The banking industry in Colombia: competition, consolidation and systemic stability

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1. Antecedents

At the beginning of the 1990s Colombia's financial sector was characterised by its small size, its segmented and oligopolistic structure, and a dominant presence of the state, which held 50% of the banking system's assets. The sector was severely repressed and highly inefficient. Reserve requirements were more than 40% of total deposits and interest rate spreads exceeded those of the developed countries by more than 500 basis points. In a context of high inflation and directed subsidised credit, the banking sector concentrated most of its voluntary credits in maturities of one year or less, limiting long-term financing to the indexed system of Savings and Loans.

During the period 1990-92 Colombia embarked on an ambitious programme of economic modernisation oriented towards improving the efficiency of resource allocation and increasing competitiveness. This programme included a set of structural reforms and macroeconomic policies designed to achieve 5% annual real GDP growth and a significant reduction in the rate of inflation. The main components of the programme consisted of establishing an open economy (Law 9 of 1991) and financial liberalisation. The central bank lost its monopoly on the purchase and sale of foreign currency and was made independent (Law 32 of 1992). Complementary policies were undertaken to rationalise the public sector, improve transport infrastructure, support business renewal programmes and define a general framework for foreign investment.

With regard to the financial sector, Laws 45 of 1990 and 35 of 1993 redefined its role and structure. Among other things, these laws simplified the entry and exit rules, established a scheme akin to universal banking aimed at reducing specialisation, and introduced stricter prudential regulations. Thanks to this, the process of re-privatising the institutions that were nationalised as a consequence of the crisis at the beginning of the 1980s gained momentum. In addition, Colombia's businesses were given increasing access to external credit, and foreign direct investment in the financial sector was encouraged. The number of financial institutions rose from 91 in 1989 to 148 in 1995. At the beginning of the decade, domestic assets of banks and other similar financial institutions had represented 34% of GDP. Then, a rapid expansion of the system occurred, reaching its peak in 1997, when the same category of domestic assets amounted to nearly 50% of GDP.

With the positive prospects generated by the economic reforms, the expected appreciation of the exchange rate and domestic interest rates higher than foreign, there was a marked capital inflow, which could not be completely sterilised. This brought about a pronounced increase in credit provided by the financial system. Loans rose from 26% of GDP in 1989 to 40% in 1997. A large part of that increase was accounted for by housing and consumption funding, which in turn led to a rise in the price of real estate and an expansion of aggregate demand, reflected in a significant fall in private sector savings.

Parallel to the strengthening of private demand, a sizeable in public sector expenditure occurred from 1997, generating a deficit close to 4% of GDP. The expansion of public and private expenditure exceeded the productive capacity of the economy, leading to a growing current account deficit in the balance of payments that reached 5.2% of GDP in 1998. The existence of a fiscal and an external imbalance, together with significant public and private debt, weakened Colombia's economic fundamentals, making it more vulnerable to external shocks. Under these circumstances, the Asian

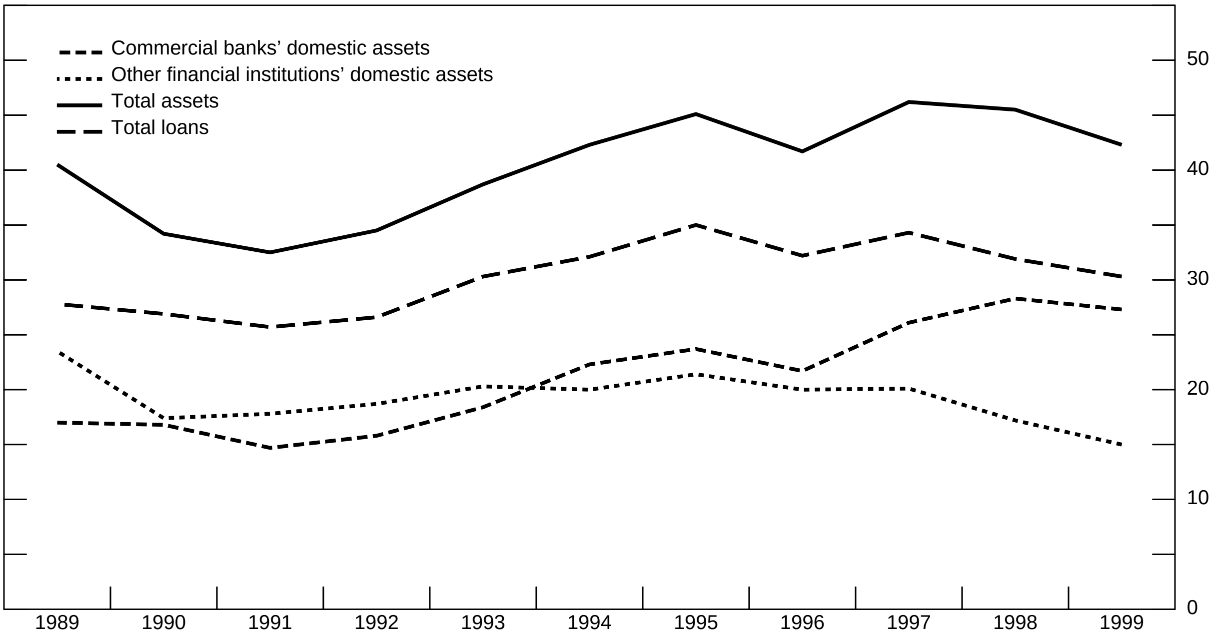
[1] This paper was written in November 2000. I would like to thank Mauricio Avella and Jorge Toro for their extremely helpful comments, and Santiago Muñoz for his efficient editorial assistance. All opinions, errors and omissions are my own responsibility.

and Russian crises of 1997-98 had severe repercussions. Indeed, GDP decreased by 4.3% in 1999, the unemployment rate surpassed 20% and the fiscal deficit widened to 5.2% of GDP.

Graph 1

Financial system in the 1990s

As a percentage of GDP



The economic recession, among other factors, sharply affected the financial sector. Non-performing loans rose from 8% of total loans in 1998 to more than 14% in 1999. Most of the deterioration was concentrated in the state-owned institutions, whose NPLs reached an average of 25% in 1999. As a result, the financial system's losses climbed to $2.8 billion, which was reflected in equity prices dropping by 28% in real terms. As a result, the solvency ratio declined from a level of 13.4% at end-1996 to 11.6% in 1999. This deterioration was much more accentuated among the state-owned financial institutions, whose solvency ratio in 1999 fell below 6%. The financial crisis brought about major changes in the structure of the financial system, through the privatisation of some state-owned institutions and liquidation and merger processes, as described below.

2. Structure

In the second half of the 1980s, Colombia's financial system had 91 financial institutions with assets equivalent to 46% of GDP. Public banks held approximately 43% of the system's assets (20% of GDP), banks with foreign participation only 3% (1%), domestic private banks 20% (9%), and the Savings and Loans corporations 15% (7%).

The number of financial institutions increased considerably during the first half of the 1990s. It peaked in 1995 at 148 institutions, with total assets equivalent to 68% of GDP. This number of institutions was high relative to the size of the economy. The concentration level of the banking system was particularly low; the three largest banks held only 38% of total assets, compared to 68% in the richest countries and 81% in the poorest.

In the second half of the 1990s the financial system's assets fell by 6.4% of GDP. The biggest decrease was recorded by the state-owned banks (2.9%) and the Savings and Loans corporations and other non-bank financial institutions (3.3%). The size of private domestic banks increased by 1.7% of GDP, and foreign banks by 0.5%. The number of financial institutions dropped to 105, slightly higher than before the structural reform process began.

Table 1

Colombia's financial system in the 1990s

	Total		Banks					Savings & loans		Other	
			Total		Private domestic	Private foreign	State-owned				
	no	Assets[1]	no	Assets[1]	Assets[1]	Assets[1]	Assets[1]	no	Assets[1]	no	Assets[1]
1986-89	91	45.6	…	29.7	9.1	1.2	19.5	…	7.0	…	8.9
1990	135	64.5	26	29.9	14.1	2.3	13.5	10	10.5	99	24.1
1995	148	67.8	33	34.3	18.6	7.2	8.5	9	14.4	106	19.2
2000	105	61.4	35	33.6	20.3	7.7	5.6	6	11.9	64	15.9

[1] As a percentage to GDP.

Source: Superintendencia Bancaria.

The involvement of financial conglomerates in the intermediation process also increased. At the beginning of the decade financial intermediation was mostly the domain of individual financial institutions, while by the end financial conglomerates owned close to 70% of assets. This brought the Colombian financial system nearer to a universal banking scheme.

The two biggest conglomerates, Aval group and Sindicato Antioqueño, accounting for 18% and 16% of total assets respectively, are domestic. Another seven minor conglomerates, three of which are foreign, have assets of more than 1% of total assets. The largest conglomerate, the Aval group, owns three commercial banks, four commercial financing companies, two savings and loans corporations, three leasing companies and four insurance companies, among others.

Table 2

Participation in the financial system (% of total assets)

	Banks				Savings & loans	Other
	Total	Private domestic	Private foreign	State-owned		
1986-89	65	20	3	43	15	20
1990	46	22	4	21	16	37
1995	51	27	11	13	21	28
2000	55	33	13	9	19	26

3. Domestic mergers

It is the responsibility of the banking supervisory agency (Superintendencia Bancaria), which is attached to the Ministry of Finance, to approve or reject the institutional reorganisation of any credit establishment. The central bank has no jurisdiction over such authorisations.

To assess a merger proposal, the Superintendency of Banks requires the following information:

- The motives for the merger and the administrative and financial conditions under which it will take place.

- The relevant financial statements, to be assessed by the fiscal auditor with a view to establishing the conditions under which the merger will take place. The financial statements cannot predate the merger statement by more than six months.
- Corporations must add an explanatory annex on the evaluation methodology used by them and the exchange relationship resulting from its application.
- Copies of the acts by which the commitment to the merger was approved. In the case of an advance announcement, once the commitment is approved, copies of the acts are remitted to the supervisory agency.

A domestic merger plan can be disapproved by the Superintendency of Banks if any of the following cases occurs:

- the absorbing or new institution does not comply with the minimum capital requirements established by law and, under the Superintendency's judgment, there is no likelihood of the institution being sufficiently capitalised in adequate time.
- the absorbing or new institution does not comply with the minimum equity requirements or the solvency regulation currently in effect and, according to the Superintendency's judgment, it is not feasible for the institution to satisfactorily adjust its balance sheet in adequate time.
- according to the Superintendency's judgment, the managers or the stockholders that own more than 5% of any of the merging institutions do not satisfy the character, responsibility or suitability criteria necessary to participate in the merger operation.
- as a result of the merger, the absorbing or new institution can maintain or determine unequal prices, limit services, or limit free market competition. It is understood that this does not apply if the absorbing or new institution controls less than 25% of the corresponding markets.
- according to the Superintendency's judgment, the merger can harm the common interest or the stability of the financial system.

The current regulation applies to all credit establishments, in particular banks; institutions specialised in mortgage loans; financial corporations (investment banking); commercial financing companies and financial cooperatives. There are no restrictions on the fusion of credit establishments with non-bank institutions, so long as they are credit intermediaries or credit establishments. Nonetheless, these types of institutions are not allowed to merge with insurance companies, fiduciaries or retirement funds. For example, when a commercial financing company merges with a financial corporation, all of the requirements for operating as a financial corporation must be met.

Between 1997 and October 2000, there were 42 financial institutions merged in Colombia. Thirty-seven of these mergers (88%) were between private institutions and five of them (12%) between state-owned institutions. The largest portion of the mergers (33%) took place between commercial financing companies, the majority of which are small financial intermediaries. Next in importance were the mergers between financial corporations (19%), between banks (14%), and between banks and commercial financing companies (12%). In the case of the absorption of institutions specialised in mortgage loans or commercial financing companies by a bank, the resulting institution was a bank. Most merger procedures have been the outcome of financial difficulties inside the institutions. This explains why most mergers have taken place between institutions with overlapping operations or between institutions operating in different markets.

4. State-owned banks

4.1 Antecedents

Colombia has a long tradition of direct state participation in the financial system. In 1931 Caja Agraria was created as an entity with exclusively public capital, directed towards extending credits to small agricultural producers. Its first task was to refinance the debts of coffee growers, badly hit by the Great Depression. The following year Banco Central Hipotecario (BCH) was founded, with the purpose of buying bad loans from mortgage and commercial banks. Banco de la República bought half of the stock options of BCH. With these two banks, the share of public assets in the financial system reached levels close to 50%.

In 1951 Banco Popular was founded, with the specific purpose of granting credits to commerce and small urban businesses. Later, in 1953, on the initiative of the National Federation of Coffee Growers, Banco Cafetero was created. In 1954 it became a semi-public bank, when the National Coffee Fund, an institution with state participation, became its main stockholder. Two years later Banco Ganadero started operations, as a state-owned institution oriented towards the financing of commercial cattle raising. All of these banks were created to channel resources at subsidised prices towards sectors that faced liquidity restrictions.

The four banks mentioned above were, until the 1990s, the prime state-owned financial institutions. Other important public institutions were the Institutes of Industrial Development (Instituto de Fomento Industrial, IFI) and the Institute of Territorial Credit (Instituto de Crédito Territoral, ICT), lending institutions founded in the 1930s. However, they were not financial intermediaries because their funds came from the national budget.

In the first half of the 1980s, the financial crisis severely affected the private banks. As a result, the share of total assets held by domestic private banks fell from 33% to 18%. In contrast, the commercial state-owned banks increased their share, reflecting the confidence of the public in state-owned institutions and the nationalisation of six insolvent banks (Banco Nacional, Banco del Estado, Banco de Colombia, Banco Tequendama, Banco de los Trabajadores and Banco del Comercio). These banks, four returned to the private sector in the first half of the 1990s (two of them sold to foreign investors from Venezuela - Banco de los Trabajadores and Banco Tequendama - and the other two to domestic investors - Banco del Comercio and Banco de Colombia).

4.2 The 1990s crisis

The privatisation of four state-owned institutions in the first half of the 1990s and the growth in those years of the domestic and foreign private banks reduced the state-owned banks' share of financial system assets to approximately 25%. Moreover, in the framework of the financial reform of 1990-93, some public institutions acquired the character of rediscount financial institutions, which offer financial resources at market prices (IFI, Finagro, FEN and Bancoldex). By the middle of the 1990s, the assets of these institutions, together with the assets of the traditional state-owned banks, reached nearly 30% of the total assets of Colombia's financial system.

When the financial crisis exploded in 1998, the assets of the state-owned banks represented barely 15% of the system's assets or, taking into account rediscount banking, 22%. From the mid-1990s, non-performing loans for the state-owned financial institutions were about 10% of loans, twice the system average. By end-1999, for the financial system as a whole, 14% of loans were non-performing, while for the state-owned institutions NPLs exceeded 26%. In October 2000 these ratios were 12% and 21% respectively.

These statistics include the loans of three nationalised institutions, namely: (i) one institution specialised in mortgage loans (Granahorrar); (ii) one bank (Uconal); and (iii) one commercial financing company. At the time of nationalisation, the institution specialised in mortgage loans represented 10% of the total assets of its sector, the bank 1%, and the commercial financing company 16% of the total assets of the commercial financing companies.

Apart from Banco Agrario (formerly Caja Agraria) and rediscount institutions, the other public financial institutions will disappear or be sold to the private sector. For that purpose a general strategy has been designed which involves the following steps: First, the cleaning-up of assets, through the adoption of necessary provisions. Second, equity strengthening, through the recapitalisation of the institutions until a solvency ratio of at least 9% is reached. Third, separate management of the unproductive assets through an institution designated for their recollection and sale (CISA), with the purpose of recovering the highest possible value from them. Fourth, the administrative restructuring of the institutions. And finally, the sale of the institutions, or their dismantling if sale is not possible.

The general strategy for dismantling the state-owned banks has been accompanied by special treatment according to the specific circumstances of the institutions. Caja Agraria was liquidated and a new state-owned bank was created under the name of Banco Agrario, with the same functions as the old Caja Agraria but with fresh financial resources, a reduced number of branches and fewer labour commitments. In the case of Granahorrar and BCH, it was considered convenient that the former receive the productive loans and a major part of the liabilities vis-á-vis the public of the latter. Consequently, the loans need to be valued, a process that is still under way. When this stage finishes, Fogafin (the financial institutions guarantee fund) will strengthen its equity and initiate the sale process. Banco del Estado was merged with Banco Uconal, their assets were cleaned up and the resulting institution had its equity strengthened. Subsequently, the institution was administratively and technologically restructured and its sale will go ahead. Banco Cafetero has been cleaned up and capitalised, with bad loans and repossessed assets sold to CISA. At the moment Banco Cafetero is under administrative restructuring and will pass on to the sale phase in 2001.

The cost of the crisis in the state-owned financial system is estimated between 5.5 billion and 6.5 billion pesos, or 8.5 billion pesos if the liquidation of Caja Agraria is included. These figures represent approximately 3.5% and 5.8% of GDP respectively. Considering that at end-1999 the total capitalisation required by the private banks was estimated around 2.5-3.0% of GDP, the capitalisation required by all of Colombia's financial system would be between 6.0% and 6.5% of GDP, or 8.3-8.8% if the liquidation of Caja Agraria is included. Hence, solving the equity problems of the state-owned banks, including Caja Agraria, would represent approximately 70% of the rescue of the whole financial sector. At this moment no studies exist on recouping the resources of the state through the privatisation of some financial institutions.

4.3 Privatisation: legal framework

The Organic Statute of the Financial System and Law 226 of 1995 regulate the privatisation of the financial system, establishing the following:

- When a privatisation is due to take place, the operation must be conducted through the stock market and be sufficiently publicised and open to all. The Superintendency of Securities will establish the requirements and procedural rules of the auction.
- special conditions apply to the active and former or pensioned workers of the institution undergoing privatisation, labour unions, mutual investment funds, pension funds and cooperative entities.
- The state's stock participation will be transferred under conditions that maintain the public equity. The balance resulting from the transfer will be incorporated into the budget of the relevant holder so as to comply with the development plans, except where it is part of the quasi-fiscal funds, in which case the same objectives as for the quasi-fiscal funds will apply.
- The approval of the Superintendency of Banks must be obtained when, as a result of a transaction, more than 5% of the stocks (or the bonds exchangeable for stocks) are acquired.
- The approval of the Superintendency of Banks is not needed provided the persons interested in acquiring the stocks (or the bonds exchangeable for stocks) of the institution have obtained such approval in the previous three years, and are not subject to any sanction or charges.
- If difficulties arise in connection with these arrangements, Fogafin will propose alternative procedures to the Council of Ministers.
- When the privatisation involves a financial institution that has contributed to capitalising Fogafin, the latter will present the stock and bond transfer programme, once the Superintendency of Banks certifies the institution's equity is sound. In the remaining cases, Fogafin will present the proposals according to the petition submitted either by the ministry to which the institution is assigned or by any insurance or public agencies that hold stock in the institution.

The state or its decentralised entities can entrust Fogafin with the valuation, the preparation of the programme as well as the administration or transfer of the stocks and bonds.

5. Foreign direct investment (FDI)

5.1 Antecedents

The 1970s and 1980s in Colombia were a period of severe restrictions on foreign investment in general, and in the financial sector in particular. Decree Law 444 of 1967 gave the government a set of tools to channel FDI towards the sectors considered "a priority for economic development". This meant that for many years no foreign investment in the financial sector was approved. Later, Law 75 of 1975 applied Decision 24 of the Andean Pact to the financial sector, requiring foreign banks to become joint ventures within three years. It was established that at least 51% of the property concerned had to be in hands of Colombians, and limits were set on the reinvestment and external transfers of profits.

In practice, the conversion to joint ventures was implemented without foreign investors relinquishing control of their institutions; the financial joint ventures did not increase their capital but their relative size increased. All of this was contrary to the government's initial intention of preventing a further portion of domestic savings coming under foreign control. Furthermore, the FDI inflows to the financial system completely stagnated. On average the inflows of foreign investment to the financial system as a portion of total foreign investment in the country decreased from 23% in 1975-79, to 7.4%, 4.5% and –3.9% in the following five-year periods respectively. As a proportion to GDP, the magnitude of these flows was negligible.

As previously mentioned, in the first half of the 1980s the private banks faced a particularly difficult financial situation. However, the banks with some foreign ownership performed on average slightly better. In 1985, the capital-to-assets ratio of the domestic banks was 4%, while the joint venture banks maintained levels close to 6%. Similarly, the percentage of non-performing loans for the domestic banks was double that for the banks with foreign capital (17% versus 6% respectively). Differences also existed in the average profits-to-assets ratios, even though these were negative for both groups (–5% and –2% respectively). Some foreign banks, however, faced serious difficulties. For example, Banco Tequendama and Banco del Comercio were nationalised and the prohibition whereby foreigners could not own more than 49% of an institution was waived for Banco Mercantil, Banco Crédito y Comercio, Banco Colombo and Banco Real with the purpose of avoiding their total collapse.

5.2 Liberalisation in the 1990s and results

As stated above, at the beginning of the 1990s the restrictions on foreign investment in Colombia were significantly reduced with the Law 9 of 1991 enabling the greatest transformations. This law established the foreign exchange principles which the government drew on in drafting the statute on foreign investment, itself based on three key principles: (i) equality of treatment for nationals and foreigners and equal investment opportunities; (ii) universal access to all sectors of the economy; and (iii) automatic authorisation of the establishment of foreign investors in the country. For the financial sector this meant free entry for foreign investors, all within a framework of a wider process of financial liberalisation intended to improve the allocation of resources, promote competition and improve administrative efficiency.

The institutional changes had a positive effect on foreign investment in the financial sector. The banks that had been foreign-owned before 1975, and were transformed into joint ownership banks in the second half of the 1970s or 1980s, became foreign-owned banks (ie Citibank, Anglo and Sudameris). Foreign investors bought banks that had been nationalised during the 1980s crisis (Banco Tequendama and Banco Mercantil, purchased by Venezuelan investors), and others that had not been (Banco Ganadero and Banco Comercial Antioqueño, bought by the Spanish banks Bilbao Vizcaya and Santander, respectively). Lastly, some banks entered Colombia for the first time (for example Banco del Pacífico, owned by Ecuadorian investors, and ABN-Amro and Bank of Boston). With these investments, the participation of foreign banks in the total assets of the banking system increased from 10% in the second half of the 1980s to more than 30% in 2000.

The largest foreign banks are the Spanish banks Ganadero and Santander, and Citibank. These banks conduct similar lines of business to the domestic banks. Banco Ganadero and Banco Santander also have an extensive number of branches in the country. The rest of the foreign banks are significantly smaller than these banks and their principal activity is investment banking. Some institutions do not take deposits from the public and the majority of them manage their risk by conducting depository and loan operations with triple-A sectors and multinationals. These types of institutions offer support to businesses oriented towards the international markets, related to commercial credit operations and the management of private foreign debt, and run active treasury operations (ie the purchase and sale of foreign currencies).

A recent detailed evaluation of the role of foreign banks in Colombia's financial system showed that foreign banks have fewer non-performing loans, lower reserve requirements and are more productive than the domestic banks. Regardless of this, foreign banks do not appear to have lower spreads, possibly benefiting from the lack of competition inside the financial system. Moreover, the largest improvements in the indicators of the foreign banks have been seen for the banks that were formerly government-owned. As a consequence, these banks have been operating with lower spreads than the rest of the foreign banks. However, based upon an econometric analysis, the authors conclude that the lower administrative costs and the better quality of the loans extended by the foreign banks have allowed these banks to establish spreads slightly lower than those of the domestic banks.