SOME RELEVANT LESSONS LEARNED FROM THE COLOMBIAN FINANCIAL CRISIS 1998-1999

JOSE DARIO URIBE E.

Governor Banco de la República

XLV Meeting of Central Bank Governors of the American Continent

PLAN

I. INTRODUCTION

II. BACKGROUND

A. Macroeconomic Context

B. Financial system

III. FINANCIAL CRISIS

IV. POLICY RESPONSE

V. LESSON

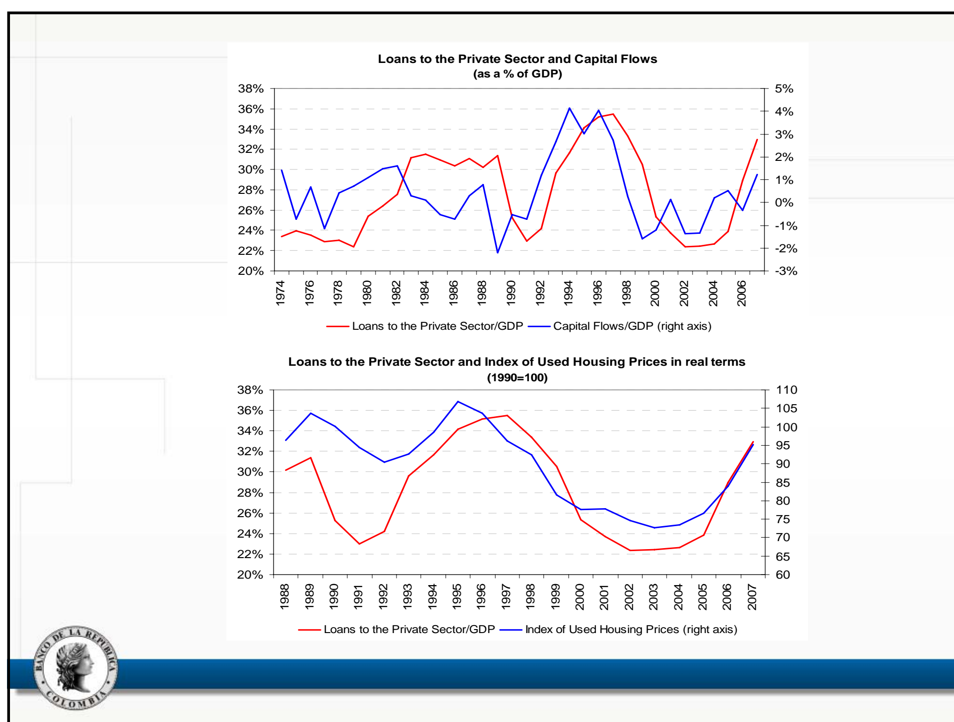
INTRODUCTION

- 1998-1999 Financial Crisis
  - Mortgage banks
  - State owned banks
  - Cooperatives
  - Small financial entities
- Objective: Mains lessons derived from the mortgage banks crisis

II. BACKGROUND

A. MACROECONOMIC CONTEXT

- In the early 90's Colombia underwent a process of financial liberalization
- Almost simultaneously, there was an important surge in capital inflows which prompted a large monetary and credit expansion, and led to higher private and public spending
- Public and private saving rates diminished and current account deficits widened
- Demand for non-tradable goods expanded (especially real estate), leading to a rise in both local credit and asset prices and an appreciation of the Colombian peso in real terms



B. FINANCIAL SYSTEM IN THE EARLY NINETINE

- The banking sector concentrated most of its credits on maturities of one year or less, limiting long-term financing to mortgage banks
- Mortgage banks were in charge of providing long-term loans for construction and housing as an element of a strategy aimed at promoting construction as a leading sector

- Due to their specific role, until early 1990´s mortgage banks were granted some privileges:
  - They were the only financial intermediaries authorized to offer demand deposits with non-negative real interest rates
  - They were given special unrestricted and permanent access to an automatic Central Bank facility in case of deposit shortfalls.
  - Their capital requirements were lower than those of other intermediaries

- However, liberalization had a deep impact on mortgage banks:
  - Elimination of quasi-monopoly in savings market (other intermediaries were allowed to offer savings with non-negative real rates)
  - Level playing field for all intermediaries regarding access to LOLR (elimination of automatic central bank facility for mortgage banks)

- Increase in competition led to higher funding costs and less stable funds for mortgage banks (higher reliance on indexed and peso-denominated CD's and on interbank market financing (1993)) → increased interest risk and liquidity gap.

- Liquidity gap and interest rate risk were hard to manage:
  - No hedging instruments available in the market
  - Securitization was allowed but did not develop (lack of experience)
  - Macro environment did not promote diversification → high demand for real estate and soaring housing prices
  - Lack of experience of mortgage banks in other markets

- Given the dynamics of the mortgage and housing markets, mortgage banks engaged in "Subprime" like amortization schemes. In addition to lack of proper evaluation in mortgage disbursements, this increased their credit risk exposure
- Further, the indexation of mortgage loan rates to the market interest rate (CD's rate) reduced mortgage bank's exposure to interest rate risk at the expense of higher credit risk

III. FINANCIAL CRISIS

- Between 1997 and 1999, there was a reversal in capital flows and a decline in the terms of trade, leading to a sharp correction of aggregate spending and the current account deficit
- Output fell by more than 4% in 1999, and real estate prices contracted by nearly 27% in real terms
- The reversal in capital flows affected the financial system through a reduction in liquidity and a subsequent increase in the cost of funds

- The rise in real interest rates, coupled with the fall in real estate prices, affected the financial burden of households, increasing NPLs and affecting the solvency ratios of intermediaries
- One private mortgage bank and a large, public mortgage bank went bankrupt. Others remained weak for a long period and went through a process of consolidation
- Increased credit risk perception led to a shift in the composition of financial intermediaries' portfolio towards government bonds

IV. POLICY RESPONSE

Mortgage Banks

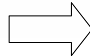
- Liquidity was provided through conventional LOLR facilities
- Relief program for borrowers in good standing, through loans with softer conditions
- The bankrupt private mortgage bank was intervened by the Government, nationalized and ultimately sold in 2005
- The bankrupt public mortgage bank was liquidated

- Specialized public “collector” agencies were created to sell the assets of the liquidated institutions
- Banks were not allowed to create their own amortization models anymore:
  - Only 3 schemes of amortization were authorized
  - A maximum of 70% of loan to value was imposed

- The Constitutional Court issued crucial rulings relating to these issues:
  - Reduced interest rates on *outstanding* mortgage loans and instructed the CB to establish a maximum rate for this tipe of loans
  - Detached indexation formula for mortgage loans from the market interest rate and linked it to observed inflation Reduced the size of debts by forcing a recalculation of mortgage debt balances (government covered the losses caused by this
- In relative terms, Colombia's financial crisis was low-cost (less than 4% of 2001 GDP international evidence suggests the cost of crisis oscillates around 7.3 – 9.7%)

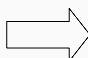
V. Lessons

i. Credit and money creation in the wake of large capital inflows exacerbated the business and credit cycles



Thus, allowing more flexibility to the exchange rate regime dampens the credit cycle

ii. High credit growth is usually followed by high default rates and consequent credit reductions

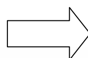


Hence, mechanisms such as countercyclical provisioning schemes, to moderate the procyclical behavior of credit, are desirable

iii. As a result of the crisis of the late 90's, which revealed many of the limitations of the financial sector's risk management tools, Colombia has made important improvements in its assessment of credit, market and liquidity risk in the spirit of BASEL II

iv. Monetary authorities might need to internalize the short-term trade-off between financial stability and monetary control(?)

v. High value of collateral does not necessarily imply high recovery rates. During the 90's, real estate prices skyrocketed, prompting banks to issue mortgage loans. However, as interest rates increased real estate prices plummeted, leading to higher loan/value and default rates



Thus, the need to monitore on asset prices becomes apparent, and the CB does so in its Financial Stability Report, as part of its early-warning indicators

vi. During the crisis, supervisory and regulatory deficiencies became exposed:

- Insufficient provisions regime
- Low capital requirements (where existent)

vii. The response of the Constitutional Court to the mortgage banks' crisis may have generated serious moral hazard problems that could endanger the provision of long-term credit in the future

FINAL COMMENT

- During the crisis, the CB limited its role to that of LOLR without facing substantial credit risk
- The Government assumed credit risk and the cost of the crisis