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Transforming Bad Banks into Good Banks: Lessons from the Chilean Financial Crisis

Philip L. Brock

Department of Economics
University of Washington
Seattle, Washington 98195
plbrock@u.washington.edu

Abstract

This paper provides a narrative account of the 1980s Chilean banking crisis. The Chilean crisis saw the nationalization of the two largest financial conglomerates and resulted in more than half of the financial system's assets and liabilities falling under direct control of the government. The paper provides details of the bank rescue measures as well as the resolution of the banks' nonperforming debt problem. By providing a detailed chronology of the financial crisis, the paper highlights the evolutionary process that characterized the interventions taken by the Chilean authorities to restore the financial system to solvency. Despite the pessimism that accompanied the early stages of the banking crisis, the fifteen-year process of intervention, restructuring, and recapitalization left the financial system well-positioned to finance Chile's economic growth, which averaged six percent per year (in real terms) for the 20 years following 1985.

1. Introduction

On January 13, 1983 the Chilean government took over the flagship banks of the two largest economic groups in Chile, intervened in another three smaller banks, and forced the liquidation of another three financial institutions. Government authorities then took control of the business groups by refusing to renew thirty-day loans to the companies affiliated with the banks, thereby forcing them into bankruptcy. On this day Chile's initial experiment with bank privatization, which began in 1975, came to an end.

This paper provides a narrative account of the twenty year period of bank privatization in Chile. Previous papers—especially Larraín (1989) and Velasco (1991)—have provided accounts of the financial interventions up to the late 1980s but not of the final recapitalization of the banks that took place in 1996.[1] Sanhueza (1999), Barandiarán and Hernández (1999), and Reinstein and Rosende (2000) are comprehensive studies of the financial crisis, but they do not focus on the chronology of the crisis and its resolution. This paper gives an accessible narrative account of the events between 1975 and 1996 that are important for understanding the 1981-1985 crisis and its ten-year resolution. The paper's focus on the evolution of policies over time gives a sense of the shifting nature of the government's initial response to the financial crisis, as well as the more deliberate process that ultimately led to the successful resolution of the crisis following 1985.

The paper proceeds as follows. Section 2 describes the Allende government's nationalization of the banks and the military government's subsequent privatization plan. Section 3 covers the run-up to the 1981-83 financial crisis and details the initial measures taken to rescue the banks. Section 4 discusses the resurgence of protectionist trade policies during 1982-1984. Section 5 chronicles the steps taken to recapitalize the financial system during 1985-96, including measures to write down dollar loans and emergency central bank loans. Section 6 concludes.

[1] See also Arellano (1984), Larroulet (1987), Brock (1989), De la Cuadra and Valdés (1992), and Fontaine (1995).

2. The 1974-75 Economic Crisis and Bank Privatization

When the Popular Unity government of Salvador Allende took power in November 1970, a prime objective was to obtain state control of the banks. Although the government had no power to nationalize the banks, it authorized the Chilean Development Corporation (Corfo), a state agency, to buy bank shares at attractive prices. The central bank opened a special line of credit with the Banco del Estado for this purpose. Simultaneously, the government began to intervene in banks, citing either financial irregularities or labor problems, thereby signaling an intention to harass banks that attempted to remain private. By using this carrot and stick approach the government obtained majority control of fourteen banks (which accounted for about 90 percent of all bank credit) as well as minority participation in three other banks by the end of 1971. In addition to these banks, the government controlled the savings and loan system (SINAP), the Banco del Estado, as well as several other public credit institutions (Meller 1996, 147-49).

Following the nationalization of the banks, the government targeted credit toward the social (state) sector of the economy, so that at the time of the military coup in September 1973 about 50 percent of bank credit was directed toward the state at a five percent nominal annual interest rate. Given the annual inflation rates of 163 percent in 1972 and 508 percent in 1973, this bank credit was extended at very negative real rates. At the same time, commercial bank lending was capped in nominal terms by the use of credit ceilings by the Central Bank. On the margin domestic credit was extended solely by the central bank, with commercial banks being relegated to the role of administrating the credit.

By the time of the military coup in September 1973, the financial system had become severely repressed and decapitalized. The decapitalization of banks worsened as the economy moved toward a severe recession in which GDP fell by 13 percent in 1975. During the height of the recession the government began the process of privatizing the banks that had been nationalized by the Allende government. The shares of the nationalized banks were held by the Chilean Development Corporation (Corfo). The first notices of the sale appeared in the press in July 1975 (Valdés 1988). The terms of the sale were 20 percent down with the remainder to be paid in 8 quarterly installments. Corfo lent the remainder at an inflation-indexed (real) interest rate of 8 percent.[2]

A law passed in December 1974 had limited concentration of ownership in banking to 1.5 percent for a natural person and 3 percent for a judicial person. Nevertheless, these provisions were circumvented by the creation of shell companies and interlocking groups of firms, with the tacit blessing of the government (the law was rescinded in 1978). Ownership of banks became highly concentrated and banks were highly leveraged. Lüders (1990) refers to this privatization as the debt-led divestiture of government-controlled banks. Partially as a result of the high leverage, banks were undercapitalized and subject to tight liquidity constraints.

In spite of some of these problems, the privatization process of the banks in 1975 and early 1976 initially appeared to have been a structural success which also generated revenue for the government from the sale of the banks. But subsequent behavior by banks demonstrated the existence of deep-seated problems tied to connected lending. For example, in January 1977 the Central Bank intervened in the operations of Banco Osorno. The intervention was associated with the failure of an informal sector financiera named Manuel Rodríguez. The owners of Banco Osorno had used funds from Manuel Rodríguez (which they also owned) to purchase Banco Osorno from Corfo, thereby circumventing Corfo's capital and concentration requirements.

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[2] There is evidence that the highly-leveraged purchases resulted in inflated prices for the banks. Corfo had set the book value of the banks as the minimum bid price, which substantially exceeded the value of most banks based on stock market values. Between September 1975 and February 1976 eleven banks were sold to the private sector for $118 million dollars, a figure which substantially exceeded Corfo's own estimate prior to the sale.

One of the first systemic indicators of a financial sector problem was the very high loan rate following the privatization. Column (4) of Table 1 indicates an impressively rapid growth of private domestic credit, starting from a low base. Nevertheless, column (5) indicates that the simple rolling over of the July 1976 stock of private domestic credit at the real loan rate would account for about 80 percent of the observed increase between July 1976 and June 1979.[3]

De la Cuadra and Valdés (1992) have noted that contemporaneous rumors in the Chilean press suggested that between 10 and 15 percent of the banking system's loan portfolio was non-performing. Harberger (1985) maintained that this non-performing loan portfolio created a "false" demand for credit: banks rolled over the loans and capitalized the interest payment with the loans, even though the loans would never be paid. De la Cuadra and Valdés (1992, p. 69) have argued that the real growth of the banking system's loans would have partially diluted the bad loans. If the non-performing loans had been 10 percent of the banking system's portfolio in 1977, by 1979 they would have only been 7.7 percent. Even if the bad loans were not creating a "bubble" in the banking system, the volume of bad loans in June 1979 almost certainly compromised much of the banking system's book value capital.[4] This sort of balance sheet weakness created a moral hazard that increased bankers' incentives for risk-taking and for over-extension of new credit.

3. The 1981-83 Economic Crisis and Bank Rescue

Following the intervention in Banco Osorno in 1977, the Superintendency of Banks began a several year process to improve bank supervision. In early 1978 revisions to the banking law required that all banks have external audits whose results would be published in nationally-circulated newspapers. In early 1979 Price Waterhouse reported that Banco Español was in

[3] That is, approximately $(79+45+32)/(90+79+21) \approx 0.8$ of the increase in credit could be attributed to this rollover of credit.

[4] It was not until the period between July 1979 and June 1981 that domestic credit to the private sector outstripped the real loan rate. In those two years the real stock of private sector domestic credit doubled while the cumulative real loan

excellent condition. But a year later the 1980 audit reported that 37 percent of the loans were of doubtful quality. Following this revelation, the Superintendency required banks to rate the quality of their 30 largest loans on a risk scale from A to D. Several institutions were unable to identify their borrowers or to document the uses of the loans. The Superindency then expanded the loan classification requirement in June 1980 to the largest 80 loans of each bank, and then to the 300 largest in April 1981. The information revealed by the loan classifications resulted in the November 1981 government intervention in eight banks and financieras that represented thirteen percent of the banking system's assets (De la Cuadra and Valdés 1992).

Bank regulations were further tightened in late 1981 to place strict limits on the concentration of ownership of banks, thereby attempting to reverse the initial concentration that took place at the time of the 1975 privatization. The stricter guidelines on ownership concentration and on information provision on loan portfolios went into force as the economy slipped into recession in late 1981. The subsequent 1982 world recession and high dollar interest rates added to the severity of the banking collapse by making the fixed exchange rate impossible to defend.

On June 15, 1982 Chile devalued its exchange rate by 15 percent. At the time of the devaluation the government created a preferential dollar exchange rate for dollar debtors. This step was taken because of the government's previous implicit guarantee that the 39 peso/dollar fixed exchange rate would be a permanent anchor for the economy. In addition, on September 1 the Superintendency of Banks and Financial Institutions allowed banks to use the June 30 exchange rate when calculating the peso value of their dollar liabilities. This represented a 35 percent underestimation of the value of dollar liabilities by the end of 1982, but prevented a number of banks from violating minimum regulatory capital ratios. Banks were originally to provision against these losses by the end of 1982, but were later given an extension until the end of 1986.

rate was less than 40 percent. It should be noted that this expansion occurred after the June1979 fixing of the exchange rate and involved extensive dollar borrowing.

On July 12, 1982, two weeks after the devaluation the central bank announced (Accord 1450) that it would buy part of a bank's nonperforming loan portfolio at face value. As a counterpart to this transaction the bank would agree to buy back the portfolio over a period of three to five years. The repayment terms were UF + 16.5 percent for peso loans (where UF, Unidad de Fomento, is an indexation mechanism that is tied to the consumer price index) and LIBOR + 6 percent for dollar loans. This action improved the balance sheets of banks by replacing nonperforming assets with a central bank bond, but because the central bank bond was not interest bearing and was not transferable, there was no transfer of resources to the banks. There was, of course, a contingent transfer created for those banks that would not be able to repurchase their nonperforming loans within the three to five year period.

The intervention in the flagship banks of the two largest economic conglomerates (Banco de Chile of the Vial group and Banco de Santiago of the Cruzat-Larraín group) on January 13, 1983 terminated the creation of shell companies and other measures that were being used to evade prudential regulations. This step resulted in more than 50 percent of financial system assets and liabilities falling under direct control of the government and the additional explicit state backing of the liabilities of the remaining institutions. The step also gave the government control of a number of the largest firms in the economy.

A major departure of the government from its previous policy that all bank debt, both external and domestic, was private and not guaranteed by the government came shortly after the bank interventions. Law number 18,203 of January 15, 1983 extended the government's guarantee to bank deposits and other liabilities. Although the law created a huge contingent liability for the government, it prevented a run on the banks and converted the banks' external debt into sovereign debt that would prevent the forced liquidation of banks by foreign creditors.

By early 1983 it had become clear that many debtors would not be able to repay their loans at the contracted terms. In response to the growing threat of a widespread debtor revolt, the government announced a "productive debtor" restructuring plan (Accord 1507) on April 12, 1983. The plan rescheduled 30 percent of an eligible company's debts at UF + 7 percent for a period of 11 years, with a one-year grace period for interest and a five-year grace period for principal. To provide the banks with an incentive to restructure the debts, the Central Bank lent the banks an amount equivalent to the restructured loans at UF + 5 percent (with the same grace periods as the restructured loans). As counterpart to this operation, the banks were required to use the Central Bank's loan to buy 6-year Central Bank pagarés that paid UF + 12 percent. The operation, therefore, did not result in an immediate expansion of domestic credit but rather created a flow subsidy to the banks of 7 percent (12-5) of the amount of the restructured loans.[5]

The last major stabilization measure involved the creation of a program for home mortgages (Accord 1517, June 29, 1983) that rescheduled unpaid installments since 1981. Restructured mortgages were made at UF + 8 percent with a maturity that was extended to incorporate the unpaid installments.

By one year after the June 1982 devaluation, all the stabilization measures were in place for the financial system. Three of the programs were substantially modified during the second year following the devaluation. The repurchase of banks' bad debt was expanded on February 9, 1984 (Accord 1555), the productive debtor plan was extended in June 1984, and the home mortgage refinancing plan was augmented in July 1984. However, none of these stabilization measures resulted in any restructuring of the financial system. The largest banks and the largest enterprises were still in limbo, under temporary government control but without any plan to restore private ownership.

[5] This flow subsidy was the carrot to encourage the banks to restructure their loans. Out of 130,150 eligible debtors, 48,200 participated in the program, with about 39 percent of the eligible debt reprogrammed.

4. Trade Policy

Trade policy during 1982-1984 tended to mirror the general confusion in the government regarding the appropriate response to the economic crisis. During this period Chilean policy turned the economy increasingly inward. Former president Alessandri (1958-64) and other conservatives argued that the economy needed to return to restrictive tariffs. In mid-November 1982 the government abandoned the uniform 10 percent tariff and imposed duties on 20 products (20 percent on canned fish products, 31 percent on cement, 12 percent on matches, etc.). On March 24, 1983 the tariff was raised to a uniform 20 percent for a period that was to last until October 1984. Both of these measures were undertaken by finance ministers who essentially represented continuity with the economic liberalization undertaken during the 1970s and early 1980s.

On July 19, 1984 an avowedly protectionist minister raised the tariff to 35 percent on 240 "luxury" imports. The plan was to set up a system of differential tariffs that could be used to create high effective rates of protection for favored industries. A large outcry by manufacturers forced an abandonment of the differential tariffs in favor of a uniform 35 percent tariff.[6] On September 17, two years and three months after the initial devaluation, the economic team announced the 35 percent tariff and simultaneously devalued the exchange rate by 20 percent (from 93 to 115 pesos/dollar). The devaluation was a hastily chosen measure in response to a rapidly deteriorating trade balance which had fallen from a surplus of US$230 million during each of the first and second quarters of 1984 to $3 million in July and negative $57.1 million in August. The decline in the trade balance rapidly reduced the Central Bank's international reserves and jeopardized Chile's standby loan program with the IMF.

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[6] See Lederman and Edwards (1998) for an extensive discussion of tariff policy during this time period.

During the fourth quarter of 1984 the inflation rate rose to 51 percent (compared to 14 percent during the first half of the year) and by November and December ex-post real interbank rates were about 28 percent (compared to an average ex-post real rate of 12 percent for the first half of the year). By the end of 1984 the finance minister and economy minister were publicly quarreling about economic policy, leading the IMF team in charge of negotiating the standby agreement to let it be known that it wanted to hear a single voice. (*Latin American Weekly Report*, 12/14/1984)

5. Recapitalizing the Financial System, 1985-1996

After a cumulative 15 percent decline in 1982 and 1983, real GDP grew by 6.3 percent in 1984.[7] But Table 2 shows that the resumption of growth in 1984 was a false indicator of the Chilean economy's recovery: the growth was accompanied by a worsening of the trade balance, an increase of the current account deficit to 10.7 percent of GDP, and an increase in the fiscal deficit.

The crisis that Chile faced in the latter half of 1984 was due to an economy whose recovery was running out of steam in the face of great uncertainty regarding the allocation of financial system losses, the ownership of firms, and the direction of trade policy. Economic policies undertaken in Chile during the two years following the initial devaluation had succeeded in temporarily stabilizing the economy. The stabilization of the financial system consisted largely of short-term and long-term measures to ensure the liquidity of the system. Although the restoration of liquidity stabilized the means-of-payment function of the banking system and prevented bank runs, even long-term assistance to banks and debtors was failing to address the underlying solvency problems in the financial system. Moving from stabilization to restructuring of the financial system required a policy switch away from liquidity provision toward an emphasis on the resolution of private ownership rights, including the adoption of mechanisms to allocate financial losses among

[7] During 1982 and 1983 real domestic expenditure fell by 25 percent, reflecting the sharp decline of capital inflows to the economy.

shareholders, foreign and domestic debtholders, and taxpayers (via operations of the central bank or treasury). It also required a clear signal on the direction of trade policy.

When a new finance minister was appointed in early 1985, he quickly addressed the issue of trade policy by reducing tariffs to 30 percent in March 1985 and lowering them again on January 1, 1986 to a pre-announced level of 25 percent. The resolution of property rights and the allocation of financial losses also began in earnest in 1985. Two of the important structural adjustments that took place in the financial system beginning in 1985 concerned the treatment of dollar loans and emergency central bank loans to the banks.[8]

Dollar Loans

At the time of the June 1982 devaluation commercial banks' dollar liabilities accounted for half of Chile's external debt. The commercial banks' dollar liabilities had been passed on to domestic borrowers as dollar loans. The real depreciation of the exchange rate hurt the ability of borrowers (especially those in nontraded activities) to repay dollar loans. The Central Bank responded, as discussed above, by establishing a preferential exchange rate for dollar borrowers. The favorable treatment given to dollar debtors was augmented in an important way during the middle of 1984. On May 25th of that year a plan to reprogram loans permitted dollar loans up to US $540,000 to be converted into CPI-indexed loans, with the Central Bank bearing the risk of a real devaluation of the currency. Ambiguous wording in the law allowed four banks to expand the loan conversion plan beyond its original intent, so that they undertook US $200 million in loan conversions between the beginning of August and mid-September. At the time of the 20 percent devaluation in mid-September, other banks demanded equal treatment and all banks were given until

[8] Under the new finance minister fiscal austerity was also renewed. Domestic expenditure fell relative to output and, as a consequence, the trade account swung from a deficit of 1.1 percent of GDP in 1984 to a surplus of 2.8 percent in 1985. These trade surpluses were maintained throughout the remainder of the 1980s. The move from trade deficit to trade surplus required an additional 25 percent depreciation of the real exchange rate in order to switch expenditure away from traded goods. See Table 2, column 6: 61 (1986)/86 (1984).

October 15 to convert eligible dollar loans into CPI-indexed loans at the pre-devaluation exchange rate.

When the new finance minister took over in 1985 he pressed the argument with foreign creditors that the Chilean government had provided assistance of US$3.4 billion (about 20 percent of Chile’s GDP) to help borrowers repay their dollar loans, and that now it was time for the creditor banks to bear their share of the losses. The creditor banks were pressing Chile to renew its guarantee on the Chilean banks' debt, especially since much of the debt was maturing during 1985-87. (*Latin America Weekly Report*, 5/31/1985) Out of this negotiation came Chile's agreement to renew its guarantee on bank debt, combined with creditor banks' tacit approval for the creation of debt buyback and debt-equity conversion mechanisms. Between mid-1985 and mid-1987 about US$3.2 billion of bank debt was written down or converted into equity by these mechanisms at market discounts of about 30 percent (Larraín and Velasco 1990).

The preferential exchange rate, the conversion of dollar loans into CPI-indexed loans, and the debt buyback/debt-equity conversion mechanisms were three important ways in which the Central Bank rescued dollar debtors. Without these rescue measures, it is questionable whether the observed stabilization and subsequent recovery of the financial sector would have taken place.

Subordinated Debt

Between 1982 and 1984 seventeen private national banks sold nonperforming loans to the Central Bank in exchange for Central Bank bonds, as shown in Table 3. The two largest banks, Banco de Santiago and Banco de Chile, were among the banks with the worst loan portfolios. During the first half of 1984 a special commission created to propose solutions to the problem of the intervened banks recommended capitalizing a portion of the Central Bank's loans to those banks. The proposals resulted in the passage on January 26, 1985 of the law on "popular capitalism" (Law

18,401). The law provided a mechanism for recapitalizing four of the five intervened banks.[9] The law allowed the Superintendency to require that banks be recapitalized to a level that made them financially viable. Existing stockholders had first claim on stock purchases, followed by third parties. The remainder of the stock was given to Corfo (the Chilean Development Corporation), which purchased a nominal amount equivalent to the Central Bank's emergency credits to the intervened banks (so that the emergency credits were capitalized).

The capital was then sold in small amounts to individual investors. A down payment of five percent was required, with the remainder of the financing provided by Corfo over 10 years at UF + 5 percent. Buyers with no tax arrears could finance the purchase over 15 years at UF + 0 percent. In addition, dividends were exempt from taxes. Hachette and Lüders (1993) have estimated the government's subsidy was about 40 percent of the cost of the shares, which could be justified partly as an offset to the future tax liabilities associated with the bank bailout.

The law created three classes of shares. Class 'A' shares were pre-intervention shares and could not pay dividends until a bank's loans from the Central Bank had been repaid. Class 'B' shares, the shares created by popular capitalism, were entitled to dividends from operating profits that remained after paying back the installment on the Central Bank's loans. Class 'C' shares were issued to new investors (who had not used the popular capitalism program) and had equal claim with the Central Bank to dividends based on operating profits. Because the government was worried about the difficulty of attracting new equity capital for the banks, the law specified that the new 'popular' capitalists could choose to capitalize their dividends. The capitalized dividends would automatically turn into class 'C' shares. By December 31, 1986 all the new shares of stock had been sold. The number of stockholders in Banco de Chile increased from 17,700 to 39,222 and in Banco de Santiago from 15 to 15,871.

[9] These were Banco de Chile, de Santiago, Internacional, and Concepción. The fifth bank, Colocadora Nacional de Valores was merged with Banco de Santiago.

The sale of the nonperforming loan portfolio to the Central Bank during 1982-1984 carried with it an obligation to repurchase the portfolio over a contractually set period of a number of years. If at any point a bank failed to make its yearly payment, the Central Bank could seize control of the bank. In 1989 the outgoing military government redrafted the agreements between the banks and the Central Bank. In place of a fixed obligation, the new law created 'subordinated debt' that was equal in nominal value to the fixed obligation, but which had no fixed timetable of payments. The new contracts with the Central Bank were guaranteed protection by the law against unilateral changes by the Central Bank. In the cases of Banco Santiago and Banco de Chile, the Central Bank was entitled to 70 percent of operating profits, with the remaining 30 percent going to holders of class B stock (the popular capitalists). For these heavily indebted banks, as well as for Banco Concepción, BHIF, and Banco Internacional, there was effectively no date at which the subordinated debt would ever be repaid.

When the newly-elected democratic government took power in 1990, one of the pressing issues was an acceptable resolution of the subordinated debt problem. Table 4 shows that the total value of the subordinated debt of eleven banks in 1991 reached about US$3.3 billion while the value of paid-in capital was only $1.3 billion. In September 1991 the finance minister stated that the problem needed to be solved right away (*El Mercurio*, 8 Sept. 1991). Despite renewed efforts in 1992 and 1993, the government made no appreciable progress in drafting a law that would replace the subordinated debt law and which would be acceptable to the banks.

The subordinated debt law maintained the right of stockholders to automatically capitalize their dividends. In 1994 the class 'B' shareholders of Banco de Chile and Banco Santiago voted to capitalize their dividends and receive class 'C' shares in return. Both because the Central Bank feared the loss of income associated with class 'C' shares and because it wished to prevent the growth of the capital base (and loan capacity) of the two banks, the Central Bank viewed the capitalization of dividends as a threat.

In response the government passed a law in early 1995 prohibiting stockholders from capitalizing dividends until the subordinated debt obligation was extinguished. The Constitutional Tribunal proceeded to declare the law unconstitutional. The government then entered into talks with the banks which produced an agreement in April 1995 to solve the subordinated debt problem. The solution (which was eventually embodied in Law 19,396) created mechanisms for the banks to repay part of their debt in exchange for forgiveness of the remainder. The banks also had the opportunity to repay the value of their debt in 40 annual installments. The law established a July 23, 1996 deadline for coming to an agreement with the Central Bank (July 18, 1997 for banks that chose to merge with another bank).

During the intense period of negotiations in June 1996, the Central Bank president became convinced that the banks were being let off too easy, to the detriment of the Central Bank's net worth. The Central Bank president resigned on June 28 over this issue and left his successor to negotiate the final agreements. Banco Santiago eventually agreed to give the Central Bank a greater proportion of its shares (38.5 instead of 35.5 percent) as its payment to extinguish the debt.

Of the total subordinated debt obligation of about US$4.6 billion, the Banco de Chile agreed to pay off its debt of US$1.7 billion in equal installments of $100 million over forty years. Of the remaining $2.9 billion of subordinated debt, the Central Bank wrote off approximately US$1.6 billion as follows: a US$200 million writeoff for BHIF in exchange for a payment of US$174 million, a $480 million writeoff for Banco Concepción in exchange for a payment of $170 million, a $106 million writeoff for Banco Internacional in exchange for a payment of $25 million, and a $800 million writeoff for Banco Santiago in exchange for stock with an estimated value of $900 million.

The intervention and recapitalization of the largest banks altered the ownership structure of the Chilean economy. The Cruzat-Larraín group, which had controlled Banco Santiago, lost 90 percent of its assets and control over the bank. In 1996 control of Banco Santiago passed to the Luksic group, which controlled Banco O'Higgins and emerged during the mid-1980s as one of the dynamic groups. The Vial group lost control of Banco de Chile and approximately 30 nonfinancial companies. Other groups, such as Grupo Angelini, also emerged stronger from the financial restructuring process.

6. Conclusion

Bank privatization in 1975 in Chile had as its goal the transfer of decision-making authority from the government to the private sector. This goal reflected a belief that state-owned banks did not have the incentives to choose investment projects as well as the private sector, and that the public sector could not impose hard budget constraints on these state-controlled banks.

The privatization of banks in Chile accompanied a significant trade liberalization as well as other reforms. These reforms tried to decentralize decision making in the economy. The reforms envisioned that entrepreneurs would actively search out new products for which there was an international market, and banks would provide the financing to channel resources toward new productive activities. In practice, the initial bank privatization turned out to be a temporary privatization: the Central Bank was forced to intervene in the operations of privatized banks, first in 1977 in Banco Osorno and then during 1981-83 in numerous banks, because privatized banks became insolvent or undercapitalized.

The process by which the 1975 privatizations led to the future bailouts by the government was tied to the contingent nature of the transfer of ownership to the private sector. When banks were sold it was not clear to what extent the government would protect depositors and other lenders to the banks. The bailout of Banco Osorno in January 1977 was a watershed event in the post-privatization process because it solidified the implicit understanding that public money would be used to help banks in trouble. That understanding and the difficulty of implementing prudential supervision of banks between 1978 and 1980 created a contingent government guarantee that was valuable to bank owners who wished to loan to risky projects or to expand bank assets much faster than was prudent. The bank bailouts of 1981-83 were created by a series of pressures and policy decisions that turned the contingent guarantee to protect depositors and other creditors into a realized guarantee and which, in the process, returned the control of the banks to the government.

By 1984 it appeared questionable whether Chile was capable of resolving the financial crisis in a stable macroeconomic environment. It was only in 1985 when the debt conversion plans transferred some of the losses to foreign banks that the recapitalization of Chilean banks began to involve private lenders rather than the government. In addition, the Popular Capitalism program effectively transferred a substantial amount of the bad debt of the intervened banks off the balance sheet of the Central Bank and onto the balance sheet of Corfo (the Chilean Development Corporation). Finally, individual banks were forced to recapitalize themselves by repurchasing the nonperforming loans that they had sold to the Central Bank during 1982-1984. When the remaining subordinated debt was extinguished in 1996 the banks were better capitalized and supervised than had been the case 20 years earlier.[10]

Despite the pessimism that accompanied the early stages of the banking crisis, the fifteen-year process of intervention, restructuring, and recapitalization left the financial system well-positioned to finance the economy's economic expansion, which averaged six percent per year (in real terms) during the 20 years following 1985.

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[10] Bergoeing, Kehoe, Kehoe, and Soto (2002) find that Chile's willingness "to pay the cost of reforming its banking system and of letting inefficient firms go bankrupt" was a key difference between the responses of Chile and Mexico to their respective financial crises in the 1980s. The Chilean financial reforms led to much higher productivity (TFP) growth than in Mexico between 1987 and 1995. See also Corbo and Schmidt-Hebbel (2003) for corroborating results.

Detailed Chronology of Events:
Bank Intervention and Recapitalization

March 1979: The Superintendency prohibits the accrual of interest on delinquent loans.

February 1, 1980: The Superintendency establishes an experimental loan classification system in which each bank must classify, on a scale from A to D, its thirty largest individual debtors. (Circular 1662, Superintendencia de Bancos)

June 1980: The Superintendency requests that the classification be extended to the largest 80 debtors of each bank.

April 20, 1981: The Superintendency requires the classification of the 300 largest debtors and introduces classification procedures for both consumer and housing mortgage loan portfolios. (Circular 1732)

May 1981: CRAV group (Sugar refinery) fails, threatening to pull down some banks.

August 1981: The military junta approves an amendment to the banking law which states:
"Failure to diversify loans away from persons and societies linked, either directly or indirectly, to a bank through ownership or management will signify that the bank is managed in a deficient way." (*Latin American Weekly Report* 9/11/81).

September 14, 1981: In response to the August amendment to the banking law, the Superintendency issues a circular (1749) which delimits connected lending and drastically curtails its use by the financial groups. Banks are given three months to comply. In response, banks set up many shell companies.

November 1981: As a direct result of the loan classification procedure, the Superintendency takes over eight banks and financieras (of which Banco Español is the largest). These institutions account for 13 percent of financial system loans.

March 11, 1982: Loan loss provisioning is permitted to take place over 36 months, as a result of the rising quantity of bad loans (Circular 1786).

June 15, 1982: The peso is devalued.
A preferential dollar exchange rate is established to help dollar debtors pay back their debts.

June 18, 1982: The Superintendency announces a new limit on connected lending of 5 percent of total loans, which must be met by a five semester plan (Circular 1808).

June 30, 1982: The Central Bank begins to pay interest on reserve requirements at the average deposit rate of interest. The payment is made with non-transferable Central Bank pagarés of five year maturity that pay UF + 5 (UF is a CPI-based unit of account).

July 12, 1982: The Central Bank begins to buy bank's loan portfolios at face value, with the provision that the banks must repurchase the loans at face value over time with 100 percent of their profits. The terms: UF +16.5 for peso loans, LIBOR + 6 (repayment periods of 3-5 years) for dollar loans.

September 1, 1982: The Superintendency allows banks to use, for accounting purposes, the June 30 exchange rate when calculating the value of their dollar liabilities. This prevents banks from violating minimum capital ratios. This provision gives banks until December 1983 to incorporate the exchange rate devaluation on their books (additional forbearance mechanisms are established in 1983).

October 8, 1982: The 30 day time limit to declare a loan non-performing failing payment is extended to 90 days.

November 1982: In an effort to stop the rollover of loan losses, the Superintendency publishes a circular, Process of Definition of Bank Debtor Solvency. According to De la Cuadra and Valdés (1992, pp. 82-3):

> Numerous inspectors and members of the banks' operating staffs revised the banks' evaluations of recovery of their debtors, and many debtors had to prepare a presentation to their banks to show that they were still solvent or that they deserved a rescheduling.
>
> The publicly announced outcome of the evaluation process was as follows: A volume of 110,688 billion Chilean pesos of debt [about 9 percent of 1982 GDP] was due by "nonviable" debtors, so their guarantees would be seized and the banks would have to request their bankruptcy. In addition, the volume of debt owed by debtors defined as "in difficulty" was 315,107 billion Chilean pesos, and these debtors were made eligible for the sought-after rescheduling.
>
> In response many debtors rushed to shift collateral out of debtor corporations. Banks, on the other hand, dragged their feet on both bankruptcy proceedings and rescheduling.

November 26, 1982: A repurchase mechanism for dollars sold to the Central Bank ("Swaps") is established. (Circlar 1860)

December 1982-February 1985: The Central Bank "suggests" the 30-day interest rate. During these two years and three months, the president of the Central Bank defends the policy (5/9/84) as the only one that can reduce the cost of credit to a level compatible with that necessary for the recovery of productive activities. This policy's effectiveness depends on the state control of the majority of the banking system.

January 13, 1983: The Superintendency takes over the flagship banks of the Vial group (Banco de Chile) and the Cruzat-Larraín group (Banco de Santiago), intervenes in another three smaller banks, and forces the liquidation of another three financial institutions. The authorities take control of the business groups by refusing to renew thirty-day loans to the companies affiliated with the banks, thereby forcing them into bankruptcy, with the creditors' committees dominated by the flagship banks.

1983: The Bankruptcy Law is reformed, privatizing the function of a bankruptcy syndicate, whose management is the responsibility of a Junta de Acreedores. This reform facilitates the bankruptcy process of numerous finance companies, companies related to economic groups, and many small and medium enterprises.

March 31, 1983: Payment of interest on demand deposits in pesos is prohibited. (Circular 1900)

April 12, 1983: Productive Debtor Reprogramming Directive (Accord 1507): 51 percent of banking sector loans are classified as debts to "productive debtors". 39 percent of the eligible debt is reprogrammed (i.e., about 20 percent of total bank loans). 48,200 debtors out of 130,150 participate in the program.

The program reschedules up to 30 percent of a debtor's debts at terms of UF + 7 percent, with a one year grace period for interest and a five year grace period for principal. In order to induce banks to reschedule loans, the Central Bank creates a mechanism that generates an annual cash flow to the banks equal to 7 percent of the stock of rescheduled loans for six years. This mechanism consists in having the Central Bank make loans to the banks at UF + 5 (for ten years, with one year grace period on interest and five years grace period on principal) and in exchange having the banks use the proceeds to buy 6-year Central Bank pagarés that pay UF + 12.

April 28, 1983: Payment of interest on demandable savings accounts is prohibited.

June 29, 1983: The Central Bank (Accord 1517) establishes a refinancing mechanism for home mortgage holders. The plan reschedules installments unpaid since 1981 and a decreasing amount of installments payable between 1983 and 1987. Loan maturities are extended to take into account the lower installments. The rescheduled loans are at UF + 8. The Central Bank purchases part of the rescheduled loans at UF + 8 and refinances the remainder with a line of credit at UF +7.

July 19, 1983: Loan loss provisioning established in 1982 is now allowed to take place over 60 months, with a termination date of December 31, 1986.

December 1983: Financial normalization mechanism. The Central Bank buys substandard loans of non-intervened banks up to an amount equal to 1.5 times capital and reserves. The banks must use the funds to buy back the emergency loans from 1982, and must then invest the remainder in Central Bank pagarés that pay UF + 7 with a four-year maturity. The banks are required to repurchase the nonperforming loans at a 5 percent real interest rate over ten years. Banks are also permitted to exchange an additional amount of loans equal to 100 percent of capital and reserves for a non-transferable, non-interest bearing central bank note. Loans purchased this way must be repurchased at their initial real value over a ten year period. Bank shareholders are required to dedicate all earnings to the repurchase of the loans.

1984: Tax reform eliminates the high marginal income tax on company profits, provided that the profits are used to recapitalize the firms (i.e., dividends continue to be taxed at high rates). This reform is in place for one year.

June 1984: The 1983 debt relief scheme is expanded.

July 5, 1984: The Central Bank (Accord 1583) augments the home mortgage refinancing program of June 20, 1983.

September 1984: De-dollarization of debts: small and medium-sized borrowers are allowed to prepay their debts with a new credit in domestic currency. The exchange rate used is the preferential exchange rate. The cost of the program is absorbed by the Central Bank.

February 18, 1985: Hernán Bücchi becomes finance minister

1985-86: The Capitalismo Popular program removes bad bank debt from the Central Bank's balance sheet and transfers it to Corfo (the Chilean Development Corporation). As part of the process, new stock shares in the intervened banks are sold at concessionary rates to taxpayers who do not have tax arrears.

June 27, 1985: The preferential exchange rate begins to be phased out over an 18 month period (1/18 of the spread between the preferential and the official is eliminated each month), terminating in December 1986 for debtors with debts greater than $50,000. The preferential exchange rate is kept for debts under $50,000.

1982-1985: Real exchange rate policy and interest rate stabilization (Fontaine 1995, p. 30):

> It is worth emphasizing that there is nothing as effective as a correct level of the real exchange rate for gaining the confidence of domestic savers and foreign lenders. The pronounced real devaluations of the peso between 1982 and 1985, in spite of their traumatic short-run consequences, had the virtue of absolutely eliminating expectations of new devaluations. Moreover, if there was any perception of disequilibrium, it was that the peso was undervalued and that its next real movement would be upward. The counterpart of confidence in the real value of the peso was that interest rates could fall substantially without setting off capital flight. The stabilization of interest rates was therefore intimately tied to the new exchange rate equilibrium.

1986-88: Debt buybacks, Debt-equity swaps (see Larraín and Velasco 1990)

March 5, 1988: The president of the Central Bank, Enrique Seguel, announces a new program for home mortgages. Eligible mortgage holders--112,000 out of 140,000 total in the financial system--can participate in an Article 18 dollar debt repurchase operation. The Central Bank forgoes its normal commission charge. Borrowers who have not previously rescheduled their mortgage loans receive a discount of 25 percent on an amount up to US$6000. Previously rescheduled mortgages are eligible for a 15 percent discount on up to US$6000. The rescheduled mortgage installments incorporate the value of the debt writedown. The Central Bank plans to finance about US$300 million dollars of operations for this mortgage relief program, and will lose about $30-35 million by not charging its usual commission. (*El Mercurio,* International Edition, March 3-9, 1988)

1989: The outgoing military government changes the contracts with the banks that had sold nonperforming loans to the Central Bank. The Central Bank's claims on the banks are turned into subordinated debt with no fixed time obligation for repayment.

1994: Class 'B' Shareholders at Banco de Chile and Banco Santiago create a crisis for the Central Bank by voting to capitalize their dividends, a move that may potentially impede the repayment of the Central Bank's subordinated debt.

1995-96: The government and the banks enter into intensive talks that produce a resolution of the subordinated debt problem. The Central Bank agrees to realize a loss of US$1.6 billion in exchange for payments of US$1.3 billion. The largest bank (Banco de Chile) agrees to pay off its debt obligation of US$1.7 billion over forty years.

Table 1. Chile's Credit Boom

	Domestic Credit/GDP (percent) (1)	Growth Rate of Real Domestic Credit $July_{t-1}$-$June_t$ (percent) (2)	Domestic Credit to the Private Sector/GDP (percent) (3)	Growth Rate of Real Domestic Credit to Private Sector $July_{t-1}$-$June_t$ (percent) (4)	Real Loan Rate $July_{t-1}$-$June_t$ (percent) (5)	Real GDP Growth Rate (percent) (6)
1976	25.9	--	4.7	--	--	3.5
1977	25.9	-0.1	8.8	89.6	79.1	9.9
1978	31.8	23.0	15.8	79.3	45.3	8.2
1979	29.6	-6.8	19.0	20.7	31.9	8.3
1980	32.2	8.7	25.5	34.0	13.5	7.8
1981	38.7	20.3	39.3	54.1	21.3	5.5
1982	64.0	65.1	61.4	56.4	45.7	-14.1

Source: International Monetary Fund, *International Financial Statistics*. Domestic credit is line 32 and domestic credit to the private sector is line 32d. All domestic credit figures are for the end of the second quarter of each year. Real domestic credit uses the GDP deflator.

Table 2
Macroeconomic Indicators, 1980-89

	Growth Rate of GDP (%)	Growth Rate of Real Domestic Expenditure (%)	Trade Deficit (% of GDP)	Current Account Deficit (% of GDP)	Public Sector* Deficit (% of GDP)	Multilateral Real Exchange Rate
1980	7.8	9.3	4.2	7.1	-4.5	100
1981	5.5	11.6	10.3	14.5	-0.8	115
1982	-14.1	-24.1	1.9	9.2	3.5 (8.8)	103
1983	-0.7	-4.6	-2.7	5.4	3.2 (7.5)	86
1984	6.3	8.5	1.1	10.7	4.3 (9.1)	82
1985	2.4	-1.9	-2.8	8.3	2.5 (9.8)	67
1986	5.7	5.3	-3.8	6.9	2.1 (5.0)	61
1987	5.7	7.3	-4.1	4.3	0.2 (1.5)	58
1988	7.4	8.9	-7.2	0.7	-0.1	55
1989	10.0	12.2	-3.6	3.1	-1.2	56

*Figures in parentheses include estimates of quasi-fiscal (Central Bank) subsidies.
Source: Corbo and Fischer (1994)

Table 3
Central Bank Loans to Chilean Banks at the End of 1983

	Central Bank Loans/ Capital and Reserves (percent)	Loans as a Percentage of the Whole Financial System
I. Intervened Banks		
Banco de Chile	400	22.0
Banco Santiago	340	10.7
Banco Concepción	360	4.6
Banco Colocadora Nacional de Valores	350	2.0
Banco Internacional	350	1.2
II. Private National Banks		
Banco de Crédito e Inversiones	80	5.5
Banco Sud Americano	50	5.5
Banco Hipotecario y de Fomento Nacional	120	3.6
Banco del Trabajo	160	3.3
Banco de A. Edwards	60	3.2
Banco O'Higgins	50	3.1
Banco Osorno y La Unión	50	2.1
Banco Nacional	40	2.1
Banco Morgan Finansa	50	1.5
Banco Industrial y de Comercio Exterior	50	1.4
Banco del Pacífico	40	0.6
Banco del Desarrollo	180	0.4
III. Banco del Estado	80	16.8
IV. Foreign Banks	20	9.0

Source: Arellano (1984)

Table 4
Central Bank Subordinated Debt in 1991

	Amount of the Debt (Millions US$	Paid-in Capital (Millions US$)
I. Intervened Banks		
Banco de Chile	1180	632
Banco Santiago	1103	203
Banco Concepción	387	53
Banco Internacional	70	17
II. National Banks		
*Banco de Crédito e Inversiones	21	67
*Banco Sud Americano	49	77
Banco Hipotecario y de Fomento Nacional	198	60
*Banco de A. Edwards	102	64
*Banco Osorno y La Unión	98	89
*Banco del Pacífico	30	15
*Banco del Desarrollo	12	24
**Total	3250	1301

*These banks extinguished their debt obligations between 1992 and 1995.
**By July 1996 the total subordinated debt obligation had grown to about US$4.6 billion.

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