The Tequila Effect and Argentina's Banking Reform

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The disruption of Mexico's economy in late 1994 triggered a confidence crisis in Argentina that accelerated the restructuring of the banking sector. The restructuring process has involved the privatization of provincial banks, consolidation of private banks, and selective bank liquidations. It represents an important milestone in Argentina's long struggle to strengthen its banking system.

ARGENTINA'S BANKING sector has suffered from a number of long-standing problems: low mobilization of bank deposits and a resulting scarcity of credit; the prominence of public sector banks; and inefficiency and segmentation of private banks. The low mobilization of bank deposits was the direct result of macroeconomic instability. The ratio of broad money to GDP—a measure of financial deepening —declined from over 40 percent in the 1940s to about 7 percent in 1990. This decline was linked to increasing price instability, which culminated in episodes of hyperinflation, raised the degree of uncertainty of asset yields, and led to the widespread dollarization of the economy. Increased uncertainty led to a reduction in both the level and the maturities of financial instruments; by 1990, most financial instruments had maturities of less than one week. The availability of credit also suffered, not only because of low deposit mobilization but also because chronic public sector deficits crowded out private sector credit needs.

Public banks, including provincial government banks, have played a prominent role in Argentine banking, accounting for 43 percent of total loans in June 1995. Poor management of most provincial banks led to the emergence of a large volume of nonperforming loans that undermined confidence and added to the fiscal burden of already financially strapped provinces (Box 1). The adverse effect of public ownership is illustrated by sharp differences in the quality of public banks' portfolios compared with those of private banks. The level of "troubled loans" in most public banks typically exceeds that of private banks; as of December 1994, troubled loans accounted for 33 percent of total loans in public banks compared with 10.3 percent in private banks.

At the same time, Argentina's numerous private banks have been sharply segmented in terms of intermediation costs and credit quality. Intermediation costs in Argentina are among the highest in Latin America, a result of limited economies of scale and outdated banking technology. The prevalence of wide

Box 1

Restructuring provincial banks

In late 1994, provincial banks accounted for about one-fourth of deposits and one-third of all banking sector employees. Provincial governments traditionally used provincial banks to obtain credit to finance their deficits and to extend credit to borrowers that did not meet private bank creditworthiness criteria. As a result of the deteriorating fiscal situation of most provinces and poor lending and collection policies, most provincial banks became technically bankrupt, although many were maintained by central bank rediscounts or state government deposits. As these banks were created by provincial laws, privatization or liquidation required the approval of local legislatures. The central bank's Superintendency could not use the threat of liquidation to enforce capital adequacy requirements. Thus, until recently, dealing with provincial banks was one of the more difficult challenges for Argentina's financial policy.

In early 1995, the deteriorating fiscal and financial situation of the provinces encouraged a number of them to privatize their banks. Thus far, six provincial banks (Corrientes, Chaco, La Rioja, Entre Rios, Misiones, and Formosa) have already been sold to the private sector, with four others in the process of being privatized. This process is being assisted by a Trust Fund for Bank Privatization, funded by the World Bank ($500 million), the IDB ($750 million), and the government of Argentina (up to $700 million).

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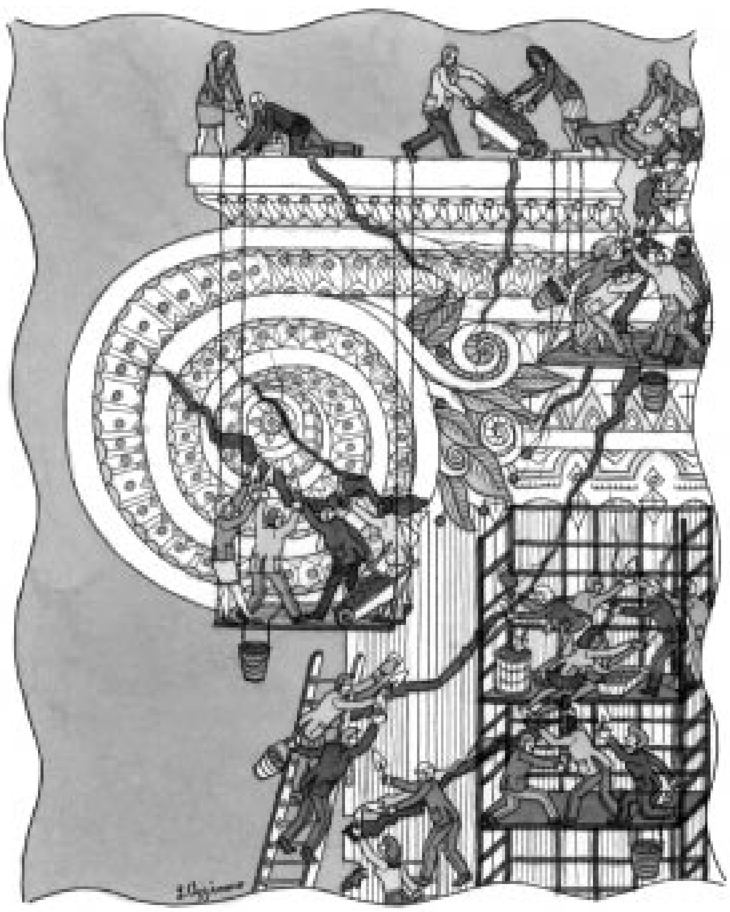
intermediation spreads allowed banks with high intermediation costs to coexist with more efficient banks. Because they might trigger a run on deposits, the weaker banks, largely medium-sized and small banks, threatened the banking system as a whole. Throughout the 1980s, several private banks were liquidated at an enormous cost to the central bank's deposit guarantee program.

Corrective policies

From 1991 through 1994, the government implemented a number of policies that sought to address the three key problems described above. First, the government implemented a program of monetary and fiscal reform that successfully stabilized the domestic currency. Under the Convertibility Law, enacted in early 1991, Argentina's monetary base cannot exceed its international reserves, thereby converting the central bank into an institution closely resembling a currency board. The Convertibility Law, coupled with major efforts to reduce federal expenditures and raise federal taxes, succeeded in bringing down inflation from monthly double-digit levels to annual single-digit levels. These policies contributed to the recovery of the ratio of broad money to GDP from 7 percent in 1990 to 18 percent in 1993. This, in turn, helped expand the volume of bank credit from 14 percent of GDP in 1991 to 19 percent by late 1994.

The strength of the financial sector more generally reflected dramatically improved economic management and superior economic performance. Inflation was halted after decades of poor performance, and growth was robust during 1991–94. Financial markets began to look at fiscal indicators for reassurance, and government policy strongly emphasized fiscal control with improvements in tax collection and expenditure rationalization. Increased confidence in the system was the clear outcome.

A second significant development was the central bank's improvement of the regulation and supervision of banks' capital adequacy and provisioning requirements. Prior to the reforms, the regulation of capital requirements was not linked to the riskiness of assets, while provisioning requirements had little to do with borrowers' repayment capacities. Enforcement was undermined by weak organization and staffing of the supervisory agency. Today, prudential regulations cover risk-based minimum capital requirements, reserve requirements, loan classification and minimum loan-loss provisioning requirements, operations with affiliated companies, consolidation, internal and external auditing, and diversification of credit risk. Minimum capital requirements for commercial banks are now subject to risk ratings based on normal CAMEL criteria. (The acronym CAMEL represents capital adequacy, asset management, management quality and integrity, earnings quality and stability, and liquidity.) Portfolio classification has been changed from a system based primarily on guarantees to one reflecting a borrower's financial situation and repayment capacity. Provisioning requirements are determined both by portfolio quality and by guarantee arrangements.



Together with the improvement in prudential regulation, enforcement capacity is being steadily strengthened. The staff of the central bank's supervision division was increased in July 1994 from 160 to approximately 300, organized into six on-site inspection groups specializing in different types of financial institutions. The Superintendency monitors compliance with prudential norms from daily and monthly reports, off-site examinations, and annual external reports. The largest 120 banks are subject to a full annual on-site inspection and the remaining smaller 80 banks and finance companies are subject to a similar inspection every 18 months. Banks that have made extraordinary borrowings from the central bank are subject to considerable on-site inspection and even daily monitoring. At the height of the crisis, some 80 banks were subject to daily reporting. Most international observers credit the newly designed and managed Superintendency with outstanding progress in recent years.

The third important development was the change in the government's stance toward privatization of public banks. Privatization of public banks lagged behind Argentina's otherwise impressive record of privatization. The change in attitude was triggered by the poor performance of public banks, which required a level of financial assistance that neither the federal government nor the provincial governments were in a position to provide. Under the Convertibility Law, the central bank could no longer bail out provincial banks through unlimited discount facilities as it had done in the past. The provincial governments, which had been experiencing severe fiscal imbalances throughout the 1980s and early 1990s, were also constrained in their ability to sustain money-losing state-owned enterprises (SOEs), including their own banks. As a result, a program to liquidate or sell public banks was begun. By the end of 1994, out of a total of 34 public banks, 1 national bank had been liquidated, another had been privatized, and 3 provincial banks had been privatized.

The tequila effect

The disruption of Mexico's economy in late 1994 triggered a confidence crisis in Argentina's financial system in early 1995. Despite the considerable progress made since 1991 in strengthening Argentina's banking system, the Mexican crisis took its toll. In late 1994, market sentiment about the Argentine financial system was distinctly more bearish owing to slower growth of deposits, rising world interest rates, reduced capital inflows, and declines in the prices of Argentine government bonds as well as stocks. In November 1994, financial markets became jittery following the failure of a small nonbank trader caused by losses in government bond trading. The failure caused most banks to cut their credit lines to other bond traders, thus further weakening a bear market. This, in turn, eroded the financial position of several banks with large government bond inventory and trading positions.

The devaluation of the Mexican peso on December 20, 1994, and the resulting capital outflows throughout Latin America triggered the crisis. The wholesale banks were among the first to feel its effects. Typically, these banks (about 30) had large stock and bond trading positions and one branch, and depended almost entirely on large corporate deposits. Withdrawals from these banks and simultaneous cuts in interbank lending forced some of the wholesale banks into liquidation. As news of the failures spread, and in the absence of deposit insurance, retail depositors fled from weak provincial, cooperative, and small retail banks, thus producing a major banking crisis. While some of the funds were redeposited in the largest private and foreign banks, there was a net deposit withdrawal of $8 billion from the banking system, equivalent to 16 percent of the deposit base.

The policy response. Argentina's Convertibility Law requires the monetary base to be limited to the level of foreign exchange reserves (with some limited flexibility), severely restricting the central bank's role as a lender of last resort. In early January 1995, the central bank tried to stabilize the system by persuading the top five banks to create a $250 million "safety net" to buy the assets of illiquid wholesale banks in exchange for lower reserve requirements. A second safety net of $790 million soon followed, this time with 25 banks transferring reserves equal to 2 percent of their pre-crisis deposit base from the central bank to the government-owned Banco de la Nación, which made collateralized advances to banks needing liquidity. In addition, the central bank charter was amended in February, permitting it to advance funds with maturities in excess of 30 days, and in amounts exceeding the net worth of the borrowing bank.

The central bank's ability to make larger advances still remained constrained by the Convertibility Law and the volume of external reserves. Moreover, the depth of the crisis, as seen in the sharp drop in asset values, made it difficult to differentiate between solvency problems and liquidity problems. The volume of central bank rediscounts rose to $1.6 billion, and about half the banks in the banking system availed themselves of credit. Remarkably, the banking regulators managed with little lender-of-last-resort capacity to maintain the system, although reserves fell by about $5 billion over the period.

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To help facilitate the restructuring and consolidation of private banks, the government established a Trust Fund, financed by up to $2 billion of government of Argentina bonds and a $500 million loan from the World Bank (Box 2). Trust Fund resources have been used in about a dozen transactions so far, mostly to assist mergers among regional cooperative banks, but also to facilitate the acquisition of a number of insolvent banks.

Effects on the banking system. The aggregate deposits of the Argentine banking system fell steadily from $45.6 billion on December 20, 1994 to a low of $36.8 billion by May 12, 1995. The fall was particularly pronounced in early March. Since then, deposits have slowly recovered, reaching $45 billion by early December 1995. Deposit losses were particularly severe among wholesale banks, cooperative banks, and private regional banks. Provincial and federal banks also have lost deposits, though to a smaller extent. Demand deposits have fallen by less than certificates of deposit, suggesting a decline in the overall maturity of deposits.

The Mexican crisis left a severe mark on the Argentine banking system. In the first nine months of 1995, 34 banks and 6 nonbanks closed (through acquisitions, mergers, or liquidations), leaving the system with 134 banks and 31 nonbank financial entities. Twenty-eight cooperative and five wholesale banks were closed. Although only one provincial bank actually closed during the period, nearly 15 are in various stages of privatization and/or closure. More private banks, particularly regional and wholesale banks, are expected to merge or be acquired by other institutions.

Lessons and prospects

How did Argentina's banking system fare during Latin America's worst crisis since the oil shocks of the 1970s and 1980s? The answer at present is: well. Within a year, deposits had reached their pre-crisis level and domestic confidence had been restored. While the capital inflows that nourished GDP growth and financial expansion after 1991 will take some time to recover, a retrenchment of this kind is not unwelcome in the longer run as it will lead to stronger efforts to raise domestic savings, a priority of government policy. Despite an unexpected severe and prolonged recession,

Box 2

The private bank restructuring Trust Fund

The Trust Fund, established in March 1995, is designed to assist the merger, acquisition, or restructuring of troubled private banks by granting the "new bank" (the merged entity, acquirer, or restructured bank) two kinds of loans. To rebuild equity, the Fund can issue subordinated, convertible loans with maturities of up to eight years, but no less than five years, covering a percentage of the risk-weighted assets involved in a transaction—up to 10 percent for restructuring, 15 percent for mergers, or 25 percent for acquisitions. This can be considered Tier II capital for purposes of meeting capital adequacy requirements, but it may never exceed 4 percent of the 11.5 percent capital requirements. The Fund can make a second kind of loan, of up to three years' maturity, to repay outstanding rediscounts and advances made to the troubled bank by or on behalf of the central bank.

The Fund operates according to a set of principles that clearly specify the qualifications for acquiring banks or becoming the dominant partner in a bank merger. There are clear rules on restructuring, where ownership does not change but new ownership capital must be provided pari passu with Trust Fund resources. Regardless of transaction type, all banks receiving Trust Fund assistance must meet prudential capital and other central bank requirements.

fiscal fundamentals and price stability remain intact. Private banks are becoming more self-reliant in meeting their short-term liquidity needs, and the privatization of provincial banks and consolidation of private banks are helping to restructure the banking system into one that will be better able to withstand shifts in confidence and to benefit from growth opportunities.

Lessons. The financial crisis of December 1994–April 1995 demonstrated the difficulty of crisis management under a currency board system. Despite its virtues and its value as the cornerstone of the post-1991 Argentine reforms, Argentina's quasi-currency board arrangement places the central bank in the difficult position of providing both limited "lender-of-last-resort" facilities and peso convertibility on demand. The central bank managed to meet these two objectives despite the size and rapidity of deposit withdrawals. In the process, the central bank's international reserves fell by some $5 billion. While the central bank and the Banco de la Nación provided substantial liquidity to commercial banks during the crisis—pressing the Convertibility Law to its limits—such assistance did not prevent interest rates from soaring during the more difficult moments of the crisis.

Banking crises, whether in Europe, the United States, or Latin America, force supervisors and policymakers to balance the degree of temporary forbearance of prudential regulations to be offered with plans to perform surgery on damaged banks. The price of excessive forbearance is dissipation of precious liquidity, while the price of aggressive action against weakened banks can be further panic. Judgments about the quality of the management and future business prospects of the affected banks often tip the scales in one direction or another.

One issue that may have affected these judgments in Argentina was the lack of deposit insurance. Insurance for small depositors (now up to a maximum of $20,000 in Argentina) can assist supervisors in closure decisions. Until the creation of limited deposit insurance in April 1995, Argentine private bank deposits were held at the depositors' risk, unlike in provincial banks or in other countries that have seen financial crisis, such as Mexico. In the event, regulators closed five banks, suspended the operations of several others, and forced the mergers of dozens of others.

The government reacted quickly in establishing the Trust Funds for provincial bank privatization and private bank restructuring. Considering the magnitude of the crisis, the authorities are to be commended for keeping the banking system functioning. The actions of the IMF, the World Bank, and the Inter-American Development Bank (IDB) in support of the government's efforts to restore stability were also crucial in restoring confidence. Nevertheless, the crisis re-emphasized the need for strong macroeconomic fundamentals, adequate liquidity, and very strong banking supervision. Since the crisis, the government has adopted even stronger fiscal measures and a new liquidity policy in place of reserve requirements, and renewed its commitment to strong banking supervision.

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The outlook. The recent Argentine banking crisis accelerated a long overdue trend toward consolidation of the banking sector. When the dust settles, the sector's profile should change considerably. The strain on provincial government finances and the losses incurred by provincial banks had long underscored the need to close or privatize these banks, and several smaller provinces had already initiated the process before the crisis. However, most provinces continued to operate their banks for political reasons, and banking regulators could not force their closure within Argentina's federal structure. With financial help from the World Bank and the IDB, the government has been able to help forge a political consensus in favor of provincial bank privatization in a critical mass of provinces. Some 15 provinces have taken legislative action and are at various stages of the privatization/closure process. The existence of provincial banks should be more an exception than the rule within the next three to four years.

Single-branch wholesale banks are also under pressure to merge. However, many of these are well-managed and well-capitalized institutions, and some of them may survive. Cooperative and regional banks are also under pressure to merge and corporatize, to widen and diversify their deposit bases, and to achieve economies of scale.

Argentine banking regulation is generally considered to be stringent. If the authorities continue to forcefully implement existing regulations, while skillfully utilizing the resources available for privatization or mergers, the process of bank consolidation should continue. Competition among banks is more likely to increase as a result, and is likely to be more vigorous within a dynamic MERCOSUR area. The two largest public banks may still retain about a third of market share, and a couple of foreign banks may operate with significant domestic branch networks, but large banks should continue to gain deposits. The retrenchment would force the banks to cut costs, rationalize staff, and introduce much-needed modern technology.

Subject to overall macroeconomic developments, several steps can be taken to hasten the recovery of the Argentine banking system:

- There is a clear need to vigorously implement existing prudential regulation. With a deposit insurance scheme, a consensus in favor of banking reform, the resources to support privatization and consolidation, and a clear demonstration of depositors' preference for size and strength, consolidation will continue.
- Following up on recent reforms in the central bank's liquidity policy, there is merit in expanding sources of liquidity for domestic banks. Areas to explore include partnerships with large foreign banks and other forms of strategic insurance.
- The provincial and federal governments can accelerate privatization and restructuring in anticipation of the privatization of banks they control directly. There is a need to consider the piecemeal sale of branches to many buyers, and to permit buyers greater leeway in the closure of nonviable branches.
- Argentine bank branching regulations need to be modernized to allow replacement of nonviable branches with automated teller machines (ATMs), limited-function or mobile branches, and other, more efficient ways to deliver banking services.
- Argentina has a payments system that relies excessively on cash payments, including payments by the federal and provincial governments for salaries and other expenditures. Greater use of electronic payments and direct debits/credits will augment the core deposit volume and depositor population. F&D