INTERNATIONAL MONETARY FUND

Staff Country Reports

May 2013
IMF Country Report No. 13/152

Uruguay: Financial System Stability Assessment

This paper was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on November 29, 2012. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of Uruguay or the Executive Board of the IMF.

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Washington, D.C.

INTERNATIONAL MONETARY FUND

URUGUAY

Financial System Stability Assessment

Prepared by the Monetary and Capital Markets and Western Hemisphere Departments

Approved by R. Sahay and S. Lizondo

November 29, 2012

This report is based on the work of a joint IMF-World Bank Financial Sector Assessment Program (FSAP) mission to Uruguay during September 5–19, 2012. The team comprised Fernando Montes-Negret (head of mission, IMF), Mario Guadamillas (head of mission, World Bank), Karl Driessen, Samar Maziad, Joaquín Gutierrez Garcia, Camilo Tovar (IMF staff); Steen Byskov, Pierre-Laurent Chatain, Massimo Cirasino, Inés González del Mazo, Heinz Rudolph, and Claire L. McGuire (World Bank staff); and Rodrigo Alfaro, José Antonio García, Tanis MacLaren, and Adolfo Rouillon (consultants).

- High buffers and a buoyant economy have insulated the financial sector from global financial turmoil. Since its 2002 banking crisis, Uruguay has built up reserves, improved its public debt profile, reduced its dependence on nonresident bank deposits, and adopted prudential measures targeting liquidity and foreign exchange risks. Landmark legal, regulatory, and institutional reforms were adopted.

- The financial system appears sound, and is backed either by the state or by international banking groups; at the same time, credit is expensive and low in relation to GDP, and the playing field between public and private financial institutions is not level. Vulnerabilities also stem from still high dollarization, the large presence of subsidiaries of major Spanish banks, and commodity price and regional economic volatility.

- Significant progress has been made in banking supervision, including in implementing the Basel II standards and in adopting a risk-based approach. Remaining challenges include the insufficiency of resources and operational independence, as well as the need to bolster oversight of, and enforcement over, state institutions.

- Recent improvements in the financial sector safety net require operational follow-up. Remaining weaknesses in the bank resolution regime should be addressed. The deposit protection agency should be involved earlier in the bank resolution decision process.

The main author of this report is Karl Driessen, with contributions from the members of the FSAP team.

FSAP assessments are designed to assess the stability of the financial system as a whole and not that of individual institutions. They have been developed to help countries identify and remedy weaknesses in their financial sector structure, thereby enhancing their resilience to macroeconomic shocks and cross-border contagion. FSAP assessments do not cover risks that are specific to individual institutions such as asset quality, operational or legal risks, or fraud.

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GLOSSARY

ACH	Automated clearing house
AFAP	Pension funds
AML/CFT	Anti-money laundering and combating the financing of terrorism
ATM	Automated teller machine
BCP	Basel Core Principles
BCU	Central Bank of Uruguay
BPS	Banco de Prevision Social (Social Security Fund)
BROU	Publicly owned commercial bank
BSE	Banco de Seguros del Estado (State Insurance Institute)
CAR	Capital adequacy ratio
CEF	Comite de Estabilidad Financiera (Financial Stability Committee)
CERT	Risk-rating system
COPAB	Corporación de Protección del Ahorro Bancario (Deposit Insurance Fund)
CR	Central de Riesgos (Credit Registry)
CSD	Central Securities Depository
EACS	Empresas Administradoras de Crédito
FDI	Foreign direct investment
FMI	Financial market infrastructure
FSAP	Financial Sector Assessment Program
GAFISUD	Grupo de Accion Financiera de Sudamerica
GDP	Gross domestic product
IADI	International Association of Deposit Insurers
ICAAP	Internal Capital Adequacy Assessment Process
IOSCO	International Organization of Securities Commissions
IT	Information technology
LOLR	Lender of last resort
MEF	Ministry of Economy and Finance
MOU	Memorandum of Understanding
NRD	Nonresident deposits
PPP	Public Private Partnerships
RTGS	Real Time Gross Settlement
RWA	Risk-weighted assets
SOE	State-owned enterprises
SPI	Sistema de Pagos Interbancarios (Interbank payments system)
SREP	Supervisory Review and Evaluation Process
SSF	Superintendency of Financial Services
SSS	Securities Settlement System
STP	Straight-through-processing

EXECUTIVE SUMMARY

Since the 2006 Financial Sector Assessment Program (FSAP), Uruguay has continued to strengthen financial sector supervision and build its resilience against shocks. The 2002 banking crisis left behind a much-reduced financial sector and significant public debt, and measures were taken to stabilize and slowly rebuild the financial system. Significant progress was noted in the 2006 FSAP, and subsequently the authorities have adopted landmark legal, regulatory and institutional reforms, including laws on insolvency, competition, payments system, capital markets, and deposit insurance.

High buffers and a buoyant economy have served to insulate the financial sector from the effects of the global financial crisis. Since its own 2002 crisis, Uruguay built up higher international reserves, improved its public debt profile (both in terms of currency composition and of maturity), sharply reduced its dependence on nonresident bank deposits that played an important role in triggering the 2002 bank run, instituted a deposit insurance framework, and adopted prudential measures targeting liquidity and foreign exchange risks. These reforms were complemented by sound fiscal policies that led to a sharp reduction in public debt, in the context of an economy enjoying rapid growth driven by exports and foreign direct investment. These efforts have been rewarded by the recovery of its investment grade status.

Uruguay's banking sector financial indicators are sound overall, but a number of challenges remain. Its small size and high-cost structure affects profitability and weighs on Uruguay's broader development prospects. There is also a significant state presence—in banking as well as in other parts of the financial sector—which may weaken competition. The presence of a systemically important publicly owned commercial bank (BROU) at the center of financial transaction processing affects both operational risk and the development of the retail payment system infrastructure. Systemic vulnerabilities stem from still high dollarization, uncertainties surrounding foreign parent banks,[1] as well as the exposure of the system to commodity prices and regional shocks. Although overall banking system capitalization is adequate, buffers of some private banks are close to regulatory minima, given group capital allocation decisions.

Leveling the playing field between public and private institutions might inject additional dynamism in the financial sector. Possible measures include extending the ability to make payroll deductions for debt service to all banks—currently limited to BROU—and designating the Central Bank of Uruguay (BCU) as the sole depository of government funds. At the same time, it is important to continue modernizing BROU in the areas of governance, information technology, and risk management systems, as well as

[1] Although there is no reliance on foreign bank funding, subsidiaries have placed significant deposits abroad including at parent banks.

simplifying its oversight and procurement regime, to enhance its efficiency and respond faster to the challenges it faces.

Supervision has improved significantly. The Superintendency of Financial Services (SSF) made progress in implementing the Basel II standards and in moving toward risk-based supervision. When judged against Basel Core Principles (BCP), improvements have been made in the areas of capital adequacy, market, liquidity, and operational risks, as well as in accounting, disclosure, and anti-money laundering and combating the financing of terrorism (AML/CFT), including by adopting a National Strategy against money laundering, amending the law, and significantly strengthening its surveillance over banks' compliance in this area.

Remaining challenges in supervision pertain to insufficiency of resources and operational independence, and of enforcement actions against state institutions. The expansion of the regulatory perimeter is straining the SSF's ability to maintain the desired quality of supervision. More resources would allow the SSF to: (i) supervise BROU more intensively given its systemic importance; (ii) increase transactional testing—thus reducing excessive reliance on external auditors; (iii) refine stress testing techniques and generally strengthen risk analysis; and (iv) refine the risk rating system (CERT) and its processes. Specifying the possible causes for removing the Superintendent from office would enhance supervisory independence, as would clarifying how SSF's operational and technical autonomy is defined by BCU's Board role regarding supervision. Finally, enforcement over public sector banks should be strengthened.

Recent improvements in the financial sector safety net require operational follow up. The Financial Stability Council should strengthen contingency planning, including simulations, deposit payout exercises, and preparation of Memoranda of Understanding (MoUs) and lender-of-last-resort (LOLR) operations. Remaining weaknesses in the bank resolution regime, including allowing the suspension of the activities of a troubled bank for up to 120 days, the absence of a bridge bank, and the reversibility by courts of bank resolution and liquidation decisions, should be addressed. The deposit protection agency—assessed against International Association of Deposit Insurers (IADI) Core Principles for Effective Deposit Insurance Systems—should be involved earlier in the bank resolution decision process to make the possibility of arranging for a purchase and assumption by another bank realistic, and offer legal protection for contractual employees.

Other measures would help develop the financial sector further. Broadening the scope for investment abroad by pension funds would reduce the reliance on low-yielding government securities. The current insolvency system would benefit from more general out-of-court enforcement of secured claims. Oversight over retail payment networks should be accelerated, and the BCU should continue to catalyze and expedite the development of the Automated Clearing House (ACH) to spur efficiency gains and foster greater competition in the banking sector.

Table 1. Uruguay: FSAP Key Recommendations

Recommendations	Paragraph
Resources and Autonomy of Regulator	
Increase supervisory independence via broadening the technical and operational independence of the SSF.	23
Increase financial and human resources for SSF.	24
Regulation and Supervision of the Banking Industry	
Better discriminate among banks of different risk profiles, including capturing low probability but high impact events.	27
Enhance risk concentration rules to capture linkages among connected borrowers due to financial, commercial, and operational exposures.	27
Provide further guidance to the industry on expected risk measurement, stress testing, contingency planning, risk management, and AML/CFT standards.	27
Require systemic and large banks to operate separate risk management units and integrate risk measures into limits/operations.	27
Securities Market	
Prepare a comprehensive capital market development strategy, including bringing new issuers to the market.	46
Insurance, Pension Funds and Annuities Market	
Contract an independent diagnostic of the Banco de Seguros del Estado (BSE), including a review of its strategy, solvency, efficiency, and governance.	31
Liberalize pension fund rules for investing abroad.	48
Provide hedging mechanisms or allow for phased withdrawals to address shortcomings of existing pension indexation requirements.	48
Safety Net and Crisis Management	
Strengthen contingency planning, develop scenarios, and specify agencies' roles.	38
Undertake joint and separate crisis preparedness work among the safety net participants.	38
Financial Infrastructure	
Amend the procedural legislation to accelerate the asset execution process, including effective measures to expedite the post-judgment phase.	49
Finalize decisions with regard to the functionalities of the CSD (efficient interfaces with trading systems, identification of beneficial owners).	34
Develop and implement the payment system oversight function, including SSS and retail payments.	34
Finalize an agreement on the interbank pricing scheme for the ACH to become operational.	50

I. Introduction

A. Macroeconomic Performance and Outlook

1. **The buffers built in the aftermath of Uruguay's 2002 banking crisis have largely shielded the financial sector from the effects of the global financial turmoil.** The 2002 banking crisis that brought all locally owned banks to bankruptcy left behind a much reduced financial sector and significant public debt, and measures were taken to stabilize and slowly rebuild buffers in the financial system.[2] These reforms were complemented by sound fiscal policies that led a sharp reduction in public debt, in the context of an economy enjoying rapid growth driven by exports and foreign direct investment.

2. **Growth has been robust over the last decade, and the outlook continues to be favorable; however, inflation persists above the target range.** In 2009, the slowdown in growth owing to the impact of the global crisis on the economy was relatively mild and short-lived, and was followed by a sharp bounce back in 2010 and 2011 (Table 2). The near- and medium-term outlook remains good in light of high foreign direct investment (on average 5.4 percent of GDP since 2004) into industries such as agribusiness and pulp, and favorable terms of trade. Although inflation has fallen to single-digit levels, it remains above the target range (4 percent to 6 percent).

3. **Capital inflows have picked up and policy measures have been taken in response.** The recent upgrade of sovereign debt to investment grade by two major credit rating agencies has increased Uruguay's attractiveness for investors, stimulating a surge in short-term capital inflows, albeit from a small base. The authorities have already put in place capital flow management measures aimed at discouraging inflows into central bank monetary policy paper.

B. Macrofinancial Risks

4. **Uruguay exhibits no obvious signs of near-term domestic macrofinancial vulnerability.** There appears to be no credit bubble, households are not heavily leveraged, enterprises have reduced their vulnerability to foreign exchange mismatches, and the banking system is relatively robust and highly liquid.

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[2] Uruguay built up higher international reserves, improved its public debt profile (reducing the share of central government foreign currency-denominated debt from 95 percent to 48 percent between 2002 to 2011, lengthening the average maturity to over 12 years by end 2012 and actively pre-financed public sector debt to mitigate rollover risks), contracted contingent credit lines with multilateral agencies, sharply reduced its dependence on nonresident bank deposits that played an important role in triggering the 2002 bank run, instituted a deposit insurance framework, and adopted prudential measures targeting liquidity and foreign exchange risks.

5. **The main external risks to the economy and the financial system come from a fragile global environment.** This may translate in a potential fall in export prices, as well as possible spillovers from the Eurozone (including from Spanish banks whose subsidiaries operate in Uruguay) or neighboring countries. Although Argentina continues to be the main trading partner in goods and services (tourism) and real estate investment, trade and financial linkages have declined over time (merchandise exports have fallen to about 7 percent of total exports), and nonresident deposits have declined to less than 17 percent of total bank deposits.

6. **Dollarization continues to expose the financial sector to risk.** Despite the gradual decline in dollarization ratios, at end-2011 about 72 percent of total loans and 74 percent of deposits were still denominated in U.S. dollars. Although banks hold long positions in foreign exchange and the country's foreign exchange liquidity buffers are ample, dollarization increases credit risk for imperfectly hedged borrowers, and poses a residual systemic risk in the unlikely event of a run on dollar deposits. Prudential measures such as foreign exchange position limits and higher provisioning requirements for nonhedged loans have helped limit the associated foreign exchange-related market and credit risks.

7. **Policy measures are recommended to reduce dollarization.** In particular better anchoring inflation and its expectations would encourage long-term savings and lending denominated in local currency, as it would reduce inflation risk premia. Moreover, improvements in public debt management and monetary operations (e.g., introducing a primary dealer program, rationalizing the maturities of securities in the market, or using repos for managing liquidity)—areas in which authorities have already made some progress—can help build up liquidity in secondary markets and promote the deepening and development of domestic currency capital markets.

Table 2. Uruguay: Selected Economic and Social Indicators

	2007	2008	2009	2010	Prel. 2011	Proj. 2012
	(Percent change, unless otherwise specified)					
Real GDP	6.5	7.2	2.4	8.9	5.7	3.5
GDP (US$ billions)	23.4	30.4	30.5	39.4	46.7	49.2
CPI inflation (average)	8.1	7.9	7.1	6.7	8.1	8.0
Unemployment (in percent, end of period)	7.7	6.8	6.3	5.4	5.3	6.0
Base Money 1/	16.4	29.3	6.5	16.2	17.3	27.4
M-1 1/	29.4	18.6	12.2	28.9	21.3	20.4
M-2 1/	30.6	17.1	15.0	30.3	21.4	17.4
M-3 1/	3.8	28.6	-2.6	22.1	17.2	27.0
Credit to the private sector (constant exch. rate) 1/	22.1	28.0	-7.5	21.3	20.3	20.8
NPL ratio	1.1	1.0	1.2	1.0	1.3	...
Bank assets (in percent of GDP)	58.5	66.1	58.8	61.5	61.5	...
Foreign bank market share	54.5	56.8	56.4	57.6	56.7	...
	(Percent of GDP, unless otherwise specified)					
Revenue 2/	28.6	26.9	28.7	29.4	28.9	29.0
Non-interest expenditure 2/	25.3	25.7	27.9	27.7	27.1	28.8
Wage bill	4.6	4.6	5.2	5.0	5.0	5.1
Primary balance 3/	3.6	1.4	1.1	1.9	2.0	0.5
Interest 3/	3.6	2.9	2.9	3.0	2.9	2.8
Overall balance 3/	0.0	-1.6	-1.8	-1.1	-0.9	-2.3
Gross public sector debt	64.4	63.3	62.7	58.0	57.8	52.3
Foreign currency debt	44.7	44.2	40.9	33.0	27.9	23.5
Net public sector debt 4/	38.1	31.6	32.0	31.2	34.4	31.2
Merchandise exports, fob (US$ millions)	5,100	7,095	6,392	8,031	9,307	9,852
Merchandise imports, fob (US$ millions)	5,645	8,810	6,896	8,558	10,690	11,195
Terms of trade (percentage change)	2.3	-1.2	5.7	-3.0	0.1	3.1
Current account balance	-0.9	-5.7	-1.5	-2.2	-3.1	-3.0
Foreign direct investment	5.7	6.9	5.0	5.8	4.7	6.8
Overall balance of payments (US$ millions)	1,005	2,232	1,588	-361	2,564	2,385
External debt 5/	48.3	46.1	40.4	35.4	32.9	30.5
Of which: external public debt	43.7	41.1	36.6	32.4	29.8	25.9
External debt service (percent of exports of goods and services)	26.1	21.7	23.8	29.7	21.2	26.9
Gross official reserves (US$ millions) 6/	4,124	6,362	8,040	7,655	10,274	12,659
In months of imports of goods and services	4.8	9.3	9.5	7.2	9.2	10.7
In percent of short-term debt	471.8	797.2	772.3	517.1	447.9	512.8
In percent of short-term debt plus bank nonresident deposits	117.2	151.4	162.6	129.5	151.4	179.7

Sources: Banco Central del Uruguay, Ministerio de Economia y Finanzas, Instituto Nacional de Estadistica, and Fund staff calculations.

1/ In 2012 corresponds to the change between June 2011 and June 2012.

2/ Non-financial public sector, excluding local governments.

3/ Total public sector.

4/ Public sector debt net of Banco Central del Uruguay' assets.

5/ Excludes nonresident deposits.

6/ Includes reserve buildup through reserve requirements of resident financial institutions.

Table 3. Uruguay: Selected Financial Soundness Indicators

	2007	2008	2009	2010	2011	2012 1/	LA5 1/ 2/
Regulatory capital in percent of risk-weighted assets	17.8	16.7	16.8	15.2	14.3	15.0	15.7
Non-performing loans in percent of total loans	1.1	1.0	1.2	1.0	1.3	1.4	2.5
Non-performing loans in percent of total household loans	3.4	3.3	3.4	3.1	3.0	3.5	n.a
Specific loan-loss provisions in percent of non-performing loans	55.1	63.1	72.8	72.2	74.0	70.4	155.0
Operating costs in percent of gross income	n.a	80.5	97.9	87.3	79.8	66.5	n.a
Return on assets 3/	1.8	1.6	0.5	1.2	1.2	2.1	1.6
Return on equity 4/	18.0	16.3	5.5	12.1	12.6	24.4	20.8
Liquidity ratio (maturities up to 30 days) 5/	53.9	66.0	64.4	56.9	54.1	52.1	30.6
Dollar loans in percent of total loans	79.8	79.2	73.9	72.4	70.3	71.6	22.2 6/
Dollar deposits in percent of total deposits	78.2	80.7	76.8	74.3	72.3	74.2	18.4 6/
Private sector credit in percent of GDP	24.1	22.4	23.9	23.4	20.5	22.0	31.8
Household consumer credit in percent of GDP	3.9	4.0	4.0	5.1	5.9	5.7	n.a
Implicit exchange rate risk 7/	35.2	36.2	31.6	31.4	31.4	34.0	n.a

Sources: Banco Central del Uruguay, IMF Global Financial Stability Report, and Fund staff calculations.

Data excludes Banco Hipotecario del Uruguay.

1/ Latest available data.

2/ Median of Brazil, Chile, Colombia, Mexico, and Peru. The official definition of soundness indicators varies by country.

3/ Annualized net income before extraordinary items and taxes from the beginning of the year until the reporting month, in percent of average value of total assets over the same period.

4/ Same as footnote 3 but in percent of average value of capital over the same period.

5/ Liquid assets with maturity up to 30 days in percent of total liabilities expiring within the same period.

6/ Excludes Brazil.

7/ Share of foreign currency credit to unhedged borrowers.

C. Financial Sector Structure

8. **Uruguay's financial system is characterized by an unusual set of structural factors.** The banking system is small (private sector credit amounted to 22 percent of GDP at end-2011, well below comparable countries), very liquid, highly dollarized, and dominated by a publicly owned bank; the largest private banks are foreign-owned branches and subsidiaries of major international banks that engage in narrowly focused activities (Table 3).[3] These characteristics are shared by the insurance and pension sectors. These factors, combined with high labor costs and restrictive labor practices, have led to disintermediation away from traditional banking activities, market segmentation, lagging financial infrastructure, and impede reaching economies of scale and a more cost-efficient and robust industrial organization. This has implications for both supervision and the sector's capacity to contribute to Uruguay's economic development.

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[3] The banking sector is continuing a process of consolidation that started after the 2002 crisis when several banks failed. In 2008, Santander and ABN AMRO merged; BBVA and Credit Agricole Uruguay merged in 2011. Lloyds announced the sale of its operations in September 2012.

9. **The excess of very liquid financial savings and a generalized lack of domestic financial assets—particularly private—explain the very low cost of deposits.** Capital market development is at a very early stage: other than government and central bank securities, investment opportunities in other instruments are virtually nonexistent, especially long-term ones; there is little secondary market activity. The biggest companies are publicly owned and rarely issue securities in the capital market and there are very few mortgage securities. There is an incipient development of Public Private Partnerships (PPPs) that can provide an opportunity for long-term instruments in the future.

10. **State-owned financial institutions dominate the banking, insurance, and pensions sectors, as well as capital markets.** A large publicly owned commercial bank (BROU) has 45 percent of the banking system's assets and more than half of household deposits (Table 4). Almost 80 percent of BROU's deposits are at zero cost; coupled with its strong presence in the high-spread personal and consumer lending, this largely explains its high profitability. It is the only significant financial conglomerate with 57 percent market share in pensions. The market share of Banco de Seguros del Estado (BSE), a state-owned insurer, is almost 79 percent—until 1993 insurance was a state regulated monopoly served by BSE. As noted above, the capital market consists almost exclusively of government debt.

11. **The capital and money markets are thin.** There are extremely few equity issuers, and essentially no market liquidity—the Bolsa de Valores de Montevideo stock market has six listed equities with market capitalization of about ½ percent of GDP; total trading in the secondary market in 2011 amounted only to US$600,000. All listed instruments may also be traded over-the-counter. There are very few corporate bond issues (the outstanding stock, including of state-owned enterprises, is less than 5 percent of the total bond market). There is limited money market and derivatives activity in the interbank market, since all banks are generally very liquid. In addition, frequent BCU intervention in the interbank market limits incentives for bank-to-bank activity. The only types of derivative contracts available are US$/Ur$ futures and forwards. Only banks are allowed to operate in the futures market, where trades are done using standard contracts and are settled daily. Other institutions are authorized to operate in the forward markets, which trade with short maturities and nonstandard contracts.

12. **The investor base—largely composed of commercial banks and domestic pension funds with limited scope for asset diversification—has a preference to buy and hold.** The defined-contribution pension system manages US$8.7 billion in assets, equivalent to 17 percent of GDP at end-2011; nearly 80 percent of their assets are government bonds, principally longer-maturity inflation-indexed government securities. Pension funds can bid directly in primary auctions of government securities, reinforcing the lack of liquidity in the market. Commercial banks have strong demand for short-term nominal peso BCU securities. In the absence of an active interbank and repo market and a primary dealers' system, virtually all government bonds are held to maturity. There is a growing nonresident investor

base that holds both BCU notes (estimated at 11 percent of the total outstanding) and government securities (estimated at 9 percent of the total outstanding).

13. **Uruguay's banking sector financial indicators are sound overall, supported by good economic fundamentals.** As of May 2012, the banking system's capital adequacy ratio (CAR) stood at 15.8 percent (10.7 percent for private banks), with risk-weighted assets at 60 percent of total assets (54 percent for public banks), driven by a large share of low risk-weight assets, particularly government bonds, BCU paper, and foreign banks deposits. Banks are liquid in both local and foreign currency, showing low loan-to-deposits ratios with the exception of a few institutions; nonresident deposits are matched to a large extent by liquid foreign assets, and trigger high reserve requirements. Loan quality is relatively high, with nonperforming loans at 1.4 percent of total loans. Bank profitability is mixed, with high BROU profits offset by low private bank profits.

14. **The credit market is becoming more and more segmented, with private banks lending to large enterprises and higher income individuals, while finance companies focus on low-income borrowers.** The growth of banks' credit to the private sector has been healthy for several years with a 54 percent cumulative growth in U.S. dollar terms since 2008 to 22 percent of GDP in 2011. The lower income segments are largely served by the BROU and Empresas Administradoras de Crédito (EACs). The latter are non-deposit-taking financial institutions (and therefore not subject to the same stringent supervision standards applicable to banks) offering installment loans and credit cards at high interest rates—typically around 65–70 percent. EACs are funded largely through securitized loan sales, often to banks belonging to the same group. Their loan portfolio grew from 0.6 percent of GDP in 2007 to 1.8 percent in 2011. Long-term credits are generally priced in U.S. dollars except for the mortgage market, which is typically linked to inflation-indexed units, providing a long-term fixed real interest rate, whereas short-term consumer lending is mostly in local currency.

15. **The presence of foreign banks has historically been stabilizing, but is now considered a potential source of vulnerability especially those headquartered in the Eurozone.** Uruguay is monitoring the continued health of the foreign parent banks of its domestic subsidiaries and branches, together with home supervisors. Local subsidiaries are largely self-standing and do not depend on financing from the parent—rather the opposite: SSF recently started to phase in new maximum exposure limits to parent banks to 15-20 percent of their capital (from two to three times the capital of the local subsidiary). The lowering of the rating of the Spanish banks has also led to significant reduction in deposits at parent institutions by Uruguayan subsidiaries.

Table 4. Uruguay: Structure of the Financial System

	December 1, 2001			December 31, 2005			December 31, 2011		
	Number	Assets (In millions of U.S. dollars)	Percent of Total Assets	Number	Assets (In millions of U.S. dollars)	Percent of Total Assets	Number	Assets (In millions of U.S. dollars)	Percent of Total Assets
Commercial banks	22	20,609	82	15	12,951	67	13	28,919	73
Of which:									
Public sector-owned banks	2	7,457	30	3	7,885	41	2	12,385	33
BROU	1	4,788	19	1	5,540	29	1	11,957	30
BHU	1	2,668	11	1	1,318	7	1	1,328	3
Nuevo Bank Comercial S.A.									
Domestic private banks	3	3,172	12	0	-	0	0	-	0
Foreign banks 1/	17	9,980	40	12	5,066	26	11	15,634	39
Nonbank intermediaries	25	2,834	12	15	3,546	19	10	731	1
Cooperatives	6		2	3	211	1	1	19	0
Financial houses	7	540	2	6	157	1	5	287	0
External financing institutions 2/	12	1,816	8	6	3,178	17	4	425	1
Pension funds (AFPs)	4	1,045	4	4	2,164	11	4	7,809	19
Insurance companies	17	572	2	15	619	3	16	2,060	5
Total financial system	**68**	**25,060**	**100**	**49**	**19,280**	**100**	**43**	**39,519**	**100**

Source: Banco Central de Uruguay.

1/ Includes both foreign branches and subsidiaries.

2/ Includes derivatives transactions.

Table 5. Uruguay: Conglomeration in Uruguay's Financial System—Group Market Share in the Industry—March 2012

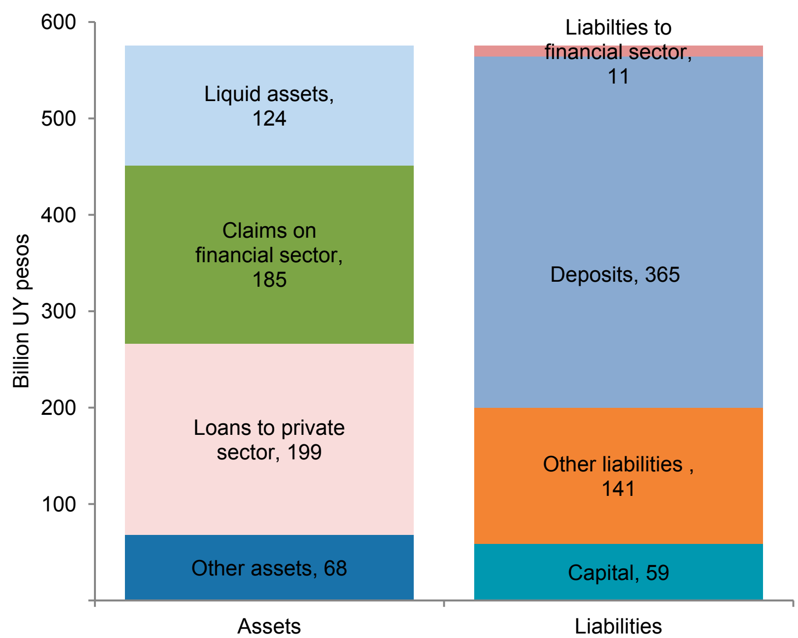
Name of Group *Percent*	BROU	Itaú	Bandes	Santander	Citi	NBC	BBVA	Other	Total	Sub-sector share of system
Banks	46	9	1	17	5	7	10	6	100	**66**
Other credit institutions	2	31		11	1	4	1	48	100	**2**
Pension funds [1]	57	17	9					18	100	**20**
Insurance [2]	79	3		1	4			13	100	**5**
Trust	22						1	77	100	**6**
Other		11						89	100	**1**
Share of system	**43**	**10**	**2**	**11**	**3**	**4**	**6**	**19**	**100**	**100**

Source: Superintendency of Financial Services.

II. Banking System Stability Analysis

A. Commercial Banks

Figure 1. Uruguay: Aggregated Balance Sheet, Banks



Source: Banco Central de Uruguay, December 2011.

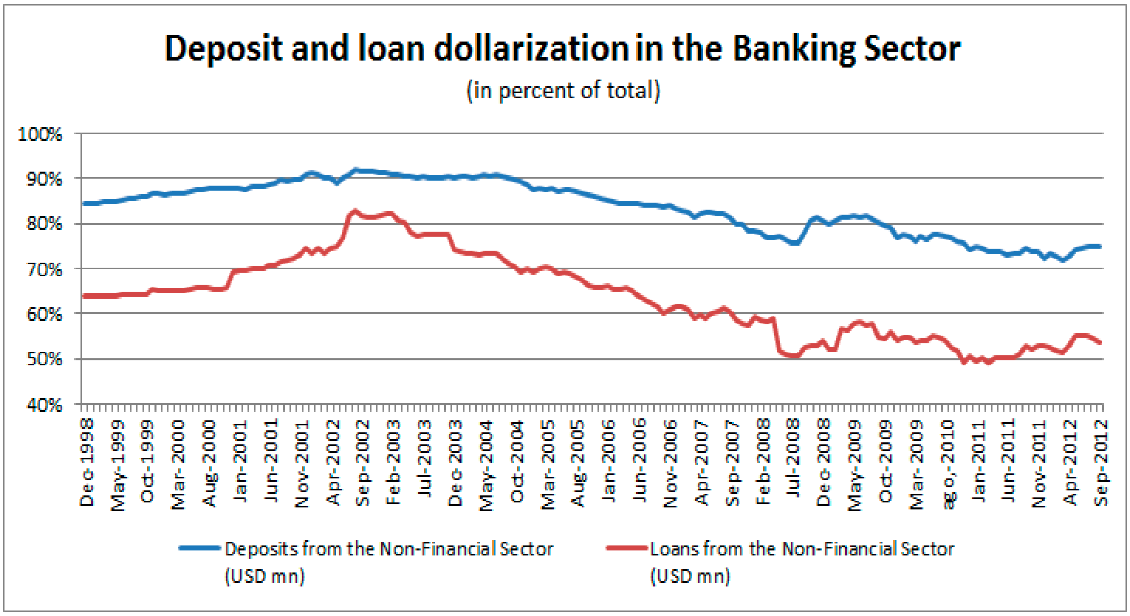
B. Competition in the Banking Sector

16. **The high cost of business for banks and weak financial infrastructure partially explain why other financial institutions are expanding more rapidly in areas such as consumer credit and payment services.** Cost are elevated because: (i) wages are high, with personnel costs exceeding those in most comparator countries (Figure 3); (ii) negotiated operating conditions are restrictive, including limited hours of operation, high cost of employee separations, and limits on staff deployment;[4] (iii) contributions to the bank pension system are very high at about 38 percent of wages for the employers and 17.5 percent for the employees (compared to about 22 percent combined in the general pension regime), with declining employment in the banking sector contributing to the high pension rates; and (iv) shortcomings in credit enforcement, repossession of collateral and in sharing of credit information lead to higher credit losses. These constraints are difficult to address, but they must be confronted if the financial sector is to develop more efficiently and enhance its contribution to Uruguay's development.

17. **Competition can be enhanced by addressing market concentration and segmentation, legal privileges, information sharing, and sub-optimal proprietary financial infrastructure.** BROU has a monopoly on serving the public sector and public utilities, has privileged access to government employees and state utility workers, manages 57 percent of workers' private pension savings assets, and enjoys special authorization to directly debit payrolls to service outstanding loans, thus reducing credit risk (Box 1). BROU's dominance in branch and automated teller machine (ATM) networks, as well as its monopoly on government deposits create a unique advantage for serving its customers, in particular as transfers between banks are costly. Finally, sharing credit information among institutions is underdeveloped, making the cost of switching between banks higher than necessary.

[4] According to the World Economic Forum's 2012–2013 Global Competitiveness Report, Uruguay scored worse on labor market efficiency than on any other dimension apart from market size when compared to countries at similar levels of development.

Figure 2. Uruguay: Evolution of Deposit and Credit Dollarization[1/]



Source: Banco Central de Uruguay.

1/ The loan figures differ from those of the FSI Table due to differences in coverage. Series reported in the figure covers the full financial system as reported by the authorities to the Integrated Monetary Database.

C. Stress Testing

18. **The SSF performs quarterly market, liquidity, and credit risk stress tests using a range of scenarios.** The impact of changes in inflation (9 percent to 13 percent), the foreign exchange (13 percent to 32 percent) and interest rates (200–750 bps), and GDP (decline of 4 percent to 8 percent) are assessed on banks' CAR and risk-weighted assets (RWA); adverse and severe scenarios correspond broadly to shocks of one and two standard deviations respectively of historical data that encompasses the 2002 crisis period.

19. **Stress tests indicate that the banking system overall can withstand significant shocks, although there are pockets of vulnerability.** The FSAP tests, which assume steeper depreciation scenarios than the authorities, found that under the adverse scenario the CARs of a few private banks would fall below the 8 percent regulatory floor. These banks start with relatively low initial CARs, reflecting capital allocation decisions at the group level and a poor growth outlook for the Uruguayan market. Capital buffers in the banking system are slated to increase in 2013 as a result of new surcharges for operational and systemic risks.

20. **Stress testing practices can be fine-tuned by using more granular information and improve processes.** For credit risk stress test, the authorities could use more disaggregated data from the official credit registry instead of aggregate nonperforming loan

information, and study loan dynamics and macroeconomic variables to estimate the impact of stressed scenarios on return on assets. To account for concentration risk, information from the official credit registry can be utilized to assess system exposure to large borrowers and/or sectors, and simulations techniques can be used to evaluate losses under extreme scenarios. Suggested improvements in work processes are more robust procedures and systems, and more staff with appropriate training.

Box 1. Competitive Advantages and Disadvantages of BROU

Competitive advantages

- The right to deduct payments directly from payroll to recover interest and principal on consumer loans.
- Monopoly on public sector deposits (although subject to 100 percent reserve requirement).
- Explicit unlimited and permanent deposit guarantee.
- Scale—BROU is the dominant bank with national coverage through 131 branches; it accounts for 51 percent of household deposits, 44 percent of peso deposits, and 48 percent of peso credit.
- Payment network effect—in the absence of an Automatic Clearing House (ACH) and given costly interbank transfer fees, the incentives to bank with BROU are strong. BROU has not moved quickly to participate in the development of an ACH that would increase the efficiency of retail transfers and level the playing field.

Competitive disadvantages

- Governance structure that leaves BROU vulnerable to political interference.
- Multiple layers of public sector oversight in addition to SSF.
- Subject to public procurement rules.
- Hiring constraints related to civil service structure.
- Maintenances of a branch network in unprofitable locations in the public interest, forcing cross-subsidization.
- No tax exemptions on investment projects, contrary to private firms.

III. Financial Sector Regulation, Supervision, and Oversight

A. Banking Supervision

21. **Significant progress has been made in banking supervision, although some challenges remain.** The SSF made progress in implementing the Basel II standards and in moving toward risk-based supervision. When judged against Basel Core Principles (BCP), improvements have been made in the areas of capital adequacy, market, liquidity, and operational risks, as well as in accounting, disclosure, and anti-money laundering and combating the financing of terrorism (AML/CFT; Annex 1).

Table 6. Intermediaries and Firms Supervised

Banks	13
Cooperatives	1
Financial houses	5
External financial institutions	4
Financial intermediary institutions	**23**
Pension fund managers (AFPs)	4
Insurance companies	16
Other financial institutions	**20**
Brokers	96
Financial advisors	44
Representation offices	31
Financial services companies	24
Securities issuers (public offer)	31
Securities exchanges	2
Capital market entities	**228**
AFISA and financial trusts	21
Funds transfer companies	6
Credit administration companies	32
Ancillary services providers	29
External audit firms	31
Foreign exchange houses	53
Rating agencies	7
Professionals/firms LA/FT	26
Groupal savings managers	1
Small mutual insurance firms	9
Other supervised institutions	**215**
Total supervised institutions	**486**

Source: FSSA (as of August 2012).

22. **The enlarged regulatory perimeter of the SSF has led to resource pressures.** All financial supervisors were integrated into a single agency inside the BCU—the SSF, responsible for regulating and supervising 486 heterogeneous institutions covering all sectors of financial intermediation (Table 6). Resource constraints, in particular in staffing and information technology, made it challenging to deliver the desired quality of supervision. In response, the SSF adopted in 2010 a risk-based approach to supervision to allocate its resources and to more closely link its supervisory strategy to the risk profile of each supervised institution.

23. **The relation between the BCU Board and the SSF is complex and poses questions about the adequacy of supervisory independence.** The Board is responsible for regulating and supervising the financial system, discharging its obligations through the SSF, which has technical and operational autonomy, but is still subject to the administrative and financial decisions of the BCU Board. In addition, the BCU Board appoints and dismisses the Superintendent (in the latter case, without the requirement to specify grounds), and the Board can issue financial sector regulations as well as revoke SSF's decisions, although these powers have not yet used. The Board's powers of budget approval and dismissal of the superintendent would seem to restrict supervisory autonomy.[5]

[5] In addition, the BCU Board is responsible for bank resolution decisions, including the validation of COPAB's decisions and, with the addition of two other members and the superintendent, forms the Supervision and Regulation Committee, which is tasked with analyzing and advising the Board of Directors regarding the proposed policies and plans prepared by the SSF.

24. **In this context, the BCU Board should take on greater responsibility for the quality of supervision.** It would be important for the Board to (i) assess and formally approve the supervisory and operational strategies, as well as their associated risk assessment and rating systems; (ii) address SSF's resource gap estimated at about 50 staff; (iii) ensure appropriate disclosures regarding the supervisory process and goals; and (iv) introduce a rigorous quality assurance process to assess compliance with policies and procedures.

25. **BROU's systemic importance amplifies the supervisory challenges in dealing with its governance and risk management issues.** BROU has significantly improved its internal governance processes in recent years, but it has no independent directors and some directors are nominated by political parties, making it difficult to properly oversee management as indicated by Core Principles 1 and 23. Improvements in risk management and information technology (IT) systems as well as control functions face public sector contracting and procurement requirement hurdles.

26. **Implementation of Basel II and risk-based supervision continues apace.** Capital charges are being introduced for operational, commodity price, equity and systemic risk. By year-end, major banks will submit the results of their first International Capital Adequacy Assessment Process (ICAAP). The SSF plans to publish its Supervisory Review and Evaluation Process (SREP), including the associated Pillar 2 capital guidelines, in 2013, and update its road map for implementing Basel III. There is also good progress in moving toward risk-based supervision. The SSF has, during the last two supervisory cycles, implemented its risk-based supervisory and operational strategy, emphasizing banks' effective implementation of the qualitative aspects of the internal governance and risk management standards. In the process, it has updated banks' risk profiles, and worked on remedying any gaps detected through its supervisory response.

27. **The authorities can take a number of steps to further improve banking supervision:**

- Reduce reliance on external auditors—whose qualifications are difficult to ascertain—for assessing credit quality, internal controls and information systems, thus achieving a better balance between review of processes and transactions.

- Increase capacity of staff (including through adopting formal career development, training plans, and hiring IT and risk specialists) and systems (including for work planning, costing and stress testing).

- Exploit information from the credit registry for supervisory purposes.

- Refine the risk matrix to better gauge banks' risks, providing a sounder basis for the supervisory response, including for determining the level of supervisory capital above the minimum regulatory capital under Pillar 2; currently ratings do not differentiate much, despite large differences between risk profiles. This would likely result in much greater supervisory attention to BROU given its risks and systemic nature as noted above.

- Strengthen BCU's remedial powers and enforcement, particularly regarding public banks; a good recent step is publishing the sanctions, but BCU's capacity to impose corrective measures against public banks remains constrained by the inability to make management changes.

- Improve its problem bank toolkit, including by adopting formalized procedures detailing the temporary administration process.

- Other measures include: (i) increase foreign currency sovereign credit risk weights; (ii) introduce a prompt corrective action regime with well-defined thresholds in case of progressive erosion of capital; (iii) enhance risk concentration rules to also cover financial, commercial and operational interlinkages; (iv) expand the scope of related party transactions; (v) reduce the exceptions to lending limits with related financial entities; (vi) provide further guidance on expected risk measurement, stress testing, contingency planning and risk management standards; (vii) require systemic and large banks to operate a separate risk management unit independent from the business areas; (viii) encourage the re-intermediation of the lending done through financial subsidiaries (EAC) of foreign banks when such separation is driven by cost distortions and restrictive labor practices; and (ix) extend risk management standards to banking groups to enhance consolidated supervision.

B. Financial Integrity

28. **Uruguay has made considerable progress in the area of AML/CFT; some further improvements to ensure compliance are desirable.** The 2006 FSAP report rated AML/CFT supervision "materially noncompliant," and the Grupo de Accion Financiera de Sudamerica (GAFISUD) 2009 assessment placed the country under close scrutiny due to persistent problems in complying with key international standards. In response, the authorities have: (i) adopted a National Strategy against money laundering; (ii) amended the AML/CFT law to expand information sharing; (iii) created a new registry of owners of bearer securities; and (iv) upgraded the regulations for money transfers. With respect to supervision of AML/CFT compliance, the BCU has significantly strengthened its surveillance of banks, but some further improvements are needed: (i) the reinforcement of the Intelligence Unit; (ii) the provision of further detailed guidance to the industry; (iii) the revision of the scoring methodology; (iv) the adoption of stronger and more consistent enforcement measures; and (v) the removal of legal barriers to international cooperation.

C. Securities Markets Regulation

29. **The SSF has all of the powers it needs to regulate the securities markets and the overall framework is largely in place, although some gaps remain.** The regulation of

issuers is largely compliant with the expectations of the International Organization of Securities Commissions (IOSCO) Principles. Market intermediaries, securities exchanges and trading systems are required to be registered and to meet initial and on-going requirements. However, there remain some gaps: (i) some of the legal provisions that support the independence of the regulator are missing; (ii) the securities regulatory function of the SSF does not have sufficient resources to operate an effective supervision program for the intermediaries or the stock markets; (iii) there are no risk-based capital requirements and very limited requirements regarding internal controls or risk management systems that apply to brokers; and (iv) trades in listed securities may take place over-the-counter, and in that case do not have to be reported to the exchange, limiting transparency.

30. **To remedy these issues, the authorities could consider the following measures:** (i) amend the law to give security of tenure to the head of the SSF and allow his removal only for stated causes; (ii) review the statutory immunity provisions; (iii) provide additional resources for capital market activities, particularly supervision of intermediaries and surveillance of markets; (iv) complete the prudential framework for market intermediaries; and (v) enhance market transparency and the effectiveness of surveillance.

D. Insurance and Pensions Supervision

31. **A recent self-assessment of IAIS principles flagged progress in various key areas.** The insurance sector, which manages assets amounting to about 5 percent of total financial system assets, is dominated by state-owned BSE, for which the government should contract an independent diagnostic, including a review of its strategy, solvency (also from an actuarial point of view), efficiency and governance. In 2010, the SSF approved minimum standards for the management of insurance companies that have already been used for the integral assessment of two private insurance companies.

32. **However, the self-assessment also identified a number of areas for improvement.** In particular, there is no regulation on corporate governance or risk management and the only requirement in terms of internal controls is the company's obligation to present an external audit report. Risk management is not considered for establishing capital requirements. There are no license requirements for insurance agents/brokers and so they are not supervised. There are no specific requirements or procedures to ensure customers are treated fairly, though the SSF reports a very low number of complaints. The disclosure principle is also not observed and there are deficiencies in countering insurance fraud. A draft law was presented in 2011 to the Ministry of Economy and Finance (MEF), with the purpose of addressing some of the issues mentioned above, such as to guarantee the protection of insured customers and those with annuities contracts.

33. **Supervision of pension funds (AFAPs) is focused mainly on compliance.** While this type of supervision has been very efficient in minimizing the risk of misuse of pension funds, for example, through compliance of investment limits, it does not promote portfolio

optimization. The SSF intends to extend risk-based supervision for pension funds. There are important challenges in the areas of governance and risk management of AFAPs. Supervision should emphasize proper risk management systems at the AFAPs and ensure that the AFAPs are acting in the best interest of the contributors. In addition, the SSF should gradually replace the current functions of authorization of securities by drafting regulations that ensure that AFAPs have proper procedures in place for selecting new financial instruments.

E. Payment System Oversight

34. **The BCU has made progress in the modernization of the payment systems.** The BCU is working on the implementation of the new Real Time Gross Settlement (RTGS) system, scheduled to be launched in the first half of 2013, which also includes an integrated Central Securities Depository (CSD). A full assessment of the systems against the CPSS-IOSCO Principles for Financial Market Infrastructures (FMIs) should be conducted when the new systems are launched. The oversight function was established by the Payment System Law in 2009, but has not yet been fully implemented. Regarding retail payment instruments, the “redes de cobranza” oversight should be included as a priority, as planned by BCU, given their significance for the day-to-day operation of the real sector.

IV. Safety Net and Macroprudential Policies

35. **The financial sector safety net has evolved in response to the principal systemic risk—foreign exchange liquidity risk related to the high degree of dollarization—which was at the root of the 2002 crisis.** The largest and state-owned bank BROU is unique in so far as it guarantees all its deposits fully. Private banks are all foreign owned, and the larger ones benefit from access to liquidity and the reputation of parent banks (confirmed during the 2002 crisis by the ability to honor large deposit withdrawals). These protections are supplemented by a new deposit insurance agency. Despite significant inflation, most deposits are held as sight deposits—which were paid back in full during the crisis unlike time deposits. With regard to nonresident deposits, liquidity requirements have been increased significantly, and international reserves are sharply up.

A. Institutional Framework and Coordination Arrangements

36. **The new Financial Stability Council (Comite de Estabilidad Financiera, CEF) is designated as both safety net and macroprudential coordinator.** Established by decree in 2011, it brings together all institutions that play a principal role in crisis management: the Minister of Economy and Finance, the President of the BCU, the Superintendent of Financial Services, and the President of the Deposit Guarantee Corporation (Corporación de Protección del Ahorro Bancario—COPAB, which acts as secretariat to the CEF), and has a Technical Committee to prepare analysis and reports in which each of the bodies is represented. Interactions are further guided by a set of MoUs between the participants, as well as additional meetings in different configurations. The CEF’s work program includes

reviewing the financial sector legal framework for inconsistencies, and preparing regular forward-looking systemic risk reports for internal discussion.

37. **CEF's structure seems appropriate for Uruguay's financial system and it is recommended it focuses its near-term activities on contingency planning.** The CEF decree lists the responsibilities of BCU, SSF, and COPAB as complementary, and instructs the CEF to adopt strategies that optimize each institute's mandate, putting a premium on each agency's institutional efficiency. In this context, the coordination role is especially important, since the non-overlapping nature of agencies' mandates makes it less likely that coordination issues are resolved over time as individual mandates evolve. The near-term focus should be to strengthen contingency planning. As the coordinating body for crisis managers, CEF should develop a variety of scenarios for which agencies' roles are specified, and interactions clarified. In this context, COPAB and SSF have started to develop bank intervention and resolution procedures.

B. Crisis Preparedness

38. **The level of crisis preparedness is still low owing to the recent institutional changes and the emergence of new (global crisis-related) risk scenarios.** The legal framework surrounding bank resolution has changed dramatically since the 2002 crisis, and it would be useful for its workings to be tested through simulation. Other recommendations are: (i) to undertake joint and separate crisis preparation work; (ii) for COPAB to organize operational simulations, including with the industry; (iii) for CEF to organize "war games," including, possibly, with foreign supervisors; (iv) for BCU to develop LOLR procedures, now that LOLR operations are embedded in the Central Bank law; (v) for SSF to consider adoption of a prompt corrective action framework, prepare for solvency testing (needed for LOLR operations, since lending is limited to 150 percent of net worth) and resolvability assessments, and integrate recovery and resolution planning into its supervision framework, following FSB guidance on the Key Attributes for Effective Bank Resolution.

C. Bank Resolution Framework

39. **The bank resolution framework provides for (open) problem bank intervention by the SSF, and suspended bank resolution by COPAB.** Both agencies have wide-ranging authority and powers to fulfill these mandates. The SSF can approve mergers and acquisitions, request capital increases, and approve banks' proposals to change the composition of capital, restructure a bank's activities, and propose to the BCU Board to appoint a temporary administrator in a problem bank, suspend its activities, and withdraw its license. Once the BCU Board decides to proceed with bank resolution, the suspended bank is passed to COPAB, which has up to 120 days to work out a least-cost solution. It can use the deposit guarantee fund to facilitate solutions, and can avail itself of wide-ranging powers, including moving assets and liabilities out of the problem institution, and arranging a

purchase and assumption, or proposing to proceed with liquidation. When breaking contracts, damage claims will be paid against the liquidation estate according to creditor priority.

40. **There are a number of areas where the bank resolution framework could be improved further.**

- **The possibility that the activities of a troubled bank could be suspended for up to 120 days is problematic.** Since this could create excessively long delays for depositor payout and possibly lead to destruction of value, a shortening of this period is recommended.

- **The current framework does not foresee the possibility of a bridge bank.** Under certain circumstances, when resolution options are identified that may take more than 120 days (e.g., to approve a new bank license), it would be useful to have a time-limited bridge bank option.

- **Bank resolution and liquidation decisions are in principle reversible by the courts according to the law (as is any administrative act)—this is not considered good practice.** However, in practice this possibility is not a major concern; given the technical impossibility of reverting to the original state, courts may award monetary damages in case the decision is overturned.

- **At liquidation, creditor approval is needed to transfer liabilities to a new owner.** Creditors representing at least 66 percent of the value of liabilities being transferred must consent (guaranteed deposits are excluded from this requirement), and removing this requirement would ensure a more seamless resolution process.

- **Although COPAB can break contracts and claims directed against the state, it may be useful to explicitly specify administrative limits to damages.**

- **The role of unions in past bank resolutions has led to costly delays.** Lack of access to IT systems has impeded supervisors in assessing problem banks' financial situation, and delayed depositor payout.

- **The framework will require seamless cooperation between SSF and COPAB.** Since SSF and COPAB have different bank resolution authority and powers at different times (before/after suspension), close cooperation is required as the problem bank deteriorates, including through resolvability assessments and resolution planning, to ensure a least-cost resolution.

D. Deposit Insurance

41. **COPAB is in broad compliance with Core Principles for Effective Deposit Insurance Systems (Annex 2).** COPAB has experienced staff, an effective computerized

system for tracking bank deposits by depositor and a close working relationship with other members of the safety net. It has made impressive progress in its functioning since its independence from the BCU in 2008.

42. **Uruguay's deposit insurance framework is based on modern principles.** It protects local (up to around US$29,000) and foreign currency (up to US$5,000) deposits, and fully covers 99 percent of all local currency depositors, and about 50 percent of foreign currency depositors. The premium is partly risk-based—aimed at reducing moral hazard—and differentiated by currency—to encourage de-dollarization. Funding options include pre-levying premiums from banks (up to three years worth of premiums), and a credit line with the government. Payout is within 30 days of liquidation, which is feasible given COPAB's technical preparations and past experience with a payout in 2006 related to the failure of a financial institution.

43. **However, a number of issues arise, apart from the possible 120-day suspension period mentioned above:** (i) civil and criminal legal protection for contractual employees—an important resource during crisis periods—is insufficient; (ii) related to this, a separate law specifies that deposits corresponding to recent salary and pension payments remain accessible during a bank suspension, posing operational difficulties and creating inequality of protection; (iii) public awareness is low; and (iv) state banks BROU and BHU have blanket deposit guarantees mandated by their charters, providing them with a competitive advantage. Also, although COPAB is consulted before ownership changes and recapitalization plans are approved, there is no requirement that COPAB be consulted before issuing a new bank license. Changes to the legal framework and/or procedures should be made to involve COPAB earlier in the resolution process and accelerate the decision on whether to arrange a purchase and assumption transaction or liquidation of a troubled bank.

E. Macroprudential Framework and Policies

44. **Uruguay actively uses a range of macroprudential tools.** These include incentives to de-dollarize (using prudential norms, monetary policy tools, as well as differential deposit insurance premiums by currency), and measures to build countercyclical buffers (using monetary policy and prudential instruments),[6] and (recently), a systemic risk capital charge.[7] Capital inflows have picked up and measures have been put in place to stem these, as noted

[6] Uruguay introduced dynamic provisioning in 2001, in which banks contribute to their individual provisioning funds the difference between the monthly statistical losses on loans and the realized net loan loss in the month, estimated for five categories of loans, bounded between 0 percent and 3 percent of total loans subject to provisions. Over-provisioning led to a recalibration of the parameters in April 2012 and the addition of new factors to reflect credit ratings, the speed of credit growth and to capture more closely provisions and the credit cycle.

[7] The surcharge will be between 0.5 percent and 2 percent for systemically important banks according to size.

above. However, given the high dollarization, a thin capital market and low yields on local currency securities related to the captive demand of pension funds, pressures from this source are relatively less important than in other emerging markets that have experienced sharp capital inflows in recent years.

45. **Better coordination of macroprudential tools used by the various agencies should form an important part of the CEF agenda.** A case in point are the various measures taken to reduce dollarization, including reserve requirements, deposit insurance premia, and prudential standards all differentiated by currency. It would be useful for CEF to analyze the use of instruments to address systemic risk more holistically, identifying which instrument combination is most effective to bring about the desired effect.

V. Financial Infrastructure and Development Issues

A. Securities Market Development

46. **A comprehensive capital market development strategy should seek to improve liquidity and market structure, benefitting from current favorable circumstances.** Uruguay is experiencing sustained growth, has an open capital account, local expertise, and growing foreign investor interest in the country. The proposals for a primary dealer system and the introduction of secured interbank repo market are welcome initiatives to address some of the issues that limit secondary trading. Measures to improve the market structure and expand the investor and issuer base such as providing incentives to the private sector to tap the local capital market to fund large projects or fill the financing need of select state-owned enterprises (SOEs) could go a long way toward spurring market development and diversification. On the investor side, easing restrictions on the investment mandate of pension funds would enhance diversification of investments, reduce risk and contribute to market development by expanding the investor base for different types of assets. Consideration should be given to rationalizing the structure of the market and provide incentives for consolidation and professionalism of stockbrokers, which would enhance market efficiency and support market liquidity.

B. Pension Funds and Annuities Markets

47. **Uruguay's two-pillar pension system has outgrown the size of the domestic capital market.** A first pillar is managed by the state-owned Banco de Prevision Social (BPS), and a complementary funded pillar managed by Administradoras de Fondos de Ahorro Previsional (AFAPs), which are dominated by state-owned AFAP Republica. Each AFAP manages a single fund for its contributors—regardless of contributors' time to retirement, forcing a sub-optimal risk/return trade-off. Given the limits on the scope for investing abroad, pension funds remain highly concentrated in government securities, and this raises questions about the system's ability to replicate historical rates of return, and its ability to sustain projected pension increases.

48. **A number of other issues affect efficiency and potential solvency of the pension regime.** Most important among these is the indexation of pensions to wage increases—mandated by the constitution—that risks building contingent fiscal liabilities, and reduces incentives to develop the annuities market; introducing alternative hedging mechanisms and phased withdrawals would alleviate this concern. Broadening the scope for investment abroad is also recommended.

C. Insolvency and Creditor Rights

49. **The current corporate insolvency system is quite effective, but there is no scope to fine-tune some legal provisions.** The main legal weakness of the system continues to be judicial enforcement. Claims secured through trusts and leasing agreements enjoy private execution mechanisms, but there is no out-of-court enforcement available to secured claims generally. BHU, however, is allowed by law to use an out-of-court enforcement mechanism, which typically requires a four-month period until the auction of the collateral is carried out. Other mortgagors or holders of non-possessory pledges must always resort to judicial enforcement procedures.

D. Retail Payments

50. **In the area of retail payments, BCU should continue to catalyze and expedite the development and timely launching of the Automated Clearing House (ACH).** Uruguay ranks below the average for Latin American countries in terms of deployment of transactional channels and usage of electronic payments means. The BCU should work actively with BEVSA, the operator of the Sistema de Pagos Interbancarios (SPI), and banks to ensure SPI evolves into a full-fledged ACH, helping to resolve the issue of interbank fees. This will lead to significant efficiency gains, and foster greater competition in the banking sector by facilitating the mobilization of deposits across banks. Also, as payment system overseer, BCU should ensure appropriate relative pricing of different payment instruments (e.g., cheques vs. electronic transfers) and promote the government's use of electronic payments. Finally, to further promote a level playing field among banks, authorities should consider designating the BCU as the sole depository of government funds.

E. Credit Reporting

51. **The credit reporting system in Uruguay has made important advances in recent years.** These include the broadening of the scope, coverage and role of the BCU's credit database (Central de Riesgos, CR), strengthening of private credit reporting firms, and enacting a new legal framework. Credit bureaus are working to add positive credit data. To accelerate this, the BCU could consider sharing the complete CR database with private credit bureaus. Current regulation and supervision arrangements for the credit reporting industry should be enhanced to consider: (i) minimum entry criteria; (ii) governance; (iii) soundness, reliability and efficiency of their systems, processes and communication; (iv) ensuring data on individuals is sufficient and balanced, which implies the collection of positive data; once

this is done, ensuring also that data providers report all their loans to credit bureaus; (v) product quality; and (vi) ensuring appropriate levels of competition across the industry.

F. Access to Finance

52. **Access to finance is weak along many dimensions including credit, deposits, and the number of people with accounts.** The EACs reaches the broad population, but with a narrow range of services and high costs akin to micro-finance. Priorities in access to finance are both to improve services for medium and small enterprises and to expand the scope of services to households while lowering costs. Contrary to these objectives, regulatory interest rate caps introduced to protect borrowers preclude the development of microfinance for enterprises.

ANNEX I. BASEL CORE PRINCIPLES – SUMMARY ASSESSMENT

A. Introduction and Methodology

1. **An assessment of the Basel Core Principles for Effective Banking Supervision (BCP) was conducted as part of the FSAP Update in September 2012.** The assessment was performed by Pierre-Laurent Chatain of the World Bank and Joaquín Gutiérrez García from the IMF. It reflects the banking supervision practices of Uruguay as of end-June 2012. Assessors conducted the evaluation in accordance with the guidelines set out in the Core Principle Methodology issued by the Basel Committee in October 2006 and assessed compliance against both essential and additional criteria.

B. Macroeconomic Background

2. **In 2002–2003 Uruguay experienced a crisis that had a major impact on the economy and the financial system.** The crisis led to a major upheaval in the financial system. The number of banks and the value in U.S. dollars of assets under management declined drastically, with the latter falling almost in half, as nonresident deposits (NRD) left the country. The state-owned bank BROU provided a safe haven for deposits, but all private, domestically owned banks disappeared and the number of foreign banks shrank.

3. **The financial system has recovered since.** Private domestic banks have regained the market share lost during the crisis. Pension fund assets have increased their market share in total financial assets by a factor of five over the decade. Total financial assets in U.S. dollars rose almost 58 percent in the last decade, but financial depth in Uruguay is still well below its income level and below other comparator countries in the region,[1] with a ratio of total financial assets to GDP of only 83 percent and bank assets to GDP of 61 percent.

4. **The recovery of the financial system has taken place against the backdrop of a dynamic economy and sound macroeconomic framework.** Annual real GDP growth rates have averaged 5.8 percent since 2004, underpinned by prudent macroeconomic policies, important legal reforms, and a largely positive external environment. Sound fiscal positions and a proactive debt management have reduced the public debt burden inherited from the 2002–2003 crisis and improved its profile and currency composition. The share of foreign currency debt has declined (from 89 percent to 50 percent) and its maturity has been extended (currently 11.3 years). Inflation has been reduced to single-digit levels.

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[1] Bank credit to GDP is particularly low at about 27 percent, compared with 60 percent and 100 percent for Brazil and Chile, respectively.

5. **The global environment constitutes the main risk factor to the Uruguayan financial system.** Favorable global financing conditions and terms of trade still support the economy, and the recent upgrade by major credit ratings of its sovereign debt to investment grade has increased the attractiveness of the country. However, there are potential spillovers from Europe and the region (mainly Argentina). Nonetheless, trade and financial linkages with Argentina have diminished. Merchandise exports there have plunged to about 7 percent of total exports, and the role of Argentinean nonresident deposits—which exposed the banking system to a withdrawal of deposits during the crisis—have declined. Nonresident deposits represent today less than 17 percent of total deposits. Furthermore, the authorities have built substantial liquidity buffers through an active pre-financing debt strategy to mitigate rollover risks, a build-up of international reserves, contingent credit lines with multilaterals, dynamic loan-loss provisions, and high reserve requirements on local and foreign currency deposits. These buffers should add resilience to the already strong fundamentals of the economy.

C. Main Findings

6. **The following summarizes the main findings of the detailed assessment of compliance with the BCP.**

- **Objectives, Autonomy, Powers and Resources (CP1)**
    - **There are concerns regarding the autonomy of and the resources available to supervision, which impinges on its effectiveness.** BCU's Board can revoke the decisions and administrative acts of the SSF and there is no clarity about the scope of its limited "technical and operational autonomy." The SSF does not have all the discretion it needs in terms of its internal organization and personnel selection and management (including promotions), its work is underfunded and its IT capacity is lacking. Moreover, the SSF needs means to develop and implement a specialized curriculum and provide its staff with incentives to obtain external accreditation. In addition, the BCU Law does not specify explicit grounds for the removal from office of Directors and of the Superintendent, nor the need to make public the reasons for such decision.

- **BCU's enforcement powers are limited vis-à-vis public banks.** When a public bank fails to comply with the law and regulations, the scope of sanctions and corrective measures is more limited than for private banks. Tolerance has also been observed in a certain case of serious and persistent breaches of regulations in state-owned institutions. Also, there is no clear and well articulated regime to deal with problem banks by means of an objective regime of prompt corrective action anchored in a well specified combination of qualitative and quantitative triggers, including addressing progressive levels of undercapitalization.

- **Prudential Regulation and Requirements (CPs 6–18)**

  - **The capital adequacy regime for banking in Uruguay is in transition toward full implementation of the Basel II regime.** The BCU will have implemented all the standard charges for Pillar 1 capital by December 2012. However, it still needs to pilot its Pillar 2 approach, adopting a precise protocol to relate the risk assessment of the SSF to the required supervisory capital adequacy above the minimum regulatory capital determined under Pillar 1. This should include the use of stress testing to set capital buffers as part of the requirement for banks to operate an internal capital adequacy assessment process (ICAAP). In addition, as part of implementing Pillar 2, the BCU will need to consider the introduction of capital charges for concentration, including collateral and industry sector concentrations.

  - **Regarding risk management processes, further actions were found necessary in several areas.** In particular, the authorities are advised to communicate explicit standards for bank directors to implement the internal capital adequacy assessment process (ICAAP) governing forward-looking capital planning. Risk management requirements need to be extended to all entities in a group and large banks should be required to operate risk management units truly independently from business operations. In addition, the BCU should develop the capacity to assess ICAAP as an essential input to the supervisory review and evaluation process ("SREP"), as well as specify with clarity the response of BCU's Board to excessive risk accumulation. The SREP and the nature and scope of the criteria used to exert supervisory judgment about risk should be made public to the institutions. Moreover, BCU's Board will need to endow the SSF with sufficient specialized staff and resources to operate under a risk-based approach to supervision.

  - **Credit risks are much better identified and supervised at present.** However, some actions are suggested to enhance the effectiveness of implementation. This includes monitoring in depth the quality of the external auditors' work, the expertise and seniority of the audit staff, and the scope of the audit work programs, including the sufficiency of audit costs for all activities. Transactional review by the SSF should increase following a formal sampling policy that mitigates excessive reliance on external bank auditors, including further onsite efforts to understand credit risk pricing and the soundness of credit underwriting standards. In parallel, BCU's Board should provide incentives to banks for more diligent remedying of the credit risk management gaps assessed by supervisors. BCU's Board should also modernize the technological infrastructure of the Credit Risk Bureau for the SSF to use its information flexibly, to elaborate quantitative measures of credit risk, including conducting more sophisticated stress testing which considers collateral and concentration risk explicitly and that relates credit risk to its fundamental macro-economic drivers.

- **Concentration risk needs further attention.** The criteria to identify interconnections among obligors needs to be broadened. The additional criteria should consider common sources of concentration risk such as financial, commercial and operational inter-dependencies among parties not related by control or significant influence, when the failure of one party to perform could reasonably lead to the default of a second interconnected party. In addition, the BCU will need to mitigate the risks associated with the exceptions to large and maximum lending limits. These exceptions provide liberal space for local subsidiaries of foreign banking groups. Concentration risk should be also treated under ICAAPs, and BCU's Board should require the SSF to adopt specific procedures to ascertain other dimensions of concentration risk, such as collateral and sector-related risk.

- **All forms of related party transactions need full consideration.** Besides intergroup credit risk transactions, the BCU should incorporate other forms of related party transactions to its rule book such as all those contemplated under IAS 24. Moreover, a more complete regime of ex-post notifications should be put in place, as well as to require interested parties from participating in decisions where a related party transaction is being evaluated or approved.

- **The assessment of noncredit financial risks has improved substantively, but there is scope to enhance the effectiveness of implementation.** As a priority, the BCU will need to increase the number of financial risk specialists aligned to current and anticipated work load, as well as to support their continuous professional development. In addition, the technological infrastructure available for the SSF to process data and quantify risk measures needs upgrading. Also, the BCU can promote the use of stress test and contingency planning as part of the banks' ICAAP.

- **The reliability and effectiveness of internal controls, information systems, and audit programs are paramount to the success of the risk-based approach followed by the SSF.** The SSF needs to design and compile proxy indicators of capacity, processes and practices to benchmark the evaluation of systems and controls among institutions. The SSF needs also to specify in further detail to the industry its expectations regarding the characteristics it wishes to see in operation to attest their effectiveness and reliability, including evaluating the amount of resources invested in controls and central functions. The capacity, number and skills of the supervisors available to assess such systems need further reinforcing.

- **Progress has been made in upgrading the AML/CFT regime and the most important flaws observed in the supervisory regime have been corrected (CP 18).** Notwithstanding, the AML law needs to be amended to ease limitations that still hamper international cooperation. Also, given the large scope of entities under supervision, the BCU needs to consider increasing the resources dedicated to AML/CFT oversight. To entice diligent remediation by the entities themselves of their processes and systems, the BCU needs to apply more severe sanctions, more systematically, whenever serious breaches are observed.

- **Methods of Ongoing Supervision (CPs 19–21)**

  - **The risk-based supervisory approach, and its associated tools and techniques have taken root, but further development will need to be carefully managed.** As recommended above, the supervisory staff, their skills, and their supervisory toolkit need continuous support and development, including re-evaluating the work load and properly costing and funding supervision. The methodology to assess and rate risk profiles, and the criteria utilized to reach qualitative judgments are also important. Supervisory manuals must provide more granular guidance on risk assessment, and the current risk rating system (CERT) needs recalibration to discriminate among different risk profiles, combining proxies (always imperfect) measures of risk of failure and systemic impact. In addition, further efforts are needed to upgrade the response strategy and to reinforce its effectiveness based on the enforcement regime, including a reasonable, ex-post, quality assurance process.

- **Accounting and Disclosure (CP 22)**

  - **Accounting standards continue to differ from IFRS and some of the differences can have material impact.** The BCU should adopt IFRS according to the current timetable, including addressing existing gaps between domestic and international standards. The authorities would like to carefully consider adapting IAS 39/IFRS 9 to ensure that the necessary rigor on loan loss provisioning is preserved, including under an expected loss model whose parameters are consistent and prudently applied. In addition, there is the need to speed the implementation of Pillar 3 standards.

- **Corrective and Remedial Powers (CP 23)**

  - **The response of the BCU continues to be limited by the same issues identified in the last 2006 FSAP.** Whilst the legal framework (Financial Institutions Law and BCU Charter) provide a number of valuable powers and mechanisms to the BCU, the BCU seems still reluctant to resort to harsh penalties as a means for achieving better market discipline, particularly regarding public banks. There is the need to take a more aggressive approach to respond to gaps in governance and risk management, adopt consistent enforcement policies across all institutions, as well as to design a clear and well-articulated regime to deal with problem banks whilst limiting unwarranted interferences. A more granular set of quantitative and qualitative prompt corrective actions closely aligned to the internal supervisory ratings and its deterioration is recommended.

- **Consolidated and Cross-Border Banking (CPs 24–25)**
  - **Financial conglomeration continues to be subdued except for a very limited number of players and narrow activities.** Accordingly, whilst not an immediate priority, further implementation of regulatory standards and group wide supervision practice is recommended, including rendering operational a dedicated unit responsible for supervising conglomeration risk. The SSF should require consolidation of all local credit operations of foreign subsidiaries, as well as develop procedures for consolidated supervision of systemic bank led groups. The AML law should be amended to lift barriers hampering home-host cooperation on AML/CFT issues.

G. Authorities' Response

7. **The authorities are broadly in agreement with the BCP assessment.** However, differences remain regarding the assessment of the independence of supervision (CP1), constraints on sharing information for AML/CFT purposes (CPs 18 and 24), and the scope of supervision applied to public banks (intensity and response, including enforcement of sanctions), as well as the extension of the Supervisor's Minimum Management Standards (EMG) to public banks.

Annex Table 1. Uruguay: Summary of Compliance with the Basel Core Principles

Core Principle	Comments
1. Objectives, independence, powers, transparency, cooperation	
1.2 Independence, accountability, transparency	Subordination to BCU's Board. Limited interpretation of the budgetary autonomy of the SSF. Significant budget and resource constraints. Reasons to remove Superintendent not in the law. Decision not public.
1.4 Legal powers	Still limited enforcement and resolution powers.
1.6 Cooperation	Legal limitations for information exchange with foreign counterparts for AML/CFT
6. Capital adequacy	Lack of PCA regime. Operational risk in force by end-2012. No Pillar 2 capital regime/concentration risk.
7. Risk management process	ICAAP not operational until December 2012.
8. Credit risk	Lack of arms-length requirement. Low sampling and excessive reliance on external auditors. Incentives to remedy gaps and prompt correction.
10. Large exposure limits	Lack of interconnection criteria and concentration risk.
11. Exposure to related parties	Scope of transactions below IAS 24. Excessive exceptions to limit with well rated parent/group.
14. Liquidity risk	Lags in stress test development, integration into operations, and in implementing contingency planning.
15. Operational risk	Absence of detailed guidance to the industry and insufficient resources for better surveillance of Operational Risk
16. Interest rate risk	Lags in integrating risk and stress measures into operations. Lack of risk management units and/or lack of independence in some large/systemic banks.
18. Abuse of financial services	Existence of provisions in the AML law (art. 7) that restrict the condition for international cooperation; limited UIAF and SSF resources and limited enforcement actions.
19. Supervisory approach	Risk rating method CERT needs recalibration and linking to Pillar 2 capital assessment (ICAAP).
21. Supervisory reporting	Excessive reliance of external auditors not off-set by enough control on their performance. IFRS not implemented in full.
22. Accounting and disclosure	Adoption of the IFRS still pending.
23. Corrective and remedial powers of supervisors	Insufficient sanctions against banks displaying persistent weaknesses and not implementing timely remedial measures. Absence of a consistent enforcement policy across institutions independently of ownership. Absence of a clear and well articulated regime to deal with problem banks.

Core Principle	Comments
24. Consolidated supervision	Lag in implementation. Unit responsible not operational. Small credit units not consolidated.
25. Home-host relationships	Existence of legal barriers hampering the effectiveness of international cooperation between home-host supervisors on AML/CFT.

Annex Table 2. Recommended Action Plan to Improve Compliance of the Basel Core Principles

Reference Principle	Recommended Action (Responsible Agency/Entity)
Objectives, Independence, Powers, Transparency and Cooperation (CP1)	• Grant more enforcement power to the BCU vis-a-vis state-owned banks (ME) • Provide explicit/public grounds for the removal of the superintendent (ME) • Request a legal opinion regarding scope of article 33 of the BCU's CO (BCU) • Act on the opinion to provide further administrative autonomy to SSF (BCU) • Resolve shortage of resources to attract, train and retain valuable staff (BCU) • Enable a permanent solution to substitute IADB's loan to finance staff (BCU) • Modify process to promote/reassign staff within SSF and to retain staff (SSF) • Provide agile database management/programming of SSF's applications (BCU)
Capital Adequacy (CP6)	• Amend LIF including a PCA regime for response and escalation (ME) • Develop procedures to related the risk profile to Pillar 2 capital add-on (SSF) • Include concentration risk in Pillar 2 capital requirements as needed (SSF) • Plan/quantify the introduction of Basel III the cyclical capital buffer (SSF)
Risk Management Process (CP 7)	• Develop procedures to review ICAAP linked to Pillar 2 capital needs (SSF) • Require effective risk management units to systemic/large banks (SSF) • (For all risks) re-evaluate work load/further need of risk specialists (SSF) • Provide incentives for continued professional development (accreditation) (SSF)
Credit Risk (CP8)	• Require explicit arms-length free of conflict credit decisions (SSF) • Review sampling policy considering adequacy of risk management (SSF) • Provide further incentives to reinforce gaps observe in controls/systems (SSF) • Develop procedures for more sophisticate stress testing (SSF)

Reference Principle	Recommended Action (Responsible Agency/Entity)
Large Exposures (CP10)	• Expand interconnection factors (financial/commercial/operational links) • Factor concentration risk in the risk rating and in Pillar 2 (SSF)
Related Parties (CP 11)	• Include all other non-credit-related party transactions listed in IAS 24 (SSF) • Reduce scope of exceptions to lending limits with parent/group entities (SSF)
Liquidity Risk (CP 14)	• Increase to monthly the frequency of bank reporting maturity gaps (SSF) • Integrate better risk measures and stress test into limits and operations (SSF) • Reinforce requirements to implement contingency plans (SSF) • Plan/quantity the introduction of the LCR/NSFR of Basel III (SSF)
Operational Risk (CP 15)	• Provide detailed guidance to the industry on OR risk management (SSF) • Clarify provisions in the EMGs on contingency planning and ensure that banks test their systems including for outsourced activities • Reinforce resources of the SSF's Unit responsible for OR surveillance (SSF)
Interest Rate Risk in the Banking Book (CP 16)	• Integrate better risk and stress measures into limits and operations (SSF) • Require independent risk management units in large/systemic banks (SSF)
Internal Control/Audit (CP17)	• Develop metrics to evaluate and monitor the intensity of banks' audit efforts • Provide guidelines with more granularity on what internal control entails and the level of expectation of the supervisor (SSF)
Abuse of Financial Services (CP18)	• Amend art. 7 of the AML law in order to lift limitation that may hamper international cooperation by the UIAF and the SSF on AML/CFT matters (BCU/ME) • Increase UIAF and SSF resources to ensure a full coverage of the 486 entities subject to AML/CFT oversight (BCU) • Apply sanctions on a larger scale and more systematically whenever serious breaches are observed (BCU/SSF) • Develop industry-specific guidelines (SSF)
Supervisory Approach (CP 19)	• Refine/recalibrate CERT criteria to discriminate among risk profiles SSF) • Combine rating (risk of failure) and systemic impact (dimension) (SSF) • Made public the Supervisory Review and Evaluation Process (SSF) • Re-evaluate work load/costing in TeamMate to monitor and to justify/ control current and anticipated staff needs, including their profile (SSF)

Reference Principle	Recommended Action (Responsible Agency/Entity)
Supervisory Techniques (CP 20)	• Reinforce oversight of the quality of External Auditors in order to mitigate the risks of possible gaps in external evaluation (SF) • Provide guidance to SSF staff to ensure better calibration of effectiveness of risks management (SSF) • Increase sampling checks and cover a broader range of files and operations in the conduct of on-site inspections (SSF) • Set clear policies for communicating the closing letters to banks that have been inspected (SSF) • Consider the possibility of sharing with the inspected bank the inspection report (and not only the closing letter) (SSF)
Supervisory Reporting (CP 21)	• Exercise more supervision of the quality of work performed by external auditors (SSF)
Accounting/Disclosure (CP 22)	• Adopt the IFRS according to the timetable (2013) (SSF) • Address gaps between the domestic and internationally accepted accounting and reporting standards (SSF) with carve-out of IAS 39 as per SSF rules (SSF) • Further anticipate the implementation of Pillar 3 standards (SSF)
Supervisors' Corrective and Remedial Powers (CP 23)	• Take a more "aggressive" approach against banks displaying persistent weaknesses and not implementing remedial measures (BCU/SSF) • Adopt a consistent enforcement policy across institutions independently of ownership (BCU/SSF) • Design a clear/well articulated regime to deal with problem banks (SSF)
Consolidated Supervision (CP 24)	• Further implementation. Render operational the responsible unit (SSF) • Require consolidation of small nonbank credit units of foreign banks (SSF) • Develop procedures for consolidated supervision in 'systemic banks' (SSF)
Home-Host relationships (CP 25)	• Amend AML law to lift existing barriers hampering the effectiveness of international cooperation between home-host supervisors on AML/CFT (ME)

ANNEX II. DEPOSIT INSURANCE PRINCIPLES – SUMMARY ASSESSMENT

A. Introduction and Methodology

1. **An assessment of compliance with the Core Principles for Effective Deposit Insurance Systems (Core Principles) was conducted as a part of the FSAP Update in 2012.** The assessment was conducted by Claire McGuire, Senior Financial Sector Specialist with the World Bank, during a mission to Uruguay from September 5 to 19, 2012, with the assistance of Inés González del Mazo, Junior Professional Associate. The evaluation was conducted on Uruguay's deposit insurer, the Corporación de Protección del Ahorro Bancario ("COPAB") utilizing the Methodology for Compliance Assessment adopted in December 2010 by the Bank for International Settlements and the International Association of Deposit Insurers.

B. Main Findings

2. **The deposit insurance framework in Uruguay, managed by COPAB, broadly conforms to best international practice.** COPAB was established in 2008 pursuant to amendments under Ley No. 18.401(COPAB Act). It assumed the duties and responsibilities of the Superintendencia de Protección del Ahorro Bancario or Bank Savings Protection Authority, a unit of the BCU. COPAB administers a Deposit Insurance System (DIS) which covers deposits in 13 banks and one financial intermediary cooperative. COPAB has a statutory target ratio of 5 percent of total insured deposits, both in national and foreign currency. As of December 31, 2010, COPAB's target ratio was approximately 18.3 billion pesos. As of July 31, 2012, the Fund is at 1.17 percent of insured deposits.

3. **COPAB is funded by annual premiums collected from members. Membership is compulsory for all on-shore deposit taking financial institutions.** There is a flat rate and risk-based element to the premiums paid to COPAB and rates are further differentiated by currency, with higher flat rate premiums for foreign currency-denominated deposits. COPAB protects all retail depositors, including corporate depositors, small businesses and individuals, up to the maximum of approximately US$29,000 in peso denominated deposits per person per member institution. Foreign denominated deposits are insured up to US$5,000 per person per member institution. COPAB is legally mandated to reimburse depositors within 30 days of the declaration of liquidation of a bank by BCU in the currency of their deposits.

4. **COPAB is compliant with most of the Core Principles (one Principle is Not Applicable).** COPAB has a number of strengths, including its experienced staff, its computerized data collection system, and its close working relationships with other members of the safety net. However, there are several areas for improvement; most importantly, the resolution framework that provides a significant role for COPAB, but imposes conditions that would make a prompt, cost-effective resolution of a troubled bank very difficult.

The following table summarizes the main findings of the detailed assessment.

Annex Table 3. Uruguay: Main Findings of the IADI Detailed Assessment

Reference Principle	Main Findings
Public Policy Objectives; Mitigating Moral Hazard (CP 1, 2)	• COPAB is a nongovernmental legal entity created under public law, whose public policy objectives are clearly stated but do not precisely specify financial stability, even though its design could suggest so. The deposit insurance system provides a significantly lower level of coverage for dollar-denominated deposits.
Mandate and Powers (CP 3, 4)	• COPAB has an expanded mandate with consistent powers to act both as an insurer of deposits and an implementer of the Bank Resolution Process.
Relationship with Other Safety-Net Participants; Cross-Border Issues (CP 6, 7)	• There is excellent coordination between SSF and COPAB. COPAB gets deposit information directly from its member institutions and also has access to all supervisory information at SSF, including the results of SSF stress tests. • Neither SSF nor COPAB have agreements with foreign deposit insurers. Given the importance of foreign banks, it would be important that COPAB communicates with other deposit insurers about possible pay-out activities in the bank's home jurisdictions.
Compulsory Membership (CP 8)	• All onshore deposit-taking institutions are members of the deposit insurance system. However, COPAB does not have a role in the licensing process and there is no requirement that its views be considered before membership in the deposit insurance system becomes effective.
Funding (CP 11)	• COPAB manages an ex ante fund and has the power to request both advance contributions from members and a credit line from the MOF—upon written request and for up to US$40 million from BCU. However, COPAB cannot assess a special or extraordinary premium in the event that it needs to recapitalize its fund.
Public Awareness; Legal Protection (CP 12, 13)	• Public awareness of the deposit insurance system seems limited. • Only COPAB employees have legal protection. Legal protection for all people working at COPAB's direction is essential (e.g., external contractors).
Early Detection and Timely Intervention and Resolution; Effective Resolution Processes (CP 15, 16)	• Although there is no Prompt Corrective Action regime, the good coordination between SSF and COPAB would allow timely intervention. • The resolution regime does not allow for early resolution of troubled banks. COPAB is involved in the resolution process once the BCU, at its discretion, declares the PRB. Then, COPAB has only 120 days to arrange for a P&A, during which time the activities of the institution are suspended and depositors do not have access to their insured accounts. Actions from BCU and COPAB can be challenged, with no limitation on remedies. If it is not possible to arrange a P&A, COPAB must seek the approval of BCU to begin the liquidation process, at which time its obligation to pay insured deposits within 30 days is triggered.

Reference Principle	Main Findings
	In addition, depositors whose accounts contain salary or pension payments from the 30 days preceding the declaration of the PRB are entitled to receive those funds immediately without consideration of their insured accounts. COPAB needs the approval of 66 percent of creditors to transfer liabilities after liquidation. There is no temporary bridge bank authority.
Reimbursing Depositors; Recoveries (CP 17, 18)	• COPAB has access through its SIDIIF system to depositor data, which would allow it to make a payout within 30 days of liquidation, if required. • COPAB is subrogated to the claims of depositors it pays. It also acts as liquidator and is therefore involved in the entire liquidation process. Adequate judicial processes exist to allow for asset recovery although the process of realizing on collateral can be slow.

ANNEX III. STRESS TESTING MATRICES

Annex Table 4. Uruguay: Stress Test Matrix for Solvency

Domain	Assumptions		
	Bottom-Up by Banks	Top-Down by Authorities	Top-Down by FSAP Team
Institutions included	NA	• All banks (12): 11 private and BROU (public)	
Market share		• Percentage of total sector assets: 100	
Data and baseline date		• Supervisory (SSF), quarterly	
Methodology		SSF stress testing framework (reported)	
Stress test horizon		One year	
Shocks		• **Adverse:** depreciation of 13% of the exchange rate, inflation rate of 9.4%, increment of 200 bps. in country risk, a shock of 60 bp in the external interest rate, and GPD growth of -3.6%. **Severe:** depreciation of 31.7% of the exchange rate, inflation rate of 13%, increment of 750 bps. in country risk, a shock of 200 bps. in the external interest rate, and GDP growth of -8%	
Risks/factors assessed		• Credit losses in non-financial sector (modeled by aggregate NPLs) adjusted by loan loss provisions. • Market risks.	Credit losses in non-financial sector modeled by risk profile (stressed-PD). Credit losses in financial sector using ratings.
Calibration of risk parameters		• Credit risk: historical data (2001- 2012). • Market Risk: point in time estimate (based on balance-sheet).	
Behavioral adjustments		• None.	
Regulatory standards		• Hurdle rate based on minimum for Core tier 1, Tier 1, and Total Capital. • Basel II (Standardized Approach)	
Results		• CAR/shortfall, by bank. • Pass or fail; percentage of assets that fail in both scenarios (adverse and severe).	

Source: IMF staff.

Annex Table 5. Uruguay: Stress Test Matrix for Liquidity

Domain	Assumptions		
	Bottom-Up by Banks (if applicable)	Top-Down by Authorities (if applicable)	Top-down by FSAP Team (if applicable)
Institutions included	NA	• All (12)	NA.
Market share		• 100	
Data and baseline date		• Supervisory data.	
Methodology		• Bank-run type test with limited asset fire sale.	
Risks		• Market and funding liquidity risks.	
Regulatory standards		• NA	
Results		• Pass Rate (by number of banks and assets).	

Source: IMF staff.

ANNEX IV. RISK ASSESSMENT MATRIX

Nature/source of main threats and possible triggers	Overall Level of Concern	
	Likelihood of severe realization of threat sometime in the next three years	Expected impact on financial stability if threat is realized
Sharp reduction in nonresident deposits.	**Medium** Uruguay's banking system is vulnerable to changes in Argentina's exchange controls.	**Low** Less than 20 percent of total deposits are owned by nonresidents and denominated in foreign-currency. A shock to depositor confidence could tighten liquidity conditions, but the authorities have important liquidity buffers in place (e.g., liquid asset and reserve requirements).
Intensification of the turmoil in European financial markets (particularly Spain).	**Medium** The two largest private banks are subsidiaries of major Spanish banks. At this point, it looks like ESM support for Spanish banks may shield these banks from excessive funding pressures that might force them to turn to subsidiaries for funding and capital.	**Low** Resembling other countries in the region (e.g., Mexico) local subsidiaries are well-capitalized, liquid, and funded with a large stable domestic base and low loan-to-deposit ratios. Difficulties at the parent bank are likely to have a low impact on the subsidiary. Moreover, intra-group exposure limits have been decreased and also the downgrade of Spain has forced Uruguayan subsidiaries to reduce their exposure to headquarters.
Spillovers from the region.	**Medium** Developments in Europe and Asia could induce a severe slowdown in the region, and therefore have an amplified spillover effect over Uruguay. Also, the risk of rising protectionism by Argentina is high.	**Low** Uruguay is highly integrated with Argentina and Brazil, but the adverse effect on the domestic financial system of shocks would be mitigated by: (i) a highly liquid banking system; (ii) large liquidity buffers; and (iii) a large state-owned bank. [Chris commented on this sentence: 'is this relevant for a 'run'?]
Commodity price shocks in a highly dollarized economy.	**Medium** The probability of a slowdown of the Chinese economy—which supports commodity prices—has increased.	**Medium** Shocks in soy, meat, and grain prices could impact Uruguay's BOP, reserve accumulation, and exchange rate. Given the high degree of dollarization and Uruguay's dependence on agricultural exports it would have spillover effects on the financial system. Nonetheless, the system is highly liquid and regulation prevents significant currency mismatches.

ANNEX V. PROGRESS IN IMPLEMENTING THE RECOMMENDATIONS OF THE 2006 FSAP

Area of Policy Recommendation	Time frame	Progress as of July, 2012
Financial Institutions		
Continue close monitoring of public banks and other vulnerable institutions to ensure that their risk-management policies and practices are brought up to standard.	S/T	The same regulatory methodology and procedures are consistently applied over corporate governance and risk management for all banks, without distinction between private and public entities, according to the supervisory strategy already defined. In addition, the rules are the same for public and private banks, as well as compliance requirements. Public banks have made significant progress in risk management.
Continue to limit lending activities in vulnerable public banks and other institutions until improvements in risk management practices are achieved.	S/T	In June 8, 2010 BHU's prohibition to grant credit with disbursement of funds, established in October 2004 was replaced by a liquidity requirement of 25 percent on top of the general rule. The reduction of that percentage shall be based on the degree of progress in correcting identified weaknesses. In December 2011 the additional liquidity requirement on foreign currency deposits imposed to BROU in December 2004 was rescinded, due to the significant progress achieved in the bank's compliance with required conditions.
Restructure and downsize state institutions, in particular state banks, to minimize moral hazard.	L/T	BHU was restructured, transferring US$900 million of loans to trusts, MEF assuming liabilities amounting to US$$1,133 million (following BHU's recapitalization for US$$233 million) and the transfer of 432 officials to the National Housing Agency (NHA). The NHA was established by law as a State Agency to fulfill the mission of managing the resources allocated by the State directly or in the form of subsidies, to facilitate access to housing for people requiring State support.
Require directors and managers of public financial institutions to satisfy fit and proper requirements applied to private institutions.	L/T	By a particular instruction in May 2003 and later on by a general rule (Circular No. 2066 of November 2010), the approval from the SSF for the appointment of General Managers of public banks was introduced.
Address the factors contributing to the weak credit culture by making the credit registry easier to use,	L/T	BCU's Credit Bureau can be consulted by the public through its webpage BHU reports to the Credit Bureau loans granted from January 1, 2009 and

Area of Policy Recommendation	Time frame	Progress as of July, 2012
speeding up incorporation of BHU loans and the small loans of BROU, and strengthening the lax credit and debt relief practices of public banks.		restructured loans from June 1, 2010. In addition, BHU is implementing a plan to report its entire portfolio over a three-year period. BROU has adapted itself to what is required by the regulations. From the portfolio reviews of recent years, it does not seem that BROU has lax lending practices. In May 2007, the Law 18,125 amending the Charter of the BHU was promulgated limiting its lending only to mortgage loans for the purchase of new or used houses and home improvements. BHU has modified its policies and credit manual.
Pensions		
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 government-guaranteed minimum rate of return in *República* AFAP.	L/T	The first and second recommendations exceed the regulatory powers of the pension system overseen by the BCU. They apply only to the public pension system managed by the Social Security Bank. The minimum return guarantee by *República AFAP,* to no less than the system's minimum, has not been amended. Such a guarantee was a condition for reaching the agreement allowing the approval of the Social Security Reform Act (16 713).
Insurance		
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.	L/T	The State Insurance Bank (BSE) has a legal monopoly to insure against work accidents and occupational diseases. Case No. 2007/844 analyzed the reserves accumulated for these risks and BSE has made a commitment to set aside 25 percent of its annual profits to create the required reserves (Note NE/4/2011/760). In addition, BCU has proposed in Article 115 of the draft Insurance Bill sent to the MEF (exp 2011/736), the amend paragraphs 1 and 2 of article 67 of the Law 16074, replacing the *system of allocation ("régimen de reparto")* by the *capitalization method,* granting BSE time to comply with the new requirement, which will expire on December 31, 2021.

Area of Policy Recommendation	Time frame	Progress as of July, 2012
		To sum up, by allocating part of its profits or by complying with the Insurance Act, if approved, the BSE is reducing the gap between the reserves under the existing legal regime and those reserves that it should have been based on actuarial criteria. In addition, all insurance companies shall annually report the opinion issued by the External Auditor on its financial statements and supplementary information, specifying whether they have been prepared according to the accounting standards and valuation criteria issued by the SSF (RNSR article 138 lit a). The rule for setting reserves is the same for all market participants (it applies both to the BSE and to private companies).
Payment systems		
Implement the shift to an upgraded RTGS system and improve the legal framework related to payment and securities settlement systems.	L/T	The implementation of the RTGS system is in its final stage. The legal upgrade of the payment and securities settlement systems has been implemented through the adoption of the Law 18,573 approved in September 2009 and its regulations.
Supervisory and regulatory framework		
Increase resources to carry out effective supervision and to provide training for staff; improve information systems.		The budget for human resources has been increased, even though part of the staff is temporary hires. Since the merger of all supervisory sectors (banking, securities, insurance, pensions and AML/CFT) today, staffing has increased from 159 to 183. An annual training plan has been implemented, giving additional training to all staff in areas of interest. Since the merger, on average 105 staff per year have participated in training courses, through about 65 courses per year.

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		Information systems have substantially improved. A web page has been developed for collecting information, allowing an efficient control of compliance by institutions' submitting information, as well as, the settlement and payment of fines for delays or mistakes in the submission of information and for failing to comply with prudential standards. A management tool for working papers and documenting the supervisory process has been developed. BCU also implemented electronic filing.
Provide legal protection for staff of supervisory agencies and deposit insurance agency.		Law 18.401 of November 24, 2008.
Enhance the regulatory authority over securities intermediaries; improve supervision of BSE, composite life and non-life insurance companies, and the annuities industry.		BCU's Charter has been amended, establishing the SSF with regulatory and supervisory powers for the whole financial sector, including capital markets and insurance. The SSF has defined a strategic framework, a methodology and supervisory processes and issuance of regulations for securities brokers and insurance companies. Law No. 18,627 of December 16, 2009 and related norms set out a comprehensive framework for regulation of all aspects of capital market activity carried on by issuers, stock markets and market intermediaries.
Enhance AML/CFT legislation.		Law No. 18.494 of June 5, 2009.