In October 2003, the President signed a political agreement with the heads of both houses of Congress and with opposition party leaders to pass a series of economic reform laws designed to constrain current expenditures, tackle key fiscal drains on the public accounts, enhance tax and tariff revenues, and address urgent vulnerabilities of the economy such as those associated with the financial sector and public enterprises. These bills included an austere budget for 2004, the renegotiation of domestic debt obligations with commercial banks, a tax reform bill to widen the tax base and eliminate loopholes and exemptions, laws to strengthen the banking system through improved bank resolution and deposit insurance and to reorganize ailing public banks, legislation reforming the government employees' pension plan which was the major drain on public finances, a new customs code to modernize and strengthen the customs administration, and a plan for the restructuring of public administration. Of the eight bills included in the agreement, six have already been approved by Congress (the 2004 budget law, debt restructuring, deposit insurance and bank resolution, the government pension law, the tax reform, and the customs code).

Box 1: Progress To-Date on 'Political Agreement' and CAS Benchmarks

Reform Initiative	Status in Congress	Comment
Budget Law for 2004	Approved	Implemented
Tax Law	Approved	Key CAS Benchmark: Approved by Congress and in effect
Government Pensions Law	Approved	Key CAS Benchmark: Approved by Congress and in effect
Debt Restructuring Law	Approved	Law in effect
Deposit Insurance and Bank Resolution Law	Approved	Law in effect
General Banking Law	Presented	To be debated
Public State 2nd Tier Banks Law	Presented	To be debated
Customs Code	Approved	Law in effect
Public Administration Restructuring	Pending	Not yet presented

15. In addition to legislative advances, the Government has taken concrete actions to address some of the main immediate obstacles impeding Paraguay's return to sustained economic growth and

poverty reduction. Steps for improving the soundness and performance of Petropar, the State petroleum company are underway[4]. Significant steps have been taken to tackle short-run fiscal issues. A number of measures were swiftly implemented to halt growth of spending including withdrawal of budgetary supplements presented during the previous Administration and freezing of public sector wages. The administration also moved to tackle the pervasive problem of tax evasion and poor tax revenues. The results of this effort to date have been impressive: a 36 percent increase in tax revenues in 2004 as compared to 2003. More recently, in order to ensure that fiscal targets for the year are met, the Government announced the imposition of a temporary 4 percent tax on soybean industry exporters who traditionally bear a very low tax burden in Paraguay.

16. Alongside fiscal measures to contain spending and increase revenues, the Administration has also embarked on a program of administrative measures to increase transparency and reduce waste and corruption in the public sector. These have included steps to begin the cleaning up of two state institutions: the state development bank (Banco Nacional de Fomento, BNF) and the state social security institute (Instituto de Previsión Social, IPS). The top command in the military and national police have been replaced and the Government succeeded in the difficult political challenge of changing two thirds of the judges sitting on the Supreme Court. The Administration has also taken actions in the areas of tax and customs administration. A census of public sector employees was recently completed which, in addition to playing a key role in rationalizing resources and enhancing the performance of the public sector, is serving to audit employee rolls in order to eliminate phantom workers and those illegally collecting more than one salary. Similarly, the government pension rolls are being cleaned, with 1600 non-justified pensions eliminated to date.

17. The Government has made important progress in implementing Paraguay's Procurement Action Plan following the regulation of the recently approved Public Procurement Law and the resolution creating the Directorate General of Public Procurement (DGCP). A procurement portal has been launched on the Web. At this stage, this website is an informational one which includes the annual procurement plans for state institutions, available bidding documents, the bulk of invitations to bid and contract awards, as well as a list of ineligible and black-listed contractors. This is seen as the first step in a full-fledged electronic procurement system. In addition,a public process for the competitive selection of the head and key staff of the DGCP has taken place, as have public hearings on the newly designed standard public bidding documents. Progress on these measures and the increased transparency of public procurement practices has already led to reductions in spending on goods and services and to more efficient public investment.

18. The Government is implementing strategies to continue to improve financial management in Paraguay. Public sector budgeting and accounting have been transformed and an integrated financial management system (SIAF) has been implemented in the Central Government and in some decentralized agencies. The IDB has been supporting the Government in this effort through technical cooperation operations. Measures to introduce accrual accounting into the SIAF and to further expand it to other decentralized agencies were supported under the World Bank's Economic Recovery

[4] A CAS benchmark for the base case scenario is that the net worth of Petropar should not decline with respect to its level on December 31, 2003. Petropar's net worth fell in 2004 as a result of the failure of domestic prices to keep up with the rising international price of oil. Diesel prices have been adjusted only to the level prevailing in neighboring countries. Recently, however, an important change to the way in which domestic prices are set has been effected allowing Petropar, rather than the Government, to set price increases. This should ensure that increases will be governed by economic rationale rather than by political expediency. Moreover, with the assistance of the Bank, a new law for the fuel sector has been prepared, which would increase competition in the sector, and would end Petropar's *de facto* monopoly in the import of diesel. The framework is currently being discussed by the Cabinet's Economic Team, which will present a draft law to Congress.

Structural Adjustment Loan approved in December 2003. A peer review of the Comptroller General's audit procedures is underway, and an internal audit manual for the institution is being prepared. The Government has announced that it will perform regular, independent audits of public enterprises which will also be subject to increased data publishing requirements to improve transparency. Five such audits were performed in 2004, of the electric power utility, the telecommunications company, the telecommunications corporation, the urban water and sewerage company, and the social security institute. This is part of an effort to improve efficiency and governance in Paraguay's public enterprises which, despite having a strong presence in key economic activities of the country, have been plagued by inefficient operations and inadequate financial management.

19. The new Government's track record has been encouraging, and the Administration has shown strong commitment to macroeconomic and fiscal stability. This has begun to engender increased confidence by the private sector and has paved the way for implementing a financial sector reform program developed through years of collaboration between the Bank and successive governments. In addition to the recently approved Deposit Insurance and Bank Resolution Law, the Government has put in place a new regime to phase in higher cash provisions in the banking system to guard against potential losses on non-performing loans.

C. Economic Prospects and Financing Needs

20. The Government's economic reform program, along with greater external stability, make the outlook in Paraguay more stable than it has been in recent years. Forecasts are for continued GDP growth on the order of 3.2 percent in 2005, supported by enhanced overall confidence and gradually strengthening domestic demand. While a severe drought affected agricultural yields in 2004, other sectors of the economy are expected to expand. Inflation has declined and the exchange rate has remained broadly stable.

21. Public finances improved in 2004 as tax receipts grew at 36 percent above their level in 2003, generating over 2 percent of GDP in additional revenues. Implementation of the tax reform bill that was approved in 2004, and which is expected to generate an estimated 1 percent of GDP in additional revenues in 2005, will help ensure continued good revenue performance in the medium term. On the spending side, the growth of current expenditures in 2004 was constrained to 8 percent in nominal terms, largely reflecting salary increases following 3 years of a public wage freeze.

22. As a result, the Government over-performed on its target of a fiscal surplus of 0.1 percent of GDP for the full year, as established in the IMF SBA, with the estimated surplus standing at 1.9 percent[5]. Paraguay met the quantitative targets for the third quarterly review of the program, which was completed and approved by the Fund's Board in December 2004. The third review also supported the Government's request for an extension of the SBA to September 2005, in order to complete outstanding structural reform measures, especially in the financial sector.

23. The projected improvement in the public finances eases concerns about debt sustainability. Fiscal constraint, combined with economic expansion and a stable local currency, translated into a gradual reduction in Paraguay's debt-to-GDP ratio in 2004. The debt ratio is estimated to have fallen to about 39 percent of GDP from 44 percent in 2003. Under a scenario of continued fiscal prudence (with real primary spending growth of 2-3 percent) medium-term GDP growth of 3-3.5 percent, a stable real

[5] Central Government.

exchange rate and 5 percent inflation, public sector debt is projected to decline to about 33 percent of GDP by 2008 (Table 2). The debt dynamics assume continued access to official financing at concessional rates.

Table 2: Public Sector Debt Sustainability, 2003-2008

	2003	**2004**	**2005**	**2006**	**2007**	**2008**
Public sector debt (% of GDP)	44.7	39.0	38.1	36.0	34.4	32.8
Key macroeconomic / fiscal assumptions						
Real GDP growth (%)	2.6	2.9	3.2	3.4	3.4	3.4
Avg. nominal interest rate on public debt (%)	6.0	5.8	5.8	5.8	6.1	6.4
Inflation rate (GDP deflator, %)	9.3	2.8	5.0	5.0	5.0	5.0
Growth of real primary spending, (%)	-5.0	4.0	2.2	3.8	2.1	2.2

Source: Bank Staff projections, IMF.

24. Given Paraguay's lack of access to international financial markets, the Government continues to face financing needs on the order of US$200 million for 2005 that are projected to be met by multilateral and bilateral lending (Table 3). In addition, the balance of payments projections for Paraguay show an overall financing need of US$186 million in 2005 and US$281 million in 2006, out of which the expected foreign exchange contribution from multilateral and official flows (net of new commercial inflows/outflows) would be US$185 million and US$150 million respectively, with this loan's projected disbursements of US$15 million constituting a portion of those amounts (also see Table 12).

Table 3: Estimated Public Sector Financing Needs

	2004		**2005**	
	Million US$	*% of GDP*	*Million US$*	*% of GDP*
Gross financing requirements	118	1.7	203	2.8
Deficit	-100	-1.4	39	0.5
Amortizations	123	1.8	164	2.3
Domestic debt	19	0.3	27	0.4
External debt	103	1.5	137	1.9
Net reduction in arrears	95	1.4	0	0
Financing sources	118	1.7	203	2.8
Net credit from banking system	-6	-0.1	0	0
Quasi-fiscal deficit financing	-34	-0.4	17	0.2
Multilateral/Bilateral/Official	158	2.3	185	2.6
Project Lending	158	2.3	155	2.1
Program Financing	0	0	30	0.5
Of which World Bank PFSAL			15	0.3

*Includes Fonplata and Taiwan rescheduling, and changes in reserves.
Source: IMF and Bank Staff estimates.

D. Multilateral Coordination

25. The Bank is closely coordinating the design of a financial sector and state bank reform program with both the IMF and the IDB (Box 1). The IMF SBA includes structural benchmarks for financial sector reform. The Bank and IDB have prepared a joint financial sector program with actions related to the reform and modernization of the banking sector and the rationalization and downsizing of the state banks. IDB has postponed its adjustment lending and will initiate the process through financial

intermediation lending to support the new consolidation of the state banks into a single second tier institution, reflecting the first half of the state bank reforms. The Bank has also prepared a parallel Technical Assistance project to support reform implementation and institutional strengthening. The IMF program supports the financial sector reform commitments in the Bank program, but also includes complementary issues such as increasing the independence of the Central Bank, supporting the organizational reengineering of the Central Bank, providing technical assistance for twinning arrangements with Chile's banking superintendency, and moving towards obtaining international credit ratings of Paraguayan banks. The IDB program also supports separate but complementary issues such as improving the supervision and institutional framework for the cooperatives and credit union sectors.

26. The sectoral program supported by this programmatic operation is aimed at financing policy reform efforts to ensure the stability of the financial system during this critical period. A well functioning banking system which can provide broad access to credit in the economy, while maintaining prudent reserves against risks, is essential to achieving a higher sustained level of investment and GDP. A lack of investment financing can quickly stifle the renewed growth if domestic sources of financing do not become available due to balance sheet weaknesses in financial institutions. The reform program intends to prevent such outcomes by undertaking up-front reform actions to fortify the banking system.

Box 2 – Donor Technical Assistance Coordination

The following delineates the specific policy and technical areas that each donor is focusing on with respect to technical assistance activities and funding for the financial sector:

<u>World Bank</u>: Technical assistance sources include a Japan PHRD grant for use in preparation of the PFSAL program and a Technical Assistance project to accompany the PFSAL. Activities include financing of (i) the regulatory and operational development of the bank resolution procedures to be used for managing and transferring failed bank assets and deposits, (ii) the design and implementation of the new deposit insurance fund, (iii) the upgrading of supervisory processes, systems and procedures, (iv) the strengthening of procedures and systems for the detection and prevention of money laundering, and (v) the modernization of the banking payments system.

<u>IMF</u>: Technical assistance sources include funds from the IMF's internal technical assistance program. These include financing twinning arrangements with Chile's banking superintendency to develop market risk regulatory and provisioning requirements for Paraguay and upgrade bank examination techniques. IMF assistance also includes technical input for the reorganization of the Central Bank, auditing requirements for Central Bank financial statements, and advice on payment system issues as they relate to systemic risks.

<u>IDB</u>: Assistance from the Inter American Development Bank is funded both by multilateral investment grants resources and technical assistance loans. Activities include (i) improvement in the infrastructure and regulatory framework for the supervision of cooperative credit institutions, (ii) technical assistance for the implementation of the reform to consolidate the State owned financial institutions, (iii) upgrading of the systems infrastructure for reporting on money laundering activities, (iv) upgrading of the securities settlement systems, and (v) establishing of a supervisory authority to oversee non bank financial institutions.

<u>US Treasury</u>: The US Treasury has been instrumental in assisting in the drafting and completion of a modernized anti money laundering law which centralizes the coordination and data analysis function for detecting and prosecuting potentially illicit money flows.

PART II. FINANCIAL SECTOR CONTEXT AND THE REFORM PROGRAM

A. Overview

27. The Paraguayan banking system has been in a vulnerable state for a number of years, in large part due to the continuing anemic economic growth, but also due to the incidence of at least three separate banking crises since 1995 to-date, during which twenty one banks and over thirty finance companies were dissolved. Presently, the banking system is primarily foreign owned. In terms of deposits, 35 percent of banks represent branches of foreign banks and another 41 percent are either regional banks or locally based banks with a majority foreign ownership. Excluding the finance companies which represent under 10 percent of the financial system, the remainder of the banks are three local banks which hold 24 percent of deposits including the State bank, BNF with 9 percent.

28. Although deposit growth has been steady, credit has been contracting, primarily due to a higher share of non-performing loans from slow economic growth, and more recently due to credit defaults of borrowers highly exposed in dollars. Average intermediation spreads in local currency remain high, easily reaching 20 percentage points. This not only reflects cost inefficiencies, but more importantly high rates which compensate for large portions of loan portfolios which are not performing, particularly those denominated in local currency. Banking reserve requirements are inversely proportional to the maturity term of deposits. This puts a higher reserve cost on short term deposits and would normally encourage banks to offer longer term instruments.

29. However, given depositor preference for short term deposits and banks' preferences for shorter term lending, the result is a relatively high reserve/deposit ratio which increases intermediation costs particularly on dollar denominated loans, and therefore on lending rates. For deposits in domestic currency the reserve requirement is: 15 percent for deposits up to 1 year maturity; 7 percent for maturities between 1 and 1½ years; and zero for over 1½ years. For dollar deposits, the requirement is: 27 percent for up to one year; 15 percent for between 1 and 1½ years; 5 percent for between 1½ to 3 years; and zero above 3 years.

30. Due to the difficult external environment in the past three years, generated in part by Paraguay's large neighbors (Brazil, Argentina), the Paraguayan monetary authorities took action towards managed devaluations in order to maintain export competitiveness vis-a-vis the country's main trading partners. However, such devaluations have also put indirect stress on the banking system since a large portion (57 percent) of loans are denominated in US dollars and for borrowers with no hard currency income (approximately 85 percent of borrowers), any devaluation translates into a higher debt servicing load in local currency terms, thus increasing credit risk and possibilities of default on payments. Therefore, about 48 percent of the loan portfolio is at risk of payment difficulties due to current and potential devaluations.

31. The devaluation effect has, however, strengthened Paraguay's ratio of hard currency reserves to national currency since the latter has lost value. Even taking the most conservative measurement of available international reserves to back up a potential currency run, the reserve backing appears adequate (see tables below) and the Government does not pretend to defend the currency with a fixed rate policy, particularly given the recent loss of reserves in trying to defend the currency after the previous wave of Brazilian devaluations. Nevertheless, while reserves are adequate for this particular purpose, additional shocks related to trade payments and withdrawal of banking system dollar deposits, may render them somewhat limited for covering international payment obligations, if needed. In

addition, the dollarization risk which affects the corporate borrowing sector represents a large potential vulnerability problem for banks in terms of the higher credit risks, and therefore increasing non-performing loans, that this implies from unhedged borrowers.

Table 4
Percent Coverage of Currency & Short Term Liquidity by International Reserves

Ratio 1	***Ratio 2***	***Ratio 3***
Total net international reserves / Currency	Total net international reserves / (currency + open market c.b. bills + call money liabilities)	Total net international reserves - US$ bank reserve deposits at central bank / (currency + open market c.b. bills + call money liabilities + bank local currency deposits at c.b.)
291%	177%	93%

Source: Central Bank of Paraguay Data as of December 31, 2004

Table 5
Monetary Components of Ratio 3

	(US$ millions)
I. Net international reserves (NIR)	1,168
Less: $ bank deposits in BCP	254
Available NIR	**914**
II. Currency in Circulation	401
Plus: Central Bank Bills	258
Call Money Liabilities	---
Bank Local Currency Deposits in BCP	320
Sub-total M0 (modified)	**979**
III. Net International Reserves (available) / M0 + banking system liquidity	**93%**
IV. Gap for full forex backing of currency	**(65)**

Source: Central Bank of Paraguay (BCP) Data as of December 31, 2004

32. Money supply indicators show that M1 grew by 29 percent in the year on year period from end November 2003 through November 2004. Credit to the private sector increased by 17 percent during the same period although this was accounted for in part because the nominal exchange rate appreciated slightly during the same period. M2 grew by 27 percent during that annual period reflecting more liquidity in the financial system with lowered interest rates. While the BCP's open market operations continued to place additional paper on the market to absorb excess liquidity, these were priced at lower rates, which, along with the extremely low inflation achieved, allowed the guaraní to appreciate against the dollar (the guaraní had reached a devaluation peak in early 2003). The preference for foreign currency deposits was reversed in 2004 with a decline of 6 percent since the end of the first quarter, with an increasing share moving to local currency deposits which increased by 12 percent, in part due to the very low interest rates offered for dollar deposits and the stabilization of the exchange rate. While additional dollarization might have some benefits such as making the financial system less vulnerable to currency risks, it also generates more structural vulnerabilities due to emergence of corporate credit risks from increased local currency debt servicing costs on dollar denominated borrowing. The loosening of monetary policy and overall lowering of interest rates under a more

stable exchange rate environment has de-dollarized the banking system by about 5 percent. The increased banking liquidity which now remains at very high levels has resulted in the expansion liquid financial investments to compensate for the reduced willingness of banks to lend within an environment of lower solvency ratios and decreasing earnings.

System Vulnerabilities

33. The reform program supported by the PFSAL to a significant extent developed out of the Paraguayan Financial Sector Review (Grey Cover Report No. 24249-PA, November 15, 2002). That Review took an FSAP-style approach to diagnosing financial system risks and regulatory vulnerabilities. It recommended key reform actions and was discussed extensively with the authorities (particularly the Central Bank and the Ministry of Finance) who worked closely with the Bank to define the future policy actions implied from that diagnosis.

34. The Review addressed a number of critical issues in the Paraguayan banking system, including the need to reform the exit procedures for weak or insolvent banks, the need to strengthen banking prudential regulations such as loan loss provisioning and capital adequacy norms, the need to establish a banking sector funded deposit insurance scheme versus a publicly guaranteed scheme, and the critical need to reform the State owned banks which required capital injections and major reforms to stem losses and limit exposures to smaller borrowers. The Review also conducted a vulnerability stress test of banking balance sheets (described further below) to determine which institutions had capital deficiencies and where existing regulatory norms could be improved to address these and mitigate future risks.

35. The main challenge in Paraguay's financial system is to assure stable banking institutions and to manage the smooth exit of financial institutions not capable of weathering the economic cycles and ensuring an adequate capital base. The financial system remains vulnerable after periodically re-emerging banking crises. The first crisis in 1995 was primarily generated by the collusion of various banks representing about 10 percent of the financial system and the Central Bank, in which banking reserves were re-lent on the black market through unregistered institutions. Besides the illegality of the entire scheme, the derived effects ended up affecting 18 financial institutions and the Central Bank ended up spending US$400 million equivalent to bail out the banking system to avoid a systemic collapse.

36. In 1997 the second banking crisis occurred when Banco Union, followed by Banco de Desarrollo del Paraguay collapsed after a run on deposits. In part, the weakness manifested in these banks also pertained to the legacy of the previous banking crisis, since Banco Union in particular suffered from non-performing assets which were in large part linked to the absorption of repossessed assets as part of a settlement in the previous crisis. The next crisis occurred in 1998 following the Government's decision to raise domestic interest rates to maintain currency stability and attract foreign investment. The sale of Central Bank T-bills for this purpose, resulted in a sharp contraction of liquidity from the financial system prompting some public sector agencies such as the social security institute to begin withdrawing its deposits from banks which appeared weak after the liquidity tightening. This generated contagion effects until finally a total of eight banks had to be intervened and closed. While not considered a full blown crises per se, there were additional scares in 2001 when another local bank, Bancoplus was intervened due to liquidity problems and a regional bank, Banespa, closed. Following that, in mid-2002 the foreign owned Banco Aleman was closed after depositors withdrew their funds, and in 2003 Banco de Asunción and ING Bank closed due to solvency problems.

37. The recent crises also highlighted the problems of Paraguayan banks due to their over-reliance on public sector deposits for their operations as well as their accounting practices which hid underlying solvency problems until liquidity crises hit. It also highlighted the risks to pensioners in having the Social Security Institute deposit excessive funds in risky banks, particularly public sector banks. This latter issue is of particular prominence currently as the remaining state-owned commercial bank, BNF, holds a large quantity of social security deposits and is experiencing liquidity problems due to borrower defaults. Some of these are due to government initiatives in the previous Administration to forgive debt repayment in order to help reactivate the economy as well as by the generally politically motivated lending practices seen historically in the bank. Recently, a new management team was installed to overhaul operations.

38. The Government considers it critical that an updated banking framework be put in place to both detect banking weaknesses early on and to ensure corrective action, as well as to implement market based financial mechanisms to allow the smooth exit or sale of insolvent banks from the system.

B. The Banking System

Background

39. The Paraguayan financial system is dominated by banks which comprise 85 percent of all financial intermediaries and 91 percent of licensed deposit taking institutions[6]. Foreign owned banks hold 75 percent of banking system assets and deposits. The four large international foreign banks which are the strongest group of banks in Paraguay represent 44 percent of all bank assets. Credit cooperatives, insurance companies, securities firms, pension managers, and other non-bank financial institutions are currently overseen by supervisory authorities which are separate from the banking superintendency.

Table 6

THE PARAGUAYAN BANKING SYSTEM
January 31, 2005

(Millions of Guaranies)

BANKS	ASSETS Total	ASSETS % of Total	DEPOSITS Total	DEPOSITS % of Total	EQUITY Total	EQUITY % of Total
BRANCHES OF INTERNATIONAL BANKS						
Citibank N.A.	1,057,403	7%	868,582	7%	158,479	10%
Lloyds TSB Bank P.L.C.	1,246,978	9%	1,063,785	9%	134,860	9%
ABN Amro Bank N.V.	1,954,408	14%	1,657,198	14%	223,496	15%
Banco Do Brasil S.A.	352,380	2%	279,927	2%	57,523	4%
Banco de la Nación Argentina	217,949	2%	177,869	2%	32,992	2%
Chinatrust Commercial Bank	48,723	0%	11,269	0%	17,244	1%
SUB-TOTAL	**4,877,841**	**34%**	**4,058,631**	**35%**	**624,594**	**41%**
MAJORITY FOREIGN OWNERSHIP BANKS						
Interbanco S.A.	2,178,773	15%	1,885,141	16%	173,836	11%
Banco Sudameris S.A.E.C.A.	1,030,052	7%	772,942	7%	150,688	10%
Banco Bilbao Viscaya Argentaria Paraguay S.A.	1,997,069	14%	1,744,642	15%	209,858	14%
Banco Integración S.A.	464,327	3%	395,340	3%	53,273	4%
SUB-TOTAL	**5,670,221**	**40%**	**4,798,065**	**41%**	**587,656**	**39%**
MAJORITY LOCAL OWNERSHIP BANKS						
Banco Regional S.A.	874,673	6%	735,418	6%	62,235	4%
Banco Amambay S.A.	385,671	3%	326,147	3%	41,226	3%
Banco Continental S.A.E.C.A.	873,370	6%	747,934	6%	79,316	5%
SUB-TOTAL	**2,133,714**	**15%**	**1,809,499**	**15%**	**182,777**	**12%**
TOTAL PRIVATE SECTOR BANKS	**12,681,775**	**90%**	**10,666,194**	**91%**	**1,395,027**	**92%**
STATE PARTICIPATION						
Banco Nacional de Fomento	1,462,963	10%	1,093,314	9%	118,508	8%
SUB-TOTAL	**1,462,963**	**10%**	**1,093,314**	**9%**	**118,508**	**8%**
TOTAL BANKS	**14,144,739**	**100%**	**11,759,508**	**100%**	**1,513,535**	**100%**
FINANCE COMPANIES (14 Companies)	**1,384,068**	**9%**	**1,044,413**	**8%**	**266,689**	**15%**
TOTAL CREDIT INSTITUTIONS IN SYSTEM	**15,528,807**		**12,803,921**		**1,780,224**	

Source: Superintendency of Banks, Central Bank of Paraguay

Non-Performing Loans

40. As of January 31, 2005, the Paraguayan banking system which represents over 90 percent of assets of deposit taking institutions, had an aggregate non-performing loan ratio of 11 percent. Excluding BNF which in itself reports 50 percent of its loans as non-performing, the aggregate level

[6] Excludes non banks such as exchange houses and cooperatives, and non deposit taking State intermediaries.

would be 6 percent. If provisions are taken into account, then the unprovisioned portion of the non-performing portfolio for all banks would stand at 5 percent of net loans. These levels of non-performing assets may not fully take into account refinanced or restructured loans which in some cases become reclassified if a borrower has paid at least 10 percent of previous debts, therefore, if one were to use stricter criteria, these ratios could potentially be higher.

41. The loan classification system uses standard non-accrual time triggers, although until recently, following entry into non accrual status not all interest accruals were fully reversed as they should. Category 1 and 2 loans did not require any generic provisioning either and extended to longer elapsed days before being reclassified, although categories 3-5 use standard provisioning ratios. However, up until recently, there was an over reliance on underlying collateral as a substitute for provisions, and while this might normally be acceptable if collateral assets were quickly collectible, the delays in legal procedures to obtain court judgments, which average three years, effectively reduce or discount the present value of such collateral substantially. The reported level of non-performing loans makes the financial system vulnerable not only from a general solvency viewpoint but also because such circumstances put pressure on interest rates to rise in order for banks to compensate their income from losses on the non-performing portfolio and new provisioning needs.

Table 7
Paraguay: Non-performing Loan Ratios in the Banking System

Non-performing loans (NPLs) / Total loans	11%
Unprovisioned NPLs / Total loans minus provisions	5%
NPLs / Total loans, excluding BNF	6%
Unprovisioned NPLs / Total loans, minus prov.; excl. BNF	2%

Source: Superintendency of Banks, Central Bank of Paraguay As of January 31, 2005

42. While the financial condition of the banking system improved through 2004, the fragile state of the system had been compounded by past currency devaluations. While banks' dollar denominated loans and investments surpass their dollar denominated deposits, thus providing them with a "long" hedge in dollars, borrowers are generally exposed to exchange risks on debt servicing costs. About 57 percent of loans are dollar denominated and it is estimated that 85 percent of borrowers (in terms of borrowed amounts) are unhedged. This means that about 48 percent (= 0.85 * 57 percent) of the loan portfolio is subject to risk due to devaluation. While banks themselves are not directly exposed to the foreign exchange risk from a highly dollarized system, the borrowers' exposure generates a significant additional credit risk, and hence risk management issue, for bank portfolios, thus requiring the formulation of policies to mitigate such risks.

Experience with Safety Net, Liquidity Facilities and Deposit Insurance Mechanisms

43. The Central Bank of Paraguay has recently instituted changes in its policies governing the use of safety net and other Central Bank credit mechanisms, particularly in light of the past six years' experience which resulted in substantial Central Bank Losses from failed banks which had previously made extensive use of BCP credit (Table 8).

44. In approximate historical costs, 12 percent of GDP has been expended on various rescue packages. In terms of amounts expended, over US$1 billion equivalent was used for such operations,

whose historical dollar value of still unrecuperated items would have been about US$700 million[7]. However due to ongoing devaluations, the current outstanding balances of non-repaid BCP credit and/or other funds extended, as of end 2003, would now equal US$244 million at 2003 and current exchange rates, or equivalent to 12 percent of present banking system deposit liabilities. Some instruments which had previously been allowed have been recently halted as a matter of policy. These include overdrafts on banks' clearing accounts, and the use of discretionary credits from the BCP to banks, most of which were used during the 1995-96 banking crisis but have now been discontinued.

Table 8

Accumulated cost to-date of Central Bank rescue measures (non-reimbursed credits, write-downs, deposit payments):

As of 12-31-03 in millions of Guaraníes a/		Total Disbursed	%	Amounts Outstanding	%
Loans to credit institutions		87,493	3%	13,500	1%
Loans to banks		647,790	26%	580,094	37%
Safety net loans		183,667	7%	46,564	3%
Overdrafts		149,395	6%	4,225	0%
Rehabilitation plans		338,108	13%	45,438	3%
Short term loans		87,000	3%	62,201	4%
Subrogated payments		83,524	3%	51,242	3%
Receivables		50,271	2%	77,383	5%
Deposit guarantee payments		784,999	31%	557,541	36%
Accrued interest		92,769	4%	121,919	8%
Discount/rediscount facilities		28	0%	28	0%
BNA bonds		2,651	0%		0%
Contract loans		8,395	0%	8051	1%
Total		2,516,090	100%	1,568,186	100%
$US Equivalent (millions)					
@ exchange rate 1997 of:	*2,178*	1155		720	
@ exchange rate 2003 of:	*6,435*	391		244	
Paraguay GDP - Guaraníes (millions):		20,934,352		Year 1997	
in $US millions		9,612		Year 1997	
GDP - Guaranies (millions):		35,782,154		Year 2003	
in $US millions		5,561		Year 2003	
Historical outlays disbursed as % of 1997 GDP =				12%	
Outlays disbursed at 2003 dollar value, as % of 2003 GDP =				7%	
Net outstanding amounts historical value, as % of 1997 GDP =				7%	
Net outstanding amounts at 2003 value, as % of 2003 GDP =				4%	

a/ Reflects reference date through which bulk of payments took place.
Source: Central Bank of Paraguay

[7] Approximating assumption is that bulk of the funds were disbursed during a period centered around 1997.

Deposit Insurance

45. Until recently, Paraguay's deposit insurance scheme was named a deposit "guarantee" scheme since it reflected a guarantee by the State which was not backed by any private premiums contributed by financial institutions in order to accumulate a fund. The scheme was not funded and depended on disbursements from the Central Bank when needed[8]. In this regard, the system already induces moral hazard since banks have no stake in funding the cost of the scheme and depositors have no incentives to monitor bank risks. The level of covered deposits is approximately $11,000 per person (i.e., not per account) reflecting 75 minimum wages, which is about 9 times Paraguay's GDP per capita, a level above global and regional averages but also recently biased upwards by the fact that Paraguayan per capita income in dollars has decreased in recent years on account of currency devaluations. To-date the Government guarantee scheme has disbursed approximately $700 million equivalent since 1994.

46. The Government is now developing the creation of a privately funded deposit insurance scheme. The capitalization of such a scheme would be based on the accumulated invested premiums complemented by State supported funds/guarantees in the initial years of operation. As of January 31, 2005, total deposits in the banking system amounted to US$2,032 million equivalent. If one uses 5 percent of deposits as a reasonable target level sought for an insurance fund[9], this would need to reach US$102 million equivalent assuming current exchange rates. However, this only reflects 5 percent of the present day level of deposits and the objective would be to reach at least 5 percent of ongoing and future levels of the deposit base. Based on recent historical trends, deposits in the banking system in Paraguay have grown by 15 percent annually on average. If one uses this figure to project the level of future deposits, say in ten years, one obtains the following:

Table 9: Estimation of Deposit Insurance Funding Requirements

Funding Parameters/Projections	Amount (in US$ millions)
1. Initial Deposit Base at 1/31/2005	$2,032
2. Deposits after 10 years at 15% annual growth:	$8,221
3. Average deposit level in 10 year period:	$4,111
4. 5% of average deposit level:	$206
5. Proposed premium of 0.45% x Deposits:	$18
6. Estimated time for full capitalization: (excluding any Government contribution)	11 years

Source: World Bank staff estimates and Central Bank of Paraguay

47. It should be noted that, although 5 percent of deposits appears small, based on present data on "insured/covered deposits", it would in fact cover about 20 percent of all such portions of deposits in the system as of January 31, 2005. This means that if the fund was capitalized today at 5 percent, its resources would be sufficient to cover at one time, one fifth of all insured deposit amounts – any amounts above the insured limit for larger deposits would not be covered as is the present policy under

[8] In this case, as with others, the central bank in Paraguay covers a number of funding costs which normally should be attributed to the Treasury. These include medium term funding facilities for systemic liquidity problems as discussed earlier. In 1999, however, this policy was temporarily modified when proceeds from a Taiwanese credit (issued as a bond of the Paraguayan Government) were used in part, for the pay-out of depositors.

[9] The new Deposit Insurance / Bank Resolution Law (2334/03) states that the fund will be capitalized at up to 10 percent of deposits. The insured amount per depositor remains at 75 minimum monthly wages as in the previous system.

the deposit guarantee. An "excess of loss policy" sourced from Government funds, for any payments above the 5 percent limit, based on the current banking structure, would cover any portion of the remaining 80 percent of legally insured deposits. Since a scenario of more than 20 percent of insured deposits being at risk at any one time is almost equivalent to a systemic crisis, it is unlikely, once such a fund is fully capitalized, that it would even need to finance such a level of loss unless a crisis was bank wide. At the current level of US$11,000 equivalent per person as the deposit guarantee, approximately 80 percent of *individuals* holding deposits would be fully covered.

48. The investment regime for deposit insurance funds would be extremely conservative and riskless. For conflict of interest purposes, the funds could not be invested in the financial sector or if so, likely under a trustee arrangement. A more viable option would be for the Central Bank to place invested funds in highly rated correspondent banks.

Bank Exit / Bank Resolution Mechanisms & Early Corrective Actions

49. Paraguay's banking law is clear on the steps and triggers for intervention and monitoring of weak banks, and provides clear indications of shareholders'responsibilities in restoring capital. In terms of flexible options for the resolution and restructuring of bank balance sheets to avoid full liquidation, a Law (No. 1420) had been adopted in early 1999 with Bank assistance[10] in which the modalities of splitting weak banks into good and bad banks for the purpose of transferring viable assets and deposits to other purchasing institutions was included (Articles 22, 24, 25: "Depuración"). This law, however, only lasted one year since the Government saw it as a crisis resolution measure which the Congress only authorized as a temporary special measure. That law while including the menu of modalities for resolving failed banks, had lacked some prioritization in the sequencing of steps to be followed as well as the clarification of least cost criteria in the use of deposit guarantee and/or fiscal funds to restructure and sell banks prior to considering the liquidation option. However, since the law was authorized for one year as a contingent emergency measure, there was no opportunity to apply it before it expired.

50. Until recently Paraguay's banking resolution procedures were governed by Title IX, Chapter II, and Title X of the Banking Law (No. 861) which existed prior to Law 1420. While Articles 122-123 of Title X of Law 861 permit the sale of a bank by shareholders, once intervened, this is the only modality which alludes to market based mechanisms for "saving" bad banks. Once such mechanisms are exhausted, the remaining option is liquidation, either judicial or extra-judicial which normally entails a higher cost to the State in terms of immediate payments for all insured depositors. The extra-judicial route was traditionally preferred since it maintained the full control of the process in the SB, whereas, under judicial liquidation, the courts are involved and there are constraints in execution due to judicial system delays as well as problems inherent in the bankruptcy law. However, to diminish the SB's draining of resources from carrying out such liquidation exercises, the Government intends to modify the legal framework so that all liquidations are carried out within the context of formal judicial and improved bankruptcy proceedings. Under the new Bank Resolution and Deposit Insurance Law, the contingent cost issues and bank dissolution procedures are substantially optimized under a sequenced procedural framework so as to diminish State liabilities while protecting depositors.

[10] A Bank mission visited Paraguay in late 1998 for the purpose of identifying changes to the existing banking law as part of potential conditionality for a financial sector operation. Shortly after the mission, political upheavals obviated the possibility of continuing with the financial sector program.

Assessment of Financial System Vulnerabilities

51. In order to assess latent weaknesses in the banking sector, an exercise was conducted in conjunction with the Government to determine the inherent financial strength of financial institutions. A number of balance sheet adjustments and "stress test" adjustment, beyond regulatory requirements, were made for this purpose. The adjustments include two basic components. First there are *adjustments to the financial statements* presented to the Superintendency of Banks by the financial institutions, and these adjustments attempt to reflect more accurately the actual financial condition of the system. These financial reporting adjustments include a change in the calculation of solvency capital, as well as four adjustments related to the loan portfolio.

52. Following these, a *stress test* of portfolio impact over selected macroeconomic variables is conducted (stress test 1 for exchange rate devaluation, and stress test 2 for real economic growth). The impact of the macroeconomic variables on non-performing loans is calculated by means of multiple regressions in two scenarios (elasticities calculated for the entire banking system and by bank categories). Regarding the adjustment to financial statements a fully accurate analysis would still require a validation review on an institution by institution basis, which will be conducted by the Superintendency of Banks utilizing these results to prioritize its supervisory activity.

53. The net effect is a potential capital deficit in the banking system on the order of US$134 million. While these adjustments go beyond existing regulatory requirements, they do attempt to scale up, by proxy, the prudential standards to the highest international levels. While the adjustments may be overly rigorous in some cases, the overall diagnosis nevertheless indicates that certain banks that do not count on capital cushions in any substantial way, are not in the strongest position. This indicates the need for close monitoring by the Banking Superintendency in case bank resolution actions need to be applied if the conditions of such banks deteriorates further.

Non Bank Credit Institutions

54. The assessment of sub-sectors requiring financial system strengthening also include, besides banks, the finance companies which generally represent much smaller scale operations and constitute about 10 percent of the deposit-taking financial system. The primary difference between banks and finance companies is that the latter are not permitted to offer checking accounts or otherwise constitute a formal part of the payments system for transactions processing, daily fund transfers and cash settlement. In all other respect, finance companies require prudential oversight given their core business of lending against funding provided by individual depositors. However, to-date, a much less regulated and growing sector is the credit cooperatives (credit unions as known in some countries) sector. While traditionally such cooperatives have been less regulated since many are not credit providing institutions (e.g.: some farmers' coops) and others are strictly for professionals or trade members only (e.g.: in the agricultural or education sectors), this segment of the financial services industry has begun expanding rapidly[11] and more recently membership requirements have become more lenient. In this context, even though the cooperatives are supervised by the Cooperatives Institute (INCOOP) an autonomous agency previously under the Ministry of Agriculture, the Central Bank has considered their growth to be systemically important, and since membership is now expanding to the general public, it is felt that cooperatives, particularly those with a significant mass of

[11] Estimates of their size in the financial system vary with estimates as high as 15%-20% regarding their share within the total of all deposit taking financial institutions.

deposits, should be regulated with minimum solvency requirements as the other deposit-taking credit providing institutions are, to avoid an unfair competitive advantage via regulatory arbitrage as well as putting depositor funds at risk through unsound financial management practices. While the IDB has been taking the lead in this sector, the Bank has provided complementary technical advice and worked in conjunction with the World Council of Credit Unions (WOCCU) to recommend a sound set of regulations for implementation in the credit cooperatives sector, supervised by INCOOP.

Money Laundering and Combating the Financing of Terrorism

55. Given the increased emphasis post September 11, 2001, as well as due to the crackdown on contraband trade and drug trafficking activity, the Government will also implement new measures to oversee and detect money laundering activity. On top of the already existing legislation for this purpose, the new measures will require financial institutions to adopt a monitorable code of conduct in line with Basel Core Principle No. 15, so that banks can better know their clients and report any suspicious operations to the Central Bank and the National Secretariat for the Prevention of Money Laundering.

56. Money laundering is a problem in Paraguay which hampers private sector development since illicit funds 'compete' unfairly by not having to pay market interest rates. Besides affecting above board businesses, laundered funds are not subject to taxes and eventually those responsible for such funds accumulate sufficient capital so as to have the capability to influence or confront the Government itself. Overall, this activity affects the Government in its ability to engender sustainable development. While Paraguay has signed international agreements (U.N., OAS, Egmont Group, GAFISUD, IMF and World Bank) committing itself to fight money laundering and terrorist financing, much needs to be done at the local implementation level. For the Egmont Group, an association of financial intelligence units with 80 members worldwide, Paraguay is currently suspended and under probationary status which has motivated an overhaul of its AML framework.

57. Previously a special unit for analysis of money/asset laundering was set up in the Central Bank, and this Unit would coordinate with the Central Bank's Department of Economic Crimes which would then liaise with the National Secretariat for Anti Money Laundering. The Unit was also meant to maintain contact and seek advice on best practices from the Egmont Group which exchanges procedural information on these matters with participating financial authorities. Technical assistance for the strengthening of the Unit is being provided by the IDB through a technical cooperation grant, and the IMF will also be providing advice in this area. The U.S. Treasury is assisting the Government in drafting a new framework. The Bank would also support the institution building efforts as necessary, while considering the funding already available.

58. Other reforms being put in place include a new 'manual of conduct' guideline that will apply to all entities supervised by the Superintendency and emphasize "know thy client" principles. This will require regular reporting on connected businesses and forwarding of information on potentially illicit activities to the Secretariat for Prevention of Money Laundering.

59. The reforms under the framework for anti-money laundering and detection of terrorism financing will apply to a wider sectoral coverage including financial institutions outside of the banking system, such as insurance companies and securities firms which could also potentially channel illicit funds.

60. In addition, the Superintendency of Banks will, for banking and deposit taking institutions, include in its 'fit and proper' reviews, criteria to assess adequacy of bank managers and major

shareholders (both at the licensing stage or for change in ownership), factors to assess or identify any potential money laundering connections. In addition, under the SB's review of bank risk management procedures, its evaluation of internal controls and susceptibility to fraudulent practices, will also assess within the same context, the institutional vulnerability to money laundering.

The State Owned Banks

61. There is currently one public bank and 6 other state-owned institutions operating in the Paraguayan financial sector. Together, these public institutions have total assets of about US$450 million, which corresponds to about 17 percent of the total financial sector assets[12] and 5 percent of Paraguay's GDP. The Banco Nacional de Fomento is by far the largest state-owned financial institution in Paraguay. It manages about 60 percent of the total assets in its peer group, and about 11 percent of banking sector assets. It is the only state-owned institution to accept deposits from the public. The remaining entities are just used as conduits to channel subsidized funds, mainly from the international donor community. Accordingly, the loans granted by these institutions, including BNF, are offered at rates substantially lower than those of private sector institutions. Three out the seven institutions are offering their services directly to their target group, whereas the remaining ones, UTEP, FDI, FDC and CONAVI/BANAVI (see pages 21-23) are operating as a second-tier institutions, using other financial intermediaries to offer their services.

Table 10
Public (State-owned) Financial institutions in Paraguay

(Millions of Guaranies)

Public Financial Institutions	Total Assets 6/30/2001	Total Assets 7/31/2003
1st Tier Institutions		
1 Banco Nacional de Fomento (BNF)	1,156,391	870,216
2 Credito Agricola de Habilitacion (CAH)	229,091	338,641
3 Fondo Ganadero	181,749	178,499
SUB-TOTAL	**1,567,231**	**1,387,356**
2nd Tier Institutions		
1 UTEP	58,945	89,875
2 Fondo de Desarrollo Industrial	83,171	59,271
3 Fondo de Desarrollo Campesino	94,442	118,672
4 Banco Nacional de la Vivienda	129,485	134,250
SUB-TOTAL	**366,043**	**402,068**
TOTAL PUBLIC FINANCIAL INSTIT.	**1,933,280**	**1,789,424**
TOTAL PRIVATE BANKS[13]	**9,385,855**	**11,329,892**
TOTAL BANKING SYSTEM	**11,319,129**	**13,119,316**

Source: Ministry of Finance of Paraguay

62. Most public financial institutions are loss making primarily because of substantial operational inefficiencies and unsound lending policies. This constant drain on public finances was the primary

[12] Excludes finance companies and other private non-bank financial intermediaries from calculation.

[13] Excludes finance companies (non-deposit / non-clearing account intermediaries) representing 10 percent of the system. Figures on rightmost column as of August 31, 2003.

motivation behind the current bank restructuring proposal of the Government of Paraguay. In the remainder of this section, a brief assessment of the institutional set-up and the financial situation of each of these state-owned financial institutions is conducted. Thereafter, the insights of these institutional assessments are used to review the current restructuring plans prepared by the Ministry of Finance and the Banco Central of Paraguay, and elaborate a selected number of alternatives to support the decision-making process.

First Tier Institutions

63. *Banco Nacional de Fomento*: The BNF was incorporated in 1961 by means of the Law-Decree 281/ 1961with the objective to promote various segments of the Paraguayan economy, in particular agriculture and selected trade and manufacturing activities. According to its organic law, the bank is divided into three business areas: an agricultural department, a commercial department and a development banking department. All three areas have their own capital endowment and maintain a separate accounting . However, they are supported by the same administrative system and operational infrastructure. Art. 1 of the organic law states that BNF's obligations are guaranteed by the Paraguayan State. In addition, Art. 12 prescribes that any losses from the agricultural department will be absorbed by the Government of Paraguay (GOP), through the Ministry of Finance (MoF).

64. The value BNF's assets is substantially inflated due to non conventional accounting. After the required adjustments, it is shown that the institution is decapitalizing at a very fast pace, and thereby destroying value for the taxpayer. It is more alarming, therefore, to know that nearly a third of BNF's funds originates from deposits of the social security system. Overall, the quality of the loan portfolio is very poor with over 55 percent of the portfolio in arrears. Over 70 percent of these non-performing loans have been in arrears for more than 360 days. Surprisingly, legal proceedings are underway for only less than half of these cases. The analysis of BNF's arrears statistics indicates that the bad loans are concentrated essentially in the loan portfolio at the headquarters, which currently shows an arrears rate of 66.6 percent. After minimum adjustments to raise accounting standards according to international practices, BNF was found to have a provisioning deficit for bad debts of about $50 million.

Table 11
Distribution of BNF's Deposit Liabilities

	12/31/99	12/31/00	8/31/01	9/30/03
	(millions of Guaranies)			
Private Sector Deposits	**254,744.0**	**233,477.0**	**200,711.0**	**280,631.0**
Public Sector Deposits o/w:	**407,130.0**	**285,761.0**	**320,756.0**	**93,293.0**
IPS	204,103.0	163,380.0	174,010.0	11,202.0
OTHER PUBLIC AGENCIES	117,552.0	61,344.0	69,254.0	42,440.0
ANDE	26,392.0	29,012.0	41,698.0	13,915.0
CONATEL	35,703.0	12,812.0	16,449.0	2,411.0
PETROPAR	2,101.0	6,632.0	777.0	2,750.0
FDC	---	3,704.0	2,581.0	3,482.0
ANTELCO	13,766.0	3,258.0	8,428.0	---
CORPOSANA	6,062.0	1,664.0	6,023.0	---
CAH	---	---	---	13,119.0
SENACSA	198.0	1,385.0	361.0	3,058.0
INC	1,155.0	1,374.0	1,053.0	916.0
ADM.PUERTOS	98.0	1,196.0	122.0	---
TOTAL DEPOSITS	**661,874.0**	**519,238.0**	**521,467.0**	**323.071.0**

Source : BNF, Superintendency of Banks, Central Bank, Ministry of Finance.

Box 3

FINANCIAL SOUNDNESS OF BNF

In contrast to published reports, BNF, with an asset base of almost US$200 million equivalent, has an estimated capital gap equivalent to one quarter of its assets, based on the application of best practice bank accounting norms.[a/] BNF's operational losses have been historically absorbed by the Government by removing from BNF's balance sheet, foreign loans received to fund BNF's operations (effectively capitalizing such liabilities). Hence, BNF has been able to technically comply with the solvency requirements of the Banking Superintendency. But with an accumulating burden on the MoF and the recent deteriorated public finances, the institution has increasingly turned to less sound accounting practices to delay recognizing its losses. To assess BNF's real equity position, four different types of adjustments were conducted on recent financial statements. First, the deficit for bad debts provisions was adjusted. Second, BNF was found to have increased its earnings since 1999 by adding the accrued but previously not accounted interest on those bad loans which were reactivated or cancelled according to the laws 1418/99 and 1470/99 – these figures were thus excluded. As BNF proceeded with the debt restructuring, it also dissolved existing provisions for those loans and accounted it as extraordinary income. The third adjustment consisted in reversing this procedure. The fourth and last adjustment was to reverse unpaid amounts due from the Ministry of Finance to cover losses accumulated in recent years.

The assessment of BNF's liquidity position clearly portrays the fragility of its financial situation. Its cash, short term investments and reserve deposits at the Central Bank could eventually cover only its current accounts and a small fraction of savings accounts and other deposits. The loan portfolio is shrinking as the consequence of the insufficient cash-flow generation given the ever increasing delinquency rates and the large operational costs. Receivables from the MoF are not likely to be paid in cash or negotiable instruments. Foreign loans and credit lines outstanding are subject to foreign exchange adjustments. At the current devaluation rate, foreign exchange adjustments to multilateral and bilateral loans could further erode significantly the institution's liquidity reserves and its equity base. Unless there is a strong improvement plan with a capital infusion, rising debt service payments will necessarily lead to a sustained shrinking of productive assets in the near future.

Deposits have been declining and have been particularly pronounced in the last two years, and public sector entities such as the state social security/pension fund (IPS) have recently removed massive deposits from the bank for fear of eroding the pension fund savings. A recent law initiated by congressional representatives, mandated that BNF's non performing portfolio be transferred to the Ministry of Finance so as to recapitalize the bank. However, the law has not yet been implemented since the Finance Ministry does not feel it has the capacity nor should manage such 'lines of business'. Encouragingly though, a new management team for BNF was appointed to stem losses and to downsize the bank. To-date, the team has severely restricted lending and limited it to small loans consistent with future reforms anticipated for the public banks. Loan collection operations have intensified in order to build up a stronger loss provisioning base and stem the loss of earnings, and an overly top heavy management structure has been greatly downsized with a budget estimated for future severance packages and requisite financing being sought.

a/ World Bank estimates based on application of international accounting standards and Basle guidelines.

65. *Crédito Agrícola de Habilitación (CAH)*: The CAH is not a bank, but a state-owned development finance institution with independent legal status which is dedicated to the promotion of low-income producers and small to micro-enterprises in rural areas. The institution was set-up in 1943 and is governed by the Law no. 551/75. CAH does not take deposits from the public. Its activities are financed mostly by international donors, in particular Japan and Taiwan, and the Ministries of Finance and Agriculture. CAH has over four times as many clients as BNF, particularly in the agricultural sector, but with a much lighter organizational structure. However its income, much of it earned via below market loan rates is sufficient only cover half of its operating expenses, thus the institution is decapitalizing.

66. *Fondo Ganadero*: Like CAH, the Fondo Ganadero (FG) is not a bank, but a state-owned development finance institution with independent legal status, dedicated to the promotion of the livestock sector in Paraguay through subsidized credit and know-how transfer to increase productivity. The activities of the FG are profitable in spite of its below-market interest rates, however the margin is

very sensitive to fluctuations in the exchange rate. With most of the FG's funding denominated in foreign currency this has generated added liabilities to the Government, from local currency devaluations. About one quarter of FG's loan portfolio is in arrears.

Second Tier Institutions

67. Paraguay's second tier institutions are non deposit taking funds financed by external international agencies. They are the *Unidad Técnica Ejecutora de Programas* which is currently housed in the Central Bank and which extends second tier loans to private finance companies for the micro enterprise and agro sector, the *Fondo de Desarrollo Industrial* which has a similar funding structure focused on small and medium industry, the *Fondo de Desarrollo Campesino* which focuses on the farming sector, and the *Banco Nacional de la Vivienda* which provide housing finance.

68. *Unidad Técnica Ejecutora de Programas (UTEP)*: UTEP is a special unit of the Banco Central de Paraguay set to implement the IDB's Global Program to Finance Microenterprises in Paraguay. The unit was set-up in 1994 and its activities consist in refinancing up to 90 percent of loans provided to micro-entrepreneurs by participating financial institutions, which in turn receive training on best practice methodologies for micro-enterprise finance, in particular risk analysis of projects. The participating intermediaries are selected according to a CAMEL type of system and financial information provided by the Superintendency of Banks. Since UTEP is funded at "market rate" by the IDB, loans from UTEP to the intermediaries as well as the loans to the microentreprises have be to granted on a for-profit basis.[14] In spite of UTEP's remarkable performance, its income is not sufficient to cover losses from exchange rate fluctuations.

69. *Fondo de Desarrollo Industrial (FDI)*: FDI is a second-tier lending fund housed within the Paraguayan Ministry of Finance, which was established to channel international donor resources towards the small and medium industry in Paraguay. The fund was created in 1993 with, among others, resources provided by the World Bank. FDI has a total staff of 10 including a director. In its operations, the FDI works in a way similar to that of UTEP, but (i) grants about half of its loans, and (ii) has less stringent selection criteria for participating financial intermediaries. Actually, UTEP used to be part of FDI before it was decided to transfer it to the Central Bank. Still, a significant link remained between the two institutions, as illustrated by the fact that UTEP is responsible for managing FDI's accounts. Unlike UTEP, the performance of the FDI has so far been very disappointing. The institution did not manage to attract financially sound institutions such as foreign banks to participate to the project. Due to these factors, the volume of FDI's loan portfolio has been falling since 1995 with a drop of more than 50 percent in the last two years alone.

70. The remaining second tier entities are the *Fondo de Desarrollo Campesino (FDC)* and the *Banco Nacional de la Vivienda (BANAVI)*. The Fondo de Desarrollo Campesino does not take deposits from the public, but relies mostly on funds provided by the international donor community and channeled through the Ministry of Finance. Related to BANAVI is the Consejo Nacional de la Vivienda (CONAVI) which oversees BANAVI operations. The Government expects to unwind and liquidate these entities whose portfolios are effectively not performing and no new lending is taking place.

[14] UTEP adjusts its rates on a quarterly basis according to movements in the 180 days - certificate of deposit rates.

C. The Government Reform Agenda for the Banking System

71. The new Government team which took office in August of 2003, appointed a Minister of Finance and a new Central Bank President both of which have prioritized addressing the structural problems and risks in the financial system, particularly given Paraguay's recent history of financial distress and fiscal losses on an account of such events. To this end, the Central Bank, including the active involvement of the Banking Superintendency and with the support of the Ministry of Finance, agreed to undertake a substantial reform of the current banking legal framework in order to strengthen regulation, supervision, early corrective action powers, bank resolution mechanisms and operation of the deposit insurance system. The required reforms involve substantial modifications to the banking law (implementation of a new Law for Bank Resolution and Deposit Insurance) as well as related modifications to the overall master banking law (Law No. 861) in a number of areas pertaining to licensing, capital adequacy, portfolio management, related parties, and supervisory enforcement and sanctioning.

The First Operation Under the Program

72. Under this first operation, the Government has put in place the new framework governing the regulation of the banking system and in particular the new exit procedures for banks which are deemed insolvent as well as a number of prudential preventive actions and strengthened supervision efforts as further described below. The loan is in the amount of US$15 million and is presented to the Board based on all agreed prior policy actions having now been met.

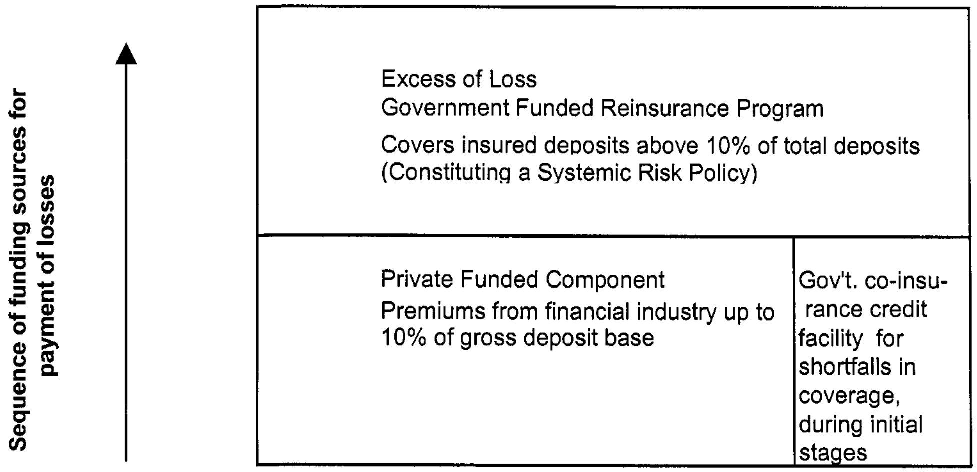
The Deposit Insurance System

73. The Government's recent deposit guarantee system generated moral hazard since the banking sector did not contribute to its funding via premiums and there was no loss sharing with depositors to encourage monitoring. Under the reform program, the Government has set up a defined institutional function and financial structure including the implementation of regulations and operating procedures, for a new insurance system which will be support bank resolution and restructuring processes approved under Law 2334/03. The new insurance fund will be managed by the Central Bank with input from industry participants and have its own statutory identity to insulate it from fiscal influences. Its charter and operations which will defined by regulation under the reform program, will be under the oversight of the Central Bank and the Superintendency.

74. The new deposit insurance system is funded by premiums paid by the banking industry, so that a target funding of 10 percent of the financial system's depositary base is reached. The insurance fund will have a Government "reinsurance" feature for any losses which exceed the 10 percent deposit base, so that losses above that level would be automatically assumed by the Government under an 'excess of loss' policy in its charter. During the early years of the fund's accumulation of resources, a co-insurance feature would be in effect whereby the Government will provide a funding contribution in realizable bonds, if losses below the 10 percent level occur, before the fund has accrued sufficient financial resources. In such an event, the co-insurance feature would finance any *insured* deposits not covered by accumulated premiums paid in by the private industry. The co-insurance feature would be structured as a defined initial capital contribution with the possibility of the Government's treasury issuing additional bonds to finance the insurance fund for special case bank restructuring/resolution operations.

Figure 1

Financing Structure for Proposed Deposit Insurance Fund



75. Under the reform of the deposit insurance system, the Government will take all the necessary precautions to ensure that the new system will be sustainable, particularly as it is building up its funds (which will be invested to obtain additional compounded returns). For this purpose, the potential obligation limits of the new system will be steadily phased in and supported by the State co-funded amounts while the scheme becomes capitalized.

76. The setting of premiums will in the longer term, is expected to be based on the assessed risk of individual banks, including rating factors to incorporate bank management factors rather than solely the mechanical application of financial ratios. However, to avoid inadvertent signaling via the premium level, the Central Bank is considering an initial flat premium and a future risk based premium that would be charged at the start of the year through bank clearing or deposit accounts held at the Central Bank, followed by potential rebates to banks at the end of the period, based on ex-post maintenance of a low risk financial condition. Currently, the system has started with a flat premium.

77. The deposit insurance fund will also be intricately linked to bank restructuring responsibilities following their intervention by the SB, in terms of resolving banks through the sale of their acceptable assets with matching deposits and liablities, and using the deposit insurance funds to pay residual insured deposits, so as to minimize use of insurance or State funds. Residual non-performing assets will be transferred for liquidation to specialized firms. These mechanisms are explained further below.

Bank Resolution Procedures

78. One of the highlights of the banking sector reform which the Government will undertake, constitutes the modernization of procedures to remove weak banks from the system, using market mechanisms and risk sharing with the rest of the financial industry. This involves implementing under the new Bank Resolution and Deposit Insurance Law and rolling into the overall banking law, the use of 'good bank/bad bank' procedures to carve out viable assets from weak banks, and match them with deposit liabilities, for transfer/sale to other banks before considering payment to 'uncovered depositors'. These procedures have been approved under a recent Law (Ley 2334/03) developed with the assistance of the Bank and approved under the prior Economic Recovery Loan.

79. However, implementation of this law requires the design of highly detailed regulations which will specify the operational procedures for implementing "bank resolution actions" including methodologies for valuing matching liabilities and assets to segregate viable portions of balance sheets, optimization and decision criteria to minimize the use of deposit insurance resources for "gap filling", methodologies for securitizing loan assets before they can be transferred as marketable bonds to other banks, and specification of the various new institutional roles for operating the new deposit insurance fund and its rules for engagement in resolution transactions. In addition to the banking resolution process, the Government reforms also include the institutionalization of early corrective actions as part of the supervision process to permit ex ante preventive measures before banks become completely insolvent.

80. The main features in the implementation of the approved law governing new procedures for banking resolution including specification via regulations of the sequence of actions required, involves the following key steps and institutional responsibilities to be carried out by the SB:

a. The prioritization and specificity in the use of "good bank" asset carve-outs and restructurings to transfer viable loans and other assets with matching deposits and other liabilities to market buyers, while maintaining intervened banks as 'going concerns'.

b. The utilization of pre-specified bank restructuring contingency plans developed prior to official intervention, so as to minimize the time in which a bank remains closed prior to reopening under new ownership.

c. Following the preference in the use of the "good bank" modality and definition of qualifying assets, the subsequent structuring of the residual "bad bank" assets for transfer to collection/liquidation agents. Under the terms of recovery of such assets, these will include agreements for the sharing in losses and gains among assuming agents/banks and the Government, when such losses/gains fall outside of projected ranges of recoveries contractually agreed.

d. Under the above modalities, the primary criteria in selecting from the available options (including the liquidation option) will be specified as the *minimization* in the use of deposit insurance and fiscal resources to accomplish the restructuring, sale, or liquidation, in line with the "least cost" principle.

e. The provision of legal options for setting up trust accounts and trustees to administer "good bank" asset portfolios and securitize such portfolios through the collateralized issuance of special purpose bonds backed by such assets. The asset backing (collateralization) of such securitized bonds will be over-collateralized via underlying loans by a multiple of bond face value, according to the overall risk established for the subject portfolios, in order to assure that the bonds minimize their default probabilities and thus are marketable.

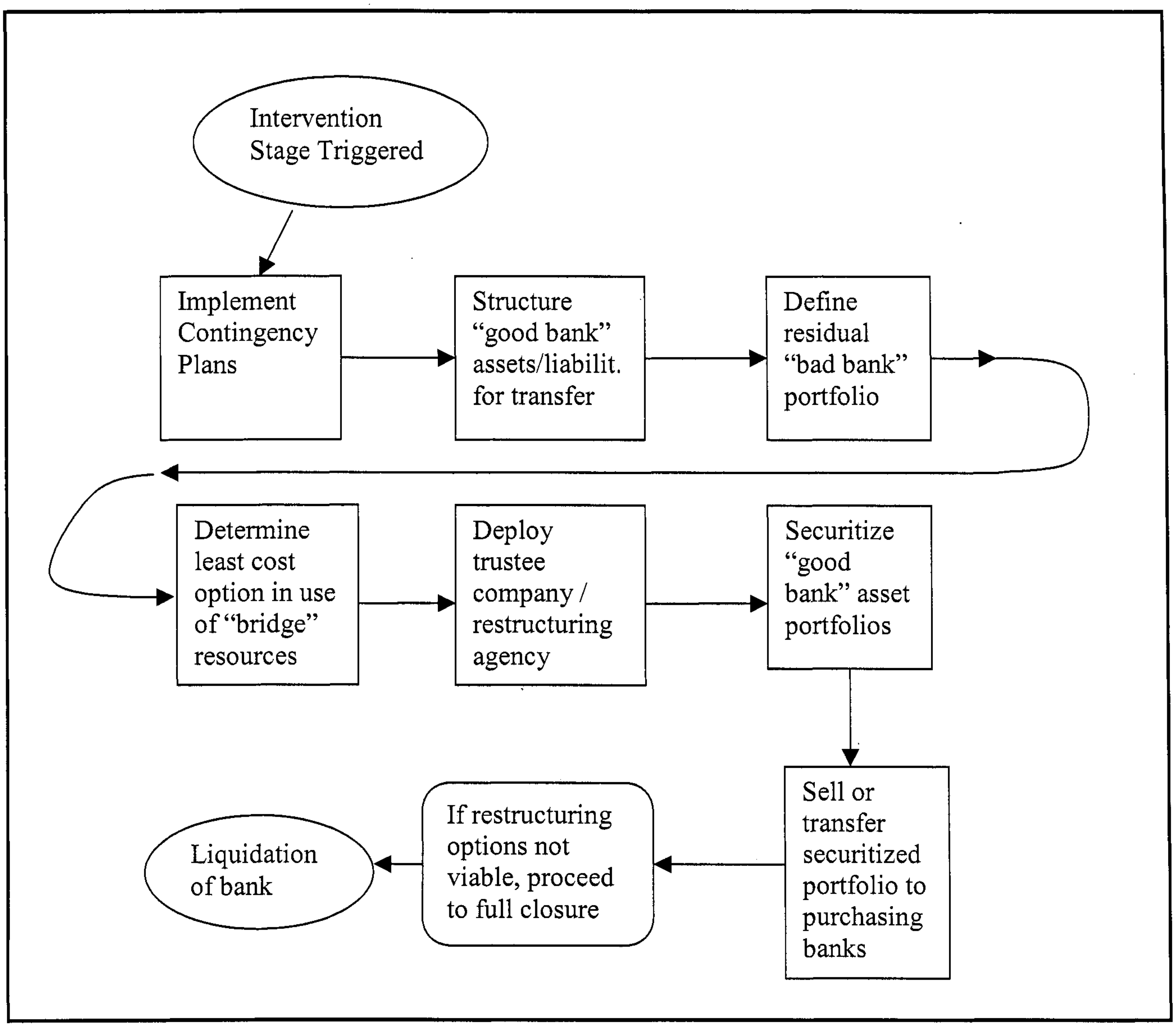
f. Purchasing banks/institutions/investors of the bonds listed above, while receiving their bond coupon payments from the trust, will simultaneously agree to take on the collection function for the underlying loan portfolios. Collection fees for such work are to be pre-agreed, or alternatively, they will be included as part of the spread in the overall coupon rate for the bond representing a particular loan portfolio.

g. The trustee will act with the deposit insurance fund as the restructuring administrator and portfolio securitization agency, with the overall management of the process being operated and overseen by the BCP.

81. The implementation in the new Bank Resolution and Deposit Insurance law contains changes which impact the overall banking law in terms of incorporating modernized procedures for the resolution, restructuring and exit of insolvent banks from the financial system as summarized in the diagram below:

Figure 2

Summary of Bank Resolution Regime



82. Besides the need to specify detailed implementing regulations delineating the sequenced functioning of these new procedures and their operationalization (e.g.: using judicially supported trust and securitization mechanisms), the Central Bank has issued a regulation prohibiting banks to

encumber assets (loan portfolios, securities, etc.) using these as collateral to guarantee deposits, as occurred during a recent bank closure of the Multibanco institution. The banking law did not explicitly prohibit such action and thus it created difficulties in the final settlement and liquidation of Multibanco. However, since such a practice is inconsistent with the principle of hierarchies of creditor preferences both under standard bank restructurings as well as under the new Resolution procedures, the Central Bank intends to resolve this legal loophole by making explicit the prohibition against encumbering bank assets for the benefit of specified depositors.

Banking Exposure to Government Debt

83. While potentially it might have generated an adverse development for the balance sheet soundness of the banking system, the Government engaged in negotiations to reschedule overdue treasury securities held as investments by the banking system, without unduly affecting bank solvency or profitability. Because of severe fiscal pressures during 2003 and inability to meet all its fiscal obligations, including the payment of public sector wages, the Government suspended some its principal and interest payments due on government securities leaving an overdue debt owed to the banking system of US$130 million. As part of its effort to increase financial transparency, promote confidence in government financial management, and lay the way for future financial sector reforms, the Government and the banking sector (as well as construction contractors) agreed to reschedule bonds which had become due as well as overdue accrued interest.

84. The terms of the rescheduling are to extend final maturities of the bonds for an additional four years during which the interest rate on the bonds will be reduced after the first two years from the current coupon level of 9 percent to 7 percent. Since the banking system did not have alternative liquid investment options, the rescheduling of principal has little or no impact on their balance sheets. The reduction in the interest rate has a small but insignificant effect on bank net earnings.

85. As part of its reform effort, the Government has successfully completed negotiations with the banking system in order to give itself additional fiscal space to meet other pending fiscal obligations. The debt restructuring agreement initiative was well received by the banking system given that it had already accumulated unpaid overdue debts during 2003 with the previous Government and without any certainty on the prospects and terms of eventual repayment.

Regulatory and Supervisory Framework

86. In terms of strengthening the banking sector's prudential regulations to better assess solvency in line with best practices, the Government's modifications to the banking laws and key regulations governing credit risk management will address a number of bank accounting and prudential practices including legal requirements for classifying loan portfolios and ensuring adequate loss provisioning.

Coverage of Regulation 8 Reforms – Loan Loss Provisioning

87. The reform of this key regulation as approved and put into effect by the BCP, involves the phasing in of stricter requirements, with 100 percent compliance of the regulation's norms required by the start of 2007, including: (a) Reintroduction of interest reversal for loans in non accrual status; (b) Precluding directly or indirectly new lending to improve loan classification; (c) Minimizing recourse to collateral as a substitute for loan provisioning; (d) Adopting strict rules for collateral appraisal; (e) Increasing minimum provisioning for category 2 loans from 1 percent to between 5 and 10 percent; and (g) Establishing a generic provision (0.5 to 2 percent) for category 1 loans.

88. In addition, associated regulatory changes also reflected in this initiative and in the new general banking law, address the computation of risk weighted capital to ensure that best practices in line with international standards are utilized in the determination of bank solvency. Such measures will include: (a) Minimizing the use of collateral to reduce risk weights and augment risk limits; (b) Requiring capital adequacy not only on an individual institution, but also on a consolidated basis; (c) Excluding from tier 2 capital, 50 percent of revaluation reserves after validation; (d) Excluding from tier 2 capital, 50 percent of current year profits before distribution; (e) For rating loan asset risks, permitting a 50 percent risk weighting only if assets are guaranteed by residential mortgages, but 100 percent risk if backed by commercial mortgage collateral; and (f) Adding market risks to the computation of capital.

89. In the area spanning market and portfolio risks there exists an overlapping issue pertaining to foreign exchange risks on account of partial dollarization of the banking system. To mitigate the risks from dollarization, of borrowers not being able to repay loans following currency devaluations, the regulatory reform includes the development and implementation of risk management guidelines regarding the provisioning for credit risks generated from open foreign exchange exposures of borrowers.

Reform of the General Banking Law

90. The key pillar on which the Government's financial sector reform program is anchored is a wholesale reform of the General Banking Law (currently Ley No. 861). Besides the incorporation as part of this law, of the new bank resolution and deposit insurance system which was already approved under a separate law (see section on Bank Resolution Procedures above), the new proposed Banking Law includes several major reforms which upgrade Paraguay's prudential regulatory framework and modernize the supervisory approach. Among various other aspects, the new proposed General Banking Law includes the following policy reforms:

a. The new law defines categories of particular institutions subject to bank regulation, but also regulates any 'financial intermediation' activity involving deposit-taking. The law also requires credit cooperative to follow prudential rules applicable to the banking sector.

b. Financial groups are identified as subject to licensing for banking activity, and linked party risks are identified as subject to exposure limits and capital requirements, including cross-ownership and concentration limits. Additional powers are given to the SB to conduct supervision of consolidated financial groups. Bank credit exposure limits are specified for individual credit risks as well as group risks.

c. Governance norms are upgraded in line with international practices. Bank mangers, directors, shareholders, auditors, attorneys and personnel are subject to accountability norms and application of sanctions for duties pertaining to ensuring prudent banking operations. Bank management are accountable not only to prudential financial performance but also for risk management policies and appropriate internal controls.

d. The minimum capital requirements to operate banking businesses are increased substantially, more in line with international standards, and such requirements are subject to periodic revaluation linked to an inflation index.[15]

[15] Credit cooperatives do not fall under the banking law. Separate regulations under development with WOCCU, require their meeting phased-in solvency requirements and prudential risk management and credit classification standards.

e. Net income and/or dividends are prohibited from being recognized or distributed until earnings are received in cash. A limit of 50 percent is also applied to the amount of revaluation reserves which can be counted s capital.

f. The minimum solvency ratio is specified at a minimum requirement but is not capped at any upper limit, and the SB has discretion to increase it for any particular bank if it is deemed to be at risk and requiring a higher capital/solvency cushion.

g. The Law gives the SB autonomy in applying sanctions for infractions committed, without need for prior authorization from BCP. Additional sanctions are added including penalties to banks for not ceasing and desisting or following directives issued by the SB previously, for imprudently putting bank depositors at risk, and for not meeting improvement targets under previously agreed 'regularization' programs. Fines are increased in line with international standards and expressed as a percentage of bank capital.

h. The mechanism of judicial liquidation is incorporated as a rule once the bank resolution process is completed. This allows the SB to discontinue the management and oversight of closed banks and allow their remaining assets to be liquidated as part of formal bankruptcy proceedings.

Reform in Paraguay's Anti-Money Laundering Policies

91. Paraguay has a number of initiatives which reflects its evolution in the implementation of an anti-money laundering framework. This recently gained priority and increased importance following the September 11, 2001 terrorist attacks in the U.S. and the discovery of financing links in Paraguay's border towns. The following describes Paraguay's existing AML framework and legislative reforms being developed in the sector.

92. The Central Bank serves on the Boards of national agencies set up to detect and prosecute money laundering activities. These include the Secretariat for the Prevention of Money Laundering and the National Anti-Drug Secretariat. The framework Law No.1015/97 requires from financial institutions, the identification of clients, the setting up of a monitoring registry, and maintenance of such registries for at least 5 years. The law was updated in mid 1997 to explicitly define as illegal, the use of the financial and payments system for transacting illicit activities. Liability was defined to equally include the executors of specified transactions as well as the "moral" authors or planners of such. All financial (bank and non bank) institutions as well as funds and NGOs are included in terms of reporting requirements and monitoring responsibilities.

93. The Superintendency's (SB's) Regulation 245 of 1997 establishes and defines the specific means of communication and reporting formats between financial institutions and the SB for operations above US$10,000. Regulation 455 of 1999 reinforces this by requiring new internal control units to be set up in each institution, and specifies their responsibilities in preventing money laundering as well as the additional oversight functions of corporate audit committees. Regulation 536/97 elaborates on *external* auditor requirements and responsibilities in this area.

94. A separate regulation No. 2 of 1997 defines the scope of institutions, financial activities, operations, clients, and modes of registering these for reporting to the designated Government agencies once suspicious activities have been detected. Protections are included with respect to lawsuits against reporting banking officials no matter what the outcome of investigations might be (i.e., meaningful or not). Regulation 153 of 1998 requires entities which transfer funds abroad to inform the SB and the Department of Economic Crimes of the Central Bank, while providing specific amounts, destinations

and origins of funds. Regulation 224 of 2000 provides additional guidelines and reporting requirements specifically tailored to exchange houses. A separate MERCOSUR agreement also exists to define guidelines for suppressing money laundering in the MERCOSUR countries and formalizing cooperation among those Central Banks.

95. Act 105 and Regulation 9 of October 2001 has set up within the BCP, a special purpose Unit for financial analysis on money and asset laundering. This Unit coordinates activities and information with the BCP's Department of Economic Crimes. Most recently, Act 123 and Regulation 1 of November 2001, implemented a "manual of conduct" requirement for banks to delineate the steps necessary for the identification and prevention of asset laundering, as related to Basel Core Principle 15 and codes of ethics. This regulation applies to all entities supervised by the SB. Essentially it emphasizes "know thy client" guidelines and requests reporting on connected businesses. Suspicious operations are reported to the National Secretariat for Prevention of Money Laundering.

Reform of the AML Framework

96. The Government with assistance of the U.S. Treasury, has developed a new draft AML legislation expected to be approved in 2005. This would reform the AML framework law No. 1015, and replace it with a modernized AML approach.

97. The new law, already presented to the Congress contains provisions for defining the AML/CTF as specific crimes. Better coordination arrangements in line with best practices worldwide, are set up in order to centralize the oversight of AML/CTF activities within the Government to avoid dispersed accountabilities, and to operate the relevant Unit under the President's Secretariat.

98. The law also addresses information technology issues and the ability for law enforcement to have legal tools to follow up on 'high tech' criminal activity. With regard to asset seizures under AML/CTF activity, the new framework is also specific with respect to procedures to be followed.

99. Financial institutions and other entities under the new framework, will also have reporting obligations with regard to suspicious transactions under standardized formats allowing quick analysis by the financial authorities.

Strategic Plan of the Banking Superintendency

100. As part of the reform effort and as part of the process delineated above, the Government considers it essential within the proposed framework and prior to its implementation, to have in place a strategic plan whereby a more risk management approach to bank supervision would be conducted and a sequenced, and a structured set of actions would take place before any event of bank failures occurred which might provoke systemic contagion. For this purpose, the following pro-active measures have been identified as part of the Central Bank's supervisory strategy and a contingency plan which would be implemented early on in the reform effort, and maintained as a key tool for effectively leveraging the new resolution mechanisms.

101. *Risk Ratings of Banks:* As part of a pro-active risk based focus of a new supervisory strategy, the SB will begin implementing an internal rating method using both quantitative (e.g., CAMEL criteria) and qualitative assessments of the soundness of banks and their associated management and risk mitigation functions. The risk rating approach will count on advanced financial, economic and balance sheet simulation tools to evaluate varying risk scenarios and capital adequacy for subject

banks. This will move beyond the mechanical application of financial ratios and provide ratings based on the internal risk management practices and controls of banks being supervised.

102. *Adaptation Plan for New Norms:* With the implementation of the reformed banking laws and regulation #8 which requires a phase in of increased loan loss provisions (and lower dependence on collateral as reserves), the SB will assess the adequacy of banks' business prospects, cash flows and financial cushions, to allow them to successfully transition into a stricter regulatory regime required under the new framework. This will involve continuous oversight and guidance by the SB to the financial sector, to engender corrective actions if banks are not taking adequate measures to reach their target levels of reserves under the new norms. While this exercise is in itself geared towards establishing regulatory compliance, it will also serve to identify latent weaknesses in institutions and determine their viability for survival in the long run.

103. *Solvency vs. Liquidity Issues:* Once weak banks are identified, and following the application of prompt corrective actions mandated by the SB to stop further deterioration, an immediate diagnosis would be made as to whether their problems constitute liquidity or solvency constraints. For those banks that appear solvent, liquidity assistance would be considered by the BCP. For those banks diagnosed as insolvent, a bank resolution strategy would be mapped out a priori.

104. *Consolidation Strategy and Resolution Plan:* The SB will give high priority under its strategic plan to fully develop and implement regulations to operationalize the procedures for conducting bank resolution and the institutionalization of the new deposit insurance fund. The BCP and SB would a priori approve a banking consolidation strategy and develop alternatives for promoting the merger of weak banks (or selected assets therefrom) with other banks in the market. A set of models estimating the good bank portions of the insolvent banks, would be drawn up, in order to determine the level of deposits that can be matched against viable assets before invoking any deposit guarantee funds. Any funding gaps would consider resources or securities from the deposit insurance fund provided they met the 'least cost criteria'.

105. *Industry Consultation Process:* The above exercises will require ongoing consultation with the banking industry to: (i) determine potential buyers of the remaining viable portfolio assets from the weak banks, (ii) consider alternative market based arrangements for handling the weak banks, and (iii) execute these processes in a matter of days to avoid disruption of the financial system.

The Second Operation Under the Program

106. The second operation supported by a loan of US$15 million, will focus on the implementation of the reforms and legal framework set out in the first phase through, inter alia, the measurement of improvement in the banking sector's financial condition.

107. Under this second operation as defined here, the reforms in the new *Banking Resolution and Deposit Insurance* framework would be implemented with applicable provisions enforced. Besides the application of that law (No. 2334/03), this will include the issuance of key regulations governing procedures to minimize the use of deposit insurance resources ('least cost criteria' rule) in the pay-out of depositors during banking resolution activities. Related to this will be the directive to prioritize the mechanism of transfers of assets and liabilities to sound banks (versus the outright liquidation process) in order to minimize State outlays.

108. As part of the above framework, the second operation will have fully developed and applied the legal, regulatory and market mechanisms to allow the *securitization* of asset portfolios through the legal establishment of special purpose trusts which would hold loan portfolios as collateral for securities issued by such trusts to interested banks and investors, as a means of selling such assets while providing sufficient assurances of the credit quality of the security.

109. In addition, regulations and practices governing the *operation of the new deposit insurance fund* will be in place including the budgetary and institutional set up as well as the fund's accounting and investment regime for premiums collected from the banking system, and the formalization of the Finance Ministry's capitalization contribution to the insurance fund via special bond issuances. As well, coupled with the bank resolution procedures, the deposit insurance fund will have in place policies defining its criteria for covering any asset/liability gaps of failed institutions in line with minimizing costs of such procedures while compensating all insured depositors.

110. Under the second operation, the *contingency plans* of banks and financial institutions will be presented to provide assurances that they are able to adapt their balance sheets to the more stringent capital and loss reserving requirements. This will ensure compliance with the new capital and provisioning norms meant to strengthen the financial condition of the system and be able to withstand future credit portfolio or market risks.

111. The new proposed *general banking law* that upon its entry into effect will replace Law No. 861, will include application of its norms including those mentioned in the preceding paragraph, and others such as the application of new sanctions for breach of norms, enforcement of exposure limits to related borrowers, implementation of risk management standards as part of banks' corporate governance, and new minimum bank licensing requirements including fit-and-proper criteria for new owners, shareholders and managers.

112. The second operation is also expected to fully bring into effect the new anti-money laundering law which is to have been approved by the Congress. The law will correct and improve on the following issues:

(a) Under the existing framework, judicial action against AML activity can only be applied once the underlying crime involved (e.g.: goods trafficking) is first ruled on. This creates judicial delays and duplication of costs across jurisdictions. Under the new law, AML activity in its own right will be grounds for immediate judicial/penal action, independent of underlying criminal activity;

(b) The institutional framework under the existing law essentially includes two financial intelligence units, i.e., the National Secretariat for AML prevention and the Central Bank intelligence unit. As per best practice and to ensure highest confidentiality and centralization of information while avoiding problems in information sharing, the new law would create only one unique intelligence unit in charge of overseeing all AML activity and reporting to the judiciary, a change which would help to modify Paraguay's status as seen by the Egmont Group;

(c) Under the existing law, the National Secretariat for AML is managed by a council constituted of high ranking officials in the Executive branch, which makes management of the Unit slow and inoperative. Under the reformed law, the Unit will depend directly on the President allowing expedited decision making and related actions.

(d) Under the current law, drug trafficking and other 'traditional' activities are recognized as being subject to AML legislation. However, given the evolution of techniques used by launderers, and other practices including the use of technology, which have advanced the sophistication of laundering processes, the current law as well as investigatory methods have become outdated. Under the new legislation, new and unusual types and sources of money laundering activity will be recognized in terms of their expanded scope, allowing for more judicial and penal follow up without being restricted to traditional types of illicit activities. The new law will also provide more flexibility in investigatory techniques subject to judicial control, but more in tune with the sophistication of the crime.

(e) The new law will also regulate the reporting requirements by subject entities to report suspicious cash or financial transactions. This will standardize such reports according to international standards, allowing quicker verification of information and expedited follow up action.

(f) The current framework is not specific on the decommissioning of assets or funds seized from illicit activities or establishments. Under the new reform, procedures for seizure and decommissioning of assets as well as their safeguarding, will be specified, in order to ensure more efficient and transparent processes while protecting individuals and supporting institutions that assist in AML efforts.

113. Under the second operation, in addition, the key actions defined under the *SB's Strategic Plan* will have been executed. These cover the supervision strengthening activities such as the completion of the evaluation of risks inherent in banking institutions including focused intensive inspections of 20 percent of banks in the system deemed more risky, and the undertaking of corrective actions demonstrating the application of the new bank resolution framework as well as the provisions in the new general banking law and implementation of regulation 8 for loan loss provisioning.

114. As part of the reform of the law governing the *Central Bank Charter,* the second operation will support the adoption of additional institutional reforms complementary to the general banking law but developed under as part of the planned changes in the BCP Charter (Law No. 489) -- these changes will ensure more autonomy and independence of both the BCP and the SB. The BCP's Board of Directors are currently appointed in staggered terms so as to span across more than one electoral cycle and prevent a single Administration from appointing all Board members within one electoral term. Currently, however, if a Board member departs, resigns or is dismissed prematurely, the next appointee begins his/her term and follows through for the full term of five years. This effectively breaks the "staggering" rule. A reform of the BCP Charter will require that if new appointments occur in the middle of the term of a recent Board member, then the new appointment should first run the remaining course of the prior member's term, and then expire before consideration for a new five year term. This would prevent the staggering rule from being broken and would maintain appointment periods crossing electoral cycles. Another reform planned under the BCP Charter, is granting the Superintendent more of a voice on the BCP Board's decisions in matters pertaining to banking supervision, and granting the SB more autonomy in applying sanctions based on its own technical judgment, something already incorporated in the reform of the General Banking Law. In addition, the BCP Charter which currently includes the schedule of sanctions, will require a technical modification so that this schedule is referred to more appropriately under the General Banking Law.

115. Finally, under parallel reforms complementing the government's program and following consultations among INCOOP the *Credit Cooperatives* Supervisory Agency, the Banking

Superintendency, the World Council of Credit Unions and the Bank, a new regulatory and supervisory framework will be put in place covering adequate solvency norms, asset risk weighting, loss provisioning and accounting for capital for the credit cooperatives sector.

The Third Operation Under the Program

116. The prior policy actions for the third operation will constitute reforms pertaining to the restructuring of the state owned banking sector and progress made under the overall program. This phase of reforms follows from the prior stages given that the establishment of the new State banks requires a baseline regulatory framework from which the design and a sustainable structure for this sub-sector can be established and monitored against future performance. A loan of US$30 million would support this operation and its extensive reforms envisioned as described below.

117. As defined currently, this third operation will focus on the reform of the State owned financial institutions. In order to address the pressing issues regarding the financial health of the state owned financial institutions, and to resolve the deteriorating condition of BNF, the Government will undertake a reform program through the implementation of a new legislative framework to rationalize the state owned banking sector. Through mergers and liquidations, it is planned to reshuffle the current institutional landscape and reduce the number of state-owned financial intermediaries to two consisting of a first-tier rural agricultural bank, and a second tier institution structured as a fund to channel bilateral and multilateral resources. The reform will be initiated with a public information campaign organized by the Ministry of Finance to assure all stakeholders of the benefits of restructuring loss making state institutions and focusing credit to the sectors with the highest needs.

118. As first steps in the reform program, the Government will take measures to prevent any further financial deterioration in BNF. This includes the (a) appointment of well experienced professional and politically independent bankers to the Management and Board of Directors and revisions of corporate governance policies, (b) provisioning fully all the non-performing loan assets and closure of unprofitable branches, (c) elimination of lending rate subsidies which did not generate cost recovery and the setting of rates to fully cover all administrative and financial costs, (d) halting all new lending to the commercial and development sectors as well as to individual borrowers with over US$15,000 equivalent in outstanding short term debt to the bank, (e) sharp reductions in administrative and advisory staff and an increase in staff assigned to loan/credit review and collections, (f) reorganizing the bank to drastically reduce the number of departments and line managers, and (g) updating the registry of loan collateral and determination of the liquidation value of such.

119. Under the first major component of this reform, a 2nd tier development finance fund will be created primarily out the merger of the existing second-tier institutions, UTEP FDI, FDC, and CONAVI/BANAVI. Whereas the first tier bank will be created with an option as a future joint-stock company, the status of the 2nd tier fund would be that of an autonomous public entity with independent legal status. The 2nd tier fund will have the mandate to rediscount medium and long term investment loans to banks and finance companies selected competitively. Lending would be deemed to promote the development of various areas of the Paraguayan economy by providing loan funds to financial institutions willing to lend directly to targeted areas and sectors, for the promotion of financing of investment and development projects by domestic enterprises, housing investment programs, agricultural investments, export-related activities or any other activities deemed fit to its institutional objectives. The institution will not collect any deposits from the public and would be funded from

multilateral, bilateral and government credit lines. The minimum term of its loans would be two years. Accordingly, the institution would not be authorized to accept any liabilities with a maturity of less than 1 year. For both institutions (1^{st} and 2^{nd} tier), the interest rates on loans must be equal to the administrative costs plus the costs of deposit-taking (in the case of 1^{st} tier), cost of borrowed funds, and provision for exchange risks.

120. Under the second main component of this reform, the first tier bank will be formed primarily from the merger of the sound portions the existing first tier institutions (BNF, CAH, FG), which will be extracted according to a "good bank / bad bank" liquidation procedure and with the intent of limiting the target clientele and portfolio character to small rural and small enterprise borrowers, many of which are current BNF and CAH clients. The 1^{st} tier bank will be limited in its borrowing from the 2^{nd} tier fund, in an amount not to exceed 25 percent of its liabilities. The portions of assets which include all non-performing loans, will be aggregated into a bad asset residual fund whose liquidation will be managed by private contractors under the oversight of the Ministry of Finance. Any well performing assets not included in the new bank will also be placed in the residual fund to be wound down, sold to the private sector either as select assets or a going business concern, or securitized if feasible. A temporary Government restructuring commission will be created to consolidate the management and downsizing of the institutions during this restructuring process as well as to re-negotiate or wind down bilateral or multilateral donor financed projects which do not fit into the framework of the new 2^{nd} tier institution.

121. The new 1^{st} tier bank will operate as a credit and payments institution dedicated to the broad-based development of the Paraguayan economy through the provision of financial services to creditworthy small and medium enterprises primarily in the agricultural sector, and which lack access to private financial institutions. All loans outstanding provided by the institution will be subject to a credit maximum for individual credit risks, and another for investment loans of four or more years allowed to be funded through the second tier institution. Public sector entities will be excluded as recipients of services. For both institutions, the interest rates on loans must be able to cover the administrative costs plus the costs of funding and any market and exchange risks. To avoid the risk of over dependence on public sector deposits and/or of relying on social security deposits for funding, the 1^{st} tier bank will be able to take deposits from the public sector limited to 12.5 percent of its total deposits for any single institution (e.g., social security), and to 25 percent for all public sector institutions combined.

122. The 1^{st} tier bank and the 2^{nd} tier fund will be subject to a more stringent corporate governance than the public financial institutions operating today. Directors at both institutions would be required to have extensive previous business experience in banking and finance. Both the new 1^{st} and 2^{nd} tier institutions will operate under the umbrella of the existing financial sector/banking legislation; and they will have no State guarantees or favorable tax treatment.

123. The special restructuring commission that will be established to coordinate the process of the creation of the new state banks, will also oversee the consolidation of operations, policy and accounting, and the contracting of private specialists to undertake the carving out of assets and liabilities which will be transferred to the new institutions, and the liquidation of residual assets which will be wound down or sold.

124. The reform of the State owned financial institutions will require substantial fiscal injections to wind down current unprofitable operations and match assets with existing liabilities during the

consolidation process into the two new remaining institutions. The main cost will be the reduction and wind down of BNF and its consolidation at a smaller scale into the new first tier rural and small enterprise bank. If a full liquidation procedure was used, the cost to the State would be approximately $74 million to pay for all outstanding liabilities and deposits, net of asset recoveries. However, the anticipated scenario under the proposed operation, would entail conducting an asset/liability matching and transfer exercise so that all outstanding liabilities need not be liquidated outright, but rather transferred to the new bank with matching loans in currently performing status. Good loans which do not qualify under the guidelines under the new first tier bank structure would be sold along with matching deposits to the private banking sector.

125. Under these reforms scenario, the anticipated cost of the State to fund the asset/liability gap, would be US$47 million. Severance payments to reduce the State banking workforce to half of the current level, would amount to approximately US$7 million. The contracting of expert bank restructuring consultants and liquidators to carry out the process of asset disposition and continue management of institutions until the reform is fully implemented is estimated at US$1 million[16]. In addition, some contingency funds may be needed to make deposit insurance payments and assist in bank mergers if fragile banks in the system are forced to close, as well as to pay off depositors from BNF if their deposits cannot be transferred to other institutions. In such an event, the Government may need to capitalize any initial obligations under the new deposit insurance fund which requires an initial capital through government bond issuance. Thus, the total "all-in" cost of the reform would amount to about US$55 million excluding any contingencies to pay out funds for deposit insurance. The Bank will work with the Government on the timing of the requisite financial support in relation to any debt service incurred on bonds issued to capitalize the restructured banks and finance the deposit insurance fund.

[16] These funds are separate and not included in the financing provided under the accompanying Technical Assistance project.

PART III. THE PROPOSED LOAN

A. Loan Description: Objective and Rationale for Bank Involvement

126. ***Loan Objective***. The objective of the loan is 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 objective, by promoting increased financial health, aims to avoid the recurrence of prolonged banking crises, and augment Paraguay's growth prospects by maintaining a banking sector with sufficient underlying capital and improved allocation of savings to expand the provision of credit in the economy. At an institutional level, the objective will be to strengthen the capabilities and financial/supervisory technology used by the Central Bank and the superintendency of banks to maintain the health of the financial system. This would be accomplished through invoking stronger capital adequacy rules combined with restructured asset/liability sales, and supported with deposit insurance funding, in order to resolve insolvencies at the lowest cost.

127. A key aspect of the proposed program is the design of an effective financial safety net feature in Paraguay's financial system, to prevent repetitions of past experiences and languishing banking crises brought on by inadequate regulations. These cost the state enormous resources that might have been contained with more effective modernized bank resolution instruments. The weak economic environment in Paraguay and in the region as a whole, pose significant vulnerabilities to financial institutions. The loan's design is meant to support prompt legal reforms to permit the State to pre-arrange and deploy problem resolution tools in the event of new bank insolvencies. This PFSAL loan program will be accompanied by a small 4-5 year Technical Assistance project which will provide technical support to the banking superintendency for the longer term institutional implementation of the reform program, including the areas of regulation, supervision, bank resolution, anti money laundering and others.

128. ***Loan Amount and Sequencing.*** The first PFSAL loan will be in the amount of US$15 million under a programmatic operation that will consist of three loans amounting to US$60 million in the aggregate. Compliance with the first loan's prior policy actions is required prior to submitting the operation to the Bank's Board for approval. Disbursement will take place immediately following approval and compliance with standard effectiveness conditions of the Bank. Presentation of the second PFSAL to the Board will take place following completion of tangible implementation indicators and compliance with the policy actions aimed to enforce the application of the new legislative framework approved under the first loan. Presentation of the third PFSAL loan will take place following the approval of a legislative package and implementation of actions for the reform and restructuring of the State owned financial institutions, and overall progress under the program. Given that the original concept paper for this program was prepared prior to September 2004, this document remains under the guidelines of the earlier Operational Directive 8.60 rather than under the new Development Policy Lending framework. However, the subsequent loans under this program will be prepared according to Development Policy Lending guidelines under the new Operational Policy 8.60.

Rationale for Bank Involvement and Strategy

129. ***Relation to Country Assistance Strategy.*** The loan constitutes a main pillar in the Bank's Country Assistance Strategy (CAS) as delineated in the CAS document discussed and approved by the

Board on December 16, 2003 (Report No. 27341-PA dated November 26, 2003) reflecting the current program. The assistance strategy which relies on the Government completing a number of structural changes supporting its own economic management strategy, includes strengthening of the State's policy apparatus to promote fiscal discipline and increased revenue inflows, fortifying the banking system as a main instrument for engendering investment and development, and reducing public pension liabilities. Given the Bank's extensive involvement in this sector and its policy dialogue with the Government through an earlier conducted Financial Sector ESW exercise to examine banking system vulnerabilities (as specified under Part II, A, pg. 11 of this report), the Bank has a comparative advantage in providing informed policy support for this type of operation.

130. While current economic and policy conditions preclude strong incentives for private bank lending, and thus financial access is very restricted, the banking system requires substantial strengthening to ensure that once economic activity picks up, financial institutions have sufficient capital to extend credit to support growth. In the current environment, the authorities are not able to deal efficiently with fragile financial institutions, therefore the banking system becomes encumbered with weak balance sheets, and without consolidation, is not able to reach more optimal levels of financial capacity. Recent growth prospects have improved, however, and the private foreign investment environment is becoming more favorable. Since one of the main pillars of the CAS is to increase the role of the private sector in promoting growth, an assurance of strong balance sheets in the banking system (via the application of rigorous prudential norms, prompt and strong corrective actions, and quick resolution and exit of weak banks) will substantially leverage the Government's macroeconomic tool kit to achieve its stated goals, which would merit Bank support.

131. ***Timing and Level of Financial Support.*** The program financing is justified on two grounds: (a) a balance of payments need, and (b) the overall budgetary cost of the reform. At this juncture, Paraguay has little if no access to financing from the international private capital markets, and due to the fiscal situation, there are no reassignable funds. From a balance of payments and budgetary perspective, the country's external financing requirement from multilateral, official and other sources, so as to assure a sound level of international reserves and a sustainable capacity to repay future debt obligations taking into account ongoing capital outflows and elimination of arrears on external debt service, amounts to an average of about US$200 million annually through 2006. While commercial banking flows decreased in the aftermath of recent period of banking instability through 2003 these were offset by foreign exchange inflows, with additional commercial and net private inflows observed in 2004. Commercial and investment flows are expected to rise during the period of the reform program. Therefore, including new projected capital inflows and net foreign currency deposits, private capital flows are projected to be positive under a more stable macroeconomic and financial environment. International reserves are expected to modestly rise in order to maintain a steady coverage of $4^1/_2$ months worth of imports as well as to bolster confidence by assuring an appropriate level of foreign exchange reserves with respect to Paraguay's partially dollarized banking system.

132. For the subsequent operations under the program, the restructuring of the State banking sector may require up to US$55 million in direct or indirect capital support to close down and liquidate institutions (assuming modest recoveries in bad loan portfolios, severance payments and the price of asset disposition contractors) and to create the remaining two new State institutions while assuring they are fully solvent. Also, contingent needs exist to pre-fund the new deposit insurance scheme which by law requires that the Treasury provide support with an initial bond infusion to capitalize the fund while it builds up premium based reserves. The Bank's support of US$60 million for this multi-year program will be complemented by IDB support through a financial intermediation loan to launch the

public second tier bank and the possibility of a later adjustment program. Both institutions will work with the Government on the phasing issues with respect to evolving financing needs. The overall program is being implemented with a precautionary Stand-By Arrangement with the IMF. The proposed loan would, through the more efficient mechanisms for bank failure resolution and the halting of losses of banks, aim to sharply reduce future fiscal outlays and engender solid financial institutions, thus eventually attracting additional external and internal financing and investment.

Table 12
External Financing Requirements
(US$ millions)

	2003	2004 (est.)	2005 (proj.)	2006 (proj.)
Current Account Balance	132	48	(25)	(14)
Repayment Obligations	(199)	(234)	(161)	(267)
Financing, net (gap = ( ))	(67)	(186)	(186)	(281)
Multilateral/Official Flows	213	157	185	150
Commercial Bank Flows	(147)	65	83	65
Foreign Currency Inflows	343	54	(53)	100
Other Investments/Deposits	(40)	91	22	41
Int. Reserves [(-) = increase]	(302)	(181)	(51)	(75)

Source: World Bank, BCP, IMF, Economist Intelligence Unit

133. ***Medium Term Objectives and Outcomes.*** The Government's medium term goals for the banking system are to ensure the stability and strength of the system so that it may return to a position where the provision of credit can be increased to support the reactivation of the economy, a key requirement in the success of the government's economic program. Within this process, the government intends to reduce its fiscal obligations and contingent liabilities. The reduction of these obligations would not only provide the government with additional "fiscal space" but also encourage a new policy framework in which the private sector might share the risks inherent in the financial system with the support of a modernized bank resolution process and deposit insurance system. Outcomes sought include a well capitalized, regulated, supervised, stable and efficient consolidated financial system that can effectively intermediate savings and provide broader credit, capital, and other financial services and products for Paraguayan consumers, investors and underserved enterprises while also attracting foreign direct investment into the financial industry.

134. ***Bank Role in the Medium Term Program.*** The Bank expects a continued visible presence in the financial sector dialogue with Paraguay in the medium term. Given the Bank's regional leadership in the area of modernized 'asset carve-out' style bank resolution procedures and transfers of partial balance sheets, the Bank has a reputational interest in continuing to assist the Government in the implementation of the new legal framework and associated financial mechanisms required. In addition, the Bank will be simultaneously implementing a Technical Assistance project to support the institutions in charge of implementing the new banking regulatory framework, and this project will serve as an instrument to continue the Bank's engagement and assist in implementation. The Bank will also be commencing in late FY05, a Financial Sector Assessment Program (FSAP) in Paraguay

which will help to deepen the diagnostics and continue the policy dialogue to strengthen ongoing and future reform efforts. The Bank will also be involved in the ongoing preparation of programs related to both private sector development and pension reform which will have direct links to the financial sector issues addressed under this loan.

B. Conditionality

Prior Policy Actions for Board Presentation / First Operation

135. ***Prior to Board Presentation***. Summary of Loan Conditions: The Government has: (i) taken the necessary steps to maintain a sound macroeconomic framework and fiscal policies; (ii) agreed to implement an overall medium term financial sector reform program as indicated in the Letter of Sectoral Development Policy; (iii) presented the requisite legislative bills to Congress, and (iv) carried out the specified legal, regulatory and institutional reform actions in the areas of banking system reform (prudential regulation, supervision, bank resolution/exit procedures, deposit insurance). The disbursement of US$15 million is to be take place upon loan signature and completion of standard procedural requirements for loan effectiveness. The prior actions are listed in detail as follows:

Macroeconomic Framework

Maintenance of an adequate macroeconomic policy framework agreed with the Bank, covering fiscal, monetary, exchange, external, and financial policies.

Modernization of the Bank Resolution and Deposit Insurance System

The Board of Directors of BCP has issued resolution No. 6 dated March 15, 2004 which regulates Article 6 of the Bank Resolution and Deposit Insurance Law through the establishment of specific technical criteria for subjecting troubled financial institutions in Paraguay to adopt regularization actions to improve their financial condition.

The Board of Directors of BCP has issued resolution No. 31 dated March 18, 2004 which regulates Article 20 of the Bank Resolution and Deposit Insurance Law by explicitly prohibiting all financial institutions in Paraguay to pledge their assets as security for deposits held by individuals and/or legal entities in the financial institution.

(a) The Government, through MoF, and the association of private banks operating in Paraguay have agreed to renegotiate and restructure the public internal debt of Government treasury bonds through the exchange and refinancing of the bonds with new bonds to be issued by the MoF in accordance with the terms and conditions stipulated in the Preliminary Declaration of Intent; and (b) the Congress has approved law No. 2336/03 which authorizes the MoF to issue and circulate the new bonds in accordance with the stipulated terms and conditions as agreed with the banking industry.

Banking Legal, Regulatory and Institutional Framework

The Board of Directors of BCP has issued resolution No. 8 dated November 27, 2003 which establishes regulations to be followed by all financial institutions (as defined in Law No. 861/96) in Paraguay concerning, inter alia, the classification of these institutions' assets and credit risks, *and definition of recognition of loan loss reserves, accrued interest payments, and refinancings, resulting from financial institutions' loans to individuals and/or legal entities.*

The Government's executive branch has presented to the Congress for approval, the Banking Draft Law which contains provisions for, inter alia: (i) stricter capital adequacy requirements; (ii) loan classification and provisioning standards; (iii) schedule of sanctions for breach of norms; (iv) exposure limits to related borrowers and within financial groups; (v) corporate governance and risk management; and (vi) minimum bank licensing requirements, and provides for the derogation of Law No. 861/96.

The Government's executive branch has presented to the Congress for approval, the Anti-Money Laundering Draft Law which contains provisions for, inter alia: (a) the definition of money-laundering as a crime; (b) the establishment of a centralized intelligence unit of the Government to deal with anti-money laundering issues; and (c) the definition of financing of terrorism as a crime.

The Superintendency of Banks' (SB) Strategic Plan has been approved by the Board of Directors of the BCP setting out the mission, objectives, strategies and short-, medium- and long-term targets of the SB and provides for SB's institutional commitment to, inter alia: (i) upgrade supervision procedures of financial institutions; (ii) undertake risk vulnerability ratings of financial institutions; (iii) enforce corrective actions against imprudent banking practices; and (iv) establish the institutional procedures necessary to implement the Bank Resolution and Deposit Insurance Law (as defined above) and the regulations to that law.

136. ***Implementation Benchmarks and Results Monitoring.*** All agreed prior actions have been met for this first loan covering reform of the legal, regulatory and supervisory framework of the banking system. Monitorable benchmarks will include the passage of key legislation such as the reformed General Banking Law and the enforcement of new resolution procedures for dealing with troubled banks through the application of the pertinent asset and liability carve out mechanisms used for such procedures. In addition, the levels and quality of bank capital in the system will be carefully monitored to ensure that the solvency of the banking system is improving and strengthening given stricter requirements. The execution of resolution actions to disband and carve out assets and liabilities of weak or failed banks will constitute key evidence (where situations warrant) of applying the new procedures while minimizing State or Deposit Insurance cash outlays. Other indicators such as evidence of bank mergers or closures as well as corrective actions directives issued by the SB an adhered to by non-compliant financial institutions, will also be monitored as key implementation benchmarks. During the final stages of the program, the main benchmarks will include the actual creation of the new State banks and winding down of residual operations, and the ensuing provision of credit to the small borrower population of entrepreneurs and rural enterprises. Given the three stage programmatic approach, subsequent approval of future operations will also provide key opportunities to verify the implementation of prior agreed reforms before proceeding to the next loan(s).

137. ***The Second Operation.*** Summary of Loan Triggers: The second operation will be available once the Borrower has (i) maintained a sound macroeconomic framework, (ii) approved all legislative and related reforms presented under the first operation; (iii) approved a revised comprehensive banking law and presented a new Central Bank charter to the Congress, (iv) applied the new banking resolution mechanism and deposit insurance functions for implementation of the reforms, and (v) applied preventive corrective actions to banks in non compliance with prudential requirements. The second

loan amount of US$15 million would be presented to the Board once evidence was received that triggers had been satisfied. The details of the triggers for the second operation are listed below:

<u>Macroeconomic Framework</u>

Maintenance of an adequate macroeconomic policy framework agreed with the Bank, covering fiscal, monetary, exchange, external, and financial policies.

<u>Modernization of the Bank Resolution and Deposit Insurance System</u>

The Board of Directors of BCP has issued regulations to govern the implementation of the Bank Resolution and Deposit Insurance Law, such regulation containing: (a) resolution procedures applying the principle of least cost criteria to minimize use of deposit insurance resources; (b) the requirement to transfer matching assets and liabilities to financially sound banks; and (c) provisions for securitization of such assets.

The Board of Directors of BCP has issued regulations to govern the implementation of the Deposit Insurance Fund, containing: (a) criteria to be used for quantifying the asset/liability gap in failed banks to be funded by the Fund; (b) the definition of the organizational, budgetary, institutional and statutory framework of such Fund; (c) the accounting and investment regime and management of the collected premiums in custody of such Fund.

<u>Banking Legal, Regulatory and Institutional Framework</u>

Banks and all Other Financial Institutions subject to the current Banking Law (as referred to in the prior action below) have submitted Contingency Plans to comply with BCP's Regulation 8 loan loss provisioning, and capital requirements.

(A) The new Banking Law (which replaces Law No. 861) is in effect, including provisions for: (i) stricter capital adequacy requirements; (ii) loan classification and provisioning standards; (iii) a schedule of sanctions for breach of norms; (iv) exposure limits to related borrowers and within financial groups; (v) corporate governance and risk management; and (vi) minimum bank licensing requirements; and (B) the Board of Directors of BCP has issued the regulations to govern the implementation of the law.

The Anti-money Laundering Law (AML) is in effect, containing provisions for: (a) definition of money-laundering as a crime; (b) establishment of a centralized intelligence unit of the Borrower to deal with anti-money laundering issues; and (c) definition of financing of terrorism as a crime.

Key actions under the SB's Strategic Plan have been carried out including: (a) completion of risk evaluation of banks; (b) focused supervisory examinations of at least 20% of all banks, those banks having been evaluated as financially-unsound banks, based on the risk assessments obtained; and (c) actions to address bank weaknesses or failures, for which corrective measures have been conducted consistent with the new legal framework and the supervisory framework defined under the SB's Strategic Plan.

A law that modifies Law No. 489 has been presented to Congress, containing provisions for: (a) removing the corrective action and sanctions regime from such Law 489; (b) investing the SB with increased execution abilities for sanctioning non-complying banks; and (c) having members of the BCP Board of Directors maintain staggered term appointments to ensure BCP independence.

138. ***The Third Operation.*** Summary of Loan Triggers: The third operation will become available and be presented once the Borrower has: (i) maintained a sound macroeconomic framework, (ii) shown

verifiable implementation progress under the earlier phases of the program, and (iii) approved, promulgated a legislative package that has implemented the restructuring of the State owned banking sector including the resulting formation of single first tier public bank and a single second tier development fund. The third PFSAL loan of US$30 million would be prepared and presented once evidence was received that all triggers have been met. The details of these are listed below:

Macroeconomic Framework

Maintenance of an adequate macroeconomic policy framework agreed with the Bank, covering fiscal, monetary, exchange, external, and financial policies.

Restructuring and Consolidation of the State Owned Banks

A management and institutional reform for the National Development Bank (BNF) has been undertaken, the bank is reorganized and streamlined, new regulations are approved specifying credit limits placed on new lending, a staff downsizing program is implemented including a sharp reduction in departments and management posts, branches are rationalized according to cost recovery criteria.

The Legislative Package for the Restructuring and Consolidation of the State Financial Institutions and its implementing regulation is in effect, including the establishment of:

(A) A single public first tier bank created via the merger and downsizing of the State's 1st tier institutions, with the following features: (i) statutory lending limits per borrower established for both short term and investment loans; (ii) limits on holding of public sector deposits; and (iii) limits on borrowing from the public second tier bank; and

(B) A single public second tier fund created by merging and/or extinguishing the five existing second tier financial institutions with the minimum following features: (i) establishment of a reserve fund to cover foreign exchange exposure and/or other hedging instruments; (ii) interest rate setting on loans to cover all financial and operating costs; and (iii) no authority to channel funds to individual persons or entities that do not constitute banks, finance companies, savings and loans associations or cooperatives, subject to prudential financial regulations.

New prudential rules and operational directives for setting interest rates on loans, lending limits and risk exposures applicable to all assets of the State banking sector, are in effect and loss reserving standards are being enforced.

The reform is underway and in operation and under its legal mandate, contracted specialists are managing, valuing and transferring assets and liabilities from the pool of State Financial Institutions' assets, to form the new balance sheets of the new first and second tier banks.

139. ***Expected Outcomes, Benchmarks and Follow Up.*** Following the end of the program, the targeted outcomes in the banking sector will include a measurable reduction in fiscal liabilities and contingent obligations from the resolution of insolvent institutions. A quantifiable improvement in the financial health of the sector under the assumption of moderate economic growth should be observed, as well as a verifiable record of corrective actions achieved through the financial authorities' improved supervision and prudent application of sanctions and penalties to reverse deficient risk management practices. Under the State banking sector, the restriction of imprudent credit policies and the consolidation of the sector into special purpose entities with specified corporate governance mandates and that demonstrate the ability to evaluate and provide lending to underserved but productive sectors, will constitute key outcomes to measure the success of the last phase of the reform. The programmatic

design as well as the FSAP exercise and its recommendations, coupled with the implementation dialogue that will take place under the Financial Sector Technical Assistance project will allow continuation of the policy dialogue with the Government to follow up on progress made. As well, the to-date collaborative joint efforts with parallel teams from the IDB and the IMF will ensure a continuous follow up on financial sector reforms by the three multilateral institutions.

C. Disbursement and Auditing

140. Disbursement arrangements will follow the simplified procedures for SALs/SECALs approved by the Board since 1996 and in effect presently. Based on a CFAA prepared by the Bank with the IDB during 2003, financial management system controls were assessed as weak and in need of improvement, despite the existence of a computerized public financial management system platform. For the purpose of this PFSAL loan, the Government will open an account in the Central Bank of Paraguay. Once the Bank formally notifies the borrower that a tranche is available for withdrawal, the borrower may submit a withdrawal application so that the proceeds of the tranche are deposited by the Bank in this account to be used in accordance with the Loan Agreement. An audit of the deposit account, as part of the Central Bank's newly implemented external audit oversight, would be conducted for the project only upon the Bank's request, to assure that proceeds are transferred according to acceptable budgetary procedures and standards, and that sufficient controls exist under the Treasury accounts linked to the Deposit Account to ensure adequate monitoring and financial reporting of Government budget balances.

141. As part of the CFAA and a prior risk assessment of financial management processes, Regional financial management staff of the Bank conducted a summary diagnostic analysis and set forth recommendations for improvement in financial controls of the Government's Treasury, particularly as they relate to fiduciary issues in the management of loan funds and adequacy of Government financial statements. Besides the internal control weaknesses mentioned, the diagnosis also identified the need for Government systems to record budget commitments and accruals properly and completely for all public entities receiving central Government funding as well as those with own funding, and to apply generally accepted accounting principles as well as consolidation of financial statements for all public entities and enterprises.

D. Environmental Aspects

142. The PFSAL has no direct impact on the environment. For the purposes of Operational Directive 4.01, it has an environmental category of C, which does not require an environmental assessment.

E. Program Objective Categories

143. The PFSAL belongs to the category of *Economic Management*. It supports the Government's economic reform program aimed at improving the environment for sustained and stable economic growth, by ensuring a stable, appropriately capitalized, and well functioning financial system. The PFSAL includes features to improve the Government's institutional capacity to prevent financial system deterioration and to have financial policy and funding mechanisms to promptly resolve and insulate weak financial institutions if problems should arise. The reform of the public bank sector will also significantly reduce financial system risks, while lowering the cost to the state of maintaining the operating infrastructure and continuing losses from such institutions. Implementation of the wider financial sector program will also benefit the population at large by eventually generating improved

access to finance and savings. The program thus complements assistance by the Bank and other donors designed to directly support the Government's development objectives.

F. Benefits and Risks

144. ***Benefits.*** This proposed programmatic loan would have benefits in a number of areas of the financial system. The new legal framework would significantly modernize and facilitate the management and regulation of the financial system thus providing the public more transparency and confidence in the health of financial institutions and eventually attract increased foreign investment into the financial services industry. The modernization of bank supervisory practices would cover the early application of sanctions to halt accelerated deterioration of financial institutions and correct deficient management practices regarding operational decisions and risk taking, as well as upgrading the Superintendency's monitoring tools for risk assessment. This will reduce future disruptions in the financial system and 'surprise banking crises', and thus engender a banking culture more predisposed to reserve adequately against losses and able to extend credit during economic growth periods. The program would support these outcomes by increasing the autonomy of the supervisory body, and upgrading prudential financial regulations to enhance banking sector surveillance and thus reduce the frequency and severity of bank failures.

145. Modernization of the failed bank resolution procedures will reduce potential drains on the public budget and thus provide more room for spending on critical social programs including health, education as well as infrastructure. The establishment of an industry funded deposit insurance system will delink bank resolution funding from the fiscal purse, while providing incentives to the private banking industry to better safeguard deposit insurance resources. The modernized rapid and efficient mechanisms for bank exit will reduce the likelihood of contagion effects and thus enable the economy to resume growth quickly without being unduly affected by bank failures, banking runs and/or exchange rate crises. The rationalization of the state owned banking sector will reduce fiscal exposure and generate additional market niches for the private banking system to develop and to increase credit to smaller productive rural enterprises which can contribute to growth and to the export market. State banking rationalization will, in addition, reduce the misallocation of resources to highly exposed subsidized borrowers that generate losses, while focusing the provision of financial services to those populations and sectors with least access and geographically dispersed.

146. ***Risks.*** The principal risks to the reform program are the uncertainties of the national policy debate and macroeconomic factors, as well as the risk of incomplete implementation of the reforms due to weak institutional capacity. The reform of the banking system's regulatory framework and the restructuring of the state owned banking sector may be a politically charged process. In the first instance, the stricter prudential regulations to be established for the operation of banks may generate lobbying opposition from the private banking sector with appeals to their respective congressmen. The reform will necessitate the eventual regularization or resolution of weak banks. The Paraguayan Congress has traditionally been a very activist and politically galvanized body which does not easily approve reforms proposed by the executive branch if they threaten political interests generated from constituency pressures. These factors could threaten the integrity of the reform program if the Congress does not approve any of, or a combination of these pieces of legislation under the program, a circumstance which would not allow the second tranche to be disbursed.

147. On another front, and more concerning the latter phases of the program, the restructuring of the state owned banking sector poses additional political challenges: the closure of credit operations

beyond those aimed at the small farmer or entrepreneur, could generate political issues from the influential cattle ranching sector that currently benefits from some of these programs such as the Fondo Ganadero which would be merged, wound down or privatized. At the other end of the spectrum, the closing of certain branches of institutions across the country, so as to rationalize operations, could spark protests from the rural sectors on which the Government relies heavily for political support. Because of the large scope of this reform, the Government is considering alternative strategies in the latter phases such as beginning with a reform of the second tier institutions to be followed by a subsequent stage where the first tier institutions would be addressed. While this to some extent could achieve political consensus, it also carries the risk of splitting the reform and delaying its subsequent phase.

148. These risks will be ameliorated through a transparent and well disseminated public disclosure and educational campaign carried out by the Ministry of Finance in conjunction with partner agencies, regarding the intent of the reforms, showing that they are meant to benefit the economy as a whole, and the poorer rural sectors in particular. The public information campaign will also extend to consultations with congressional members to clearly disclose that the financial backing of the multilateral community is conditioned on the approval of the reforms, whose implementation would release the needed financial resources to support the national economic program. The Government has also started a closer ongoing dialogue with the key committees in the Congress that oversee this reform, to ensure that both the Executive and the Congress communicate regularly regarding strategies and proposed changes in the design of the reform.

149. On the macroeconomic front, anemic growth could pose a threat to the viability of implementing banking system reform. Given the higher capital requirements for banks under the new legislative framework, low growth would make it difficult for the financial system to generate sufficient incremental returns to capitalize itself adequately, therefore, there may be a need to phase in the reforms over a medium term period. The external and regional environment will also have an impact were past competitive devaluations with Brazil to start again, not only from the overall macroeconomic perspective (e.g.: loss of markets), but also due to the effect on Paraguay's domestic debtors who borrowed in dollars and whose debt in guaraní terms would continue rising. Other external developments in either the Argentine or Brazilian economies could adversely affect Paraguay's projected growth. The currency mismatch within a highly dollarized economy can also pose severe credit risks to Paraguayan banks. The program envisages reforms and risk management criteria for the banks to address, ex ante, the issues of dollarization and devaluation induced effects on the financial system. If regional instability were to recur, however, generating new bank failures, the Government might face serious difficulties to sustain implementation of the reforms.

150. At a time when prudential and reserving requirements as well as capital adequacy standards were becoming stricter, the loss provisioning required by banks under the new norms, coupled with the possibility of yet higher provisioning needs (if local borrowers were to default due to foreign exchange exposures), could hamper effective implementation of the reforms if such provisioning implied excessive reductions of reported capital, and the associated regulatory insolvency status. These measures will be ameliorated by building in a grace period for full implementation so as to phase in the stricter requirements without causing undue technical failures or accounting bankruptcies in the interim. While such instances would provide the Government and the Central Bank opportunities to deploy the bank exit mechanisms included in the new legislative framework, any materialization of a systemic problem might short circuit the reform given political pressures which could emanate to

rescue banks and depositors before an adequate deposit insurance fund and its operating staff and procedures were constituted.

151. Other risks pertain to overall governance issues within an environment susceptible to corruption as well as risks of illicitly laundered monies within the banking system, either from contraband, drug or terrorist activity. However, the new Government, with Bank support, has embarked on a public anti corruption campaign to clean up the State sector, an initiative which will help to counteract past abuses. In terms of illicit funds, the program envisages a number of measures to fortify the anti-money laundering institutional framework which is already supported by a number of pieces of legislation developed over the last few years. These are included as part of the supervisory and prudential aspects under the reform program, and are also being supported by multilateral funding in the form of grants and other assistance. Some of the perceived risks of corruption and lack of transparency will be ameliorated, as discussed earlier, through: (a) the audit of the special account used for deposit of loan proceeds as required, (b) new annual audits of the Central Bank as an institution, and (c) continued implementation of the Government's so far successful public transparency campaign, as well as follow up on the recommendations of the IMF's safeguards assessment and the Bank's diagnostic of public financial accountability.

PARAGUAY
PROGRAMMATIC FINANCIAL SECTOR ADJUSTMENT OPERATION
POLICY MATRIX FOR REFORM PROGRAM

(Prior Actions / Triggers noted in bold)

Annex 1 - Policy Matrix

FIRST PROGRAMMATIC FINANCIAL SECTOR ADJUSTMENT LOAN – POLICY ACTIONS TAKEN PRIOR TO BOARD APPROVAL	SECOND PROGRAMMATIC FINANCIAL SECTOR ADJUSTMENT LOAN – FUTURE ACTIONS IN SECOND PHASE	THIRD PROGRAMMATIC FINANCIAL SECTOR ADJUSTMENT LOAN – FUTURE ACTIONS IN THIRD PHASE	KEY EXPECTED RESULTS AND OUTCOMES AT THE END OF THE PROGRAM
MACROECONOMIC POLICY ENVIRONMENT *Policy Objective*: Maintenance of a sound macroeconomic policy framework. Responsible Government Agency: MH			
Maintenance of an adequate macroeconomic policy framework agreed with the Bank, covering fiscal, monetary, exchange, external, and financial policies.	**Maintenance of an adequate macroeconomic policy framework agreed with the Bank, covering fiscal, monetary, exchange, external, and financial policies.**	**Maintenance of an adequate macroeconomic policy framework agreed with the Bank, covering fiscal, monetary, exchange, external, and financial policies.**	Fiscal surpluses are achieved in 2005 and sustained, promoting an increased allocation of funds for investment purposes, and increased economic growth.
I. MODERNIZATION OF THE BANK RESOLUTION AND DEPOSIT INSURANCE SYSTEM			
IMPLEMENTATION OF THE REFORMED BANK RESOLUTION AND DEPOSIT INSURANCE LAW *Policy Objective*: Upgrading the Bank Resolution and Deposit Insurance Operational Framework. Responsible Government Agencies: BCP/SB			
The Board of Directors of BCP has issued resolution No. 6 dated March 15, 2004 which regulates Article 6 of the Bank Resolution and Deposit Insurance Law through the establishment of specific technical criteria for subjecting troubled financial institutions in Paraguay to adopt regularization actions to improve their financial condition. **The Board of Directors of BCP has issued resolution No. 31 dated March 18, 2004 which regulates Article 20 of the Bank Resolution and Deposit Insurance Law by explicitly prohibiting all financial institutions in Paraguay to pledge their assets as security for deposits held by individuals and/or legal entities in the financial institution.**	**The Board of Directors of BCP has issued regulations to govern the implementation of the Bank Resolution and Deposit Insurance Law, such regulation containing: (a) resolution procedures applying the principle of least cost criteria to minimize use of deposit insurance resources; (b) the requirement to transfer matching assets and liabilities to financially sound banks; and (c) provisions for securitization of such assets.** Regulations are being implemented allowing the initiation of securitization of performing asset portfolios through trust mechanisms to improve the sale and yield of transferred loan portfolios as marketable securities along with matching deposits.	Evidence is demonstrated that resolution transactions have been executed and applied as per the policies and procedures consistent with the new law.	A managed process resulting in the orderly downsizing and consolidation of the banking system leaving the most solvent and healthy banks to manage depositor funds and provide credit. Initial diagnostics and efficiency considerations imply a resulting 15% reduction of financial institutions existing at start of 2004, by end 2006.
International consultants have been contracted based on agreed terms of reference to prepare (b) the implementing regulations for the bank resolution system and underlying operating procedures; and (b) implementing regulations for the institutional	**The Board of Directors of BCP has issued regulations to govern the implementation of the Deposit Insurance Fund, containing: (a) criteria to be used for quantifying the asset/liability gap in failed banks to be funded by the Fund; (b) the**	Evidence that the deposit insurance fund is operating according to the established legal framework including its funding provisions and policies for the use of its insurance proceeds.	The new privately funded deposit insurance scheme is implemented and premiums are collected on a regular basis from the banking system, to finance the deposit insurance fund and reduce future contingent liabilities of the State.

Annex 1

PARAGUAY
PROGRAMMATIC FINANCIAL SECTOR ADJUSTMENT OPERATION
POLICY MATRIX FOR REFORM PROGRAM

(Prior Actions / Triggers noted in bold)

Annex 1 - Policy Matrix

FIRST PROGRAMMATIC FINANCIAL SECTOR ADJUSTMENT LOAN – POLICY ACTIONS TAKEN PRIOR TO BOARD APPROVAL	SECOND PROGRAMMATIC FINANCIAL SECTOR ADJUSTMENT LOAN – FUTURE ACTIONS IN SECOND PHASE	THIRD PROGRAMMATIC FINANCIAL SECTOR ADJUSTMENT LOAN – FUTURE ACTIONS IN THIRD PHASE	KEY EXPECTED RESULTS AND OUTCOMES AT THE END OF THE PROGRAM
operation of the deposit insurance fund and its financing role in bank resolution restructurings. **(a) The Government, through MoF, and the association of private banks operating in Paraguay have agreed to renegotiate and restructure the public internal debt of Government treasury bonds through the exchange and refinancing of the bonds with new bonds to be issued by the MoF in accordance with the terms and conditions stipulated in the Preliminary Declaration of Intent; and (b) the Congress has approved law No. 2336/03 which authorizes the MoF to issue and circulate the new bonds in accordance with the stipulated terms and conditions as agreed with the banking industry.**	**definition of the organizational, budgetary, institutional and statutory framework of such Fund; (c) the accounting and investment regime and management of the collected premiums in custody of such Fund.** The BCP has formalized with MoF the government's funding/capitalization arrangements for the deposit insurance fund.		Bank closures and preventive action by the authorities result in sharp reductions of emergency resolution actions, thus minimizing deposit withdrawals and ensuing contraction of credit.
II. BANKING LEGAL, REGULATORY AND INSTITUTIONAL FRAMEWORK			
IMPLEMENTATION OF AN UPGRADED AND MODERNIZED BANKING, LOSS PROVISIONING ANTI-MONEY LAUNDERING FRAMEWORK __Policy Objective__: Upgrading the General Banking Legal Framework, the Loss Reserving Regime, and Strengthening the Anti-Money Laundering Institutions Responsible Government Agencies: BCP/SB/MH/MIC			
The Board of Directors of BCP has issued resolution No. 8 dated November 27, 2003 which establishes regulations to be followed by all financial institutions (as defined in Law No. 861/96) in Paraguay concerning, *inter alia*, the classification of these institutions' assets and credit risks, and definition of recognition of loan loss reserves, accrued interest payments, and refinancings, resulting from financial institutions' loans to individuals and/or legal entities. **The Government's executive branch has presented to the Congress for approval, the Banking Draft Law which contains provisions for, *inter alia*: (i) stricter capital adequacy requirements; (ii) loan classification and provisioning standards; (iii)**	**Banks and all Other Financial Institutions subject to the current Banking Law (as referred to in the prior action below) have submitted Contingency Plans to comply with BCP's Regulation 8, loan loss provisioning, and capital requirements.** **(A) The new Banking Law (which replaces Law No. 861) is in effect, including provisions for: (i) stricter capital adequacy requirements; (ii) loan classification and provisioning standards; (iii) a schedule of sanctions for breach of norms; (iv) exposure limits to related borrowers and within financial groups; (v) corporate governance and risk management; and (vi) minimum bank licensing requirements; and (B) the Board of**	AML and counter terrorism financing (CTF) guidelines are applied to other non banks such as insurance and securities firms.	Banking capital norms are brought up to international standards and a measurable increase in banking system capital for solvency purposes, consistent with Basel guidelines and requirements, is achieved by 2006. Due to strengthening of banking system capital, reduction of regulatory arbitrage, minimization of money laundering, increased economic growth and consolidation/closure of institutions, bank credit to the private sector for productive uses, increases.

PARAGUAY
PROGRAMMATIC FINANCIAL SECTOR ADJUSTMENT OPERATION
POLICY MATRIX FOR REFORM PROGRAM

(Prior Actions / Triggers noted in bold)

Annex 1 - Policy Matrix

FIRST PROGRAMMATIC FINANCIAL SECTOR ADJUSTMENT LOAN – POLICY ACTIONS TAKEN PRIOR TO BOARD APPROVAL	SECOND PROGRAMMATIC FINANCIAL SECTOR ADJUSTMENT LOAN – FUTURE ACTIONS IN SECOND PHASE	THIRD PROGRAMMATIC FINANCIAL SECTOR ADJUSTMENT LOAN – FUTURE ACTIONS IN THIRD PHASE	KEY EXPECTED RESULTS AND OUTCOMES AT THE END OF THE PROGRAM
schedule of sanctions for breach of norms; (iv) exposure limits to related borrowers and within financial groups; (v) corporate governance and risk management; and (vi) minimum bank licensing requirements, and provides for the derogation of Law No. 861/96.	**Directors of BCP has issued the regulations to govern the implementation of the law.**		
The Government's executive branch has presented to the Congress for approval, the Anti-Money Laundering Draft Law which contains provisions for, *inter alia*: (a) the definition of money-laundering as a crime; (b) the establishment of a centralized intelligence unit of the Government to deal with anti-money laundering issues; and (c) the definition of financing of terrorism as a crime.	**The Anti-money Laundering Law (AML) is in effect, containing provisions for: (a) definition of money-laundering as a crime; (b) establishment of a centralized intelligence unit of the Borrower to deal with anti-money laundering issues; and (c) definition of financing of terrorism as a crime.**		
The Superintendency of Banks' (SB) Strategic Plan has been approved by the Board of Directors of the BCP setting out the mission, objectives, strategies and short-, medium- and long-term targets of the SB and provides for SB's institutional commitment to, *inter alia*: (i) upgrade supervision procedures of financial institutions; (ii) undertake risk vulnerability ratings of financial institutions; (iii) enforce corrective actions against imprudent banking practices; and (iv) establish the institutional procedures necessary to implement the Bank Resolution and Deposit Insurance Law (as defined above) and the regulations to that law.	**Key actions under the SB's Strategic Plan have been carried out including: (a) completion of risk evaluation of banks; (b) focused supervisory examinations of at least 20% of all banks, those banks having been evaluated as financially-unsound banks, based on the risk assessments obtained; and (c) actions to address bank weaknesses or failures, for which corrective measures have been conducted consistent with the new legal framework and the supervisory framework defined under the SB's Strategic Plan.**	Actions undertaken as part of Bank Resolution Law 2334 and the SB's Strategic Plan include appropriate sanctions for non compliance and risky operations, financial improvement programs, bank intervention and resolution actions, and application of corrective measures taken by the SB for all banks including State financial institutions, examined and adversely rated or found in breach.	The SB demonstrates the application of early warning indicators and corrective actions which mitigate bank deterioration and serve as an alternative corrective tool to strengthen banks before they reach resolution status.
	A law that modifies Law No. 489 has been presented to Congress, containing provisions for: (a) removing the corrective action and sanctions regime from such Law 489; (b) investing the SB with increased execution abilities for sanctioning non-complying banks; and (c) having members of the BCP Board of Directors maintain staggered term appointments to ensure BCP independence.	The reforms included as part of the modification of the Central Bank Charter Law are under implementation.	Political partiality in decisions on appointments of Central Bank Directors is eliminated with the maintenance of a fixed staggered appointment system mandated by law.

PARAGUAY
PROGRAMMATIC FINANCIAL SECTOR ADJUSTMENT OPERATION
POLICY MATRIX FOR REFORM PROGRAM

(Prior Actions / Triggers noted in bold)

Annex 1 - Policy Matrix

FIRST PROGRAMMATIC FINANCIAL SECTOR ADJUSTMENT LOAN – POLICY ACTIONS TAKEN PRIOR TO BOARD APPROVAL	SECOND PROGRAMMATIC FINANCIAL SECTOR ADJUSTMENT LOAN – FUTURE ACTIONS IN SECOND PHASE	THIRD PROGRAMMATIC FINANCIAL SECTOR ADJUSTMENT LOAN – FUTURE ACTIONS IN THIRD PHASE	KEY EXPECTED RESULTS AND OUTCOMES AT THE END OF THE PROGRAM
III. RESTRUCTURING AND CONSOLIDATION OF THE STATE OWNED BANKS			
CONSOLIDATING AND DOWNSIZING THE GOVERNMENT OWNED FINANCIAL SECTOR *Policy Objective*: Transferring viable credit operations to the private banking system and limiting public sector banks to critical development sectors. Responsible Government Agencies: MH, SB			
	A comprehensive regulatory framework for the credit cooperatives sector is implemented, and includes solvency requirements and prudential norms consistent with Basel recommendations and minimizing regulatory arbitrage between the banking an cooperative sectors.	**A management and institutional reform for the National Development Bank (BNF) has been undertaken, the bank is reorganized and streamlined, new regulations are approved specifying credit limits placed on new lending, a staff downsizing program is implemented including a sharp reduction in departments and management posts, branches are rationalized according to cost recovery criteria.** A BCP monitored financial and portfolio improvement program for BNF, covering prudent lending practices, exposure limits, and loss provisioning is implemented.	The seven existing State-owned financial institutions are consolidated into the two specialized (first and second tier) institutions.
		The Legislative Package for the Restructuring and Consolidation of the State Financial Institutions and its implementing regulation is in effect, including the establishment of: **(A) A single public first tier bank created via the merger and downsizing of the State's 1st tier institutions, with the following features: (i) statutory lending limits per borrower established for both short term and investment loans; (ii) limits on holding of public sector deposits; and (iii) limits on borrowing from the public second tier bank; and** **(B) A single public second tier fund created by merging and/or extinguishing the five existing second tier financial institutions with the minimum following features: (i) establishment of**	Access to credit and financial services from the State banking sector is focused on the medium, small and micro enterprise sectors in geographically dispersed areas and focusing on rural entrepreneurs by end 2006. The composition of the State banking sector's lending shifts markedly so that its portfolio is composed of at least 80% lending to small borrowers by end 2005.

PARAGUAY
PROGRAMMATIC FINANCIAL SECTOR ADJUSTMENT OPERATION
POLICY MATRIX FOR REFORM PROGRAM

(Prior Actions / Triggers noted in bold)

Annex 1 - Policy Matrix

FIRST PROGRAMMATIC FINANCIAL SECTOR ADJUSTMENT LOAN – POLICY ACTIONS TAKEN PRIOR TO BOARD APPROVAL	SECOND PROGRAMMATIC FINANCIAL SECTOR ADJUSTMENT LOAN – FUTURE ACTIONS IN SECOND PHASE	THIRD PROGRAMMATIC FINANCIAL SECTOR ADJUSTMENT LOAN – FUTURE ACTIONS IN THIRD PHASE	KEY EXPECTED RESULTS AND OUTCOMES AT THE END OF THE PROGRAM
		a reserve fund to cover foreign exchange exposure and/or other hedging instruments; (ii) interest rate setting on loans to cover all financial and operating costs; and (iii) no authority to channel funds to individual persons or entities that do not constitute banks, finance companies, savings and loans associations or cooperatives, subject to prudential financial regulations. The implementation of the reform includes provisions for a special purpose restructuring commission to oversee the grouping of all public banking institutions' assets, and the carve out viable assets to establish the state financial institutions, with a residual asset disposition fund established and managed privately to liquidate assets not assigned to the new institutions. Management of assets and liabilities of the prior seven State financial institutions are overseen by the State Bank Restructuring Commission using private specialists. **New prudential rules and operational directives for setting interest rates on loans, lending limits and risk exposures applicable to all assets of the State banking sector, are in effect and loss reserving standards are being enforced.** **The reform is underway and in operation and under its legal mandate, contracted specialists are managing, valuing and transferring assets and liabilities from the pool of State Financial Institutions' assets, to form the new balance sheets of the new 1st and 2nd tier banks.**	The new state banking institutions verify adequate loss reserving and capital on their balance sheets, in accordance with the new banking law, allowing them to sustain future lending operations to target sectors, while provisioning for risks.

Annex 2

LETTER OF FINANCIAL SECTOR DEVELOPMENT POLICY

Asunción, March 3, 2005

Mr. James D. Wolfensohn
President, International Bank for Reconstruction
and Development (IBRD)
Washington, D.C.
United States of America

Dear Mr. Wolfensohn,

I have the pleasure of addressing you in order put to your knowledge information on the development of Paraguay's economy and financial system, and also to present the framework within which the financial sector reform program will be implemented. It is our intention to request financing from the International Bank for Reconstruction and Development for introducing the programmed adjustments for carrying out the reform of the financial sector. The assistance requested will facilitate the implementation of the structural reforms to be carried out by the Paraguayan Government, which are based on an efficient and stable administration of both banks and finance companies, with the aim of establishing a reliable financial system capable of contributing to the economic recovery of Paraguay (Exps. M.H. No. 27.878 and 29.369/ 2004).

A. Recent Developments in the Paraguayan Economy

In recent years, the Paraguayan economy has been mired in a deep recession and persistent stagnation, with their resulting negative effects on the population's well being. The growth rate of the economy during the last twenty years has been running below the rate of demographic growth, and in the past five years, the average annual growth of the Gross Domestic Product (GDP) has been negative.

The weakness of the financial sector has generated constraints on its capacity to provide financing for the productive sector. Added to this is the low level of agricultural productivity and the limited diversification of export products. This situation reveals the country's vulnerability to international market fluctuations and its effects within and outside of the region.

The structural crisis prevailing in the country has been mirrored in the recession of the last five years and especially in the significant slump in economic activity in 2002. The 2.3 percent decline in GDP led to a reduction in the goods and services available for the population, low incomes, and fewer sources of employment. Annual inflation stood at 14.6 percent, as a result of a scant supply of goods and services coupled with the effect of a sharp devaluation of the guaraní against the dollar. The financial sector cut back lending due to the cumulative losses caused by the recession and borrower defaults, as many borrowers are exposed to exchange rate risks. This situation has reduced the private sector's capacity to invest.

In the monetary sector, the aggregates have shown a high concentration of deposits in foreign currency, plus a drop in loans to the private sector owing to the increase in past due payments on bank loans, which rose from 12 percent to 22 percent in 2003, a situation that was compounded by the recurrent financial crises besetting the country since mid-1995.

Nevertheless, this situation was addressed immediately by the Central Bank, at significant cost to the State in terms of funds allocated to protect depositors and also support in the granting of emergency loans that have not always been repaid.

In the fiscal sector, considerable increases have been posted in the fiscal deficit since 1995, due to the fact that fixed expenditures increased in relation to tax revenues. This led to a rise in the fiscal deficit to 3.1 percent of GDP in 2002. Rationalization and prioritization of the allocation of expenditure, combined with the present Administration's efforts to improve collections, subsequently enabled consolidation of the cumulative deficit to only 0.1 percent of GDP for fiscal 2003 and a surplus of 1.4 percent for 2004. In addition, the surpluses generated, facilitated the financing of fixed expenditures and funding of active personnel's salaries, pensions, and debt interest payments.

B. Vision, Objectives, and Guiding Principles of the Government's Program

The situation described above calls for substantial changes in the economic model applied in recent years and requires transformation of both the structure of production and the institutional structure of the State. This transformation entails the adoption of a holistic approach to the different dimensions of the development process and promotion of a new model of society based on sustainable economic growth, in conjunction with fiscal, social, and environmental responsibility.

To achieve this new country model, clear, fair and transparent laws are needed, corruption must be combated by ensuring the enforcement of laws, internal security must be strengthened, and credibility and confidence in the nation and its future must be restored. In addition, steps must be taken to overcome internal conflicts deriving from the preeminence of sectoral interests.

The present Government is committed to the restoration of the State as a legal, administrative, and political entity that ensures preservation of the rules laid down in the laws. In this context, the Government's program includes as one of its pillars for economic recovery and financial stability a far-reaching reform of the financial system. Emphasis is also placed on the need to reform the banking regulations, the resolution framework for banking institutions, public sector banks, social security systems, both public and private, and public enterprises. A growing concern on the part of society is for transparency and the need for an effective legal system for the conduct of business.

C. Economic Outlook for 2004-2005

The present Administration inherited a nation that was plagued by a prolonged period of stagnation and a persistent economic recession during the preceding years, with weak financial institutions and deteriorated public finances which impose limits on the Government's ability to meet its domestic and external payment commitments on the public debt.

The Government has negotiated an agreement with the International Monetary Fund (IMF) for economic policy reforms that will help reduce uncertainty by sending clear signals to the private sector and preparing and strengthening it to become a true catalyst for sustainable economic growth.

In 2003, the real GDP growth rate was 2.6 percent and growth of approximately 2.9 percent or above is projected for 2004. Regarding the general price level, annual inflation is projected at around 2.8% for 2004.

The current account should close with a positive balance of approximately 1 percent of GDP, and the expected figure for public investment is 3.5 percent of GDP.

The steps taken to-date by the Ministry of Finance, starting since 2003 and aimed at transparency in its actions have played a significant role in the improved tax collection to date which, together with the reduction of superfluous public expenditure, have paved the way for reversal of the trend in fiscal performance for 2004. It is important to note that the approval of the Law on Restructuring the National Pension Fund has resulted in a considerable improvement in the fiscal situation in the first half of 2004.

In addition, various measures have been taken to contain expenditure, including elimination of budget supplements submitted during the previous Administration and the freezing of public salaries. The Government has moved to deal with the problem of tax evasion, resulting in a 36 percent increase in collections in the fiscal year ending in April 2004. Other important reforms having an impact in the fiscal sphere and helping to mitigate the scope of corruption and maintain control of expenditure are being carried out proactively in the areas of public procurement, customs, the Supreme Court, review of public payrolls, financial administration, and strengthening of the public audit function.

The projections of the main macroeconomic variables for 2004 and 2005 show an improvement in the economic situation. GDP growth of approximately 3.5 percent is estimated for 2005, inflation is expected to remain at around 6 percent. The guaraní-dollar exchange rate should remain stable. The 2005 central government budget is anticipates a primary surplus of 0.8 percent compared to an estimated primary surplus of 2.6 percent in 2004, a surplus of 0.9 percent in 2003, and a deficit of 1.7 percent for 2002.

Regarding external debt, the Government has begun to honor the commitments to creditors and also to renegotiate debt with the aim of holding it at approximately 40 percent of GDP.

It is also important to note that the document "Interinstitutional Agenda for the Executive and Legislative Branches" was signed in early October 2003. This document has been converted into a political agreement, as a result of negotiations with the leaders of the National Congress and the representatives of the main political parties forming the legislative body. The Agenda considers reduction of the fixed expenditures of the 2004 budget as a commitment, together with submission for review and discussion of the following bills: (i) Pension Reform; (ii) Law on Administrative Reform and Fiscal Adjustment; (iii) New Customs Code; (iv) Public Debt Restructuring; and (v) Public Sector Bank Reform. These are all actions that will complement the reform of the financial system, which seeks to strengthen the system and insulate it from possible shocks, while at the same time putting in place appropriate measures to protect depositors.

D. The Financial Sector Reform Program

The Government has launched a financial system reform program with the aim of strengthening its capacity to regulate the system and prevent contagion from systemic crises.

First Phase

Under the first phase of the program, Law No. 2334/2003 was promulgated, pertaining to Deposit Insurance and Resolution of Financial Intermediaries subject to the General Law of Banks, Finance Companies, and other Lending Entities, as well as accompanying regulations for its implementation. This law forms part of a complete package of reforms of the financial system and envisages the creation of a deposit insurance fund which will be established initially with capital provided by the State through the issuance of State bonds, and subsequently be made up of contributions furnished by the financial institutions. It is important to emphasize that use of the deposit insurance fund resources will be subject to the new regularization and resolution rules for financial entities, laid down in Law No. 2334/2003. The reform being implemented places the Paraguayan legislation in a vanguard position and in line with similar regional and international mechanisms.

Under the previous system, the taking over and closing of banks and financial institutions was a slow process that generally resulted in the loss of market value of the institutions and their collateral. The proposed new regularization and resolution procedures will enable timely identification of viable assets and liabilities, so that attractive balance sheet packages can be offered to other banks.

This would make it possible to reduce the use of funds for deposit insurance, since the portfolio of troubled banks can be transferred immediately to interested banks. Only the remaining deposits, i.e. those not absorbed by the other banks, will require using deposit insurance funds.

The proposed bank resolution arrangements envision modern methods of transferring assets and liabilities from troubled banks to sound banks. This will eliminate the delays in transferring assets from troubled banks resulting from the need to wait for assessments of asset quality before the transfer is made.

Therefore, the reform accordingly proposes the transfer of the largest possible number of deposits together with bonds issued by means of securitization of the portfolio made up of the assets of the entity undergoing resolution, employing mechanisms that ensure competition and are consistent with the creditor hierarchy stipulated by law.

The instruments in question will involve complex regulations requiring technical and legal expertise and experience. To that end, the Government hired international experts in these areas in order to draft the requisite regulations and implement the proposed scheme. These processes have already advanced and as a result the Central Bank issued Regulation 6 of March 15, 2004 establishing the criteria to subjects financial institutions to Regularization/Improvement Plans, and Regulation 31 of March 18, 2004 prohibiting financial institutions to guarantee client deposits with assets as collateral.

Another essential aspect of the reform process under the first phase is the Government's commitment to amend the General Law for Banks, Finance Companies, and other Lending Entities. Important amendments have been introduced to this bill pertaining to bank licensing, standards to be met by boards of directors, tighter requirements with respect to capital and adjustments for inflation, procedures for corrective actions, and a system for sanctions and assessment of fines. The bill further envisages limits on lending concentration, responsibility of managers with respect to oversight and risk management policies, a 50 percent limit on the inclusion of the revaluation reserve as capital, greater autonomy for the Superintendency of Banks in the imposition of sanctions, regulation of financial intermediation activity, and management of related party risks.

The General Banking law bill that the Executive has submitted to Congress on December 10, 2004, is primarily designed push forward the above mentioned reforms and to establish uniform regulatory standards for all entities in the financial system. The national economic authorities understand that the establishment of uniform rules and standards is crucial to establish a framework through which the competition of financial entities works to maximize efficiency.

In addition, uniform regulatory standards are also essential for ensuring that the financial intermediaries do not obtain benefits or advantages that encourage them to act less effectively in certain cases due to fewer requirements, and to the detriment of other types of competitors and possibly savers as well.

The amendments to Regulation 8 of the Central Bank, dated November 27, 2003, include new rules concerning the increase of provisions against losses and limitation in the use of real estate collateral, rules on assessing collateral, on classifying refinanced loans and interest accrual, and regulatory adaptation or contingency plans to be submitted by the banks.

In addition, the sanctions regime under the Central Bank Charter Law has been amended to incorporated this under the General Banking Law. The reform of the General Banking Law will facilitate more active oversight of financial institutions and adoption of the appropriate measures required by the Central Bank and the Superintendency of Banks to reduce the level of risk in the financial system.

To complement these reforms and prevent contamination of the financial system with illicit money, the approval and subsequent enforcement of a draft law aimed at preventing and suppressing illegal acts intended to launder money and goods will be supported. The draft law on anti-money laundering which was presented to the Congress on May 13, 2004, proposes centralizing the detection and monitoring of such activities in one agency, together with an updated definition of crimes in this area: the financing of terrorism as a criminal offense and money laundering as a separate, independent crime.

For these reforms to be implemented, institutional changes will be needed in the degree of oversight. To that end, a Strategic Plan for the Superintendency of Banks was prepared with the aim of establishing short, medium, and long-term goals relating to targeted oversight of institutions, contingency plans for dealing with weaknesses, and undertaking appropriate corrective actions. The Strategic Plan was approved and formalized by the Central Bank's Board of Directors and will facilitate a more in-depth evaluation of the bank risks as well as full-scale activation of the new rules governing resolution and regularization of the financial institutions.

<u>Second Phase</u>

The second phase of the reform anticipates the implementation of the new legal and regulatory framework including putting in force the new Banking Law. With respect to the Banking Resolution and Deposit Insurance Law, actions include the implementation of procedures that permit applying the new insurance mechanism using a least cost criteria as well as standardizing the resolution practice of using matching assets and liabilities to transfer those balances to acquiring banks in the financial system, including the use of the securitization mechanism for that purpose.

Under this phase it is also anticipated that the operational procedures of the Deposit Insurance Fund will be institutionalized including the criteria for the use of its funds such as the principal of least cost, its functional structure and internal controls, and its custody and investment regime for insurance premiums collected from the financial system.

Under this phase of the reform, the Central Bank will ensure compliance with the regulations on provisions as defined under Regulation 8, so that banks and finance companies show the adequate allocation of capital and reserves to cover actual and projected losses in their loan portfolios. These actions will be essential to strengthen the financial system and better protect it against future economic and financial shocks.

To complement these changes, this stage of the reform will also implement a stremngthened supervision process according to the guidelines under the Banking Superintendency's Strategic Plan under which banks in the system will be evaluated against their inherent business risks, and corrective actions will be taken when considered justified according to the new regulatory framework.

It is also anticipated in this phase to have approved and in effect the new Anti Money Laundering Law. In addition, the Government will present to the Congress a new bill of law which modified the Central Bank Charter and which will cover, among other reforms, a more robust process to maintain at any point in time, a structure of staggered appointments and terms for the members of the Central Bank's Board of Directors.

E. Restructuring of the State-Owned Financial Institutions

<u>Third Phase</u>

The third phase of the program deals primarily with the restructuring of the public state-owned financial entities. If the implementation of these reforms were carried out early on, this phase might be accelerated.

Public Sector financial institutions need to be restructured and consolidated, primarily in light of the insolvency of a number of them, the deficient allocation of subsidies, political and social considerations regarding the criteria for profitability, solvency and growth, the evident patronage in their portfolios, and their level of non performance. This reform will apply to the National Development Bank (*BNF*), the Livestock Fund (*FG*), the Industrial Development Fund (*FDI*), the Technical Project Implementation Unit (*UTEP*), the National Housing Board (*CONAVI*), the National Housing Bank (*BANAVI*), the Government Agricultural Bank (*CAH*) and the Farming Development Fund (*FDC*).

Taken as a whole, State financial institutions have had efficiency problems and have generated continuous negative fiscal impacts, jeopardizing the reliability of the financial system as a whole and negatively impacting the country's international reserves. At this time, the difficulties facing public sector banks, the negative effect of these problems on the functioning of the financial system in the country, and the consequences of this situation on the real sectors of the economy, have made it imperative to reform the institutions concerned.

Against this backdrop, the Law on the Restructuring of the Public Sector Financial Institutions was elaborated. The objective of this law is the overhaul of the State-owned financial entities, channeling state participation to two entities, one a first tier institution and the other a second tier entity, in order to eliminate the existing obstacles in the present configuration of public sector banks which hinder efficient channeling of funds available for lending, and to focus their activity on potential borrowers who do not at present have access to the formal financial system.

To assure an agile reform effort and gain political support during this process, the Government recently modified its strategy for implementing the reform of the state-owned banks so as to consider two phases; one through the presentation and approval of a second tier bank, and another which includes presentation of a reform bill for the restructuring of the first tier banks. Both bills have been presented to the Congress on November 2, 2004 and February 16, 2005, respectively. In the first case, the FDI, FDC, UTEP, CONAVI and BANAVI will be restructured, and in the second phase this will cover the BNF, CAH and FG. Given the current situation, the original draft bill which had not yet been reviewed by the Congress was replaced by a bill to create the Financial Agency for Development as the only second tier bank and the sole channel for loans from the public sector to the financial system. Even though this sequential strategy is considered as the most politically viable currently, the option to consolidate these reforms under a single bill will remain open if subsequent developments lead toward this under this third phase of the reform program.

At the initiation of the reform, efforts that were started and will continue, involve the restructuring of the National Development Bank (BNF), the largest public sector bank, to trim its size and limit its operations to priority clients and sectors that have scant access to financing through the private banking system, and for this purpose, via Decree No. 4818 of February 3, 2005, a Commission was created to monitor the action plan for BNF's reorganization. The reform of the State bank system seeks to utilize the advantages offered by the existence of public institutions such as the BNF, which already have a network and a computerized system covering the entire country, and the CAH, which has experience with rural micro lending. Since the BNF and the other public institutions are currently in deficit as regards their capital levels, funding will be needed to fully capitalize the newly institution.

As regards second tier banking activities, the intention is to set up a single entity resulting from the restructuring of the current development funds that will transfer resources to financial intermediaries at competitive rates. The primary purpose of the second tier financial entity will be to administer the resources deriving from loans granted by international development financing agencies.

With the restructuring of the first tier banks, which work directly with the public, the aim is to serve clients which, besides qualifying for credits, are those with the most difficult access to financial and banking services, and operating the bank to prevent mismanagement resulting in financing from restricted public funds. To that end, limits will be placed on lending and borrowing operations and indebtedness from the second tier bank, and it will be ensured that all financial and operating costs are covered by the institution's lending rates, and that its loan portfolio is adequately provisioned against losses.

The reform will be carried out under the coordination of a special restructuring commission that will contract private specialists to manage the creation of the balance sheets of the new institutions. Upon the conclusion of the reform process, it is expected there will be efficient state participation in the financial system, appropriate and clear assignment of roles in the financial sector plus better utilization of the tax revenues obtained from the population as a whole, inasmuch as they will no longer be financing the losses caused by inefficient management.

F. Conclusion

The protracted recession that Paraguay has been experiencing is the outcome of structural rigidities in the economy that do not foster growth and significantly impact the well being of the country's population. The present Administration has begun to design medium-term policies for achieving a sustainable fiscal and financial sector, with a view to improving the conduct of public administration and the operations of the financial system in order to reactivate the economy.

At the same time, short and medium-term measures have been implemented to meet the National Treasury's funding needs and cope with the severe budgetary constraints, in parallel with the priority initiatives aimed at putting the financial system on a sound footing.

The purpose of the loan being requested from the World Bank is to support the Paraguayan State in resolving its present liquidity, balance of payments and budgetary needs which, among others, will require incremental resources for moving forward with the restructuring of the public financial institutions. The three phase medium-term program for reactivating and strengthening the financial sector the Government of Paraguay is seeking to promote, will require the requisite funding.

As mentioned earlier, the Government has negotiated a Stand-By Arrangement with the International Monetary Fund (IMF) for a period of 15 months[17], which will be essential for guaranteeing the actions planned for the recovery of the system in the fiscal sphere and from the standpoint of monetary and financial stability, and for enhancing the country's solvency, so that it can honor its commitments with respect to public debt contracted.

In the present circumstances, the support of the World Bank and other multilateral financing agencies will be of paramount importance and will lay the groundwork for promoting the structural reform of the financial sector, thereby achieving economic growth in Paraguay.

Let me take this opportunity to convey to you my distinguished regards.

[original signed – Spanish version – see next section]

Dionisio Borda
Minister of Finance
and Governor for Paraguay

---

[17] The program originally spanned from January 2004 through March 2005, and was subsequently extended for an additional six months through September 2005.

Ministerio de Hacienda

Transparencia y Responsabilidad Fiscal para el Desarrollo

Asunción, 3 de Marzo de 2005

N° 438.-

SEÑOR
***JAMES D. WOLFENSOHN**, PRESIDENTE*
BANCO INTERNACIONAL DE RECONSTRUCCIÓN Y FOMENTO (BIRF)
WASHINGTON D.C, USA

Tengo el agrado de dirigirme a usted para poner a su conocimiento información referente al desarrollo de la economía del país y del sistema financiero, además de presentar el marco en el cual se desarrollará el programa de la reforma del sector financiero. Es nuestro propósito solicitar recursos del Banco Internacional de Reconstrucción y Fomento (BIRF) para introducir los ajustes programados para llevar adelante la reforma del sector financiero. La asistencia requerida facilitará la implementación de las reformas estructurales que serán implementadas por el Gobierno Paraguayo cuyas propuestas están basadas en una administración eficiente y estable, tanto de las instituciones bancarias como de las financieras, con el objetivo de lograr un sistema financiero confiable y capaz de contribuir con la reactivación económica del Paraguay (Exp. M.H. N° 3953/2005).

A. Desarrollo Reciente de la Economía Paraguaya.

La economía paraguaya de los últimos años se ha caracterizado por una profunda recesión y un persistente estancamiento con sus consecuentes efectos negativos en el bienestar de la población. La tasa de crecimiento de la economía durante los últimos veinte años, ha venido creciendo por debajo de la tasa de crecimiento demográfica y, en los últimos cinco años la tasa promedio anual de crecimiento del Producto Interno Bruto ha sido negativa.

Por su parte, la fragilidad del sector financiero ha generado restricciones en cuanto a la capacidad de conceder créditos para el sector productivo, que se ha sumado a la baja productividad agrícola y la escasa diversificación de bienes para la exportación. Esta situación refleja la vulnerabilidad del país ante fluctuaciones de los mercados internacionales y ante efectos internos y externos de la región.

MINISTERIO DE HACIENDA
REPÚBLICA DEL PARAGUAY
PAZ Y JUSTICIA
MINISTRO

...///...

Ministerio de Hacienda

Transparencia y Responsabilidad Fiscal para el Desarrollo

Nº 438.-

...///...

La crisis estructural experimentada por el país, se reflejó en la recesión de los últimos cinco años y particularmente en la caída significativa de la actividad económica en el año 2002. El PIB cayó en 2.3%, lo que significa una disminución de los bienes y servicios disponibles para la población, bajos ingresos y disminución de fuentes de trabajo. La inflación anual fue de 14.6%, como resultado una escasa oferta de bienes y servicios, estimulada también por una profunda devaluación del Guaraní frente al Dólar. El sector financiero, redujo los niveles de préstamos debido a pérdidas acumuladas por la recesión económica y por la falta de pagos de los prestatarios, estando muchos de ellos expuestos a los riesgos de cambio. Esta situación redujo la capacidad de invertir del sector privado.

En el sector monetario, los agregados han mostrado una alta concentración de depósitos en moneda extranjera, y una caída en los préstamos al sector privado, debido al incremento en los atrasos en los pagos de los préstamos bancarios, los cuales pasaron de un 12% a un 22% en el 2003, afectado además por las recurrentes crisis financieras iniciadas a mediados del año 1995.

No obstante, esta situación fue atendida inmediatamente por el Banco Central, implicando costos significativos para el Estado en términos de fondos destinados a la protección de los depositantes, así como al apoyo en la concesión de créditos de emergencia los cuales no siempre fueron devueltos.

En el sector fiscal, desde el año 1995 se registraron incrementos considerables en el déficit fiscal, producto de que los gastos rígidos se incrementaron en relación a los ingresos tributarios. Esto se refleja, en el hecho de que el déficit fiscal del 2002 llegó a 3.1% del PIB. La racionalización y priorización en la asignación del gasto, sumado al esfuerzo de mejorar las recaudaciones por parte de la Administración actual, posibilitaron la consolidación del déficit acumulado de solo el 0.1% del PIB para el ejercicio 2003 y un superávit del 1.4% en el 2004. Además, los recursos excedentes posibilitaron el financiamiento de los gastos rígidos, sueldos del personal activo, jubilaciones y el pago de intereses de la deuda.

MINISTERIO DE HACIENDA · REPÚBLICA DEL PARAGUAY · PAZ Y JUSTICIA · MINISTRO

...///...

N° 438.-

...///...

B. *Visión, Objetivos y Directrices del Programa de Gobierno.*

El escenario descrito arriba, amerita profundas revisiones del modelo económico aplicado en los últimos años y requiere transformación tanto de la estructura de producción como de la estructura institucional del Estado. Esta transformación, implica una visión integral de las diferentes dimensiones del proceso de desarrollo y la promoción de un nuevo modelo de sociedad con un crecimiento económico sustentable, y con una misión la responsabilidad fiscal, social y ambiental.

Para lograr este nuevo modelo de país, se requieren reglas claras, equitativas y transparentes, luchar contra la corrupción asegurando la aplicación de las leyes, fortaleciendo la seguridad interna y recuperando la credibilidad y la confianza en la nación y su futuro. Además se deben superar conflictos internos que surgen de la preeminencia de los intereses sectoriales.

El gobierno actual está comprometido en la recuperación del Estado como una entidad legal, administrativa y política que asegure la permanencia de las reglas establecidas en las leyes. En este contexto, el Plan de Gobierno incluye como uno de sus pilares para la reactivación económica y la estabilidad financiera una profunda reforma del sistema financiero. Se debe destacar, también, la necesidad de reformar las regulaciones bancarias, el marco resolutivo de las entidades bancarias, la banca estatal, los sistemas de seguridad social tanto público como privado y las empresas públicas. Una preocupación creciente de la sociedad hace referencia a la transparencia y la necesidad de operar en un sistema legal eficaz.

C. *Perspectivas Económicas para el 2004-2005.*

La actual administración ha recibido una nación que ha sufrido un prolongado estancamiento y persistente recesión económica durante los años anteriores, con instituciones financieras débiles y deterioradas finanzas públicas que se traducen en límites a la capacidad del Gobierno para cumplir con los compromisos de pago tanto internos como externos de la deuda pública.

MINISTERIO DE HACIENDA
REPÚBLICA DEL PARAGUAY
PAZ Y JUSTICIA
MINISTRO

...///...

N° 438.-

...///...

El Gobierno ha negociado un Acuerdo con el Fondo Monetario Internacional (FMI) para reformas de políticas económicas que ayuden a minimizar el grado de incertidumbre, enviando señales claras al sector privado, capacitándolo y fortaleciéndolo para convertirlo en el genuino conductor de un sustentable crecimiento económico.

En el 2003 la tasa de crecimiento real del PIB fue de 2.6% y se estima un crecimiento del producto, alrededor de 2.9% o mayor para el 2004. Con respecto al Nivel General de Precios, se estima una inflación alrededor del 2.8% para el 2004.

La balanza de cuenta corriente cerraría con saldo positivo de aproximadamente 1% del PIB, y la expectativa de inversión pública sería del 3.5 % del PIB.

Las acciones tomadas hasta la fecha, comenzando desde el año 2003 por el Ministerio de Hacienda conducentes a la transparencia en su gestión posibilitaron en buena medida el incremento en la recaudación tributaria hasta la fecha que conjuntamente con la reducción del gasto público superfluo posibilitarán un cambio de la tendencia en el resultado fiscal 2004. Es importante mencionar, que la sanción de la Ley de Reestructuración de la Caja Fiscal, permitió mejorar considerablemente la situación fiscal en el primer semestre del año 2004.

Además, varias medidas se han tomado para contener los gastos, incluyendo la eliminación de suplementos presupuestarios que habian sido presentados en la Administración anterior, y el congelamiento de salarios públicos. El Gobierno ha tomado acción para afrontar el problema de la evasión de impuestos lo que resultó en un aumento del 36% en recaudos en el periodo anual del 2004. Otras reformas importantes que complementan el aspecto fiscal y para reducir la incidencia de la corrupción y mantener control del gasto, se vienen llevando a cabo pro-activamente en las áreas de contrataciones públicas, aduanas, la Corte Suprema, evaluación de nóminas públicas, administración financiera y fortalecimiento de la función de auditoria pública.

MINISTERIO DE HACIENDA
REPÚBLICA DEL PARAGUAY
PAZ Y JUSTICIA
MINISTRO

...///...

Ministerio de Hacienda

Transparencia y Responsabilidad Fiscal para el Desarrollo

Nº 438-

...///...

Las proyecciones de las principales variables macroeconómicas para 2005 muestran un mejoramiento de la situación económica. Se estima que el Producto Interno Bruto crecerá en torno al 3.5% en el 2005, mientras que se espera una inflación en torno al 6.0%. El tipo de cambio guaraní-dólar se mantendría estable. Para el Gobierno Central, la ejecución del presupuesto de 2005 anticipa un superávit primario de 0.8% comparado con un superávit primario del 2.6% en 2004, un superávit en el 2003 de 0.9% y un déficit de 1.7% en el 2002.

Respecto a la deuda externa, el Gobierno ha empezado a honrar los compromisos asumidos con los acreedores, además de renegociar la deuda, con el objetivo de reducir la proporción de la deuda en relación con el PIB a niveles menores del 40%.

Es también importante señalar que el documento denominado "Agenda Interinstitucional para el Ejecutivo y el Legislativo" fue firmado a inicios del mes de octubre del 2003. Este documento se ha convertido en un acuerdo político, resultado de una negociación con los líderes del Congreso Nacional y de los representantes de los principales partidos políticos que conforman el cuerpo legislativo. Esta agenda considera como compromiso la reducción de los gastos fijos del presupuesto del 2004, así como la presentación para el estudio y discusión de los siguientes proyectos de ley: i) Reforma del Sistema de Pensiones, ii) Ley de Reforma Administrativa y Adecuación Fiscal, iii) Nuevo Código Aduanero, iv) Reestructuración de la Deuda Pública, y v) Reforma de la Banca Pública. Acciones que complementarán la reforma del sistema financiero que busca fortalecer el sistema y protegerlo contra eventuales shocks, mientras se van adecuando las medidas de protección a los depositantes.

D. Programa de Reforma del Sector Financiero.

El Gobierno ha iniciado un programa de reformas en el sistema financiero con el objetivo de fortalecer su capacidad reguladora en el sistema financiero y prevenir el contagio de crisis sistémicas.

MINISTERIO DE HACIENDA
REPÚBLICA DEL PARAGUAY
PAZ Y JUSTICIA
MINISTRO

...///...

Nº 438.-

...///...

Primera Fase

Bajo la primera fase del programa fue promulgada la Ley Nº 2334/2003, de Garantía de Depósitos y Resolución de Entidades de Intermediación Financiera sujetos de la Ley General de Bancos, Financieras y otras Entidades de Crédito acompañada de reglamentación base para su implementación. La Ley citada forma parte de un paquete integral de reformas del sistema financiero y contempla la creación de un fondo de garantía de depósitos, el cual será constituido inicialmente con capital aportado por el Estado, a través de la emisión de bonos del Estado, y posteriormente integrado con aportes de las instituciones financieras. Es importante destacar, que la utilización de los recursos del fondo de garantía de depósitos estará sujeta a las nuevas normas de regularización y resolución de entidades financieras establecidas en la Ley Nº 2334/2003. La reforma que se viene implementando coloca a la legislación paraguaya en la vanguardia y en línea con mecanismos similares tanto regionales como internacionales.

Bajo el régimen anterior, la intervención y cierre de los bancos e instituciones financieras constituía un proceso lento, que generalmente derivaba en pérdida del valor de mercado las instituciones y garantías. Los nuevos procedimientos de regularización y resolución propuestos permitirán la identificación a tiempo de los activos y obligaciones viables, de manera que puedan ser atractivos para ofrecer a otros bancos.

Esto permitiría reducir la utilización de los fondos disponibles para el seguro de depósito, debido a que la cartera de los bancos con problemas podrán ser transferidos inmediatamente a bancos interesados. Solo el remanente de los depósitos, aquellos que no fueron absorbidos por los demás bancos requerirá la utilización del seguro de depósitos.

El esquema de resolución bancaria propuesto contempla métodos modernos de transferencia de activos y pasivos de los bancos con problemas a los bancos sanos. Serán solucionadas las demoras en la transferencia de los activos de los bancos con problemas a causa de la evaluación desde el punto de vista de su calidad antes de realizar la transferencia.

MINISTERIO DE HACIENDA
REPÚBLICA DEL PARAGUAY
PAZ Y JUSTICIA
MINISTRO

...///...

N° 438-

...///...

Por ello, la reforma propone como una alternativa la transferencia del mayor número posible de depósitos juntamente con participaciones emitidas a través de la titularización de cartera formada con los activos de la entidad en resolución, utilizando mecanismos que aseguren la competencia y de acuerdo al régimen de prelación establecido en la ley.

Los instrumentos mencionados requerirán de regulaciones complejas que implican capacidad y experiencia, técnica y legal. Para este propósito, el Gobierno ya ha contratado expertos internacionales en éstas áreas, para desarrollar la reglamentación correspondiente, así como la operativización del esquema propuesto. Estos procesos ya han avanzado y como resultado el BCP emitió la Resolución N° 6 del 15 de marzo de 2004 estableciendo los criterios para sujetar a entidades financieras a un Plan de Regularización, y la Resolución N° 31 del 18 de marzo de 2004 prohibiendo a entidades financieras garantizar con sus activos, los depósitos del público.

Otro de los aspectos esenciales bajo la primera fase de la reforma, es el compromiso del Gobierno de modificar la Ley General de Bancos, Financieras y Otras Instituciones de Crédito. Importantes cambios se han introducido en el Proyecto de ley concernientes a licencia y estándares de los directorios de los bancos, aumento de requerimientos de capital y ajuste por inflación, procedimientos de acciones correctivas, régimen de sanciones y aplicación de multas. Asimismo, el proyecto contempla límites a la concentración de crédito, responsabilidad de gerentes en controles y políticas de riesgo, límite de 50% de la reserva de revalúo para integrar el capital, mayor autonomía del poder sancionatorio de la superintendencia de bancos, regulación de la actividad de intermediación financiera, y manejo de riesgos vinculados.

El proyecto de Ley General de Bancos que el Poder Ejecutivo ha remitido al Congreso de la Nación el 10 de diciembre de 2004, tiene como principal objetivo impulsar las reformas arriba mencionadas y establecer normas regulatorias uniformes, para todas las entidades que componen el sistema financiero nacional. Las autoridades económicas nacionales entienden que el establecimiento de normas uniformes es crucial para la determinación del marco referencial en el que de la competencia económica de las entidades de intermediación financiera se traduzca en la máxima eficiencia.

MINISTERIO DE HACIENDA
REPUBLICA DEL PARAGUAY
PAZ Y JUSTICIA
MINISTRO

...///...

N° 438.-

...///...

Adicionalmente, las normas regulatorias uniformes son indispensables para que las entidades de intermediación financiera no tengan beneficios o ventajas que les incentive actuar bajo la forma de determinadas clases, por la existencia de menores exigencias en perjuicio de los otros tipos de competidores y potencialmente también de los ahorristas.

Por su parte, la modificación de la Resolución N° 8 del Banco Central del Paraguay, de fecha 27 de noviembre de 2003, incorpora nuevas reglas referente al aumento de previsiones contra pérdidas y limitación en el uso de garantías inmobiliarias, reglas de tasación de garantía, de clasificación y refinanciación de créditos y sobre devengamiento de intereses, además de planes de adecuación o contingencia a ser proveídos por los bancos.

Además el régimen de sanciones y penalidades establecido actualmente en la Ley Orgánica del Banco Central ha sido incorporado en el Proyecto de Ley General de Bancos. La reforma de la Ley General de Bancos, permitirá mayor dinamismo para el monitoreo de las instituciones financieras y la adopción de las medidas oportunas demandadas por el BCP y la Superintendencia de Bancos de manera a reducir los riesgos del sistema financiero.

Para complementar estas reformas y para evitar la contaminación del sistema financiero con dinero ilícito, se impulsará la sanción y posterior implementación de un proyecto de Ley que previene y reprime los actos ilícitos destinados a la legitimación de dinero y bienes. El proyecto de Ley que ha sido presentado al Congreso el 13 de mayo de 2004, propone centralizar en una agencia la detección y monitoreo de este tipo de actividades, además de la definición moderna de los crímenes en esta área: el financiamiento del terrorismo como crimen y el lavado de dinero como delito autónomo.

Para la implementación de las reformas, serán necesarios cambios institucionales en los niveles de supervisión. Por ello se elaboró un Plan Estratégico para la Superintendencia de Bancos con el objetivo de contar con metas a corto, mediano y largo plazo que hace referencia a supervisiones focalizadas para instituciones, planes de contingencia para enfrentar debilidades y tomar acciones correctivas oportunas.

MINISTERIO DE HACIENDA · REPÚBLICA DEL PARAGUAY · PAZ Y JUSTICIA · MINISTRO

...///...

N° 438.-

...///...

El Plan Estratégico mencionado fue aprobado por Acta del Directorio del BCP, y permitirá evaluar con mayor profundidad el riesgo de los bancos y operativizar el nuevo régimen de resolución y regularización de las instituciones financieras.

Segunda Fase

La segunda fase de la reforma anticipa la implementación del nuevo marco legal y regulatorio incluyendo poner en vigencia la nueva Ley de Bancos. Respecto a la Ley de Garantía de Depósito y Resolución Bancaria, las acciones incluyen la implementación de procedimientos que permitan aplicar el nuevo mecanismo de garantía con criterio de menor costo, además de normalizar la práctica de resolución utilizando el calce de activos y pasivos para la transferencia de tales balances a otros bancos adquirentes en el sistema financiero, incluyendo el uso del mecanismo de titularización para estos propósitos.

Bajo esta fase también se anticipa la institucionalización operacional de los procesos del Fondo de Garantía de Depósitos, incluyendo criterios claros para el uso de sus fondos incluyendo el principio de menor costo, además de su estructura de funciones y controles internos, y su régimen de custodia e inversión para los recursos recolectados como aporte a la garantía de depósitos, del sistema financiero.

En esta etapa de la reforma, el Banco Central asegurará el cumplimiento de la normativa sobre previsiones definida en la Resolución N° 8, para que los Bancos y empresas financieras del sistema demuestren la asignación debida de capital y reservas para cubrir las pérdidas actuales y esperadas en sus carteras crediticias. Estas acciones serán esenciales para fortalecer al sistema financiero y protegerlo mejor contra choques económicos y financieros futuros.

Para complementar estos cambios, esta etapa de la reforma también implementará un proceso de supervisión fortalecido de acuerdo con los lineamientos del Plan Estratégico para la Superintendencia de Bancos, bajo el cual los Bancos del sistema serán evaluados por sus riesgos inherentes en su negocio, y acciones correctivas se tomarán cuando se considere justificado de acuerdo al nuevo marco normativo.

MINISTERIO DE HACIENDA · REPUBLICA DEL PARAGUAY · PAZ Y JUSTICIA · MINISTRO

...///...

Nº 438

...///...

También se anticipa en esta fase, tener aprobada y en vigencia la nueva ley que previene y reprime los actos ilícitos destinados a la legitimación de dinero y bienes (lavado de dinero). Además, el Gobierno presentará al Congreso Nacional un proyecto de ley que modifique la Carta Orgánica del Banco Central, y que cubra, entre otras reformas, un proceso más robusto para mantener en todo momento, un esquema de nombramientos de plazos escalonado para los miembros de junta directiva del Banco Central.

E. Reestructuración de las Instituciones Financieras Públicas.

Tercera Fase

La tercera fase del programa abarca principalmente la reestructuración de las entidades financieras públicas. Si la implementación de estas reformas se efectuaran tempranamente, esta fase se podría adelantar.

Las instituciones financieras públicas necesitan ser reestructuradas y consolidadas, principalmente considerando la insolvencia de algunas de ellas, deficiente asignación de subsidios, consideraciones políticas y sociales sobre los criterios de rentabilidad, solvencia y crecimiento, el clientelismo de sus carteras y la morosidad de las mismas. Esta reforma abarcará al Banco Nacional de Fomento (BNF), el Fondo Ganadero (FG), el Fondo de Desarrollo Industrial (FDI), la Unidad Técnica Ejecutora de Proyectos del BCP (UTEP), el Consejo Nacional de la Vivienda (CONAVI), el Banco Nacional de la Vivienda (BANAVI), el Crédito Agrícola de Habilitación (CAH) y el Fondo de Desarrollo Campesino (FDC).

En su conjunto las entidades financieras públicas han tenido problemas de eficiencia y han generado continuos impactos fiscales negativos, poniendo en riesgo la confiabilidad del sistema financiero en su conjunto e impactando negativamente en las reservas internacionales. A la fecha, las dificultades de la Banca Pública, la influencia de ésta en el inapropiado funcionamiento del sistema financiero en el país y las consecuencias de este fenómeno sobre los sectores reales de la economía, ha tornado imprescindible su reforma.

MINISTERIO DE HACIENDA
REPÚBLICA DEL PARAGUAY
PAZ Y JUSTICIA
MINISTRO

...///...

N° 438.-

...///...

En este marco, fue elaborado el Proyecto de Ley de Reestructuración de las Instituciones Financieras del Sector Público, que tiene como objeto la transformación de las entidades financieras públicas, encausando la participación estatal a dos entidades, una de primer piso y otra de segundo, de manera a eliminar los obstáculos existentes en la configuración presente de la Banca Pública que impiden la canalización eficiente de los recursos disponibles para el crédito, y principalmente focalizar su actuación en aquellos sujetos de créditos que hoy no acceden al sistema financiero formal.

Para asegurar una reforma más ágil y ganar apoyo político en este proceso, el Gobierno recientemente ha modificado su estrategia de implementación de la Reforma de la Banca Pública, considerando dos etapas, una para la presentación y aprobación de la creación de la Banca de segundo piso y otra que incluye un proyecto de reestructuración de la Banca de primer piso. Ambos proyectos se han presentado al Congreso el 2 de noviembre de 2004 y el 16 de febrero del 2005, respectivamente. En el primer caso serán reestructurados el FDI, el FDC, la UTEP, el CONAVI y el BANAVI, y en la segunda etapa el BNF, el CAH, y el FG. Dada la actual coyuntura, se ha reemplazado el proyecto de ley original que aún no habría sido analizado por el Congreso de la Nación, por un proyecto de Ley que Crea la Agencia Financiera de Desarrollo como única Banca de Segundo Piso y único canal de préstamos del sector público. Aunque se considera esta estrategia secuencial como la más viable políticamente en esta coyuntura, se dejará abierta la opción de consolidar las reformas bajo un proyecto de ley único, si desarrollos posteriores así lo indicasen dentro de esta tercera fase del programa de reforma.

En su inicio, la reforma comenzó y continuará con la reestructuración del BNF, la mayor banca estatal, de manera a reducir el tamaño de la institución y acotar sus operaciones limitándolas a las clientelas y sectores prioritarios que tengan menos acceso a financiamiento por vía de la banca privada, a tal efecto, por Decreto N° 4.818 del 3 de febrero de 2005, se ha creado la Comisión para el seguimiento del plan de acción de Reorganización del Banco Nacional de Fomento. La reforma de la Banca Pública busca aprovechar las ventajas de la existencia de instituciones estatales como el BNF, que tienen una red y sistema informático ramificado por todo el país y el CAH, que cuenta con experiencia en micro créditos rurales. Debido a que el BNF y las demás Instituciones estatales presentan déficit en sus niveles de capital, se necesitarán fondos para capitalizar completamente a la nueva institución.

MINISTERIO DE HACIENDA REPÚBLICA DEL PARAGUAY PAZ Y JUSTICIA MINISTRO

...///...

Nº 438.-

...///...

En lo que a las actividades de segundo piso se refiere se plantea una única entidad resultante de la reestructuración de los actuales fondos que repasará los recursos a las Instituciones Financieras Intermediarias (IFIs) del sistema con criterios competitivos. La entidad financiera de segundo piso tendrá por objeto primordial la administración de los recursos provenientes de créditos otorgados por organismos internacionales para financiamiento de proyectos de desarrollo.

Con la reestructuración de la banca de primer piso, que tendrá una relación directa con el público, se pretende que los clientes sean, además de sujetos de crédito, aquellos que tengan mas difícil acceso a servicios financieros y bancarios, y que una gestión defectuosa no resulte en financiamientos provenientes de fondos fiscales cautivos, para ello se impondrán límites a las operaciones activas, a las operaciones pasivas y al endeudamiento con la Banca de segundo piso permitirán, y se asegurará que todos los costos financieros y operacionales sean cubiertos por las tasas activas de la institución, y que su cartera esté debidamente provisionada contra pérdidas.

La reforma se llevará a cabo bajo la coordinación de una comisión especial de reestructuración que contratará a especialistas privados para gestionar la creación de los balances de las nuevas instituciones. Al final del proceso de reforma se espera una participación estatal eficiente en el sistema financiero, una adecuada y clara asignación de roles en el sector financiero y una mejor utilización de los impuestos del conjunto de la población que ya no financien las pérdidas causadas por una gestión ineficiente.

F. Conclusión

La larga recesión económica que ha venido experimentando el Paraguay, es resultado de rigideces estructurales en la economía que no promueven el crecimiento y que afectan significativamente el bienestar de la población paraguaya. La administración actual ha empezado a diseñar políticas de mediano plazo para lograr un sector fiscal y financiero sostenible, para mejorar la conducción de la administración pública y las operaciones del sistema financiero, a fin de reactivar la economía.

MINISTERIO DE HACIENDA
REPUBLICA DEL PARAGUAY
PAZ Y JUSTICIA
MINISTRO

...///...

Nº 438.-

...///...

Al mismo tiempo, se han implementado medidas de corto y mediano plazo para hacer frente a las necesidades de recursos del Tesoro Nacional y a las fuertes restricciones presupuestarias, paralelamente a la aplicación de las primeras iniciativas para sanear y poner al sistema financiero en buen camino.

La asistencia crediticia por parte del Banco Mundial que está siendo requerida tiene la finalidad de apoyar al Estado Paraguayo en solucionar los actuales problemas de liquidez, en relación a la balanza de pagos y al presupuesto que entre otras necesidades, requerirá recursos incrementales para llevar adelante el proceso de reestructuración de las instituciones financieras públicas. El programa de tres fases de mediano plazo para la reactivación y el fortalecimiento del sector financiero que el Gobierno de Paraguay pretende impulsar, demandará la disponibilidad de recursos.

Como se menciona anteriormente, el Gobierno ha negociado un Acuerdo Stand By con el Fondo Monetario Internacional (FMI) por un periodo de 15 meses y recientemente extendido por 6 meses adicionales, lo cual será fundamental para certificar las acciones planeadas para la recuperación del sistema tanto desde el punto de vista fiscal, como desde el punto de vista de la estabilidad monetaria y financiera, así como el incremento de la capacidad de pago a fin de honrar los compromisos de la deuda pública contraída.

El apoyo del Banco Mundial y de otras agencias multilaterales de crédito será de suma importancia en las circunstancias actuales y sentará las bases para promover las reformas estructurales del sector financiero y así lograr el crecimiento económico en el Paraguay.

Hago propicia esta oportunidad para saludarle con mi distinguida consideración.

MINISTERIO DE HACIENDA
REPUBLICA DEL PARAGUAY
PAZ Y JUSTICIA
MINISTRO

DIONISIO BORDA
MINISTRO DE HACIENDA
GOBERNADOR POR PARAGUAY

SSEEI/SG/aaa.

Annex 3

BACKGROUND AND DIAGNOSTICS OF THE PARAGUAYAN BANKING REGULATORY AND RESOLUTION FRAMEWORK AND TECHNICAL ISSUES IN THE REFORM

a. Institutional Issues: Regulation and Supervision

1. The supervision of financial activities in Paraguay is distributed among several official agencies. The Central Bank and the Superintendency of Banks are responsible for supervising those institutions regulated by the banking law (banks, finance companies, and exchange and receipt warehouses). The conduct of their banks and finance companies falls entirely under the supervision of the Central Bank of Paraguay (BCP) and the legal provisions of its Organic Law 489/95 and the Banking Law 861/69[18]. Savings and Loan Associations, earlier supervised by the Superintendency of Societies (part of BANAVI[19]) and regulated by Law 325/71 are now under the banking law, while Credit Union Cooperatives are subject to oversight by the INCOOP (Cooperatives oversight agency in the Ministry of Agriculture) under the terms of Law 438/94. Supervision of deposit taker intermediaries is, therefore, fragmented among three institutions and lacks the necessary compatibility. A parallel operation prepared by the Inter American Development Bank (IDB) has included a reform and technical assistance program to strengthen the supervision of cooperatives and tie it more closely with the banking and depositary institution norms overseen by the Superintendency of Banks.

2. In addition, the financial sector includes insurance companies, brokerage houses and investment funds. Insurance activities are carried under the provisions of Law 897/96, and their supervision is the responsibility of the Superintendency of Insurance, under the aegis of the Central Bank (BCP). Brokerage and capital market activities, albeit very reduced, fall under the control of CNV (Comision Nacional de Valores) and are carried under the precepts of the Securities Law, while investment management activities and services are regulated by the Law 921/96 on Trusts, presumably under the supervision of the BCP.

3. Paraguayan prudential banking regulations incorporate many of the key Basle principles, although for some accounting practices they differ, leading to potential overstatement of capital of banks. The use of different types of real collateral both for capital computation purposes as well as for loss provisioning purposes overestimates freely available capital, especially since the unwinding or liquidation of collateral backing if needed, can normally take years and therefore its present value should be heavily discounted. Other accounting adjustments in line with best practices would imply that the Paraguayan banking system is under capitalized, with the local (private and public) banks reflecting the largest gap to ensure technical solvency if the strictest

---

[18] Ley 861/69 de Bancos, Compañías Financieras y Otras Instituciones de Crédito.

[19] BANAVI is the "Banco Nacional de Ahorro y Préstamo para la Vivienda" a State owned housing bank.

accounting standards are used. An estimate of the required capitalization at the system wide level, yielded a potential gap of $134 million if one were to apply best practice standards beyond the minimum Basle requirements.

4. The Central Bank of Paraguay (BCP) is the sole banking regulator and supervisor in the country. According to its Organic Law 489/95 , it has all the basic powers (licensing, regulatory, enforcement and exit authority) required to promote the stability and soundness of operations of banks and finance companies. The Superintendency is closely affiliated with the Central Bank through a common Board of Directors, but by law it operates as a separate department with very little autonomy in practice, since all powers are vested in the Board of the BCP. The Superintendent of Banks (SB) directs the operations of the SB but does not have much administrative authority which is exerted by the President of the BCP.

Supervisory Structure and Method

5. The SB has no direct power regarding licensing and enforcement, and few bank resolution and regulatory competencies. The role of SB in these matters is limited to advising the Board of BCP which retains the core competencies and decision making authority. The real banking supervisor in Paraguay is de facto, the Board of the BCP itself and not the Superintendency, as a reading of the Organic Law would indicate. The lack of delegation by the Board of some of its powers to the SB, and a relative scarce formalization in writing of core supervisory policies --communicated both internally and to bank directors and management-- have also contributed towards limiting the autonomy of SB and the efficiency of banking supervision.

6. In part as a by-product of these limitations, the Supervisory approach followed in the past has focused more on determining compliance with the letter of laws and regulations rather than focusing into assessing the risk profile of activities and the quality of the management processes followed by banking institutions. Absent of a set of communicated standards on good governance and risk management --and short of the capacity to evaluate risk and risk management practices -- supervision has evolved from a compliance approach to one of a solvency diagnostic type. As the BCP and SB have not developed policies for addressing varying degrees of risky practices, they have not been capable of preventing and early remedying excessive accumulation of risks and poor risk management, governance and control processes associated with banking failures and crises.

7. State banks with their own statutory mandates and which do not fall under the same provisions as the commercial banking law, also represent an area of needed reform and increased oversight, something the Government is already considering in its reform efforts. This is particularly so for State financial non bank intermediaries utilized to channel bilateral and multilateral resources for credit. Given the non deposit taking nature of these institutions, they are supervised scantly and their loan portfolios have been deteriorating. Consolidation of some of these operations into a small rural sector bank and one second tier intermediary, will help to increase supervisory oversight. The one commercial State bank (BNF) which has suffered from both adverse debt forgiveness initiatives and large non-performing borrowers, will be dismantled so that its lending can

better focus on small businesses with a higher need for credit access, while lowering its overall exposure.

Prudential Approach

8. Prudential quantitative standards (capital ratios, risk weights, and risk limits) are explicitly established in the Banking Law 861/69 with a degree of detail that makes regulatory development and adaptation to changing circumstances too rigid. Major risk limits and prudential ratios are established in the Law including risk weights and detailed definitions. In many countries these would be established by secondary regulations that develop the principles of the Law, facilitating continuous development and adaptation. An additional issue in the Paraguayan context is the problem of money laundering, primarily due to the contraband trade, but also more recently on account of suspected terrorist links in its border communities. The BCP has, and will continue to strengthen its institutional resources and its legal framework to better detect such money flows which impact the operations of the financial system.

9. In terms of prudential reforms, however, even a small amendment to capital adequacy or regulations on risk limits, requires in Paraguay an amendment to the Banking Law approved by Congress. This prevents adapting prudential regulations to international evolving standards without reforming the Banking Law. Albeit, it is of particular importance for establishing the sufficiency of capital, since risk weights assigned in the Banking Law differ markedly from international standards, resulting in an overstatement of risk weighted solvency of the system and individual banks. The Board of the Central Bank should consider obtaining legal delegation to establish by regulation the more important prudential parameters.

10. Another feature of the evolving regulatory framework in Paraguay is its marked quantitative style, with few standards having been promulgated regarding governance, control structures and risk management. In turn, as in many other countries, the formalism of prudential quantitative regulations may have precluded the development of a risk based Supervisory Approach that focuses on identifying varying degrees of risk, summarizing the risk profile of institutions, and acting preemptively to address weaknesses detected in risk management and controls.

11. The CADEF is the Superintendency's bank rating system which is a CAMEL based composite index of financial ratios prepared with information reported by banks and finance companies; and currently required by law to be published by the SB. Accordingly, its value as a predictor of problems, or as a tool to classify institutions, is dependent on the quality of the data reported by banks and finance companies. Due to the distortions in regulations, accounting and reporting practices, there are serious doubts about the current transparency of that information and the final value of the CADEF.

Process Constraints

12. The SB's ability to identify serious banking solvency or liquidity problems appears adequate during its normal course of on-site inspections. However, and as discussed earlier under the regulatory/supervisory framework, the enforcement of sanctions applied

for non compliance suffer from delays both within the Central Bank and due to lack of response from the supervised institutions. While "corrective action" is not a formally specified stage under the banking law, it is important to identify deficiencies in its application and how this may impact the overall bank resolution framework. Corrective action directives and sanctions are established by the issuance of regulations ("resoluciones") by the Central Bank, which follow from the provisions in the Law covering exceedance of specified limits, etc.

13. Some of the constraints in effectively applying prompt corrective actions orders and enforcing them, involve the following:

a. Lack of timely response from banks to recommendations/orders communicated by the SB to improve their internal management processes;

b. Existent application of fines for exceeding regulated financial limits but not for judgments regarding faulty management;

c. The formality of preparing legal documents prior to officially implementing sanctions; and

d. The lack of delegation by BCP's Board to the SB, to apply sanctions for ongoing non compliance issues.

b. Current Framework for the Bank Vigilance, Intervention Regimes

14. The current Banking Law (No. 861) invokes the Vigilance Regime (*'Vigilancia Localizada'*) which implies, the following actions (Article 113) affecting the target bank: (i) Permanent ongoing inspection of the financial entity, (ii) Reduction in the period during which the institution's minimum reserve requirement at the BCP is calculated, (iii) Prohibition against accepting management of Trusts, (iv) Non eligibility of the entity to participate as intermediary for promotional/directed credits, (v) Deposit of any surplus or repaid funds above what is needed to meet depositor payments, in a remunerated BCP account, and (vi) No distributions of net income, and no increase in personnel or salaries. During the vigilance regime, a rehabilitation program is required within 7 days of the start of the regime and the program delineates an action plan to reverse the tendencies which resulted in triggering vigilance by the SB.

15. The triggers for placing a bank under the Vigilance regime as specified in Article 110 of the banking law, are the following:

a. Non compliance with the reserve requirements for 30 consecutive days or for a total of 60 non consecutive days during a 12 month period.

b. Exceeding the limits established under articles 58 and 59 (investment, capital, connected lending) during two consecutive months, or four non consecutive months during a 12 month period.

c. A capital deficit below the minimum for more than 60 days.

d. An observed need to refinance obligations or use BCP liquidity credit for over 60 days during a 180 day period. This excludes extraordinary credit demands generated from seasonal requirements.

e. Non compliance with implementation of corrective actions.

f. Offering deposit rates at levels markedly higher than the market in terms of similar institutions.

Intervention

16. Under the Paraguayan banking framework, intervention of a bank by the SB is triggered by one or more of the following (Article 118):

a. Suspension of a bank's payment of obligations;

b. Having lost over 50 percent of its capital;

c. Not complying with a rehabilitation plan agreed during the Vigilance stage, or not presenting an adequate plan to the SB;

d. Having committed various continued infractions of the banking law and its statutory requirements as well as non compliance with regulations or resolutions issued by the BCP and SB;

e. Having supplied false information to the SB or the BCP; and

f. Not complying with the requisite shareholder meetings or parent company actions to ensure appropriate operational actions and meeting of legal requirements.

17. During intervention, the SB undertakes the following actions which are consequences of entering into such phase: (i) powers of management and the Board are suspended; (ii) the bank's administration is taken over by the SB through officials designated for such purpose, (iii) the intervened entity continues to operate under the administration of the interventor subject to the operating constraints put into force under Vigilance; (iv) the SB will determine loss provisioning requirements for assets according the proper accounting norms after approval by the BCP Board, and subsequent reduction of capital in order to determine the market value of the bank; and (v) the SB will order all shareholders to deposit their share securities at the BCP within 15 days of a request for such via the public media. Securities not deposited during that time period will be considered valueless subsequently.

18. As mentioned above, the subsequent stage after intervention either involves immediate capitalization of the bank by shareholders or other parties via purchase & assumption, or moving towards liquidation. Under the current law, the sale option named

"forced sale" as described in Articles 122 and 123, is very briefly described with most of that chapter of the law dedicated to the modalities of liquidation including the contracting of third parties for this purpose. However, modernized resolution mechanisms using selected carve-out of assets and liabilities are not explicitly contemplated as part of this legislation.

c. Stress Test and Accounting Adjustments to Banking System Balance Sheets

Adjustment to Risk Weighted Capital

19. The initial financial statement adjustment conducted as part of the diagnostic of the soundness of the financial system, corresponds to the calculation of risk weighted capital, i.e. the capital adequacy ratio (CAR). The levels of reported CAR for Paraguayan entities are among the highest in the Region but this is caused in part caused by a less strict and in some cases, incomplete regulation of particular accounting norms. For example, some risks are not considered, such as market risks, exchange rate risk, etc., and the regulation is based mainly on credit risk parameters. The CAR adjustment, therefore, is the starting point to make comparisons for the latter adjustments and for the exogenous factors (stress tests). The CAR adjustment to reported equity (the numerator in the risk weighted capital calculation) consists of including revaluation reserves at only 50 percent of reported value, particularly given the economic situation in Paraguay where any past revaluations of fixed assets such as real estate may not be adjusted to current market conditions of low demand for such assets. Another adjustment within the CAR ratio numerator is for earnings before distributions. In Paraguay, earnings are reported at 100 percent for the purposes of calculation of capital but this adjustment places them at only 50 percent since typically a large share of earnings are distributed to stockholders rather than allocated to capital reserves.

20. On the denominator side of the CAR ratio, the adjustment to Risk Weighted Assets (RWA the denominator) entails valuing loan assets collateralized by real estate/mortgage properties at 100 percent risk versus 50 percent, thus increasing the riskiness of the asset and reducing the CAR. This adjustment is based on international standards which dictate that only residential mortgage assets have a lower risk of 50 percent but all other mortgages have full 100 percent risk for weighting purposes. The adjustment is also based on the reality of the difficulty of collecting and liquidating collateral in Paraguay and thus the need to discount its value based on elapsed time for collection. The adjustment could be considered strict, and perhaps could understate capital, however, it is balanced by the fact that no calculation was carried out to estimate capital requirements for risks other than credit risks, such as market risks. The result is that there is an important decrease from the reported CAR ratio. For banks in aggregate, this reduces the reported risk weighted CAR by almost 8.0 points.[20]. This effect is different across different groups of banks with the most significant decrease affecting the state bank, BNF.

[20] In Paraguay the current minimum legal CAR requirement is 10, although Law 861 permits setting it in a range between 8 and 12. This analysis excludes finance companies which represent 10% of the banking system.

Loan Portfolio Adjustments

21. The following analysis compares additional adjustments:

22. *Adjustment 1: Value of Collateral in Lieu of Provisions*: This adjustment addresses the common practice of using collateral as a substitute for loan provisions. The assumption is that the collateral is liquid and can be executed promptly. However, since collateral (usually real estate) particularly in Paraguay, due to both economic and judicial factors, is effectively not liquid, this adjustment increases loan loss provision requirements based on appropriate downward adjustment to collateral based on the criteria described below.

23. Financial statements are used to obtain the shares of collateral types such as mortgages, monetary collateral and other types. These shares are applied to each loan risk category (1 to 5) as reported by the entities. The allowance for collateral instead of provisions is considered based on the following criteria: 100 percent allowed for monetary collateral; 50 percent for mortgage collateral; and 0 percent for others (e.g.: automobiles, equipment, etc.). The rationale for considering 50 percent for mortgage collateral is based on estimates of 3 years (based on Paraguayan experience) for executing and collecting the value of mortgage collateral. By utilizing as a discount rate the nominal interest rate in domestic currency (which approximates the weighted domestic interest rate for credits over one year in maturity and adds administrative costs) the present value of the collateral declines to under 50 percent.

24. *Adjustment 2: Provisioning for Refinanced Loans:* This adjustment addresses provisioning increases for renewed, refinanced and restructured loans. As most of these loans are classified in category 1 ('Pass') but are likely refinanced and restructured from previous non-performing loans or loans having paid the minimum to avoid 'non performance', the adjustment conservatively places them into category 3 (substandard) which would require 20 percent in loss provisions. The same collateral adjustments as above are made. In addition, since prior interest accrual reversals and provisioning for principal may have not been effected after the loans were refinanced, it is estimated that there exists a 30 percent level of under-provisioning underlying these loans based on those which they refinanced. These two adjustments add a requirement of 50 percent in provisions for the refinanced portfolio . This adjustment and the prior one for collateral value has a very significant for all groups of banks, lowering the overall capital adequacy ratio by 7 percentage points for both factors combined.

25. *Adjustment 3: Inclusion of Generic Provisions:* This adjustment adds a generic provision of 1.5 percent to category 1 loans, and increases provisions for loans in category 2 from 1 percent to 10 percent. This adjustment is based on international practices. The result is not very significant and from this effect alone. The effect might be slightly less since Basle standards allow up to 1.25 percent of generic provisions (category 1) to be counted as second tier capital, therefore, such an amount would not reduce the banks' available capital.

26. *Adjustment 4: Repossessed properties and Deferred charges.* Repossessed properties are included at a 50 percent value following a similar rationale used for mortgage collateral. Some deferred charges are reversed at 100 percent given that they reflect incurred losses which are being amortized. The adjustments are not very significant in terms of this effect on the adjusted CAR for the banking system.

27. *Aggregate effect – Sum of initial Risk Weighted Capital Adjustments plus effects of Adjustments 1 through 4:* This takes into account all the reported provisions and the deficit over the estimated minimum requirements based on the above methodology. In sum, the effect of all the adjustments is significant for all groups. These cumulative adjustments lower the effective capital asset ratio for the banking system to levels requiring careful monitoring particularly for a small set of banks which could be vulnerable to additional shocks. The most significant effects of the sum of these adjustment are for BNF. Other effects requiring follow up are observed for banks established in Paraguay and also local domestic banks.

Table 13
Sequence of Adjustment Measures to 'Stress Test' Banking System Capital Adequacy

Risk Weighted Capital Adjustments	Adjustment to Collateral in lieu of Reserves	Adjustment to Provisions for Refinanced Loans	Increase in Generic Provisions and Category 2 Loans	Adjustment for Repossessed Property and Deferred Charges

d. Detail of Prudential Upgrades Foreseen by the Government to Improve Bank Risk Management

28. The reforms to the banking system legal and regulatory framework being implemented by the Government consider actions in a number of policy areas as listed below:

<u>Banking Operations</u>

29. As part of a review of the Banking Law and existing regulations, it has been identified that at least the following areas will be subject to regulatory reform:

a) Requirements and policy standards for licensing of new institutions;
b) Shareholders registration and transfer of existing participations;
c) Requirements and policy standards to conduct permissible activities;
d) Restrictions to maintaining participations in other companies;
e) Definition and policy standards for insiders and bank related parties;
f) Standard requirements for internal audit programs;
g) Reforming minimum capital adequacy rules and regulations;
h) Eliminating the 12 percent ceiling for minimum capital adequacy ;

i) Conditions and policy standards to increase minimum capital on an individual basis;
j) Inclusion of foreign exchange market, and other risks into the risk weighted assets;
k) Limits for FX, market and interest risk, and liquidity risk;
l) Criteria for augmenting risk limits ;
m) Adoption of enforceable risk managements standards;
n) Requirements for consolidated regulation and supervision; and
o) Criteria and policy standards for enforcing prudent banking practices.

Treatment and Assessment of Credit

a) Coordination of standard definitions of regulations on credit quality;
b) Reintroducing interest reversals on non accruing loan income;
c) Improving the definition of "effective interest and principal payment";
d) Precluding directly or indirectly new lending to improve loan classification;
e) Establishing rules to classify overdrafts by arrears and other relevant criteria;
f) Repealing weighted classification and provisioning of borrowers;
g) Requiring 'stress' cash flow projections for large exposures and borrowers;
h) Strengthening conditions for restructuring and rescheduling problem debtors;
i) Regulating sales of problem loans to trust and related offshore vehicles;
j) Minimizing recourse to collateral as a substitute for loan provisioning;
k) Establishing a register for authorized professional independent appraisers:
l) Adopting strict rules for collateral appraisal;
m) Increasing minimum provisioning for class 2 assets from 1 percent to between 5 and 10 percent;
n) Establishing a generic provision for class 1 assets currently at 0 percent;
o) Suspending or provisioning currency revaluation for classified loans;
p) Requiring forward provisioning based on expected loss; and,
q) Augmenting generic provisioning based on credit risk management quality.

Capital Adequacy and Asset Quality

a) Minimizing the use of collateral to reduce risk weights and augment risk limits;
b) Deducting from the capital base any excesses in risk concentrations;
c) Eliminating the 12 percent maximum threshold level for capital adequacy;
d) Providing BCP with powers requiring additional capital above the minimum;
e) Mandating consolidated accounting to support consolidated regulation;
f) Requiring capital adequacy also on a consolidated basis;

g) Including exchange and market risks in the risk weighted assets formula;
h) Dividing tier capital into two levels according to the quality of its components;
i) Excluding from tier two of capital 50 percent of revaluation reserves after validation;
j) Excluding from tier two of capital 50 percent of current years profits before distribution;
k) Delegating power to SB within appropriate policy standards;
l) Considering existing liquidity and interest rate risk exposures;
m) For rating loan asset risks, permitting 50 percent risk weighting only if asset is guaranteed by a residential mortgage, but 100 percent risk if backed only by commercial mortgage.
n) Factoring in qualitative aspects according to each institution's risk profile; and,
o) Using new powers and standards, as incentives to strengthen the banking system.

Off-Site Surveillance

30. The following processes are being considered to strengthen the off-site surveillance activities of SB in order to enhance its overall efficiency and capacity:

a) Having a separate component for surveillance in the SB's Institutional Development Plan (IDP), including training;
b) Adopting a surveillance policy aligned to a new proposed supervisory strategy;
c) Revising as necessary surveillance procedures (manual and work papers);
d) Performing book adjustments per examination before ratio analysis takes place;
e) Developing a methodology to combine quantitative and qualitative measures;
f) Standardizing a uniform bank performance report and ratio analysis system;
g) Developing further warning systems (dynamic, stress, proxy early indicators);
h) Coordinating as a policy matter, the monitoring, examination, and enforcement activities;
i) Using a risk rating profile to anchor the coordination policy;
j) Developing processes to compile and compare qualitative management reviews;
k) Staffing the surveillance function satisfactorily and train analysts to supervise;
l) Forming a rating committee coordinating surveillance and examination functions;
m) Consolidating supervisory responsibility by nominating account managers.

Institutional Capacity and Modus Operandi

31. In order to successfully implement the above standards, the following are considered to strengthen operating policies and procedures of supervision in order to enhance its overall efficiency and capacity:

a) Adopting a multiyear institutional development program (IDP) for SB;
b) Having a sub-IDP for each function: examination, surveillance, enforcement;
c) Adopting a supervisory strategy that discriminates risk profile among institutions;
d) Adopting core policies for each function (licensing, on-site, enforcement,etc.);
e) Discriminating (cycle, frequency, extension, tools) as per risk profiles;
f) Reviewing and reforming procedures of each function (licensing, off/on-site, etc.);
g) Linking supervisory functions by means of a risk profile rating methodology;
h) Estimating supervision work load (monitoring, examination, visitation);
i) Staffing major functions to adequate levels for dealing with work load;
j) Training staff in implementing new policies and procedures and rate risk profiles;
k) Providing resident advice along the duration of the multiyear IDP.

32. In terms of the signaling to the public regarding overall banking health, the reform of the Banking Law also includes the elimination of the obligation for the BCP and the SB to make public the classification of banks as currently required. Forcing SB to rate banks publicly crates undue pressure on SB, brings information of little value to the general public that can destabilize the system and, under stress, forces the SB to collude against transparency. Thus, under the proposed legal reform, bank ratings by the SB will be kept as internal information of the BCP and SB. While a more reliable rating index is developed which should include a larger weight with respect to bank management quality, the SB will only publish a set of standard financial ratios including those relating to overall exposure, asset performance and prudential indicators for each bank, but without consolidating these indicators into a single artificial rating index as is currently done. This will provide more transparent information which the market can use to assess bank quality. In the meantime, banks will also be required to obtain and disseminate ratings given by internationally recognized rating agencies.

33. Other institutional issues to ensure the transparency of operations at the BCP, besides the above mentioned areas, include improving internal controls (as per IMF safeguards assessment being conducted) and carrying out external audits of the BCP every year versus the bi-annual cycle currently in effect.

e. Lender of Last Resort Facilities and Emergency Liquidity

Lender of Last Resort Facilities

34. While seldom used now following BCP's losses during prior banking crises, the criteria and policy for the use of LOLR short term facilities as well as BCP credit under supervised rehabilitation plans, became substantially stricter under more recent norms implemented, to avoid easy access by banks with high potential for insolvency. The current policies and facilities available include in addition to the call money facility: (i) a short term facility for credits between 1-10 days in a 30 day period; (ii) a 'safety net' facility for credits up to 60 days within a 180 days period (but renewable for an additional

90 days in exceptional circumstance); and (iii) a longer term 'rehabilitation' facility for credits potentially up to a maximum of 5 years. The interest rate on these facilities is based on a 2 percent spread over an average of outstanding Central Bank bill rates or call money rates. Required collateral for the credits includes Government or BCP paper, other liquid negotiable securities or IOUs. The BCP is considering, to avoid moral hazard, that the interest rate charged on these LOLR facilities be based on a spread above the market rate, and that IOUs be excluded as collateral guarantees which should be limited to very low risk negotiable securities.

Market Based Liquidity Instruments and Constraints

35. The interbank market in Paraguay is limited and mostly relationship based. The size and frequency of interbank flows, however, can be good indication of how the market qualifies its member banks, since weak banks are generally cut off from access to this credit. However, the direction and size of flows in this market has not yet been used systematically to monitor and provide early warning indicators of potential bank illiquidity as well as insolvency. Nevertheless, liquidity transfer mechanisms are crucially needed in the Paraguayan financial system, particularly at this time.

36. Besides the limited interbank market, there are very few liquidity facilities available in the money market. The Central Bank's call money facility and the extremely limited repo market are some options, but the process of collateralizing such short term facilities still requires more streamlining to make them effective and widespread instruments. The short term corporate paper market is practically non-existent, with the fixed income money market being predominantly driven by an active primary market in Central Bank bills (monetary regulation/open market instruments) for which there is a very limited secondary market. The current stock of Government (BCP) bills outstanding is about $266 million which represents 40 percent of banking system usable liquidity (i.e., cash and liquid assets excluding reserve requirements) and 12 percent of total bank assets.

Actions under the Reform Agenda

37. To ensure that modernized safety net mechanisms are in place for the provision of liquidity and the prompt payment of depositors, the Government's reform agenda includes modifications to legislation covering in a number of key areas:

38. While not a traditional LOLR issue, the authorities are concerned about financial system instability during periods of currency devaluation, not only on account of dollar denominated loans which may default, but also from potential currency runs and withdrawal of deposits from the system, including dollar denominated deposits. Such instances demand a sufficient cushion of resources to avoid financial system collapse. The Government cannot rely on a constant source of contingent international credit (either commercial or multilateral) to affront such circumstances, and the Central Bank cannot and should not utilize its own resources or international reserves as an automatic response mechanism as has been used in the past. However, the Government and the Central Bank will reexamine its reserves policy for bank deposits, to permit additional

flexibility for increasing dollar deposit reserve requirements for use as a potential supply of emergency liquidity.

39. By subsequently reducing such reserve requirements or utilizing the stock of reserves during periods of devaluation induced stress, banks will be able to protect their balance sheets until such macro financial tensions stabilize. In this regard, under systemically vulnerable situations, the Central Bank would be able to release liquid funds by lowering an already raised dollar reserve requirement, without having to access its own resources or assume additional debt (which at times may simply be unavailable). Under the reform program, the Government will develop the criteria under which reserve requirements could be adjusted to affront such situations, as part of its crisis response tool kit.

40. Under the new Banking Resolution and Deposit Insurance law, the provision of emergency liquidity facilities is contemplated in the event of *systemic-wide financial crises*. In such instances, and with the consent of the President of the Republic, the Central Bank and the Finance Ministry would present a contingency plan for illiquid but solvent entities, allowing temporary regulatory forbearance and the availability of additional liquidity facilities. The measures permissible under such crises scenarios would include (a) full coverage of deposits to prevent systemic runs, (b) increase in the Government contribution towards the deposit insurance fund, (c) lengthening of the elapsed times and triggers normally required for bank corrective action programs, (d) case by case exemption of intervention and resolution of entities considered temporarily illiquid, (e) increase in the credit facilities offered by the Central Bank, (f) imposing timelines for meeting standard prudential requirements during and after crisis periods, and (g) setting up a temporary fund for strengthening of the banking system, with the sole objective of recapitalizing viable institutions and bringing stability and continuity to banking operations.

f. Specification of Early Corrective Actions and Securitization Mechanisms under the New Bank Resolution Procedures

41. The reforms to enhance the prompt corrective actions regime and which would precede the stage of bank resolution in order to steer banks toward a sounder financial condition before considering asset carve out, will include:

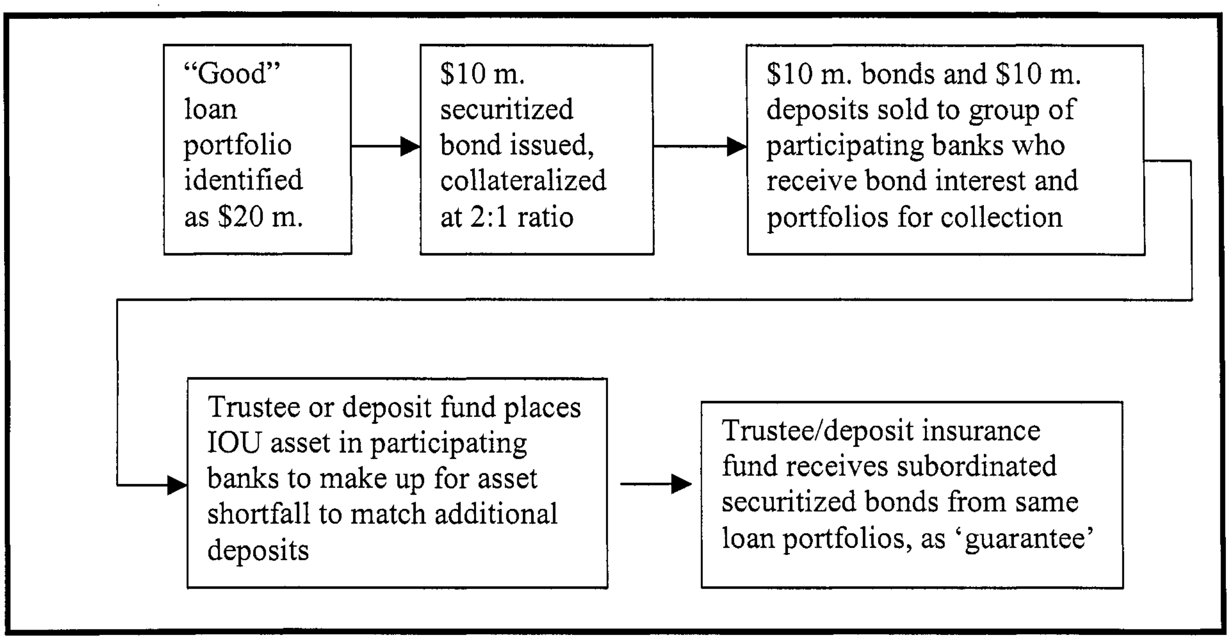
(i) The development of a set of qualitative indicators of faulty bank management practices, and associating each indicator with a set of sanctions and fines to be applied. Since weak, faulty or purposeful deficient management generally is an accurate early indicator of potential bank problems, the regulation and establishment of a schedule of corrective actions associated with specific fines in this area, will help to reverse negative trends at an early stage, while insuring compliance due to the associated monetary penalties.[21] Along with the already existing schedule of corrective actions for the exceedance of prudential limits, the SB will implement a matrix of corrective actions and penalties covering both the quantitative and qualitative (management performance) areas.

[21] It should be noted that fines already exist for exceedance of lending and other limits, but such fines are limited to quantifiable financial indicators but not to qualitative assessments of deficient management.

(ii) The current requirement for the BCP's legal department to prepare legal documents before invoking compliance from the industry, while intended to provide more 'force and legality' to the application of sanctions for inducing corrective action, has can at times result in delays since the legal processes take time to be finalized and documented, and months can elapse before formal sanctions are communicated. Since the banking law itself does not require this step and allows the BCP to directly mandate action under threat of sanction, this paperwork stage will be reformulated to expedite the quick reversal of identified problems. The application of sanctions under most cases during the SB's ongoing supervision work as well as during its supervision under the Vigilance regime, will also be further delegated directly to the SB by the BCP's Board of Directors.

42. Once the resolution regime is invoked the asset/liability carve outs would be carried out for purchase and assumption by sound banks. To facilitate this strategy, the a priori securitization of loan assets would permit purchasing banks to count on overcollateralization of the value of the loan-backed security which would facilitate its acquisition along with matching deposits. The structure of the securitization scheme for this purpose, is illustrated below:

Figure 3
Structure of the Loan Portfolio Securitization Scheme and Participation of Deposit Insurance Fund



g. Strategy for Management of Residual Liquidations

Bank Closure and Liquidation of Non Performing Assets

43. On assessing the desired separation of duties, a key differentiation must be made between the functions of bank resolution/restructuring with deposit insurance operations,

and those pertaining to collection of non-performing loans and/or liquidation of underlying assets. The latter function, i.e, the management of the residual "bad bank" is *not* a function of the new restructuring/resolution process established under this reform program, and should not be mixed with that function. This is because the resolution process works on short term restructuring arrangements while the 'collection/liquidation' function is longer term and drawn out and usually subcontracted.

44. In Paraguay, the experience since the banking crises of 1995-98 has been to contract individual liquidation experts to collect and/or dispose of loan portfolios of closed banks. The strategy of the Government initially was to hire individual liquidation experts and compensate them based on a percentage of proceeds collected. However, this practice had some obstacles for two reasons: (i) in some cases, the collection of bad loans and the disposal of assets was done using creative 'financial engineering' methods which technically liquidated assets with non cash instruments (e.g.: bonds to maturity) but did not actually recover the promised amounts in present value terms, and (ii) by assigning liquidators to individual banks some of which were in worse shape than others, the variable percentage commissions were not profitable in some cases and resulted in a non-viable recovery effort. Subsequently the SB modified the contractual terms of liquidators so that their compensation was based on fixed sums or fixed monthly payments. This system, however, is still being tweaked; while attracting more professional liquidators, it sometimes reduces their incentives to recover and collect funds quickly and thus liquidations became protracted, sometimes spanning over 3 years or more. Judicial impediments also prevent assets from being liquidated at "fire sale" prices.

45. A key ingredient for an effective mechanism settle liquidation sales of assets, is the establishment of a centralized registry of collateral assets. An effective registry should be supported by a comprehensive property titling effort to ensure that all available usable collateral is documented as a mechanism to help promote credit access. A central collateral/guarantee registry for the financial sector, along with the upgrading of property assessment/valuation standards would constitute a primary institutional tool to improve the efficiency and criteria for settling debt, bankruptcy and liquidation issues. As a medium term issue related to the use of real collateral, the Government has considered a program to register and provide formal title to property owners in Paraguay so as to increase access to credit via the provision of guarantees such as collateral backing.

Actions under the Reform Agenda

46. The function of managing the residual "bad bank" will not be a responsibility of the restructuring/resolution process or of the SB proper, and will not be mixed with that function. Under the agenda of the Government's reform effort, and to ensure the proper incentives in the recovery of assets, the liquidation process will and its institutional set up will be reexamined with the objective of considering alternative options to align incentives for maximizing proceeds within short time periods:

(i) Where significant size portfolios are managed, options for compensation to liquidators will be considered as variable commissions related to proceeds recovered at cash value. Such a modality would provide the best incentives to assure performance in this task. In order for the SB to maintain increased control against creative financial engineering and accounting arrangements to demonstrate asset recovery, while not encumbering its staff by managing such operations directly (as at present), the SB will approve final transactions to liquidate collateral for example, when such transactions utilize securities with unclear market values. In this context, the "property assessment" service industry in Paraguay has undergone a significant upgrading of standards established by the SB to ensure consistent and fair valuation of underlying collateral assets used to price non cash recoveries.

(ii) The bidding system to obtain offers from liquidators will consider proposals from firms to oversee an entire portfolio of assets from many banks under liquidation, rather than limiting the system to utilizing individual liquidators for individual banks. This will, besides generating business efficiencies and better diversification of portfolio risks for non-performing assets, permit a more viable implementation of the variable (percent-based) commission as the primary compensation mechanism linked to recoveries.

(iii) The asset recovery process will immediately be transferred to direct judicial bankruptcy proceedings while providing flexibility to the liquidating firm to sell portions of the loan asset portfolio for a fee to interested banks, when such assets are considered to be viable in terms of producing some minimum earnings returns. Such a modality of 'recovery' will supplement the traditional collection mechanism based on the sole liquidation of the underlying loan collateral.

(iv) Liquidation contracts will also begin including exit clauses for the Government including contractual time limits and expiration dates which will allow the BCP and the SB to delink from the direct management of the process and replace firms which do not perform or have not met minimum targets within a specified period.

(v) In order to ensure a fair and transparent process, as well as to protect the BCP against lawsuits by creditors of the failed banks (who would wish to maximize the value of recoveries and wait until a buyer 'shows up'), a triple consecutive auction system will be considered for usage under liquidator contracts. This will help so that the value of collateral goods/assets which are difficult to sell on the market, are offered/auctioned in three consecutive stages (each time lowering the auction 'reserve' price) to ensure that the final purchase offer received fully reflects existing market demand.

47. In order to support the efficient use of the above mechanisms, the Government will implement a new centralized registry of property appraisers based on recent regulations set forth to value collateral underlying banking assets so as to support more streamlined procedures for bank resolution and liquidation.

Annex 4

TIMETABLE OF KEY PROCESSING EVENTS

Time taken to Prepare: (Identification to Negotiations)	27 months
Prepared by:	Government and World Bank Staff
Identification Mission Departure:	March 4, 2002
Concept Review	April 24, 2002
Preparation Mission	June 26, 2002
First Management Review:	September 5, 2002
Pre-Appraisal Mission:	October 2003
Regional Operations Committee	February 24, 2004
Appraisal Mission:	April 27, 2004
Technical Discussions:	April 29, 2004
Initial Negotiations:	June 20, 2004
ROC Final Review:	February 9, 2005
Final Negotiations:	February 24, 2005
Board Presentation:	March 31, 2005
Planned Date of Effectiveness:	July 31, 2005
Closing Date:	September 30, 2006

PARAGUAY: FUND RELATIONS NOTE

Press Release No. 04/271
December 20, 2004

International Monetary Fund
700 19th Street, NW
Washington, D.C. 20431 USA

IMF Executive Board Completes Third Review Under Paraguay's Stand-By Arrangement

The Executive Board of the International Monetary Fund (IMF) today completed the third review under an SDR 50 million (about US$76.2 million) Stand-By Arrangement for Paraguay, originally approved on December 15, 2003 for 15 months (see Press Release No. 03/218), and granted an extension of the arrangement by six months, through September 30, 2005.

In completing the review, the Executive Board also granted the Paraguay authorities' request for waivers of the nonobservance of two quantitative performance criteria and two structural performance criteria, and the modification of four performance criteria.

The remaining amounts available under the arrangement were also rephased in four equal tranches in an amount equivalent to SDR 3 million each (about US$4.6 million). However, Paraguay has not made any drawings under the arrangement so far, and the authorities have indicated that they continue to treat the arrangement as precautionary.

Following the Executive Board's discussion of Paraguay's economic performance, Mr. Takatoshi Kato, Deputy Managing Director and Acting Chair, stated:
"Paraguay's macroeconomic performance has improved significantly under the program supported by the Stand-By Arrangement. Economic growth has been sustained in 2004 despite a drought, inflation has declined significantly, international reserves have increased, and the exchange rate has stabilized.

"Overall, Paraguay has performed well under the program. On the structural side, the authorities have approved key pieces of economic legislation over the last 12 months, including the fiscal adjustment law, the customs code, the bank resolution law, and the public pension reform law. The authorities will need to press ahead with the reform agenda in order to reduce unemployment and poverty, which remain stubbornly high.
"Reform of public banks remains a critical component of the program. It is important that this process move forward expeditiously, and that the authorities carefully monitor lending by the public banks in the run-up to their reform in order to prevent the resumption of unsustainable lending practices.

"Fiscal policy has been placed on a sustainable path and the authorities' 2005 program is aimed at maintaining this improved performance. The fiscal outlook has improved significantly following the improvements in tax administration and the approval of the fiscal adjustment law. Tax collections have increased while expenditures have been kept in check, although capital outlays remain low. The government has eliminated sizable arrears and taken decisive steps toward normalizing relations with all creditors. The stock of public debt is now on a declining trend. For 2005, the authorities intend to pursue a balanced overall budget, with higher projected revenues allowing for a significant increase in capital expenditure in needed infrastructure. It will be important to have mechanisms in place to limit expenditure to programmed levels, and to ensure that investment spending supports high quality projects.

"Monetary policy has been effective in containing inflation while allowing for rapid reserve accumulation. However, monetary management has been complicated by large capital inflows, which threatened to generate rapid monetary expansion or a sharp appreciation of the currency. In order to minimize these risks, the central bank has pursued an active sterilization policy while accumulating international reserves. In 2005 the authorities intend to use interest rate and exchange rate policies more flexibly in order to stabilize inflation," Mr. Kato said.

Press Release No. 05/26
February 11, 2005

International MonetaryFund
700 19th Street, NW
Washington, DC 20431 USA

Statement by IMF Staff Mission to Paraguay

The following statement was issued in Asunción by an International Monetary Fund (IMF) staff mission:

"A mission from the International Monetary Fund (IMF) visited Asunción during February1-11,2004 to conduct discussions for the fourth review under the Stand-By Arrangement (SBA). The mission was headed by Mr. Alejandro Santos and met with Finance Minister Borda, Central Bank President González, senior officials, as well as business and legislative representatives. Considerable progress was made towards completing the review and discussions are expected to continue in the following weeks.

"The mission will conduct the final assessment of this review in Washington in coming weeks. Some technical issues on the budget and aspects of the public banking reform agenda are to be resolved.

"The main findings of the mission were: Macroeconomic performance was significantly better than anticipated in 2004. Real GDP grew by almost 3 percent in 2004, the highest in almost a decade. Inflation fell below 3 percent in 2004, one of the lowest in the region, and the lowest in Paraguay in more than two decades. The fiscal accounts were in surplus for the first time in a decade and international reserves are at record highs.

"The program is broadly on track. The majority of the program targets for end-December 2004 were observed. An important target ahead is the approval of the second-tier public banking law by at least one chamber of Congress.

"Progress was made on all elements of the structural reform agenda. In particular, several important banking bills were submitted to Congress, a commission was created to design a restructuring plan for the first-tier public banks, additional external audits for public enterprises were completed, the civil service reform was advanced, and preparations continue to finalize the domestic bond exchange.

"The main challenges for 2005 will be to consolidate the macroeconomic gains of the recent past and to continue implementation of the structural reform agenda. An important objective for 2005 will be to maintain fiscal discipline while paying due regard to social spending. On the structural side, while there are many challenges ahead, efforts should be concentrated on implementing the public banking reform agenda. The agreements reached with civil society in designing a development plan with equity are important steps towards the consolidation of a medium-term policy framework.

"The mission would like to take this opportunity to thank the authorities and the citizens of Paraguay for their hospitality.

PARAGUAY

Status of World Bank Operations

IBRD Loans as of December 31, 2004

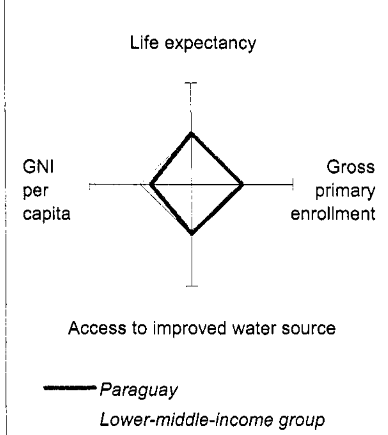
Loan	Project	Principal	Disbursed	Approval	Closing
37080	Natural Resource Management	$50,000,000	$40,469,062	22-Feb-94	31-Dec-05
42220	Fourth Rural Water Supply and Sanitation	$20,000,000	$14,934,037	28-Aug-97	31-Dec-05
42230	Fourth Rural Water Supply and Sanitation	$20,000,000	$ 7,181,244	28-Aug-97	31-Dec-05
71090	Pilot Community Development Project	$ 9,000,000	$ 1,668,167	21-Mar-02	31-Dec-06
71900	Education Reform Project	$24,000,000	$ 1,000,000	31-Jul-03	30-Jun-07

Paraguay at a glance

3/3/05

POVERTY and SOCIAL	Paraguay	Latin America & Carib.	Lower-middle-income
2002			
Population, mid-year *(millions)*	5.8	527	2,411
GNI per capita *(Atlas method, US$)*	1,100	3,280	1,390
GNI *(Atlas method, US$ billions)*	6.4	1,727	3,352
Average annual growth, 1996-02			
Population *(%)*	2.5	1.5	1.0
Labor force *(%)*	3.2	2.2	1.2
Most recent estimate (latest year available, 1996-02)			
Poverty *(% of population below national poverty line)*	46	..	..
Urban population *(% of total population)*	57	76	49
Life expectancy at birth *(years)*	70	71	69
Infant mortality *(per 1,000 live births)*	22	27	30
Child malnutrition *(% of children under 5)*	..	9	11
Access to an improved water source *(% of population)*	79	86	81
Illiteracy *(% of population age 15+)*	6	11	13
Gross primary enrollment *(% of school-age population)*	111	130	111
Male	112	131	111
Female	109	128	110

Development diamond*

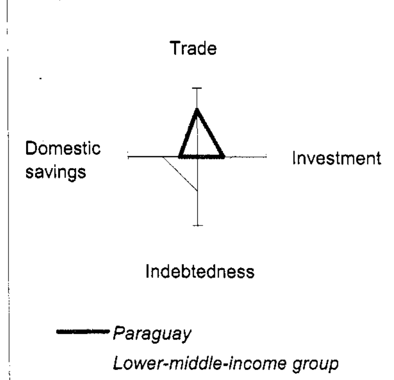


KEY ECONOMIC RATIOS and LONG-TERM TRENDS

	1982	1992	2001	2002
GDP *(US$ billions)*	5.4	6.4	6.8	5.6
Gross domestic investment/GDP	25.6	22.9	19.8	18.6
Exports of goods and services/GDP	12.1	28.1	27.4	33.6
Gross domestic savings/GDP	18.0	12.4	10.8	13.6
Gross national savings/GDP	19.2	12.7	15.8	16.9
Current account balance/GDP	-9.3	-0.9	-4.1	1.7
Interest payments/GDP	0.8	3.6	1.8	1.9
Total debt/GDP	24.0	25.3	41.2	50.0
Total debt service/exports	17.9	24.2	14.2	11.6
Present value of debt/GDP	..	..	..	..
Present value of debt/exports	..	..	..	..

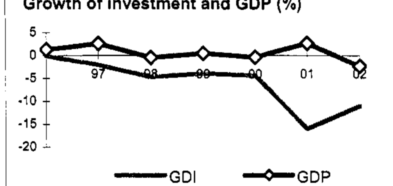
	1982-92	1992-02	2001	2002	2002-06
(average annual growth)					
GDP	3.3	1.5	2.7	-2.3	1.8
GDP per capita	0.2	-1.0	0.1	-4.8	-0.8
Exports of goods and services	12.7	-8.0	-0.4	0.1	6.0

Economic ratios*



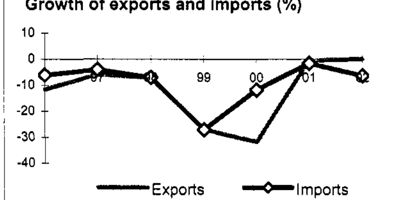
STRUCTURE of the ECONOMY	1982	1992	2001	2002
(% of GDP)				
Agriculture	25.9	24.5	29.0	29.4
Industry	26.0	25.9	18.7	18.2
Manufacturing	16.4	16.5	14.1	14.0
Services	48.1	49.6	52.3	52.4
Private consumption	74.9	81.1	79.6	76.8
General government consumption	7.1	6.5	9.6	9.6
Imports of goods and services	19.8	38.6	36.4	38.6

Growth of investment and GDP (%)



	1982-92	1992-02	2001	2002
(average annual growth)				
Agriculture	3.7	2.1	2.2	1.4
Industry	3.4	2.8	-9.8	-7.4
Manufacturing	0.7	0.8	-6.0	-0.7
Services	3.1	0.5	-0.6	0.2
Private consumption	3.4	2.4	7.8	-4.1
General government consumption	6.3	3.3	-11.0	-4.4
Gross domestic investment	3.8	-2.5	-16.0	-11.0
Imports of goods and services	12.3	-4.1	-1.6	-6.3

Growth of exports and imports (%)

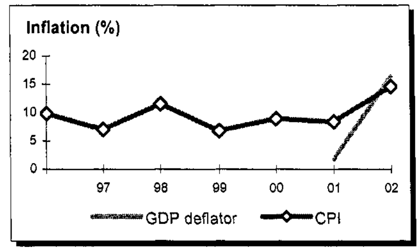


Note: 2002 data are preliminary estimates.

* The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.

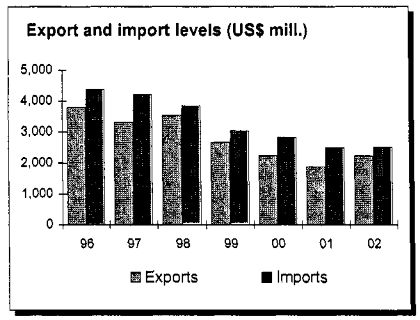
PRICES and GOVERNMENT FINANCE

	1982	1992	2001	2002
Domestic prices				
(% change)				
Consumer prices	..	15.1	8.4	14.6
Implicit GDP deflator	5.1	14.7	1.7	16.4
Government finance				
(% of GDP, includes current grants)				
Current revenue	..	13.4	17.2	15.8
Current budget balance	..	2.1	1.6	0.9
Overall surplus/deficit	..	-0.6	-1.1	-3.1



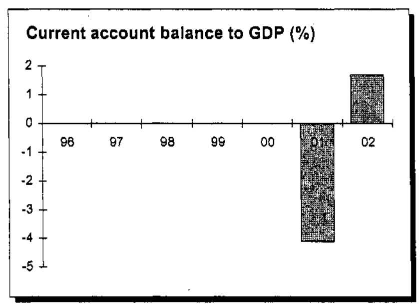
TRADE

	1982	1992	2001	2002
(US$ millions)				
Total exports (fob)	..	2,118	1,883	2,241
Soy products	..	137	356	285
Cotton	..	209	84	78
Manufactures	..	1,461	1,210	1,374
Total imports (cif)	..	1,988	2,499	2,515
Food	..	751	1,032	877
Fuel and energy	..	145	181	154
Capital goods	..	404	491	418
Export price index *(1995=100)*	..	..	..	..
Import price index *(1995=100)*	..	..	..	..
Terms of trade *(1995=100)*	..	..	..	..



BALANCE of PAYMENTS

	1982	1992	2001	2002
(US$ millions)				
Exports of goods and services	670	2,362	1,876	1,878
Imports of goods and services	1,209	2,453	2,495	2,159
Resource balance	-539	-91	-619	-281
Net income	32	-28	175	95
Net current transfers	2	62	166	280
Current account balance	-506	-57	-278	92
Financing items (net)	382	-303	327	-12
Changes in net reserves	124	360	-49	-82
Memo:				
Reserves including gold *(US$ millions)*	..	614	723	641
Conversion rate *(DEC, local/US$)*	136.0	1,500.0	4,105.9	5,715.9



EXTERNAL DEBT and RESOURCE FLOWS

	1982	1992	2001	2002
(US$ millions)				
Total debt outstanding and disbursed	1,298	1,633	2,820	2,706
IBRD	147	213	205	216
IDA	47	39	27	25
Total debt service	142	626	266	218
IBRD	16	62	25	26
IDA	1	1	2	2
Composition of net resource flows				
Official grants	8	43	..	..
Official creditors	91	-84	1	-7
Private creditors	152	-168	-29	-30
Foreign direct investment	37	118	82	-8
Portfolio equity	0	0	0	-30
World Bank program				
Commitments	0	52	0	9
Disbursements	44	10	27	14
Principal repayments	6	43	15	17
Net flows	37	-33	12	-3
Interest payments	10	21	11	11
Net transfers	27	-54	0	-14