This Financial Sector Assessment summarizes the findings of a joint IMF-World Bank Financial Sector Assessment Program (FSAP) team that visited Montevideo in October 2005 and January-February 2006. The purpose of the assessment was to help the authorities identify financial system strengths and weaknesses with a view to implementing an action plan to increase the system’s contribution to economic development. The FSAP assessment is based on information provided by the authorities at the time of the missions.

OVERVIEW

1. Uruguay suffered a severe banking and currency crisis in 2002 from the spillover of Argentina’s crisis. Uruguay and Argentina are linked through deposits and tourism of Argentines in Uruguay; in addition, they export similar products. Both countries had already been suffering from falling output since 1998. At the end of 2001, Argentina’s efforts to protect its currency board by freezing most deposits and its

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1 The FSAP team comprised Ceyla Pazarbasioglu, leader (IMF), James Hanson, deputy (World Bank); Marco Espinosa, Ivan Guerra, Socorro Heysen, Silvia Iorgova, Andrei Kirilenko, Jorge Canales-Kriljenko, André Santos (all IMF), Mariluz Cortes, Gustavo Demarco, Mario Guadamillas, W. Britt Gwinner, John Pollner, Craig Thorburne (all World Bank), Ernesto Livacic and Walter Zunic (experts). Gaston Geles (IMF resident representative) and David Yuravlivker (World Bank resident representative) joined some meetings. Elsa Portaro provided administrative assistance. The AML/CFT team was composed of Manuel G. Vasquez (team leader), Antonio Hyman Bouchereau, Ernesto Lopez, and Nelson Mena. Mr. Esteban Fullin, Deputy Executive Secretary from the South American FATF Regional Style Body (GAFISUD) participated as an observer by prior agreement with the authorities.

2 The first FSAP mission reviewed financial sector conditions and conducted two assessments of international codes and standards—Basel Core Principles for Effective Banking Supervision (BCP) and Payments and Securities Settlement Systems. During the missions, staff met with the Minister of Economy and Finance, Mr. Astori; Governor Cancela, Central Bank of Uruguay; and other senior officials and representatives of the Central Bank of Uruguay (BCU), the Ministry of Economy and Finance, and representatives of the private and public financial sector as well as representatives of several corporate entities. A separate team conducted an assessment of anti-money laundering (AML) and combating the financing of terrorism (CFT) in November 2005.
subsequent exit from the currency board triggered a withdrawal of Argentine deposits in Uruguay followed by a general run on Uruguayan banks. Uruguay's reserves fell sharply and the peso was substantially devalued.

2. The crisis highlighted important underlying weaknesses of the Uruguayan financial sector, many of which were already well known. Dollarization and nonresident deposits were high. In particular, the government mortgage bank (BHU) had a massive currency mismatch between its dollar deposits and its inflation-indexed loans, as a result of government policy. The already-large nonperforming loans (NPLs) in BHU and the state commercial bank (BROU) increased sharply, as did NPLs in private banks, reflecting the severe difficulties in nonfinancial companies, especially in servicing their dollar obligations. These problems also highlighted the weak oversight, governance, and inadequate internal controls and risk management systems in the state banks and some private banks, including fraud in some cases. Moreover, supervision had been weak, particularly of the state institutions, and prudential regulations and monetary arrangements had not reduced risks in credit, liquidity, and cross-border activities arising from dollarization and regional contagion. When local private banks failed, their resolution was complicated by the inadequate bank resolution framework and rigid employment practices. Difficulties in resolving the problems of the state banks were complicated by their autonomous legal status.

3. The authorities acted to resolve the banking problems and implemented a stabilization program supported by the international financial institutions and the economy has recovered substantially from the crisis. New BHU deposit-taking was effectively stopped and, correspondingly, new lending. Most of BHU's deposits were transferred to BROU and the government is currently working on details of a further restructuring of BHU. The state banks' time deposits were reprogrammed; their assets were substantially restructured and enhanced by government guarantees. Public sector debt was also reprogrammed. The government closed four insolvent local private banks. The good assets and deposits of three of these banks were combined with government capitalization to create a new bank (NBC) that is currently being sold. The foreign banks that survived the crisis did so without government liquidity support. The initial cost of resolving the banking crisis is estimated at 20 percent of 2002 GDP; the final cost will depend on asset recovery and proceeds from asset sales. Under the stabilization program, and with improvement in the international situation facing Uruguay, GDP has returned to its 1998 level (in real terms), export growth is buoyant, inflation has fallen to single digits, interest rates are low, reserves have recovered, and Uruguay has received FDI and re-accessed international debt markets. Nonetheless, public sector debt remains high — 69 percent of GDP — and much of it is denominated in foreign exchange. These large foreign currency obligations represent a substantial fiscal risk.3

4. Although banks and bank regulation and supervision are now much stronger, macro-economic and financial risks remain, due to the high level of government debt and guarantees and the still-high dollarization and nonresident

3 In addition, the government has contingent liabilities in the form of a government guarantee on promissory notes to BROU arising from the transfer of deposits from BHU to BROU, the transfer of nonperforming loans from BROU to trust funds, and guarantees all BROU deposits.
deposits. Banks, including BROU, have improved risk management. Banks have
strengthened their liquidity and capital adequacy, increasing their capacity to withstand
shocks. The remaining foreign banks have already demonstrated their resiliency by
withstanding the crisis. Bank regulation and supervision have improved and measures
have been taken to encourage de-dollarization and reduce credit risk. The improved
liquidity of public banks has reduced the need for government support in the event of a
moderate liquidity shock. Nonetheless, a major external shock may lead to a significant
deterioration of several banks’ capital and solvency, according to stress tests. Liquidity
problems could develop, especially if access to international capital markets declined.
Given the role of nonresident deposits in the 2002 crisis, the government may wish to
review the costs and benefits of further limiting domestic banks’ capacity to attract
deposits held by nonresidents. Issuance of more peso-indexed debt would promote de-
dollarization. More fundamentally, strong macroeconomic policies, further reforms of
state financial institutions, and further strengthening of supervision and the safety net are
critical to increasing the resiliency of the financial system.

5. **The large state presence in the financial system creates significant distortions
and risks and hinders sound financial development.** The predominance of state-owned
institutions throughout the financial sector raises informational, oversight, and
governance issues, makes regulation and supervision challenging, and, because of the
many explicit and implicit government guarantees, represents major risks. In the past,
state bank lending was often politically motivated and fostered a poor credit culture.
Since the crisis, risk management has improved in BROU and BHU is being restructured.
Nonetheless, a rapid increase in credit from BROU and BHU would raise risks of new
NPLs and hurt the nascent private mortgage market. Moreover, the implicit and explicit
government guarantees to state-owned financial institutions and their various credit
practices and products also limit financial development and the ability of private
institutions to compete with state institutions.

6. **The key challenge for the authorities is to increase financial intermediation
while reducing vulnerabilities.** In particular, a rapid increase in state bank lending
would risk growth of new NPLs. Nonbank state intermediaries also pose challenges in
terms of the contingent liabilities of their products. Policies and reforms that would help
financial intermediation include strengthening the transparency, governance,
accountability and performance of the state-owned banks, insurance company, and
pension company, while eliminating their distortionary advantages; developing local
capital markets (including securitization); improving the housing market by better
targeting and accounting of subsidies and allowing the private mortgage market to grow;
improving the credit culture and credit registry; strengthening collateral execution and
bankruptcy procedures; and enhancing financial infrastructure. These recommendations
are discussed below and summarized in Annex 1. The recommendations also reflect the
findings of the Basel Core Principles for Effective Banking Supervision (BCP), Core
Principles of Systemically Important Payments Systems (CPSIPS) and CPSS-IOSCO
Recommendations for Securities Settlement Systems (RSSS) and an assessment of the
compliance with AML/CFT, as well as the five Technical Notes.4

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4 Technical Notes were provided on Banking, Housing, Insurance, Pensions, and Securitization.
I. FINANCIAL STRUCTURE AND ISSUES

A. Overview of Financial Intermediation and Major Financial Risks

7. Uruguay’s domestic financial system is smaller than before the crisis and is still dominated by banks. Total assets of financial institutions were about US$19 billion and end-2005, compared to US$25 billion at end-2001, before the crisis (Annex II, Table 1). This decline mainly reflects a fall in the size of the private banking sector. Nonetheless, the banking sector still accounts for about 67 percent of all financial institutions’ assets. The banking sector remains large relative to other countries in South America, with assets of about 78 percent of GDP at end-2005, though this ratio is smaller than in 2001 (Annex II, Figure 1). The banks remaining after the crisis are: BROU (43 percent of bank assets compared to 23 percent in 2001), BHU (10 percent of bank assets, compared to 13 percent in 2001), the foreign banks (12 banks with 39 percent of bank assets, compared to 17 banks with 48 percent of bank assets in 2001) and Nuevo Banco Commercial (6 percent of bank assets; it was formed from the good assets, the deposits, and government capital of 3 bankrupt local banks and is now being sold to foreigners).

8. Bank’s dollarization and nonresident deposits remain high. Dollarization is somewhat higher than before the crisis – at end-2005, dollar deposits were 85 percent of deposits and dollar credits were 71 percent of credit. However, dollarization has been declining, as the peso appreciated and capital returned to Uruguay. Nonresident deposits are about 23 percent of total deposits, a decline from about 50 percent at end-2001.5

9. Outside the banks, the only important part of the domestic financial sector is the fully-funded portion of the pension system. The assets of the four firms that operate defined-contribution pensions (AFAPs) are 11 percent of GDP. They ultimately weathered the crisis well because their initial capital losses were more than offset by capital gains after interest rates fell. The insurance sector suffered during the crisis as holders of life insurance policies cashed them in; the sector is still only 3 percent of GDP. The equity market (capitalization of 2.2 percent of GDP) and the domestic corporate bond market (an outstanding amount of 0.5 percent of GDP) are small and illiquid.

10. A substantial part of Uruguay’s financial intermediation, particularly sale of government debt, occurs in international markets. Offshore institutions, including their derivative transactions, represent 17 percent of GDP (Annex II, Table 1). Uruguay’s external public debt represents about 60 percent of GDP. As a result of the government’s reliance on offshore borrowing, Uruguay’s banks have little government debt. However, about 80 percent of AFAP assets are government or central bank debt. Uruguay’s debt ratios have greatly improved since the crisis, because of primary surpluses, growth and peso appreciation. After a successful external debt exchange in 2003, Uruguay regained market access, helped by its strong macroeconomic performance and easing international conditions.

11. Although the economy is performing well, macroeconomic vulnerabilities remain high. Financial liabilities in both the private and public sectors are still largely expressed in foreign currency, while the dollar value of domestic income is exposed to

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5 Some nonresidents make deposits through Uruguayan representatives. Hence the reported figures are a minimum estimate of nonresident deposits.
high volatility. In addition, public debt remains high and the government’s servicing ability depends on continued fiscal discipline, moderate world interest rates, low sovereign risk premiums, sustained economic growth, and an active debt management. The government also has large contingent liabilities arising from explicit and implicit guarantees to the state banks and nonbanks and the large public sector pension system.

12. The main vulnerability in Uruguay arises from the interplay between the still-high level of public debt, state guarantees to public banks, and high dollarization and nonresident deposits. An external shock such as major economic distress in Argentina or a sharp rise in foreign interest rates would lead to a significant deterioration of the capital adequacy of several financial institutions in Uruguay, according to stress tests conducted by a working group that included the staff of BCU and the FSAP team. It could also lead to a fiscal deterioration. The liquidity of banks has improved considerably, including the state banks. This reduces the need for public support in the event of a moderate liquidity shock. However, a major macroeconomic shock (for example, if the government were to lose adequate market access or face sharp adverse movements in exchange rates or interest rates) could lead to larger liquidity problems. Given the role of dollarization and nonresident deposits in the 2002 crisis, the government may wish to consider further measures, such as issuing more peso-indexed debt and conducting a cost-benefit analysis of further restricting onshore banks’ ability to attract deposits held by nonresidents. More fundamentally, continued strong macroeconomic policies and further reforms of state financial institutions, as discussed below, would increase the financial system’s resiliency.

B. The Role of Public Sector Intermediaries

13. State-owned institutions dominate the financial sector, represent contingent liabilities for the government and complicate financial development. BROU has over 50 percent of bank deposits; its policies have had a large impact on exchange rates, interest rates and credit and financial market development. BHU’s currency mismatch and high NPLs were a major factor in the cost of the crisis. Its low rates and weak collections distorted the mortgage market and effectively eliminated private mortgages before the crisis. The approach taken in its on-going restructuring will affect the development of the nascent private mortgage market substantially. Box 1 summarizes some of these issues and, more generally, approaches to improving housing finance. In insurance, BSE has over 60 percent of the market; it offers unhedged, wage-indexed annuities, has a monopoly on workers compensation insurance that it does not reinsure, and, by offering low-cost life insurance to AFAP affiliates, has driven out private competitors. The AFAP República accounts for 56 percent of AFAPs’ and is owned by BROU (51 percent), the state insurance company (BSE), and government social security agency (BPS). It is the only AFAP that guarantees a minimum return.
Box 1. Housing Finance in Uruguay

Uruguay’s costly public sector housing programs failed to deliver a sustainable housing finance system and crowded out private lenders. Until 2002, BHU effectively monopolized mortgage lending to moderate and upper income households because of its favorable terms and its lack of pressure on borrowers to repay. In addition, the Ministry of Housing (MoH) made subsidized loans via several trust funds. Almost all of this government lending for housing was plagued by poor collection and steep losses, as is the case for such lending in most countries.

Uruguay has many of the conditions required to create a sustainable, private sector-based housing system that could efficiently serve the population. Compared to most of Latin America, Uruguay has a relatively small informal sector, high average wages, an active rental market, and unusually, an excess supply of housing. Rental housing could be an important policy tool for reaching the lowest income families. The existing program to renovate the stock of older, vacant units could be extended through private-public partnerships and policies that encourage renovation or transfer of titles to those interested in renovating. However, the greatest challenge lies in fostering private housing finance.

With BHU lending stopped, private lenders re-entered the residential mortgage market in 2005, targeting BHU’s former market segment. Private lenders are lending to individuals earning US$700 per month and up, a somewhat lower figure than had been considered the minimum for a BHU mortgage. Experience in other countries suggests private lending eventually could serve even lower income borrowers.

Any resumption of BHU lending to this group runs the risk of driving out private lenders as borrowers are likely to assume they need not service BHU mortgages. BHU’s lending on commercial terms means it will have to enforce debt service obligations and execute collateral to change the credit culture of its borrowers. Resumed BHU lending also runs the risk of new NPLs and increasing contingent liabilities, even if the financing for the lending is only through market instruments.

Any resumption of BHU lending and MoH programs should encourage the growth of private housing lending. Any renewal of BHU lending should focus on income segments below those targeted by private banks, at market rates of interest and with execution of collateral of defaulters, demonstrating the viability of underserved segments. The action plan for BHU’s restructuring appropriately eliminates BHU’s role in granting subsidies. This positive move should be accompanied by retargeting MoH subsidies to stimulate private sector participation as is done in other countries, not just state lending.

Any mortgage default insurance (MI) program should wait until BHU’s collection weaknesses are resolved. Mortgage default insurance has proved to be a useful means to provide loans to underserved populations in Peru, Mexico, Guatemala, and others. However, its success requires efficient mortgage lien enforcement, commercial pricing, and actuarially adequate capital. Given the culture of nonpayment in Uruguay and the lack of transparency and weaknesses in risk management in BSE, a MI program could create an additional contingent liability to the government without stimulating lending sustainably.

The enforcement of mortgage liens should be improved to foster the growth of private mortgage lending. International studies show that rapid enforcement of creditors’ rights, balanced with protections for distressed borrowers, leads to lower mortgage interest rates and increased lending. It takes a private bank an average of 1.6 years to foreclose on a mortgage and have the property free and clear in Uruguay; some cases extend to 6 years. Extending extra-judicial foreclosure powers to private banks would put them on an equal footing with BHU in their ability to enforce of mortgage liens, although BHU has not used its powers.
14. **Despite recent changes, government guarantees and other advantages of state institutions mean that state and private institutions do not compete on a level playing field.** Deposits in state banks have an explicit full government guarantee, while deposit insurance of private banks is limited. Only state institutions can offer unhedged products and guarantees because they represent implicit contingent liabilities of the state. In addition, state banks receive favorable tax treatment on consumer loans and have special legal rights to withhold salaries for loan collection and execute collateral on loans without going to courts, although they have not used these privileges.

15. **Moreover, in state banks, politically-motivated lending and weak collection have fostered a poor credit culture and reduced private markets finance.** Public banks have a history of distorting market prices and under-pricing credit risks, often under political pressures. Their lax credit evaluation procedures and continued refinancing of nonperforming loans by state-owned banks contributed to their high nonperforming loans even before the crisis. These policies also have contributed to the lack of private lenders in housing and agriculture and the lack of interest by business owners in raising funds in financial markets.

16. **The state institutions would benefit from improved information, governance, and accountability and a monitoring of the costs and benefits of any subsidies and the guarantees and other advantages enjoyed by state institutions.** Supervisory actions and changes in charters have prevented new unsound lending. Despite the improvements in BROU's credit systems, additional efforts are needed to transform an environment that favored a culture of nonpayment of debts into one with incentives to service debts. BHU will need substantial improvement. In all state institutions, the costs and benefits of products, policies, and implicit and explicit guarantees need to be evaluated and carefully monitored, including their impact on the playing field for private institutions.

**II. STRENGTHS AND CHALLENGES IN THE BANKING AND CORPORATE SECTORS**

17. **The banking system has become smaller, more liquid, and stronger since the crisis.** Commercial bank assets have fallen from US$21 at end-2001 to US$13 billion at end-2005 (Annex II, Table 1). At the same time, banks have increased their holdings of liquid assets to 36 percent of total assets at end-2005 compared to 14 percent at end-2001. The increase in the liquid asset ratio is a response to the crisis and the post-crisis shortening of deposit maturities, and also reflects the high liquidity requirements imposed by BCU on specific banks. Banks' holdings of public debt continue to be low, reflecting the government's reliance on offshore borrowing, although BROU's exposure to the government has increased as a result of state-guaranteed assets provided in the aftermath of the crisis. Asset quality has improved but remains an issue for state banks. Private banks largely wrote off their NPLs, which are now only about 3 percent of total loans, and their provisions are about 150 percent of their NPLs. However, a majority of BHU’s

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6 BROU transferred US$1.4 billion of nonperforming assets to an AMC trust (fideicomiso) at an accounting value of US$456 million in exchange for a government-guaranteed, participation certificate. BHU’s obligation to BROU to cover its deposit transfer to BROU is also government guaranteed.
assets are nonperforming. Loan provisioning covers only 42 percent of NPLs in the state banks. On average excluding BHU, bank capital is over 20 percent and banks have returned to profitability following a recovery in their collection rates as the economy grew.

18. **Corporate debt remains high and profits low, making many firms unattractive to lenders.** Although corporate leverage, as measured by the debt-equity ratio, has been reduced since the crisis, the average corporation nonetheless remains highly indebted and vulnerable to peso depreciation according to stress tests carried out by the FSAP mission. In 2004, foreign currency debt represented 65 percent of total corporate liabilities on average and about 75 percent for the median firm (in a sample of 575 firms). Compared to other firms in Latin America, Uruguayan firms have high ratios of liability dollarization, exposing them (and their creditors) to risks from exchange rate fluctuations. A substantial number of firms in 2004 still exhibited negative net worth, largely as a result of the substantial depreciation of the peso in the crisis. A large number of loss-making firms remain, despite the economic recovery. Not only did the cost of servicing unhedged foreign currency debt more than double, but the temporarily high interest rates also caused an increase in debt service on local currency liabilities.

19. **Corporate debt restructuring remains on the agenda.** Although most financial institutions have reported a sharp decline in nonperforming loans, the high corporate debt levels suggest that corporate nonperforming debts were restructured by transferring them to AMCs or extending maturities, not by writing them down. Partly this approach may reflect limits on BROU’s ability to write down debt. The debt restructuring process can be improved by reforming the insolvency legislation to allow for the reorganization of viable firms and the faster and efficient liquidation of nonviable ones as envisaged under the major improvements to the proposed current law.

20. **Banks’ risk management has generally improved, but progress has been uneven and could benefit from strengthening of systems in state banks and improvements in the information collected and provided by the credit bureau.** As in many other countries, credit risk standards were tightened in the aftermath of the crisis. Regulation and supervision were also refocused to stress risk management and to address the risks of a dollarized financial system. Most banks have implemented independent risk management structures and involved senior management in the development of a risk culture. Many of the foreign banks have adopted risk-management systems and practices of their parent institutions. However, the public banks still lack adequate systems to assess their risks fully. Over one-third of the banks do not conduct independent reviews of the risk management and measurement processes and lack adequate risk management infrastructure, according to a survey conducted under the FSAP. Managing the risks of dollarization remains a challenge, but banks are increasingly reducing the share of foreign currency loans to the nontradeable sector. Improvements in the credit bureau and collateral execution will also help improve risk management.

21. **Banks’ intermediation costs, which limit intermediation, reflect high reserve and liquidity requirements, labor market issues, and high, distortionary taxes.**

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7 The assessment of banks’ risk management practices is based on a survey prepared by the FSAP team and answered by all banks.
Bank's required reserves are high (15 percent on peso deposits and 25 percent on foreign currency deposits, on average) and have low remunerations. While liquidity risks associated with foreign currency deposits may justify relatively high reserve requirements, the low rate paid by the central bank on these reserves has effectively become a tax. Banks' costs reflect the generous salaries and benefits paid to banking sector workers in the politically important union of financial sector workers. Benefits paid to dismissed staff have been high in the banking sector (up-front payment of up-to-20 months of salaries in the banking sector versus a maximum of 6 months salaries in other sectors). Employer contributions under the pay-as-you-go banking pension system (*Caja Bancaria*) are also higher than in other sectors, and finance generous benefits — though the decline in banking workers after the crisis is creating problems in the system, as discussed below. Uruguayan financial intermediaries are currently subject to an asset tax and a portfolio tax, as well as profit and net worth taxes. A value-added tax (VAT) is levied on interest on bank loans by private banks. Credit cards are also taxed. Relief from these taxes and the uneven treatment of private and state banks may come through the tax reform submitted to Congress. This reform envisages eliminating the asset tax, the portfolio tax, the credit card tax, and the value-added tax exemption for state bank loans.

22. **A key challenge for the authorities is to restore financial intermediation while reducing vulnerabilities.** Loans to the private sector were only 23 percent of GDP at end-2005, compared to about 55 percent prior to the crisis. This decline reflects the decline in deposits (relative to GDP) and the rise in banks’ demand for liquid assets, as well as the write-off of bad assets, the shift of BROU’s and NBC’s NPLs to asset recovery trusts, and the limits on lending of BROU (imposed by the superintendency) and BHU (because of its restructuring). Consumer credit has grown, as it has in most countries, and private banks have begun mortgage lending. However, demand is lacking from good-quality commercial borrowers. More finance at lower spreads will eventually be needed for growth but increased lending by the state banks, despite the improvement in BROU, raises risks of new NPLs. Policies and reforms that would help improve intermediation include improvements in the transparency, accountability and performance of the state banks; improving the housing market by better targeting and accounting of subsidies and allowing growth in the private mortgage market; and improvements in the credit culture and credit registry; strengthening collateral execution and bankruptcy procedures; developing local capital markets, including securitization; and enhancing financial infrastructure.

III. **STRENGTHS AND CHALLENGES IN PENSIONS INSURANCE AND CAPITAL MARKETS**

A. **Pension Funds**

23. Uruguay’s main pension system, the defined-benefit, pay-as-you-go, public pension system, still has a deficit, despite earmarking of tax revenues to fund it. The system’s deficit was 2.6 percent of GDP in 2005 and is projected to be 1.5 percent of GDP in 2006. In addition to the BROU’s AMC, the weak assets of the three banks that were merged into NBC were transferred to an AMC.
GDP in 2010. The deficits persist, despite the high contribution rates of affiliates (15 percent of salaries) and employers (12.5 percent) and earmarking to the system of one-third of the VAT and an additional tax (COFIS), which together represent nearly 3 percent of GDP. The contributions of employers and employees only finance about 50 percent of the system’s payments. Salaries of about 90 percent of affiliates are too low to pay contributions that would finance the system’s minimum pension. Thus, the deficit not only reflects the aging population but also the lingering effects of low retirement ages and generous benefits, relative to contributions, that existed before the 1995 reforms. Exemptions of some employers from contributions are another factor in the deficit – exemptions are estimated to equal 25 percent of actual employee contributions.

24. **Reforms, some of which have already been proposed, would help narrow the pension deficit.** Reducing the deficit and the distortionary impact of the public pension system would involve further matching of benefits and contributions and raising retirement ages, as well as switching from wage indexation to price indexation of benefits. The current tax reform proposal envisages elimination of the exemptions of employers from contributions and the COFIS tax, but the actual impact will depend on the law that is passed.

25. **Some sectoral pension schemes may represent a potential risk to the government, notably the financially weak scheme for bank employees (Caja Bancaria).** The Caja Bancaria has generous benefits and is financially weak, despite high required contribution rates by banks, because of the post-crisis decline in employment in financial institutions. Expanding coverage might temporarily reduce its financial problem. However, it would worsen problems over time, because of the intertemporal mismatch between contributions and benefits. Given the economic and political importance of bank employees, the government may at some point be pressured to inject funds into the Caja, although it has no legal obligation for these pensions. The authorities are considering options to reform the public sector schemes for the military and the police. In general, it would be desirable to move all the sectoral schemes into the combination of the public pension and AFAP system that apply to most of the population.

26. **Uruguay’s fully-funded pension system has been fairly successful but its limited investment options, the large role of government, and its market concentration remain issues.** Over half of the country’s employees also participate in the full funded, AFAP system, as well as contributing to and being guaranteed a basic pension by the public pension system. The system has had the highest return in Latin America, partly reflecting its large capital gains after the crisis. However, government and central bank debt represent most of the portfolio – 60 percent and 22 percent, respectively. This means that the system’s main effect has been to make (part of) the government’s pension liability explicit, and that the system has not fulfilled its promise to provide long-term resources for the private sector. Moreover, contributors have substantial sovereign risk. In addition, about 7 percent of AFAPs’ assets are held in cash due to limits on exposure and unavailability of private sector issues. AFAP concentration is also high – there are only four AFAPs and the BROU-controlled AFAP República accounts for 56 percent of total AFAP assets and 38 percent of all affiliates. República guarantees a minimum return, an unrecognized contingent liability for the government.
27. **Performance of the system could be improved and risks reduced by various measures.** Removal of the minimum return of *República* would eliminate the government’s explicit contingent liability and level the playing field for private AFAPs. Regulation and oversight should include monitoring of *República*’s pricing practices to ensure competition. Investment regulations governing the AFAPs need to be eased to ensure a prudent asset diversification of affiliates’ investments. Possible measures include: (i) allowing limited overseas investments in high quality assets, an option available for other investments of Uruguayans; (ii) allowing alternative pension funds with different risk characteristics; and (iii) allowing AFAPs to use currency and interest hedging instruments to protect against losses. To some extent, diversification also will depend on developing private sector instruments for AFAP investment by improving the capital market framework, as discussed below.

28. **Consider ways to improve competition and transparency and to reduce costs and the AFAPs’ commissions, which are the second highest in the region.** High commissions partly reflect the market’s small size and the need for the AFAP owners to recover their initial investment, but they also appear to generate high profits. To some extent better accounting would improve the transparency of the AFAPs’ costs, sales and profits, which now neglect the inter-temporal nature of the business. Marketing costs for new affiliates, who tend to remain with their original AFAP, represent about 26 percent of total costs but the AFAPs actually differ little in portfolios or service currently. Various approaches might be considered for reducing costs, including assigning new affiliates to an AFAP initially (affiliates would retain the option to switch after 6 months), for example to the AFAP with the lowest commission; allowing employers to negotiate terms for new employees; or using secure internet sites for subscription. Another approach would be to allow development of new funds, some of which could be allowed to charge commissions based on assets-under-management, as in Mexico.

B. **The Insurance Sector**

29. **The Uruguayan insurance sector is small and is dominated by the state-owned BSE, which has 60 percent of life and 67 percent of nonlife business.** While the FSAP examined data from all firms, many of its recommendations focus on the BSE because of its size and the issues associated with it. Although solvency indicators of the insurance sector have improved since the 2002 crisis, profitability remains poor and may be overstated by the treatment of reinsurance in the various insurance firms’ accounts. The private insurance firms’ growth has been limited by BSE’s actual and potential activities and its pricing policies. Finally, the government has difficulty in overseeing BSE, since the timeliness and quality of its data are weak and its transparency, internal controls and risk management need improvement.

30. **BSE represents a contingent liability on the government.** The state is effectively BSE’s reinsurer and guarantor. Two particular risks for the government are: (i) BSE’s effective monopoly position as provider of annuities, which legally must be indexed to wages and for which there are no good market hedges for private providers;

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9 This comparison does not control for the maturity and size of the pension funds sector in the countries.

10 AFAPs already share some back office functions, including account processing and custodial services, so there is little room for seeking cost efficiencies in these areas.
and (ii) BSE’s legal monopoly as a provider of workers compensation and disability, a high-risk line of business. Furthermore, any proposals for BSE to develop a mortgage default insurance system should be evaluated carefully. If BSE were to offer such insurance at prices that do not reflect the underlying risks, this may lead to a transfer of losses from BHU to BSE. It may also create incentives for BHU to take higher risks, leading to additional government contingency risks.

31. **The strategy for the sector should focus on realigning BSE, improving its performance, and encouraging innovation in insurance products and portfolio investments.** The BSE will remain a major provider of insurance for some time. A restructured BSE, with a clear mandate and increased accountability and transparency, could make a significant contribution to the insurance sector and the financial sector in general. The first steps would be an improvement in the timeliness and quality of BSE’s information, as well as pricing policies, internal risk management, and controls. It would also be desirable to conduct an independent analysis of the contingent liabilities in BSE’s products, such as wage-indexed annuities and workers’ compensation. Proposals for any new products, such as mortgage insurance, should be studied with a view to avoiding government contingent liabilities, for example, by greater use of commercial reinsurance. More generally, oversight should be strengthened on annuities and composite firms, including reporting, accounting, and asset separation in composite firms, of which the largest is BSE. Innovation should be encouraged, as it is necessary for the sector’s profitability, growth and, ultimately, its sustainability. For example, if legal requirements that require wage-indexed annuities were relaxed, BSE were to stop offering this risky product, and concerns about BSE’s pricing were reduced, then private firms might be able to enter the segment and offer new products and services. The possibilities for commercially-priced products, such as universal third-party motor insurance and a basic life insurance product for a wider market would also contribute to the sector’s growth.

C. **Capital Markets**

32. **Capital markets in Uruguay are small and illiquid, reflecting both structural issues and the crisis.** In 2004, equity market capitalization amounted to only 2.2 percent of GDP and trading accounted for 0.5 percent of market capitalization, with only 11 listed firms. Bond and commercial paper issues peaked in the latter half of the 1990s at between US$100–$200 million annually but have collapsed since 1999. The market’s limited size reflects (i) the country’s small size, which limits liquidity; (ii) the easy access to and the ability to roll-over loans from state banks for firms in the main industry, livestock, and in construction; and (iii) the full state-ownership of major utilities that typically would issue stock. In addition, confidence in the market was hurt by the 1999 fraud in the commercial paper market by a major issuer, *Granja Moro*. Issuance costs, public scrutiny and governance, and legal issues and tax treatment, particularly of securitized instruments in the local market, are also issues.

33. **The legal framework is not sufficiently specific and the regulators have been increasingly resorting to a narrow set of administrative measures.** The Securities Market and AFAP Control Division of the BCU act as the country’s securities markets regulator. The legal framework (based on the 1996 Law on Capital Markets) does not provide specific guidelines on disclosure of information by the issuers and reporting standards by the intermediaries. In response to problems in these areas, the securities
markets regulator has resorted to using administrative sanctions, including the suspension of trading of some issues. During 2005, the securities markets regulator issued (and made publicly observable) sanctions and citations to 16 entities, which resulted in the suspension of trading of more than 60 percent of traded corporate issues for an average of 5 days each. The disruptive nature of these sanctions partly reflects the fact that in the current legal environment the securities markets regulator has limited authority over the broker/dealers whose conduct under the current law is monitored by self-regulated stock exchanges. It is important to broaden the BCU’s powers pursuant to which it may investigate and punish problems in broker/dealer conduct without prior involvement of the Bolsa de Valores and in order to ensure that licensing is the prerogative of the BCU and not of the Bolsa, in line with international best practices.

34. **The authorities have repeatedly announced their intentions to develop local capital markets.** However, even the forthcoming changes in the legal, regulatory, and taxation regimes may be insufficient to expand capital markets, given the underlying structural issues. Simplifications in taxation would make securitization easier. The powers of the supervisor over market agents, such as powers to regulate and directly impose penalties on stock exchange brokers, are limited—they remain with the exchanges. Continuing macroeconomic stability, the growth of pension funds, and attempts to develop new instruments and strengthen market infrastructure and the regulator may lead to some improvement in the role of capital markets.

35. **One product area where the capital market might expand is in financial trusts (fideicomisos) and securitization.** In Latin America, securitizations have been successful instruments, with US$7.8 billion issued in local markets in 2004. Uruguay’s 2003 Trust Law (Ley de Fideicomisos) was enacted with the expectation that securitizations would be an effective instrument the AFAPs and insurance companies would demand. However, only three such instruments have been created since the law became effective, all of which were highly structured deals based on special laws and tax concessions to relax the heavy tax burden on such instruments. In addition, the lack of standardized instruments has contributed to a lengthy approval process. A wider use of fideicomisos would require lowering and simplifying of the tax burden, standardization of contracts, and an availability of regulatory resources that could analyze the special features of each contracts.

36. **Key policy initiatives should focus on fostering new financing and risk sharing structures.** For example, the creation of structured products that would combine several small issues of varying credit quality with some credit enhancements may allow small- and medium-sized companies to offer instruments attractive to pension funds. Similarly, the development of markets for hedging instruments should be supported by the establishment of a reference yield curve for government debt (a task of the Debt Management Unit at the Ministry of Finance) and a speedier establishment of the necessary legal and regulatory basis for such instruments (including the draft Law on

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11 For example, the corporate bond market in Mexico was marginal until the introduction of a new instrument — Certificados Bursatiles (CBs) — in the 2001 securities law. The CBs, which combine the structure of medium-term notes and the flexible amortization structure of debentures, contributed to a market takeoff for corporate bonds and accounted for 99 percent of corporate debt issuance in 2004.
37. **An improved framework for corporate governance could also help develop capital markets for corporate securities.** The corporate governance assessment identifies an urgent need to revise the legal framework; improve awareness, understanding, and investor protection; and support a number of private initiatives. The improved transparency of the corporate sector would allow for a better assessment of corporate sector risks, which in turn would encourage capital markets development. The draft amendments to the Capital Market Law, currently under consideration by the BCU's legal department, include corporate governance provisions that are in accordance with IOSCO standards.

### IV. FINANCIAL MARKET INFRASTRUCTURE

#### A. Payments and Securities Settlement Systems

38. **The BCU’s recent upgrading of payments and securities settlement systems should be complemented by strengthening its oversight function and the legal framework.** The BCU should create a Payments System Department with clear responsibility for the operations of its increasingly complex systems and form a small unit in charge of payments system oversight, separate from systems operations. The legal framework needs to be improved in the following areas: the protection of the payment systems against bankruptcy procedures and the establishment of the legal basis for netting arrangements; public securities and repos; custody arrangements; and electronic signatures and documents. To ensure cooperation on payments issues, a formal National Payments Council should be formed involving representatives of all major stakeholders.

39. **The main payments system of the BCU—the Sistema Electrónico de Comunicaciones (SEDEC)—does not comply completely with several CPSS Core Principles (CPs), though improvements are underway.** The BCU is addressing some shortfalls of the existing system to make it fully compliant. A project to migrate the current RTGS (Real Time Gross Settlement) payments system to a new payments system platform is underway. Areas for further improvement include development of clear rules and procedures, establishment of a secondary processing site, and development of business continuity and disaster recovery plans. A comprehensive external audit of the new system should be conducted once the upgrade is completed.

40. **The check clearinghouse operated by the Bolsa Electronica de Valores (BEVSA) is a major funds transfer system that handles some large value payments; it does not comply with most CPSS CPs. Payments safety and stability would be greatly enhanced by requiring large-value payments to move to the RTGS system.**

41. **BEVSA is developing an automated clearinghouse (ACH) to settle electronic credit transfers, direct debits, and other new means of payment.** It is expected, in light of the experience in other countries, that the ACH will help modernize payments and reduce payments costs substantially. The BCU needs to provide oversight and to play a catalytic role in encouraging agreements among potential system users in order to help the ACH begin operations on a large scale and with a sound legal backing.
42. The payments of public sector institutions and the transactions in the over-the-counter foreign exchange (OTC-FX) market should both be moved to the RTGS or ACH. The BCU should closely cooperate with the Treasury and the BROU to increase the efficiency of government payments. In the area of foreign exchange, roughly half of the transactions are on the OTC market and exposed to settlement and credit risk because trades are not on a payment-versus-payment (PvP) basis. The BCU should encourage OTC FX traders to shift to SEDEC, where trades are on a PvP basis.

43. The BCU’s oversight of the securities settlement framework needs to be strengthened. The responsibility of supervision of the settlement of AFAP instruments is the Operational Control Management Office of the Securities Market and AFAP Control Division, and it acts in accordance with AFAP rules. Security settlement oversight is also done in a limited way by the stock exchange in its self-regulatory (SRO) capacity. This SRO function should be complemented by stronger, adequately-resourced BCU oversight to increase investor confidence in the market.

44. The authorities should move toward a single securities depository, linked to RTGS, and strengthen the legal framework for securities custody. The current diversity of custody/depository systems amplifies financial, operational and custodial risks, related to both the lack of delivery-versus-payment settlement (DvP) and weaknesses in the legal framework. The authorities should consider cost-effective ways of establishing a single depository. The shift to a single depository should be done in the context of a comprehensive reform of the payments and securities settlement systems, linking it to the RTGS to allow for DvP. The new securities settlement system should observe the “Recommendations for Securities Settlement Systems” issued by CPSS-IOSCO in November 2001.

B. Accounting and auditing

45. International accounting standards are legally required for nonfinancial corporations but are still poorly understood and compliance is uneven: financial institutions are subject to accounting rules established by the BCU and are expected to move to international standards by 2008. The Accounting and Auditing ROSC found a number of cases of noncompliance with international standards in listed companies.

46. Significant improvement in corporate disclosure is needed to improve lending to corporates and to develop the capital market. Public disclosure of financial information is required for most companies, but not adequately observed, except for banks and issuers of market instruments, where BCU pressure has brought improvement. Information quality is also uneven, even among listed companies. The stock exchanges do not monitor disclosure quality closely and rarely penalize listed companies for noncompliance with rules on information. Regulators of nonfinancial corporations – the National Audit Office (Auditoría Interna de la Nación) and the BCU securities market regulators – have limited capacity to conduct investigations of discrepancies in corporate accounts that may appear. Disclosure of ownership is also limited. These weaknesses

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\[12\] BCU’s securities regulator has made some gains in improving the promptness of filing of information by listed companies, but lacks legal power to fine issuers and has limited access to issuers’ accounts.
complicate lending by financial institutions and enforcement of regulatory rules on exposure, as well as capital market development.

C. The legal system

47. Uruguay has a well-deserved reputation for its legal and judicial integrity, but the length of the judicial enforcement proceedings is often an issue for both secured and unsecured creditors. In the areas of creditor rights significant improvements in this field could be achieved by taking the following measures:

- **Revise the legislation for both secured and unsecured credit execution.** More efficient, accelerated procedures of debt-collection, such as out-of-court enforcement, should be considered. Ways to shorten the current proceedings should also be considered, focusing on reducing judicial intervention.

- **Increase the resources for overburdened courts to increase qualified staff, auxiliaries and modern equipment.** This will help speed up proceedings.

- **Interconnect the data bases of the National Registry.** This will make it possible to obtain nation-wide information on different types of property and their encumbrances, particularly on a company name basis.

48. Uruguayan bankruptcy legislation is not effective but a comprehensive legal reform is under way. The government has recently completed a draft of a new insolvency law that will be subject to public discussion. The proposed law is an integral reform of the fragmented and antiquated insolvency system and envisages approaches to allow both the reorganization of viable enterprises in financial difficulties and the efficient liquidation of nonviable ones, including procedures similar to the U.S. Chapter 11 approach. Of course, the impact of the law will depend on what is passed. It will be desirable to track how the new legislation and improvements in the courts speeds up judgments, and publicize this information.

D. Credit information

49. Credit information is reasonably good and will improve as BHU loans and BROU loans to small borrowers are added and if the system becomes easier to use. Credit information is largely based on the data BCU collects on bank borrowers to ensure banks' ratings are appropriate. This data is made available to all who supply information to the system. Extending the system to the smaller borrowers of the BROU and including the data from BHU and the liquidated banks will increase the incentive for small borrowers to service debt and let them develop the intangible asset of a good credit record. This in turn will improve credit access and help banks improve their portfolios. In addition, access to the BCU data could be made more user-friendly.

V. THE FINANCIAL STABILITY POLICY FRAMEWORK

A. Independence of the Central Bank

50. The proposed amendments to the BCU's charter are aimed at improving its autonomy and accountability. In the draft law, the BCU's main objectives would be
price stability and regulation and supervision of the payments and financial systems. Inflation objectives would be set in coordination with the Treasury. The draft law enhances institutional autonomy of BCU by separating the timing of board appointments from the electoral cycle. The draft law also provides for BCU’s operational autonomy and legal protection for the BCU staff in fulfillment of their duties. Regarding accountability, the BCU would be required to submit an annual report to Congress. The draft law also tightens the financial reporting of the BCU by requiring publication of an audited financial statement in accordance with international accounting standards.

51. The BCU needs recapitalization to strengthen its ability to conduct monetary policy and improve its net income. Currently, seigniorage revenue does not cover BCU’s operating expenditures and the carrying cost of its debt-financed foreign and domestic assets. The deficit constrains monetary policy: for example, the ability to reduce required bank reserves and/or increase their remuneration. It also makes BCU dependent on the Treasury for resources. While BCU’s income position could be improved by downsizing its balance sheet, it needs to maintain reasonable levels of international reserves and domestic public debt. Addressing these issues will require recapitalizing the BCU and, preferably, transferring at least some of its debt to the government.

B. Regulation and Supervision

52. Over the last three years, financial regulation and supervision have improved significantly, especially regarding banks; the draft BCU law envisages integrating regulation and supervision across the whole financial sector. The Superintendency has played an important role in stimulating the banks, particularly BROU, to improve risk management. The authorities have taken various measures to make banks internalize credit risks from dollarization and cross border activities and to limit exposure and risk concentrations. It has also overhauled loan classification and capital regulations. Regulations imposing capital charges for market risk are taking effect. Guidelines on interest rate and operational risks will need to be issued. Progress has been made in the regulation and supervision of state banks, although much remains to be done. The bank resolution framework is being strengthened, although constitutional constraints limit the framework’s applicability to the state banks. The Superintendency has also systematically increased the disclosure of financial information to the market, which has contributed to greater market discipline. The proposed new law envisages financial supervision and regulation becoming a separate autonomous unit within the BCU and reorganized to integrate coverage of banking, insurance, securities and pensions.

53. Three key problems hinder the effectiveness of financial sector oversight across all sectors – lack of resources, limits on powers with regard to state institutions, and quality of data that state institutions provide. While technically competent, the supervisory staff is generally overstretched, and focused on day-to-day supervisory needs. Funding is scarce for information systems and training staff in up-to-date supervisory methods, financial practices, and market risks, reflecting the general problem of the BCU’s net income. Access to resources from multilateral organizations has allowed the Banking Superintendency to partially overcome these constraints, but these resources are temporary. Second, the supervision of public financial institutions is limited by the legal framework. The capacity of supervisors to enforce corrective actions is limited by their inability to require changes in direction and management in public
sector financial institutions. Third, the quality and timeliness of data provided by the public financial institutions remain a problem, which affects both their supervision and the general ability of the government to oversee public financial institutions. These issues are reflected in the assessment of compliance with the Basel Core Principles (BCP) which indicates that, in spite of recent progress, additional improvement is required.

54. **Efforts are also needed to improve the supervision of banks’ compliance with anti-money laundering (AML) polices and procedures.** Uruguay is vulnerable to money laundering and the financing of terrorism, particularly from its cross-border activities. Its role as an offshore center exposes it to such risks including from banking, securities, currency exchange and remittance business. Uruguay has put in place many of the basic legal elements for an AML/CFT regime but the legislation does not cover all categories of serious offenses required by FATF. Furthermore, no system-wide review of money laundering and financing of terrorism risks has been conducted, and awareness of risks is generally low. Financing of terrorism was criminalized in September 2004, but limitations in the law seem to exclude financing of terrorist organizations or individuals not linked to specific terrorist acts. AML/CFT supervision by the BCU, an integrated supervisor, is still developing but is more advanced in the banking sector. A key challenge will be in finding adequate resources for AML/CFT supervision given the many institutions under BCU’s jurisdiction. An in-depth review of AML procedures was conducted by a separate team of specialists from GAFISUD. The findings and recommendations were provided to the authorities.

55. **Significant differences exist between the Chart of Accounts for financial institutions issued by the BCU and international accounting standards, which is expected to be remedied by end-2008.** All enterprises, except financial institutions, must comply by 2006 with International Accounting Standards (IAS) issued by the International Accounting Standards Board (IASB). Key issues for financial institutions relate to the accounting treatment of derivatives, the accrual of labor costs and taxes as well as lack of sufficient information in audited financial statements to allow analysts to estimate divergence from IAS. The BCU contemplates updating the Chart of Accounts by end-2006 and banks’ full compliance with the IAS to commence on December 31, 2008.

56. **In the nonbank sectors, the supervision of AFAPs is generally adequate, though some improvements in regulation and supervision would reduce vulnerabilities and improve their potential.** To implement rapidly the recently adopted risk-based supervision and the regulations on internal controls systems, the investment allocation rules to improve diversification would need to be liberalized along with an increase in resources, both generally and for staff training.

57. **Regarding the insurance sector, the regulation and supervision of composite companies, annuities and BSE should be improved.** There is a need to strengthen capital and provisioning rules and financial reporting, including a review of the treatment and transparency of reinsurance. Composite companies (life and nonlife) represent a special challenge; a clear separation of results and portfolios is necessary. Companies providing annuities need to be better supervised in terms of capital and financial reporting standards, particularly before annuity growth accelerates as AFAP retirees grow in number. Finally, BSE represents perhaps the most significant challenge. Efforts are
needed to improve the quality and timeliness of BSE data. Furthermore, an independent analysis is needed of the potential contingent liabilities of BSE products.

C. Safety Nets and Crisis Management

58. Powers to assist and resolve weak banks have been enhanced since the 2002 crisis, but additional measures are necessary. The legal framework adopted in 2002 gives the BCU broad range of powers to impose corrective actions and resolve problem banks, and substantial discretion in their use. Although supervisors need flexibility, excessive discretion can delay corrective actions and may create legal contingencies. It is recommended that the law establish situations in which specific corrective actions are mandatory within a limited time frame. Additionally, the BCU should set up clear internal procedures for applying prompt corrective actions. Most important, the role of the BCU as liquidity provider “under extreme circumstances” needs clarification.

59. A deposit insurance fund became operational in 2005. The maximum coverage is US$5,000 for dollar deposits and the equivalent of US$15,000 for peso deposits, per depositor per bank. This coverage is more generous than elsewhere in the region. Also, BROU’s charter provides full government guarantees for its depositors. (The maturity of BROU and BHU time deposits was, however, reprogrammed in the 2002 crisis.)

60. The draft BCU legislation establishes the deposit insurance agency (COPAB) as an autonomous institution outside of the BCU with the responsibility for the resolution and liquidation of problem institutions. The draft law stipulates that once the BCU declares a financial institution insolvent or unfit to operate, the COPAB has 90 days to decide whether to liquidate or to proceed with an alternative resolution plan, based on least-cost criteria. Deposit insurance funds can be used to pay depositors of a liquidated bank or to facilitate the resolution plan. The draft law calls for the COPAB to develop a decision-making and accountability framework for the resolution process. It appropriately includes the legal protection for COPAB staff while in fulfillment of their duties. While the draft law calls for the coordination of information sharing and other activities between the COPAB and the new Superintendency of Financial Services, no arbitrator is specified in case of a conflict. Coordination and conflict resolution may prove even more difficult once the agency moves outside the BCU.

61. The authorities would benefit from developing a comprehensive contingency plan for handling banking crises and other market disturbances. A comprehensive contingency plan would allow the authorities to identify probable solutions for alternative crisis scenarios, test these solutions and the effectiveness of the implementation arrangements in place, and identify weaknesses to be addressed. The plan should define the roles of each of the parties involved in managing a crisis and the means for effective coordination (BCU, Deposit Insurance Agency, MEF and private institutions).
RECOMMENDATIONS

Short-term stability-related issues

- Continue close monitoring of public banks to ensure that their risk management policies and practices are brought up to standard.
- Continue to limit lending activities in these banks until such improvements are achieved.

Key structural and longer-term issues

- Restructuring and downsizing of the state institutions, in particular state banks, to minimize moral hazard.
- Require directors and managers of public financial institutions to satisfy fit and proper requirements applied to the private institutions.
- Strengthen central bank independence and recapitalize the central bank as envisaged in the draft law submitted to congress.
- Remove the selective employer exemptions from contributions to public pensions as envisaged in the proposed tax law, carry out further reforms to reduce the public and sectoral pension funds' deficits, and eliminate the guaranteed rate of return in AFAP República that is implicitly government-guaranteed.
- Conduct an independent analysis of the potential contingent liabilities from products offered by the state insurance company, BSE, as well as any proposals for mortgage insurance.
- Reduce the tax burden and improve the legal and regulatory framework for trust funds and securitizations.
- Reform the insolvency legislation to allow for the reorganization of viable firms and the faster, efficient liquidation of nonviable ones as envisaged in the proposed bankruptcy law.
- Strengthen the credit culture by making the credit registry easier to use, speeding up incorporation of BHU loans and the small loans of BROU, strengthening the credit and debt relief practices of public banks, and shortening foreclosure and bankruptcy processes.
- Implement the shift to an upgraded RTGS system and the launch of the ACH for retail payments and improve the legal framework related to payments and securities settlement systems.
Strengthening the supervisory and regulatory framework

- Increase resources to carry out effective supervision and to provide training for staff; improve information systems.

- Provide legal protection for staff of supervisory agencies and deposit insurance agency.

- Enhance AML/CFT legislation.

- Improve cooperation and information exchange with foreign supervisors, including through additional MOUs.

- Enhance the regulatory authority over securities intermediaries; improve supervision of BSE, composite life and nonlife insurance companies, and the annuities industry.
Table 1. Uruguay: Structure of the Financial System

<table>
<thead>
<tr>
<th></th>
<th>December 31, 2001</th>
<th>December 31, 2005</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number</td>
<td>Assets (In millions of U.S. dollars)</td>
</tr>
<tr>
<td>Commercial Banks</td>
<td>22</td>
<td>20,609</td>
</tr>
<tr>
<td><em>Of which</em></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Public sector-owned banks</td>
<td>2</td>
<td>7,457</td>
</tr>
<tr>
<td>BROU</td>
<td>1</td>
<td>4,788</td>
</tr>
<tr>
<td>BHU</td>
<td>1</td>
<td>2,668</td>
</tr>
<tr>
<td>Nuevo Banco Comercial S.A.</td>
<td>1</td>
<td>4,788</td>
</tr>
<tr>
<td>Domestic private banks</td>
<td>3</td>
<td>3,172</td>
</tr>
<tr>
<td>Foreign banks 1/</td>
<td>17</td>
<td>9,980</td>
</tr>
<tr>
<td>Nonbank intermediaries</td>
<td>25</td>
<td>9,980</td>
</tr>
<tr>
<td>Cooperatives</td>
<td>6</td>
<td>478</td>
</tr>
<tr>
<td>Financial houses</td>
<td>7</td>
<td>540</td>
</tr>
<tr>
<td>External financial institutions 2/</td>
<td>12</td>
<td>1,816</td>
</tr>
<tr>
<td>Pension funds (AFPs)</td>
<td>4</td>
<td>1,045</td>
</tr>
<tr>
<td>Insurance companies</td>
<td>17</td>
<td>572</td>
</tr>
<tr>
<td><strong>Total financial system</strong></td>
<td>68</td>
<td>25,060</td>
</tr>
</tbody>
</table>

Source: Banco Central de Uruguay.
1/ Includes both foreign branches and subsidiaries.
2/ Includes derivatives transactions.
Table 2. Uruguay: Selected Macroeconomic Indicators

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(Percent change, unless otherwise indicated)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>I. Output, prices, and employment</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Real GDP</td>
<td>-11.0</td>
<td>2.2</td>
<td>11.8</td>
<td>6.8</td>
</tr>
<tr>
<td>GDP (US$ billions)</td>
<td>12.1</td>
<td>11.2</td>
<td>13.3</td>
<td>16.9</td>
</tr>
<tr>
<td>GDP deflator</td>
<td>18.7</td>
<td>18.4</td>
<td>7.5</td>
<td>1.7</td>
</tr>
<tr>
<td>CPI inflation (eop)</td>
<td>25.9</td>
<td>10.2</td>
<td>7.6</td>
<td>4.9</td>
</tr>
<tr>
<td>Exchange rate change (Ur$/US$ (eop))</td>
<td>84.2</td>
<td>7.3</td>
<td>-9.9</td>
<td>-8.3</td>
</tr>
<tr>
<td>Average public sector wage (end-of-period)</td>
<td>0.5</td>
<td>7.9</td>
<td>9.7</td>
<td>10.2</td>
</tr>
<tr>
<td>Unemployment (in percent)</td>
<td>17.0</td>
<td>16.9</td>
<td>13.1</td>
<td>12.1</td>
</tr>
<tr>
<td><strong>II. Monetary indicators</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Base Money 1/</td>
<td>22.1</td>
<td>24.9</td>
<td>11.1</td>
<td>34.1</td>
</tr>
<tr>
<td>M1</td>
<td>1.7</td>
<td>34.6</td>
<td>13.4</td>
<td>29.4</td>
</tr>
<tr>
<td>M3</td>
<td>15.8</td>
<td>21.7</td>
<td>-2.0</td>
<td>0.1</td>
</tr>
<tr>
<td>Credit to the private sector (constant exch. rate) 2/</td>
<td>-17.6</td>
<td>-23.9</td>
<td>-11.2</td>
<td>2.7</td>
</tr>
<tr>
<td><strong>III. Public sector operations</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenue</td>
<td>32.1</td>
<td>32.0</td>
<td>30.9</td>
<td>31.8</td>
</tr>
<tr>
<td>Non-interest expenditure (incl. discrepancy)</td>
<td>32.1</td>
<td>29.3</td>
<td>27.2</td>
<td>27.9</td>
</tr>
<tr>
<td>Primary balance</td>
<td>0.0</td>
<td>2.7</td>
<td>3.8</td>
<td>3.9</td>
</tr>
<tr>
<td>Interest</td>
<td>4.7</td>
<td>6.0</td>
<td>6.0</td>
<td>4.6</td>
</tr>
<tr>
<td>Overall balance</td>
<td>-4.6</td>
<td>-3.2</td>
<td>-2.2</td>
<td>-0.7</td>
</tr>
<tr>
<td>Public sector debt 3/</td>
<td>96</td>
<td>104</td>
<td>92</td>
<td>69</td>
</tr>
<tr>
<td>Public debt service (as a percent of GDP)</td>
<td>13</td>
<td>14</td>
<td>19</td>
<td>16</td>
</tr>
<tr>
<td><strong>IV. Savings and investment</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross domestic investment</td>
<td>11.5</td>
<td>12.6</td>
<td>13.3</td>
<td>13.2</td>
</tr>
<tr>
<td>Gross national savings</td>
<td>14.7</td>
<td>12.1</td>
<td>13.6</td>
<td>12.6</td>
</tr>
<tr>
<td>Foreign savings</td>
<td>-3.2</td>
<td>0.5</td>
<td>-0.3</td>
<td>0.5</td>
</tr>
<tr>
<td><strong>V. External indicators</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Merchandise exports, fob (US$ millions)</td>
<td>1,922</td>
<td>2,281</td>
<td>3,145</td>
<td>3,758</td>
</tr>
<tr>
<td>Merchandise imports, fob (US$ millions)</td>
<td>1,874</td>
<td>2,098</td>
<td>2,992</td>
<td>3,826</td>
</tr>
<tr>
<td>Merchandise terms of trade (percentage change)</td>
<td>4.3</td>
<td>2.9</td>
<td>-3.1</td>
<td>-9.7</td>
</tr>
<tr>
<td>Current account balance</td>
<td>3.2</td>
<td>-0.5</td>
<td>0.3</td>
<td>-0.5</td>
</tr>
<tr>
<td>Of which: Excluding cellulose projects</td>
<td>3.2</td>
<td>-0.5</td>
<td>0.3</td>
<td>0.1</td>
</tr>
<tr>
<td>Foreign direct investment</td>
<td>1.5</td>
<td>3.6</td>
<td>2.4</td>
<td>3.6</td>
</tr>
<tr>
<td>Overall balance of payments (US$ millions)</td>
<td>-2,328</td>
<td>1,380</td>
<td>454</td>
<td>951</td>
</tr>
<tr>
<td>External debt 4/</td>
<td>87.5</td>
<td>98.2</td>
<td>87.4</td>
<td>67.8</td>
</tr>
<tr>
<td>External debt service (percent of exports of goods and services)</td>
<td>55.0</td>
<td>52.3</td>
<td>44.8</td>
<td>47.0</td>
</tr>
<tr>
<td>Gross official reserves (US$ millions) 5/</td>
<td>772</td>
<td>2,087</td>
<td>2,512</td>
<td>3,438</td>
</tr>
<tr>
<td>In months of imports of goods and services</td>
<td>3.7</td>
<td>9.2</td>
<td>8.0</td>
<td>8.7</td>
</tr>
<tr>
<td>In percent of short-term debt plus FX deposits</td>
<td>7.0</td>
<td>20.0</td>
<td>27.7</td>
<td>32.9</td>
</tr>
<tr>
<td>REER (percentage depreciation , e.o.p.)</td>
<td>-20.3</td>
<td>-13.2</td>
<td>9.3</td>
<td>11.9</td>
</tr>
</tbody>
</table>

Sources: Data provided by the Uruguayan authorities; and Fund staff estimates.
1/ Program definition (end of period data).
2/ Part of the sharp drop in 2003 is due to the removal of the three liquidated banks from the database in May 2003.
3/ Covers debt of the NFF'S and the central bank (excluding monetary policy instruments and free reserves).
4/ Excludes nonresident deposits.
5/ Includes reserve buildup through reserve requirements of resident financial institutions.
Figure 1. Banking System Total Assets and Deposits in Latin America, 2004
(In percent of GDP)

Total Assets

Total Deposits

Note: Data for Uruguay is as of December 2005.
Source: IMF staff calculations based on data from Uruguayan Authorities, Superintendencia de Bancos e Instituciones Financieras - Chile, Federación Latinoamericana de Bancos, IMF International Financial Statistics and WEO.