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# Uruguay Capital Market: Law-in-the-books or Law-in-the-action

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# Uruguay Capital Market: Law-in-the-books or Law-in-action?*

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## Sumario

El documento discute el proceso de reforma de infraestructura legal para mejorar las bases institucionales del desarrollo del mercado de capitales en Uruguay en la década del 90. Contiene una descripción de los eventos, una revisión de la literatura, una explicación y una evaluación. Intentamos extraer lecciones y realizar una análisis prospectivo del desarrollo del mercado de capitales local bajo el nuevo escenario de la primera administración de izquierda en la política nacional. Encontramos paradojal una reforma legal en un país en que el legislador y el político han jugado un papel de primer orden en la interpretación del derecho y en la regulación de la brecha entre el discurso y la práctica jurídica.

## Abstract

This paper discusses the process of legal infrastructure reform to build better institutions for capital market development in Uruguay during the 1990s. It contains a description, a brief literature survey, an explanation, and an evaluation. From this we draw lessons and make a prospective analysis of the fate of capital market development under the new political scenario shaped by the first left-wing government in the national history. In particular we find fascinating the conundrum of a legal reform in a country in which the legislator and the politician have played a first order role in the interpretation of the law and regulating the gap between "law-in-the-books" and "law-in-action".



*Classification JEL:* G, K, Z13.
*Keywords:* bankruptcy, capital markets, finance, common law tradition, civil law tradition, disclosure, law, legal, reform, trust

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## Introduction

From mid 1990s up to early this century Uruguay has passed important legislation to lay the foundations of capital market development as a part of a package of market-friendly reforms in a vein of others attempted in most Latin America.

The immediate goal was to make the country's business and corporate law more hospitable to domestic and foreign investment. Innovative areas were exchanges, investment and pension funds, securitization, factoring, and trusts. Furthermore, reforms were carried out in corporate bonds and investment regime. A primary allocation of regulatory powers left an ample room to market participants self-regulation with the last resort oversight of the Central Bank.

More specifically, since mid 1990s important legislation regarding capital markets has been passed: Exchanges and Corporate Bonds Law (1996), Investment Funds Law (1996), Securitization and Factoring Law (1999), and Trust Law (2003). The Social Security Reform Law (1995) was partly a leading driver of this legislation by setting the stage for pension funds (AFAPs), major stakeholders in the domestic capital market development. Legal innovation and reform are still unfinished tasks: attempts to reform the bankruptcy code have been unsuccessful.

We do not discuss every aspect of the legal reform. Rather, we focus on bankruptcy, funds, and trusts. We ask what the central innovation was. With a diagnostics of weak protection of investor's rights, the introduction of "fund" (and later on the more general "trust") as an asset or collection of assets endowed with a legal identity making them autonomous of the managers or shareholders' fates, whether be natural or legal persons, collateral for project finance could be placed more safely and managed more professionally. By that time many Latin American and European countries already imported and adapted these legal institutions from Anglo-Saxon tradition.

Policy reforms in this area entail the use of the legal infrastructure merely as a highway on which other reforms and development can go at a faster pace. Following Fanelli-Popov [2003], they are typically "procedural", i.e., they are supposed to set an adequate frame for better development performance. Beyond the establishment of legal and regulatory framework on which we plan to focus here, the "legal making", the State has had an important actual market building role as a major short and long horizon security issuer. Early good regard of social security reform and successful inflation control were rewarded with the achievement of investment grade in 1997, giving great momentum to the GOU public debt issues at local and global levels.

The gap between the “real world” and the law is widely acknowledged in Latin America. When the “rule of law” and “law and order” are a larger or smaller extent defective, what can legal reform achieve? If societies are more regulated by non-legal social norms, organized in more or less self-governing bodies, how to approach best legal infrastructure reform. Esquirol [2003] discusses at length this issues for Latin America legal systems.

At the time of writing a major political shift has taken place: the first left-winger political force in history is taking office after its crushing electoral victory at the end of 2004. In principle, there are signals that the new administration will pursue capital market institutional development further, in part because the gigantic twin crises of 2002 left the banking system in a fragile position to grant credit at pre-crisis levels. Although prospective is difficult in unchartered waters, this paper attempts to highlight opportunities and perils of capital market development under the new political framework.

In this paper we try to understand the gap between the “law-in-the-books” and “law-in-action” in Uruguay capital market legal reform and to draw some policy lessons. The presentation is organized as follows: a) description of the reform process, b) brief survey of theoretical and empirical work on the relationship between financial and legal systems, c) an examination of the domestic reform process in the light of theoretical and empirical material laid out in “b”, and closes with d) evaluation, lessons, and perspectives under the new political scenario.

## 1. Historical background and foundations

It is important to place the size of local capital markets in context. The twin crises of 2002 halved the relative size of financial intermediation and hammered a heavy blow on the regionally important offshore activities. Capital market size measured by institutional investors’ portfolio as percent of GDP have gone from negligible in early 90s to at least half of knocked down banking loans of 2003. Although the upward trend is clear, domestic financial markets are still limited to fixed income securities, most of which are public. Furthermore, whatever growth of institutional investors, it has been to a significant extent an upshot of Social Security reform (1995).

**Table 1: Capital markets and banking system (% of GDP)**

| | 2001 | 2002 | 2003 |
|---|---|---|---|
| Banking loans | 57.2 | 41.3 | 22.0 |
| Pension assets funds | 5.6 | 7.2 | 11.0 |
| Insurance companies assets | 2.3 | 3.3 | |

Source: Central Bank of Uruguay

What was expected from the development of local capital markets? The goals then were

1. Raise income per capita and accelerate growth.
2. A strong capital market alternative to banking credit can furnish:
    a. Lower funding costs.
    b. Longer horizons.
    c. Better risk spreading.
    d. Higher liquidity (entry & exit).
    e. Ownership-management separation.

Putting aside the contentious issue of causal link between savings and growth, there is a broad consensus that financial development broadly defined covaries positively with GDP per head and growth rates[1]. Although an abstract comparison favors direct finance over intermediated one, the key issue we will deal below is whether local firms' prevailing low disclosure levels and self-dealing possibilities leaves much room for liquid private securities.

### *1.1 What critical events trigger the reform process?*

Early 1990s the country saw the final stages of the resolution of the banking crises and high external indebtedness rooting in the hard peg exchange regime collapse of 1982 (our previous comparable twin crises). The currency regime breakdown had negative sharp effects on banks' quality loans portfolio and non financial corporate balance sheets. The Central Bank of Uruguay (BCU) purchased (and/or "cleaned up") poor quality banks loans for about USD 1000 millions in 1983-84. In 1985-88 the Government of Uruguay (GOU) took over the management the four private banks in trouble with the intention of their reprivatization[2]. In 1991 partial success of the strategy was the reprivatization of the largest state managed and a formerly distinguished house name bank: Banco Comercial. In 1990 this bank was already managing for a fee the mentioned poor quality portfolio loans.

Footing the bill of banking and exchange crises engrossed public sector deficits (with a peak 12 % of GDP) and higher indebtedness until early 1990s. The GOU, along with many other Latin American governments, participated in Brady's debt restructuring plan for USD 1611 millions (22% of gross external debt) by swapping Uruguay's foreign banking loans for the so-called Brady bonds in 1990-91. From then onwards a timid rebound in confidence went hand-in-hand with an upwardly trending economic activity.

[1] For instance see the previously mentioned Levine-Zervos [1998].
[2] A good account and discussion is Roldós [1991].

The protracted banking crisis resolution left productive endeavors craving for funding. It was then clear that some development of capital markets could fill the gap. Heavy reliance on banking credit (or "intermediated finance") prompted a GOU's attempt at developing capital markets institutions. It is not surprising the transformation of banking loans in securities with US Government guarantee may have fed a plausible expectation for capital market development based on negotiable public debt. And with the benefit of hindsight, it has been the case that Latin American external and public debt have moved away from loans to capital market financial instruments.

### *1.2 What structural weaknesses demand the reform process?*

A number of underlying permanent flaws of local financial sector were then put at the table:

1. Secular weaknesses in domestic investment and savings rates.
2. Risky and unreliable external funding (foreign capital flows).
3. Almost exclusive reliance on banking credit, expensive, and short term.
4. Negligible show-up of capital markets, especially private sector issues. Not even public debt instruments made the absence.
5. Creditors' perception of a legal and judicial bias against them.

1 & 2) The widely accepted stylized fact of the investors "home bias" has supported the idea that local capital markets foster domestic savings and raise investment rates. A beneficial outcome of this, as usually conjectured, is a reduction in external vulnerability. Current IADB's unofficial statement of its technical assistance is Dowers-Masci [2003], and it points clearly in this direction.

3) Although intermediated and direct finance are viewed as competitors, synergies are also possible. Levine-Zervos [1998] report a 65 % correlation between banking credit and stock market capitalization as percent of GDP.

4) Macroeconomic stability and orderly public debt management normally suffice to capital markets for government securities. As for the private sector, preconditions are much trickier. For stock markets, Black [2001] summarizes the preconditions

1. *Coping with asymmetric information:* Satisfactory information disclosure about the value of firm's business.
2. *Coping with self-dealing:* Investors' trust on insiders' avoidance of self-dealing, i.e. profiting from transactions between the firm and insiders controlled counterparties.

The lack of stock markets can be thought as a "lemons" equilibrium of a basic adverse selection process. Honesty-best-policy firms do not have the incentive to issue shares because investors heavily discount their prices, and then the honesty of the pool dwindles until there is no outsider shareholder to take on the gamble. The dearth of outsider investors will not bring a very vocal demand for a more protective public policy.

5) From López-de-Silanes [2002] we extract comparative information about investors protection in the world, and how the country stands in the backdrop of LDCs and DCs samples.

**Table 2: Rankings of legal protection of investors' rights**

| | URUGUAY | LDC[3] SUB SAMPLE | DC[4] SUB SAMPLE | TOTAL SAMPLE |
|---|---|---|---|---|
| Shareholders rights (0-6) | 2.0 | 2.84 | 3.17 | 3.0 |
| Creditors rights (0-4) | 2.0 | 2.48 | 2.13 | 2.3 |
| Efficiency of judicial system (0-10) | 6.5 | 6.26 | 9.14 | 7.67 |
| Rule of law (0-10) | 5.0 | 4.68 | 9.10 | 6.85 |
| Accounting standards (0-8) | 3.1 | 5.29 | 6.72 | 6.09 |

The sample size is 49 countries. The sub samples were defined by the median GDP per capita. In the comparison of less developed countries vis a vis developed ones, the message has two parts:

1. Shareholders rights are more protected in DCs than in LDCs, and the creditors ones is the other way around, but the differences are *not* statistically significant.
2. DCs score definitely higher than LDCs in the remaining criteria: Efficiency of judicial system, Rule of law, and Accounting standards. In this instance the differences *are* statistically significant.

The morale here is that the LDCs' problem is not placed in the written law but in the poorer working of rights enforcement, higher corruption and less transparency. As for Uruguay we have

1. Creditors and shareholders' rights ratings and accounting standards are below LDCs average, and the creditors even below the already lower DCs average.
2. With the LDCs benchmark, the country scores a bit higher in the efficiency of judicial system and more clearly so in the rule of law.

Unlike the typical LDC, the country is more deficient in the legislation than in the procedural aspects.

Although some local readers could contend the specifics of country scores, it is a meaningful fact that they reflect perceptions of potential foreign investors, investment bankers, rating agencies, etc..

[3] Less Developed Countries.
[4] Developed Countries.

### *1.3 Other factors*

One of the multilateral organizations, Inter-American Development Bank, played an important role through the technical assistance “Investment Sector Reforms Program” in 1992. Its purpose was to improve “investment climate” by identifying stumbling blocks and suggesting instruments to overcome them.

Unlike other areas, Mercosur commitments did not shed any sharp focus on this area. Uruguay is still the most attached to an open capital mobility policy in the region. Interestingly, private exchanges have signed integration agreements.

A highly positive synergy for capital market development was the approval of an original social security reform. This reform, praised by some novel aspects, made possible the achievement of investment grade for public securities, which boosted in the provision of market liquidity and furnished the boundaries of the yield curve. During many years the failure of outright public firms privatization agenda (1992 referendum) and public opinion reluctance to open up to private sector participation areas of public domain won for the country the label of “laggard” reformer. Nowadays, in view of uneven international experience, being a “laggard privatizer” carries less stigma than in the heyday of reforming 90s.

## 2. Formal law-making and “globalizing law”

In a celebrated book, Watson [1974, 1993] asserts that society’s law is primarily *borrowed* from other societies, i.e., they are “*transplants*”. Whether by political imposition of colonial powers or voluntary imitation of “prestigious models”, legal systems development need not have any evident bearing on society specifics. This put into question “comparative law” understood as simple minded comparison of written rules. This thesis could be an “explanation” of the gap between the “law-in-the-books” and “law-in-action”. However, for many readers this approach leaves many unanswered questions. An attempt to address Watson’s theory lacunae is Sacco’s notion of “legal formants” (see below).

### *2.1 Applying and making laws*

From domestic Congress debates[5] it is clear that domestic reformers searched for solutions already implemented in other Latin American countries whose origins are in Anglo-American

[5] For a good account from one of the major reformers see De Posadas [1996a, 1996b].

legal culture or tradition. Congressmen were very well aware that rule-writing is not per se real progress, and try not to legislate with excessive detail.

As customary in Latin America, the Legislator's role is to write laws in very general terms leaving out for the Administration to issue decrees with more detailed and technically minded norms. It is usually the case that regulatory and supervisory bodies have a great deal of input in this later stage. In our case, that role goes to the Central Bank, under whose umbrella is virtually all financial regulation and supervision.

The local Congress does not have an institutional advisory unit such as the Accounting Office in the US. Legislators have advisors on an ad hoc individual bases. Most of legislative pieces on capital markets in the 90s had roots in IADB technical assistance projects.

Politicians are blamed for a high degree of discretionary management, although their behavior can be hardly independent of a multitude of power brokers. Politicians are expected to play a role of "intermediaries" in building consensus. Thus the political economy of reform process is a key component in any meaningful understanding. Forteza *et al.* [2005] discusses gradualist approach as central characteristics of domestic reforms as an outcome of consensus-seeking political process.

Although sometimes it is blamed for slowness and little expertise in economics or finance, justice administration is well regarded for independence and lack of outright corruption. Table 2 shows that local justice administration stands out well international comparisons.

It is one of our central contentions that regulators and supervisors have difficulties to apply sanctions. Sometimes technical staff is uncertain about political backing. Defective institutional design leaves lacunae as to the functional hierarchy of the regulator-supervisor over state owned financial enterprises. In other instances, parts of private sector long used to ad hoc self-regulation and poorly defined ex post liabilities seem rather unconcerned about reputation-building.

It is common to hear seemingly inconsistent claims on "excessive regulation" and "lack of controls" in financial regulation and supervision. A hypothesis to reconcile both extremes is that "excessive regulation" is a regulator "rational" response anticipating difficulties in the application of sanctions when misbehavior is verified, putting differently, "lack of controls" may be a perverse incentive toward a "baroque" or "tropical" regulation.

If enforcement is a problem, what can be done?

### *2.2 "Globalizing law" and the import of institutions*

At first it is difficult to disentangle the notions of law and sovereignty. However, international treaties in public law and an increasing trend to introduce the choice of national jurisdiction to settle differences in business contracting are examples of globalizing law which help to cope with weakly enforcing legal systems. Of course, they are not problem-free remedies: limitations on national tax enforcement and on autonomy economic policy are resented by weaker states.

In the context of capital market institutional development a natural question arises: is it worth developing domestic capital markets for small states with weak currencies and financially open to foreign flows?

The alternative to building domestic capital markets is *piggybacking* on other countries stronger institutions. This is to say, if you do not have the "right" institutions, "just" import them. For an excellent analysis of piggybacking we follow Black [2001]. Institutions you may want to import are

1. *Local enforcement and culture*: e.g. able, honest, and efficient courts and regulators, a good compliance culture, class action or similar procedures.
2. *Disclosure rules*: disclosure requirements on financial statements and ownership, good accounting and auditing rules.
3. *Reputational intermediaries and independent directors*: sophisticated accountants, investment bankers and lawyers, insider trading surveillance.
4. *Liability to investors*: criminal liability for insiders who intentionally violate disclosure and engage in self-dealing and civil liability otherwise, civil liabilities for accountants, investment bankers, and independent directors.
5. *Self-dealing rules*: review by independent directors, ban on insider trading.
6. *Others*: market transparency, active and free financial press.

Importing institutions is an option more open to individual companies than entire countries. The most glaring instance is for a stock issuer to list in a foreign exchange with higher disclosure standards or to place fixed income instruments in foreign jurisdictions with higher perceived legal investors protection. Instruments such as America Depository Receipts (ADRs) and Global Depository Receipts (GDRs) are close substitutes of direct exchanges' listings. In fact the local Government was one of the first to issue public debt abroad. It has to be said, however, that private domestic corporations did not follow suit.

Some piggybacking's shortcomings are

1. It is very difficult to import a good substitute of local contractual and law enforcement. A foreign listed company would always suffer a discount if its local enforcement and cultural institutions are perceived as not hospitable investment climate.
2. Reluctance of home insiders' controlled companies.

3. The access to foreign exchange listings is limited to large firms. International accountants, auditors, rating agencies, investment bankers, and lawyers are certainly a substantial expense.
4. In multiple instances foreign ownership or trading in foreign securities are a hot political issue. This may deter investment in foreign listed companies.

Bonding devices such as escrow accounts, special insurance policies for company directors and officers, and securitizations have been used as well to cope with domestic judicial and regulatory limitations.

## 3. Conceptual framework

A legal system is a body of rules and a justice administration performing their interpretation and enforcement. It is common to classify legal systems in a reduced number of "families" or "traditions". In a minimalist classification we have a civil law tradition and common law tradition. The former can trace its roots in Roman Law[6].

It is common to consider two versions of civil law: French and German. As characterized by Monateri [undated], in the "official" French model, law consist of general principles, rules and exceptions organized in legislative "texts", often articulated in larger pieces of legislation or "codes". Judges are expected to apply general rules to individual cases by making short references to "texts", "conducts", and "facts". Legal scholars are to make contributions to the *clarité* by thoughtful conceptual taxonomy. In the "official" German model, law is made up of "theories" developed by legal scholars and superior judges cast in a highly technical discourse. The lower standing of the French judge came from the French Revolution reaction to the extremely corrupt *Ancien Régime* judiciary.

The common law is of British origin, and places judges work resolving individual disputes and cases in the spotlight of law-making. In common law jurisdictions judge-making law through precedent and interpretation authority prevails whenever statutory law (e.g. codified law) gaps unravel.

For historical reasons not difficult to understand, the development of capitalism in 18th and 19th centuries favored an ideological association between common law and "free markets" and "freedom of contract". Although a central tenet of modern liberal Western law is that "it permits all what it doesn't prohibit", civil law practice is best reflected by the more restrictive injunction "it prohibits all what it doesn't permit". Thus it is not a surprise that entrepreneurship and innovation are a little bit more difficult in civil law tradition.

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[6] A very readable account of the civil law tradition from a common law point of view is Merryman [1985].

Driven by colonialism, imperialism, borrowing, and imitation, these legal traditions have spread around the world. Uruguay and Latin American have borrowed French Napoleon civil code since the Independence days.

We follow with a brief outline of two strands of literature germane to legal reform area: a) Law & Finance and b) Legal Formants.

### *3.1 Law & Finance*

La Porta, López-de-Silanes, Shleifer, and Vishny [1996, 1997, 1999] work is a flagship of a well developed research paradigm known as "Law & Finance". López-de-Silanes [2002] is the most recent statement of the approach. Its central tenet is that financial sector development and the legal tradition of an economy are consistently related. More specifically, it puts forward the hypothesis that poor legal protection of minority investors' rights are associated with higher ownership concentration and little willingness for corporations to go public. Although as a monocausal approach it has been contested, their empirical findings seem decently robust to date[7].

Law & Finance approach sheds further light on the extensively explored correlation between financial depth and economic development and growth[8]. Law & Finance's highlights of empirical findings of cross-country data are as follows:

1. Common law countries have generally the best and French civil law countries the worst *legal* protection of investors (creditors and shareholders), with German civil law based countries are somewhere in between.
2. Ownership concentration is negatively related to investor protections, and very widespread all over the world. Diversified shareholding is unlikely in countries that fail to outside investors.
3. Poorer investor protection, whether by the content or rules or the quality of enforcement, is consistently associated with smaller and narrower capital markets (equity and debt).
4. Inside investors have control rights exceeding cash flows rights. The evidence points to a much larger role of the agency problem inside-outside investors than that of investors-managers.
5. Tunneling is insiders' pocketing benefits out of firm's assets and profits. Certain types of tunneling are less likely to pass legal scrutiny of common law countries courts.
6. Procedural formalism is greater in civil law countries, and is associated with slower judiciary, more corruption, and inferior access to justice.
7. There is stronger evidence that law facilitating private enforcement through disclosure and liability rules works better for capital markets than public enforcement.

[7] See Beck-Levine [2003] for an update.
[8] See Levine-Zervos [1998] on this correlation.

Table 2 summarizes Law & Finance data bases to place the standing of Uruguay in the thorny issue of creditors' negative perception.

### *3.2 "Legal formants" and qualifications to "Law & Finance"*

Sacco [1991], Monateri & Sacco [1991], Monateri [undated], and Monateri-Sacco [1998] propose a strategic approach to legal systems, which they call "legal formants". The central hypothesis is that the nature of a legal system is not in textual records of rules but rather the solutions to problems posed by legislators, judges, and legal scholars. The legislator, the judge, and the legal scholar, *the legal formants*, are representative players in a game where they compete for professional and/or social standing by making authoritative interpretations. Notice the parallelism between the "legal formants" and the traditional sources of law: legislation, jurisprudence, and doctrine. An implication is that two legal systems whose written rules seem to be different may have in the end similar working solutions for the interplay of interpretations, and similar written rules may end up working very different. The main moral is that comparative law based on pieces of legislation and jurisprudence is tricky business.

Although the scope of Legal Formants seems a little bit too specific to the law field, digging deeper in the idea that the legislator captures in a reduced form way the influences of public opinion, political constituencies, interests group and other stakeholders, Legal Formants approach can shed further light on the topics at hand.

To some extent "legal formants" insights qualify many aspects of the "Law & Finance" approach. China and Vietnam show how little legal infrastructure is needed for growth. Civil law countries such as the Netherlands, Germany, and Japan outperformed United Kingdom for long spells. In a recent historical analysis of French corporate world, Murphy [2004] has shown that, while family run business and ownership concentration limit entry and stifle a source of innovation, family's longer horizon perspective is also granted higher markets valuations. Even in the US family business in the S & P 500 had a 10 percent premium, thus outside shareholders can also do well. Perhaps for this reason it is hard to see any clear convergence to any single system. More generally, Schleifer [1997] put "shareholding concentration" and "legal protection of minority inverstors" on equal footing to solve basic corporate agency problems.

## 4. Firms exit: "law-in-the books" and "law-in-action"

In this section we present one possible reason of poor private sector showing in domestic negligible markets where the state is the dominant issuer. It is a clear case where bankruptcy legislation ceased to be the ”law-in-action” in the land. Interestingly, legal bankruptcy reform to date has made little headway.

There are about 100,000 firms recorded in the country. By staff size, 80 % of firms have at most four people. For the remaining 20 %, when size justifies a more elaborate legal shell, normally a close corporation. Family owned firms (and to a lesser extent family run conglomerates) are common private sector phenomenon. Ownership concentration in family members is consistent with La Porta *et al.* [1996, 1997, 1999, 2003] and López-de-Silanes [2002] hypothesis of poor legal protection of minority investors, as previously discussed. That is, Uruguayan insiders value their control rights a great deal. The largest companies are state owned public utilities and banks, followed to a much lesser extent for subsidiaries or branches of foreign ones. Even as late as the 1990s, many of these firms have roots in protectionist international trade policy.

It is well-known the relevance for a market economy of the presence of the exit mechanisms to handle failed endeavors by closure or restructuring. A good mechanism should provide the right incentives to transfer control to the parties which can reallocate the resources to the best uses. If exit is clogged, new entrepreneurship will be very difficult. Bankruptcy is a particular exit mechanism to handle the collective action problem of multiple creditors of a financially distressed firm. It intends to transfer partially or totally the control of the assets to creditors as a safeguard of their claims value according to a well defined judicial procedure.

It is beyond the purpose of this report to present even a summary of the local bankruptcy regime and the supporting corporate law[9]. The regime is highly complex: is the accumulation of several laws from XIXth up to date, normally approved under economy wide crises. The regime varies according with the firm's legal shell. Holders of secure debt titles (e.g. mortgages) have preference, and their credit is not affected by bankruptcy proceedings. Tax authorities and labor creditors have legal collection privileges within the proceedings. It is possible for distressed firms to make restructuring proposals to creditors in court (or outside court in some cases).
Written bankruptcy law, normally very old, tend to be heavy handed on the failed entrepreneur. The code views business failures with criminalizing overtones. An important point for us is the obligation of a financially distressed firm to make a disclosure of it.

We dubbed "bankruptcy failure" the lack of application of the written law clogging an important exit mechanism. It has a microeconomic dimension and a political economy one. Under

[9] A hands-on very updated presentation is Martínez Blanco [2003]. A thorough comparative study is Olivera García [1999].

the former we look at the ways in which the entrepreneur obtains a way out of the negative consequences by gaming judicial procedures, and extract some implications for the real workings of governance. In the second dimension we look at the ways in which the society as a whole sidestepped the bankruptcy framework without revising it but passing ad hoc legislation.

### *4.1 The microeconomics of bankruptcy failure*

The poor working of bankruptcy regime has been blamed for the lack of incentive of private firms to go public.  The key point is close corporation can hide financially distress for a long time[10]. When the financially distress firm goes to the court with a restructuring proposal for creditors ("Concordato or Moratorium"), it is more likely to be "too" late[11]: at this stage most of the firms should be subject to outright liquidation.

The actual working of the bankruptcy regime works in favor of firm's insiders and against creditors and competitors. Insiders' self-dealing, i.e. profiting from transactions with connected or controlled counterparties, can be exercised for longer periods at the expense of creditors and other minority investors. At the very least, stretching out hidden financial distress spells  is unfair with financially compliant competitors.

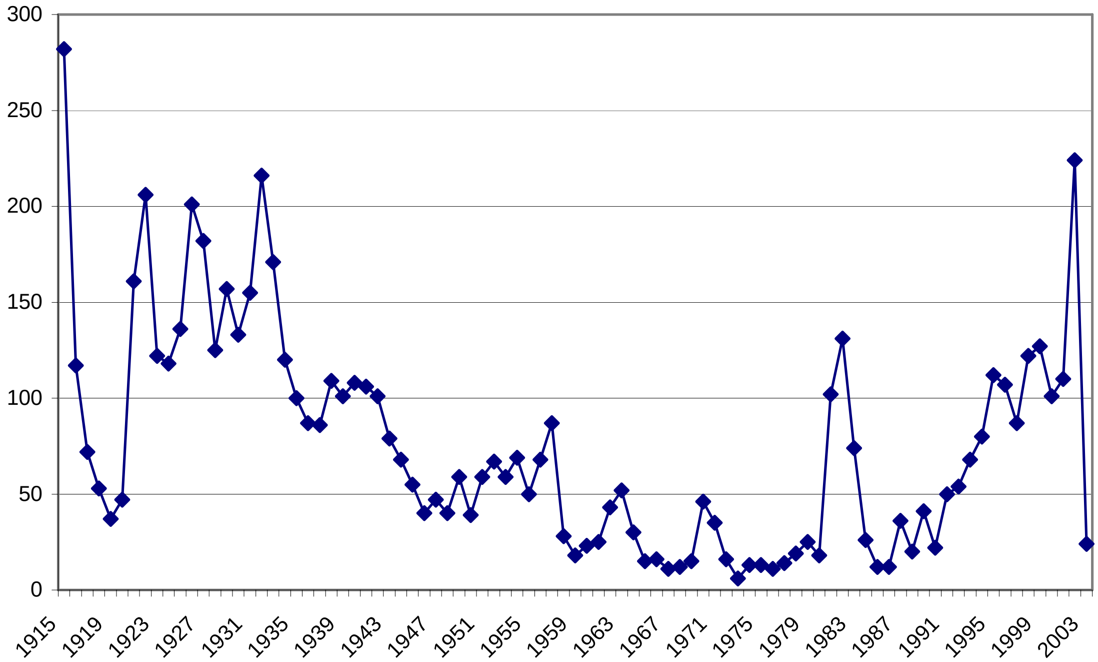
Masking financial distress is more difficult, albeit not impossible, for an open corporation subject to the closer scrutiny of capital market participants. Although not the most common situation, insiders' ability to discriminate among creditors may induce to some of the latter to mask the financial distress, at least until they buy their way out of a poorly grounded credit granting decision. In other words,  lenders' complicity may play a role in poor disclosure outcomes.

### *4.2 The political economy of bankruptcy failure*

It is intriguing how the explicit 19th century Commercial Code requirement of early disclosure of financial distress was circumvented in practice. Fig. 1 suggests that creditors and debtors resorted

[10] See Ferrere Lamaison [2001].
[11] See Olivera García [1999] and Martínez Blanco [2001].

**Fig. 1: CONCORDATOS & MORATORIAS 1915-2003**




Source: Liga de Defensa Comercial (LIDECO).

to the courts to a larger extent in the first four decades of the 20th century than afterwards in spite of a lower economic development. After the second World War the State took a larger part in the resolution of episodes of financial distress. It was not uncommon for the Congress to pass laws with a provision of taking financially distress specific large firms assets and declare of public interest the continuation of their operations (especially in the 1960s). In the 1980s the resolution of the exchange and banking crises had a heavy state involvement through “temporary” management of troubled banks, and “refinancing laws” bailed out farmers and other debtors. The Mortgage State Bank (BHU) went soft in payment collections affecting segments of middle class home buyers. Finally, the newly created National Development Corporation (Corporación Nacional para el Desarrollo or CND) had a visible role in the capitalization of firms and the funding of endeavors considered of “national interest”.

Reflecting professional perceptions, World Bank [2000] highlighted the difficulties to pass financial legislation. This is more clearly so in the area of bankruptcy. Even in the productive period 1995-2000 when important and somewhat novel legislation on capital markets, including bills on pension and investment funds, exchanges, corporate bonds, securitization and factoring, a couple of bills to reform the bankruptcy code got a negligible Congress attention in 1998. One of the bill proposals included a timid form of "discharge" patterned in the American bankruptcy code as an incentive for earlier disclosure of financial distress[12]. A partial explanation is the lack of clear stakeholders of such a reform. When financially distressed firms reaches courts, suppliers as trade creditors take the major losses. Normally, banks are secure creditors who further benefit from Central Bank sponsored information sharing mechanism ("central de riesgos") on "large" debtors' positions *vis a vis* the whole banking system.

When financial distress becomes a systemic feature it is more likely that necessary legislation will be passed. A recent example is the last year law on financial firms liquidation[13] submitted amid the twin crises resolution process. This piece of legislation establish a special administrative procedure, i.e. non judiciary, with a great deal of Central Bank empowerment. With uncommon foresight, amendments to speed up procedural aspects and reinstate specialized bankruptcy jurisdictions[14] were approved in 2001 as parts of an "Urgent Law"[15].

There is a creditors' perception of a legal and judicial bias against them. In the last 20 years the Congress passed a number of general "Refinancing Laws" bailing out financially distressed sectors such as farmers, corporations, and SMEs with the burden of dollarized liabilities or mortgage indebted households. Public banks were instrumentals in the rescue operations. While the serious 1982 exchange regime breakdown sparked this shift of debtor burden to the general taxpayers, the 1999 Brazilian devaluation triggered a large loss of competitiveness of the already beleaguered tradable sector. It has been argued that Refinancing Laws had deleterious effects on the incentives of debtors able to keep up with payments and fostered a "non payment culture".

During the ongoing process of 2002 twin crises resolution, in an important break of a long honored tradition of 1980s Refinancing Laws, there has been an attempt at avoiding so far legal bail outs to debtors and promoted voluntary renegotiation the GOU administrative persuasion of all parties. Although the extremely poor public finance shape can partly explain this development, it could be a step to redress creditors' perception of a legal and judicial bias against them, provided that the GOU's political will carries on unchanged.

## 5. Political economy of reform: Public opinion and interest groups

Here we furnish a stylized description of the major players' stance in the "reform game".

[12] See Olivera García [1999].
[13] Ley No. 17613 of December 27, 2002.
[14] Until the third decade of the XXth century there was a specialized jurisdiction on commercial law matters.
[15] Ley No. 17292 of January 25, 2001.

Polity and public opinion. Traditional parties were the primary sponsors. More often than not, the left supported this legislation with important nuances about regulation regime and concerns on private parties jurisdiction choice (domestic vs. foreign). In occasions the left disputed the traditional parties priorities and try set a different legislative agenda and priorities. Multilateral credit organizations such as IADB have been active to place these topics in the legislative agenda with mixed success.

Public opinion has been decisive in shaping the reform process, and certainly politicians have to pay heed to it regardless of their constituencies. The following data about the Uruguayan public opinion profile (*Latinobarómetro* poll series 1995-2002) illustrates widespread values in the economic arena:

- Uruguay's approval of the *free market economy* is by far *the lowest in Latin America*: 35 per cent versus a continental average of 57 per cent. Satisfaction is very consistent with approval: it is among the four lowest (10 per cent versus the Latin America average of 24 per cent).
- Only Argentina has a more negative view of privatization than Uruguay: the former has an approval rating of 14 per cent and the latter of 16 per cent.

Thus public preferences on Market vs. State debate are tilted in favor of the latter. Although harder to document, swathes of public opinion have a negative perception of financial sector and display some distrust on financial globalization. To place financial issues in the agenda and to pass financial legislation are difficult endeavors. Not surprisingly, public demand for financial regulation and supervision, which contrast to the opposite views of some actual and would-be market participants. However, regardless of political orientation, more informed segments of society tend to see "domestic capital markets" as a good idea.

Bureaucracy. Submitted bills to the Congress were prepared by the Central Bank of Uruguay (BCU) in consultation with private sector to build up as broad consensus as possible.
The role of BCU widened and strengthened a great deal. In addition to the regulation and supervision of depository institutions, it is the institutional home for the embryos of regulatory units for investment and pension funds, exchanges, and insurance. It is paradoxical the degree of integration of regulators of the whole financial industry achieved in a LDC, which mirrors the fashionable trend in developed countries. The BCU as an instance of "fourth power" raised a hot Congress debate. The label "fourth power" has been applied to agencies which perform, albeit in a scaled down fashion, executive, legislative, and jurisdictional functions.

Banks. As an interest group kept a low profile. Their position vis a vis the reforms was lukewarm since disintermediation is a concern (capital market as a competitor). There is no tradition of investment or merchant banking. Although the magnitude is contentious matter and hard to document, it is widely suspected that commercial banks acting as arrangers and underwriters of corporate bonds issues were engaged in the practice of “liability substitution”. Arranging banks were likely to have already an unbearable exposure to many of the issuers. Unlike what is customary in the world, where issuers of capital markets tend to be either better credits or highly visible junk bonds issuers, in Uruguay 90s some undisclosed poor credit takers found their way to the capital market as a part of a financial “dumping”. A suggestive, albeit not fully compelling, illustration is the statement of Granja Moro, which went bust fraudulently later on with far reaching consequences for the whole market, in its USD 10 millions bond issue Prospectus about the proceeds destination: “Restructuring the debt cost profile by replacing short term funding in domestic currency with strongly positive real interest rates, which have not tracked properly an inflation declining trend, with medium and long term indebtedness at competitive rates.”

Brokers. Typically brokers have satisfied the needs of local and regional retail investors with domestic or foreign securities. The old club of brokers, the backbone of Montevideo Securities Exchange (BVM), has traditionally been a self regulated body. When the Congress considered the Exchanges and Corporate Bonds Bill in 1996, BVM strove for less BCU’s regulatory involvement and advocated for a “security commission” with important private participation.

In part for the participation of a few brokers in banks’ self dealings in the 2002 twin crisis, the Central Bank has tightened the regulatory bolts in December 2002. The requirement of externally audited accounting statements is the first step, which is intended to be followed by minimum solvency requirements.

The market microstructure of BVM is such that much of the securities turnover goes unreported, impairing transparency, unlike the financial intermediaries and institutional investors trading platforms Electronic Exchange (BEVSA). Dimensions of market “underdevelopment” were then extensive, albeit declining, use of securities in bearable form, and the difficulties to set up a fully functioning clearing and settlement mechanism.

Accounting profession and rating agencies. Table 2 uncovered a Uruguay’s below LDCs average accounting standards. There is a generalized perception that professional liability to vested third parties is very poorly developed. Rating agencies are relative newcomers. They have not made much difference. As in most developed countries, they lag behind the market, and have not performed in a distinguished fashion. As a matter of fact, they have had some resounding slippages.

Politicians and Development National Corporation (CND). The game among politicians and interest groups have nurtured many business endeavors under the umbrella of international trade protection or other forms of promotion. The difficulties to resolve the exit of terminally financially distressed firms closes the full circle. Since mid 1980s sometimes the task is done in a low profile government agency: the Development National Corporation (CND). The agency has displayed a poor accountability; typical public budgetary controls have been missing, and external accounting auditing rather uneven.

Pension funds management companies. Pensions funds were a fundamental creature of the legal framework reform of social security system and capital markets. So far they are the only ones clearly committal to a domestic capital market development. To some extent the current ban of investing in foreign securities explain the pressure of pension funds to find contractual arrangements and financial instruments a natural way out to an undesired "cash hoarding" (20 % in December 2002).

Tax administration. Tax authorities have had concerns about the misuse of new forms of financial contracting in massive evasion. Early on, legal reform seemed to have been poorly coordinated with the tax administration at design stage. This resulted in implementation problems. In the more recent Trust Law (2003) reformers tried better coordination, but even so voices from private sector raised tax disadvantages as reason of its little use to date. We will elaborate further on tax administration after a discussion of reform implementation.

To Sum up. It should not be surprising the lack of domestic capital markets: the dearth of positive stakeholders is remarkable. We have identified only one, pensions funds, which in turn were an endogenous spin-off the reform itself. All the other are low profile foes or outright indifferent.

## 6. Reform implementation: General aspects

L.A. Lacalle's administration (1990-1994) brought about the initial plan in early 1990s. Although the banking system and the external public debt were going through restructuring, general growth performance was good. The submissions of most bills took place under the next J.M. Sanguinetti's administration (1995-2000). In the following box we describe the legislative sequencing:

**Box: Legislative milestones**

1. IADB Technical assistance 1992.

2. Social Security Reform Law 16713, September 3, 1995.
3. Exchanges and Corporate Bonds Law 16749, May 30, 1996.
4. Investment Funds Law 16774, September 27, 1996.
5. Investment Law 16906, January 7, 1998.
6. General Bankruptcy Code Bill, submitted to the Congress in June 1998 (never left Commission).
7. Securitization and Factoring Law 17202, October 1, 1999.
8. Movable Property Collateral Law 17228, January 24, 2000.
9. Amendment to Bankruptcy Law 17292, January 25, 2001.
10. Trust Law 17703, November 4, 2003.

1) Like in all the civil law tradition countries, the domestic legal system could not conceive assets, liabilities, and net worth independently of the corresponding legal or natural persons as holders. The most innovative idea of all these reforms was the (pension or investment) “fund” as a collection of assets with its own legal identity whose fate is independent of the manager’s or shareholders’. This allow for more efficient way of placing more safely and managing more professionally collateral for project finance.

2) Difficulties to pass bankruptcy reform is a remarkable feature. It is useful to go over some stylized facts on local bankruptcies, as summarized by Olivera-García [1999]:

Very few failed firms go bankrupts.
Bankrupt firms are not particularly large.
Judiciary procedures are slow.
Creditors loss interest in the proceedings.
Creditors never collects.

An illuminating feature is that the referred creditors are suppliers. Thus trade credit is the most affected. Banks, “professional” creditors and debtors, normally have real estate or another real asset as collateral. Furthermore, banks have access to information sharing mechanisms devices such as the Central Risks Unit of BCU. And on the top of that, banks, as financial firms are more likely to be bailed out than a non financial.

Notice that any firm is very likely to be a supplier. Thus it is unlikely that a well focus lobby comes up to claim for a better bankruptcy order. After all, bankruptcies are relatively rare. And to wrap up, politicians are more likely to be unwilling to relinquish the option to bail out firms, as previously discussed.

3) The implementation strategy was too put off the introduction of the most novel concept (investment and pension funds first and trust later). Funds are more regulated by financial supervisors and used by sophisticated operators, while the introduction of trusts require

adjustment in basic family law (e.g. inheritances). The momentum of reform was high around 1995-96 when coalition of traditional parties seemed to work best, when consensus among stakeholders was finely tuned at the beginning.

In the aftermath of the twin crises of 2002, investment funds legislation did not work, corporate bonds were in disrepute, and banking credit dwindled drastically. The GOU's response in this bleak landscape was the submission of a Credit Facilitation Bill to Parliament in November of that year. It was based on legal consulting work in the 90s trying to prepare the local adoption of trust law. The heading "Credit Facilitation" was a timely eye-catching amid a virtually complete bank credit dried up and by then the all dead corporate bond market. Crises are sometimes timely occasions to speed up change. The bill was approved as a Trust Law in November 2003[16], and the Administration Decree in the following month[17].

## 7. Reform implementation: Taxation aspects

Tax systems have normally built-in a set of incentives which affect, one way or the other, the workings of capital markets. The more obvious is the extent to which personal and corporate taxation affect security holders' net returns. In the same vein, discriminatory transaction taxes and the efficiency of tax administration are bound to play a role. Last but not least, the interplay between corporate and personal income taxes are bound to have effects on firms' capital structure as discussed in classical corporate finance literature.

The inland revenue administration (DGI) has a technically competent staff, but compensation, size, and IT investment leaves much to be desired. Staff dedication and compensation open up a real risk of conflicts of interest. An attempt of reform of this unit with IADB technical assistance started in 2000, but the interest in the project faded out a few years later. Available reports suggest that local firms' opacity and bankruptcy malfunction are not a main concern for tax collectors. It seems that inspective powers and bankruptcy privileges suffice to cope with these problems.

### *7.1 Treatment of financial instruments*

A particular feature of the local taxation system is the lack of personal income tax. Together with a strict banking secret and the widespread use of bearable form securities, the absence of that tax sheltered the development of a regional offshore banking sector until 2002 year twin crises.

[16] Ley N° 17703 Fideicomiso 4-11-2003.
[17] Decreto N° 516 Registro de Fideicomisos y Fiduciarios 11-12-2003.

Therefore,  personal tax income exemptions and benefits to security holdings, commonly used in many countries, are not applicable here.

Nonetheless, the system includes a corporate and personal net worth tax[18] offering favorable treatment for security holders and issuers. Holdings of public securities and corporate bonds quoted in exchanges are exempt. Issuers of corporate bonds quoted in exchanges are allowed to compute them along with their other liabilities. Issuers of corporate bonds in bearable form and non quoted in exchanges are required to withhold holders' net worth tax.

Interest paid on bonds quoted in exchanges are fully deductible in the corporate income tax[19]. By the same token, interest received from bonds holdings is a corporate taxable income. Personal interest income is tax-free.

Banking loans have been subject to an asset tax all along. In early 90s tax exempt corporate bonds had a head start, but later on, the requirement of exchange quotation (and periodical audits) has been stringent enough to obliterate any fiscal advantage.

Tax on dividends remittances abroad is hardly a burden: it takes place only when the foreign receiver is taxed in a similar way and has a fiscal credit for taxes paid overseas.

Closures of loopholes in the corporate income tax open up by the lack of personal income taxation have required a number of ceilings on admissible costs and expenditures deductions. Some experts think that this tax has become overly complex and distorting of corporate income.

It is tempting, but more contentious, to assert that this favorable treatment of corporate bonds quoted in exchanges couple with lack of personal taxation may have reinforced firms' incentives to increase leverage[20]. Some examples of personal income taxation in the world, such as the US one, effective taxation on equity income is a bit smaller than on interest income, which ameliorates the incentives to higher leverage.

### *7.2 Treatment of business legal shells*

There was at least one important instance in which the implementation of a piece of capital market legislation was so poorly coordinated with tax authorities that it did not take off the ground. The Securitization Law (1999) defined "close credit investment funds" as special vehicles for mortgages securitizations[21]. The inland revenue administration[22] criticized the lack

[18] Official name: Impuesto al Patrimonio (IP).
[19] Official name: Impuesto a la Renta de Industria y Comercio (IRIC).
[20] It is a common perception that local firms are excessively leveraged.
[21] The ideal legal instrument, the trust, was not then available.
[22] Official name: Dirección General Impositiva (DGI).

of explicit tax treatment of these funds. The argument went that any bank could take advantage of a loophole by transferring part of its loans portfolio to a foreign company with no local base, and in this way taking out a vast swathe of domestic tax base. When a budget law (2001) put a remedy, recession was well entrenched. The original securitization framework had another shortcoming as well: an exclusive reliance on a small and very special sector of the state owned mortgage bank's portfolio[23]. This bank, after many years of mismanagement and undercapitalization, is expected to go through a process of downsizing and restructuring.

## Reform: performance, lessons, and new political scenario

### *1. Technical evaluation*

- The fate of the new framework was highly sensitive to the misbehavior of private market participant. Granja More, as mentioned before, was involved in a major fraudulent bankruptcy shattering the local bond market. An important foreign bank's affair regarding open ended investment fund put in evidence the possibilities of self dealing through insider trading.
- The public and financial intermediation sectors made the fixed income market until the collapse of 2002. It is awkward that capital markets meant as an alternative to banking was in fact a sideshow of a couple of failing commercial banks in corporate bonds.
- Legislation on securitization (1999) was poorly prepared and presented for a rush Congress consideration. First, the institution of trust, not included yet in our legal system is more appropriate. The lack of trust was filled with an original "close ended credit fund", which never took off. Securitization was restricted to mortgages to avoid larger tax collections. Furthermore, the state-owned Uruguay Mortgage Bank (BHU) was allowed to securitize only a small fraction of its mortgage portfolio: lending to buy used houses and foreign currency denominated loans.
- The Tax Administration had concerns about massive evasion by misuse of new legal shells and financial contracts. Coordination across state agent was not a strong point of reform. It was, and it still seems, a major hindrance in implementation.

### *2. Political evaluation*

[23] Official name: Banco Hipotecario del Uruguay (BHU).

- Demand for tighter regulation in view of the banking system and public finance collapse, and the financial intermediaries linkages has been on the way.
- Lack of interest to modernize the bankruptcy regime. Politicians interests in keeping some level of discretion and the lack of clearly identifiable interest group can primarily account for this.
- An advantage of civil law tradition is to enact legal reform in “one shot”. The disadvantage is lack of case law for the judiciary and no first hand experience for supervisors and regulators.
- There is a long tradition of polity and society of consensus based progress. Much of it expresses through broad based political accords, which easily can circumvent legal rules by new legislative interpretations or outright overhaul of them. This legal lack of stability may very well be in occasions a form of collective insurance, perhaps appropriate for aggregate shocks since law is an “incomplete contract”. But it makes very hard to support desirable incentives.

### *3. Learning & lessons*

- The intent to launch a domestic capital market in 1992, the banking system was recovering in an uneven fashion. After a dismal 2002 twin crisis, the question 10 years later is still on: can capital market emerge to fill the vacuum left for the backing out of banking system? Free financial flows may be the right choice for a small size country, but it mail entail a leakage of domestic participants (specially savers).
- It is a platitude to say that capital markets require macroeconomic stability. It is not a just an issue of low inflation, but rather keep real exchange volatility within narrower bounds. Des-dollarization and capital mobility oversight, although steps in the right direction, won’t do a full job. The underlying fundamental is unstable Argentine driving domestic real domestic exchange[24]. More stable macro fundamentals can reduce the need of politicians ad hoc insurance mechanisms at the expense of legal security.
- Although links can be very subtle, formalization of the economy and capital markets can have important synergies, which should be exploited further.

[24] See Hausmann *et al.* [2005].

- A new view of state owned firms as holdings of smaller and specialized corporate structures could be a way to couple this important sector of the economy and capital market development to foster productive investment.

### *4. New political scenario*

At the time of writing a major political shift has taken place: the first left-winger political force in history is taking office after its crushing electoral victory at the end of 2004. Although prospective analysis is difficult in uncharted waters, this paper closes pointing out opportunities and perils of capital market development under the new political framework.

Within the winning force there are different views on economic and financial policies, but for the time being top policy makers are highly trained economists holding moderate views, have the upper hand of the whole process, and count with strong support from the Presidency of the Republic. In principle, there are signals that the new administration will pursue capital market institutional development further, in part because the gigantic twin crises of 2002 left the banking system in a fragile position to grant credit at pre-crisis levels. On more general grounds, with less compromises with the past, it could take a reformist stance more easily.

Crisis management resolution is an ongoing driving force which will push forward much of the new financial legislation needed. Even it could put in check less enthusiastic sectors of the left in financial issues.

Explicit presidential statements of support of bankruptcy framework reform have been made from the start. Since industrial policies are back in fashion under new arguments[25], the overhaul of bankruptcy framework must be top on the agenda. This is not a callback for a Sixth century version of draconian Roman XII Tables of our old commercial code. A new bankruptcy code should partly insure honest debtors and fully penalize opportunistic and strategic defaults.

It will probably be the case that enforcement of legal norms will be stronger. Strengthening of regulation & supervision has been on the way all along after the twin crises. A peril of good enforcement is poor law making: as bad as laws with no enforcement is enforcement of poor quality laws[26].

The old stock exchange, the Bolsa de Valores de Montevideo (BVM), a private syndicate of broker houses, has elected new authorities who are expected to communicate well with the new

[25] See Hausmann *et al.* [2005].
[26] See Posner [1998b].

GOU. Hopefully, it will undertake much needed reforms itself to put this old institution on track of modernization..

The new GOU has made of taxation reform systems a real flagship. In particular, the introduction of a personal income tax and increase in their revenue collection agencies are top in the agenda. Desai-Dyck-Zingales [2004] argue that better enforced corporate income tax collection enforcement reduces firm income diversion away from outsiders to the insiders pockets, improving corporate governance and capital market development. To the extent that corporate income tax collection is better enforced, and that personal income tax can help to reduce distortions on its corporate sibling, a positive effect on capital market is possible.

However, personal income tax is hard to collect without substantial administrative costs unless its very simply design and rates are not very high. But since personal income taxation reduces savings, more or less sophisticated exemptions are normally included, making evasion easier. Thus the effect of this type of taxation is at best unknown, and too much could hinge on details. So the effect on capital market in an extremely open and high capital mobility is likely to foster capital flight. Capital controls may be needed without having a well developed domestic unit of account.

For the time being groups in the left questioning the for profit nature of pension funds ("AFAPs") and the level of fees are not in the driving seat. But they have some levers of powers.

To sum up, opportunities are perils are real, but in part that's the result of the new grand political project taking off the ground. The success will depend in part of the wisdom to distinguish the good from the bad of our legacy and to drive wisely with the flow of a globalized world striking a right balance between the "law-in-the-books" and "law-in-action".

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