

Argentina and the Changing Nature of Financial Regulation

GABRIEL GOMEZ GIGLIO

Associate, Baker & McKenzie, Argentina

Introduction

It has been argued that structural change is never simple. Proposals tend to be met with protests from affected parties. Neither is getting the right result easy. Reformers grapple with conflicting considerations, including the desire to promote a country's international competitiveness. Nonetheless, regulators should couple this with the need to keep the financial juggernaut under control.¹

More than two years have elapsed since the beginning of the latest Argentine financial crisis and hundreds of regulations have been enacted to tackle the banking run and the demise of the currency board. A proper understanding of the reasons behind the crisis is crucial in developing a regulatory system that may effectively reduce the risk of future failures.

Financial deregulation during the 1990s was followed by hundreds of new rules after the collapse. Like all reforms, the latest developments in the Argentine saga of financial regulation did not take place in a vacuum. Regulatory changes following the collapse of the financial system may be considered not only as indicators of what national authorities perceived as the underlying causes of the problems but also as legal tools to avoid further crises.

This article analyses the causes of the appearance and the demise of the currency board from a financial regulatory standpoint and aims to provide the reader with the latest developments in the Argentine financial regulatory framework.

Lessons from the Eighties

Instability was the striking feature of the Argentine economy in the 1980s. The external debt crisis battered an already weakened structure and exacerbated

its imbalances until it almost fell apart. The hyperinflationary episodes of 1989 and 1990 marked the culmination of a pronounced deterioration of the currency and threatened to destroy the structure of the economy.²

Arguably, the basic financial imbalance of the Argentine economy in the 1980s was due to the mismatch between the public sector's considerable needs for domestic financing and the private sector's low voluntary supply of funds. The first situation seemed to be based on the steep rise in fiscal deficits, generated to a great extent by the greater commitments with foreign creditors and the rationing of the international financial markets in the wake of the debt crisis. The second situation—low supply—was associated with the drastic decline in private savings as available income plunged, as well as with the significant change in the composition of savings in favour of external assets.

Two additional factors of great importance were rationing in the international credit markets and the failure of the financial liberalisation experience of the late 1970s. The reason lay not only in the crowding-out effect exerted by that demand, but also in its destabilising effects on the still fragile financial system. The difficulties in finding voluntary financing in the context of a falling private surplus and rationed external credit forced the public sector to make routine use of seigniorage to finance its budgetary imbalances.

Three requirements needed to be met to eliminate that imbalance and strengthen the domestic financial system: achievement of sustainable fiscal adjustment, reversal of the demonetisation process, and normalisation of the country's relations with external creditors. After the hyperinflationary episodes of 1989 and 1990 were overcome, and particularly following the implementation of the convertibility rules by the end of March 1991, the economy made great strides in those three areas.³

Financial Deregulation

Since 1989 Argentina has undergone major regulatory changes with the intention of liberalising its economy. Foreign investment has played a key role in the process through its participation in and acquisitions of privately held companies in a wide range of activities. Consequently, foreign investment regulations have been relaxed to assure equal treatment of local and foreign ventures.

1. See William Blair, "The Reform of Financial Regulation in the U.K." [1998] J.I.B.L. 43.

2. See Adolfo Canitrot and Silvia Junco, "Macroeconomic Conditions and Trade Liberalization: The Case of Argentina" in Adolfo Canitrot and Silvia Junco, eds, *Macroeconomic Conditions and Trade Liberalization* (Inter-American Development Bank and Torcuato Di Tella Institute, 1993).

3. As a parallel analysis and even though Argentina has not yet fully addressed the issue of external creditors, in 2003 the demonetisation process was reversed and, arguably, fiscal adjustment has been reached.

A key objective of the structural reforms introduced during the 1990s was to create a “climate of investment” that would make sustained growth viable. The tools selected were market liberalisation and deregulation, economic integration with the rest of the world, and the public sector reform, all of which revolved around an ambitious privatisation programme.

Similarly, the policies aimed at expanding the domestic financial market also gained relevance, not only because a larger market would be more attractive to foreign investors but also because the market should be capable of efficiently converting external savings into domestic capital growth.

A brief review of structural factors that contributed to promoting external capital flows within the framework of the reform process will be useful in defining its context and understanding its direction and structure.

The first significant factor was the low rate of national savings. After the severe fiscal and external shocks that followed the debt crisis, and in an environment of macroeconomic instability and stagnation, both public and private savings underwent a serious decline. As an inevitable consequence, the process of structural transformation would rely heavily on external savings, at least in the early stages.

A second essential structural characteristic was that when the reform was being planned, the economy was suffering from a serious, chronic external constraint caused by the heavy burden placed on the current account by interest on external debt. Investment levels were incompatible with an acceptable growth rate. The recovery of growth required not only greater savings but also a more fluid foreign exchange supply. It was essential, therefore, that the reform should help to promote the investment of foreign funds in the domestic financial market. This was also important because investment decisions of local economic agents, by giving preference to foreign investments, not only exacerbated the shortage of foreign exchange but also caused a portion of national savings to be used for the purchase of foreign assets rather than the financing of domestic capital growth.

These structural characteristics—insufficient savings and severe external constraints—also helped to change the perception of direct foreign investment. In the period before the crisis, direct foreign investment was seen primarily as a means of supporting the industrial investment process, improving the level of business management, and gaining access to advanced technologies. The first priority was to promote investment through new capital growth projects in order to increase the level of external savings and the supply of foreign exchange. Particular emphasis was given to the purchase of existing productive assets, even in old technology sectors. Privatisation programmes were the main instrument of this strategy because they facilitated the direct investment orientation toward the purchase of state-owned assets.

A third structural characteristic was the advance dollarisation process the economy had been

experiencing for years. Not only was a sizable percentage of agents’ portfolios denominated in US dollars but also many contracts between residents specified the US dollar as the currency used for the fulfilment of payment obligations. This increased the transaction demand for US dollars, which had the effect of “crowding out” the national currency. To finance investment recovery, it was, therefore, necessary to obtain long-term credit in the international market, at least until significant progress was made in developing the domestic financial market.

A fourth structural feature influencing the reform was the very high degree of financial fragility in the public sector following a decade of continuing fiscal crisis. The strategy chosen to overcome this situation was to initiate a thorough restructuring of the public sector balance sheet by privatising a large number of assets. This strategy required a policy shift toward external capital flows because the domestic financial market was extremely tight and was not in a position to handle the supply of new assets associated with the privatisation of state-owned property. Plans to swap external debt for profitable state assets became the basic tool of this strategy.

Consequently, specific reforms concerning financial flows from abroad, the exchange market, and the domestic financial market were implemented in a surprisingly short period of time and effected a drastic change in the institutional characteristics of these markets, significantly increasing the sources of external financing. The most important tools were the following:

- State Reform Law (Law No.23,696 of August 1989) provided the legal basis for the process of privatising public enterprises through the restructuring of external debt.
- Economic Emergency Law (Law No.23,697 of August 1989) established equal treatment for national and foreign capital invested in productive activities in the country and eliminated the requirement of obtaining prior approval for foreign direct investment.
- Convertibility Law (Law No.23,928 of March 1991) established a fixed exchange rate between the peso and the dollar and imposed the requirement that the money stock be backed 100 per cent by exchange reserves held by the Central Bank.⁴ In addition, it modified ss.617 and 619 of the Civil

4. Pursuant to s.1 of the Convertibility Law (as amended by Law No.25,445), the peso was convertible for selling purposes, at a ratio of one peso by the simple average of one US dollar and one euro. To these effects the selling rate of euros to US dollars at the London market applied. In this regard, the Convertibility Law provided that foreign currency required for conversion transactions at the aforementioned exchange ratio shall be sold by the Central Bank. Accordingly and pursuant to s.3 of the Convertibility Law, at any time the reserves of the Central Bank in gold and foreign currency should be equivalent at least to 100% of the monetary base. Moreover, all reserves invested in deposits, other interest accruing transactions, or in national or foreign state securities payable in gold, precious metals, US dollars or any other similar foreign currency, should be computed at market value.

Code providing for the enforceability of contracts and payment obligations denominated in foreign currency.

- Deregulation Decree (Executive Order No.2,284 of November 1991) repealed an entire series of regulations affecting a wide range of economic activities. Regarding the financial market, it included various provisions aimed at reducing intermediation costs through transactions in the securities market. In particular, the tax on the sale of securities was eliminated, the tax stamp on stock market transactions was abolished, and brokers' commissions in this market were deregulated.

- The National Securities Commission was authorised to introduce a series of new regulations aimed specifically at expanding the stock market and creating new financial instruments to be traded in the securities markets, as a means of mobilising domestic savings and attracting external capital. Thus, access to the stock market was facilitated for new companies, and innovative financial instruments such as Negotiable Bonds (Law No.23,962 of July 1991) and Commercial Papers (short-term negotiable bonds) were established.

- The Tax "Amnesty" term for the reporting of assets and goods held abroad in order to remove tax barriers to capital repatriation, and for the regularisation of assets in foreign currency held within the country.

- Central Bank Law (Law No.24,144 of September 1992) abolished the official deposit guarantee,⁵ prohibited monetary financing of the deficit, and established strict limits on both the placement of government bonds in the Central Bank and the granting of discounts to commercial banks. It also established the Central Bank as an independent institution.

- Modifications to the Financial Entities Law No.21,526 abolished the "reciprocity principle", increasing competition in the financial system and, consequently, decreasing high spreads.

- Through various Central Bank Communications, regulations were established to promote the development of the US dollar deposit and credit segment carried out through banks in the domestic financial system (Communications "A" 1493 of July 1989 and "A" 1820 of March 1991). In addition to specific financial measures, the development of this segment, known as "Argendollars" (*i.e.* US dollar deposits in US dollar denominated accounts in the Argentine financial system), received a substantial boost from the full deregulation of the exchange market at that time (Communications "A" 1589 of December 1989 and "A" 1822 of April 1991) and

5. Although not directly sponsored by taxpayers, a deposit guarantee scheme was enacted by means of Law No.25,485 passed on April 5, 1995, to cope with the local effects of the Mexican Crisis of 1994–95.

the establishment of a fixed exchange rate by the Convertibility Law.

The inflow of private capital had a significant impact on the domestic financial market, affecting the trend of both the existing financial instruments and those created as part of the reform. Similarly, institutional changes in the exchange and financial markets—which were clearly oriented toward deregulation and the reduction of transaction costs—facilitated the relationship between the external flows and domestic financial transactions. Moreover, greater financial integration and the increase in the quantity and diversity of financial instruments, together with growing macroeconomic stability, led to a sizeable decrease in the country risk, which in turn encouraged the capital inflow channelled through the financial system.

Demise of the Currency Board⁶

During most of 2001, Argentina faced a progressive deterioration in its perceived creditworthiness (as reflected by a market increase in the international spreads on its government bonds), as well as increased doubts about the Government's capacity to maintain its exchange rate arrangement, as evidenced by the sharp rise in the three and 12-months forward peso-US dollar rate.⁷

After more than 10 years under a currency board regime, successful in abating inflation and ensuring macroeconomic and financial stability, in January 2002 the country was forced to abandon the convertibility of the peso to the US dollar and moved to a floating exchange regime, amid probably the deepest political and institutional crisis ever experienced by the country.

On January 6, 2002, the Public Emergency and Exchange Regulations Reform Law No.25,561 (as amended by Law No.25,820—the "Emergency Law") was enacted. Pursuant to the Emergency Law, the fixed peg system between the peso and the US dollar (in force for more than 10 years) came to an end. In retrospect, the new regulations tried to address three main issues: debts and deposits denominated in foreign currency, and access to the foreign exchange market.⁸

6. It has been argued that: "History has shown that a sovereign, when in trouble, tends to change its law to alleviate its troubles". Michael Gruson, "Legal Aspects of International Lending" in Ingo Walter, ed., *Handbook of International Business* (1983), para.27–13.

7. In order to provide the reader with a simple and structural overview of the main regulatory changes passed during the 1990s *vis-à-vis* those enacted following the devaluation of the peso, reference is not made to nor are the consequences analysed of the Tequila effect and the local impact of the Mexican crises of 1994–95 as well as the modifications made to the financial system regulatory framework at that time.

8. For a detailed analysis of the modifications passed at that time, see "Emergency Law and Financial Entities in Argentina" [2003] J.I.B.L.R. 397–405.

Executive Order No.71/2002, issued on January 9, 2002, established an official foreign exchange market. All purchase and sale transactions of US dollars by the Central Bank were performed at the exchange rate of one peso and 40 cents per each US dollar. In addition, the Central Bank was empowered to specify the operations and transactions that should fall within the scope of the official exchange market. On February 8, 2002, Executive Order No.260/2002 abrogated the official foreign exchange market and established a free-floating exchange market, which, subject to Central Bank's regulations, remains in place up to date.

As for foreign currency denominated debts, on February 4, 2002, Executive Order No.214/2002 (the "Executive Order") was enacted. Pursuant to the Executive Order, all obligations to pay a certain sum of money denominated in US dollars or any other foreign currency outstanding as of the enactment of the Emergency Law (*i.e.* January 6, 2002) and not already converted into pesos, were converted into pesos, irrespective of their origin.⁹ The peso to US dollar rate is one peso per each US dollar or its equivalent in any other foreign currency. Accordingly, the debtor was permitted to fulfil its obligation by returning the amount denominated in pesos at the above-mentioned ratio.¹⁰

As for deposits denominated in foreign currency, the Executive Order provided that they were to be converted into pesos at the peso to US dollar ratio of one peso and 40 cents per each US dollar or its equivalent in any other foreign currency. Accordingly, the financial entity fulfilled its obligation by returning to the depositor the amount denominated in pesos at the above-mentioned ratio.¹¹

9. Law No.25,820, published in the Official Gazette on December 4, 2003, modified the Emergency Law setting out that the conversion of foreign currency denominated payment obligations not related to the financial system, existing as at the enactment of the Emergency Law (*i.e.* January 6, 2002), operates regardless of whether the debtor was in arrears as of that date. This amendment, while not altering the situations already settled by private agreements and/or legal judgments, aims at reinforcing "pesification" and for the future, intends to unify case law criteria related to this matter, considering that this was a very controversial issue and that courts' decisions have varied according to the existence or absence of debtor's default when the Emergency Law came into force. Nonetheless, the modification to the Emergency Law did not solve the constitutional issues of the mandatory "pesification" of debts and deposits.

10. Initially, in accordance with the Emergency Law, obligations to pay sums of money in foreign currency were treated as follows: the debtor was permitted to fulfil its obligation by paying in pesos at the one peso = one US dollar ratio, as payment on account, during a maximum term of 180 days; the parties shall negotiate the restructuring of the corresponding obligations. If the parties fail to reach an agreement after having negotiated, they may submit the matter to the courts, following the procedures then in force. Then, Executive Order No.214/2002 mandatorily converted into pesos all foreign currency denominated payment obligations at a one peso = one US dollar ratio.

11. Needless to say, all these emergency provisions have serious constitutional deficiencies. Accordingly, different courts have already refused to accept the legality of several aspects of the abovementioned regulations. A Supreme Court

Moreover, the Executive Order provided for the application of a ratio called "Reference Stabilising Ratio" (*Coefficiente de Estabilización de Referencia—CER*), as issued from time to time by the Central Bank, on the debts and deposits mandatorily converted into pesos. Interest on US dollar denominated debts with the financial system and converted into pesos shall accrue at a maximum annual interest rate ranging from 3.5 per cent to 8 per cent. Interest rates of any other kind of US dollar denominated debt shall be maintained as originally agreed upon in accordance with Central Bank Communications "A" 3507 and 3561. Executive Order No.762/2002 issued on May 6, 2002 exempted certain mortgage, pledge and personal loans from the application of the CER. This exemption is applicable to loans granted by financial entities to individuals. Individual housing rental payments were also exempt from the application of the CER.

Financial Regulation Again

Following the devaluation and the mandatory conversion into pesos of deposits and credits formerly denominated in US dollars, an avalanche of Executive Orders and regulations was passed in order to set out the new regulatory framework. Initially, the regulatory measures were mainly directed to (i) limit the demand and the transfer abroad of foreign exchange; (ii) increase the offer of foreign exchange (by means of the liquidation of foreign exchange proceeds by exporters), (iii) provide the Central Bank with more room for manoeuvre to act as lender of last resort, and (iv) provide for a more cost-efficient allocation of resources following a financial entity's winding-up or restructuring process.

Below, there is a summary of the main regulations issued by the Central Bank in this regard and of the main provisions of Laws Nos 25,780 and 25,782 ("the Laws") which were enacted to modify the Financial Entities Law No.21,526 ("the Act") and the Central Bank's Charter Law No.24,144 ("the Central Bank's Charter").

Access to the foreign exchange market and transfer of monies abroad

As a general reference, transfers of foreign currency abroad are prohibited by Executive Order No.1570/2001. The exemptions from this rule are (i) import and export transactions, (ii) payment of credit card expenses incurred abroad, and (iii) those transfers specifically authorised by the Central Bank. This last exception was broadened gradually to allow transfers almost generally, subject only to information

decision is expected in one of the 100,000 cases still outstanding related to private financial entities and individuals suffering from the mandatory conversion into pesos of their formerly foreign currency denominated deposits.

to the Central Bank. Moreover, transfers of US dollars abroad are also restricted indirectly by certain limitations imposed by the Central Bank on the purchase of foreign currency.

In this regard, in accordance with Central Bank Communication "A" 3909, as amended by Communications "A" 3944, 4079 and 4128, Argentine resident individuals and corporations must obtain the Central Bank's prior authorisation for the purchase of foreign currency for amounts that, in a single calendar month, and considering all the financial entities authorised to sell the foreign currency, exceed US\$2 million, for transfers abroad for the following purposes: real estate investments abroad; loans to non-residents; residents' direct investments abroad; resident individuals' portfolio investments abroad; any other residents' investments abroad; resident corporations' portfolio investments abroad; purchase of foreign currency bills for holdings in Argentina and purchase of travellers' cheques.

Moreover, Central Bank Communication "A" 3998 allows individuals and corporations not authorised to act as financial entities, access to the foreign exchange market, to purchase foreign currency in order to repurchase or cancel debt (including notes, bonds, syndicated loans or financial loans with foreign banks) existing as of March 31, 2003. The amount of foreign exchange so purchased is subject to a two-part limitation: (i) it cannot exceed US\$40 million per month (the unused portion of this amount may not be used in the following month), and (ii) foreign currency must be applied to the payment of the debt within the 180 days following the purchase. The amount of foreign exchange purchased can neither exceed 15 per cent of the total outstanding capital subject to restructuring nor the total amount due and outstanding for interest accrued and principal. Any purchase of foreign currency under this Communication "A" 3989 which due to subsequent negotiations among the involved parties results in violation of any of the limitations imposed must be repatriated to Argentina, or, if not delivered, reimbursed to the selling financial entity if such funds are not applied to cancel the restructured debt within the aforementioned 180-day period.

Central Bank Communication "A" 3661 as amended by Communication "A" 3866 established that the sale of foreign currency to non-residents for amounts over the equivalent of US\$5,000 per person per calendar month shall also require the Central Bank's authorisation. This threshold shall not be applicable for the sale of foreign currency to non-residents when the funds used for the purchase were paid by a resident to the purchasing non-resident for matters related to imports, services and other ordinary transfers, provided that the resident had access to the funds through the foreign exchange market in accordance with the applicable exchange control regulations referring to payments abroad. According to Communications "A" 3944 and "A" 3999, the Central Bank's authorisation shall not be required either when (i) an international organisation sells foreign currency to

non-residents; or (ii) the non-resident is repatriating collections of principal and interest in respect of public national bonds issued in foreign currency paid in Argentina. In case (ii), the non-resident must provide evidence to the financial entity before which it is requiring the transfer abroad that (a) payment under the bonds was made in Argentina, and (b) the Argentine pesos with which the foreign currency is purchased were obtained through the settlement of the US dollars collected under the bonds in the foreign exchange market.¹²

In addition, pursuant to Central Bank Communication "A" 4129, financial entities may allow non-residents (either individuals or legal entities) to have access to the foreign exchange market, without the Central Bank's authorisation, for repatriation of direct investments and portfolio investments that were collected in Argentina for the following reasons: (a) residents' foreign debts for imports and financial debt for foreign loans granted by non-residents; (b) credits against Argentine bankruptcy estates; (c) sale of direct investments in Argentine non-banking businesses; (d) other sales of Argentine portfolio investments, such as stock, investment funds and Argentine trusts participations, investments in local bonds denominated in pesos and other local credits. Transfer of these funds abroad for the reasons indicated in (c) and (d) are limited to an aggregate maximum amount of US\$2 million per month, while any transfer of funds performed exclusively under (d) may not exceed the maximum amount of US\$500,000 per month.¹³

12. Regarding the exceptions to the limitation of remittance of funds abroad, in all cases, the intervening local financial entity must request of the transferor, prior to effecting any transfer of funds abroad for paying either principal or interest on loans: (i) a certificate of compliance with the debts declaration regime, according to Communication "A" 3602; and (ii) an affidavit declaring that the requested transfer shall be applied for payment of a declared debt. Notwithstanding the foregoing, it is still possible to exchange pesos for US dollars through arbitrage of public or private US dollar denominated bonds which may be purchased at the Buenos Aires Stock Exchange in pesos, and may be exported from Argentina without any restriction, and then sold for US dollars in other financial markets where they are quoted.

13. Additionally, for all the cases indicated in (a) to (d), the intervening financial entity shall: (i) request all the documents needed to certify the type of investment declared; (ii) in the event of local collections of principal of financial loans, verify that such debts shall have been validated by the Central Bank under the terms of Communication "A" 3602, and been incurred in accordance with the then applicable foreign exchange rules for disbursement of loans (not applicable to concept (b) above); (iii) if any total or partial collection of sale of investment or loans occurred in foreign currency, request proper documentation of its previous settlement through the local foreign exchange market; (iv) for all the cases indicated in concept (d), request proper documentation issued by a financial entity stating the amount of the investment and the date it entered into Argentina; (v) verify, in all cases, that the investment remained in Argentina for a period not shorter than 180 days; (vi) in all cases, request sufficient evidence to certify the reasonability and genuineness of the transaction and all the documentation required by the foreign exchange regulations applicable to the specific case. These documents shall remain filed in the intervening financial entity.

Moreover, pursuant to Central Bank Communication "A" 3473, issued on February 9, 2002, as from February 11, 2002, collections for exports of goods and services, net of advances and pre-financing loans, shall be declared and settled through the foreign exchange market. Imports of goods shipped as from February 11, 2002 that were not evidenced by documentary credits opened by domestic financial entities before February 11, 2002, shall be financed in accordance with the minimum payment terms established by the Industry and Trade Secretariat.

As for forwards and derivative transactions, pursuant to Central Bank Communication "A" 3525, issued on March 22, 2002—as amended by Communication "A" 3620 on June 3, 2002—financial entities shall require the Central Bank's prior authorisation to clear their own international forwards and derivative transactions.

Principal and interest payments of international financial debt shall require the Central Bank's prior authorisation. This requirement is not applicable to (i) debt payments of international financing and multi-lateral credit institutions; (ii) payment of financing facilities granted after February 11, 2002, and (iii) certain public sector obligations.

Pursuant to Central Bank Communication "A" 3610, issued on May 21, 2002, no prior Central Bank authorisation is required for the payment of principal of financial loans if at least 50 per cent of the outstanding principal is capitalised or converted into an irrevocable capital contribution after January 1, 2002. Communication "A" 3859 of the Central Bank, as amended, authorises the remittance abroad of capital gains and dividends corresponding to fiscal year end financial statements, duly audited by external auditing firms, without the Central Bank's prior authorisation.

In addition to those exceptions mentioned above, Central Bank Communication "A" 3973 allows the purchase of foreign currency to pay:

- (i) principal payable to foreign private non-financial lenders under financial loans, bonds or other debt securities, within 15 days prior to the payment's maturity;
- (ii) principal with no time restriction if the following conditions are met:
 - (a) the payment must not exceed the present value of the debt being cancelled if such payment is not a part of a debt restructuring;
 - (b) if such payment is a part of a debt restructuring, then the new conditions of the indebtedness and the payment being performed should not result in an increase of the present value of the debt; and
 - (c) a 180-day term from the purchase of the currency has elapsed for transactions involving bonds and financial loans;
- (iii) accrued interest of financial loans held with private non-financial creditors pursuant to a debt restructuring.

Lastly, for the purposes of avoiding the influence of volatile capital on the market, the Executive Power

issued Executive Order No.285/2003. Accordingly, any foreign currency entering into or going out of Argentina as from July 1, 2003 must be registered with the Central Bank. Repatriation of funds entered into Argentina may only take place 180 days after their entry. The inbound transactions exempted from this requirement are: (i) those corresponding to foreign trade, and (ii) those investments of foreign residents in companies with direct investments in Argentina (as indicated by Central Bank Communication "A" 3972).

Modifications to the Financial Entities Law

Cash depositors' preference regime

Pursuant to the modifications made by the Law to the Act,¹⁴ when a financial entity is wound up, its cash depositors have an exclusive preference right over all the other creditors of such a financial entity, except for mortgage and secured credits and labour creditors, to be repaid in the following priority order:

- (a) all deposits made by a single individual or legal entity for the maximum sum of \$50,000, or its equivalent amount in foreign currency. Multiple depositors of a single account shall collect under this preference pro rata;
- (b) all deposits made by a single individual or legal entity for a sum in excess of \$50,000 or its equivalent in foreign currency; and
- (c) financial loans granted directly to the wound-up financial entity related to international commerce.

Depositors may pursue further repayment of outstanding deposits through the subsidiary mechanism set forth by the Deposit Insurance Fund.¹⁵ The exclusive preferences set forth in (a) and (b) above are not applicable to deposits made by individuals or legal entities directly or indirectly related to the financial entity in accordance with the definitions and standards to be set forth by the Central Bank.

14. Before the modifications made by the Laws, the Act provided for the payment of depositors as follows: (i) all deposits made by a depositor up to the amount of \$5,000; (ii) fixed-term deposits for a minimum of 90 days participated on a *pro rata* basis in the financial entity's cash balance; and (iii) all other cash depositors (including those referred to as (i) and (ii) above with respect to any other cash deposits) participated on a *pro rata* basis in the cash balance, if any.

15. The Deposit Insurance Fund ("the Fund") established in Argentina covers, up to \$30,000 (i) fixed-term deposits; (ii) demand deposits in current accounts, and (iii) demand deposits in saving accounts (whether in pesos or in foreign currency). The Fund does not cover (i) inter-financial entities deposits, (ii) deposits made by parties related to the financial entity, (iii) fixed-term deposit of securities or guarantees, and (iv) any deposit made after July 1995, on which the interest rate to be paid by the financial entity exceeds by 2% the annual interest rate of the National Bank of the Republic of Argentina. The Fund is not guaranteed by the Central Bank, rather its resources are provided by the financial entities and it is privately managed by a special purpose corporation named Seguro de Depósitos S.A. ("Sedesa").

The exclusive preference set out above provides for the repayment of depositors with the financial entity's cash reserves and other funds existing at the time of the revocation of its licence.¹⁶

Modifications to the restructuring process regime—transfer of assets and liabilities

Should the absolute majority of the Central Bank's Board decide that a financial entity is in a position that would cause the revocation of its licence, the Central Bank may authorise the restructuring of such financial entity to safeguard depositors. Accordingly, the Law modifies the Act providing for the exclusion and transfer of assets and liabilities of the distressed financial entity to other financial entities or to a financial trust.

As regards such exclusion and transfer, pursuant to the modifications made by the Law to the Act, the Central Bank may decide the exclusion of those assets determined by the Central Bank, assessed according to the accounting rules applicable to financial entities' balance sheets, adjusted to their sale net value, for an amount equivalent to the different items of the liabilities related to items (a), (b) and (c) referred to above.

Moreover, the Central Bank may exclude mortgaged or pledged assets for their net value considering the final sale value and the mortgagor's and pledgor's rights to such assets. Furthermore, attached assets may be excluded without any limitation.

Should the Central Bank consider it advisable, financial trusts may be set with all or part of the financial entity's assets by issuing one or more certificates of participation for the financial entity's creditors for the nominal value of the excluded assets. The financial entity shall be the beneficial owner of the trust balance, if any. In addition, the Central Bank may transfer secured credits and Central Bank's credits but without adversely affecting related creditors' privilege.

The transfer of assets and liabilities of financial entities and any act related to it shall be governed by the Act. Accordingly, no action may be filed or ruling enforced in order to execute excluded assets, the transfer of which the Central Bank has already

authorised, commissioned or decided pursuant to this procedure, except when the purpose of these executions is the collection of loans secured by mortgages or pledges or the enforcement of labour contracts. Moreover, precautionary measures may not be taken against excluded assets. Furthermore, creditors of the financial entity whose assets are excluded are neither entitled to act nor have rights of any kind whatsoever against the purchaser of such assets, unless they have special privileges over certain assets.

Those acts which are authorised, commissioned or decided by the Central Bank involving the transfer of assets and liabilities are not subject to any court authorisation and cannot be deemed non-enforceable against the creditors of the financial entity who were the owners of the excluded assets even though the insolvency preceded such exclusion.

The propriety, merit and advisability of the acts made by the Central Bank or the Superintendency of Financial Entities in full exercise of its powers granted by the Act, as amended, in order to implement any of the measures set out hereinabove or regarding any act related to such implementation shall only be reviewed in court whenever they are presumed to have been arbitrary or unreasonable.

Modifications to the Central Bank's Charter

Temporary advances to the National Government

Pursuant to the modifications made by the Laws to the Central Bank's Charter, the Central Bank may grant temporary advances to the National Government up to an amount equal to 12 per cent of the monetary base, which consists of the monetary circulation plus sight deposits of financial entities in the Central Bank, either in special or current accounts.

Moreover, the Central Bank may also grant advances that shall not exceed 10 per cent of the cash resources obtained by the National Government during the last 12 months. Except for advances applied to the payment of obligations with multilateral credit organisations, temporary advances granted to the National Government shall not exceed 12 per cent of the monetary base, as defined above. Such advances should be reimbursed within a 12-month period. If any of these advances remains unpaid after the expiration of such period, no new advances may be granted until full payment of the owed amounts.

Issue of currency

In order to deal with the so-called quasi-currencies (*i.e.* bonds issued by provincial governments for the payment of public services and salaries at the time of the banking freeze), the Central Bank shall exclusively issue banknotes and mint coins in the Argentine Republic and no other agency of the nation, provincial or municipal government bank or institution shall be entitled to issue either banknotes, coins or any other kind of legal tender.

16. Moreover, local depositors have a preference over the assets of an Argentine branch of a bankrupt foreign financial entity. It is worth mentioning that the registration and admission of creditors in a bankruptcy proceeding commenced in the Republic of Argentina who are payable outside the Republic of Argentina and who are not participating in foreign bankruptcy proceedings, is conditional upon evidence that proves reciprocity (*i.e.* that a creditor whose credit is payable in the Republic of Argentina will be allowed to participate and be paid, under the same conditions, in a bankruptcy proceeding commenced in the country where the claim of the former creditor is payable). If the financial entity is also declared bankrupt outside the Republic of Argentina, the creditors registered under the foreign bankruptcy proceedings will be entitled to claim only on the balance of the financial entity's assets located in the Republic of Argentina that are left over once all the creditors payable in bankruptcy proceedings in Argentina have been paid off.

Pursuant to the Law and to avoid any further issue of quasi-currencies by provincial governments, it is considered that an illegal currency is circulating when: (i) the issuer imposes or induces, either directly or indirectly, the compulsory acceptance of the illegal currency for the payment of any kind of obligations; or (ii) the illegal currency is issued for nominal values lower than or equal to 10 times the value of the highest rated bill of the legal currency in circulation.

Central Bank exceptional powers during the emergency period

During the emergency period established by Law No.25,561, as amended (*i.e.* up to December 30, 2004) and when exceptional circumstances occur, the Central Bank may, with the approval of two-thirds of its Board of Directors: (i) act as lender of last resort to financial entities that undergo financial and/or solvency difficulties; (ii) authorise the merger of the reserve deposits with other assets; and (iii) waive, either totally or partially, the privilege as regards its credits, in order to assist restructuring processes of financial entities for depositors benefit.

Conclusions

The latest Argentine latest financial crisis revealed that there were at least two sources of financial fragility neither addressed nor assessed at the time of the enactment of the financial regulatory system in the early 1990s. First, the combination of a currency board regime, fiscal imbalance and highly dollarised bank balance sheets implied a solvency risk for the financial system, should the economy have to adjust to a shock either through nominal devaluation or a deflationary process. The other was the non-regulated exposure for banks to sovereign risk.¹⁷ In this regard, preliminary researches seem to confirm that banks that were large lenders to the government were subject to a more intense run.¹⁸

In addition, doubts about the sustainability of the announced government policies had adverse consequences on the banks' balance sheets, mainly through two main channels: (a) the stock of government paper held by banks, part of which was "forced"

on their balance sheet by the government,¹⁹ and (b) the significant proportion of dollar-denominated loans extended to borrowers with peso-denominated income. While the increased perception of government default reduced the market value of government bonds held by banks, increased devaluation expectations diminished the expected return from banks' loan portfolios.²⁰

Liability dollarisation seriously amplified the costs of the crisis. Regulations did not make depositors aware of the higher risk involved in foreign currency deposits, especially considering that the Central Bank did not have policy instruments to act as lender of last resort in the case of a run on foreign currency denominated deposits.²¹ The conventional assessment that head offices of foreign-owned banks would act as lender of last resort of their local offices was not confirmed in all cases by the evidence.

Nonetheless, the mass closure of banks has been avoided thanks to a far-reaching policy for assistance to financial entities; the run on the exchange market has been halted and the volatility of the exchange rate has been reduced to its minimum expression in the last six months. Moreover, deposits have continued to rise; bank liquidity needs have declined; and most importantly, the inflation rate has not matched the depreciation rate of the currency. Much of this improvement can be attributed to the responsible monetary policy introduced by the Central Bank that has provided a significant contribution towards the generation of a radical change in investor expectations and local depositors.

Recent experiences of emerging market crises and, more specifically, the 2001 Argentine financial crisis, made clear that financial liberalisation policies must

17. As pointed out by L. Rojas-Suarez, when non-OECD countries apply the Basle recommendations to their domestic economies, most non-OECD countries attach a 0% risk weight to their own government paper. That is, banks in emerging markets treat paper issued by their governments as a "safe asset", an assumption far from reality if one takes into account the large number of episodes of "government debt" crises in emerging markets, including the recent ones in Ecuador and Argentina. *Can International Capital Standards Strengthen Banks in Emerging Markets?* (Institute for International Economics Working Series, Washington D.C., 2001), p.13.

18. Tamara Burdisso, Verónica Cohen Sabban and Laura D'Amato, "The Argentine Banking and Exchange Rate Crises of 2001: Can We Learn Something New from Financial Crises?" (www.cemla.org/pdf/red/RED_VII_ARGENTINA-Burdisso-Cohen-Damato.pdf).

19. It has been argued that: "Ultimately, we learned in Argentina that when sovereigns are at the end of their rope, they'll use all the power at their disposal—including financial sector supervisory and regulatory powers—to address their short-term needs, irrespective of the long-term consequences for the financial system or the economy". C.W. Calomiris, "Lessons from Argentina and Brazil" (2003) 23 *Cato Journal*, available at www.cato.org/pubs/journal/cj23n1/cj23n1-5.pdf.

20. By late 2001, banks' claims on the government as a proportion of total assets amounted to 30%. Latin American Shadow Financial Regulatory Committee, Statement No.5, Buenos Aires, May 5, 2002. As argued by Barry Eichengreen and Michael D. Bordo: "Of course, even a very firm commitment to the peg was not guarantee against other financial problems ... This is an important lesson of history for emerging markets today." Barry Eichengreen and Michael D. Bordo, "Crises now and then: what lessons from the last era of financial globalization?" in Paul Mizen, ed., *Monetary History, Exchange Rates and Financial Markets. Essays in Honour of Charles Goodhart* (Edward Elgar, Cheltenham, 2003), Vol.II, p.73.

21. Moreover, the currency board regime favours the perception that depositors would be permanently protected against devaluation risk, considering the high dollarisation of banks' assets and liabilities, adding more political pressure and less room of manoeuvre to both the government and banking regulators. To make things even worse, although most bank assets were denominated in foreign currency, the payment capacity of banks' clients was closely linked to the trend in the level and stability of domestic business activity.

be accompanied by regulations that widely control banking risk, preventing excessive credit expansion and fiscal imbalance. Emerging market economies, probably due to a lack of domestic savings to sustain growth, are highly dependent on capital inflows. In this sense, banking systems in emerging markets face

particular risks not shared by those of mature economies. As a consequence, the regulatory and supervision standards for emerging economies' banking systems need to be revised in light of recent experiences, including Argentina's and might differ in some aspects to those of developed countries.