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From Financial Weakness to Financial Strength:

The Chilean Case

Enrique Marshall

Superintendent of Banks
And Financial Institutions, Chile

Moneda 1123, piso 6, Santiago – Chile. www.sbif.cl – lrromero@sbif.cl

I am very pleased to share with you on this important occasion institutional features of the financial development of the Chilean economy, as it went from financial weakness in the eighties to financial strength at present. Some of the lessons of our experience may be useful when considering financial policy issues in your own countries.

This address will first refer briefly to the financial crises of the first half of the eighties and to the measures which were taken to overcome it. Then, to bank reform as well as to pension and capital market reforms, which since the eighties are pillars of the development of financial markets. Third, to institutional changes for an independent Central Bank and for a fiscal policy anchored on a structural surplus concept, with the view to macroeconomic and financial stability. Finally, to indicators on financial development and economic growth of the Chilean economy.

I. FINANCIAL CRISIS OF THE EIGHTIES AND MEASURES TO OVERCOME IT.

1. Financial liberalization of the seventies.

Financial liberalization of the Chilean banking system started in the first half of the seventies as part of wider reforms which included the privatization of banks and the opening of the economy to foreign trade and to cross border capital flows.

Quantitative credit allocations were lifted at the end of 1973. Interest rates could be freely negotiated since the end of 1975. Reserve requirements were reduced starting 1975 and reached 10% and 4% for sight deposits and time deposits in 1980. Restrictions on banks as regards taking on foreign debt were gradually removed starting December 1977 and virtually abolished in April 1980.

The financial liberalization measures were soon followed in the second half of the seventies by abnormally high rate of growth of the loan portfolio of the banking system, at nearly 40% in real terms per year; by very high active interest rates averaging nearly 20% in real terms per year, by provisions and write offs of less than 2% a year, and a profit rate which stood at around 20% per year, all of which reflected a booming banking system which looked safe and profitable.

However, solvency problems showed up in 1981. A foreign exchange crisis and a sharp increase in the exchange rate increased these problems in 1982. The financial crisis became “systemic” when a severe macroeconomic adjustment led to a 15% drop of GDP in 1982-83.

In looking back at the factors which led to this crisis, the following played an important role in weakening the capital basis of banks: severe shortcomings in prudential regulation and supervision, lax and risk-prone bank management, and adverse macroeconomic conditions. Among the former the following stand out: i) excessive related party credit in economic groups of which bank become part; ii) inadequate measurement and handling of credit risk and of foreign exchange risk, and iii) rolling over of risky credits, capitalization of interest on such credits and insufficient provisioning. Poor bank management was also partly due to shortcomings in prudential regulation on account of inadequate entry conditions.

Among adverse macroeconomic conditions for the financial stability of banks, the following led to abrupt changes in profitability and risk of debtors: i) swift reduction in tariffs from 100% in 1974 to 10% in 1977, amid a severe fiscal and macroeconomic adjustment which reduced GDP by 13% in 1975; ii) adoption of a fixed rate of exchange in 1979 as part of a stabilization program, but which soon led to a overvalued domestic currency, and thus, to a sharp devaluation and a severe recession once capital inflows stopped in 1982.

2. Measures to overcome the financial crisis.

The Government took deliberate measures to overcome the crises, on the argument that delaying them would only increase the fiscal cost of bail-outs and retard the recovery of economic growth. These measures also referred to bank regulation and supervision.

Recovery measures were implemented in 1982-86. They included programs aiming at recovering the solvency of banks as well as of bank debtors. Large scale firms indebted in foreign currency were granted access to a preferential exchange rate in view of the sharp increase in market rates in mid 1982. In the case of small and medium sized firms and households, their over indebtedness was mainly due to the severe recession of 1982-83 and high interest rates. Measures to recover their solvency consisted mainly in various programs rescheduling their debts at lower interest rates and longer payment periods.

Programs directed at recovering the solvency of the banking system, were based on an assessment of the viability of banks and of financial societies, taking into account the losses which they had accumulated in their assets. Thus, banks and financial societies which had been intervened and which were judged not viable were liquidated and their assets were sold. Their shareholders lost most or all of their property. Banks and financial societies which were deemed viable, both intervened and not intervened, were able to sell bad loans to the Central Bank with a repurchase commitment out of future profit. The recapitalization of viable entities benefited from tax incentives, and in the case of the two largest banks, also from credit incentives to persons who purchased newly issued shares.

The banking crisis was overcome in 1986. The following indicators stand for one of the largest ever recorded financial crises in Latin America. Bad loan portfolios which had been sold to the Central Bank were at the end of 1987 equivalent to 30% of the loan portfolio of the banking system, 25% of GDP and three times the capital of the banking system.

Table 1 shows the fiscal cost of programs recovering solvency. The overall figure of public sector resources which had been committed to overcome financial crisis stood at the end of the eighties at the equivalent of almost 42% of GDP. Among the mentioned programs, the preferential exchange rate for domestic debtors in foreign currency and the liquidation of unviable banks and financial societies meant resources of almost 15% and 11% of GDP, making of them the most expensive programs.

II. BANK REFORM.

The bank reform of the end of 1986 was enacted immediately after the solvency of the banking system was recovered. It introduced substantial changes in the legal and regulatory framework of banking, and stands in Chile as a turning point as regards bank regulation and supervision.

Table 2 summarizes outstanding institutional features of bank reform measures: i) tightening of entry conditions into the banking industry, ii) limits to related bank credit, iii) capital indexes, presumptions on financial instability and self correcting solvency measures, iv) limited State guarantee on bank deposits, and v) transparency of the financial condition of banks.

Further regulatory changes were introduced in 1987 and periodically up to the present. They also set in motion a trend which has enlarged the responsibility of bank directors and upper level bank managers as regards defining policies and setting up procedures which safeguard bank solvency and bank liquidity.

All these reforms left financial liberalization fully in place, after the Central Bank had “suggested” short term deposit interest rates in the course of the financial crisis of the eighties.

1) Tightening of entry conditions into the banking industry.

The financial crises of the eighties led to a large change in the ownership of banks which were intervened but not liquidated. Hence onwards, a tightening of entry conditions into the banking industry has meant the fulfillment of strict solvency and integrity criteria for main founding shareholders. Persons applying for banking license and wishing to hold more than 10% of the shares of a new bank have to demonstrate that they have a net worth at least equal to their projected investments. They are therefore unable to set up bank just relying on debt finance, and will be exposed to losses if the bank takes on excessive risks when undertaking its business.

The business plan of a new bank must also be in line with foreseeable industry standards, while the bank must be able to show resilience when stress tested.

2) Limits to related bank credit.

Strict norms were defined as regards persons related to the property or the management of a bank in order to limit related party credit. The latter played an important role in the high risk and loss loan portfolio of banks in the financial crises of the eighties.

Natural persons who own more than one percent of the shares of a bank, or more than five percent of the shares of a society who owes shares of a bank, are defined as related to its property. In turn, bank directors and managers down to branch managers, or who have more that five percent of the property of a firm receiving credit, are defined as related to its management.

The bank reform of 1986 did not change individual credit limits of up to five percent of a banks capital and up to twenty five percent if loans are backed by first class guarantees, but credit to any related party were subject to the same limits. In addition, banks cannot grant related credit on terms more favorable than credit to other debtors, and the total amount of related credit cannot exceed bank capital.

The total of related bank credit fell continuously in the following years after 1987, and actually stands at less than two percent of the loan portfolio of the banking system.

3) Capital indexes, presumptions on financial instability and self-correcting solvency

measures.

The capital position of banks has been measured in terms of the Basel capital index since 1998. In line with the first Basel capital accord, the general rule is that the regulatory capital of a bank cannot be lower than 8% of its risk weighted assets. However, in the case of a merger between banks which lead to a bank with a significant market share, the Superintendence of Banks and Financial Institutions can require the latter to keep a minimum Basel capital index above 8%. Also, in order to counter concentration in the banking industry, the minimum entry capital for a new a bank was reduced in 2001 from an equivalent of around US$ 21 million to around US$ 10 million (at the current rate of exchange), but banks with a capital of less than the equivalent of US$ 2l million have also to keep a Basel capital index above 8%.

Pension funds have required banks wishing to place bonds and other financial instruments as part of their investment portfolios, to hold a Basel capital index of at least ten. This ratio has in the meantime become a market standard. In fact, the average Basel capital index of Chilean banks stands currently at 14%.

The presumptions on financial instability and self-correcting measures were defined on the basis that expected losses must be fully provisioned. On this account, bank capital stands fully available to face unexpected losses.

Self-correcting measures are preventive since they have to be taken when bank capital is still largely positive but starts to fall below predefined levels. Thus, in the case of the general rule, shareholders of a bank whose Basel capital index falls below 8% but which is above 5% must promptly recapitalize the bank. If they do not do so, the bank is unable to increase its loan portfolio, and any additional deposits must be invested in Central Bank issued financial instruments. On the other hand, if the Basel capital index of a bank falls below 5%, a creditors committee must take prompt action in order to strengthen its solvency, including the capitalization of deposits and other measures. If the committee fails to agree on such measures, the bank faces the risk of intervention by the Superintendence of Banks and Financial Institutions.

Preventive capitalization has been relied upon on a few occasions to strengthen the solvency of financial institutions. So far, the capitalization of deposits and other measures to recover bank solvency have never been used.

4) Limited State guarantee on deposits.

The bank reform of 1986 withdrew the explicit State guarantee on deposits which had been granted when banks were intervened in the course of the financial crises of the eighties. Instead, it introduced a limited State guarantee to foster market discipline, as bank depositors and investors now run the risk of loosing funds in case of a bank insolvency.

The complement to a limited State guarantee is transparency of risk and of the capital position of banks, which is commented below, since otherwise depositors and investors would be unable to make informed decisions.

The State guarantee covers sight deposits, which as part of the means of payment were considered in need of protection, as well as smaller scale time deposits, on the argument that a large proportion of households have difficulty in assessing the financial condition of banks.

The counterpart of the State guarantee on sight deposits is that banks must invest any excess of sight deposits above two and half times their capital as a “technical reserve” in financial instruments issued by the Central Bank, as a precautionary measure to safeguard the payment system. As regards time deposits, the State guarantee covers the deposits of natural persons in domestic currency up to the equivalent of around US$ 3.000 dollars per calendar year.

There has not been a single bank insolvency case since 1987. Therefore, the State guarantee on deposits has not so far never required of public sector resources.

5) Transparency of the financial condition of banks.

The bank reform of 1986 introduced transparency to credit risk in the loan portfolios of banks and to their capital positions with the view to foster market discipline by investors and depositors.

Transparency of credit risk is based on the publication of expected losses in the loan portfolios of banks on a quarterly basis. Five categories were used to classify credit risk starting 1987 and up to 2003 (normal, potential risk higher than normal, expected losses, substantial expected losses and non recoverable).

New provisioning rules on expected losses become effective starting 2004 in terms of the credit risk concepts which are part of the New Basel Capital Accord: probability of default, exposure at default and loss given default. Provisions and credit risk measures of different types of bank loan portfolios based these concepts, were for the first time published in May of this year.

The capital position of banks has also been informed on a quarterly basis since 1987. Starting 1998, once capital requirements were determined following the first Basel Capital Accord, the capital position of banks has been published in terms of the capital index prescribed in that Accord, and which cannot be lower that 8% of risk weighted assets.

6) Corporate governance and bank solvency.

The changes to the banking law of 1997 set in motion a trend which has assigned larger responsibilities to bank directors as regards setting up policies and controlling bank risks. They have to take an active stance in monitoring credit risk, market risk and other risks, and must assume responsibility for the level of provisions which cover expected losses out of these risks. They have also to involve themselves in overseeing the management of liquidity, in defining policies as regards the internationalization of activities, in the prevention of money laundering, in internal audit committees and in other important bank activities.

The counterpart to this trend is the evaluation of the solvency and the quality of management of banks by the Superintendence of Banks and Financial Institutions. A bank wishing to qualify in category A as regards solvency and quality of management must show a Basel capital index of at least ten. This process became official in 2002.

III. PENSION AND CAPITAL MARKET REFORMS.

Table 3 highlights main institutional reforms linked to pension funds and capital markets. A private pension fund system was created by law at the end of 1980. It is based on mandatory contributions of workers and employees, equivalent to 10% of their wages, which are deposited in individual capitalization accounts of a pension fund. These funds are managed by private administrators which charge a management fee and which compete in attracting affiliates in terms of that fee and of the profitability which they achieve when investing pension funds in the capital market.

The pension fund law also put in place the Superintendence of Pension Fund Administrators, which in the financial sphere has regulatory and supervisory powers as regards the investment of resources of pension funds, taking into account the risk profile of issuers of financial instruments and of financial instruments themselves.

The pension fund reform brought about a large scale accumulation of pension funds and thus required a complete overhaul of the regulatory and legal framework of capital markets. Thus, a new law of the Superintendence of Securities and Insurance was issued at the end of 1980, new laws on the securities market and on corporate firms were enacted at the end of 1981, while additional adjustments to specific aspects of capital markets have been introduced periodically up to this date.

The continuous accumulation of pension funds provided ground to new long term financing alternatives to private sector agents. These have included housing finance for households based on mortgage letters and which have unleashed the housing and real estate market; and corporate finance relying on bonds and shares which have competed with corporate bank credit and called for specialized credit risk rating agencies and the expansion of stock exchange activities.

The Central Bank also relied heavily on pension funds in the eighties when it placed financial instruments in the market to counter the monetary effects of its programs to recover the solvency of banks and bank debtors once the financial crisis had erupted.

IV. INSTITUTIONAL CHANGES TOWARDS MACROECONOMIC STABILITY.

Against an historic background of an economy which had been inflation prone up to the seventies, the Central Bank was made autonomous in virtue of a law of 1989. Also, after three decades of fiscal policy geared to macroeconomic and financial stability, and with the view to back up the sustainability of macroeconomic policies, the public sector budget was anchored on a structural surplus concept starting 2001.

Table 4 sums up institutional changes seeking macroeconomic and financial stability.

1. Autonomy of the Central Bank of Chile.

The law on The Central Bank of 1989 defined its objectives as safeguarding the stability of the currency and the normal functioning of internal and external payments.

The first objective has meant a policy geared to reducing inflation on a gradual basis, and in the last years, the setting of a yearly inflation target in a range of 2% to 4%. Domestic inflation stands at present at less than 2% per year.

In order to safeguard internal payments, the Central Bank provides banks with short run credit lines for liquidity purposes. In case of a bank insolvency, it is the lender of last resort and can also purchase bad loans from troubled banks with repurchase commitment (out of profit), a practice which proved itself in the crisis of the eighties. When tackling the effects of bank insolvency, the Central Bank performs as fiscal agent in the sense that the treasury will have to even any outstanding losses.

The Central Bank introduced recently an electronic large value payment system for banks which liquidates transactions on a real time and gross settlement basis. This system has improved the safety and efficiency of such payments and reduced the exposure of the Central Bank to counterparty risk.

The Central Bank has fully opened the capital account of the balance of payments, and there are currently no restrictions on cross border capital flows. Such a stage was achieved stepwise, after achieving macroeconomic stability, and once a solid regulation and supervision of the financial system was in place.

It also opted at the end of the nineties for a free and floating exchange rate system. A main advantage of such a system is that it allows more protection against external shocks, thus also contributing to safeguard external payments.

2. Fiscal policy anchored on a concept of structural surplus.

The concept of structural surplus excludes the main cyclical components of the budget, thus seeking to achieve long term sustainability of fiscal policy while also making room for a stabilizing role along the economic cycle. In order to contribute to stabilize economic activity, the structural balance can translate into a Government deficit in the downside of an economic cycle, provided it achieves a sufficient surplus in the upside of the cycle.

The public sector budget was for the first time formulated in terms of a fiscal policy rule based on a structural surplus of the Central Government equivalent to 1% of GDP in 2001 (thus excluding public sector enterprises from its definition).

In the case of Chile, swings in the price of copper and other commodities and fluctuations in economic activity have an important effect on the income tax profile of the Central Government. The price of copper was at low levels while the economy registered sluggish growth in 2001-03. On this account, the Central Government showed structural deficits of 0.5% to 1% of GDP in these years. However, in 2004, with a price of copper at a high level and an economy currently growing at a 5% per year, a fiscal surplus of at least 1% of GDP is in sight and which an expansive cycle could sustain in the forthcoming years.

The structural fiscal surplus sets a limit to the growth of public sector debt, and thus to the financing of the Central Government in capital markets. On this account, it favors lower interest rates and allows domestic savings to be channeled mainly to private sector investment projects.

V. INDICATORS OF FINANCIAL DEVELOPMENT AND ECONOMIC GROWTH OF THE CHILEAN ECONOMY.

Bank reform and pension and capital market reforms have relied on market determined interest and exchange rates under conditions of financial liberalization. But these reforms have at the same strengthened prudential regulation, financial transparency and market discipline to upkeep financial stability. An independent Central Bank and robust fiscal accounts have also played and important role in fostering macroeconomic and financial stability.

The above factors have underpinned financial development and provided enterprises and households with a growing array of outlets for their savings as well as of financing alternatives for their investment projects.

Table 5 shows in its upper part financial asset. They grew continuously in the nineties and registered at the end of 2003 the following figures: banks assets of almost US$ 80 billion (95% of GDP of 2003); pension funds of almost US$ 50 billion (60% of GDP); mutual funds assets equivalent to US$ 8.4 billion (10% of GDP); while market capitalization of corporate firms stood at almost US$ 86 billion (103% of GDP).

Table 5 also shows liabilities figures. They also grew continuously in the nineties and were at end 2003 as follows: firms had outstanding loans with banks equivalent to almost US$ 30 billion (36% of GDP); bonds and commercial paper issued by firms stood at almost US$ 12 billion (14% of GDP), while private external debt of firms was US$ 29 billion (35% of GDP).

Total external debt, both private and public, stood at the end of 2003 at US$ 43 billion (52% of GDP). However, international reserves of the Central Bank were US $ 16 billion (19% of GDP, or equivalent of 10 months of import of 2003), while foreign assets of Chilean residents were equivalent to US $ 40 billion (48% of GDP).

The macroeconomic and financial stability which has been achieved, and the above financial figures, have improved country risk ratings since the nineties and have led to a current investment grade of A (according to Standard & Poor's) wile the sovereign spread was 86 basis points at the end the 2003.

The economy entered into a strong phase of expansion starting 1986, once the financial crisis of the mid-eighties was overcome, and when favorable foreign sector conditions boosted exports and foreign investment in the nineties. After decades of underachievement, the country grew on average 7.7% per year until 1997, as compared to a historical reference rate of 4% per year.

Financial development has been an important factor of economic growth. It is estimated that of the difference of 3.7% among these above mentioned growth rates, the combined effects of the pension fund reform on national savings, on the average product of capital and on total factor productivity can explain a full one percentage, that is, almost a quarter of that difference.

The economy was hard hit by the spillovers of the East Asian financial crisis in 1998 and which led to a fall of almost 1% of GDP in 1999. An important feature of this recession is that with the exception of a small financial institution devoted to consumer credit which was recapitalized by its owners, all banks were able to absorb its negative effects on the quality of their loan portfolios out of their current incomes. Stress-tests on the resilience of banks have also shown that their current Basel capital indexes, all above ten and averaging fourteen, allow them to withstand unharmed considerable economic shocks.

The economy is currently in an expansive phase which is expected to reach into the following years. GDP is growing at 5% per year, a figure which is showing up in bank's loan portfolios and profit rates.

The financial development of the Chilean economy illustrates the importance of a timely adoption of institutional and regulatory measures which meet the evolving demands of financial markets. Thus, at present a number of challenges are at hand. These include the supervision of financial conglomerates, the adoption of international financial reporting standards, coming to terms with the New Basel Capital Accord, improving the clearing and settlement system of securities transactions, and reviewing the investment limits of pension funds.

It is thus also the responsibility of the Superintendence of Banks and Financial Institutions to provide for ongoing market developments, but within a framework where risks are properly measured, managed and covered.

Table 1

Financial crisis of the eighties
Financial cost of programs recovering solvency[1]

Program	Cost (% of GDP)
1. Preferential exchange rate for domestic debtors in foreign currency	14,7
2. Rescheduling of domestic debt	1,6
3. Liquidation of not viable banks and financial societies	11,0
4. Sale of bad loans to Central Bank with repurchase	6,0

[1] The total cost is measured as the sum of the costs of each year as a percentage of GDP over the 1982-89 period.

	commitment	
5.	Popular capitalization of banks	2,4
6.	Foreign exchange losses of Central Bank after assuming the foreign debt of liquidated financial institutions	6,1
	Total financial cost	41,8

Table 2

Bank reform in Chile

Institutional features	Objectives
1. Tightening of entry conditions into the banking industry.	Bankers committed to “safe and sound” banking.
2. Limits to related bank credit.	Control of credit risk.
3. Presumptions of financial instability and self-correcting measures.	Timely recapitalization of banks.
4. Limited State guarantee on deposits.	Market discipline: depositors subject to bank losses.
5. Transparency of the financial condition of banks.	Market discipline by bank investors and depositors.

Table 3

Pension and capital market reforms

Main institutional features	Objectives
1. Private administered pension system.	Pension funds based on individual capitalization accounts.
2. Superintendence of Pension Fund Administrators.	Safe investment of pension funds. Up to date registry of individual capitalization accounts.
3. Law on the securities market.	Conditions on the issue and transaction of securities.
4. Law on corporate firms.	Conditions on the constitution and issue of shares. Protection of minority shareholders.
5. Law on the Superintendence of Securities and Exchange.	Transparency of the capital market and fair dealings.

Table 4

Institutional changes towards macroeconomic stability in Chile

Main features	Objectives
1. Autonomy of the Central Bank.	Stability of the currency. Normal functioning of internal and external payments.
2. Fiscal policy anchored on a concept of structural surplus.	Long term sustainability of fiscal policy. Make room for a stabilizing role of fiscal policy.

Table 5

Indicators of financial development

A. Financial assets (US$ Billions)

Year	Banks assets	% GDP	Pension Funds	%GDP	Mutual funds	%GDP	Market capitalization of corporate firms	%GDP
1990	32,7	85	9,0	23,4	0,6	1,5	18,4	48,0
1995	49,0	84	23,1	39,8	2,3	4,0	65,5	112,6
2000	70,7	93	36,4	48,1	4,6	6,0	62,0	81,9
2003	78,9	95	48,7	58,9	8,3	10,1	85,5	103,4

B. Financial liabilities of firms (US$ Billions)

Year	Commercial debt with banks	%GDP	Bonds and commercial papers	%GDP	Private external debt	%GDP
1990	9,7	25,3	1,6	4,2	7,3	18,9
1995	19,4	33,3	2,2	3,8	10,2	17,6
2000	27,7	36,6	3,7	4,9	30,4	40,1
2003	29,4	35,5	11,6	14,0	29,0	35,1