SM/95/39

CONTAINS CONFIDENTIAL
INFORMATION

February 17, 1995

To: Members of the Executive Board

From: The Secretary

Subject: Venezuela - The Banking Crisis

There is attached for the information of the Executive Directors a paper on the banking crisis in Venezuela, which is being circulated in connection with the 1994 Article IV consultation discussions with Venezuela (SM/95/28, 2/2/95), and is now tentatively scheduled for discussion on Wednesday, March 1, 1995. A summary and conclusions appear on pages 19-22.

Mr. Pérez (ext. 37326), Mr. E. Feldman (ext. 34978), or Mr. Tweedie (ext. 38245) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

Other Distribution:
Department Heads

CONTAINS CONFIDENTIAL
INFORMATION

INTERNATIONAL MONETARY FUND

VENEZUELA

The Banking Crisis in Venezuela

Prepared by the Western Hemisphere Department in
Conjunction with the Monetary and Exchange Affairs Department

Approved by Claudio M. Loser and Manuel Guitián

February 16, 1995

Contents — Page

Text Tables

I. Introduction

The banking crisis that emerged in 1994 in Venezuela is of major proportions. During 1994 the authorities nationalized or closed 13 out of the 47 banks that were in operation at the beginning of the year, including three of the four largest banks in terms of deposit shares. 1/ These 13 banks accounted for about half of total banking system deposits at end-December 1993 (Table 1). 2/ Given the structure of the financial system in Venezuela, whereby commercial banks typically form part of a larger financial group, the authorities also have had to take over a wide range of related enterprises. 3/

The direct fiscal cost incurred during 1994, in terms of spending to recapitalize or support ailing institutions or to pay depositors, amounted to some Bs 1,100 billion, which is equivalent to 13 percent of GDP or US$8.6 billion (Table 2). 4/ A more recent estimate of the losses of banks that were taken over in 1994 amounts to about Bs 1,470 billion (US$10.9 billion). By way of comparison, it has been estimated that the fiscal cost of the U.S. Savings and Loan Industry crisis in the 1980s could reach 4 percent of GDP in 1990 dollars, 5/ while loan losses of banks in the Nordic countries in 1991-92 amounted to between 5-7 percent of GDP. 6/ In Argentina, banks that were liquidated in 1980-81 accounted for 24 percent of total deposits of private commercial banks at end-1979. 7/ The direct fiscal cost incurred to pay depositors was about 4 percent of GDP.

1/ In addition, two small banks owned previously by banks that were nationalized or closed in 1994 also came under government control.

2/ At the time this paper was being finalized, the authorities announced that three further banks had been nationalized and that rescue plans had been proposed for two other banks involving recapitalization by the bank owners in one case and the purchase of a controlling interest by a group of private banks in the other. The paper has not been modified to take account of these most recent developments, which will further increase the fiscal cost of the crisis, but do not alter the basic analysis or conclusions presented below.

3/ This paper does not address the spillover effects of the crisis to other parts of the financial sector such as the insurance industry, which has been severely affected.

4/ Using the exchange rates prevailing when the assistance was given.

5/ The Economic Effects of the Savings and Loan Crisis, a Congressional Budget Office Study, January 1992. The present value of the Government's costs was estimated at approximately US$215 billion in 1990 dollars. This total included the estimated cost of the cleanup efforts of the original FSLIC, the FSLIC Resolution Fund, and the Resolution Trust Corporation, which will be spread over a number of years.

6/ The Nordic Banking Crises: Pitfalls in Financial Liberalization?, B. Drees, C. Pazarbasioglu, F. Caramazza, and S. Fries, International Monetary Fund (draft working paper), p.2.

7/ Central Bank of Argentina, Boletín Estadístico, 1980 (several issues).

This paper analyzes the factors that may have accounted for the size of the banking crisis in Venezuela and its timing. Although the crisis only emerged in 1994, there had been major weaknesses in the banking industry for several years. The paper concludes that the magnitude of the crisis reflects in large part a failure over an extended period of time to correct these weaknesses or to put in place incentives for bank owners and managers to follow sound banking practices and avoid excessive risk-taking. These factors were compounded in recent years by weak and often inconsistent implementation of macroeconomic policies and increased political instability, which contributed to periodic episodes of capital flight and a steady erosion of real money demand, and a downturn in economic activity after 1992. In addition, the magnitude of the crisis was exacerbated by its handling in the period since January 1994.

The paper is organized as follows. Section II describes the structure of the financial system in Venezuela. Section III discusses the situation prior to the initiation of major economic reforms in 1989, including the economic setting, the regulatory framework, and the financial condition of the banking sector. The major elements of the 1989 reforms and post-reform developments in 1989-93 are discussed in Section IV, while Section V describes the evolution of the crisis in 1994, its handling, and the linkages to recent macroeconomic developments. Section VI provides a summary and some concluding remarks.

II. The Structure of the Financial System

The Venezuelan financial system developed on the basis of a legal and regulatory framework prior to 1994 that promoted the development of financial institutions that specialized in certain types of business and were prohibited by law from engaging in other types. As a result, more than 150 financial institutions were operating in Venezuela prior to 1994 (Table 3). Also, the banking legislation imposed severe restrictions on the entry and operations of foreign banks 1/ and, accordingly, foreign banks have played a very limited role. The public sector's ownership of financial institutions historically has been small, with state-owned institutions typically accounting for less than 5 percent of total financial system liabilities to the private sector. 2/ Despite the large number of institutions, the financial system was heavily concentrated, with the largest six commercial banks accounting for 57 percent of the total reported assets of the financial system at end-1989. By end-1993 this share had

---

1/ Entry of new foreign banks was prohibited between 1975 and 1993, with the exception of Latin American banks under reciprocal agreements.

2/ This share declined further in the early 1990s as three commercial banks owned by the Central Bank of Venezuela (BCV) were reprivatized, the Agricultural Development Bank was liquidated, and the state-owned Banco Industrial (BIV) was restructured.

declined only slightly to 52 percent. Also, private ownership of banks and financial groups generally was highly concentrated.

Although the regulatory framework was based on the principle of specialized banking, in practice there has been a de facto universal banking system as financial institutions have structured themselves as "groups" of legally independent financial entities under common ownership in order to provide clients with a full range of financial services. A financial group can include one or more commercial banks, mortgage banks, finance companies, insurance and leasing companies, brokerages, and liquid asset funds (LAFs); 1/ they also may have offshore affiliates. In addition, mainly through their commercial banks, financial groups offer trust fund operations (*operaciones de fideicomiso*), and operate money desks, which were used to channel wholesale funds directly from investors to borrowers.

III. The Setting Prior to 1989

1. The economic situation

The performance of the Venezuelan economy during the 1980s was poor. Real GDP growth averaged only about 1 percent in 1980-88, compared with more than 4 percent in the previous decade, while the average rate of inflation increased from 6 percent to 24 percent. Adjustment efforts undertaken in the early 1980s in response to declining world oil prices placed excessive reliance on exchange and trade restrictions, including a multiple exchange rate regime and direct controls. Monetary policy objectives were subordinated to the goals of maintaining low and stable interest rates, and to channeling subsidized credit to priority sectors such as the Government, agriculture, and housing. Expansionary policies adopted in 1985 with the aim of reactivating the economy led to a sharp deterioration in the external accounts and an acceleration in inflation. Real interest rates became increasingly negative, which encouraged disintermediation and strong private capital outflows. 2/ These policies culminated in a major foreign exchange crisis in late 1988 as reserves were depleted, shortages of

---

1/ LAFs originally were created as a means of circumventing interest rate controls, but they were retained after interest rate liberalization as a means of avoiding reserve requirements and to capture short-term deposits that could be used to finance activities elsewhere within the group. The size of LAFs in relation to commercial bank assets continued to increase after the removal of interest rate controls from 23 percent at end-1989 to 53 percent at end-1993 (see Table 3).

2/ Dollarization has not been a widespread feature of the Venezuelan economy, but Venezuelan residents are thought to hold substantial funds abroad. An increase in such offshore deposits may have contributed to the fall in broad money from 44 percent of GDP in 1986 to 35 percent of GDP in 1988.

price-controlled staples emerged, and inflation reached an annualized rate of over 80 percent.

2. Supervisory regime and handling of previous bank failures

There were serious weaknesses in the supervisory and regulatory framework governing financial institutions prior to 1989. The Superintendency of Banks and Other Financial Institutions (SBIF) was effectively under the control of the Ministry of Finance and focused on monitoring formal compliance with banking regulations rather than analyzing the solvency of financial institutions. Bank interventions required the approval of the Minister of Finance, which made the process vulnerable to political pressures and resulted in prolonged delays. In turn, this often permitted bank management to remain in place and continue improper banking practices for an extended period. The respective roles of the SBIF, the Central Bank (BCV), and the Deposit Insurance Agency (FOGADE) 1/ in dealing with bank illiquidity or insolvency were not well defined. Also, the SBIF lacked authority to require capital increases, sale, merger, or dissolution of financial institutions.

The SBIF was poorly staffed and lacked the financial resources to conduct any meaningful form of prudential oversight. Prudential norms covering such areas as capital adequacy, loan classification, provisioning, and lending to related parties were inadequate. Offshore operations were not monitored by the SBIF. Moreover, external audits were ineffective, reflecting in part the absence of adequate accounting standards and regulations. The failure to monitor institutions at a "group" level and to take account of the interrelationships between entities in the same group was a fundamental shortcoming of the supervisory regime. This created incentives for financial groups to divert problem loans or losses to those institutions where supervision and reporting requirements were weak or nonexistent (such as the money desk, fideicomiso, and offshore operations), and to channel deposits into institutions that were not subject to reserve requirements. The organizational structure of financial groups also lent itself to evasion of limits on bank loan concentration and lending to related parties. As a result, the structure of a commercial bank's balance sheet could be a very misleading indicator of the true condition of the bank or the financial group as a whole (Appendix I).

1/ FOGADE was created in 1985 to provide insurance for local currency deposits up to Bs 250,000 per depositor (US$33,000 at the then-official exchange rate) and also to provide long-term financing at subsidized rates to help restructure ailing financial institutions.

Previous bank failures in Venezuela 1/ generally had been characterized by insider lending, excessive loan concentration, and weak management. Depositors had been paid out in full, thereby sending a signal of unconditional government backing of financial institutions. The authorities traditionally had taken the view that problem banks needed to be maintained afloat in order to maintain public confidence in the banking system. Nationalization or liquidation had been resorted to only when the institution had run out of resources to pledge as guarantees for additional assistance. 2/ These policies had served to create an environment that promoted excessive risk-taking in the banking sector.

3. Financial condition of the banking system

The regulatory framework of direct controls and strong barriers to foreign competition fostered an excessive cost structure within the banking industry. 3/ The absence of data on the consolidated activities of financial groups and of adequate accounting standards precluded an assessment of the true condition of banks. However, even on the basis of published data, bank profitability after excluding extraordinary items had become negative in real terms during 1985-88, 4/ and the ratio of equity to assets had been declining since 1983. World Bank and Fund technical assistance reports prepared for the authorities around this time pointed to indications that there were substantial problems of insolvency and inadequate capitalization within the banking sector. These reports noted also that the implementation of appropriate accounting rules would reveal an insolvency situation that was much worse than suggested by then-available data, and highlighted the urgent need to evaluate the true condition of banks and other financial institutions and to take corrective measures. 5/

1/ Notably, Banco Nacional de Descuento, the nation's largest bank, which was intervened in 1978, Banco Nacional de los Trabajadores de Venezuela in 1982, Banco de Comercio in 1985, and three banks that were taken over by the BCV.

2/ See Medio Siglo del Banco Central de Venezuela, Carlos Silva, Caracas, 1991.

3/ For example, in 1988 the gross average margin of commercial banks was 7.5 percent of total assets, which was relatively high by international standards (see Venezuela: A Program for Financial Sector Reform, International Monetary Fund, January 1990, Table 7). These high operative costs reflected extensive branch networks, excessive labor costs, and a high level of automation.

4/ See Venezuela: A Blueprint for Financial Sector Reform, World Bank, October 1989.

5/ A summary of Fund technical assistance and recommendations on banking supervision since 1989 is provided in Appendix II.

IV. The 1989 Program of Economic Reforms and Subsequent Developments, 1989-93

In early 1989 the Government initiated a major program of macroeconomic adjustment and economic reform. 1/ Measures included a strong fiscal adjustment, a relaxation of interest rate controls, 2/ and a shift from direct to market-based instruments of monetary policy. The exchange rate was unified and a floating rate regime was introduced involving an immedi te 70 percent nominal devaluation of the official exchange rate. Most contrc is and restrictions on prices and foreign exchange transactions were abolishe , and a program to reduce trade barriers was initiated. The authorities also began work on a comprehensive program of financial sector reforms that was to include a strengthening of the legal and institutional framework of regulatory agencies, measures designed to improve the financial condition and competitiveness of financial intermediaries, and a rationalization of the Government's role in the financial sector. 3/

1. Macroeconomic reforms and economic performance

Initial strong implementation of the macroeconomic reforms and adjustment, combined with a sharp rise in oil export revenues in 1990, strengthened the fiscal and external current accounts, and permitted the restoration of a solid international reserves position (Chart 1). Real GDP contracted in 1989, but economic activity rebounded strongly in 1990 in response to improved macroeconomic policies and the oil export windfall associated with the Gulf War. Interest rates increased sharply to become positive in real terms by late 1989 (Chart 2) and this, combined with the fiscal tightening, resulted in a marked slowing in inflation during the second half of 1989. The demand for money recovered substantially in 1990 after a further decline in 1989 associated with the initial large price adjustments and the economic contraction (Chart 3).

Commitment to the adjustment effort slackened markedly after 1990. The fiscal balance weakened significantly as measures were not taken to offset the large decline in oil revenue in 1991 following the end of the Gulf War. Also, monetary policy was eased somewhat in order to promote the recovery in

---

1/ The program was supported by a first credit tranche purchase and approval in June 1989 of a three-year extended arrangement for SDR 3.7 billion.

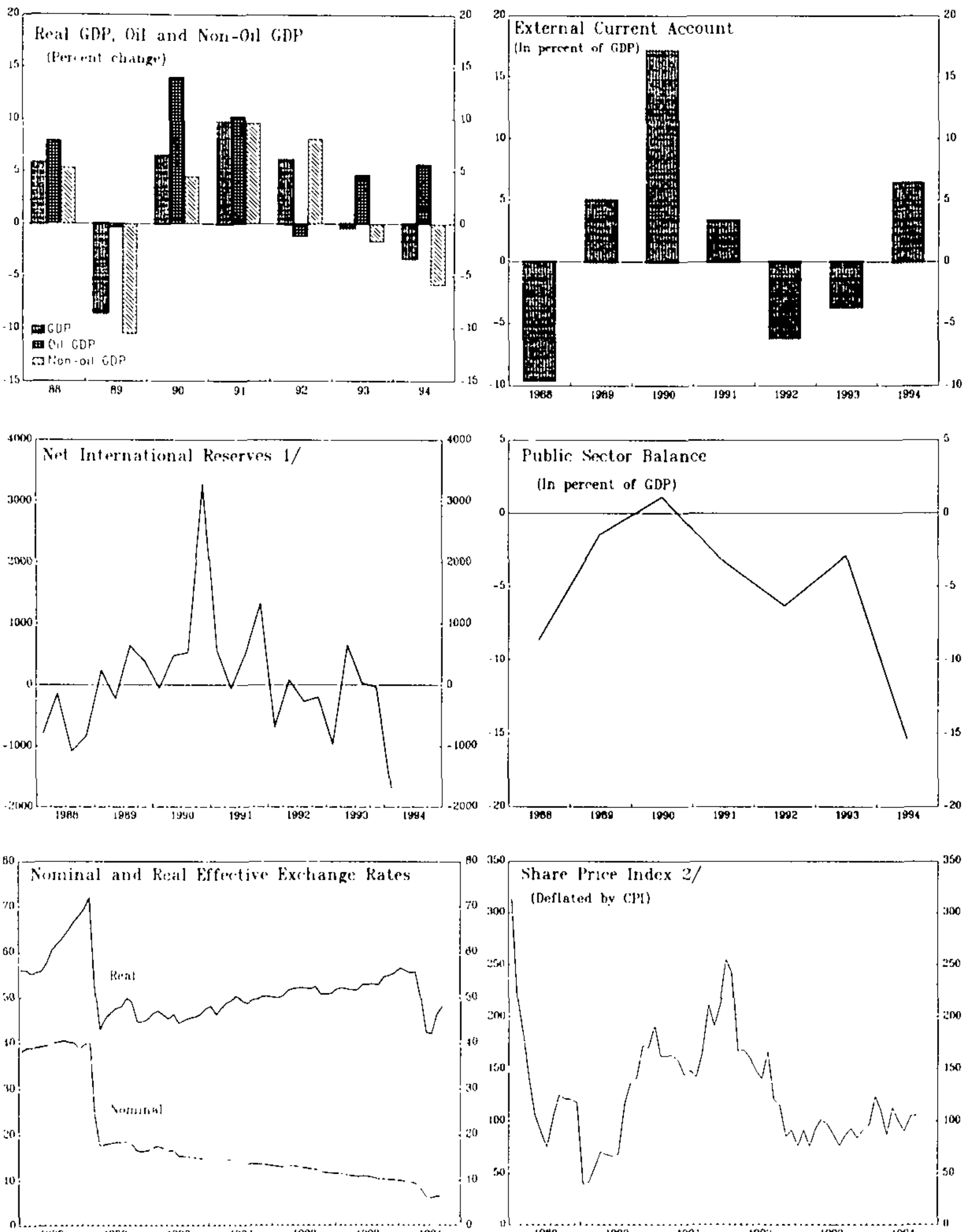
2/ The BCV abolished the system of interest rate ceilings in February 1989 but subsequently was forced by a Supreme Court ruling to re-establish maximum lending and minimum deposit rates. However, the latter controls were set at levels that were nonbinding for much of the subsequent period.

3/ These reforms were supported in 1990 by a US$300 million Financial Sector Adjustment Loan from the World Bank. This loan included a US$7 million technical assistance component that was intended, inter alia, to assist in the strengthening of the regulatory agencies and to finance studies on the condition of financial intermediaries.

CHART No 1

VENEZUELA

Selected Economic Indicators



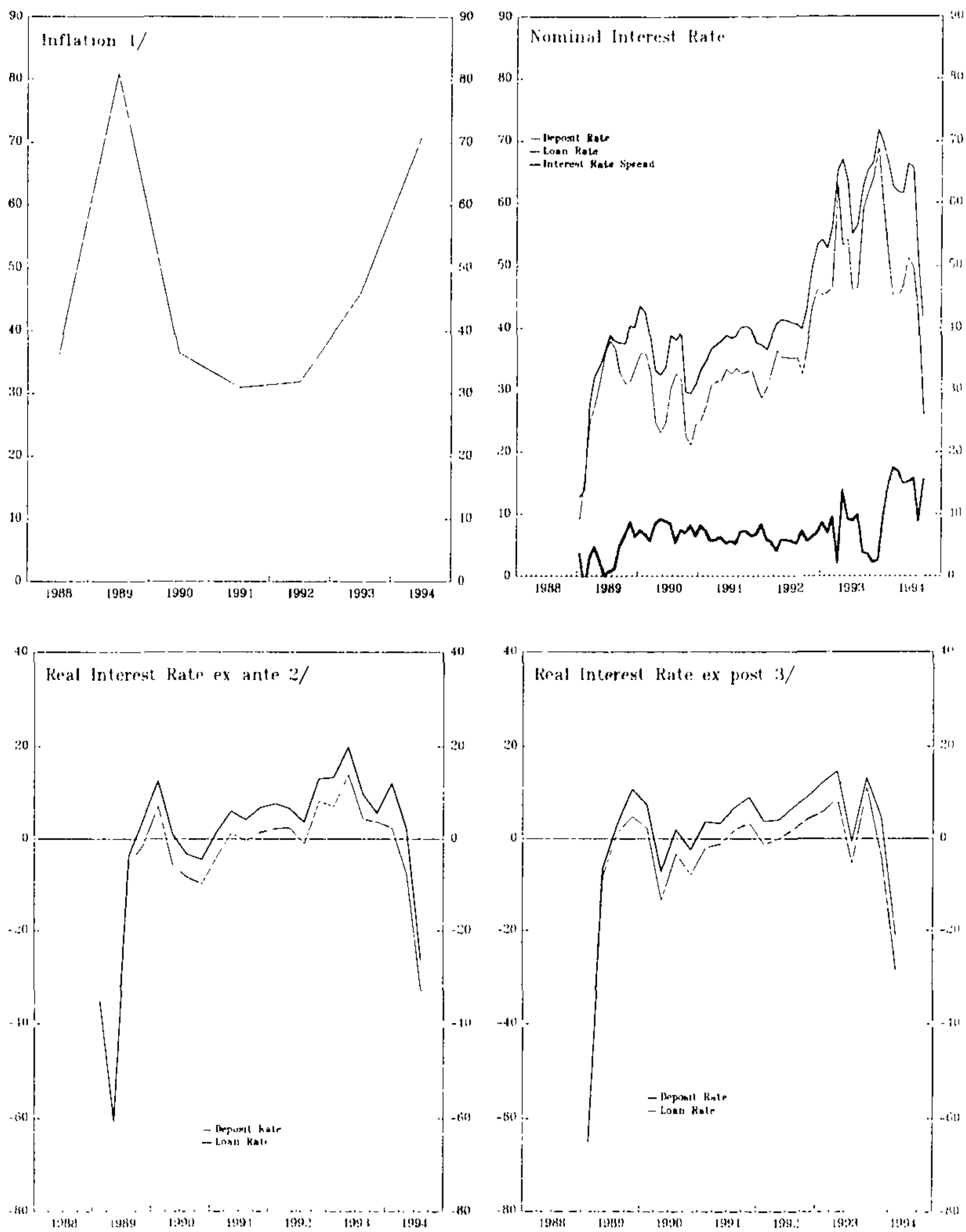
Source: International Financial Statistics, Central Bank of Venezuela, and Fund staff estimates.

1/ Quarterly changes, in millions of U S dollars.
2/ 1990 = 100

CHART No 2

VENEZUELA

Interest Rates and Inflation



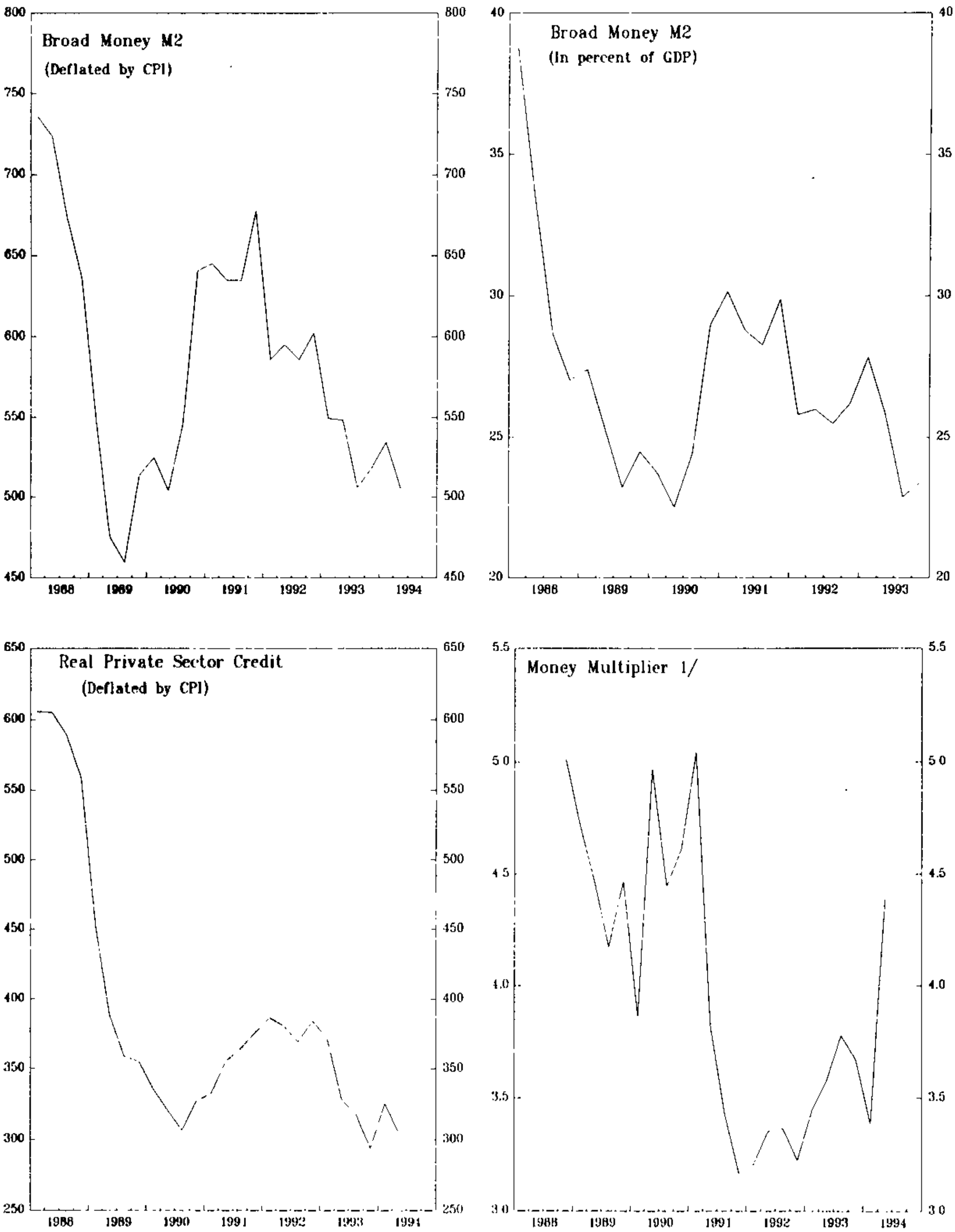
Source: International Financial Statistics, Central Bank of Venezuela, and Fund staff estimates

1/ Annual percentage change of CPI (end of period).
2/ Nominal monthly interest rate deflated by the annualized average inflation rate over the preceding three months.
3/ Nominal monthly interest rate deflated by the annualized average inflation rate over the succeeding three months.

CHART No 3

VENEZUELA

Monetary Indicators



Source: International Financial Statistics, Central Bank of Venezuela, and Fund staff estimates.

1/ M2 divided by the money base

economic activity. The relaxation of financial policies initially reinforced the strong economic upswing and the boom in asset prices, with share prices increasing by 440 percent in real terms during 1990-91. 1/ However, no further progress was made in reducing inflation in 1991 and the external current account surplus narrowed sharply.

As financial policies weakened, the authorities resorted increasingly to the exchange rate to contain inflationary pressures. 2/ The resulting inconsistency between financial and exchange rate policies made the economy vulnerable to periodic episodes of capital flight, particularly following an increase in political instability in 1992. This policy inconsistency also contributed to a steady decline in real money demand after 1991.

The economy continued to expand in 1992, but this took place against a background of sharply increased political tensions, associated with two attempted military coups, and several episodes of runs on the currency. The fiscal deficit widened to more than 6 percent of GDP as new revenue measures were further delayed in view of the increasingly difficult political situation. Monetary policy became increasingly erratic and efforts to reduce interest rates and stabilize the exchange rate culminated in an exchange crisis in October 1992. The increase in political tensions contributed to a sharp decline in asset prices in 1992, with the share price index falling 60 percent in real terms, and there was a marked deterioration in the external accounts.

In 1993 the economy contracted slightly owing to a further weakening in oil export prices and a mounting political crisis, which culminated in midyear in the removal from office by Congress of President Pérez. The fiscal deficit narrowed somewhat but remained unsustainably high. Real interest rates were strongly positive during the first half of 1993, as the BCV sought to protect the international reserves position through increased sales of short-term zero-coupon bonds, but declined somewhat thereafter as an increase in the inflation rate was not matched by higher nominal interest rates. Broad money (M2) declined in real terms by about 12 percent during 1993 after a 10 percent fall in the previous year. The ratio of average M2 balances to GDP fell to about 25 percent in 1993 compared with about 30 percent in 1991. 3/

1/ Although reliable data are not available, there also was a boom in real estate prices during this period, with construction activity increasing in real terms by 8 percent in 1990 and 31 percent in 1991.

2/ The real effective exchange rate appreciated by about 20 percent between end-1989 and end-1993.

3/ As noted above, this decline may have reflected at least in part an increase in offshore deposits held by Venezuelan residents, including deposits held in offshore branches of affiliates of Venezuelan banks.

2. Implementation of regulatory reforms

Little progress was made in addressing the major weaknesses in the regulatory and supervisory framework in the period between 1989 and end-1993. Efforts centered primarily on a major package of legislative reforms, which would establish the legal basis for a substantial strengthening of bank supervision and the prudential standards governing financial institutions operating in Venezuela. More specifically, the proposed reforms, inter alia, provided for regulation and supervision of groups of related financial institutions on a consolidated basis, increased minimum capital requirements for banks and introduced the concept of risk-based capital adequacy, reduced barriers to entry for foreign banks, and made the SBIF autonomous and provided it with financial independence. In addition, the new legislation would have enhanced the powers of the SBIF to address banking problems, clarified criteria and procedures for bank liquidation, and better defined the respective roles of the SBIF and FOGADE. The reform package included legislation designed to increase central bank independence and improve the conduct of monetary policy.

The authorities submitted the proposed reforms to Congress in July 1991, but their approval was subjected to extensive delays. Approval of the new central bank law was delayed until December 1992, while the new banking legislation was not approved until November 1993 and came into effect only at the beginning of 1994. In part, these delays may have been related to the political crisis and a deterioration in the working relationship between the executive and legislative branches of the Government. 1/ However, the extent of the delays suggests also that vested interests with considerable political influence were opposed to the reforms. 2/

During this period, little priority was accorded to measures which did not require legislative reform, such as increasing the staffing and other resources available to the SBIF, and improving the quality and coverage of the data supplied by commercial banks. Certain new prudential regulations issued by the SBIF during this period 3/ were not adequately enforced.

1/ The new banking law was approved by the interim Government of President Velásquez under emergency powers granted by Congress.

2/ Notably, the technical assistance component of the World Bank financial sector loan, which was directed mostly toward modernizing the SBIF and improving its capacity to enforce prudential regulations, was never approved by Congress and eventually had to be canceled. The rest of the loan was disbursed fully by end-1992.

3/ Such as regulations to require banks to improve provisioning and loan classification, establish a 2 percent general loan-loss provision, write off loans overdue by more than 36 months, and supply data on a consolidated basis (some of which were required to meet first tranche conditionality under the World Bank Financial Sector Adjustment Loan).

These and other measures 1/ may have served mainly to create the misleading impression that financial institutions were subject to adequate supervision. Meanwhile, key regulations relating to information on offshore banking, money desk operations, risk classification, and common standards to be met by external auditors were not issued in some cases until 1994, and firm measures do not seem to have been taken to address weaknesses in the banking system. 2/ As a result, right up until the emergence of the crisis, banks were operating largely in a regulatory and supervisory vacuum without effective disclosure requirements or any meaningful oversight over their activities and without effective legal sanctions against imprudent or corrupt banking practices.

3. Developments within the banking sector

Some of the economic reforms taken in 1989 initially may have further weakened the financial condition of banks. The combination of a large exchange rate devaluation, shifts in relative prices, increases in nominal interest rates, and import liberalization led to insolvencies in some industries; and this is likely to have adversely affected bank loan portfolios, particularly to the nontraded sector. 3/ In addition, the devaluation may have weakened the balance sheets of those banks that had significant net foreign exchange exposures. 4/

1/ In 1993 for example, the SBIF began to publish a quarterly bulletin providing detailed indicators on the financial condition of banks and other financial institutions. These indicators provided signs of problems in some banks in 1993. However, as would become apparent following the bank failures in 1994, the shortcomings in the data on which the financial indicators were based meant that they bore little relation to the true condition of the financial institutions. The same comment applies to the long-standing requirement that banks publish in newspapers their monthly balance sheets and half-yearly income statements.

2/ During 1990-93 SBIF inspections of several of the banks that were intervened in 1994 reportedly found substantial solvency problems and need for further provisioning, but preventive or remedial actions were not enforced.

3/ Reported nonperforming loans of banks not under state intervention increased by about 50 percent to close to 7 percent of total loans outstanding during the three months ended August 1989, while 12 out of 38 banks had registered nonperforming loan portfolios that exceeded their estimated capital base as at the same date. (See the Report to Executive Directors for the proposed World Bank Financial Sector Adjustment Loan to Venezuela, May 21, 1990, p.19.)

4/ At end-1988 the net foreign exchange exposure reported in the balance sheets of commercial banks amounted to about US$850 million at the official exchange rate. This exposure declined sharply to about US$150 million by end-1989 and in recent years the banks have reported a net positive position in foreign exchange. However, comparable data are not available on the net foreign exchange exposure of financial groups.

Recourse to BCV credit increased during the first half of 1989, but declined thereafter as the liquidity of the banking system improved. Moreover, interest rate liberalization permitted banks to strengthen their balance sheets through a temporary widening of interest rate spreads (see Charts 2 and 4). Bank balance sheets also benefitted from the subsequent economic recovery and deposits grew strongly in real terms during 1990-91 as real money demand recovered. Only part of these resources were reflected in lending growth, however, which suggests that depositors' funds increasingly were channeled into other investments, such as private sector securities and fixed assets (Charts 5 and 6).

There was a sharp erosion of bank deposits and lending in real terms in 1992-93, as political instability and the weakening of macroeconomic policies undermined confidence in the currency and led to a decline in real money demand. The deterioration in economic performance, combined with an increase in real interest rates in 1993, also contributed to an increase in reported nonperforming loans of the banking system (Table 4). However, this increase is likely to have substantially understated the true deterioration in bank balance sheets, given the widespread practices of rolling over nonperforming loans, capitalizing interest, and transferring losses to other parts of the financial group. 1/

Data reported by the SBIF during this period indicate significant solvency problems among the group of banks that were nationalized or closed during the first half of 1994 (Table 5). The ratio of reported losses (net of provisions) to net worth for these banks was over 40 percent at end-1992 and increased to close to 90 percent during the first half of 1993. Another early warning indicator was the interest rate premiums that these banks (including Banco Latino, which was the first bank to fail in 1994) were offering to attract and retain deposits, which at times reached more than 10 percentage points during 1993 (Chart 7).

Notwithstanding the shortcomings in the quality of data on bank balance sheets, an important clue as to why certain banks exhibited major problems of insolvency in 1994, whereas others did not, can be obtained by examining data on the changes in bank deposit shares since 1989 (Table 6). It is clear that, in the period following the 1989 economic reforms, certain banks that were nationalized or closed in 1994 embarked on an aggressive strategy of expansion, which may have been facilitated in part by the new opportunities to compete for deposits provided by interest rate deregulation. For example, Banco Latino moved from fifth to second ranking in terms of deposit shares between 1988 and 1993. Most of the increase in the recorded deposit share of Banco Latino took place in 1989, after which its share remained

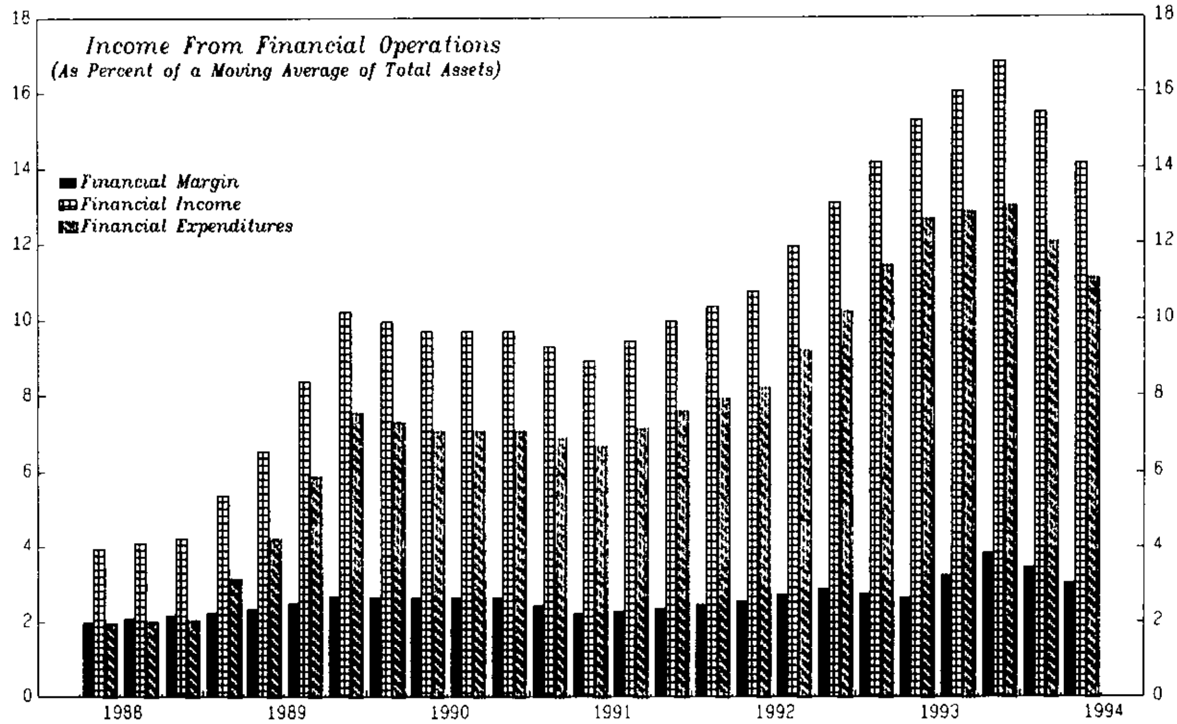
---

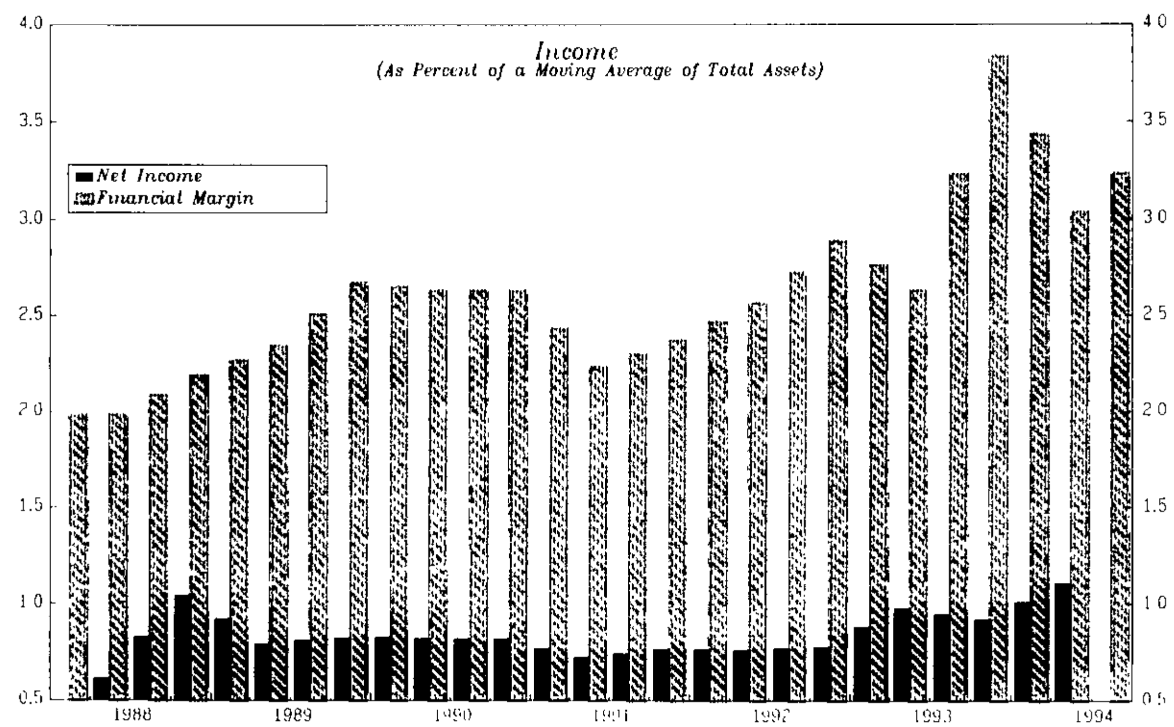
1/ The apparent deterioration in financial performance contrasts with the public perception, which was reflected in the discussion of banks in the press and in Congress, that banks were extremely profitable.

CHART 4

Venezuela

Banking System: Net Income (1988-1994)



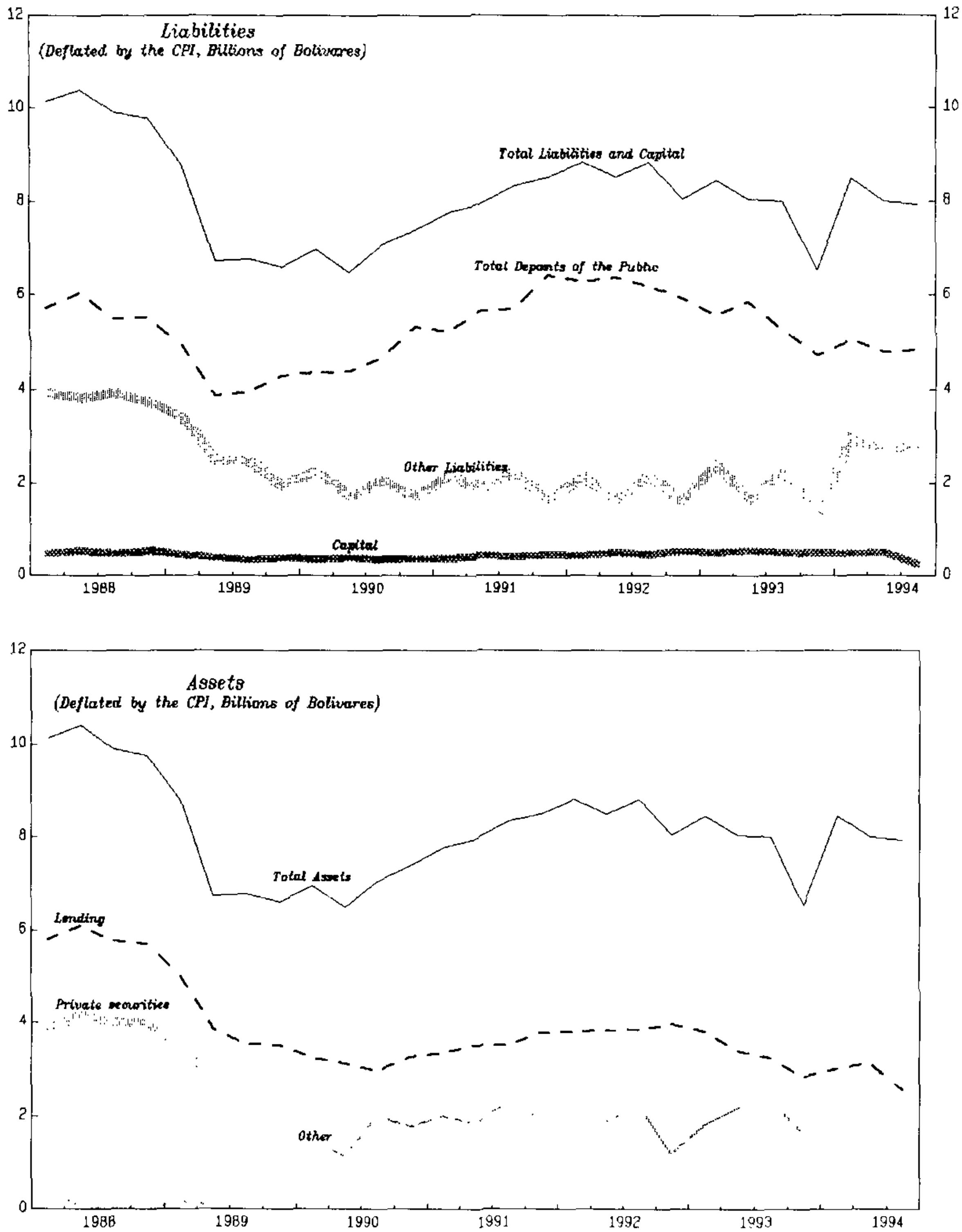


Source: Central Bank of Venezuela; and Fund Staff Estimates.

CHART 5

Venezuela

Banking System: Liabilities and Assets (1988-1994)

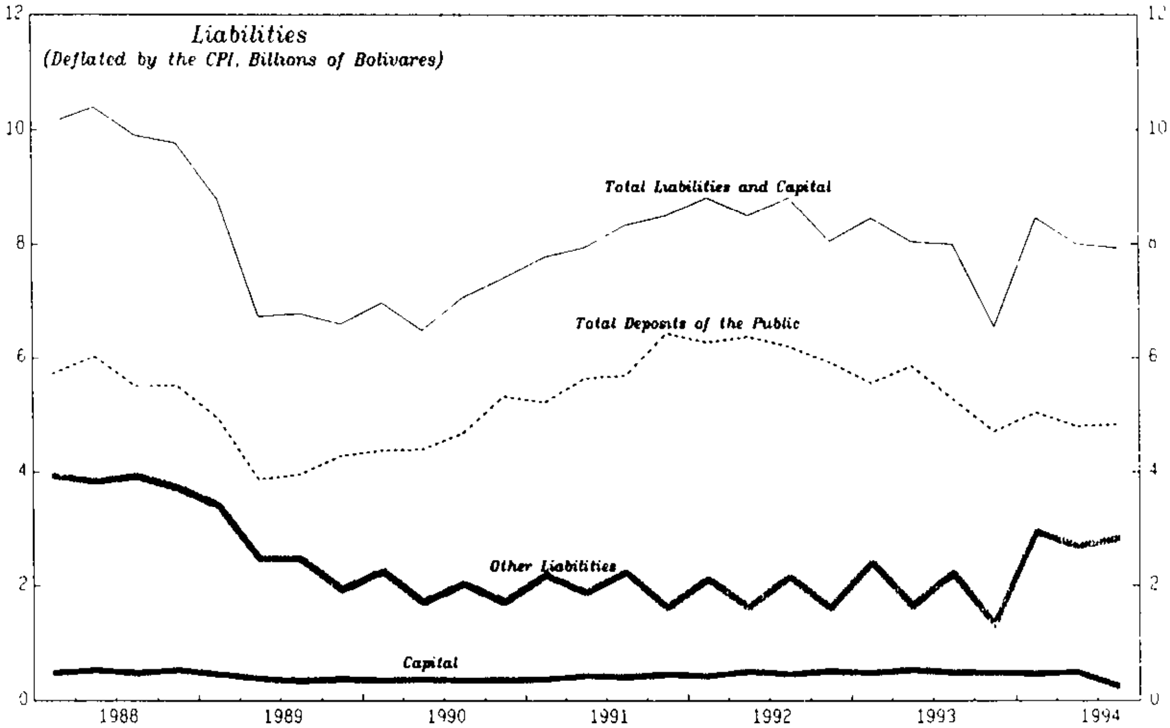


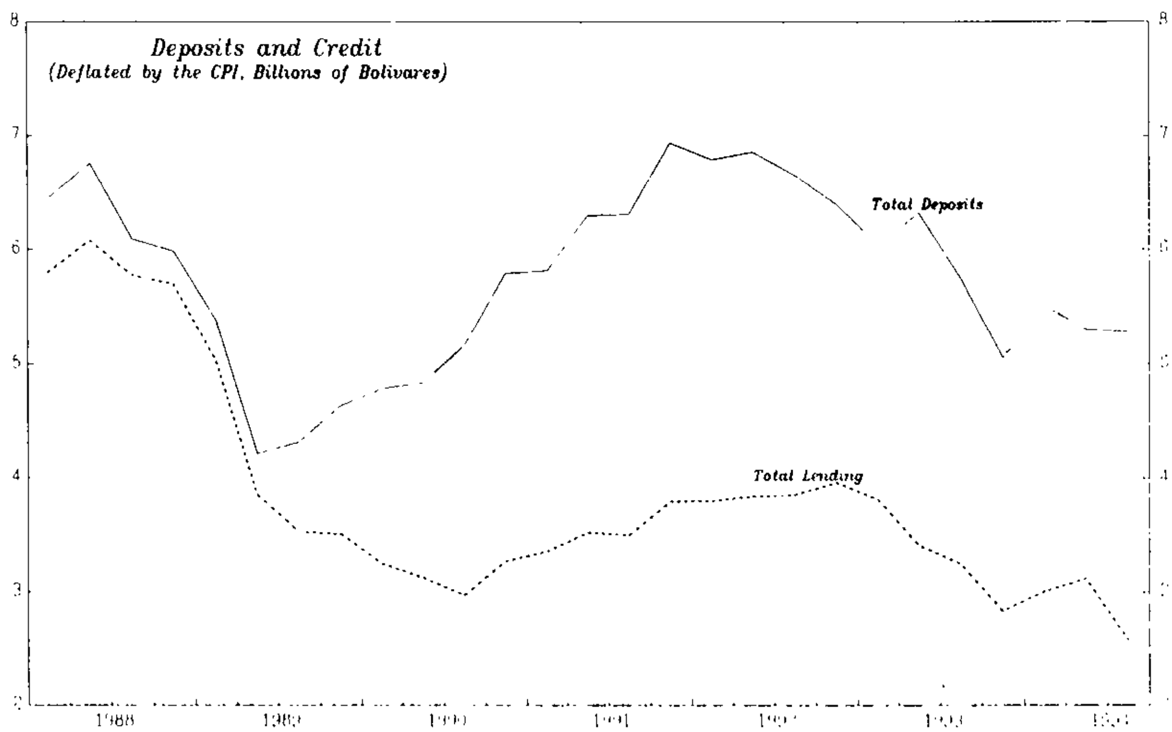
Source: Central Bank of Venezuela; and Fund Staff Estimates.

CHART 6

Venezuela

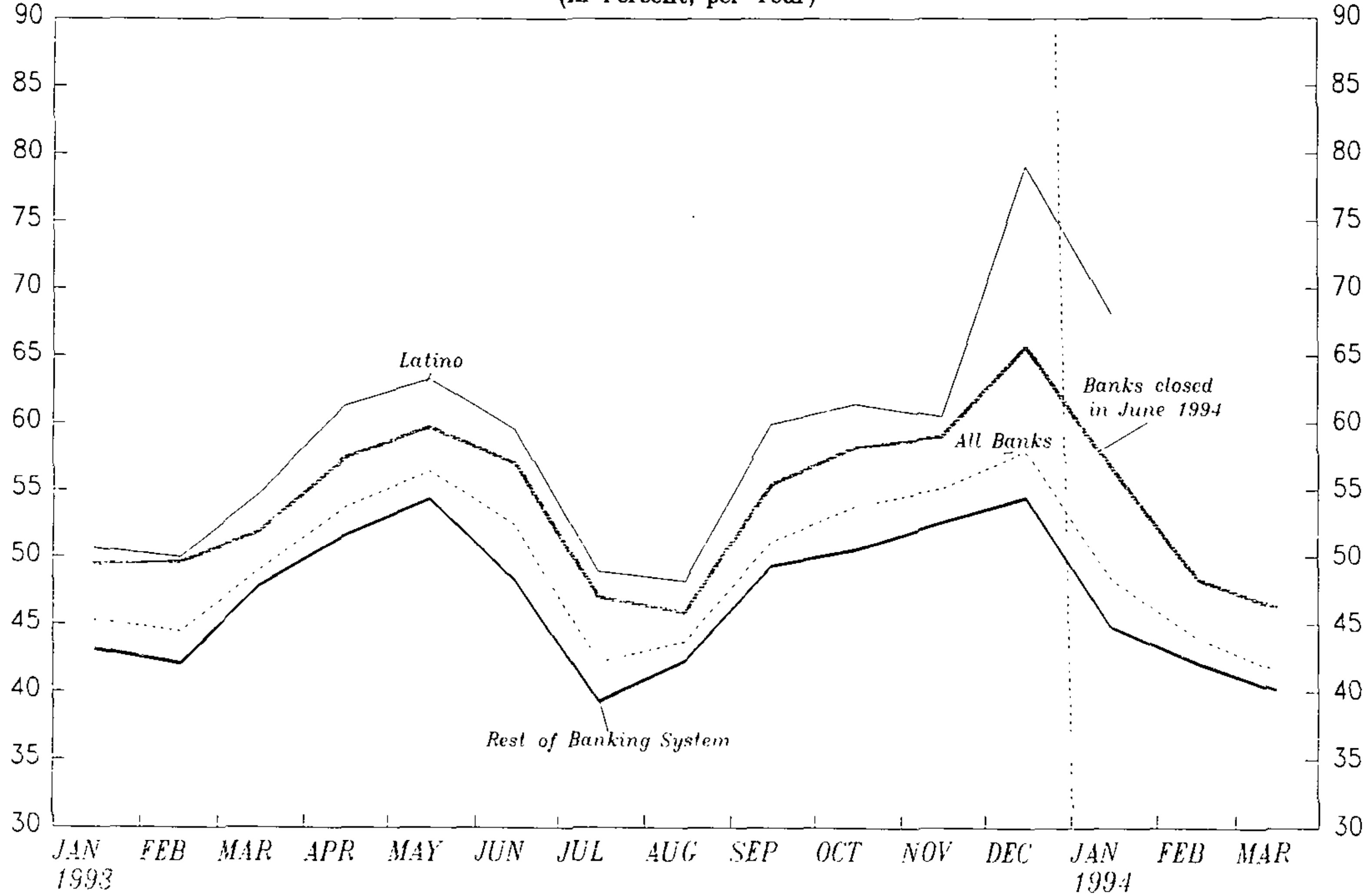
Banking System: Deposits & Lending (1988-1994)





Source Central Bank of Venezuela; and Fund Staff Estimates.

CHART 7
Venezuela
Banking System
Interest Rates on Short-Term Deposits
(In Percent, per Year)



Source: Central Bank of Venezuela

relatively stable through 1993. 1/ However, it is likely that other parts of the Latino group (e.g., fideicomisos, LAFs, and offshore operations) continued to record strong growth in the period after 1989.

Most of the seven banks that were closed in June 1994 also had followed an aggressive strategy of capturing deposits during this period. Their combined share of total bank deposits rose sharply from 10.3 percent at end-1988 to 19 percent at end-1991. Some of these banks (particularly, Banco Maracaibo, which became part of the Latino group) continued to record strong gains in market share in 1992. However, the rate of expansion for these banks as a group slowed significantly and their reported deposit base actually fell slightly in nominal terms in 1993 (though they still accounted for 21.5 percent of total bank deposits at end-1993). Of the banks that were nationalized during the second half of 1994, only Banco Progreso and Banco República (part of the same financial group) exhibit a similar pattern of rapid growth in deposit shares during the early 1990s.

Data limitations make it difficult to trace exactly how the depositors' funds attracted by these banks were invested. However, it would seem that a significant part of the funds may have been channeled into loans to related enterprises, or higher risk investments such as fixed assets and loans to cyclical sectors such as tourism and construction, which would have been adversely affected by the asset price slump in 1992-93. The funds also may have been used to cover losses elsewhere in the group. 2/ An audit of the loan portfolio of the banks that were closed in June 1994 suggested that only about 13 percent of the loan portfolio was current. Moreover, over half of the assets provided by these banks as guarantees for the auxiliary financing from FOGADE in the first half of 1994 were found to represent loans or investments in related companies.

V. The 1994 Banking Crisis

The banking crisis in 1994 can be divided into three episodes (described locally as the first three "waves" of the crisis). The response of the authorities differed in each case.

1/ The decline shown in the deposit share of Banco Latino in 1993 reflects a large run on deposits in the last quarter of 1993, which precipitated the intervention in January 1994. As at end-September 1993, Banco Latino's share in total bank deposits was 10.5 percent.

2/ There are indications also that part of these resources in some cases could have been directed into illegal or fraudulent activities. See, for example, How the Bankers at Banco Latino "Stole the Bank", Global Finance, September 1994, pp.130-135.

1. The first two waves of the crisis

The crisis emerged in mid-January when Banco Latino, the then-second largest bank in terms of deposit share, was unable to meet its clearing house obligations. 1/ Banco Latino was the center of the Latino financial group which, as noted above, had followed an aggressive growth strategy during previous years. Reportedly, the group had channeled a substantial part of its depositors' funds into loans to related companies or investments in fixed assets, including large equity holdings (e.g., in other banks, the Caracas electricity company, and a local television station), and an extensive portfolio of real estate developments concentrated in the tourism sector. Particularly given the post-1991 decline in asset prices, it seems likely that a thorough review of the asset portfolio of the Latino group would have revealed serious solvency problems well before the January 1994 closure. Banco Latino experienced major deposit withdrawals in the last quarter of 1993, which it was able to meet only through large scale asset sales and borrowing from the BCV. As an indication of the importance of activities of the Latino group outside the balance sheet of Banco Latino, total losses (following the initial closure of the bank) were estimated at about Bs 300 billion (US$3 billion), or more than three times the bank's loan portfolio at end-1993 (Bs 89 billion), and one-and-a-half times its total reported assets as at end-December 1993 (Bs 200 billion).

As mentioned, the policy adopted initially was to close Banco Latino when it was unable to meet its clearing obligations. Banco Latino eventually was reopened as a state-owned bank on April 4, after receiving a capital injection from FOGADE (financed by the BCV) to cover the above-mentioned estimated losses. Depositors of Banco Latino (including investors in the money desk and fideicomiso operations, who did not have a government guarantee under the new banking law) were allowed to withdraw their deposits up to Bs 10 million, or more than double the newly-increased legal deposit guarantee of Bs 4 million. 2/3/

In late January, shortly after the closure of Banco Latino, several other banks suffered large deposit withdrawals and resulting liquidity

---

1/ Banco Latino had received liquidity assistance from the BCV during the latter part of 1993. By the end of the year, such assistance had reached twice Banco Latino's capital and reserves. These loans were cleared in 1994 as part of the recapitalization of Banco Latino by FOGADE.

2/ The amount of the maximum deposit guarantee had been set in the new banking law at Bs 1 million, but it was increased to Bs 4 million by an emergency law introduced on March 8, 1994 in response to the crisis.

3/ Under the terms of the restructuring plan developed for Banco Latino, large depositors were to receive long-term bonds paying a below-market interest rate for amounts above Bs 10 million, thereby sharing part of the losses of the bank. However, there have since been proposals to increase the level up to which depositors would be able to withdraw their funds without penalty.

difficulties (referred to as the beginning of the second wave of the crisis). Two of these banks (Maracaibo and Barinas) and a finance company (Fiveca) had close ownership connections with the Latino group and were particularly affected by a loss of depositor confidence associated with the closure of Banco Latino. Concerns that the closure of additional banks at that time might provoke a systemic crisis, 1/ led to the decision that FOGADE would provide auxiliary financing to cover the liquidity shortfalls of banks in difficulties. 2/ By end-March, seven banks (as well as Fiveca) were receiving such assistance from FOGADE, 3/ and the aggregate amount involved had reached Bs 350 billion or 4.2 percent of GDP. The total reported deposit liabilities of these banks fell by only Bs 65 billion during the first quarter, which suggests that the major part of these funds was used to cover losses or liabilities that previously had been held elsewhere in the respective financial groups.

Such assistance continued to mount, virtually on a daily basis, until mid-June when these banks were unable to put up additional assets as loan guarantees. Accordingly, the previously announced policy of avoiding further bank closures was abandoned and these institutions were closed by the authorities. By that time, total assistance provided by FOGADE had reached Bs 500 billion (US$4.3 billion at then-prevailing exchange rates), virtually all of which was financed by the BCV. Moreover, these financial groups still had deposit liabilities amounting to Bs 290 billion (of which an estimated Bs 173 billion were subject to the legal guarantee). Thus, the sum of the assistance granted in the first half of the year and remaining deposit liabilities was more than twice the total reported deposits of these banks at end-1993 (Bs 318 billion). 4/ These banks since have remained closed, except for the payment of the legal deposit guarantee, under the control of SBIF-appointed intervenors. The authorities have announced their intention to liquidate most or all of these institutions.

The new banking legislation approved in November 1993 provided substantially improved procedures for handling bank failures. Under the provisions of the law, the granting of assistance to banks would have required an assessment of the degree of insolvency, agreement on a rehabilitation plan, and, in cases where the capital base had been substantially impaired, that shareholders replenish the capital stock within 90 days. The new law

---

1/ The closure of Banco Latino had met with widespread demonstrations from depositors, who were unable to withdraw their funds.

2/ Effective January 21, the BCV also lowered the bank reserve requirement from 15 percent to 12 percent, with the intention that the freed reserves be lent to banks facing liquidity difficulties.

3/ A mortgage bank belonging to the Latino group (Banco Hipotecario de Occidente) also was assisted (see Table 2).

4/ See Appendix I, Table 8.

provided for intervention of financial institutions 1/ and their rehabilitation, merger, or liquidation in the event that the measures contemplated were considered insufficient to restore solvency.

However, official assistance was granted to these banks over a period of up to five months in amounts that represented several multiples of (more than 20 times in some cases) the banks' respective capital bases and without a thorough assessment of their true financial condition. Moreover, existing management was permitted to remain in place for some time. Provision of liquidity assistance on such a large scale to banks that clearly were insolvent created serious moral hazard risks. There were strong incentives for insiders who knew the true condition of the banks (e.g., management and large depositors) and who would not have been covered by the legal deposit guarantee to withdraw their funds ahead of a possible government intervention. As a result, the fiscal cost associated with these bank failures was much larger than would have been the case had the banks been liquidated when the problems first emerged and had depositors been compensated in accordance with the legal guarantee.

The shortcomings in the handling of the crisis during the first part of 1994 were not helped by problems encountered by the Government in finding new leadership for the SBIF and FOGADE who were acceptable to Congress. It was not until the new President of FOGADE was appointed in April that the agency initiated the process of replacing management of the assisted banks and calling shareholder assemblies to request the bank owners to put in new capital. Also, by midyear the SBIF still lacked information on the condition of financial groups on a consolidated basis. Public confidence was further undermined by frequent contradictory statements regarding the health of the system and the policy for handling bank failures, as well as the resignation in April of the Central Bank President. There were doubts about FOGADE's capacity to continue to support ailing banks and the recourse to central bank credit to finance FOGADE's assistance to banks (FOGADE's liquid assets amounted to only about Bs 50 billion at end-1993) was widely viewed as unsustainable. 2/ This may have further contributed to the loss of confidence among depositors.

1/ Under the law, intervention would involve the designation by the SBIF of one or more persons with wide-ranging powers over the activities of the intervened bank. Such intervention would have required a decision by the newly formed Superior Council, composed of the Minister of Finance and the Presidents of the BCV and FOGADE, rather than by the Minister of Finance alone as under the previous banking law.

2/ During the first quarter of 1994, the six-monthly contribution of banks and other financial institutions to FOGADE was increased from 0.25 percent to 1 percent of deposits, and Congress approved the issuance of Bs 400 billion in domestic government bonds to recapitalize FOGADE. However, placement of the Bs 400 billion bond issue did not commence until August and, therefore, these measures did not provide FOGADE with additional financial resources during the first half of 1994.

2. Policy measures taken in June 1994 and the third wave of the crisis

Following the closure of the eight institutions in mid-June, a further group of banks began to experience large deposit losses, which coincided with increased private capital outflows immediately prior to the imposition of exchange controls. In late June the Government took measures 1/ (i) to improve coordination between the BCV, SBIF, and FOGADE, and place under executive authority the decision-making powers that previously had been distributed across the three agencies; and (ii) to allow the Government to force stronger banks to lend to weaker banks.

Regarding the issue of coordination and decision making, the Government established a Financial Emergency Board (JEF), comprising the heads of the BCV, SBIF, and FOGADE and three other presidential appointees acting under the Chairmanship of the Minister of Finance, with responsibility for formulating and implementing policies to address the banking crisis. 2/ As regards (ii) above, the JEF was given wide powers to regulate the flow and use of funds in the interbank market and, in particular, to force banks with excess liquidity to lend to those facing liquidity shortages. This measure was intended as an alternative to the policy of auxiliary financing by FOGADE, which was widely viewed as having failed to solve the crisis during the first half of the year. 3/ The provision for the compulsory recirculation of bank deposits remains in effect, though it does not appear to have been used to date. 4/

The above measure failed to slow deposit withdrawals from banks that were perceived to be in weak condition. Rather, the problems intensified in some cases as certain banks experienced large outflows from their offshore operations, which may have been related in part to uncertainties regarding the new exchange control regime. Accordingly, one of the first tasks of the

---

1/ These measures were introduced by Executive Decree No. 248 (6/27/94), which was made possible by a decision to suspend six constitutional guarantees.

2/ Though extensive powers already were provided under the new banking law, the JEF was granted authority to establish a special regime of supervision and control over financial institutions, including the designation of an official with veto rights to monitor the operations of financial institutions and strong sanctions for noncompliance with its directives.

3/ The decree also removed the constraints imposed by the central bank law on the BCV's ability to extend credit to FOGADE or directly to financial institutions in difficulties.

4/ These measures have been incorporated in a proposed new law governing the handling of financial crises, which currently is before Congress.

JEF was to evaluate the financial condition of new banks in difficulties and develop a strategy to address these difficulties. 1/

On August 8 the JEF took measures to address financial weaknesses that had been identified in a group of eight banks. Included among this group of banks was Banco de Venezuela, Banco Consolidado, and Banco Progreso, which at the time were the second, fourth, and sixth largest banks, respectively, in terms of deposit shares. Banco de Venezuela was the country's oldest bank, and had been the subject of a protracted ownership battle since the mid-1980s that culminated in control of the bank passing in late 1992 to a group associated with Banco Consolidado. Subsequently, it was revealed that the purchase of shares in Banco de Venezuela had been financed by loans from the bank itself and from Banco Consolidado through its offshore affiliates; Banco Progreso also participated in the takeover. Accordingly, the financing operations associated with the 1992 takeover of Banco de Venezuela seem to have contributed to the difficulties experienced by these three banks in 1994.

Measures adopted by the JEF included effective nationalization of Banco de Venezuela and agreements with the owners of Banco Consolidado and Banco Progreso on plans of recapitalization that, in both cases, involved initial financial support from FOGADE for a period which would allow the owners to raise new capital. 2/ At the same time, a smaller bank, Banco Andino, was placed under the management control of the state-owned Banco Industrial, which was given the task of designing a restructuring plan, and the shareholders in three other private banks agreed to recapitalization plans which would not require financial assistance from FOGADE.

In the case of Banco Consolidado and Banco Progreso, deposit outflows continued after the announcement of the recapitalization plans and the bank owners were unable to comply with the terms of these plans. As a result, the authorities nationalized these two banks in September and December,

---

1/ As discussed in Appendix II, an MAE technical assistance mission visited Caracas in late June to advise on the banking crisis. One of the main recommendations of the mission was that the SBIF should carry out a rapid assessment of the financial condition of <u>all</u> remaining banking groups on a consolidated basis to facilitate decisions as to which groups were nonviable. The mission recommended that groups found to be nonviable be liquidated as part of a comprehensive plan of action for the system as a whole. This plan needed to be explained to the public in order to strengthen the credibility of the supervisory authorities and convey the authorities' commitment to address the weaknesses in the financial system in a fundamental way. For the medium term, recommendations left by previous missions for the strengthening of the SBIF and FOGADE were reiterated.

2/ The loans from FOGADE were to be guaranteed by assets that were pledged by the respective bank owners. The recapitalization plan for Banco Progreso also included Banco República, which was a member of the same financial group.

respectively, in both cases replacing the existing management with government appointees. 1/ Banco Andino also was nationalized in November and remains under the control of Banco Industrial. As in the case of Banco de Venezuela, all these nationalizations were conducted without closing the banks for any period and without placing restrictions on the withdrawal of funds by depositors. 2/

The policy of nationalizing insolvent banks reflected the authorities' dissatisfaction with the experience during the first half of 1994. They were of the view that state takeover and recapitalization of insolvent banks was likely to have a lower fiscal cost and to be less disruptive to the financial system than further closures and liquidations. However, this policy change did not reflect a detailed assessment of the degree of insolvency in the banking system and the potential costs of liquidation versus recapitalization. 3/ Moreover, there remains the risk that deposit runs may continue after nationalization (as appears to have occurred in the case of Banco Progreso) and that losses may continue to accumulate.

The fiscal cost that has been identified to date associated with the first three waves of the crisis has been estimated at about Bs 1,470 billion (US$10.9 billion) before any receipts from asset sales. During the second half of 1994, FOGADE provided about Bs 90 billion of the estimated Bs 165 billion (US$1 billion) needed to recapitalize Banco de Venezuela and Banco Consolidado, as well as a loan of Bs 40 billion to Banco Progreso. 4/ The ultimate cost for the Government will depend on the actual level of the bank losses, receipts from the sale of assets of those financial groups that were closed in mid-1994, as well as on the success of efforts to stem deposit withdrawals and to restructure nationalized banks in a manner that re-establishes them as viable financial entities. In addition to large capital shortfalls, these banks in most cases carried excessive overheads and branch networks that will need to be reduced to make them attractive to private investors.

1/ The state takeover of the Grupo Progreso included also Banco República, three other financial institutions, and two of the largest insurance companies.

2/ However, Banco Progreso was closed in mid-January 1995 after nationalization failed to stop the run on deposits and estimated losses continued to escalate (individual depositors of Banco Progreso had their accounts transferred to other state-owned banks and therefore continued to have access to their funds).

3/ For example, by late 1994 the SBIF still lacked information on the volume of bank deposits that were covered by the legal deposit guarantee.

4/ During the latter part of 1994, substantial liquidity support was provided to Banco Progreso by other state-owned banks. In early January it was announced that FOGADE would compensate these banks for loans amounting to about Bs 70 billion. Also, Banco Andino received financial support from the state-owned Banco Industrial.

3. Macroeconomic effects of the crisis 1/

The banking crisis reflects in part the effects of past bad investment decisions and resource misallocation, which would have reduced the country's productive capital stock and real output growth (including potential future growth) below that which would otherwise have been possible. Also, the costs associated with bailing out banks and payments made to depositors during 1994 have substantially weakened the fiscal position of the public sector and resulted in a sharp increase in domestic public debt, including the domestic debt of the BCV. 2/ The cost of servicing this debt will add significantly to public sector obligations in the coming years and will need to be offset by a stronger fiscal adjustment. The large scale BCV financing of public sector expenditures associated with the banking crisis complicated the implementation of monetary policy during 1994 and contributed to large reserve losses during the first half of the year, and an acceleration of inflation. The banking crisis also contributed to a further decline in real money demand.

During the first half of 1994, virtually all of the assistance granted to the financial sector by FOGADE (about Bs 800 billion or almost double the stock of base money at end-1993) was financed by direct credit from the BCV. The resulting liquidity injections fueled large capital outflows and a sharp exchange rate depreciation. About half of the injections were absorbed through BCV sales of zero-coupon bonds (short-term debt instruments of the BCV which have maturities of 3-6 months), with the remainder reflected in large losses of international reserves. Pressures on the BCV to lower interest rates during this period limited its capacity to absorb more of the injected liquidity and, therefore, to reduce its inflationary effect and international reserve losses. These developments contributed to uncertainties over the economic outlook and resulting capital outflows. There also was a major redistribution of deposits within the banking system toward banks that were perceived as being sound.

Recourse to additional BCV credit by FOGADE was curtailed during the second half of 1994 and the additional expenditures associated with the crisis were financed mainly through the above-mentioned issue of government bonds authorized by Congress in March. 3/ However, the BCV permitted a substantial easing in banking system liquidity, and a sharp fall in interest rates, following the imposition of exchange controls at end-June. As a

---

1/ See the staff report for the 1994 Article IV Consultation (SM/95/28) for a detailed discussion of macroeconomic developments during 1994.

2/ To date, only part of the cost of the banking crisis has been recognized explicitly by the Government through the issue of Bs 400 billion in domestic bonds (completed in early 1995), the proceeds of which were transferred to FOGADE.

3/ Some assistance was given to banks in difficulties through the BCV rediscount window and, as noted above, through interbank loans from state-owned banks.

result, interest rates became substantially negative in real terms. The high level of excess bank liquidity may have provided some relief to banks in financial difficulties, but there is a risk that maintenance of strongly negative real interest rates for any significant period will fuel inflationary pressures and further weaken the banking system as a whole. Furthermore, under such a policy, the costs of the crisis will continue to be financed in part through the inflation tax, with the accompanying distortions and adverse impact on income distribution.

VI. Summary and Conclusions

Indications of serious weaknesses in the banking system in Venezuela date back to the late 1980s. Operating costs were excessive by international standards, reflecting strict barriers to entry of foreign banks and a regulatory structure that prevented banks from competing on the basis of interest rates. A combination of weak macroeconomic performance, inadequate accounting standards, and an absence of meaningful prudential supervision or disclosure requirements was reflected in widespread problems of poor asset quality, excessive loan concentration and lending to related parties, inadequate capitalization, and low profitability. The arrangements for dealing with bank failures were subject to excessive political interference and interventions were characterized by lengthy delays, a failure to penalize bank owners or management, and generalized depositor bailouts.

These problems were extensively documented in Fund and World Bank technical assistance reports prepared in connection with the 1989 program of economic reform. These reports noted that the shifts in relative prices associated with the 1989 economic reforms may have further weakened the condition of some banks. Accordingly, the reports stressed the urgent need to evaluate the condition of financial institutions and take corrective measures, including liquidation, to address cases of insolvency. There was a need also to strengthen prudential regulations, and provide the SBIF with greater autonomy and adequate staffing and financial resources. In recognition of these concerns, the authorities developed a major structural reform program for the financial sector that was intended to support the macroeconomic reforms initiated at the beginning of 1989.

However, very little progress was made in strengthening the supervisory framework governing financial institutions in the period between 1989 and 1993. 1/ The authorities submitted a major package of legislative reforms to Congress in mid-1991, but approval of these reforms was severely delayed and the new banking law only came into effect at the beginning of 1994. In

---

1/ On the other hand, considerable progress was made in other areas of financial sector reform, notably improvements in the framework for implementing monetary policy (a new central bank law was approved in late 1992), and the divestment or closure of some state-owned financial institutions.

the meantime, little priority was accorded to measures to strengthen the supervisory capacity of the SBIF or the enforcement of prudential regulations.

As a result, right up until the emergence of the crisis, bank managers continued to operate under a regulatory structure that did not impose effective penalties for excessive risk-taking and unsound banking practices. Lax accounting and auditing standards permitted banks to report fictitious profits by capitalizing interest on nonperforming loans or reporting extraordinary gains. Moreover, the absence of both prudential supervision of financial groups on a consolidated basis and adequate disclosure standards allowed banks to use depositors' funds to cover losses or nonprofitable activities in related enterprises. Particularly for those banks which already were insolvent or thinly capitalized and whose owners therefore had little or no equity capital at stake, there were strong incentives to engage in speculative or high-risk activities that offered the prospect of higher returns.

The favorable economic conditions in 1990-91, which were accompanied by strong increases in asset prices, reinforced the incentives to participate in such activities. During this period, certain banks that later experienced problems embarked on an aggressive growth strategy and recorded impressive increases in market share. However, these banks were heavily exposed to the subsequent downturn in economic activity and to the asset price collapse that followed the increase in political instability in 1992. The slackening in macroeconomic adjustment and the inconsistent implementation of fiscal, monetary, and exchange rate policies contributed to a weakening in the external accounts and made the economy increasingly susceptible to capital outflows and an erosion of real money demand after 1991, which exposed the weaknesses in the banking system.

Notwithstanding the lack of information on the true condition of financial institutions, published data available from the end of 1992 already pointed to significant financial problems among the banks that had been expanding rapidly, and this appears to have been confirmed by the results of bank inspections performed by the SBIF. However, these banks were allowed to continue operations for an extended period with no effective constraints on their activities. The absence of firm measures to address these problems in the banking sector at an early stage is an important element that explains the size of the present crisis.

It is difficult to pinpoint the factors that triggered the crisis in 1994, given that insolvency problems appear to have existed in the banking system dating back to the late 1980s. However, four specific factors may have contributed to the timing of the crisis. First, a general climate of uncertainty regarding the future direction of economic policies ahead of the December 1993 elections contributed to large capital outflows, which may have particularly affected those banks already in weak financial condition. Second, expectations of improved prudential oversight and more rapid intervention and liquidation procedures under the new banking legislation may have prompted insiders, who had access to information on the true financial condition of insolvent banks, to withdraw their funds from these banks ahead of the coming into effect of the new legislation at the beginning of 1994. Third, several banks that failed in 1994 were perceived as having close ties to the previous Administration and may have been affected by speculation that a new Government would be less willing to provide financial support. A fourth possible factor, the rise in real interest rates in the first half of 1993, may have contributed to a further weakening in the quality of bank portfolios, but could not by itself have accounted for a crisis of the magnitude that since has been uncovered.

It is clear that major problems of insolvency existed in the banking system by end-1993. However, the lack of a coherent policy response and failure to utilize the strengthened powers established under the new banking law in 1994 also contributed to the magnitude of the crisis. The initial decision to close Banco Latino seems appropriate given the magnitude of the losses that subsequently have come to light, but the fiscal cost associated with the failure of the Latino group increased substantially as a result of the decision to reopen the bank and to compensate depositors above the legal guarantee. Moreover, the failure to address other problem banks at the same time meant that bank managers were able to continue imprudent or fraudulent practices for several months, and depositors in the banks (and related financial groups) were able to withdraw their funds without limit. Moreover, contradictory policy statements further undermined public confidence and contributed to a general climate of uncertainty in which rumors of banks in difficulties were translated rapidly into runs on bank deposits. These uncertainties were compounded by major weaknesses in the implementation of macroeconomic policies, which reinforced incentives for capital flight.

During the second half of 1994, some measures were taken to improve coordination between the regulatory agencies and a policy of nationalization was adopted to deal with insolvent banks where the owners were unable or unwilling to comply with an agreed recapitalization plan. However, maintaining insolvent banks in operation, even under state-ownership and management, carries serious risks that the bank losses may continue to grow and that deposit withdrawals may not be reversed. Thus, the cost of recapitalization may end up being substantially larger than that of liquidation. Moreover, in one prominent case (Banco Progreso), this policy appears not to have prevented further abuse of government funds, and the bank eventually had to be closed in early 1995.

Several lessons may be drawn from the Venezuelan experience. First, it highlights the importance of taking measures that establish an incentive structure to promote sound banking practices at an early stage of any program of financial sector reform. Such measures should include strong policies to address cases of financial weakness or insolvency as soon as they are identified, with appropriate sanctions to ensure that bank owners and large depositors share in the losses associated with a bank failure. Measures need to be taken also to establish adequate accounting and auditing standards and to ensure, to the extent possible, that financial statements reflect the true condition of financial institutions. The opening of the financial sector to foreign competition also may assist by improving banking practices.

Where the establishment of financial groups is permitted, as was the case in Venezuela, it is particularly important that financial statements reflect the consolidated activities of the financial group, including offshore operations and the relationships between members of the same group. Prudential regulations, such as limits on lending to related parties, also need to be enforced at the level of the financial group. Moreover, it is important that the supervisory authorities coordinate with their counterparts in other countries to ensure that offshore branches and affiliates are properly monitored.

Second, liberalization of lending and deposit interest rates can play an important role in the process of strengthening the banking sector by reversing incentives for disintermediation and capital flight. If combined with an opening of the financial sector to competition, including from foreign banks, this also can assist in promoting greater efficiency and reduced reliance on costly services such as overly-elaborate branch networks as a means of gaining market share. Liberalization also may provide the scope for a temporary widening in interest rate spreads to allow banks to strengthen their balance sheets. However, liberalization also provides new opportunities for banks to compete aggressively for deposits on the basis of interest rates. Thus, interest rate liberalization must be accompanied by early measures to ensure, as discussed above, that bank efforts to compete for market share are consistent with sound banking practices.

Third, sound macroeconomic policies are important for the health of the banking system. Inadequate macroeconomic policies in Venezuela contributed to an unsustainable asset price boom at the beginning of the 1990s and to a general climate of macroeconomic instability, with periodic episodes of capital flight and an erosion of real money demand. These factors also weakened the banking system prior to 1994 and probably exacerbated the crisis during 1994.

Finally, the experience during the crisis itself points to the importance of responding quickly and in a consistent way to signs of major weakness in the banking sector, of avoiding ad hoc and inconsistent policy decisions, and of utilizing fully the preventive and corrective powers provided in the banking legislation. Rapid efforts to compile information on the true condition of financial institutions and to utilize all the information available are essential. There are major risks in allowing insolvent banks to remain in operation for significant periods, as this provides an opportunity for bank insiders and large depositors to withdraw their funds in full. In such cases, there is a likelihood that the cost of bank failures may increase substantially. Moreover, under a policy of nationalizing banks and formally or informally guaranteeing depositors' funds, this cost ultimately will be borne by the taxpayer.

Table 1. Venezuela: Indicators of the Magnitude of the Crisis

(In percent)

		Market Share at End-1993		
		Deposits	Loans	Assets
a.	Banks nationalized during 1994 1/	28.5	28.7	28.2
b.	Banks closed during 1994 2/	20.9	21.8	19.8
c.	Banks affected during 1994 (a+b)	49.4	50.5	48.0
d.	Rest of banking system	50.6	49.5	52.0
	Total	100.0	100.0	100.0

Source: Superintendency of Banks and Other Financial Institutions.

1/ Banco Latino, Banco de Venezuela, Banco Consolidado, Banco Progreso, Banco República, and Banco Andino.

2/ Banco Barinas, Banco Maracaibo, Banco Construcción, Banco Metropolitano, Banco La Guaira, Bancor, and Banco de Amazonas.

Table 2. Venezuela: Direct Fiscal Expenditures Relating to the Banking Crisis During 1994 1/

	Banks Nationalized During 1994 2/3/	Banks Closed During 1994 2/4/	Total
	(In billions of bolivares)		
January	0.3	39.7	40.0
February	8.2	165.2	173.4
March	160.4	144.8	305.2
April 5/	114.0	56.0	170.0
May	6.7	71.0	77.8
June	5.0	23.3	28.3
July-December	128.8	173.2 6/	302.0
Total	423.5	673.2	1,096.7
(In percent of GDP)	5.1	8.1	13.2
	(In millions of U.S. dollars) 7/		
January	3.0	371.5	374.5
February	74.6	1,508.1	1,582.7
March	1,422.3	1,284.3	2,706.6
April 5/	982.4	482.3	1,464.8
May	49.5	521.5	571.0
June	28.9	134.5	163.3
July-December 6/	760.0	1,021.6 6/	1,781.6
Total	3,320.7	5,323.8	8,644.5

Source: FOGADE; and staff estimates.

1/ Reflects expenditures by FOGADE only. Excludes expenditures pending at the end of 1994 to complete the recapitalization of banks nationalized during the second half of the year; lending directly to banks by the BCV; interbank lending by state-owned banks; and interest on the public debt incurred to finance expenditures associated with the crisis.

2/ See Table 1 for coverage.

3/ Includes Banco Hipotecario de Occidente, which was part of the Latino Group.

4/ Includes a finance company (FIVECA).

5/ Net of repayments estimated at Bs 54.7 billion.

6/ Includes checks issued to pay depositors of closed banks.

7/ Using the monthly average exchange rates.

Table 3. Venezuela: Structure of the Financial System 1/

	Main Offices						Branches and Agencies						Total Assets (In billions of bolivares)					
	1989	1990	1991	1992	1993	1994 2/	1989	1990	1991	1992	1993	1994	1989	1990	1991	1992	1993	1994 2/
Total	151	159	148	152	155	122	2,090	2,237	2,271	2,231	2,646	...	811.2	1,168.0	1,718.4	2,158.2	2,795.2	3,384.2
Commercial Banks	41	43	43	45	47	42	1,692	1,806	1,846	1,844	2,261	...	548.3	830.6	1,262.8	1,575.6	2088.6	2,873.6
Of which: foreign banks	4	4	4	5	5	5	...	...	...	...	...		7.1	7.1	8.2	8.7	17.7	40.7
Rest of the banking system	39	38	38	37	37	28	341	375	375	337	335	...	154.8	184.2	206.5	240.7	309.9	194.6
Mortgage banks	17	16	16	16	16	9	87	71	74	73	71	...	70.0	85.1	111.2	124.4	171.0	82.8
Savings and loan system	20	20	20	20	20	19	204	255	252	257	257	...	53.2	68.7	77.6	98.8	120.9	111.8
Specialized banks 3/	2	2	2	1	1	--	49	49	49	7	7	...	31.6	30.4	17.7	17.5	18.9	--
Rest of the financial system	71	78	67	70	71	52	57	56	50	50	50	...	108.1	153.2	249.1	341.9	396.7	316.0
Finance companies	41	43	32	35	37	26	56	56	50	50	50	...	84.5	121.6	193.3	265.4	285.5	239.6
Leasing companies	30	35	35	35	34	26	1	--	--	--	--	...	23.6	31.6	55.8	76.5	111.2	76.4
Memorandum item																		
Liquid asset funds 4/	34	34	31	33	35	25	386	420	407	418	429		126.6	234.0	424.9	731.6	1,102.7	...

Source: Superintendency of Banks and Other Financial Institutions; Central Bank of Venezuela; and staff estimates.

1/ As of December of each year, unless otherwise indicated.
2/ As at end-September. Excludes those institutions that were intervened in June 1994.
3/ The Agricultural Development Bank (through 1991) and the Workers' Bank (through 1993).
4/ Liquid asset funds consist mostly of deposits in commercial banks and financial institutions.

Table 4. Venezuela: Nonperforming Loans of Commercial Banks 1/

(In percentage of total loans)

	Average	End of Period
1988		
First semester	4.44	3.91
Second semester	4.05	2.90
1989		
First semester	4.54	3.82
Second semester	5.25	4.31
1990		
First semester	5.50	3.89
Second semester	4.74	3.28
1991		
First semester	3.71	2.98
Second semester	3.44	2.60
1992		
First semester	3.99	3.08
Second semester	4.41	4.00
1993		
First semester	8.01	7.65
Second semester	9.32	7.14

Source: Economic Information System.

1/ As reported in the monetary accounts.

Table 5. Venezuela: Indicators of Solvency Problems Among Banks that were Nationalized or Closed in 1994 1/

	1992	1993				1994
	December	March	June	September	December	March
				(in percent)		
First wave (Banco Latino)	40.1	71.7	89.0	70.9	94.7	n.a.
Second wave (eight institutions closed in June 1994)	46.9	94.0	60.7	76.3	38.7	n.a.
Third wave	6.2	42.5	29.9	54.6	29.7	64.8
Rest of the banking system	14.3	27.9	18.4	30.4	15.5	33.2

Source: Superintendency of Banks and Other Financial Institutions.

1/ The indicators show the relationship between banks' problem loans (net of provisioning) and their net worth (capital plus reserves).

Table 6. Venezuela: Deposit Market Shares of Banks

(In percent of total banking system deposits; end of period)

	1988	1989	1990	1991	1992	1993	June 1994
A. Banks Intervened in 1994							
Intervened in January 1994							
Latino	8.5	10.8	10.6	10.4	10.3	8.3	4.4
Intervened in June 1994							
Maracaibo	4.2	3.8	3.8	5.5	8.0	8.6	3.5
Metropolitano	1.2	1.2	1.9	3.2	3.2	4.3	2.0
Construcción	1.8	2.5	3.6	4.2	4.6	3.7	1.3
La Guaira	2.8	3.0	2.7	3.0	2.3	1.7	0.7
Bancor	...	1.4	1.7	2.1	1.6	1.5	0.2
Barinas	0.3	0.5	0.7	0.9	1.0	1.4	0.1
Amazonas	...	0.0	0.1	0.1	0.3	0.3	0.1
Subtotal	10.3	12.4	14.5	19.0	21.0	21.5	7.9
Intervened in the period August-December 1994							
Venezuela	12.8	11.0	11.0	9.9	9.6	9.7	10.6
Consolidado	7.3	7.3	6.3	5.5	4.9	4.1	7.0
Andino	0.3	0.2	0.2	0.2	0.3	0.4	0.4
Progreso	...	0.9	1.4	1.9	3.1	4.2	2.5
República	0.8	0.6	0.4	0.9	1.5	2.2	2.2
Subtotal	21.2	20.0	19.3	18.4	19.4	20.6	22.7
B. Rest of the banking system	60.0	56.8	55.6	52.2	49.3	49.6	65.0
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Venezuela: The Importance of Financial Groups

The purpose of this Appendix is to illustrate the importance of financial groups in the Venezuelan financial system and the need to analyze the accounts of financial institutions at the group level, taking full account of the inter-relationships between banks and other institutions in the same financial group.

Table 7 presents data for one of the commercial banks, and its related financial group, that was intervened by FOGADE and closed in June 1994. The structure of the commercial bank's balance sheet as at end-1993 is summarized in column (1); columns (2) and (3) provide comparable data at the level of the financial group compiled on two alternative bases. The first methodology (shown in column (2)) involves simply the summation of data from the balance sheets published by each of the financial institutions in the group for the same date. This methodology suffers from two serious deficiencies: first, intragroup operations are not netted out; and second, the data are incomplete as published balance sheets are not available for several important elements of the group, including the money desk and offshore operations. 1/ The second methodology (shown in column (3)) corrects for these deficiencies and represents a full consolidation of the various components of the group, with intragroup operations netted out.

As can be seen, the structure of commercial bank balance sheets may differ substantially from that of the financial group, when the accounts are prepared on a consolidated basis. In particular, holdings of cash and other liquid assets appear to be quite large (more than 30 percent of total assets) when only the commercial bank balance sheet is considered, but are sharply lower (7 percent of total assets) when the consolidated accounts of the group are presented. The same is true for net worth. Also, the relative magnitudes of "other assets" and "private deposit liabilities" both increase substantially when the accounts are consolidated. 2/ These differences are much less marked when the published accounts of the members of the group are simply added together, which suggests that the latter methodology should not be used as a substitute for a thorough consolidation. This example also highlights the fact that the commercial bank may account for only a fraction (in this case, about one third) of the total assets and liabilities of the group as a whole (column (5)).

An alternative illustration of the importance of financial operations outside the books of commercial banks is provided in Table 8. Column (1) presents the level of deposits at end-December 1993 of the seven

---

1/ The assets and liabilities of the liquid asset fund operations of the group were not added explicitly because it was assumed that most of these funds would have been invested in financial instruments issued by other institutions of the same group.

2/ The increase in "other assets" may reflect nonperforming assets or losses, which had been accounted for outside of the commercial bank balance sheet.

commercial banks and one finance company that were closed in mid-1994. Column (2) presents comparable data for the respective financial groups. Given that full consolidations for these groups were not available to the staff, the latter have been calculated by summing the deposits from published balance sheets of the members of the same group. As noted above, this methodology suffers from serious deficiencies, and probably understates total deposit liabilities of the group by a significant amount. The assistance granted by FOGADE to these eight institutions during the first semester is shown in column (3), while column (4) presents the level of deposits (and related liabilities) of the groups remaining at the time of their intervention in mid-June.

The sum of columns (3) and (4) is shown in column (5) and may provide at least a rough approximation of the total deposit liabilities of each financial group, including liabilities held outside of the respective commercial bank balance sheets, at the beginning of the year. This estimate needs to be treated with caution as it would include any new deposits that may have been attracted during the first half of 1994, as well as any funds that may have been used for purposes other than the payment of depositors. On the other hand, it would not capture receipts from asset sales that may have been used to cover part of the deposit withdrawals during this period. These estimates suggest that total deposit liabilities of these institutions on average may have been roughly two and a half times the deposits that appeared in the published balance sheets of the commercial banks (column (6)) and almost double the aggregate deposits of the financial groups based on published sources (column (7)).

Table 7. Venezuela: Balance Sheet Structure of an Illustrative Financial Group at December 1993

	Balance Sheet Structure			Weight of the Commercial Bank within the Financial Group's Balance Sheet	
	Commercial Bank	Financial Group			
		By Addition 1/	Consolidated 2/	By Addition 1/	Consolidated 2/
	(1)	(2)	(3)	(4)	(5)
	(In percent of total assets)			(In percent)	
Cash and other liquid assets	31.0	23.1	7.0	95.4	158.4
Loan portfolio	33.8	42.2	25.6	56.9	47.4
Investment portfolio	21.6	20.7	15.7	74.4	49.4
Investment in fixed and movable assets	4.2	3.4	14.2	87.3	10.6
Other assets	9.4	10.5	37.4	63.9	9.1
Total assets	100.0	100.0	100.0	71.2	36.0
Private sector deposits	66.6	71.5	80.4	66.4	29.8
Public sector deposits	5.1	3.7	2.4	100.0	76.2
Liabilities to banks	1.0	0.7	3.7	100.0	9.5
Other liabilities	15.4	13.3	9.1	82.5	60.9
Total liabilities	88.1	89.2	95.7	70.4	33.1
Net worth	11.9	10.8	4.3	77.9	98.8

Sources: Data provided by the financial group; and Fund staff estimates.

1/ The financial group's balance sheet is compiled by adding the balance sheets published by the financial institutions included in the group. There is no netting out of intragroup operations. Liquid asset funds, money desk, offshore, and other off-balance sheet operations are not included.

2/ Consolidated balance sheet compiled by the financial group for internal use. Includes liquid asset funds, money desk, offshore and other off-balance sheet operations. Intragroup operations are netted out.

Table 8. Venezuela: Deposit Liabilities and Assistance Granted to Eight Financial Groups Intervened in June 1994

(In billions of bolivares unless indicated)

Financial Groups	Deposits as at end December 1993		Assistance Provided by FOGADE between Jan.-June 1994	Estimated Deposit Liabilities of the Group at End-June 1994 2/	Sum of Columns (3) and (4)	Memorandum Items	
	of the Bank	of the Group 1/				Column (1) in Percent of Column (5)	Column (2) in Percent of Column(5)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Maracaibo	124.6	158.1	132.2	79.9	212.1	58.7	74.5
Metropolitano	62.1	92.5	126.7	140.4	267.1	23.2	34.7
Construcción	54.1	60.1	107.0	32.8	139.8	38.7	43.0
La Guaira	24.7	37.3	47.0	11.1	58.1	42.6	64.2
Bancor	21.2	23.6	35.6	16.9	52.5	40.3	45.0
Barinas	20.0	24.9	32.0	6.4	38.4	52.3	65.0
Amazonas	4.3	6.1	7.7	3.0	10.7	39.8	57.0
Fiveca	7.4	10.2	12.8	2.9	15.7	47.2	64.6
Total	318.4	412.9	501.1	293.3	794.4	40.1	52.0

Sources: SBIF; and FOGADE.

1/ Compiled by adding the deposit liabilities of commercial banks, mortgage banks, finance companies and leasing companies of the financial group, as published in their balance sheets.

2/ Information provided by FOGADE.

Venezuela: Fund Technical Assistance on Banking Supervision

Since 1989 the Fund has provided substantial technical assistance to the Venezuelan authorities to formulate and implement a program for financial sector reform. 1/ Most of the technical assistance has been provided by the Monetary and Exchange Affairs Department (MAE). The first MAE mission, in October 1989, extensively covered issues in banking, prudential regulation, and banking supervision. That mission reviewed the structure of the financial system, its competition and efficiency, and issues related to solvency, deposit insurance, and the role of FOGADE. The mission left several recommendations aimed at strengthening prudential regulation and bank supervision, and identified needed changes in the legislation. 2/ The recommendations set an overall strategy and distinguished among immediate, transitional and permanent measures.

At the time, it was agreed that the Fund's technical assistance would focus on a modernization of the BCV, a revision of the central bank and banking legislation, and the development of a capacity for market-based monetary intervention. The issue of the need to strengthen banking supervision came up repeatedly in subsequent MAE missions and the staff stressed that the allocation of necessary resources for that purpose was essential. In view of limitations in the authorities' implementation capacity, the April 1990 MAE mission 3/ recommended a gradual introduction of new regulations to be supported through heavily front-loaded external technical assistance. It reiterated the earlier recommendation that the SBIF should be given the resources to contract new staff that could act as counterparts to foreign and domestic experts, and that uniform reporting and accounting standards should be strengthened and enforced. It pointed out that the goal should be to avoid acute problems in the banking system and to gradually rebuild its strength. The mission also advised on central bank and banking legislation.

In November 1990 an MAE/LEG mission provided the authorities with comments on the draft laws on the SBIF and FOGADE. 4/ In addition, in 1990-91 an MAE consultant from the Bank of Spain provided 11 months of assistance to the BCV's Commission on Financial Sector Reform in drafting the laws and regulations necessary for moving ahead with financial sector reform.

In November 1991 an MAE mission noted that the BCV should make every effort to secure the passage of the ten laws prepared by the BCV's

---

1/ PDR (then ETR) provided technical assistance on the exchange system beginning in 1988.

2/ The recommendations are included in the report Venezuela: A Program for Financial Sector Reform, January 1990. See Section V.

3/ See report Venezuela: Financial Sector Reform, July 1990, pp.25-26.

4/ See report Venezuela: Study of the Draft "Organic Law on the Superintendency of Banks and Financial Institutions" and the Draft "Organic Law on the Deposit Guarantee and Banking Protection Fund", February 1991.

Commission on Financial Sector Reform as soon as possible. 1/ At the same time, it recommended that the BCV continue its efforts to support the SBIF even before the passage of the new law in order to give that body the needed autonomy and budgetary independence to do its work. The mission also recommended that the BCV exert moral suasion on banks to capitalize profits rather than distribute them as dividends. Furthermore, it was pointed out that there seemed to be a need for banks to strengthen their capital and reserve positions to qualify under the minimum capitalization requirement called for under the new draft banking law.

In February 1993 an MAE mission pointed to the risks associated with not devoting sufficient effort to the area of banking supervision, which could contribute to problems in the financial system that could jeopardize monetary and fiscal policy in the future. 2/ Although a strengthening of prudential regulation and supervision was one of the cornerstones of the authorities' original strategy for financial sector reform, the efforts in that area had come to a virtual halt--mainly due to a lack of budgetary support. This made it impossible for the SBIF to retain experienced supervisors and establish a proper information system. It was recommended that the BCV should insist on the need for early passage of the draft omnibus law (covering banks and financial institutions, the SBIF, and FOGADE). Until this new law had passed and the SBIF had achieved financial independence, the BCV should seek to transfer staff and budgetary resources to the SBIF so that it could develop its supervisory staff and start implementing its computerization program.

The problems with bank supervision also came up in Article IV consultation discussions. For example, the 1991 staff appraisal of the staff report for the review of the EFF arrangement (EBS/91/166) highlighted the importance of strengthening prudential regulations. A staff member of MAE accompanied the 1993 Article IV consultation mission to follow-up progress in implementing the staff recommendations for reforming the financial system, particularly in the area of bank supervision. In December 1993, following up the 1993 Article IV consultation discussions held the previous month and after the passage of the new Law for Banks and Financial Institutions, the WHD mission (in a letter to the President of BCV) recommended that the BCV be prepared to provide lender of last resort facilities indirectly through FOGADE but only for institutions with liquidity problems (<u>not</u> for insolvent ones). It recommended that the BCV, in its relations with FOGADE, keep in mind its objectives, i.e., maintaining the value of the currency and a level of international reserves that would guarantee the smooth functioning of international payments. Comments on the necessary steps to implement the new banking law also were provided under separate cover to the BCV's Coordinator of the Financial Sector Reform.

1/ See aide memoire <u>Venezuela: A Review of the Central Bank's Intervention Techniques and its Financial Relationship with the Government</u>, November 25, 1991.

2/ See report <u>Venezuela: A Follow-Up of Issues in Monetary Management and Financial Sector Reform</u>, May 1993, p.2.

MAE's offer to provide two resident banking supervision advisors to assist the authorities was not acted upon by the authorities.

In May 1994 a WHD mission visiting Caracas left with the authorities an aide memoire summarizing its main policy recommendations with an attachment outlining the elements of a possible strategy to deal with the banking crisis. 1/ In July 1994 an MAE mission focusing on the banking crisis, and following the work of the WHD mission, recommended a detailed short-term strategy to deal with the banking crisis. 2/ The recommendations included the establishment of an overall strategy for coping with the systemic crisis, and rules to be followed in cases where ailing financial groups had to be dealt with immediately, before the overall strategy could be implemented.

1/ Venezuela: Crisis del Sistema Financiero, June 1994.

2/ See report Venezuela: Strategies for Addressing the Financial System Crisis, February 1995. An aide memoire was left with the authorities at the end of the mission in July 1994 and a final report in Spanish was sent in September 1994.