Document of
The World Bank

Report No: ICR0000525

IMPLEMENTATION COMPLETION AND RESULTS REPORT
(Loan No. 7288-PA)

ON A

LOAN

IN THE AMOUNT OF US$ 15.0 MILLION

TO THE

REPUBLIC OF PARAGUAY

FOR A

FIRST PROGRAMMATIC FINANCIAL SECTOR ADJUSTMENT LOAN

June 28, 2007

Finance and Private Sector Development
Argentine, Chile, Paraguay, Uruguay Country Department
Latin America and the Caribbean Region

CURRENCY EQUIVALENTS

Exchange Rate Effective December 31, 2006

Currency Unit = Guarani
US$ 1.00 = Guaranies 5,170
Guaranies 1.00 = US$ 0.00019

FISCAL YEAR
January 1 – December 31

ABBREVIATIONS AND ACRONYMS

AFD	Agencia Financiera para el Desarrollo / Second Tier Development Finance Agency
AML	Anti-Money Laundering (Law)
BCP	Banco Central del Paraguay / Central Bank of Paraguay
BNF	Banco Nacional de Fomento / First tier National Development Bank
ESW	Economic & Sector Work
FSAL	Financial Sector Adjustment Loan
FGD	Fondo de Garantia de Depositos / Deposit Insurance Fund
FTAP	Financial Sector Technical Assistance Loan
ICR	Implementation Completion Report
IMF	International Monetary Fund
IDB	Inter-American Development Bank
INCOOP	Instituto Nacional de Cooperativas / National Institute of Cooperatives
ISR	Implementation Status Report
MOF	Ministry of Finance
PD	Program Document
PFSAL	Programmatic Financial Sector Adjustment Loan
SB	Superintendency of Financial Institutions
SEPRELAD	Secretaria Para la Prevención del Lavado de Dinero/ Anti-Money Laundering Agency

Vice President:	Pamela Cox
Country Director:	Axel van Trotsenburg
Sector Manager:	Lily L. Chu
Project Team Leader:	Eduardo Urdapilleta
ICR Team Leader:	Eduardo Urdapilleta

PARAGUAY

Programmatic Financial Sector Adjustment Loan I

Contents

A. Basic Information

Country:	Paraguay	Program Name:	Programmatic Financial Sector Adjustment Loan I
Program ID:	P039994	L/C/TF Number(s):	IBRD-72880
ICR Date:	06/28/2007	ICR Type:	Core ICR
Lending Instrument:	SAL	Borrower:	REPUBLIC OF PARAGUAY
Original Total Commitment:	USD 15.0M	Disbursed Amount:	USD 15.0M

Implementing Agencies:
Ministry of Finance
Banco Central del Paraguay

Cofinanciers and Other External Partners:

B. Key Dates

Process	Date	Process	Original Date	Revised / Actual Date(s)
Concept Review:	04/23/2002	Effectiveness:	11/21/2006	11/21/2006
Appraisal:	04/26/2004	Restructuring(s):		
Approval:	04/05/2005	Mid-term Review:		
		Closing:	09/30/2006	12/31/2006

C. Ratings Summary

C.1 Performance Rating by ICR

Outcomes:	Moderately Unsatisfactory
Risk to Development Outcome:	Substantial
Bank Performance:	Moderately Satisfactory
Borrower Performance:	Moderately Unsatisfactory

C.2 Detailed Ratings of Bank and Borrower Performance (by ICR)

Bank	Ratings	Borrower	Ratings
Quality at Entry:	Moderately Satisfactory	Government:	Moderately Unsatisfactory
Quality of Supervision:	Satisfactory	Implementing Agency/Agencies:	Moderately Unsatisfactory
Overall Bank Performance:	Moderately Satisfactory	**Overall Borrower Performance:**	Moderately Unsatisfactory

C.3 Quality at Entry and Implementation Performance Indicators			
Implementation Performance	**Indicators**	**QAG Assessments (if any)**	**Rating:**
Potential Problem Program at any time (Yes/No):	Yes	Quality at Entry (QEA):	None
Problem Program at any time (Yes/No):	Yes	Quality of Supervision (QSA):	None
DO rating before Closing/Inactive status:	Satisfactory		

D. Sector and Theme Codes

	Original	Actual
Sector Code (as % of total Bank financing)		
Banking	53	53
Central government administration	13	13
General finance sector	28	28
Law and justice	6	6
Theme Code (Primary/Secondary)		
Debt management and fiscal sustainability	Secondary	Secondary
Legal institutions for a market economy	Primary	Primary
Regulation and competition policy	Primary	Primary
Standards and financial reporting	Primary	Primary
State enterprise/bank restructuring and privatization	Primary	Primary

E. Bank Staff

Positions	At ICR	At Approval
Vice President:	Pamela Cox	Pamela Cox
Country Director:	Axel van Trotsenburg	Axel van Trotsenburg
Sector Manager:	Lily L. Chu	Susan G. Goldmark
Program Team Leader:	Eduardo Martin Urdapilleta	John Daniel Pollner
ICR Team Leader:	Eduardo Martin Urdapilleta	
ICR Primary Author:	Manuel Lasaga	
	Francis J. Earwaker	

F. Results Framework Analysis

Program Development Objectives (from Project Appraisal Document)
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 investment.

Revised Program Development Objectives (if any, as approved by original approving authority)

(a) PDO Indicator(s)

Indicator	Baseline Value	Original Target Values (from approval documents)	Formally Revised Target Values	Actual Value Achieved at Completion or Target Years
Indicator 1 :	Bank solvency ratios since end-2002 have doubled and non performing loans have declined by 25%.			
Value (quantitative or Qualitative)	Capital/NPL 1.10 NPL ratio 19.7 CAR ratio 17.9	Capital/NPL NPL ratio CAR ratio		Capital/NPL 5.79 NPL ratio 5.0 CAR ratio 22.9
Date achieved	12/31/2002	12/31/2005		09/30/2006
Comments (incl. % achievement)	No specific original target values, but improvement of indicators has been impressive. Non performing loans decreased 4 times, and capitalization increased accordingly.			

(b) Intermediate Outcome Indicator(s)

Indicator	Baseline Value	Original Target Values (from approval documents)	Formally Revised Target Values	Actual Value Achieved at Completion or Target Years
Indicator 1 :	Loan loss provisions (reserves) in the banking sector as a whole, have increased by 20%, excluding reserves against real estate collateral.			
Value (quantitative or Qualitative)	LLP 54.78% NPL ratio 19.7	LLP NPL ratio		LLP 84.66 % NPL ratio 5.0
Date achieved	12/31/2002	12/31/2005		09/30/2006
Comments (incl. % achievement)	No specific original target values, but improvement of indicators has been impressive. Loan loss provisions increased by 30 percentage points and Non performing loans decreased 4 times.			

G. Ratings of Program Performance in ISRs

No.	Date ISR Archived	DO	IP	Actual Disbursements (USD millions)
1	04/18/2005	Satisfactory	Satisfactory	0.00
2	11/21/2005	Satisfactory	Satisfactory	0.00
3	06/01/2006	Satisfactory	Unsatisfactory	0.00
4	11/01/2006	Satisfactory	Unsatisfactory	0.00
5	12/13/2006	Satisfactory	Satisfactory	15.00

H. Restructuring (if any)

Not Applicable

1. Program Context, Development Objectives and Design:

1.1 Context at Appraisal:

1. This operation was originally conceived as a two-tranche financial sector adjustment loan (FSAL) in an amount of US$60 million to support a phased program of financial sector reforms. A program document was distributed to the Board of Executive Directors in August 2004 but subsequently withdrawn at the request of the Government to allow time for the Government to submit a new banking law to Congress. A draft banking law, satisfactory to the Bank, was submitted to Congress in December 2004. However, Board presentation of the FSAL was also conditioned on progress with other financial sector reforms which did not proceed as smoothly as expected. To better manage perceived increased risks to the program, the Bank and the Government agreed to a risk mitigation strategy whereby Bank support would be based on a programmatic approach for Paraguay's financial sector reform. Under this approach, a sequence of three single-tranche programmatic financial sector loans was envisaged. They were to be presented to the Board in line with measurable progress in the reform program.

The programmatic financial sector adjustment loan (PFSAL I) in an amount of US$15 million was approved by the Board in April 2005. As the first loan of the sequence it provided up-front support for prior reforms. Under the programmatic approach there was to be a back-loading of Bank support to reflect the perceived increased risks. The Government encountered a long delay in getting Congress to approve the loan, and loan effectiveness had to be extended beyond the 18 month deadline. By the time the loan became effective and disbursed in November it was apparent that, despite the implementation of initial prior actions, the overall financial sector reform program was progressing at a slower pace than expected. With the further postponement of additional reforms in January 2007, the Bank decided not to proceed with further programmatic lending while remaining open to resume support for financial sector reform at a future date if warranted by country circumstances.

This ICR reviews the status of financial sector reform in Paraguay as supported by PFSAL I and as envisaged under the broader program that was to receive programmatic support from the Bank.

Background

2. After a hiatus in Bank lending to Paraguay between 1984 and 1992, a total of nine loans were approved during 1992 and 1997. The Bank then formalized a strategy of re-engagement in the CAS of April 1997. As part of the new strategic direction the Bank initiated a policy dialogue with the Government in 1998 on banking reform including discussions on potential Bank support involving technical assistance and policy lending. The Bank subsequently issued a Financial Sector Review in November 2002 The report addressed the following areas: condition of the financial system and vulnerabilities; reform of the State-owned banks; assessment of banking regulations and supervision; deposit insurance and bank resolution procedures and pension system reform.[1]

3. Following several years of economic stagnation and decline, a new Paraguayan administration came to power in August 2003 enjoying substantial political support. Economic performance improved during 2003-2004. This positive recovery came on the heels of a major economic crisis in 2002 induced, in part by a failure to undertake needed policy reforms. The economy had also been battered by adverse developments in its main trading partners, namely the Brazilian devaluation of 1999 and the recession and financial turmoil in Argentina during 2001-2002.

4. The Paraguayan banking system had been in a vulnerable state for a number of years. Major banking crises in 1995 and in 1997-1998 had led to the closure of a number of domestic banks, the reduction of credit to

[1] Paraguay: Financial Sector Review, November 15, 2002, Report No. 24249.

the private sector, and a sharp drop in private investment.[2] During 1995-2004, 21 banks and more than 30 finance companies were dissolved. The orderly resolution of problem banks thus became one of the priority areas in the Bank's support strategy.

5. The Bank's financial sector diagnostic report was very helpful in renewing discussions with the Government on a Financial Sector Adjustment Loan (FSAL). The principal components of the proposed operation included a new Banking Law, a new State-owned Banks Law, and reform of the Organic Law of the Central Bank (BCP) and the Superintendency of Financial Institutions (SB) to harness their autonomy, along with the need for technical assistance resources to support the Government's reform process. A preparation mission in October 2003 further defined the scope of the FSAL which was to consist of two tranches. The first tranche was to be triggered based on the following conditions: i) a new Bank Resolution / Deposit Insurance Law; ii) BCP approval of a new Resolution 8 strengthening the standards on risk asset classification and loss provisioning; iii) presentation to Congress of a State-owned Banks and an Anti-money Laundering Laws; and iv) BCP approval of a strategic plan for SB. The second tranche was to be conditioned on the approval and implementation of the laws supported by the first tranche as well as passage of a revised Banking Law, whereby presentation of a new Banking Law to Congress subsequently became a condition for first tranche release. The Government received a technical assistance PHRD grant from Japan in order to assist in the preparation of the financial sector reform program.

6. The original FSAL was distributed to the Board in August 2004, but was subsequently withdrawn at the Government's request to allow time for the Government to submit a proposed Banking Law to Congress. A draft Banking Law was then submitted to Congress on December 10, 2004, thus meeting the remaining condition for Board presentation. After evaluating the progress with financial sector reforms, the Bank and the Government agreed to shift from a single multi-tranche FSAL loan to a Programmatic approach thus providing for some flexibility in the structuring of future operations as well as the option of shortening the duration of the Program if reforms were not being effective. The Programmatic lending approach consisted of three single tranche loans, the first a Financial Sector Adjustment Loan for US$ 15 million, to be followed by two Financial Sector Development Policy loans for US$15 million and US$30 million respectively.

7. The PFSAL I was approved by the Board on April 5, 2005, with an original effectiveness date of September 12, 2005. However, it took longer than expected for the Government to secure Congressional approval and the date of effectiveness was delayed to November 21, 2006. These delays were not specific to Bank operations; other non-World Bank operations were rejected or had been similarly stalled for many months as well. Notwithstanding the delay in obtaining approval from Congress, there was no indication of reversals on the financial sector reform program supported by the FPSAL I. This was confirmed by a due diligence performed by the Bank, including a letter by the Government ratifying their commitment. The Bank also concluded that the operation's objectives continued to be achievable, albeit over a longer period than initially envisaged. However, other reforms that were to be supported by the follow-up programmatic operation were progressing more slowly than expected. In January 2007, the BCP postponed implementation of some aspects of Resolution 8, which called for new asset risk classification standards to be phased in. That, and other delays in the reform agenda, led the Bank to suspend preparation of the second operation of the Program.

8. The Bank closely coordinated the design of the Program with both the IMF and the IDB. At that time, the IMF had in place a Stand-By program which included structural benchmarks for financial sector reforms. The IDB postponed its original financial sector adjustment program to pursue a more targeted program to support the consolidation of the state-owned banks into a single second tier institution, which was part of the state-owned bank reforms. The IDB program also supported separate but complementary issues such as improving the supervision and institutional framework for the cooperatives sector.

[2] In this report the terms banking system and financial intermediaries are used interchangeably to refer to those entities that fall under the supervision of the Superintendency of Banks: banks, finance companies, foreign exchange (FX) houses, and custodians. The term financial system is used to refer to the banking system plus cooperatives but excluding insurance companies.

9. In order to strengthen the Government's institutional capacity to implement financial sector reforms, the Bank prepared a parallel Financial Sector Technical Assistance Project (FTAP) which received Board approval together with PFSAL I. The FTAP was to support many of the second-phase PFSAL policy actions such as providing training to SB for development of regulations concerning bank resolution; to monitor progress made by banks in complying with new regulations; upgrade prudential norms; and improve the quality of on-site supervision by SB. It also included a component to modernize its payments and settlement systems. The BCP was to be the implementing agency for the FTAP but a change of management at the BCP led to a change of priorities and the loan was withdrawn at the request of the Paraguayan authorities in June 2006. An IDB technical assistance project was to provide support to the Government in the restructuring of the state-owned banks.

10. At the time of loan approval the financial sector was vulnerable after several episodes of financial crises. Financial intermediaries, as defined by the BCP, comprised banks and finance companies, both under the supervision of the SB. Credit Cooperatives, although important (representing 25 percent of financial assets), were not formally classified as financial intermediaries. As of January 31, 2005, the Paraguayan banks accounted for about 90 percent of total assets of financial intermediaries (about 70 percent if cooperatives were included). Of 14 existing banks, 10 were branches of foreign banks or foreign-owned banks representing 74 percent of banking assets, three were locally-owned banks, representing 15 percent of assets and one was a state-owned bank (BNF), with 10 percent of banking assets. The banking system had an aggregate non-performing loan ratio of 11 percent of total loans. There were also 14 finance companies with a non-performing loan ratio of 7 percent. However, the loan classification standards were not considered compatible with international practices at that time thus underestimating the true extent of loan quality problems, an area that was to be addressed by the financial sector reforms.

Table 1: Paraguay- Selected Macroeconomic and Financial Sector Indicators

	2001	2002	2003	2004	2005	2006
GDP and prices						
Real GDP growth (% p.a.)	2.1	-2.3	3.8	4.1	2.9	4.0
CPI inflation (period average)	7.3	10.5	14.2	4.3	6.8	9.6
Nominal 90-day deposit rate (% p.a.)	16.22	22.86	15.83	5.11	1.66	6.72
External sector						
Trade balance (% of GDP)	-9.5	-5.5	-4.9	-3.5	-6.6	-8.9*
Current account balance (% of GDP)	-4.1	1.8	2.3	2.0	-0.3	-1.5
Exchange rate G./US$ (period average)	4,107	5,716	6,424	5,975	6,178	5,635
Gross international reserves (months of imports)	2.8	2.7	4.0	3.9	3.6	4.1
Public Sector Deficit						
Overall public sector balance – (% of GDP)	-3.3	-2.5	-0.3	2.0	-0.5	0.0*
Source: Banco Central de Paraguay (BCP), and IMF * Preliminary data						

1.2 Original Program Development Objectives (PDO) and Key Indicators (as approved):

11. As per the PD, the objective of the Financial Sector Reform Program was 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 investment.

12. The objective of the first loan (PFSAL I) was to strengthen the Government's capacity to manage weaknesses and stress 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.

1.3 Revised PDO and Key Indicators, and reasons/justification:

No changes were made.

1.4 Original Policy Areas Supported by the Program (as approved):

13. In order to achieve its objectives, the Program was organized into three areas: i) modernization of the bank resolution and deposit insurance system; ii) banking legal, regulatory and institutional framework; and iii) restructuring and consolidation of state-owned banks.

I Modernization of the Bank Restructuring and Deposit Insurance System

14. Previous banking system crises invoked ad-hoc responses by regulators who lacked a legal framework and financial resources to be more proactive in terms of supervisory actions. This program component was aimed at strengthening the effectiveness of problem bank restructuring. The Government established a Deposit Insurance Agency (FGD) within BCP to implement the regulations and operating procedures of the new deposit insurance system and support bank restructuring under Law 2334/03. As part of the restructuring of problem banks new exit procedures were designed for banks which are deemed insolvent. A number of prudential preventive actions and strengthened supervision efforts were also established.

15. As part of the reform of the deposit insurance system, the Government was to provide back-stop financial support during the initial period needed to build up to the fund's minimum reserve coverage with respect to insured deposits – estimated at 15 years. For this purpose, the Government was to co-fund any shortfalls arising from deposit insurance liabilities not covered by reserve funds either because the Fund has not attained the minimum reserve coverage or because the amount of losses associated with bank defaults were to exceed the Fund's capacity.

16. The Government was committed to modernize procedures for removing weak banks from the system, using market mechanisms and risk sharing with the rest of the financial industry. These procedures were approved under Law 2334/03 developed with the assistance of the Bank and approved under the prior Economic Recovery Loan. Implementation of the law required the design of highly detailed regulations specifying the operational procedures for implementing bank restructuring including methodologies for the valuation of matching liabilities and assets to identify and separate viable portions of balance sheets, methodologies for securitizing loans, and rules for proceeding with restructuring. Another important element was to introduce early corrective actions as part of the supervision process so that preventive measures could be taken before banks become insolvent.

17. As specified in the Policy Matrix, PFSAL I focused on the development of specific criteria for subjecting weak financial institutions to corrective actions to improve their financial performance, and to clean up certain trouble spots in bank operating practices. The second operation was to expand the implementation of this component through additional regulations dealing with resolution procedures to minimize the use of deposit insurance funds; to transfer matching assets and liabilities to financially sound banks; and to securitize such assets to facilitate their sale to other banks. Implementation of these practices was to be highlighted in the third operation.

II The Legal, Regulatory and Institutional Framework for Banking

18. In order to strengthen the banking sector's prudential regulations in line with best practices, this component supported Government reforms of the banking laws and key regulations. The principal interventions identified in this component were: a new Banking Law; new regulations governing classification of risk assets

and provision for loan losses; a new Anti-Money Laundering (AML) Law; and development and implementation of a new Strategic Plan for SB.

New Banking Law:

19. Drawing on the Bank's ESW, agreement was reached with the Government on the preparation, passage, and implementation of a comprehensive banking law drawing on international best practices including some of the concepts of Basle I and II. The list of changes to the existing Banking Law included the following: including cooperatives as a financial intermediary governed by the Banking Law; strengthening fit and proper rules; raising capital adequacy standards including limits on the revaluation of reserves as part of the capital account; defining coverage of financial groups and introducing rules on supervision on a consolidated basis; requiring authorization for significant transactions of banking shares and transfers of the loan portfolio; stipulating clear responsibilities for bank managers and board members regarding risk management, internal controls and use of external auditors; identifying financial transactions between related parties; establishing a more comprehensive schedule of penalties and fines for breach of regulations; establishing grounds for the withdrawal of banking licenses; and the composition of boards of directors.

Amendments to the Organic Law of BCP:

20. In order to enhance the effectiveness of BCP and SB as regulators of the financial system, BP's Organic Law would be amended to confer greater autonomy to both BCP and SB. The staggering of BCP Board appointments was to be one of the key changes to the existing Organic Law in order to minimize political interference.

New Regulations on the Risk Classification Assets and Provisioning for Losses:

21. The banking system reforms addressed the need to strengthen the banks' financial position by upgrading the standards governing asset quality. Building on existing regulations established by BCP Resolution 8, this sub-component contained key elements necessary to raise the standards for the evaluation of asset risks. The recommended changes included reducing the arrears period for each risk category; increasing the percentage of provisions for each category; limiting the use of collateral in the calculation of provisions; stricter rules on the reclassification of loans; classification of borrowers who are part of an economic group on a consolidated basis; and more stringent documentation requirements for all borrowers.

Reform of the Anti-Money Laundering Framework:

22. In response to the Government's anti-corruption drive, to global initiatives for combating money laundering and terrorist financing, and potential linkages between the informal economy along the borders and illegal money-laundering through the financial system, the Program supported legislative and regulatory initiatives to reinforce the anti-money laundering framework. Passage of a new AML Law and centralization of oversight within the Government were key elements of the strategy with financial intermediaries assuming greater responsibilities for the reporting of suspicious activities and collaborating with the authorities.

SB's Strategic Plan:

23. As part of the reform effort, the Government considered it essential that SB prepare and implement a Strategic Plan within the timeline of this Program. The Plan was to focus on the development of a risk-based approach to banking supervision. The Plan would address the following policy areas: i) development of a risk rating methodology for banks; ii) assessment of banks' compliance with the new rules for classifying asset risk; iii) the design of procedures for bank restructuring; and iv) implementation of an ongoing consultations with the banking industry in order to create more effective mechanisms for dealing with problem banks.

24. The sequencing of Government actions under the legal and regulatory reform component was specified in the Policy Matrix. For PFSAL I the Government was to present the draft of the new Banking and the AML Laws to Congress for approval; BCP was to have issued the new version of Resolution 8 outlining the criteria for the classification of asset risk and provisioning for losses; and SB's Strategic Plan would have been approved by the BCP Board. For the second operation both the Banking and AML laws would have been approved and made

effective along with the necessary regulations to govern their implementation; banks would have submitted contingency plans for compliance with Resolution 8; and SB would be on track with the implementation of its Strategic Plan. In addition, the amendments to the Organic Law of BCP would have been presented to Congress. For the third operation, the actions identified at the time of Program design consisted in continuing to implement the reforms adopted in the earlier operations and to begin implementation of the reforms of the Organic Law of BCP.

III Restructuring and Consolidation of State-owned Banks

25. The third component of the Program was to address reforms of state-owned banks through a restructuring of existing institutions with the goal of reducing the presence of the state in the financial sector. Historically, these financial institutions had generated substantial losses due to poor asset quality and operational inefficiencies. Due to the large size of the National Development Bank (BNF) – around 10 percent of total banking system assets, a priority step was to restructure BNF in order prevent any further financial deterioration which could disrupt the financial sector. Subsequently the Government was to focus on a two pronged strategy of downsizing and consolidation. First, the creation of a second-tier development finance bank from the merger of the existing institutions: UTEP, FDI, FDC, and CONAVI/BANAVI. This new second-tier bank would specialize in the rediscounting of medium and long-term investment loans to banks and finance companies on market compatible terms. Second, the creation of a first tier bank from the merger of existing first tier institutions: BNF, CAH, and FG. The new first-tier bank would operate as a credit and payments institution focusing on financing of micro- and small scale enterprises, primarily in the agricultural sector, and any other areas where access to the private sector banks and finance companies is limited. The restructuring of the state-owned banking sector was expected to cost of US$54 million, of which, US$ 7 million represented severance payments to reduce the workforce. All of these activities were expected to be completed as conditionality for the third operation of the Program.

Key Performance Indicators by Policy Area and Expected Outcomes for the Program

Performance Indicators	Target Indicators / Expected Outcomes	Accomplishment of Expected Outcomes
I. Modernization of the Bank Resructuring and Deposit Insurance System		
Orderly downsizing and consolidation of the banking system	15% reduction in number of financial institutions by 2006; Number of banks was expected to decline from 14 in 2004 to 13 by 2006; Number of finance companies was expected to decline from 20 in 2004 to 14 in 2006	Number of banks declined to 13 in 2006, and number of finance companies declined to 14 in 2006, as expected.
Deposit Insurance Fund collecting premiums on regular basis	Balance of Fund growing in proportion to total deposits.	FGD has been collecting premiums on a regular basis as expected. The fund currently has US$23 million
Preventive actions result in sharp reduction in emergency restructuring	SB to undertake much fewer restructuring operations on an emergency basis.	New resolution plan successfully applied. One case with assets and liabilities correctly resolved.
II. Legal, Regulatory and Institutional Framework of Banking		
Capital norms brought up to standards established by Basle guidelines.	Measurable increase in banking system capital by 2006	Banking capital increased by 40% in the period 2004-2006.
Bank credit to private sector for productive uses increases.	Banking system credit as percent of GDP increases(1)	Total banking system credit has decreased with respect to GDP, as a consequence of the stabilization program
SB adopts early warning indicators and corrective actions.	Documentation of early warning indicators and number of corrective actions initiated.	Not documented.
BCP Board appointments based on a staggered system which eliminates political partiality in Board	Staggered terms of office for the Board of Directors, resulting in greater autonomy of BCP.	Not implemented.

appointments.		
III. Restructuring and Consolidation of State Owned Banks		
Consolidation of state-owned banks.	From 7 to 2 specialized state-owned banks, a first- and a second-tier bank.	State banks consolidated into 2 institutions as expected.
Increased lending by state-owned banks to small & micro-scale borrowers focusing on the rural sector	80% of lending to small & micro scale borrowers by 2005	N/A (2)
State-owned banks verify adequate capital in accordance to standards of new Banking Law	Provision for loan losses in line with Resolution 8 requirements and banks adequately capitalized	Banks adequately capitalized with a CAR of 23%, but Resolution 8 requirements not fully implemented.
(1) Credit by end-use is not available. (2) Credit on lending by firm size is not available. Source: Policy Matrix, Program Document		

1.5 Revised Policy Areas (if applicable):

No changes were made.

1.6 Other significant changes:

26. Implementation of the Program was also undermined by certain design features which basically contributed to an impasse in terms of the types of reforms that the Government could at this juncture realistically achieve. While the triggers for PFSAL I were met, some conditions involved the submission of laws to Congress. The approval and subsequent implementation of these laws were to be prior conditions for the second operation in the Program, but political obstacles unrelated to the laws themselves made their passage as originally drafted unfeasible. In January 2007, the BCP delayed in part the implementation of Resolution 8. Presidential and Congressional elections slated for April 2008 compounded uncertainty with respect to the program.[3] The Bank made the decision not to continue with the Program but to reassess its support of Government reforms in the financial sector at a time when conditions become more favorable.

2. Key Factors Affecting Implementation and Outcomes

2.1 Program Performance:

27. Despite the long delays between Board-approval of PFSAL I in April 2005 and loan effectiveness in November 2006, the Government remained in compliance with with reforms supported by the loan throughout that period. Advancement was also noted in other areas to be supported by the second and third operations, but progress in those areas was not sufficient to justify moving forward with the Program.

[3] Based on the ICR Guidelines last updated on February 9, 2007, a programmatic series is considered to have lapsed if no subsequent operation is presented to the Board 24 months after the Board approval of the previous operation in the series, in the case of PFSAL I it was March 2005.

First Operation PFSAL I	
Prior actions from Legal Agreement	**Status**
I. Modernization of the Bank Restructuring and Deposit Insurance System	
1. Board of Directors of BCP has issued Resolution 6 establishing specific technical criteria for troubled financial institutions in Paraguay to improve their financial condition.	**Met** March 15, 2004 (BCP Board Minutes)
2. Board of BCP has issued Resolution 31 prohibiting all financial institutions from pledging their assets as security for deposits held by individuals and/or legal entities in the same institution.	**Met** March 18, 2004 (BCP Board Minutes)
3. a) The Government through MOF and the association of banks in Paraguay have agreed to renegotiate public bonds through an exchange of New Bonds for Old Bonds; and b) Congress has approved the law which authorizes MOF to issue the New Bonds and exchange them for the Old Bonds as per the letter of intent with the banks.	**Met** November 6, 2003 (Signed agreement between banks and MOF)
II. Bank Legal and Regulatory Framework	
4. Board of Directors of BCP has issued Resolution 8 which establishes norms concerning: a) asset classification; and b) the definition and recording of: (i) loan loss reserves; (ii) accrued interest payments; and (iii) refinancing operations, all resulting from loans to individuals and businesses.	**Met** November 27, 2003 (BCP Board Minutes)
5. Submission to Congress of the Banking Draft Law	**Met** December 10, 2004 (Submitted to Congress)
6. Submission to Congress of the Anti-Money Laundering Draft Law	**Met** May 13, 2004 (Submitted to Congress)
7. SB's Strategic Plan has been approved by the Board of Directors of BCP.	**Met** April 29, 2004 (BCP Board Minutes)
Second Operation[(1)]	
Prior actions from Program Document	**Status**
I. Modernization of the Bank Restructuring and Deposit Insurance System	
Board of Directors of BCP has issued regulations to govern the implementation of the Bank Restructuring and Deposit Insurance Law, including: (a) restructuring procedures; (b) transfer of assets / liabilities; and (c) provisions for securitization of assets.	Regulations have been issued and were successfully implemented in case of *Financentro*, as expected [(1)]
Board of Directors of BCP has issued regulations to govern the Deposit Insurance Fund.	Fund operating effectively, reserves reached US$23 million [(1)]
II. Bank Legal and Regulatory Framework	
Banks have submitted contingency plans for compliance with Resolution 8 (First Operation)	Banks have submitted contingency plans as expected. Implementation of other measures pending until August 2008[(1)]
New Banking Law (First Operation) is in effect and Board of Directors of BCP has issued regulations for its implementation.	No action by Congress, but Government now considering a simplified version based on the FSAP recommendations[(1)]
The Anti-money Laundering Law (First Operation) is in effect.	Passage of Law pending, AML agency needs more resources[(1)]
Key actions under the SB's Strategic Plan (First Operation) have	

been carried out including: (a) completion of risk evaluation of banks; (b) focused examinations of at least 20% of all banks; and (c) actions to address bank weaknesses or failures.	Plan partially implemented[(1)]
Reform of the Organic Law of BCP to ensure the autonomy and independence of BCP and SB. Stagger the terms of Board of Directors in order to de-politicize the appointment of new Directors	BCP struggling with governance issues – Board has not had a quorum since mid-2006. Newly designated President beginning to resolve governance problems [(1)]
III. Restructuring & Consolidation of State-owned Banks	
Adoption of a comprehensive regulatory framework for cooperatives	Initial steps taken but sector lacks autonomous regulatory agency[(1)]
Third Operation[(1)]	**Status**
Prior actions from Program Document	
I. Modernization of the Bank Restructuring and Deposit Insurance System	
Evidence that banks have been restructured as determined by new regulations.	Successfully implemented, as in the case of *Financentro*[(1)]
Evidence that the Deposit Insurance Fund is operating according to the legal framework	Operating and funded according to expectations[(1)]
II. Bank Legal and Regulatory Framework	
Actions taken in accordance with SB's Strategic Plan evidencing improved supervisory programs, effective restructuring of problem banks, and appropriate sanctions for non-compliance with existing regulations.	Partially implemented [(1)]
Reform of the Organic Law of BCP (Second Operation) implemented through appropriate regulations.	Pending[(1)]
Application of AML and counter-terrorism financing guidelines applied to other non-bank financial intermediaries such as insurance and securities firms.	SB to supervise banking system and SEPRELAD the rest of the financial system[(1)]
III. Restructuring & Consolidation of State-owned Banks	
Management and institutional reform of BNF has been undertaken and the bank is reorganized and streamlined.	First-tier bank law was not enacted but, based on new business plan, BNF has been restructured into a financially viable institution[(1)].
Legislation package for Restructuring of state financial institutions approved and implemented with the following characteristics: (A) a single first tier bank created through the merger of existing institutions; and (B) similarly, a single second tier bank.	Law 2640 created a second-tier bank, AFD, which is already operating as expected[(1)]
New prudential rules and operational directives including setting of interest rates on loans, lending limits, and risk exposure applicable to the two new state banks are in effect.	New rules in place, but BNF also lending to consumers[(1)]
Under the oversight of the State Bank Restructuring Commission the transfer of assets and liabilities from existing state owned banks to the new entities is underway.	Transfer underway, as expected[(1)].

Selected Program Implementation Accomplishments and Pending Issues

Deposit Insurance Fund (FGD) is collecting deposit insurance premiums

28. Since FGD was established in October 2004, the agency has been collecting insurance premiums on a regular basis. The insurance assessment rate is 0.48 percent per annum applied to total deposits and payable on a quarterly basis. The insurance fund currently has about US$23 million and is expected to reach the minimum reserve coverage in 15 years. BCP's Board has also issued regulations governing the Deposit Insurance Fund which was a condition for the second operation.

29. The government is committed to issuing US$50 million in the form of zero coupon non-negotiable 20 year bonds as a backup to the insurance fund. These bonds would be used by FGD as needed to obtain funds from BCP through REPO operations. The government has already approved US$20 million bonds for 2007, scheduled to be issued during the first half of the year.

Bank resolution practices successfully applied.

30. In 2005, following the specification of the technical criteria for managing problem banks as adopted by BCP, SB intervened in a finance company (*Financentro*). This case served as a proving ground for the development of policies and procedures in handling problem banks. Following an analysis of assets and liabilities, the "good" assets were sold. The bank which acquired these assets expressed a very positive view of their experience with the purchased accounts. The acquiring bank offered G13 billion for the assets backing G23 billion in deposits, and FGD contributed the difference of G9 billion in order to finalize the transaction. Based on its experience with *Financentro*, FGD staff upgraded their policies and procedures, established a data room for potential bidders and also improved coordination with bank examiners prior to intervention in order to pre-identify "good" assets for sale to other interested banks.

New Bank Law as originally submitted to Congress has not yet been approved. The Government may propose a limited number of amendments to the existing law based on recommendations made by a recent FSAP mission.

31. The new Banking Law was perhaps too ambitious in terms of the number of changes to the existing law and of the scope of new regulatory standards. The Government, through BCP, is considering simpler legislation to selectively amend the existing law to enhance financial sector stability. A recent FSAP report for Paraguay was very helpful in confirming many of the elements proposed in the original banking law recommendations and also provided useful input in the re-drafting of the proposed changes to the law. It is important to note that some changes in regulations can also be adopted through BCP Resolutions rather than going through changes to the existing law. However, the Board of BCP has not been able to assemble a quorum since mid-2006.

Resolution 8 was issued and partially implemented, but changes in provisioning and risk classification have been postponed.

32. The current favorable economic environment, and strong pickup in bank and finance company earnings, provide BCP with an opportunity to begin phasing in the new risk asset classification standards established by Resolution 8. Financial intermediaries have raised several substantive issues regarding the application of the new norms that could have been resolved without compromising its effectiveness. These concerns included the new documentation requirements from borrowers which were considered too cumbersome and unrealistic, the shortening to 30 days of the period for classifying a loan as non-performing, and treatment of agricultural credits when producers were faced with unfavorable climatic factors. In addition, finance companies considered that the new regulations would put them at a disadvantage relative to the cooperatives which are are not subject to the new asset quality standards. There were also some legitimate concerns by regulators that some financial intermediaries, particularly finance companies, may not be able to increase capital in tandem with the more stringent rules for loan loss provisions, so full implementation was delayed until August 2008. Nevertheless, SB has confirmed that banks have submitted contingency plans for compliance with Resolution 8 which was to be a trigger condition for the second operation.

Passage of Anti-Money Laundering Law pending but AML Agency is working with SB and financial intermediaries on enhanced "know-your-customer" procedures.

33. One of the challenges for a successful AML program in Paraguay is the large size of the informal economy and the growing importance of the largely unregulated cooperative sector. The government's Anti-Money Laundering agency (SEPRELAD) still lacks basic hardware and software needed to process information on financial transactions. The agency also has few trained investigators. One strategy being considered is for SB to act as supervisor for the banking system in matters relating to AML and for SEPRELAD to supervise the other financial intermediaries including the cooperatives. Nevertheless, an effective Anti-Money Laundering Law still hinges on legal reforms which have yet to be considered by Congress.

SB needs to improve the quality of supervisory staff and focus on implementing its Strategic Plan

34. With the upgrading of regulatory standards, SB faces new challenges in terms of adapting its regulatory culture to a risk-based approach. As SB officials have asserted, greater emphasis should be placed on improving the quality of supervisory staff through training and collaborative programs with examiners from other countries. Supervision should place greater emphasis on the risks associated with particular banking practices and the adoption of disciplinary measures should be consistent with the seriousness of the financial institution's non-compliance which should in turn result in more effective incentives for appropriate risk management policies by financial intermediaries.

35. The Strategic Plan supported by the PFSAL I has not been fully implemented due to lack of resources. With the absence of a governing Board at BCP it has not been possible to monitor the implementation of the Superintendency's Strategic Plan. In view of the amount of time that has elapsed since the current Plan was approved by the BCP Board, SB could consider preparation of a revised Strategic Plan.

First Tier banking through BNF: financial performance has improved.

36. BNF management developed a new Business Plan for 2006-2007 aimed at restructuring the bank into a financially viable institution. The initial challenge was to improve asset quality through more aggressive loan workouts. Significant progress was made in 2006, although the level of past-due loans remains a challenge. Credit quality improved by 20 percentage points and past-due loans as percent of total loans declined from 39.5 percent in 2005 to 19.4 percent in 2006. In terms of efficiency, there is still a need for reduction of staff, which is a politically charged issue. Overall, the actions taken by management are in line with the objectives that were pursued by the first-tier State-owned Banks Law proposal.

Second tier banking through AFD is off to a very good start

37. The newly-established second-tier development finance bank, AFD, has been well received by other banks with respect to the professionalism of its management team and lending practices. It appears to have contributed to renewed interest on the part of financial institutions in longer term lending. As an example of its innovative style, AFD has introduced a loan pricing formula to encourage intermediaries to fund variable-rate local currency loans. The key to sustainable sound growth of AFD is maintaining the professional quality of its managers. The accomplishment of this initiative was to be a trigger for the third operation.

2.1 Major Factors Affecting Implementation:

Program Design

38. The design of the Program was comprehensive but perhaps somewhat ambitious in view of the limited institutional capacity available for its full implementation. The Program conditionality relied on the presentation of extensive reforms to the Banking Law and other legislation. As it turned out, the political window of opportunity for reform legislation may have been shorter than originally anticipated.

39. On the other hand, the logical framework of the Program was well conceived:

- The establishment of a deposit insurance fund that would collect deposit insurance premiums to build up a reserve fund was expected to reduce future government liabilities from failed financial intermediaries.

- Supervisory practices that emphasize preventive actions aimed at weak financial intermediaries would result in fewer emergencies, thus lowering the possibility of runs on the banking system. By resulting in fewer bank interventions, these practices would also reduce future government liabilities.

- The passage of a new Banking Law and subsequent issuance of regulations to implement the Law was expected to result in an improvement in asset quality, sustainable earnings growth, and a strengthening of bank capital.

- Implementation of Resolution 8 was to result in more rigorous asset quality standards and increased provisions for loan losses. Better capital coverage and sound growth of financial institutions would lead to greater lending for productive uses.

- The AML Law was expected to strengthen the financial system by eliminating illegal financial activity and particularly contributing to a culture of "know-you-customer". That would also have the beneficial effect of enhancing bank relationships with their clients and enabling them to better understand their underlying banking needs.

- The restructuring and downsizing of the State-owned banks was to reduce the involvement of the State in the banking system and thus reduce future Government exposure to losses.

40. Although the program was well structured, the extent of the reforms may have exceeded the capacity on the ground, both politically and institutionally. The proposed new Banking Law embraced many changes; even when some intermediaries have felt that the existing Law was not in such a state of disrepair. Perhaps a less ambitious approach to the reform of the Banking Law, focusing as the Government is now planning on selected amendments, and putting greater emphasis on implementation of Resolution 8, would have been a more realistic strategy. The AML Law was a good initiative, but it also required reforms of the Civil and Penal Codes in order to establish its effectiveness. Dramatically downsizing BNF may not have been realistic given the bank's role in providing access to financial services by an underserved population and its role as the payment system in rural areas.

41. One of the institutional challenges to financial sector reforms has been the relatively large size of the informal economy in Paraguay. This is particularly evident in the dual nature of the financial system comprised of a regulated financial intermediation sector alongside the fast growing and considerably less regulated cooperative sector. The extension of the regulatory umbrella over the whole financial system still remains a major hurdle. With a more simplified design for the Program there might have been greater space to explore ways to upgrade the regulatory framework for cooperatives,.

Implementation Efficiency

42. One of the decisive factors for not continuing with the remaining operations of the Program has been the insufficient implementation capacity of key agencies and the lack of legislative response to the Government's proposed reforms. The complexity of the Program also affected implementation efficiency.

43. As stated in the PD, the principal risks to the reform program were the uncertainties of the national policy debate and weak institutional capacity. It was recognized that the reform of the banking system's regulatory framework and the restructuring of the state-owned banking sector was going to be a politically charged process. Anemic economic growth was also viewed as a potential threat to banking system reforms, but as it turned out, the economy has posted robust growth during the past couple of years thus contributing to enhanced financial sector performance. Other risks pertained to overall governance issues. On the other hand, the new Administration that took office in August 2003 seemed to have strong legitimacy and willingness to set the country on a different development path which at that time convinced the Bank that risks had diminished. Nevertheless, the Bank's risk

mitigation strategy which focused on a well disseminated public disclosure program and education campaign carried out by the Ministry of Finance probably fell short of what was needed to keep the Program on track.

44. The high quality of Program design from a technical point of view was offset by the shortcomings associated with weak institutional capacity. In the case of Resolution 8, enforcement was hampered by unrealistic documentation requirements that called for each borrower to present proof of tax payments to be issued by MOF. Other problems were caused by shortening the length of time for past-due loans for small consumer loans, and complicated formulas for adjusting the value of collateral. With respect to the AML Law, the financial intelligence unit (SEPRELAD) needed more resources such as hardware and software as well as the legal reforms necessary to facilitate prosecution of criminal acts.

Factors Outside the Control of Government

45. Opposition within Congress to the reform agenda compromised the ability of the Government to process key legislation. Congress took no action on the proposed new Banking Law submitted by the Government. Congress also introduced amendments to the proposed first tier State-owned Banks Law that were unacceptable to the Government and the law was vetoed. Nevertheless, the BNF has made considerable headway with restructuring under newly appointed management. `With presidential and congressional elections slated for April 2008, the political climate has become even more uncertain with most financial sector policy decisions likely to be delayed.

46. A favorable global economic environment has contributed to the strengthening of the economy. The fiscal accounts have improved thanks to the expansion in the economy as well as to the recent tax reform program. The expansion in exports have helped buttress the country's international liquidity thus stabilizing and even strengthening the currency. These positive developments may have dispelled the sense of urgency in implementing financial sector reforms and they have also noticeably reduced the country's financing requirements.

Factors Subject to Government Control

47. The macroeconomic policy framework was favorable for implementation of the Program, particularly the improved fiscal performance. The Government successfully completed a three year (2003-2005) Stand-By Arrangement with the IMF in November 2005, and in May 2006 the Fund approved a follow-up Stand-By for 2006-2008. A first review of the follow-up Stand-By was made by the Executive Directors of the IMF in September 2006, and subsequent reviews are still pending.

48. While the Government has been committed to the Program from the start, turnover of key ministers and other key government officials may have taken away from the momentum of the Program.

Factors Subject to Implementing Agency Control

49. BCP was a natural candidate for implementation of the financial sector reforms because of its role as principal regulator through SB and its management and technical capabilities. However, the Central Bank has been beset with problems of governance that have held up implementation of key reforms and compromised the effectiveness of banking supervision since most regulatory, administrative and supervisory actions need to be approved by the Board. A new President has been appointed in March 2007, who seems to be well oriented towards resolving these governance issues.

2.2 Monitoring and Evaluation (M&E) Design, Implementation and Utilization:

50. Program targets as specified in the PD were mostly expressed in terms of direction of change such as growth of the deposit insurance fund, measurable increase in banking system capital and a sharp reduction in SB

emergency restructuring. In some cases there were specific quantitative targets as in the case of a 15 percent reduction in the number of financial institutions and a consolidation of State-owned banks from seven to two. When existing information is insufficient to make specific quantitative projections, a target based on a direction of change is still helpful in evaluating outcomes.

51. Despite the abundance of information on financial intermediation, some reforms affecting institutional development are less tangible and thus more difficult to quantify. In the case of the new Banking and Anti-Money Laundering Laws, there are no specific generally-accepted indicators that measure compliance with laws and regulations and the degree to which banking supervision adheres to international best practices. Bank secrecy impedes access to information concerning banking supervision practices by individuals not affiliated with SB. Other information such as the development of early warning indicators by SB and lending to micro and small scale enterprises by state-owned banks was to be dependent on the second and third operations of the Program.

52. Monitoring of PFSAL I intermediate outcomes in the ISR reports focused on the capital – asset and the non-performing loans to total loans ratios of the banking system (all ISR ratings refer to the first operation under the Program). These indicators are widely used in the industry as primary guides of the stability of a financial system. While the absolute level of these indicators may be distorted by reporting practices, the change over time is usually a valid indicator of performance. The capital – asset ratio was also one of the key performance indicators identified in the PD.

2.3 Expected Next Phase/Follow-up Operation (if any):

53. The decision not to go ahead with the remaining two operations in the Program at the present juncture does not preclude Bank support for financial sector reform in the future. The Bank plans to maintain a policy dialogue with the current Government and will continue this process with the successor administration and thus be able to provide an effective response to future financial sector initiatives by the Government.

3 Assessment of Outcomes

3.1 Relevance of Objectives, Design and Implementation:

54. The objectives of the financial sector program supported by the Bank loans were consistent with the FY2004-2007 CAS objectives.[4] The Bank's country strategy was aimed at strengthening the Government's core economic reforms in the following areas: fundamental tax reform; rationalization of the government pension system; and financial sector reforms. One of the principal recommendations of the Poverty Assessment carried out in 2002 was that economic growth is the best overall strategy for reducing the number of poor, since the poor benefit most from increases in basic public services result from increased government spending which in turn is made possible by faster economic growth and the consequent increase in tax revenues.[5] The linkage between a healthy financial system and sustainable economic growth was underscored in the Bank's emphasis on fiscal and financial sector stabilization as the first pillar of its country assistance strategy. The current Government is strongly committed to financial sector reforms even though it has not been able to generate sufficient support in Congress for their full implementation.

[4] Paraguay: Country Assistance Strategy, Report No. 27341-PA, November 26, 2003.
[5] *Paraguay: Attacking Poverty*, Report No. 22703-PA, November 2002.

3.2 Achievement of Program Development Objectives:

55. During 2005-2006, the performance of financial intermediaries has improved significantly. This positive outcome can be attributed to a number of factors including the policies supported by PFSAL I as well as favorable economic developments in the country emanating from a good macroeconomic policy framework. Key policy actions such as the establishment of problem bank restructuring procedures by SB, the Deposit Insurance Fund (FGD) to protect depositors, the successful launch of the new second-tier bank (AFD), the restructuring of the first-tier public bank BNF (thereby reducing public institutions from seven to two focused ones) and partial implementation of SB's Strategic Plan have already been implemented. Others, principally Resolution 8, which has been partially delayed, and the new Banking and AML Laws which have yet to be passed, are expected to eventually contribute towards the Program objectives, possibly within the next one to two years. Although it may still be too soon to reach a definitive conclusion, it appears so far to be very positive. In addition to the actions taken under PFSAL I, the recent passage of the second-tier State-Owned Banks Law and the establishment of the AFD, renewed efforts to restructure BNF, and other reforms that were to be associated with the second and third operations bode well for results under what would have been the full implementation of the original Program.

56. The banking system has demonstrated improvement in a number of areas. Private sector banks have shown a moderate recovery in capitalization to 10.3 percent in 2006 up from 8.4 percent in 2003. This increase has been made possible by strong earnings growth resulting in an average ROE of 38.1 percent in 2006. As shown in the Table, the banking system experienced a dip in ROE during the problem years 2001-2002, but has since recovered strongly. It is particularly important to note that key financial indicators have improved markedly, there has been an encouraging reduction in past-due loans from 14.5 percent in 2002 to only 2.1 percent in 2006. Additionally, thanks to new information technologies and an increase in the volume of operations, banking efficiency indicators have also been improving.

57. BNF has possibly turned the corner in terms of moving towards profitability; however, its financial condition is still unsteady. After posting sizeable losses during 2002-2003, mostly as a result of bad loans, it has improved its asset quality. Additionally, its efficiency indicators have improved noticeably during 2005-2006.

58. Finance companies on the other hand have been lagging moderately behind the banks. Capitalization has been slipping since 2001 raising some concerns about their financial strength, despite a strong earnings performance during 2005-2006. Finance companies are more actively engaged in lending as seen by the loan to assets ratio of 71.3 percent compared to 52.8 percent for the banks. A few finance companies also exhibit significant weaknesses and should be monitored more closely.

59. One of the Program objectives of increasing financing to productive sectors has not yet materialized. In fact banking system loans to the private sector have fallen as a share of GDP from 25 percent in 2002 to 15 percent in 2006. This is likely to be a temporary trend reflecting a clean up of non-performing loans and the impact of stricter regulations affecting lending which may initially discourage banks from taking on commercial lending risks in preference to lower risk government securities. That is shown by the increase in the investments/assets ratio to 19.2 percent in 206, up from 4.2 percent in 2001. One of the policy actions supported by PFSAL I was the restructuring of Public Sector debt which enabled banks to improve the performance of their investment portfolio`. However, as economic growth continues and banks have been able to fully implement the new loan quality standards, financial intermediaries will likely assume a more proactive role in lending since it is one of the main drivers of banking profitability in the long term.

Table 2: Banking System: Selected Performance Indicators (percent)

	2001	2002	2003	2004	2005	2006
Capital / Assets						
Private sector banks	10.6	9.7	8.4	9.8	9.8	10.3
BNF	15.0	12.0	11.7	7.9	7.9	7.7
Finance Companies	21.0	19.2	18.6	16.8	16.7	16.7
Past-due Loans / Loans						
Private sector banks	12.1	14.5	15.0	6.0	3.2	2.1
BNF	46.6	56.2	56.2	47.6	39.5	19.4
Finance Companies	10.7	15.1	10.4	7.0	5.1	5.3
Return on Equity						
Private sector banks	24.13	14.91	9.57	21.84	29.52	38.10
BNF	1.98	-27.29	-18.74	6.72	5.33	5.74
Finance Companies	24.20	10.72	8.28	19.23	25.90	26.77
Efficiency						
Private sector banks	58.5	54.4	67.5	61.7	61.3	49.8
BNF	84.3	93.6	156.5	145.7	73.6	63.3
Finance Companies	59.0	62.4	72.7	65.9	63.7	60.8
Loans / Assets						
Private sector banks	64.7	58.4	49.6	52.9	54.5	52.8
BNF	57.3	58.8	49.6	34.8	31.4	27.5
Finance Companies	64.8	62.4	63.9	68.9	73.2	71.3
Loans (avg) / GDP						
Banks	22.9	22.4	15.1	12.4	12.3	12.4
Finance Companies	3.0	2.8	2.2	1.9	2.2	2.4
Total	25.9	25.2	17.3	14.3	14.5	14.9
Investments/Assets						
Private sector banks	4.2	7.6	11.9	14.0	15.5	19.2
BNF	0.0	0.2	0.6	2.4	28.7	30.4
Finance Companies	0.3	3.5	2.9	3.1	2.8	3.2

Note: Efficiency ratio is administrative expenses / operational margin.
Investments refer to bank investments in securities which consist primarily of government notes and bonds.
Source: Superintendency of Banks

As to the objective of reducing financial system vulnerability to future shocks, the following pending issues could have an adverse material effect on the final outcome:

Impact of Resolution 8 will only be known after examiners review bank portfolios

60. While both regulators and financial intermediaries consider their loan loss provisions to be in line with the new standards, this can only be completely ascertained once Resolution 8 becomes fully effective. Banks have already provided SB with contingency plans for implementing the new resolution; however, new provisioning requirements have not yet been implemented. The ability of SB to assess the quality of bank assets will in turn hinge on the experience of examiners in applying the new standards.

Table 3: Financial System Assets (billion G. & %)

	2001	2002	2003	2004	2005	2006
Total Assets	15,611	16,350	16,984	19,634	21,907	24,546
% growth		4.7	3.9	15.6	11.6	12.0
Percent of Total:						
Private sector banks	68.6	67.7	63.4	61.7	59.0	59.9
BNF	6.9	5.9	5.5	7.4	7.5	6.3
Finance Companies	8.1	7.0	8.7	6.9	7.2	7.6
FX Houses	0.5	0.6	0.6	0.7	0.7	0.7
Custodians	0.2	0.2	0.2	0.2	0.2	0.2
Cooperatives	15.8	18.7	21.5	23.0	25.4	25.2
Total	100.0	100.0	100.0	100.0	100.0	100.0

Note: figures for Cooperatives for 2005-2006 are estimates
Source: Superintendency of Banks and INCOOP

Cooperatives account for a significant share of total financial system assets
61. While reliable financial information on cooperatives is incomplete, preliminary estimates show that in 2006 they represented about 25 percent of financial system assets. The dimension and the dynamics of the cooperative system in Paraguay stand out in comparison to other countries. Type A cooperatives, which represent the largest institutions – numbering 40 cooperatives and 13 federations of cooperatives, out of a total of 673 cooperatives, account for 40 percent of total assets of cooperatives as of October 2006. There is still a regulatory divide between cooperatives and other financial intermediaries. As regulatory standards for banks and finance companies are raised, cooperatives will be able to expand by taking a greater market share from the banks and finance companies. For these reasons, reliable financial information on the cooperative system and regular monitoring of their operations should be a key objective of financial system regulators.

INCOOP's role as regulator is hampered by its lack of independence
62. Under the supervision of INCOOP, the cooperative sector is going through a transition from a deregulated and unsupervised system to one with some degree of supervision. INCOOP is a self-regulated organization with a Board of Directors elected by the cooperatives. It thus lacks the status of an autonomous regulatory agency. While recent efforts to strengthen its technical skills have been encouraging, INCOOP needs additional technical assistance in order to upgrade its supervisory capacity. However, the cooperative system needs to have an independent regulator with a strong legal mandate. INCOOP may be able to assume this role if it is granted legal autonomy.

Linkages between banks, finance companies and cooperatives need to be monitored more closely.
63. From the perspective of systemic risks, it is important to closely monitor linkages between banks, finance companies and cooperatives. Although it is believed that they are independent of the rest of the financial sector, some banks and finance companies may have sizeable credit exposures to cooperatives while others may be receiving a significant share of deposits from cooperatives, thus posing both credit and liquidity risks. These issues need to be monitored, and if needed, regulations should be issued to address any potential risks arising from banking and cooperative system linkages.

3.3 Justification of Overall Outcome Rating:

Rating: **Moderately Unsatisfactory for the overall financial sector program**

64. Despite the satisfactory impact of the first operation in the financial system as well as the substantial and partial achievement of several actions slated for the other two operations, the fact that political conditions make it unlikely to carry through with other Program reforms during the remaining of the present Administration, giving rise to the Bank's decision not to proceed with the operation, the overall outcome of this ICR is deemed to be **moderately unsatisfactory**. A more realistic approach to banking reforms such as passage of selected amendments to the existing Banking Law and the continuation of the current expansion of the economy, which has significantly reduced the country's financing requirements, could lead to a more favorable outcome.

65. The prospects for successful passage of reforms to the Banking and the AML laws is not favorable at present but prospects for reform could eventually improve. With respect to the goal of financial system stability, important steps have been taken and key ratios have improved considerably but the largely unregulated cooperative system remains a challenge. On the other hand, with adequate institutional and legal reforms INCOOP may be able to become an effective regulatory agency for the cooperative sector. However, it first would need to be granted legal status as an autonomous agency.

66. The restructuring of the State-owned banking sector appears to be headed in the right direction, particularly the establishment of AFD as a viable second-tier source of long-term development financing. Achievements have also been made in the restructuring of BNF. Nevertheless, more work needs to be done consistent with reducing the role of the state in the financial sector.

67. In terms of the specific objectives of PFSAL I, this Operation is considered to have been **Satisfactory**. All its conditionalities continue to be met, and the stability of the financial system has improved. The ISRs of this operation indicate that steps have been taken to improve the stability of the system, and PDO indicators in particular show important improvements.

3.4 Overarching Themes, Other Outcomes and Impacts:

(a) Poverty Impacts, Gender Aspects, and Social Development

Not Applicable

(b) Institutional Change/Strengthening (particularly with reference to impacts on longer-term capacity and institutional development):

68. The PFSAL I made significant contributions to institutional change in several areas. The strengthening of FGD and upgrading of SB's capacity to restructure problem banks was an important step in enhancing the efficiency and financial sustainability of the deposit insurance mechanism. The approval of Resolution 8 also reinforces the process for financial intermediaries to make good loans and thus reduce vulnerability to future shocks to the system.

69. Revisions to the Bank and AML Laws have triggered serious Government debate on better practices in the financial system. Less ambitious changes to the legislation may be more successful in receiving Congressional approval and thereby contribute to a shift towards more efficient financial intermediation. Nevertheless, greater institutional changes in the cooperative sector are necessary.

70. Although the reorganization of the State-owned banks was to receive support from the third operation of the Program, actions already taken in this area with support from the Bank along with a parallel IDB operation have produced encouraging results. The establishment of AFD has triggered renewed interest on the part of banks

to lend longer-term, and the initial restructuring of BNF bodes well for a more effective public sector role in financial intermediation.

71. The Bank's role in assisting SB to focus on its organizational effectiveness through the development of a Strategic Plan was a positive contribution. However, implementation of the Plan has not been consistent and the original version may have already become outdated.

(c) Other Unintended Outcomes and Impacts (positive and negative):

Not Applicable

3.5 Summary of Findings of Beneficiary Survey and/or Stakeholder Workshops (optional for Core ICR, required for ILI, details in annexes):

Not Applicable

4. Assessment of Risk to Development Outcome

Rating: **Substantial**

72. Program outcomes including those associated with the PFSAL I have to some extent been adversely impacted by political, financial, governance, and institutional risks. The economy is vulnerable to external shocks through terms of trade or adverse developments in Argentina and Brazil. Because the cooperatives sector is still relatively unregulated, a financial shock in that sector could have adverse repercussions on the banking system. Problems at BCP associated with the lack of quorum in its Board of Directors impacts negatively on the effectiveness of the principal regulator of the financial system, although the new President seems to be headed to resolve them .

73. While the Program was well designed in terms of the technical analysis and the incorporation of best international practices into the policy reform recommendations, the Bank could have been more realistic in its assessment of the limited capacity to implement ambitious and complex reforms such as those contained in the original draft of the revised Banking Law. Risk mitigation strategies perhaps should have focused on a less ambitious program that emphasized new standards for the classification of asset risk, the use of BCP Resolutions to implement new regulations, and fewer selective changes in the Banking Law. Greater monitoring of the SB's Strategic Plan could have helped implementation.

5. Assessment of Bank and Borrower Performance

5.1 Bank Performance

(a) Bank Performance in Ensuring Quality at Entry (i.e., performance through lending phase):

Rating: **Moderately Satisfactory**

74. In the design of the Program, Bank staff relied on extensive ESW particularly the Financial Sector Review (2002) which was well received by the Government, and the Bank was also supportive through an ongoing policy dialogue. Perhaps the pitfall was the ambitious scope of the Program. Greater assessment of political, institutional, and operational capacity to implement complex reforms was needed. For example, the proposed new Banking Law called for the banking system to swiftly assimilate best international standards of banking regulation. Greater sensitivity to political uncertainties given the Government's minority representation in Congress would have suggested a more cautious approach in the design of the Program and to a more engaged plan to seek wider ownership of the reform process.

75. A very positive aspect of Bank performance was the close working relationship with other IFIs, mainly the IDB and the IMF. The Bank and the IDB agreed on a division of labor whereby the Bank would focus on the new Banking Law and the IDB would give greater attention to the State-owned banking sector. Both institutions coordinated on the conditionality established in their respective policy matrixes. The Bank also collaborated closely with the IMF given the importance of the macroeconomic policy framework in determining the effectiveness of financial sector reforms.

(b) Quality of Supervision (*including M&E arrangements*):

Rating: **Satisfactory**

76. The Bank provided good support particularly in the area of problem bank restructuring and in working with the Government to develop a revised version of the new Banking Law that would be more widely accepted but would still be compatible with the initial Program objectives. The joint Bank – IMF FSAP Mission in 2005 helped to provide additional inputs for the implementation of financial sector reforms contemplated in the Program.

(c) Justification of Rating for Overall Bank Performance:

Rating: **Moderately Satisfactory**

77. The Bank provided good support during supervision, which helped to maintain Government interest in the reforms of the financial sector, but the quality at entry was only moderately satisfactory.

5.2 Borrower Performance

(a) Government Performance:

Rating: **Moderately Unsatisfactory**

78. Macroeconomic polices were consistent with the Program goals and continue to be satisfactory. The Government worked closely with the Bank during preparation of the Program, and during supervision of the loan. The Government could have devoted more efforts to building greater ownership of the Program with Congress to obtain approval of the Government's proposed legislation.

(b) Implementing Agency or Agencies Performance:

Rating: **Moderately Unsatisfactory**

79. The implementing agencies, MOF and BCP, were supportive of the Program goals. Subsequent changes in the Ministry of Finance weakened the working relationship with Congress to pass some reforms. Governance problems at BCP hampered its effectiveness as an implementing agency. SB has initiated implementation of the Strategic Plan but greater progress is needed.

(c) Justification of Rating for Overall Borrower Performance:

Rating: **Moderately Unsatisfactory**

80. Greater Government commitment to financial sector reforms could possibly have prevented the early cancellation of the Program although that is not entirely clear given the strength and depth of contrary views within Congress.

6. Lessons Learned

- **The Bank needs to strike a better balance between Program goals, the design of Program instruments, and a country's political realities.** In addition to the long-term objective of strengthening the financial sector in order to increase the flow of credit, Program goals should include specific intermediate objectives. When the design of policy instruments in a Program emphasizes the enactment of laws and regulations as in the case of Paraguay, it is crucial that the feasibility analysis include an assessment of the country's political climate and the likelihood of congressional approval for each piece of legislation. No matter how well-intentioned a Government's commitment to the passage of key financial sector legislation may be, the Bank needs to perform a reality check.

- **The complexity of design and the number of operations in a Program should be consistent with the risks to development outcomes**. The Bank may want to consider a more systematic measure of country risk factors that can be used to establish guidelines for Program design that are risk-driven.

  Where country risks are high the design of a Program should be relatively conservative. With simpler programs the Bank is able to focus greater attention on supervision of each component. If each loan in a Program is designed conservatively, it will give the Borrower greater incentive to meet expectations and then move on to the next operation.

- **It is best to be more conservative in assessing borrower's capacity to implement reforms and thus be less ambitious in Program design**. One of the lessons of the proposed new Banking Law was that it may be better to aim for a few selected changes rather than a wholesale reform of banking regulations.

- **Financial sector reform Programs aimed at reducing systemic vulnerabilities need to be inclusive of all important sectors.** For instance, finance companies were included but cooperatives were not. The issue was not whether cooperatives need to be regulated by BCP in order to achieve a level playing field with banks and finance companies, but whether INCOOP could be vested with the regulatory authority to independently supervise all cooperatives. The Bank could have placed greater priority on the cooperatives sector in designing the Program.

7. Comments on Issues Raised by Borrower/Implementing Agencies/Partners

(a) Borrower/Implementing Agencies:

The Borrower commented that this loan has highly contributed to support financial sector reform, besides of being timely for the administration of public finances. They added that they agree with the report in general, although they do not fully share the assessment on the performance of the Borrower. In that sense, they consider important to advance in a dialogue regarding government policies and the support that can be given in this sector, strengthening technical and institutional coordination with the Bank (See Annex 4 for the original in Spanish).

(b) Cofinanciers:

Not Applicable

(c) Other partners and stakeholders (e.g. NGOs/private sector/civil society):

Not Applicable

ANNEXES

Annex 1. Bank Lending and Implementation Support/Supervision Processes

(a) Task Team members

Name	Title	Unit	Responsibility/ Specialty
Lending			
John D. Pollner	Lead Financial Sector Specialist	LCSFF	Task Team Leader
Joaquin Gutierrez	Lead Financial Sector Specialist	OPD	Financial Sector Assessment
Jose Antonio Alepuz	Senior Counsel	LEGPS	Legal
Modibo Camara	Senior Financial Economist	LCSFF	Financial Sector Assessment
Peter Hansen	Country Manager	LCCPY	Country/Economic Context
Susana Sanchez	Senior Financial Economist	LCSFF	Financial Sector Assessment
Luz Meza Bartrina	Senior Counsel	LEGLA	Legal
Reynaldo Pastor	Senior Counsel	LEGLA	Legal
Zeinab Partow	Country Economist	LCSPE	Country/Economic Context
James Parks	Lead Economist	LCC7A	Country/Economic Context
Juan Gaviria	Sector Leader	LCSFP	Country/Economic Context
Javier Bolzico	Consultant	External Consultant	Financial Sector Assessment
Supervision			
Eduardo Urdapilleta	Senior Financial Economist	LCSPF	Task Team Leader
Reynaldo Pastor	Senior Counsel	LEGLA	Legal
Pedro L. Rodriguez	Country Manager	LCCPY	Country/Economic Context
Zeinab Partow	Country Economist	LCSPE	Country/Economic Context
James Parks	Lead Economist	LCC7A	Country/Economic Context
Juan Gaviria	Sector Leader	LCSFP	Country/Economic Context
Dana Rysankova	Senior Energy Specialist	LCSPE	Country/Economic Context
Denise von Gersdorf	Consultant	LCSPF	Supervision
Andres Mac Gaul	Senior Procurement Specialist	LCSPT	Procurement
Patricia Rodrigues de Melo	Language Program Assistant	LCSPF	Supervision
Amelia Camino Forsyth	Temporary	LCSPF	Supervision
Camila Rodriguez Hernandez	ET Consultant	LCSPF	Supervision

(b) Staff Time and Cost

Stage	Staff Time and Cost (Bank Budget Only)	
	No. of Staff Weeks	**US$ Thousands (including travel and consultant costs)**
Lending		
FY03	18.75	66,223.08
FY04	21.15	135,162.68
FY05	16.28	106,081.25
TOTAL:	**56.18**	**307,467.01**
Supervision/ICR		
FY06	6.28	49,406.69
FY07	12.41	60,273.24
TOTAL	**18.69**	**109,679.93**

Annex 2. Beneficiary Survey Results (if any)

NOT APPLICABLE

Annex 3. Stakeholder Workshop Report and Results (if any)

NOT APPLICABLE

Annex 4. Summary of Borrower's ICR and/or Comments on Draft ICR (Original in Spanish)

Tengo el agrado de dirigirme a usted con referencia a la nota de fecha 5 de junio del año en curso del Banco Internacional de Reconstrucción y Fomento (BIRF) (Exp. M.H. N° 11.594/2007). relacionada con la solicitud de comentarios acerca del Informe de Finalización y de los Resultados de la Implementación del Convenio de Préstamo N° 7288-PA *Préstamo de Ajuste Programático del Sector Financiero(Programmatic Financial Sector Adjustment Loan -PFSAL).* por Dólares de los Estados Unidos de América Quince Millones (USD. 15.000.000.-) -primera etapa- fechado el 13 de junio de 2005, aprobado por Ley N° 3039 del 24 de octubre de 2006, a cargo del Ministerio de Hacienda.

La operación de Préstamo de Ajuste Programático del Sector Financiero ha contribuido en gran medida en apoyar los planes de reforma del sector financiero, además de ser oportuna para la administración de las finanzas públicas.

En general coincidimos con el informe, sin embargo, no podría compartir del todo las apreciaciones referentes a la evaluación de desempeño del Prestatario. En ese sentido, considero importante avanzar en el diálogo acerca de las políticas del Gobierno y el apoyo que se pueda brindar en éste sector, resultando vital fortalecer el vínculo de coordinación técnica e institucional con el Banco para el logro de los objetivos.

Annex 5. Comments of Cofinanciers and Other Partners/Stakeholders

NOT APPLICABLE

Annex 6. List of Supporting Documents

References used for this ICR include the following documents:

1. Paraguay: Financial Sector Review, Report No. 24249-PA, November 15, 2002.
2. Paraguay: Country Assistance Strategy, Report No. 27341-PA.
3. Program Document for the Economic Recovery Structural Adjustment Loan, Report No. 27172-PA, December 2, 2003.
4. Regional Operations Committee Review meeting minutes, September 12, 2002.
5. (Virtual) Regional Operations Committee meeting minutes, February 9, 2005.
6. Program Document for PFSAL I, Report No. 23996-PA, March 7, 2005.
7. Loan Agreement for PFSAL I, June 13, 2005.
8. Review of Loan Conditions for Effectiveness, November 17, 2006.
9. Paraguay: Financial Sector Technical Assistance Project, Project Appraisal Document, Report No. 28568-PA, March 7, 2007.
10. Banking Law 861.
11. BCP Resolution 8, November 2003.
12. SB Statistical Bulletins, various issues.