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Banking issues in Argentina

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I. Banks and aggregate credit: what is new?

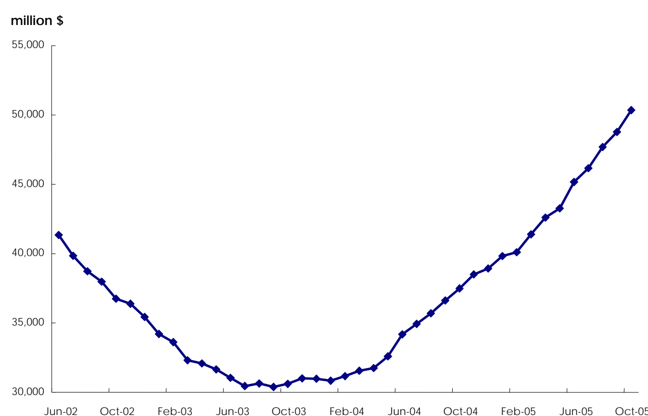
The convertibility plan ended in January 2002 in the middle of a huge social, financial and economic crisis. With a new set of relative prices in place, the economy started its recovery in the second half of 2002. The positive evolution of the economy then allowed the financial sector to begin its recovery from the crisis and since the second half of 2003, private sector credit has been steadily growing again within a framework of strong macroeconomic growth and orderly monetary and fiscal policies.

The subsequent measures implemented by the Central Bank (Banco Central de la República Argentina, BCRA) to foster local credit have had a favorable effect on credit evolution. Amongst the most relevant measures the following can be mentioned: (i) the relaxation of the classification of debtors that refinanced their obligations; (ii) the option for banks to grant new financing above the current limit of 300% of the net capital of the debtor; (iii) the reduction of provisions and of classification of debtors which refinanced their debts with reductions; (iv) the increase of the maximum limit for commercial credits from $200 to $500 thousand, which was established as a criterion so that institutions could apply consumption-portfolio guidelines as regards classification of debtors as well as credit rating and fractioning.

As a result of the favorable macroeconomic context and the measures adopted by the Central Bank, credit to the private sector grew by 25% in 2004, while the accumulated figure in 2005 shows an increment of 36% (yearly; see Chart I.1). Although the sustainable recovery of the financial system continues, there are still short and medium term pending tasks. Even though the expansion of private sector credit has characterized the financial system for the last two years, private loans have only reached around 23% of total assets and approximately 10% of GDP (see Chart I.2). These values are below both domestic historical and international levels. The vast potentiality for expansion of financial activity should materialize together with the introduction of adequate criteria for debtor assessment. These will be key mechanisms for financial system performance in the medium term.

Chart I.1

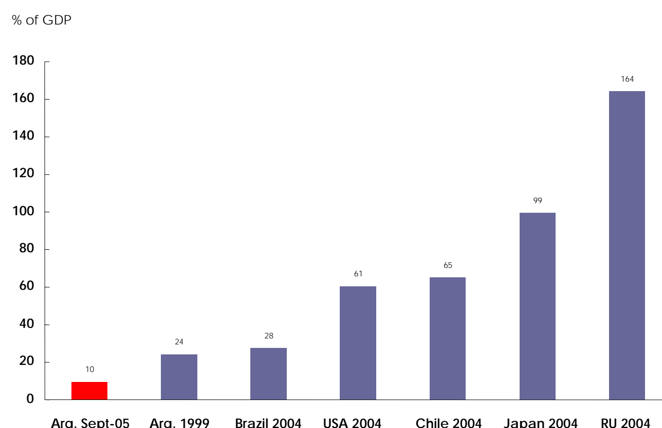
Private Credit Evolution



Source: BCRA

Chart I.2

Loans to Non-Financial Private Sector



Sources: IMF, INDEC and BCRA

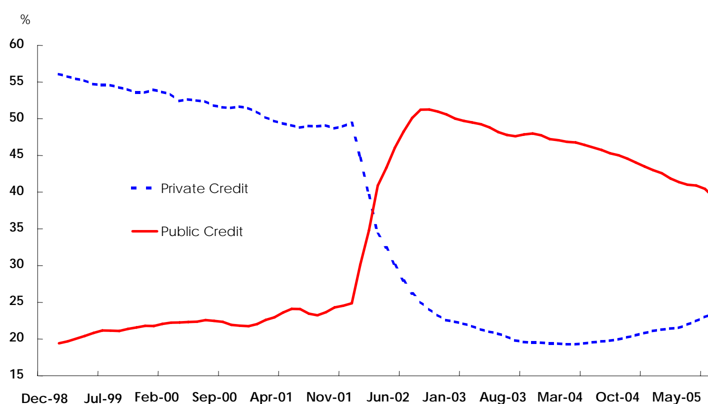
[1] Deputy Governor.

With the purpose of spurring medium and long term private financing, the BCRA is encouraging the reduction of financial institutions' exposure to the public sector. In this sense, it was established that institutions' maximum lending to the public sector should fall below 40% of total assets as from 2006 (see Chart I.3). In addition, the schedule for the valuation of public sector assets at realization value is being implemented, thus improving the quality of balance sheet information and resulting in both a lowering of the portfolio due to revaluation and a major incentive for selling these assets. This last point will also be stimulated by the conclusion of compensations for asymmetric pesification.

Chart I.3

Public and Private Credit Risk

As a % of netted assets - 3-months moving average



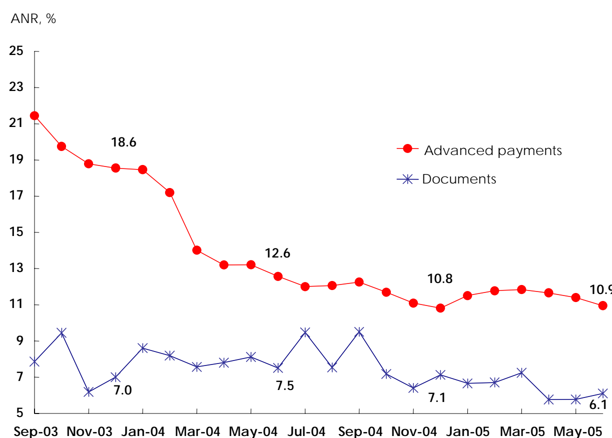
Source: BCRA

As regards costs, a sustainable fall in the interest rates of all credit line categories has been registered in the last three years. In the last few months, the large idle lending capacity of financial institutions together with the lower credit risk of companies has led interest rates paid by the corporate sector to relatively low levels (see Chart I.4).

Chart I.4

Commercial Loans

Margin between lending interest rate
and that of time deposits (less than 59 days)



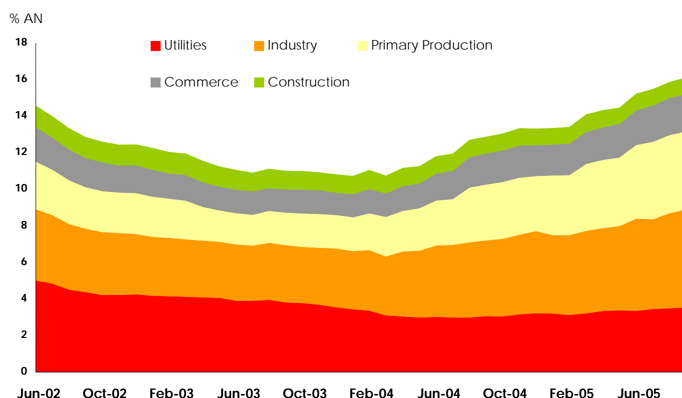
Source: BCRA

The most dynamic sectors in the current macroeconomic context (construction, manufacturing and exports) have access to corporate financing. In this sense, industry and primary production of goods financing represented, in September, 60% of lending to companies (see Chart I.5). Commerce and construction lending remained stable at 13% and 6% respectively. Only the services sector registered a decline in 2005, representing 22% of the financing portfolio. Non-performing loans (NPLs) as a percentage of total financing has steadily been declining as from 2004 in all sectors (see Chart I.6).

Chart I.5

Productive Sectors' Exposure

As a % of netted assets

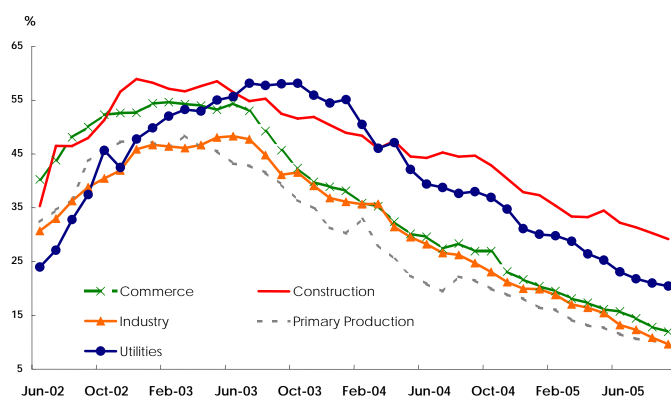


Source: BCRA

Chart I.6

Productive Sectors' NPLs

NPLs Portfolio as a % of financing



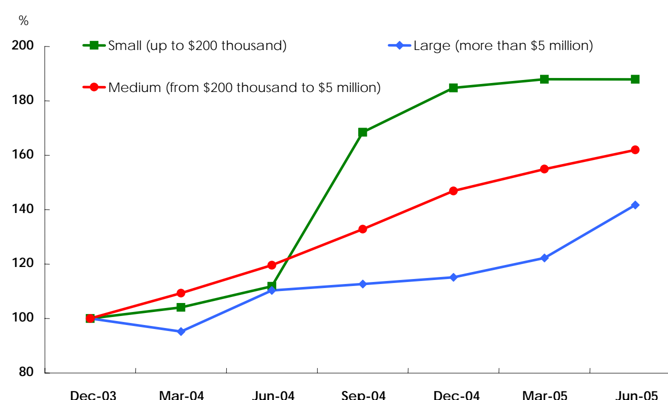
Source: BCRA

Unlike in 2004, in the first half of 2005 credit lines for large companies were responsible for credit growth (see Chart 1.7). This expansion was consistent with the relatively low levels of non-performing loans (NPLs) associated with this type of credit. The appearance of new niches in both the local and export markets will lead to better repayment by these companies.

Chart I.7

Corporate Financing Evolution according to Size

Index Dec-03=100



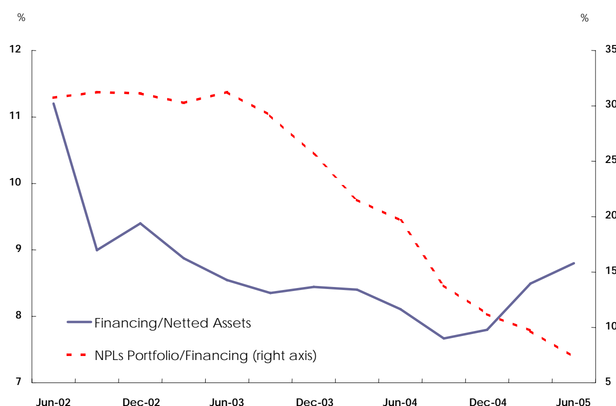
Source: BCRA

Lending to households has shown robust growth, generating an increase of the financial system exposure to individuals' credit risk of nearly 9% of assets in mid 2005 (see Chart I.8). The favorable evolution shown by secured loans (pledge backed loans) should also be mentioned (even though they still represent less than 5% of lending to the household sector) as well as the steady growth of personal loans and credit cards; these categories represent half of household financing. Additionally,

in the third quarter of 2005 the granting of mortgage loans increased for the first time after the crisis (especially because this was being promoted by a small group of strong banks). However, the evolution of the total stock of mortgages is still being affected by significant depreciation.

Chart I.8

Household Sector NPLs and Exposure



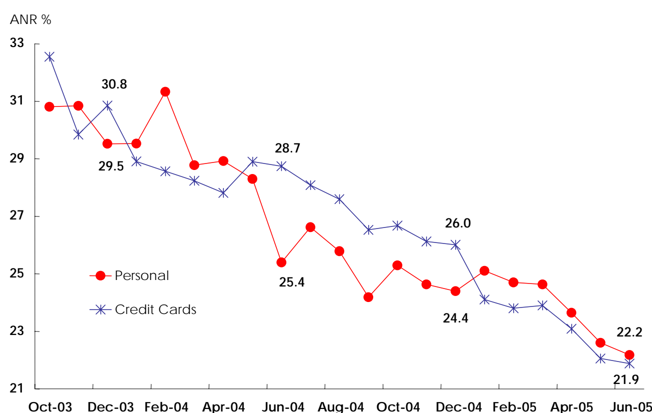
Source: BCRA

The increase of formal employment, with higher salaries, is generating an improvement in household finances. These factors, combined with the strategies of the financial institutions for granting more credit to that sector (concentrating their credit portfolio and thus their counterparty risks), within the framework of higher competition, have led to a steady fall in interest rate costs (see Chart I.9).

Chart I.9

Consumer Loans

Margin between lending interest rate
and that of time deposits (less than 59 days)



Source: BCRA

The decline in interest rates is consistent with the reduction of implicit household credit risk, and for this reason the quality of the portfolio's indicators have improved. The favorable prospects for economic growth for the rest of 2005 and for 2006 have set up an encouraging scenario for the recovery of household lending. As regards demand, the strengthening of the labor market is allowing households to finance a huge proportion of their consumption expenditure through consumer loans. Household lending will remain strong as a result of the good banking liquidity and the optimistic perspectives regarding the risk-return relation for families.

II. Changing Nature of Banks' Risk Exposure

In the last three years the financial system has succeeded in reducing its exposure to potential shocks that could have endangered financial stability. However, in terms of economic activities an increase in domestic interest rates might affect the positive trend reflected by the improved performance of the lending portfolio assigned to the private sector. This kind of shock may further cause adverse effects as a result of a currency mismatch between a financial entity's assets and CER-adjustable liabilities (CER: price-indexed Reference Stabilization Coefficient). In the case of institutions holding marked-to-market government securities, such a shock may even affect their net worth.

The current encouraging macroeconomic framework has given rise to a decrease in the counterparty risk to which the financial system is subject, with continuous improvement in financial institutions' asset quality. Nevertheless, making allowances for the mounting exposure to traded sectors within the economy over the last few years, an international drop in commodity prices or an exchange rate appreciation could reduce their competitiveness or otherwise affect their levels of non-performance. Household lending may be an additional source of potential weakness in the face of a decrease in the rhythm of economic growth. A prudential implementation of lending criteria with an in-depth assessment of related risks may smooth this risk.

As regards market risk, an increasing number of financial institutions are currently assessing the whole of their government securities holdings at market values. Nonetheless, there is a schedule in place to gradually adjust a substantial portion of government securities recorded at accounting values (according to the rule on investment accounts) to market prices. Even though market valuation may cause volatility in financial institutions' results, this effect is well counteracted by the income derived from the better reputation of banks that manage their assets and, therefore, their net worth on a more transparent basis. Prudential management of risks and the fulfillment of pay-in capital requirements for market risk may soften potential effects of these instruments' volatility.

From the viewpoint of currency risk, the BCRA has set out that a financial entity's lending capacity arising from foreign currency denominated deposits shall be basically allocated to those sectors eligible to make reimbursements in foreign currency (manufacturers of goods subject to export). Any lending capacity in excess causes an additional requirement of minimum cash in foreign currency. Thus, financial institutions shall hold such a foreign exchange surplus in cash or else deposit it with the BCRA. This mechanism helped to reduce the risk carried by the financial system over the 1990s: an implied mismatch of foreign currency within the Argentine financial system made the peso devaluation contribute with a remarkable growth of NPLs granted in foreign currency to non-tradable sector economic agents with a yield in pesos.

Over the past year and a half, securitization of assets with private sector risk has been expanded on a domestic basis (government sector securities have also been transferred to trust funds), thus providing institutions with a mechanism for obtaining additional resources to place new loans but with lower credit risk. In addition, banks may channel a portion of their resources through BCRA assets, with immediate liquidity and low maturity. The implementation of these mechanisms reduces the potential risks of financial institutions that receive US dollar denominated deposits. As regards banking liabilities, the BCRA is devoted to encouraging the term-deposit secondary market with a view to providing these instruments with liquidity. This mechanism may allow the attainment of an increase in private placement maturity within the financial system. It is worth mentioning that upon the implementation of a floating rate system, the BCRA role of lender of last resort was fully restored. In connection with the liquidity assistance provided by the BCRA to financial institutions undergoing liquidity problems, the applicable rule has provided for a transparent lending regime.

As far as hedge instruments are concerned, the BCRA is currently devoted to finding market solutions so that financial institutions can hedge against foreign exchange and real interest rate risk exposure. In this sense, it is important to point out that the dollar forward market has been increasingly active.

Focusing on the fact that capital markets and the financial system supplement each other, we may conclude that a widened capital market may help banks to attain longer term funding, which may, in turn, allow enlargement and improvement in the conditions under which banks may furnish loans to companies and households. In this regard, it should be remarked that asset securitization has been gathering momentum (particularly the creation of trust funds out of consumer and mortgage-backed loans).

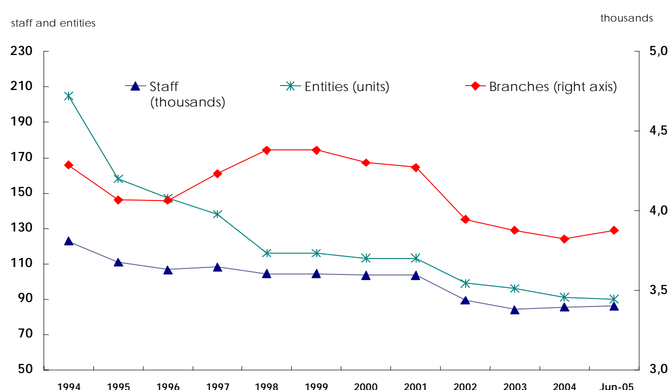
Furthermore, futures and hedge market development is of paramount importance. The need for an adequate and active operation of these markets is particularly relevant to domestic banks with a view to attaining better management of their risks as well as rendering hedging services to their customers. The BCRA has played an active role in spurring forward markets by taking part in them. The dollar futures market has recently started to widen, and the interest rate futures market is expected to do so.

III. An Evaluation of Major Structural Changes

After the Tequila crisis of end-1994, a substantial group of financial institutions, mostly cooperative and provincial banks, withdrew from the market or merged with other institutions which were free of liquidity and/or creditworthiness problems. This situation led to a sizeable reduction in the number of institutions operating in the domestic field (from 205 in 1994 to 138 by December 1997). Moreover, in the second half of the 1990s, large national private institutions were sold to non-residents; consequently, capital inflows entered the financial system. From a global viewpoint, even though the 1998-2000 period showed a slight decrease in the number of institutions making up the financial system, a significant downsizing of its structure only came to pass subsequent to the 2001-2002 crisis (a significant reduction in both branches and staff; see Chart III.1).

Chart III.1

Financial System Structure



Source: BCRA

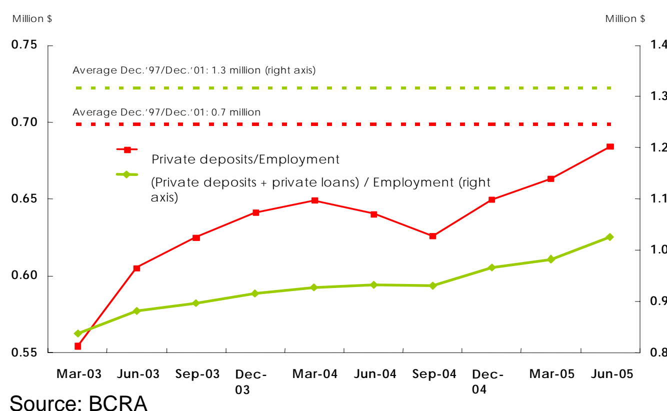
According to the Argentine experience, foreign banks' private financing endured a larger constraint over the 2001-2002 crisis (dropping to less than half of the end-1997 volume) with a slower recovery during the post-crisis period *vis-à-vis* both national private and public banks. Although foreign-owned banks' current participation in the private lending market is the largest, since the period of financial stress (1998-2002) foreign banks have lost almost 7% of their market share, while national private banks have increased their weight (a gain of 10% of that market). This performance has been basically driven by two factors: market and purchase. The former effect accounts for a reduction (in certain cases) in the exposure of foreign banks' portfolios within the domestic economy (supply) and a clear loss of public trust in foreign banks, shifting their confidence to domestic banks (demand). Secondly, a series of mergers and purchases occurred during the post-crisis period; as a result, foreign-owned institutions became banks owned by residents. Accordingly, since 2001, the number of foreign banks has decreased almost by a fourth (seven institutions), while the drop in the number of domestic private banks in the same period was 10% (four institutions).

As from 2004, the aggregate financial system structure paved the way for adapting to the new post-crisis scenario. The level of employment began to grow as from March 2004, consistent with a context characterized by a substantial recovery in the productivity of factors during the previous few years (see Chart III.2), largely related to the process of re-intermediation, effectiveness in the combination and use of factors and technological advances.

Chart III.2

Factor Productivity

At 1999 prices



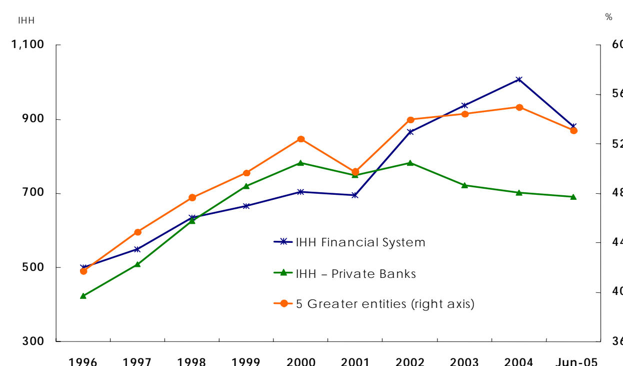
Source: BCRA

Although the financial system as a whole deepened its trend towards concentration as from 2001 (see Chart III.3), due mainly to an increase in the private national banks' market share (larger participation in private deposits) and a series of purchases of foreign banks by private national players, the degree of concentration of deposits in private financial institutions fell over the same period. This behavior was mostly related to the flight of private deposits to public banks (seen as having an implicit guarantee from the government) and the concentration of government deposits in this group of banks. As the public sector, both national and provincial, began to obtain fiscal surpluses, these surpluses became higher amounts of deposits in public banks.

Chart III.3

Financial System Concentration

Deposits



Source: BCRA

New organizational designs for financial institutions face certain challenges from the regulatory and supervisory standpoint. On many occasions, the ownership of Non-Banking Financial Intermediaries (NBFIs - namely, pension and retirement funds, mutual investment funds and insurance companies) and banks has been concentrated in so-called financial conglomerates, which opens the possibility for their members to conduct transactions among themselves, a source of both benefit and cost for consumers and financial stability alike. One of the benefits involves taking advantage of lower costs for production turnover and the unification of activities (administrative and sales activities, *inter alia*), with an impact on the effectiveness of the financial sector. In addition, institutions in good standing with "know your client" policies may offer new services with lower costs for marketing and monitoring.

Nevertheless, there are potential risks connected with conglomeration, as the Argentine financial experience in the 1990s shows us. For instance, large institutions may incur excessive risks in the

hope of a future government bailout, whereby they may endanger the rest of the system. In addition, conglomerates may find ways to avoid complying with certain regulatory aspects by acting among financial segments subject to diverse regulations or taking advantage of legal gaps. On account of these potential effects and their systemic relevance, financial conglomerates are a phenomenon to be monitored with a view to preserving financial stability.

Every type of financial intermediary poses inherent risks which affect their sector and global financial stability, basically due to the existence of different types of sector interconnection. In this respect, investment by type of institution in another, such as acquisition of mutual fund units by pension funds or through their deposits in banks, opens a direct channel by which a sector's liquidity needs may affect those of the rest. In addition, shareholdings among companies from different financial segments constitute another transmission channel. These links make potential vulnerabilities of a conglomerate's company affect profitability, and consequently, it could impact on the group solvency as a whole with possible systemic effects. Furthermore, different regulations within each financial sector could cause distortions, which may lead to inefficient resource allocation. The existence of less-taxed segments or those with relative advantages in their operating system presents arbitration opportunities, especially in a context of growing similarity between financial products.

In terms of Argentina's experience, most banking institutions have shareholdings in pension and retirement funds, insurance companies and/or companies managing mutual investment funds, whereas other banks participate in NBFIs indirectly through related companies or the financial group to which they belong. In fact, on the basis of 90 financial institutions acting in the domestic market, 24 of them hold shares (directly or indirectly) in one or more segments of an NBFI and/or in other banks. This group is segmented as follows: 13 participate in an NBFI or in another bank, six act in two of the above mentioned intermediaries, three in three of them, and the remaining two financial institutions are fully universal.

The domestic conglomeration level is made more prominent in terms of the size of institutions. If only assets administered by NBFIs are considered, more than 60% of them are handled by conglomerates. Making allowances for the fact that larger financial institutions are the main institutions connected with NBFIs, this value reaches 80% in terms of the total amount of financial intermediaries. At the domestic level, the creation of the pension and retirement fund market as from 1994 and the influx of large foreign financial groups in the second half of the 1990s fostered the expansion of this undesirable phenomenon. However, conglomeration is not currently linked with a given type of entity. National private, foreign and public institutions manage 25%, 42% and 33%, respectively, of overall conglomerate assets.

It should be noted that during 2000-2001, an analytical task force reporting to the Ministry of Economy was appointed to analyze the issue of regulation of all domestic financial players. Then, during 2003, a decree was passed implementing a Cabinet for Financial Regulatory and Supervisory Coordination as a forum to discuss and coordinate the action of the Ministry of Economy and different institutions supervising financial services, albeit with a reduced executive capacity.

In terms of financial institutions' supervision by the Superintendence of Financial and Exchange Institutions (SEFyC), it is important to point out that SEFyC implements consolidated regulatory principles. Financial institutions must submit their accounting statements and other relevant data requested pursuant to effective rules on consolidation (on a monthly and quarterly basis). The levels of consolidation are inclusive of an entity's affiliates in the country and abroad, subsidiaries in the country and abroad, and institutions where 12.5% or more of their voting power is under their control. The assessment of an entity's creditworthiness and compliance with technical ratios to determine its eligibility for loan assistance measures any financing supplied to such an entity either directly or through its subsidiaries.

After the outbreak of the crisis, the regulation requiring financial institutions to obtain a certain quarterly rating by an international rating agency, with the intention of fostering market discipline by private agents, was left in abeyance (compiled text for "Evaluation of Financial Institutions" is available at the BCRA web site). The BCRA publishes a monthly Report on Banks with information about financial institutions' balance sheets in addition to quarterly balance sheets on the internet. It also issues a half-yearly Financial Stability Bulletin. These measures encourage private agents to exercise market discipline, generating a framework to channel a growing flow of data available to assess the development of domestic financial institutions and the financial system as a whole.

IV. Is Financial Stability Policy Now Better Placed to Prevent Systemic Banking Crises?

The financial system is gradually overcoming the problems that stemmed from the crisis of 2001-2002. In this manner, although there are still some remnants of the crisis, a new map of the risks managed by the country's financial institutions is emerging. In this context, the Central Bank is focusing its efforts on monitoring both the complete normalization of the banking system and the direction towards which the new developments in financial services are leading.

In a macroeconomic framework where the current trends of growth with low levels of inflation are maintained, it is estimated that over the short run the financial system will continue to exhibit a position strengthened by a global assessment which bears in mind the principal inherent risks. The banking system also shows a growing level of resilience *vis-à-vis* possible negative shocks, which have a small probability of occurring. The combination of both elements leads to the belief that the progress in domestic financial activity will enable completion of the normalization plan in a context in which the principal conditions that make for financial stability will prevail.

During the first half of 2005 the financial system managed to improve its overall balance of risks. In this regard, the principal change during the period was the reduction in the exposure to the public sector and the increased exposure to the private sector. This improved the risk profile of the banking system, due especially to the diversification of portfolios and the contraction of the mismatch in the maturities of assets and liabilities.

On the other hand, the financial system also shows a relatively strong position as regards liquidity risk. The sustained recovery in the confidence of depositors, the high levels of liquid reserves and the deepening of money markets are signs of the good coverage that banks have *vis-à-vis* liquidity risk. In addition, and within a transparent regulatory framework, the Central Bank, by deepening the repo market and in its function as the lender of last resort, has induced a sharp reduction in the probability that an adverse individual liquidity shock will be transformed into a systemic problem.

In the first half of 2005 financial institutions increased their soundness with regard to credit risk. Although the financial system still exhibits a significant exposure to the public sector, the conclusion of the debt restructuring program and the sustained fiscal discipline mean that the most probable scenario over the medium term will be the strengthening of the payment capacity of the public sector. Likewise, the improvement in the quality of the private portfolio, added to a prudent policy of provisioning, led the financial system to show a full coverage of the losses expected from non-performing loans to the private sector. At the same time, the reduced levels of corporations' and families' debt and the low exposure of the banking system to these allow for the statement of a minimal probability of a negative credit shock and a limited impact on capital. In line with the above, during the first half of 2005 the banking system carried out a prudent policy in granting private credit. For example, the expansion of new private credit to companies with an adequate financial position reflects the increase in the exposure to credit risk on a sound basis.

On the other hand, the financial system has achieved few advances in reducing its exposure to real interest rate risk. However, the possible scenario that includes increases in real interest rates beginning to have some impact on the solvency of the financial system has a very small probability of occurring.

These developments in the financial system, and the probabilities assigned to each of these scenarios, are consistent with a scenario in which a positive macroeconomic performance is maintained. In this regard, both monetary discipline and the continuity of fiscal responsibility will be the key points that will define the total normalization and healthy expansion of financial activity.

Financial institutions have been recovering their levels of profits at a sustained pace during the post-crisis period. In the first half of 2005, for the first time after the crisis, the banking system registered half-year profits. The continued progress in terms of results, added to the sustained process of capitalizations carried out by financial institutions, make up a framework of a sustained solvency margin, increasing resilience to negative shocks.

For the next few months and years the most probable scenario in which the financial system may operate will boost the consolidation of the recovery of financial institutions, while promoting the necessary conditions for financial stability. However, the financial system should focus its efforts on the continued recovery of its portfolio of assets and in lessening the mismatch in real interest rates. Overcoming these challenges will contribute greatly to the strengthening of the financial system. For

this purpose, the Central Bank is promoting market mechanisms to support the financial institutions that overcome these weaknesses, by providing a realistic framework for the short and medium term.

Within that framework, the policy implemented by the Central Bank includes minimum capital regulatory requirements for credit, market and interest rate risks (these regulations are, in certain cases, subject to phased compliance). In addition to credit risk requirements, financial entities must pay in capital on account of interest rate risk. Interest rate risk capital requirements are set so as to put a cap on the risk arising from the sensitiveness ("duration") of assets *vis-à-vis* changes in the interest rate, when such sensitiveness is not in line with that of liabilities. On the other hand, minimum capital requirements are designed to cover the market risk of entities' portfolios measured according to their risk value (VaR). The US dollar is included as a foreign currency for the purposes of complying with the market risk capital requirements by taking into account all US dollar denominated assets and liabilities.

Finally, the prudential regulatory system provides that, in order to reduce entities' credit risk exposure for changes in exchange rates (taking into account the currency mismatch that characterized the financial system in the 1990s and that caused several problems in the most recent financial crisis), their lending capacity arising from foreign currency denominated deposits shall be basically allocated to those sectors eligible to make reimbursements in foreign currency (manufacturers of goods subject to export). Lending capacity in excess causes an additional requirement of minimum cash in foreign currency. Thus, financial entities shall hold such a foreign exchange amount in cash or else deposit it with the BCRA. The implementation of all these policies and measures, in the above mentioned healthy framework of macroeconomic growth, give us confidence that the economy is now better placed to prevent and face a systemic banking crisis.