TORONTO CENTRE

Leadership in Financial Supervision

Case Study

The Venezuelan Banking Crisis

Epilogue

Emergency legislation In the wake of the collapse of Banco Latino, congress hastily approved emergency legislation to deal with the crisis. The official deposit insurance coverage was raised to 4 million bolivars and the safety net was expanded to include uninsured deposits, deposit-like liabilities, off-balance sheet risks, and Bolivar-denominated offshore deposits. The new law expanded FOGADE's ability to deal with ailing banks and gave the central bank more flexibility in lending to FOGADE. It also authorized the Executive branch to issue public debt in order to fund FOGADE. Nevertheless, crisis management stalled. The government then changed the emergency legislation several times in 1994-1995 in order to make it easier for the government to take control of bank shareholder assets and allow the new government-owned banks to assume the deposits of other failed banks that were bound to be closed.

Waves of bank closures The Venezuelan banking crisis lasted for more than 18 months. After the collapse and reopening of Banco Latino came a second wave of bank closures. On June 14, 1994, the government seized and closed 11 financial institutions. Eight of them had been receiving financial assistance since January 1994. The government did not have many options at that point, having failed to address the earlier solvency and management problems associated with these banks.

This action created extreme public consternation, especially because the government had previously promised that none of these banks would be closed. Depositors reacted with outrage. The massive bank takeovers received worldwide media attention and set off widespread panic in the foreign exchange market. What funds were left in the system fled to safer markets, and the bolivar careened downward. This was after losing 40% of its value over the previous two months.

Disparity of treatment Two days after the June bank seizures, depositors learned that they would be treated in a discriminatory manner. They would get only 4 million bolivars per depositor, less than half of what Banco Latino depositors had received. The disparity in treatment unleashed a new firestorm of anger.

Controls and suspension of rights Massive capital outflows and financial turbulence led the government to institute foreign exchange controls and suspend Venezuelans' constitutional rights on June 27, 1994. That meant Venezuelan citizens were stripped of the right to freely conduct economic transactions. They also lost their basic civil rights, including the right to privacy in their homes and to move freely around the country. People could be detained without charge and property could be confiscated without due process.

Simultaneously, the government moved to consolidate control of all banking and financial decision-making under the Finance Minister and a small group of advisors. A presidential decree, No. 248, established a Financial Emergency Board (Junta de Emergencia Financiera, known as JEF), presided over by the Finance Minister, who had the right to cast an extra vote in the event of a tie. This new agency replaced the five-month-old Superior Council of the Superintendent of Banks established by the 1994 Banking Law. Its real purpose was to place under the direct authority of the President all the decision-making powers that had previously been distributed among the central bank, FOGADE and the Superintendent of Banks. The members of this new board were the President of the central bank, the President of FOGADE, the Superintendent of Banks, and three political appointees whom the President could name and remove.

Bank seizures unleashed runs on other banks The June bank seizures also unleashed runs on the deposits of other banks, chiefly Banco de Venezuela, Banco Consolidado and Banco Progreso. These banks were Venezuela's second, fourth and sixth largest, and accounted for 23% of total bank deposits and over 4 million depositors. Each one was the core of a financial group. Their offshore operations were quickly hit by massive withdrawals. Banco de Venezuela and Banco Consolidado were large retail banks, with more than 3.4 million depositors. Their problems were related to a hostile takeover of Banco de Venezuela launched in 1990 by the owner of Banco Consolidado, who gained control of the bank in late 1992. Both financial groups were weakened as a result of the takeover. Banco de Venezuela was also one of the two private clearing banks for the central bank.

Recapitalization and government seizure The government had to avoid closing this group of banks or risk even more turmoil, so it looked for new ideas. On August 8, JEF approved the purchase of Banco de Venezuela from its major shareholder for a token 1 bolivar per share. The government appointed new management and FOGADE recapitalized the bank. Banco de Venezuela remained open to the public and no restrictions were placed on deposit withdrawals. In this way the government avoided placing Banco de Venezuela under conservatorship – a measure that would unavoidably have led to at least a temporary closure. Although this approach was questioned from a legal perspective, it worked better than the June fiasco for depositors and helped maintain the bank's franchise value.

At the same time, Banco Consolidado and Banco Progreso entered into strict recapitalization agreements, forcing the owners to pledge personal assets in ad-hoc trusts and also post their shares as collateral. In both cases, FOGADE was supposed to provide financial support until the owners could raise new capital to buy back their banks.

But Banco Consolidado and Banco Progreso continued suffering runs. The banks' owners were unable to comply with the terms of the government's recapitalization plan. In September 1994, Banco Consolidado was taken over by the government under the same mechanism as Banco de Venezuela. The management team was replaced, deposits were guaranteed and the bank remained open. Again, no restrictions were placed on the withdrawal of funds by depositors. As in the case of Banco de Venezuela, runs ceased as soon as the bank was taken over by the government.

The government took over Banco Progreso, along with Banco República and the rest of its financial group, in December 1994, using the same mechanism. But government seizure did not dispel depositors' worries and runs on Banco Progreso continued. The government closed the bank in January 1995 and transferred its deposits to the government's expanding bank holdings.

Banco Andino, a small regional bank, also began showing signs of problems in August. It received a distinctly different treatment from all the other banks. To avoid seizing the bank or placing it under conservatorship, Banco Andino was temporarily placed under the management control of Banco Industrial, a government-owned bank that was given the task of designing a restructuring plan. This decision gave rise to heated criticism, as the President of Banco Andino, Senator Bernardo Celis, was a prominent member of Convergencia, the government party, and Chairman of the Senate's Finance Committee. The government seized Banco Andino in November, after several recapitalization proposals went unfulfilled. Later, the official version would be that FOGADE, not Banco Industrial, had been in charge of recapitalizing Banco Andino.

In February 1995, three medium-sized banks, Banco Profesional, Banco Italo and Banco Principal, reached the point of no return. Together they accounted for only 5% of total commercial bank deposits. They had been suffering runs since mid-1994 and the shareholders were unable to comply with recapitalization agreements. The government took over the banks, placed them under conservatorship and closed them. Six months later another bank, Banco Empresarial, was taken over after protracted runs. All of these banks were small and had no franchise value.

Gradually the runs subsided Throughout 1995, Venezuela was riddled with rumours about new "waves" of bank failures. Gradually the runs subsided as depositors saw that no more banks were failing.

Government seizures of banks concluded in August 1995. Nineteen financial institutions (18 commercial banks and one finance company) had failed and either closed or run by the government. The government had also taken over 35 financial institutions that belonged to the failed financial groups: 8 mortgage banks, 14 investment banks and 13 leasing companies, along with more than 1,000 non-financial companies and innumerable other assets. By this time, the government was controlling one-third of the deposits of the banking system. This indicated a great decline in the size of the failed banks, as this group of institutions had accounted for more than 60% of total deposits at the beginning of the crisis.

In the second half of 1995 a measure of stability returned to the Venezuelan banking system. The damage had run its course. The panic atmosphere subsided and runs ceased. It had been a war for survival of the fittest. The weakest banks—politically or financially – were wiped out, giving the stronger ones a greater role in the financial system.

VENEZUELA: CRISIS MANAGEMENT EPISODES

COMMERCIAL BANKS	DATE FOGADE ASSISTANCE BEGAN	DATE OF GOVERNMENT TAKEOVER	DEPOSITORS MARKET SHARE 2/	NUMBER OF DEPOSITORS 2/	PERCENT OF TOTAL
Latino		01/16/94	9.23	675,558 [1/]	5.67
Maracaibo	01/25/94	06/14/94	8.33	505,678	4.25
Barinas	01/27/94	06/14/94	1.32	63,576	0.53
Construccion	01/27/94	06/14/94	3.67	172,685	1.45
Fiveca	02/03/94	06/14/94	3.63	-	-
Metropolitano	02/11/94	06/14/94	3.98	180,623	1.52
La Guaira	02/16/94	06/14/94	1.7	182,949	1.54
Bancor	03/22/94	06/14/94	1.42	147,108	1.24
Amazonas	03/29/94	06/14/94	0.35	4,809	0.04
TOTAL			33.63	1,932,986	16.23

Venezuela		08/09/94	10.65	2,577,663	21.64
Consolidado		09/11/94	7.03	856,093	7.19
Andino		11/11/94	0.42	67,295	0.57
Progreso		1214/94	2.79	265,317	2.23
Republica		12/14/94	2.64	239,416	2.01
TOTAL			23.53	4,005,784	33.64

Italo		02/01/95	1.85	243,977	2.05
Principal		02/01/95	2.33	154,638	1.30
Profesional		02/01/95	0.67	20,100	0.17
Empresarial		08/11/95	0.25	2,784	0.02
TOTAL			5.1	421,499	3.54
TOTAL			62.26	6,360,269	53.41

Source: Fogade

1/ Estimated depositors for Latino Group: 2 million

2/ As of December 31, 1993

Second attempt at reform and deregulation In April 1996, the Venezuelan government made the second attempt at market-oriented economic reforms and financial deregulation. Exchange controls were abolished and interest rates were allowed to fluctuate in response to market conditions. Prices were also largely deregulated. Meanwhile, in early 1996, the oil industry was opened to foreign investors and oil prices also began to recover. All this created a positive economic environment, and demand for loans began to pick up slowly. Capital flowed back into the country.

Clearing the decks In 1996 and 1997, the government privatized four of the banks seized in the crisis. Foreign banks acquired all of these privatized banks. Banco Santander of Spain bought Banco de Venezuela. Infisa, the Chilean leader of a group of global investors, bought Banco Consolidado. Davivienda, a Colombian financial group, bought Banco República, and Banco Popular ended up as part of Banco Bilbao Vizcaya's large stake in the Venezuelan banking system.

Foreign owned banks by then accounted for 40% of total deposits. Some foreign financial institutions were also holding significant minority ownership positions in several major Venezuelan banks. This was a sweeping change. Venezuela, a country that had virtually no foreign bank presence, became one of the Latin American countries with the strongest presence of international banks.

Bank privatizations officially brought the crisis to an end. The government had disposed of all of the banks that ended up in its hands – all except for one. Banco Latino was also supposed to be rehabilitated and privatized. Plans to sell it were announced – and postponed – countless times. After more than two years of bailout attempts, the bank's condition was worse than anyone expected. Government appointees spent huge sums in promotion and advertising campaigns to prepare it for privatization. Efforts to collect unpaid loans were ineffective. There were allegations of mismanagement by Banco Latino's conservators, and political complications as well. With time, the franchise value of Banco Latino evaporated. Its deposit base shrank. The bank continued operating at a loss and was kept afloat primarily by revenues from the sale of assets. The government finally gave up and dismembered it, selling off the bank's assets, business units and branches. In June 1997, Banco Latino officially ceased to exist.

More boom-bust cycles After 1996 the Venezuelan economy went through another boom-bust cycle as a result of the ups and downs of oil prices. In 1996-1997 rising oil revenues generated over US$8 billion in windfall profits, which were quickly spent. The decline in oil prices triggered by the Asian crisis in 1998, coupled with elections, led the country into another deep recession. Banks went through a lending boom again in 1997, but this time the banking system was more resilient and absorbed the negative shock without major problems.

Weaknesses persist Hugo Chávez, who led the 1992 military coup attempts, won the December 1998 elections on anti-reform platform. In 1999-2001, the country went through another oil boom that generated substantial windfall profits but yielded an insignificant recovery. Political unrest in 2002 led to capital outflows that eroded the deposit base. Strict exchange controls were established in early 2003. The banking sector began to operate under the threat (which quickly materialized) of new directed lending rules. Mounting pressures to control interest rates led to near-collusion in the banking industry while trying to avoid regulations. Demand for loans was weak as the non-oil sector imploded as a result of harmful policy mix. Facing a growing deficit while virtually excluded from the international financial market, the government relied on bank investment in government bonds to fund the budget.

Throughout 2002-2003 banks operated in a highly volatile environment due to political turbulence, loss of policy credibility, sharp recession, rising inflation, shortages distorting the supply chain, and the overall threat of anti-business policies. Foreign exchange controls imposed in early 2003, however, stopped capital flight and translated into a sharp increase in deposits.

Demand for loans was weak and credit risk became more difficult to assess. Banks heavily invested in government bonds, which rose to account for more than 40% of total assets. Banks came under strong pressure from the government to increase lending to agriculture, mortgages, tourism projects and micro-enterprises regardless of their risk. Rules on mandatory loans to these sectors tended to proliferate. Bank profits became largely dependent on income from government bonds, fee income, and devaluation.

Incentives for mergers and acquisitions were established in 2001 but the rules expired without having any effect. No new incentives were put in place. In 2002-2203, some market-driven mergers and acquisitions reduced the number of banks but this activity is not yielding stronger banks.

A cash-strapped government also put FOGADE's assets at risk: its funds are being used to fund the fiscal deficit and its real estate assets are being assigned to public sector institutions without due compensation.

Interest rate regulations were enacted in 2003, with minimum deposit rates and maximum lending rates. Interest spreads widened as regulations were geared to protect not only savers and borrowers but also the more inefficient banks. Interest rates have become negative in real terms.

Banks are ever more dependent on the government. Investment in government bonds rose to an average of 40% of assets (some banks hold up to 70% in government bonds), and public sector deposits average 12% of total deposits (in some banks, up to 70%),

Money supply began to grow by 50-65% year-on-year since 2003, making deposits rise much faster than the demand for loans even though the economy recovered sharply since 2004 and demand for loans picked up. Regulatory capital was reduced in 2006.

Some foreign banks have divested their Venezuelan operations. Foreign banks now account for 24% of total assets, with only three major foreign players.

Today, liquidity risk is low (exchange controls are still in place) but liquidity is unevenly distributed. The inter-bank money market remains shallow and underdeveloped, and rates are volatile. The central bank lacks instruments to mitigate volatility in the inter-bank market.

Credit risk is high: creditor rights are not adequately protected and political barriers to foreclosures are high (especially in the housing market). Changing business conditions caused by evolving rules affect borrowers; some sectors such as agricultural loans and home mortgages are politically very sensitive.

The economy has had 15 consecutive quarters of strong growth (about 10% year on year in real terms) reflecting an oil bonanza and strong government spending. But a soft landing is unlikely when oil prices can no longer sustain the current expansionary policy. Macroeconomic volatility is rising and policy uncertainties are high and asset values are falling. Banks must thus assess their borrowers' ability to repay the loans and the value of collateral under potentially very unfavorable conditions.

Market risk is high: securities markets are shallow and distorted by the government's liability management strategies. Yields are volatile and highly negative in real terms. The central bank's policy rate is fixed and does not serve as an indicator of the banks monetary policy stance. The net effect of monetary policy ultimately depends on the decisions of bank treasurers.

Operational risk is medium: the regulatory framework is highly discretionary; labor regulations are increasingly cumbersome, risks associated with the country's telecommunication infrastructure are rising, and money laundering and terrorism financing risks are also higher.

Regulatory risk is high: the banking business is increasingly regulated, in an overall context that gives government officials strong and rising discretionary powers.

THE COST OF THE CRISIS

The banking crisis was costly for Venezuelans in many ways. There were social costs. A sharp decline in living standards forced many of the brightest young people to search for opportunities abroad. There were institutional costs as well. The banking crisis derailed reforms and weakened institutions. Then there was the literal cost, calculated by Ms. de Krivoy to be at least US$7.3 billion so far (net of revenues from asset sales). The 1994 banking crisis ate up the equivalent of 10.9% of Venezuela's GDP.

FOGADE acquired substantial assets and the process of getting title on many companies and real estate property belonging to the failed banks was difficult and protracted. Disposing of these assets would help reduce the net cost of the crisis, but many government agencies have taken over FOGADE's valuable real estate at nominal prices, making it increasingly difficult to determine the final cost of the crisis.