BANK CRISIS AND RESTRUCTURING: THE CHILEAN EXPERIENCE

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Outline

1) The banking crisis of the eighties
2) Bank reform
3) Recent regulatory and supervisory developments
4) Non-banking financial reforms
5) Institutional changes and macro stability
6) Where does the banking system stand now?
7) Concluding remarks

1. The banking crisis of the eighties

Highlights of the crisis:

- This was one of the severest crises recorded in Latin America.
- It followed a program of banking and financial liberalization.
- This resulted in rapid growth of credit aggregates within a context of high interest rates.
- A boom in economic activity sustained the system and created a perception of strength.
- Developments in financial markets created the conditions for excessive foreign-currency borrowing and foreign-exchange risk.
- The scenario changed in late 1981 when banks started to show signs of loan-quality problems.
- The crisis became systemic in 1982-83, after a major devaluation and a severe GDP adjustment.

1. The banking crisis of the eighties

Main factors leading to the crisis:

1) A severe deterioration in macroeconomic conditions, mainly on the external side.
2) Macro policies that failed to facilitate economic. adjustment in the face of adverse circumstances.
3) Serious shortcomings in regulation and supervision
4) Bank mismanagement.

1. The banking crisis of the eighties

Restructuring programs:

- Two types of program were implemented: one for bank debtors and another for banks.
- Bank debtors were offered the possibility of rescheduling their obligations and receiving a preferential exchange rate for the repayment of foreign-currency liabilities.
- Banks were assessed for their long-term viability.
- Viable banks were offered the possibility of selling bad loans to the Central Bank, with a repurchase agreement based on future profits.
- Most domestic banks used this facility and the total amount involved reached US$5 billion.
- Non-viable banks were intervened and liquidated.

1. The banking crisis of the eighties

Cost of the crisis:

- Direct cost (public-sector resources committed to different programs for banks and their debtors): 41% of GDP.
- Indirect cost (output loss due to lower growth rates): estimated at between 24% and 41% of GDP, depending on methodological assumptions.
- These are among the highest figures seen internationally for financial crises in recent decades.

2. Bank reform

Major amendments to the Banking Act:

- 1986 amendment:
  - Introduced modern concepts of prudential regulation and effective supervision.
- 1997 amendment:
  - Updated and modernized the existing legal framework;
  - Expanded bank activities, including cross-border operations.

2. Bank reform

Main components of the new regulatory framework:

1) Industry entry requirements.
2) Limits on lending to related parties.
3) Loan classification and provisioning system.
4) Effective supervision.
5) Capital adequacy in line with Basel standards.
6) Preventive and self-correcting safeguards.
7) A limited guarantee or protection for deposits.
8) Financial disclosure requirements.
9) Corporate governance standards.

3. Recent regulatory and supervisory developments

1) Full adoption of a risk-based supervisory model.
2) Update of loan classification and provisioning system.
3) Convergence of local accounting rules with international standards.
4) Preparation and implementation of Basel II.

4. Non-banking financial reforms

1) The creation of a private pension fund system is the most significant and far-reaching development of recent decades.
2) This has contributed to the growth of the financial system and the capital market.
3) It has also meant a complete overhaul of the framework for non-banking financial activities, principally securities and insurance.

5. Institutional changes and macro stability

1) Macroeconomic stability is a necessary condition for banking and financial development.
2) Two important institutional developments have taken place since the crisis of the 80s:
    - Autonomy of the Central Bank;
    - Fiscal discipline which has recently taken the form of a “1% structural surplus rule”.
3) As a result, inflation has been brought under control, and the public-sector budget has been kept in line with this fiscal rule.
4) These two institutional elements have made a significant contribution to financial stability.

6. Where does the banking system stand now?

1) The banking system appears fundamentally sound.
2) For this reason, it is well prepared to adopt new international standards and recommendations, including Basel II.
3) Financial integration has increased over time.
4) Financial and non-financial activities are kept separate to avoid undesirable bad practices, such as self-lending.
5) Competition, which was perceived as a problem in the past, has improved, although it remains limited in some segments of the retail market.
6) Banking penetration has increased and is high compared to other developing countries.
7) All these positive elements are widely recognized by market analysts and credit rating agencies.
8) However, a number of challenges remain.

7. Concluding remarks

Main factors that made it possible to move from weakness to strength:

1) Political determination to solve the crisis.
2) Sound macroeconomic policies consistently applied over time.
3) Institutional development, including the autonomy granted to the Central Bank and a structural fiscal surplus rule.
4) Increasing financial integration with the rest of the world.
5) A banking framework consistent with modern concepts of prudential regulation and effective supervision.

THANK YOU FOR YOUR ATTENTION

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