Latin American Shadow Financial Regulatory Committee
Comité Latino Americano de Asuntos Financieros
Comitê Latino Americano de Assuntos Financieros

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RESOLUTION OF ARGENTINA´S FINANCIAL CRISIS

Aware of the crucial importance for Latin America of reaching a prompt and effective solution to the current financial problems in Argentina, this statement reflects the assessment and recommendations of the Latin American Shadow Financial Regulatory Committee (LASFRC) for moving towards that end. The statement has three parts. First, it identifies the major features and problems facing the Argentine banking system. Second, it assesses alternatives for crisis resolutions. Third, it advances on general lessons applicable to the region.

I. The Nature of the Argentine Banking Crisis

During most of 2001, Argentina faced a progressive deterioration in its perceived creditworthiness (as reflected by a marked increase in the international spreads on its government bonds), as well as increased doubts about the government's capacity to maintain its exchange rate arrangement--the convertibility law (as reflected by the sharp rise in the 3 and 12-months forward peso-dollar rate). Doubts about the sustainability of the announced government policies had adverse consequences on banks' balance sheets, mainly through two main channels: (a) the stock of government paper held by banks, part of which was "forced" on their balance sheet by the government,[1] and (b) the significant proportion of dollar-denominated loans extended to borrowers with peso-denominated income. While the increased perceptions of government's default reduced the market value of government bonds held by banks, the increased expectations of a devaluation deteriorated the expected return from banks' loan portfolios.

The loss of confidence triggered by these factors resulted in a significant withdrawal of deposits. The deposit outflow was especially large in the two major public banks, which account for a significant portion of the system's deposit base. The run on Banco Provincia de Buenos Aires and Banco de la Nación Argentina reflected the increasing fiscal problems faced by the Province of Buenos Aires and the federal government, respectively. In addition, the compulsory sale of government bonds to pension funds, contributed to the fall in deposits in private banks as pension funds financed the purchase of government bonds by withdrawing their deposits in the financial system. As a result, the banking system lost about 20 percent of deposits during 2001. By

[1] By end 2001, banks' claims on the government as a proportion of total assets amounted to about 30 percent.

November 2001, the government was forced to limit monthly withdrawal of deposits to US$ 1000 per account.

Events during January 2002 validated depositors' fears. In that period the government declared default and devalued the peso by 29 percent. In February 2002, a "dirty floating" exchange rate regime is implemented.

The Argentine banking crisis is mainly the product of government policy actions undertaken during the last year in the context of a severe macroeconomic crisis associated with the loss of access to international capital markets. These measures affected seriously both the liquidity as well as the capital position of the financial system. The measures that stand out for their negative impact on the banking system are the following:

1. In November 2001, the government exchanged government bonds held by banks for illiquid government bonds ("préstamos garantizados") generating a reduction of about 30 percent in their net present value. This measure affected both the capital position as well as the liquidity of banks prompting a bank run.
2. Shortly after, the government imposed a control on the interest rate paid on deposits accelerating the run on the banking system.[2]
3. Following the imposition of controls on the deposit interest rate, the government opted to freeze deposits in the banking system, and impose tight controls on cash withdrawals, a system known as the "corralito". Despite these restrictions, however, funds were allowed to be transferred across banks at the controlled interest rate, as well as from time deposits into transactional accounts. The conversion of time deposits into transactional balances originated the monetary overhang (i.e. the excess of checking and savings account balances over the level that would be consistent with the underlying transactional needs) faced today by the system. At the same time, the interest rate control affected negatively domestic banks vis-à-vis foreign banks by impeding the former banks to retain deposits by offering higher interest rates to compensate for the higher perceived risk associated with the lack of foreign support.
4. In the first quarter of 2002, the government declared default on its debts, and devalued the currency.
5. Following the devaluation, the government imposed an asymmetric pesification of bank assets and liabilities. Banks were forced to convert dollar-denominated loans into pesos at the pre-devaluation 1 to 1 exchange rate. At the same time, dollar-denominated time deposits were converted into pesos as the rate of 1.4 pesos per dollar. This action alone wiped out the entire capital of the banking system, and introduced a significant foreign exchange exposure into banks´ balance sheets as foreign obligations and lines of credit remained denominated in their original currency. Both assets and deposits are subject to indexation.
6. Additionally, a tighter freeze was imposed on time deposits by limiting their use in transactions and by restructuring their maturity ("corralón").

[2] The control was implemented by imposing a 100% marginal reserve requirement on deposits paying a higher than the government-determined ceiling rate.

7. Congress passed legislation that undermined the value of private assets by suspending for 6 months all legal actions by creditors to collect on their debts.
8. The government has announced a modification of the indexation index to be applied to mortgages while maintaining the original indexation to inflation on most bank liabilities.

With the value of banks' assets severely deteriorated, the payment system hindered by the controls, the system continues to be subject to a continuous drainage of funds. Moreover, as output is projected to decline by over 10 percent and creditor rights have been weakened by the modification of the bankruptcy legislation, it is expected that non-performing loans will continue to increase. Reflecting the lack of confidence in the solvency of the banking system, a flight to quality translates into "capital flight," and further pressures on the exchange rate.

II. Resolving the Banking Crisis

The Committee believes that resolving the banking crisis entails three principal tasks. First, the proper functioning of the payment system should be restored. Second, rebuilding confidence in the banking system requires restoring an adequate liquidity and capital base. Third, the reestablishment of confidence in the value of the national currency requires the central bank to regain control over monetary policy, which can only be achieved if the central bank is not required to finance fiscal deficits or to offer recurrent net financing to support weak banks. In particular, to attain a healthier financial system over the medium term, the role of public banks should be radically redefined through restructuring and/or privatization.

The restoration of the functioning of the payment system requires lifting the existing restrictions on the withdrawals of cash from deposit accounts and on the use of cash as legal tender. However, recognizing the potential risks that lifting such restrictions has in view of the significant monetary overhang associated with transactional accounts, the Committee urges for adopting an integral solution of the liquidity and capital dimensions of the Argentine banking crisis, simultaneously with the removal of the corralito and exchange controls.

Restoring confidence in the financial system requires addressing the problems affecting both capital and liquidity in the shortest possible time frame. The capital position of Argentine banks has been drastically reduced not only as regards the value of (defaulted) government bonds and because of the effects of asymmetric pesification, but also because the significant uncertainty that has developed as regards to the value of banks´ claims on the private sector. In this respect, restoring confidence in the financial system requires extracting the source of this capital risk from banks' balance sheets and reversing recent changes in bankruptcy legislation.

International experience shows that there is a variety of ways to tackle this difficult issue. One such option is to establish a system-wide trust fund ("fideicomiso") made-up with an amount of system-wide bank assets (both on the private and public sectors). Creditors of banks, other than holders of transactional deposits, would be given participation certificates on that stock of assets as payment for their claims against the banks. This trust fund would be privately managed. Such a reform would leave banks "lean" with an adequate capital and liquidity position together with the management of the payment system.

A second alternative is to establish one trust fund for each bank. In either form, the value of the participation certificates would reflect the value of bank assets in the fund. In choosing between these two options, the authorities would need to compare between the benefits that a single trust fund would have in insulating the newly restructured banks from the performance of the trust fund with the benefit that multiple trust funds would generate in terms of maintaining the current relationship between banks and its clients.

A third more conventional alternative is to recapitalize financial institutions through the exchange of non-performing loans for government assets. This option entails a larger cost being borne by taxpayers, as opposed to depositors. However, in a situation where the government is in default, the credibility of this alternative requires that additional resources be put on the table either through international multilateral funding or by providing seniority to government capitalization bonds over specified revenue sources.

How is the government planning to resolve the banking crisis? It has announced its intention to solve the crisis while containing the risks of high inflation. To tackle the capitalization problem, the government has announced that it plans to compensate banks for the effects of asymmetric pesification by issuing dollar-denominated bonds. To deal with the liquidity problem and the corralito, it is considering exchanging restructured time deposits into a 10 year dollar floating-rate bond in a compulsory way. The exchange of deposits for dollar bonds would take place at an exchange rate of 1.4, which is equivalent to reverse the original pesification of those time deposits. With respect to transactional deposits, the government is considering allowing banks to gradually unfreeze current balances over a four-months period. The central bank would provide banks with the liquidity required to make the corresponding payments while, at the same time, would sterilize the associated monetary expansion with the issue of central bank short-term bills.

While these steps represent a step in the direction of removing the corralito and improving the liquidity situation of the banking system, the Committee believes that this proposal is insufficient to bring back banks to solvency as it does not deal with the increasing problem of non-performing loans. Delays in announcing a specific restructuring program only increases the size of capital injection that the government will need to provide to banks. With respect to the payment system, the current proposal under discussion runs the risk of being too gradual, delaying effectively the complete removal of exchange controls. In addition, the proposal would place additional pressure on the liquidity gap of banks by effectively resulting in the exchange of low-interest deposits for central bank rediscounts that carry a significantly higher interest cost.

Moreover, the Committee is worried that, although the proposal under discussion will tend to improve the current situation of depositors, it implies a significant increase in the fiscal burden by effectively dollarizing original bank liabilities and transferring the resulting exchange rate exposure to the government. This in a context where the government already faces a delicate process of restructuring its defaulted obligations starting from an initial position characterized by a public debt to GDP ratio of over 100 percent. The potential fiscal implications of the proposals under discussion may seriously undermine the credibility of the program. Thus, the Committee believes that an efficient and equitable solution to Argentina´s banking crisis requires striking an appropriate balance between the ultimate costs to be borne by depositors and the potential adverse effects on the economy stemming from an unsustainable fiscal burden.

III. General Lessons from the Argentine Crisis

1. Not all financial crises are caused by moral hazard in the management of banks. Argentina is a good example. The system was well regulated and supervised and was able to withstand a severe and prolonged recession, which started in 1998, without major incidents and with a rising level of deposits until February 2001. The system was well capitalized and could have withstood significant losses in the value of its assets. However, it could not survive a set of interventions that destroyed the franchise value of banks (such as the corralito) and expropriated its capital (such as asymmetric pesification). Therefore, good financial regulation and supervision while necessary are not sufficient to protect banks from crises.

2. Liability dollarization can seriously amplify the costs of crises. These crises are usually accompanied by large swings in the real exchange rate which increase the domestic cost of dollar-denominated debt at a time when borrowers are least able to service their obligations. Countries that plan to maintain flexible exchange rates should develop policies designed to increase the market for domestic currency denominated assets both at home and in the international market.

3. The importance of the integrity of the payment system cannot be overstressed. When this system fails it causes an enormous contraction in economic activity that, beyond its large social costs, also complicates fiscal solvency and limits the ability of the government to solve the crisis. Therefore, the Argentine crisis suggests that countries should be even more willing to pay the costs of ensuring a well functioning payment system in times of crisis. It also implies that governments should consider the impact of their crisis management initiatives on the stability of the payment system.

4. This is the first major crisis that takes place in the context of a highly internationalized domestic banking system. Therefore, it provides an important opportunity to assess the effect of banks´ ownership structure in times of crisis. It has often been argued that foreign-owned banks have better access to liquidity and capital in times of crisis through their relationship to their parent company and would therefore be seen by the public as safer institutions. In this context, the Argentine crisis suggests that this may be true in cases of individual or limited problems in the banking system. However, in systemic crises, parent companies are less likely to support their subsidiaries. This is especially true when the loss of capital can be attributed to government decisions.

5. The Argentine crisis also provides new evidence on the enduring lesson on the problems caused by public sector commercial banks. The temptation to exert political influence in the allocation of credit of these institutions weakens their ability to retain the respect of depositors in bad times aggravating the overall situation. In Argentina, the public banks were the ones with the worse asset quality and the poorest indicators of operational efficiency. These banks suffered heavily when flight to quality became rampant. The committee believes that it is important for countries to minimize the role of commercial public banks in the domestic system.

6. Lengthening the maturity of the public debt is important to avoid rollover problems. However, the Argentine crisis shows that when the longer term bonds are purchased by banks, they can generate maturity mismatches, as bank deposits are of much shorter maturity than government bonds. When a systemic crisis occurs, the decline in deposits takes place at the same time that bond prices are very low and that the central bank is struggling to protect its level of international reserves by controlling domestic credit. The increased maturity of the debt complicates banking crisis management.

7. Currency crises may induce the adoption of exchange controls as a temporary measure to contain the decline of the exchange rate and the loss of bank liquidity. In such a context, central banks are required to make a judgment as regards to how exchange controls should apply to transactions between head offices of domestic banks and their foreign branches and majority-owned subsidiaries. This decision is further complicated by the fact that these international transactions may take place in a context where the head office is requesting liquidity assistance from the central bank. The Committee believes that exchange controls should not interfere with the responsibilities between the head office and its above-mentioned branches and subsidiaries, consistent with the principle of consolidated supervision. In addition, in this context, efforts should be made to coordinate actions of different central banks on how to deal with liquidity problems faced by specific banks in different jurisdictions.

8. Beyond the obvious real effects of Argentina on its neighbors, Uruguay suffered significant contagion from the presence of Argentine-owned banks. When these banks were negatively affected by the Argentine crisis, they could not secure the assistance of the central bank of either country, since neither institution felt responsible for these institutions. This points to a gray area in the international division of labor between central banks, an issue that needs to be addressed.

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In addition to the Latin-American participants, the Committee also includes as invited member:

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