BANK CRISIS AND RESTRUCTURING: 
THE CHILEAN EXPERIENCE

Enrique Marshall 
Board Member 
Central Bank of Chile

Shanghai, April 10, 2006

Presentation at the Chinese–Spanish Conference on Bank Restructuring Experiences, organized by the China Banking Regulatory Commission and the Bank of Spain, and held in Shanghai, April 10, 2006.
First of all, I would like to express my thanks for the invitation to participate in this Conference on Bank Restructuring Experiences. It is, indeed, a great pleasure to be here with you, and I would like to take this opportunity to share with you some thoughts on Chile’s experience of banking crises and financial development. From a position of financial weakness in the early eighties, Chile has moved on to its current position of financial strength. Some of the lessons of that experience may be of use to you when considering banking and financial policy issues.

I. THE BANKING CRISIS OF THE EIGHTIES

The financial crisis that Chile suffered in the early eighties was one of the severest recorded in Latin America. At that time, bad or poorly performing loans reached 30% of total bank lending, representing three times the system’s capital. The system was, in other words, technically bankrupt.

This crisis followed a program of financial liberalization, implemented in the mid-seventies as part of a more comprehensive set of economic reforms. Until that time, the banking system had been heavily restricted and had developed little. The ratio of banking assets to GDP did not reach 10%, a very low figure.

As part of the liberalization program, state-owned banks were privatized, foreign banks were allowed to enter the market, a quantitative credit-allocation system was abolished, reserve requirements were reduced to normal levels, interest rates were freed, and restrictions on foreign borrowing were relaxed.

This resulted in the rapid growth of credit aggregates within a context of high interest rates. At its peak, the loan portfolio of the banking system grew at close to 40% per year in real terms, while real interest rates were
running at around 20%. And, with the system sustained by booming economic activity, it was, in fact, perceived as being strong.

High domestic interest rates, combined with the liquidity of international markets, created the conditions for excessive foreign-currency borrowing from overseas banks. Domestic banks acted as intermediary for part of these credit flows while the rest was borrowed directly by the corporate sector. The result was a rapid growth of private-sector foreign-currency debt. Most bank clients took an enormous foreign-exchange risk since their income flows were not adequately hedged in line with their financial obligations. This risk was not identified opportunely and only become evident once the crisis had exploded.

By the end of 1981, bank balance sheets had started to reveal the first signs of loan-quality problems and the ratio of non-performing loans began to rise. However, the financial crisis did not become “systemic” until 1982-83, after a major devaluation and a severe economic adjustment that was reflected in a 15% GDP contraction.

Looking back at the crisis, we can identify at least four main causes: a) a severe deterioration in macroeconomic conditions, mainly on the external side; b) macro policies that failed to facilitate economic adjustment in the face of adverse circumstances; c) serious shortcomings in regulation and supervision; and d) bank mismanagement. It is difficult to say which factor was the most important, but it is clear that their combined effect was very damaging. With the exception of branches of foreign banks and the state-owned bank, the system collapsed.

The authorities, convinced that delay in responding to the crisis would only increase its fiscal cost and postpone economic recovery, took immediate action. The measures implemented between 1983 and 1986 can be divided into two types of program: one sought to re-establish business continuity and the long-term financial health of bank debtors, while the other sought to restore bank solvency. Both types of program were considered not only necessary but also complementary since - as we
are all aware - the financial strength of banks largely depends on the financial situation of their clients.

Programs for bank debtors covered both corporate clients and individuals and consisted mainly in the rescheduling of debts at lower interest rates and over longer payment periods. In addition, a preferential exchange rate was established for the repayment of foreign-currency liabilities. This was important because of the high level of foreign-currency debt, particularly among corporate clients.

In the case of banks, access to the recovery program depended on a prior assessment of their viability. Those banks considered viable were offered the possibility of selling their bad loans to the Central Bank, with a repurchase agreement based on future profits. However, non-viable banks were intervened and liquidated, and shareholders lost their capital.

For banks, the practical effect of the transaction with the Central Bank was two-fold. On the one hand, bad loans were replaced as assets by Central Bank securities, thereby improving their balance sheet. On the other hand, banks or their owners assumed a subordinated debt with no time horizon, which was registered off-balance.

Most domestic banks, including all the largest ones, used this facility. Later, during the 90s, they were offered the possibility of restructuring and prepaying their obligation under market conditions. This option was taken up by most banks in the program, and proved successful in that only one institution still maintains an outstanding debt.

By 1986, the banking crisis had been resolved, although at an enormous cost. The direct cost - that is, the total public-sector resources committed to different programs - reached 41 % of GDP. Of course, not all of this cost was paid at the time but was gradually absorbed and, indeed, has still to be completely absorbed.
The indirect cost - defined as the output loss due to lower growth rates during the recovery period – is much more difficult to be measured, so estimates vary between 24% and 41% of GDP, depending on methodological assumptions.

These are among the highest figures seen internationally for financial crises in recent decades. According to a recent study of banking crises since 1977, the average direct cost reached 12% of GDP for industrialized countries and 18% for developing countries, while the average indirect cost was between 13% and 21% for industrial countries and between 14% and 15% for developing countries.

II. BANK REFORM

Fortunately, Chile learnt the lesson of experience. And, at the end of 1986, as soon as the banking system’s solvency had been restored, a comprehensive bank reform was implemented, introducing substantial changes in the legal framework for the industry in line with modern concepts of prudent regulation and effective supervision.

A second major amendment to the Banking Law was enacted in 1997. As well as updating and modernizing the existing regulatory framework, this deepened financial liberalization, opening up additional areas of business to banks, and permitting their international expansion.

Thus, a prudent regulatory framework was built and strengthened over time, not only reflecting Chile’s own experience but also taking international recommendations into account. Here, let me take a moment to outline the main elements of this framework:

1) Industry entry requirements

Applicants for a new bank license, or those planning to take control of an existing institution, must meet strict solvency and integrity criteria. The
solvency requirements are designed to ensure that potential investors
have an adequate financial position and to prevent bank acquisitions or
takeovers financed solely with debt as, unfortunately, occurred before the
crisis. The integrity criteria are designed to guard against the entry of
investors without adequate personal and business credentials.

2) Limits on lending to related parties

Related lending is subject to very strict limits. Each group related to a
bank is subject to a 5% unsecured lending limit. In addition, total related
lending, even if it is to parties not connected with each other, cannot
exceed the bank’s total capital. Moreover, related credit cannot be
granted on terms more favorable than those available to other borrowers.

Chile’s General Banking Act defines the conditions in which a company
or individual is considered to be related to a bank by ownership or
management. In the case of ownership, this occurs when an individual,
company or economic group owns more than 1% of the capital of a non-
listed bank, or more than 5% of a listed bank’s capital. In the case of
management, individuals are considered related when they hold a board
seat or any executive position within the bank. When the relationship is
in doubt, there are more than a dozen assumptions that can be used to
determine what is considered related-party or related lending.

The bank regulatory agency maintains an updated credit register of
companies and individuals, and their borrowing position per bank and
with the banking system as a whole.

This shows that related lending, which was a serious problem in the early
80s, has remained below 2% of total lending in recent years. It is, in other
words, very much under control and not a threat to bank solvency.
3) Loan classification and provisioning system

Given that the problems of banks in developing countries tend to relate to loan-portfolio quality, a strict loan classification and provisioning system was introduced. In order to facilitate cross-bank comparison and supervision, this includes a common scale for corporate clients, according to which banks classify their loans and establish provisions when above-normal losses are expected. The results of these exercises are periodically disclosed, so market participants can use them to make their own assessments.

4) Effective supervision

Before the crisis, banks were subject to a rules-based supervisory model, which focused on formalities - that is, legal requirements and compliance with accounting rules. After the crisis, supervisors started to move away from this model and gradually began to concentrate on more relevant issues such as loan-portfolio quality and risk management. This raised new challenges, including the need to build new supervisory capacities, to recruit and train the necessary staff, and to establish an adequate framework for interacting with bankers at different levels. This new supervisory model, which has been implemented gradually, is a key ingredient of the new framework established after the crisis.

5) Capital adequacy in line with Basel standards

The general rule in force in Chile - in line with the first Basel Capital Accord - is that a bank’s regulatory capital cannot be less than 8% of its risk-weighted assets, although, in some special cases, this minimum rises to 10% or 12%. However, in practice, 10% has become the market standard since this is the ratio demanded by institutional investors in order to hold bank securities. This is also the threshold to receive a first-class supervisory assessment.
6) Preventive and self-correcting safeguards

Self-correcting measures for troubled banks are essentially preventive. In general, whenever a bank’s Basel capital index falls below 8%, shareholders must promptly recapitalize the bank in order to restore the required minimum. Until this occurs, the bank is subject to severe restrictions on its lending and investment decisions. Moreover, if the ratio falls below 5%, a creditors’ committee must take prompt action, including the capitalization of deposits or the reduction of outstanding liabilities. If the committee fails to do this, the bank faces the risk of intervention or liquidation.

7) A limited guarantee or protection for deposits

Immediately after the crisis, full guarantee of deposits was necessary in order to restore public confidence. However, this was not considered an appropriate policy rule for normal times. For this reason, the official guarantee or protection for deposits was limited in order to foster market discipline by exposing depositors to the risk of losing at least part of their funds.

The current system covers sight and current-account deposits which, as part of the payment system, are considered to require protection. In addition, it provides a guarantee for small time deposits, on the grounds that small savers are less able to assess a bank’s financial situation.

8) Financial disclosure requirements

Financial disclosure is a necessary condition for market discipline. As well as publishing quarterly financial statements, banks are obliged to make monthly disclosure of their credit-risk profiles and capital positions. In addition, they must maintain and disclose short- and long-term credit ratings, issued by two independent credit ratings agencies.
9) Corporate governance standards

The bank reform set in motion a trend that has assigned greater policy-setting responsibilities to board members and top managers. They are required to take an active role in monitoring credit risk as well as in overseeing market risk, cross-border transactions and other important bank activities. In the recent past, following strong recommendations from bank supervisors, bank boards have adopted a committee structure, including an audit committee.

III. RECENT REGULATORY AND SUPERVISORY DEVELOPMENTS

Chile’s regulatory and supervisory framework has been continuously adjusted and improved over time in response to market developments, the experience of local authorities, and international recommendations.

1) Full adoption of a risk-based supervisory model

In 2001, the SBIF adopted a full risk-based supervisory model. With this, the focus turned to the management of the main banking risks: credit, market and operational risks. Under this model, banks are evaluated periodically and receive a supervisory rating which is not disclosed to the public. When weaknesses are detected, corrective measures are recommended, the direct involvement of the board of directors is required, and progress is closely monitored.

2) Update of loan classification and provisioning system

In 2004, the loan classification and provisioning system was updated and improved. The new system, which is fully consistent with Basel II definitions, allows for greater flexibility in the use of internal models based on credit-risk concepts. Banks are now using the new guidelines to report the credit-risk profile of their loan portfolio.
3) Convergence of local accounting rules with international standards

A project for the convergence of local accounting rules with IFRS was launched in 2004. This medium-term project, which is currently in the process of being implemented, is considered essential for enhancing financial disclosure and market discipline.

4) Preparation and implementation of Basel II

In early 2005, the SBIF and the Central Bank jointly presented a plan for moving to Basel II, which is currently being implemented according to schedule. As part of this plan, several specific measures have already been taken, including a formal assessment of the Basel Core Principles under an FSAP program, quantitative impact studies, stress-testing exercises, an increase in communication and coordination with relevant supervisors in other countries, and the creation of new lines of communication and coordination with the industry.

In one of its key characteristics, the plan takes a stepwise approach to the transition process. In the first stage, for instance, only the standardized approach to credit and operational risk will be adopted, and the option of adopting advanced models will be offered only in the second stage.

IV. NON-BANKING FINANCIAL REFORMS

Let us turn now to other financial sectors, where important developments have also taken place and major reforms have accompanied the banking reform. In this field, the creation of a private pension fund system is, without doubt, the most significant and far-reaching development of recent decades.
The system is based on mandatory contributions paid into individual capitalization accounts managed by private administrators. These assets are invested in domestic and foreign capital-market instruments.

The pension fund industry has played a major role in banking and financial development over the last two decades. It has

i) created a new source of medium- and long-term finance for banks and the corporate sector;
ii) strengthened transparency and market discipline;
iii) favored the development of a private ratings industry;
iv) facilitated financial innovation and the introduction of new financial instruments;
v) in short, it has contributed to the growth of Chile’s domestic capital market, which was previously of insignificant size.

The pension fund system also meant a complete overhaul of the legal framework for non-banking financial activities. A number of reforms were enacted to modernize regulation of securities markets, stock exchanges, insurance companies and mutual funds. Additional legal adjustments were introduced to make way for new financial institutions, such as investment funds, and new instruments, such as asset-backed securities.

Over the past few years, further legal changes have been introduced to strengthen corporate governance and financial transparency, to promote integration with foreign markets, to increase the liquidity of the stock market and to provide incentives for long-term savings.

V. INSTITUTIONAL CHANGES AND MACRO STABILITY

According to the economic literature, macroeconomic stability is a necessary condition for banking and financial development, and this has been borne out by our experience in Chile.
As we well know, macroeconomic stability depends crucially on sound monetary and fiscal policies and, in this area, the autonomy granted to the Central Bank of Chile and a commitment to fiscal discipline have both played a significant role in Chile’s banking and financial development.

Since 1989, monetary policy has been autonomously determined by the Central Bank, with decisions adopted by its five-member board, which is independent from the government. Under this framework, the Bank has successfully reduced inflation from two-digit figures in the early nineties to the current trend level which is within the Bank’s target range of 2-4%.

Fiscal discipline has also emerged as one of Chile’s assets. Although not enshrined in law, fiscal discipline is widely accepted among policy makers and is recognized as making a significant contribution to macroeconomic stability as it sets limits to public expenditure and debt and, as a result, favors lower interest rates.

Starting in 2001, the fiscal authorities took this process a step further when they introduced the so-called “1% structural surplus rule”, under which the government must run a structural budget surplus equivalent to 1% of GDP. The word ‘structural’ indicates that when this surplus is calculated, it is adjusted for the economic cycle, using, for example, potential rather than actual GDP. As a result, the rule is counter-cyclical, allowing governments to run actual deficits in periods of economic slowdown while still maintaining the structural surplus.

Since 2001, the public-sector budget has been kept in line with this rule. Initially, when the economy was slow, the actual result was a deficit but, over the past two years, this has turned into a substantial surplus, reflecting favorable economic conditions. The new administration, which took office in March, has indicated that it will continue to apply this rule.
VI. WHERE DOES THE BANKING SYSTEM STAND NOW?

The crisis of the eighties is past history and Chile’s banking system is now on a completely different footing.

Firstly, it appears fundamentally sound. It has an average Basel Index of 13% and no institution is, at present, below 10%. Over the past decade, the past-due ratio has remained within the 1-2% range and currently stands close to 1%. Profitability has remained high and stable over time, with return on equity running at between 9% and 21% over the last 15 years, providing an additional source of strength. Moreover, the widespread view is that financial institutions are professionally managed.

For the same reason, the banking system is well prepared to adopt new international standards and recommendations. It generally fulfills the necessary pre-conditions for Basel II and has no major constraint as regards moving towards the new capital framework. The preparation process for Basel II is taking place according to the guidelines provided by the authorities, and quantitative impact studies show that capital requirements will not change significantly under the standardized approach, which will be the option available in the first stage of implementation.

Financial integration has increased gradually over time. Foreign banks have a significant presence in both corporate and retail activities, with a total market share of around 40%, and have made a significant contribution to banking development. Moreover, domestic banks, although not showing significant cross-border expansion, have gained good access to the international markets for raising both equity and debt.

Financial and non-financial activities are kept separate to avoid undesirable practices, such as self-lending. Several domestic banks are still part of economic conglomerates involved in both types of activity - as they were before the crisis - but the operation of their banking business
is completely separate from the rest of the group and subject to strict rules to prevent any contagion.

Competition, which was perceived as a problem in the past, has increased as new players have entered the market. However, it remains limited in some segments of the retail market. Spreads have become quite competitive in corporate banking, but remain relatively high in retail banking, where efficiency still needs to improve.

Banking penetration is relatively high as compared to other developing countries. In 2005, bank lending represented around 70% of GDP, above the figure seen in other countries with a similar per capita income although below that of industrialized countries. Access to bank services and finance is quite wide, but needs to improve in the segment of small and medium-sized enterprises and among individuals.

All these positive elements are widely recognized by market analysts and credit rating agencies. Chilean banks, for instance, hold investment grade ratings in local and foreign currency, and some leading institutions have the same rating as the country - that is, single A. A similar positive view is reflected in a recent report by the IMF on banking strength across countries, where the Chilean system emerged in top position among emerging economies.

However, Chile still faces a number of challenges. These include the expansion of banking and financial services to new segments of the population, progress towards consolidated supervision, fostering of greater competition, the establishment of accounting and auditing rules and practices in line with international standards, and a successful transition to Basel II.
VII. CONCLUDING REMARKS

To sum up, over the past two decades, Chile has gone from financial weakness to financial strength. This has not been a random process. It has been the result of a number of factors with reinforcing effects: a strong political determination to solve the crisis in the 80s; sound macroeconomic policies consistently applied over time; institutional development, including the autonomy granted to the Central Bank and fiscal discipline; increasing financial integration with the rest of the world; and the new banking framework, which is consistent with modern concepts of prudential regulation and effective supervision.

Thank you very much for your attention.