

Preparation for a systemic financial crisis in Colombia. Resolution framework, evidence and lessons learned

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Abstract

An effective resolution regimen should reduce moral hazard in the banking industry. Countries with the right tools and monetary resources available should be able to handle a systemic financial crisis without recurring to tax payer's money and minimizing spillovers on the rest of the economy. The Colombian systemic crisis of the late 1990s is a good example to evaluate the way the authorities of the moment used resolution powers in a time when resources were almost non-existent to deal with banks failures. The Colombian literature about it is large, but all refers to the economic consequences and the issues that were behind the negative growth, the (un)sustainability of public debt and the tightening of private consumption and investment. In this paper, we go deep into the legal and institutional framework and to the tools available to take decisions and to resolve the crisis. We found that the authorities were very creative and resourceful and that they set the foundation for a healthy financial system for years to come. However, the lack of an appropriate level of funding and of some instruments, like bridge bank or P&A, could have made the dealings of the crisis more difficult and the resolution of the crisis took more time.

Keywords: Resolution framework, financial stability, banking crisis

JEL Codes: G01, G28, H1, N26

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I. Introduction

After the international financial crisis of the second half of the last decade, and after the initial reaction by policy makers in the US and Europe, an international dialogue started at the Financial Stability Board -FSB-, endorsed by the G20, with the aim of establishing the best practices and instruments to solve financial crisis of systemic importance and with global implications. Efforts have been directed to find mechanisms that do not rely on bail-out instruments, or that at least reduce the possibility of using tax payer's money to manage financial crisis of big proportions. In October 2011, the FSB issued the Key Attributes of Effective Resolution Regimes for Financial Institutions¹, a guide to solve systemic financial institutions, which has become the framework to evaluate resolution regimes of the G20 countries and that the FSB, the World Bank and the International Monetary Fund -IMF- have been expanding to middle-income countries, making some adjustments for their own peculiarities.

It is in this environment, and given the fact that the Colombian literature about our financial crisis of late 1990's is reach in presenting its causes and consequences², we think that there is no analysis of the instruments used by the authorities at that moment and of the regulation available at the time to solve the difficulties of the Colombian financial system. Under these circumstances, we decided to make a characterization of the resolution mechanisms that helped the authorities face the Colombian financial crisis of late 20th Century, recount the intervention done by the Colombian resolution authorities (Superintendence of Finance -SFC-, Ministry of Finance and the Fondo de Garantías de Instituciones Financieras -Fogafin³), update the fiscal costs and establish the sources that helped finance the intervention. The aim is to open the debate towards the best way to intervene financial institutions in Colombia under the current spectrum of best international standards to solve systemic crises.

We believe that good preparation to solve difficult situations in the financial sector will reduce moral hazard and, eventually, will limit the use of tax payer's money to rescue financial institutions. We also believe that it will reduce the consequences towards the rest of the economy, both in the short and in the long run. Most importantly, we believe that a strong framework to solve financial crisis will result in good economic policies response and good politics. For example, in Colombia, at the outset of the crisis (1999) the government created a new financial transactions tax to have some firsthand financing, at the worst economic situation for all Colombians. Clearly, a bad countercyclical policy decision. And, as it was seen during the last international financial crisis, tax payers dislike enormously the "rescue of banks" and it is very difficult to send the real message for the intervention (remember that in the US, headlines always referred to the abandonment of "main street").

It is under those circumstances and to limit bad consequences that an effective resolution framework should have the capacity to measure the direct and indirect effects of the failure of a systemic bank, to minimize costs and the use of tax payer's money, to minimize market disruption, ensure discipline through legal actions and to provide resources to secured depositors. A good resolution framework will help authorities take the correct decisions when needed.

¹ Financial Stability Board (2011).

² Fogafin (2009), Restrepo and Núñez (2008), Arango (2006), Argáez and Urrutia (2006), Cárdenas and Badel (2003), Serrano (2001) and Torres (2011).

³ After the financial crisis of the mid of 1980s, the law created Fogafin as the resolution institution. Later it was given the powers to be the deposit insurance agency.

It is not the goal of this work to make an evaluation of the decisions taken by the Colombian authorities of the moment, during the largest financial and economic crisis ever in the country. It is well known that crisis management was guided under a set of rules that were important for the historical moment, such as the need to minimize spillovers on the rest of the economy and to keep vital elements of the financial sector functioning so that the Colombian economy would not go deeper into recession. We must remember that, as it is the case in many instances, the financial sector deterioration hit the country when it was in the middle of the deepest crisis, with international markets closed to Colombia, record high levels of unemployment and private and public consumption were going through a drastic adjustment.

Before entering into the analysis of the Colombian resolution regime, we want to address the issue of why governments should have in place robust resolution mechanisms to intervene in financial markets when they enter into trouble. The more extreme view could be that banks and other financial institutions should be allowed to fail when the institution enters into insolvency as it is the case in any other business. However, and even though small banks are normally allowed to close or be subjected to any other private resolution, in the case of a systemic bank there are good reasons for the government intervention to address systemic situations and to have intervention tools that could prevent a major economic disaster. The aim is to protect the vital functioning of the economy and to preserve essential bank operations, keeping the payment system operating and the compensation and liquidation systems functioning. In the same vein, we cannot forget that the financial system is the keeper of the money and savings of the people and it is never a good idea to lose their trust. In addition, we must take in mind that a crisis that originates in the financial sector can spillover rapidly into the whole economy if the authorities do not intervene to minimize the negative macroeconomic consequences.

The financial crisis of late 1990's was a challenge to the Colombian government. It was a time to use any possible tool available at the moment to respond to the challenges ahead. When using resolution mechanisms, the government established four principles to intervene when needed to minimize traumatism to stakeholders⁴: 1) quick and comprehensive response; 2) technical support to decisions to be taken; 3) avoid moral hazard; and 4) minimize government direct intervention.

Under those principles and with the financial sector falling apart, the government through Fogafin, started the intervention in May 1998 with tools that gave support to banks, insured depositors and other some creditors. The Government and Congress issued a long set of regulations to give legal support to the intervention, appropriate fresh resources to finance the crisis and to give some support to the more vulnerable.

At the start of the crisis, end 1997, the balance of the Deposit Insurance Fund was only USD\$ 473 million, a small amount of resources compared with what would be needed. During it, Fogafin kept charging premiums, received money from the central government and issued bonds in the local market.

After this introduction, this paper has 4 sections. We make a detailed description of the resolution framework and tools used during the late 1990s Colombian financial crisis in Section II. Section III updates the fiscal costs, section IV makes a detailed description of the sources of funds used during

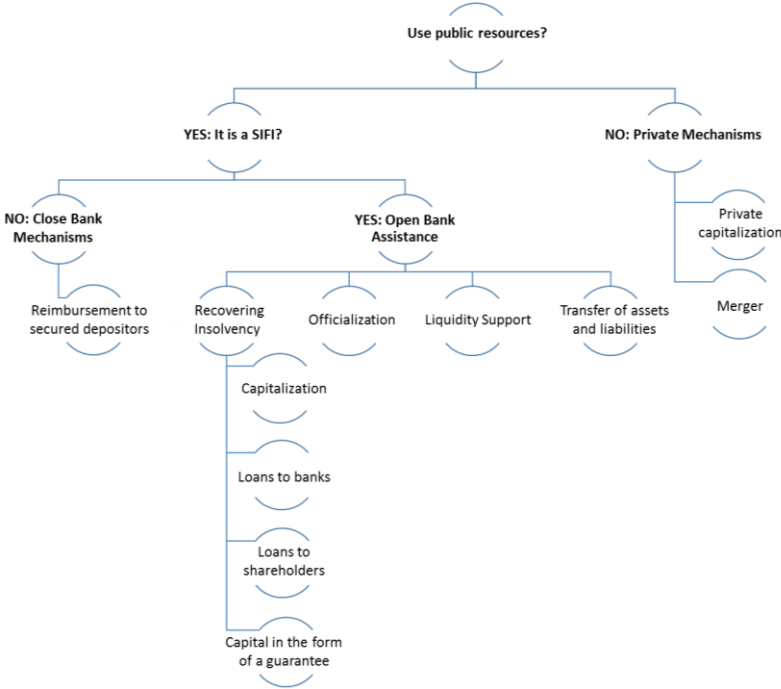
⁴ Fogafin (1998).

the crisis and in section V we conclude with some lessons from the past and make some recommendations for the future.

II. Resolution tools used during the crisis

Resolution mechanisms are the set of procedures to address failing banks with the aim of minimizing adverse consequences on the economy in general and on depositors in particular (in the Appendix A we make a detailed description of the legal framework that give support to the authorities work). Specialized literature talks of powers to intervene under three circumstances: open bank assistance, close bank mechanisms and private mechanisms (Figure 1). Best practices recommend evaluating first the option of a private solution, which means that only private players participate: shareholders undertake the need of injecting new capital, new shareholders can come, the fail bank could merge with another one or it can go through an acquisition by another private bank. The main advantages of this solution are that it does not involve tax-payer’s money and that it induces market discipline. Under a private solution, the financial sector resolves its own problems. This paper deals with the other two options, which were the tools more often used to solve the Colombian financial crisis, under the leadership of the resolution authorities. These options needed budgetary resources to solve failing banks.

Figure 1: Resolution Mechanisms



Source: Authors’ elaboration based on Fogafin (2011).

A. Open bank assistance

When the failed institution can risk the whole operation of the financial system and the trust of depositors, the instruments available to the authorities are under the umbrella of what is called open bank assistance. Under open bank assistance, tax payer’s money can be used to keep the failed

institution into operation and to restore its solvency levels. Fogafin is the entity responsible for the implementation of an open bank resolution mechanism which can take several forms as it is shown below.

Recovering Insolvency

a. Capitalization

Partial capitalization takes place when the amount of money that Fogafin put into the failing bank's balance sheet is lower than 50% of the paying capital. During the crisis, this option was used by Fogafin who acquired shares from the bank to restore its solvency legal level, by using resources from the Deposit Insurance Fund and from the Fondo Banca Pública⁵. When the capitalization raises to more than 50% of the paying capital, the operation becomes an officialization. Six banks fall into the partial capitalization and 2 banks under officialization (Table 1).

b. Loans to banks

During the crisis, Fogafin played a role as lender to institutions that faced solvency problems. Again, using funds coming from the Deposit Insurance Fund⁶, six private banks were solved with this resolution mechanism under the condition that the bank commits to a recovery plan supervised by Fogafin. As a guarantee, Fogafin received shares from the same institutions. The outcome of this operation in general was a good one in the sense that almost all of them repaid their loans under the original agreement conditions. Only two of them failed to comply and later enter into liquidation.

c. Loans to shareholders

At the start of the crisis, the government issued a decree⁷ that allowed Fogafin to set a special line of credit to shareholders. Fogafin set the conditions under which those lines should operate and the main condition was that money could be used only to capitalize the failing bank. In addition, shareholders should move bad assets to a trust account outside the bank and put 20% of the money needed to restore solvency. The source to repay Fogafin came from recoveries from selling the bad assets and from the bank's dividends (Figure 2). For this operation, Fogafin issued bonds that could be traded in the secondary market by banks to obtain cash for capitalizations. Ten private banks were put under this mechanism.

However, in 2001, and under the persistence of the crisis, a new decree⁸ was issued and this time a new line of credit was offered to shareholders of mortgage banks. The difference with the previous one was that this time the SFC would mandate how much was needed to restore solvency levels and that the resources could take the form of a loan or of special shares called BOCAS⁹. Five mortgage banks had access to this line of credit.

⁵ This Fund refers to a vehicle that the government funded to capitalize public financial entities.

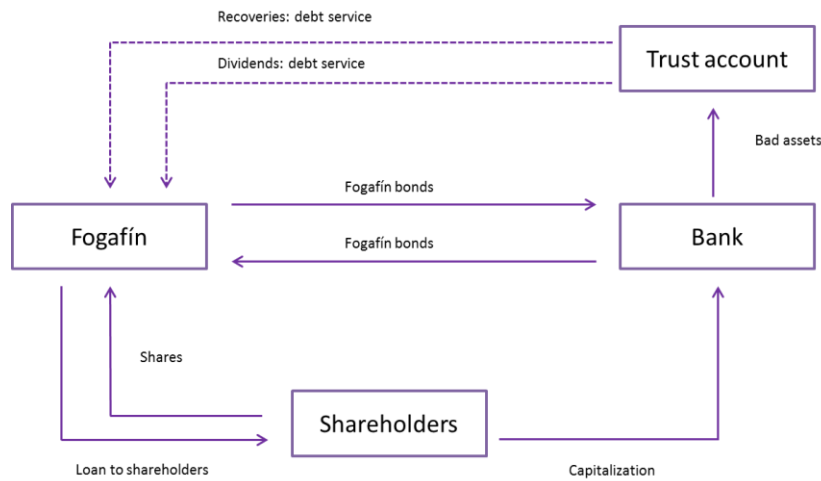
⁶ The Deposit Insurance Fund can only be used to pay the deposit insurance and to give support to member bank institutions. Under Colombian law membership is compulsory to banks, financing companies and financial corporations. In this document, we call them all banks.

⁷ Decree 836 of 1999.

⁸ Decree 1574 of 2001.

⁹ Bonds that could be converted into shares.

Figure 2: How the line of credit to shareholders worked



Source: Fogafin (2009).

d. Capital in the form of a guarantee

This mechanism was often used during the crisis. The way it was set refers to a guarantee issued by Fogafin which would be given to the bank, on a temporary basis, that could be used to comply with the legal solvency level. Eleven banks received this kind of guarantees and only 4 of them survived the crisis, showing mixed results of the instrument.

Officialization

When more than 50% of the shares of a bank get into the hands of the government/Fogafin, the bank becomes a public bank. During the crisis, there were two ways by which banks fell into this category: i) when technical support was given to consider the failing bank a systemic one (only 2 banks fell into this category); and ii) when the bank failed to comply with the conditions or to repay the loan that was given under one or more of the mechanisms described above and the mechanism involved more than 50% of the shares (one bank falls into this category).

Liquidity support (called repo operations)

Fogafin put in place resources to banks facing liquidity constraints through the possibility of buying assets (mainly loan portfolio) to institutions that could commit to buy them back later (for this reason, they were called repo operations). In this case, the central bank had already closed its doors to them. Under this mechanism, banks were under solvency problems but have committed previously to restore the legal solvency level under an adjustment program. Thirteen banks used this mechanism. At the end, it was in fact a problem for Fogafin because in many opportunities, the bank failed to comply with the repurchasing agreement and Fogafin ended up managing bank loans without the needed expertise.

Transfer of assets and liabilities

In general, the operation of transfer of assets and liabilities is taken by the board of directors of the financial institution, under a recommendation of the SFC. However, Fogafin was involved in several occasions in such operations because after becoming a partial or full owner of the bank it had decision powers to pursue the operation. The mechanism was used to detach productive assets from the failing institution to another one that, once sound, could be put for sale. What was left in the original bank entered into liquidation. This is called in the literature a good bank – bad bank operation. Six private banks and five public banks followed this path.

Table 1: Banks with open bank assistance

	Recovering Solvency				Officialization	Liquidity Support	Transfer of assets and liabilities
	Capitalization	Loans to Banks	Loans to Shareholders	Capital in the form of a guarantee			
Financiera FES	X			X	X	X	X
Interbanco		X	X	X		X	X
Banco Uconal		X		X	X	X	X
Cofinorte		X	X	X		X	X
Coopdesarrollo/Megabanco		X	X	X		X	X
Bancafé	X			X		X	X
IFI	X			X		X	X
Banestado	X			X			X
Caja Agraria	X			X			X
Granahorrar	X				X	X	
Banco Superior		X	X	X			
Multifinanciera		X	X			X	
BCH	X						X
Colpatria			X			X	
Coltefinanciera			X	X			
Bancoop						X	X
Davivienda						X	
Interleasing						X	
Banco Agrario	X						
Banco de Crédito			X				
Colmena			X				
Conavi			X				
Banco Unión			X				
Confinanciera			X				
Credinver			X				
AV Villas			X				

Source: Authors' elaboration based on information from Fogafin.

Summarizing

As it can be seen in Table 1, twenty-six banks received open bank assistance, twelve of them were public banks. More than one mechanism was used on a given bank on several occasions. Given the systemic conditions of the time, the government activity in this sense, through Fogafin, has full justification. The long list shows the efforts by the authorities to keep the crisis into control and to limit its consequences.

Even though not in all cases the banks were of a considerable size, we want to highlight the following regarding the authority's reaction. First, the major role of public banks during the crisis. As we will see later, those banks took most of the resources available to solve the financial crisis. Second, at the start of the crisis the Deposit Insurance Fund was far from having the resources needed to face a crisis of such proportions. Under this circumstance, the decision making is much more problematic, reducing the options that the government/Fogafin had and, more importantly, it is more difficult to evaluate the least costly option. Under a situation of scarce resources, the authorities must take into consideration the need of budgetary resources in a time when the government itself was under

pressure for its high levels of debt (even considered unsustainable). That is the logic behind capitalizations with only a guarantee from Fogafin, or of capitalizations with less than 50% of the capital. Third, deposit insurance payment was an instrument that could not commit to comply with its objectives, mainly to give trust to depositors that their money will be promptly reimbursed, and in this way to avoid bank runs. The deposit insurance payment was starting on average 180 days after the closure of the bank, which goes exactly in the opposite direction of the aim of such instrument.

A. Close bank mechanism

When there is no private solution and the failure of the bank does not put in danger the whole system, the best solution is to allow the financial institution to close and pay the deposit insurance when the failing institution is a member bank of Fogafin.

Reimbursement to secured depositors

Sixteen banks were allowed to fail (Table 2). After the closing of the bank, automatically Fogafin starts the reimbursement to secured depositors. However, weaknesses in the operations of Fogafin made it difficult to comply with the commitment of a prompt reimbursement. Red tape and a lack of a well design process were the causes for a reimbursement that would start, on average, 180 days after the closure of the bank. We need to remember that the deposit insurance main objective is to avoid bank runs and to give market discipline while protecting depositor’s trust in the financial system.

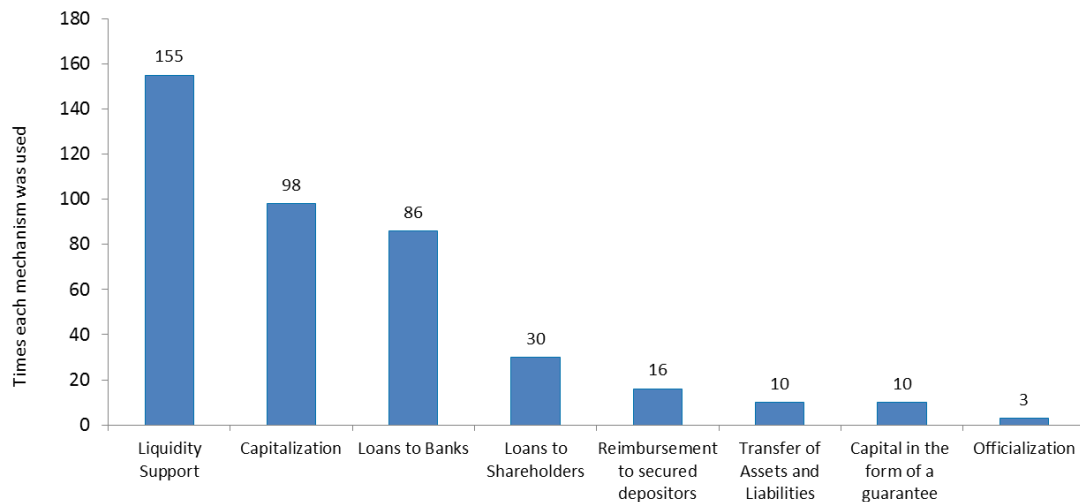
Table 2: Banks that failed and that triggered the reimbursement to depositors

Leasing Cauca Leasing Arfin La Fortaleza Leasing Patrimonio	Banco Andino Banco del Pacifico Banco Selfin Corfipacifico	C.F.C. Bermúdez y Valenzuela C.F.C. Finesarrollo C.F.C. Pacifico Corfioccidente	Leasing Selfin Capitalizadora la Grancolombiana Capitalizadora Aurora Corfitransporte
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Source: Authors’ elaboration based on information from Fogafin.

As final remarks to this section, Figure 3 shows how active the authorities were during the financial crisis. We set the beginning of the crisis in August 1998 when the authorities first intervened and the end of it in March 2002 (after this date, many banks were under the liquidation process that always takes place for several years). One interesting feature of the authorities’ activity during this period is that the use of just one resolution mechanism was not enough to put the bank’s balance sheet into a healthy solvency level.

Figure 3: How many times resolution mechanisms were used



Source: Authors' elaboration based on information from Fogafin.

Figure 4 is a chart that shows the authorities' intervention in public banks and nationalized institutions. All lines that connect the banks show the operations that were executed by Fogafin in order to solve the institution in trouble. Green lines refer to transfer of assets and liabilities, red ones to sale of the institution, blue ones to the process of officialization, liquidity support and insolvency recovery and grey lines refer to the liquidation of the institution or to the scission or a split of the company. As a proof of the authorities' activity, we can see that it was not easy to put together a solution to everything that was happening at the same time in the financial sector. Even though in this graph we put only the management of public banks and nationalized ones, one thing that we want to highlight is the efforts to find a solution that at the end will leave only one public bank and that all others would be either closed or merged with other banks that were attractive to the private sector. This is what happened at the end. Six banks, that today are good healthy Colombian banks, took over the failing of institutions that were once public banks.

As an example, we will go on detail about Bancafé (born Banco Cafetero), because it was one of the banks that demanded lots of efforts and support from the authorities and because, at the end, the solution required lots of creativity¹⁰.

The Bancafé story

In 1953, the Banco Cafetero was born as part of the Ministry of Agriculture through the Fondo Nacional del Café (FNC), but it was the Federación de Cafeteros¹¹ who was in charge of the management of the bank with the aim of giving support to the coffee business. However, by the end of the 1980's, only 5.8% of the loan portfolio was linked to this sector. During the next 10 years, the bank was on a path of a constant weakening of its financial indicators to the point that several times the FNC had to capitalize the bank. In December 1997, total assets of the bank were only 3.4% of

¹⁰ For information of other institutions, see Fogafin (2009), Restrepo and Nuñez (2008) and Espinosa (2010).

¹¹ The Federation de Cafeteros is the Colombian Coffee Growers Federation.

total assets of all banking sector. The bank was the owner, with 58% of the shares, of a mortgage specialized institution called Concasa.

In November 1998, shareholders take the decision of taking over Concasa, that was under a rapid deterioration, losing USD 9.7 million only during the first months of 1998. Bad loans of Concasa increased by 14.3% and loan provisions only reached 6% during the month before the merger. Before the operation took place, the FNC injected capital to Concasa by the amount of USD 75.2 million (USD 50.6 million to buy the remaining 42% of shares and USD 24.6 million to guarantee the operation).

The financial indicators of the merged institution, however, continued to worsen (one month after the merger took place, solvency indicator reached 4%). Besides, other subsidiaries of Bancafé (Almadelco, Fiducaf , Corficaldas, Corfioccidente and other subsidiaries outside Colombia) were too under stress, continuously losing money.

In July 1999, the SFC commands shareholders, the FNC, to increase paying capital by USD 320 million. But they fail to comply and Fogaf n takes over, capitalizing the bank by the amount asked by the SFC in September 30, 1999. Previously, shareholders had to reduce the price of shares to COP 1 and in this way Fogaf n becomes 99% owner of the bank. In addition, the bank was in great need of liquidity and it asks for repo operations with Fogaf n for USD 177 million between April 2000 and October 2001.

On another issue, the authorities had to resolve two other public banks that were in trouble, Banestado and BCH. They decide to transfer their assets and liabilities to Bancafé (worth USD 420.7 million in the case of Banestado and USD 26.5 million in the case of BCH). However, the bank's balance continues to deteriorate, and Fogaf n has to capitalize the bank in three different occasions (USD 121 million in October 2000, USD 114 million in April 2001 and USD 44 million in February 2002). None of these operations were enough to give some financial stability to the bank and, between May 2000 and December 2004, it was needed that, in addition, Fogaf n gives guaranteed capital up to the amount of USD 105 million.

The need to have a definitive solution was urgent. The authorities' evaluation was that at that moment it was impossible to close the bank because it was the bank of thousands of small coffee-grower families that were already under stress. Under this constrain, they decide to clean the bank by taking out of the balance sheet the bad assets. They were given to CISA, the public collector owned by Fogaf n. In addition, provisions were built to support overpriced assets.

In 2001, Fogaf n decides to sell the bank. Because it was a public bank, Colombian law makes it compulsory for the Cabinet of Ministers to take the decision. But at this first attempt they did not give support to Fogaf n to do it. In August 2003, however, the decision had the needed support. This time the problem was that no one was interested in buying the bank when it was put under a bid process in February 2004.

After this bad outcome, Fogaf n took the decision to create a new bank, this time to follow the resolution mechanism called "good bank – bad bank". To create the new bank, called Granbanco, Fogaf n needed to get some new capital. The decision, in March 2005, was to split capital from Granahorrar, which had been previously nationalized, and to withdraw capital from CISA. In this way, Granbanco got the license to operate as a bank (Figure 5).

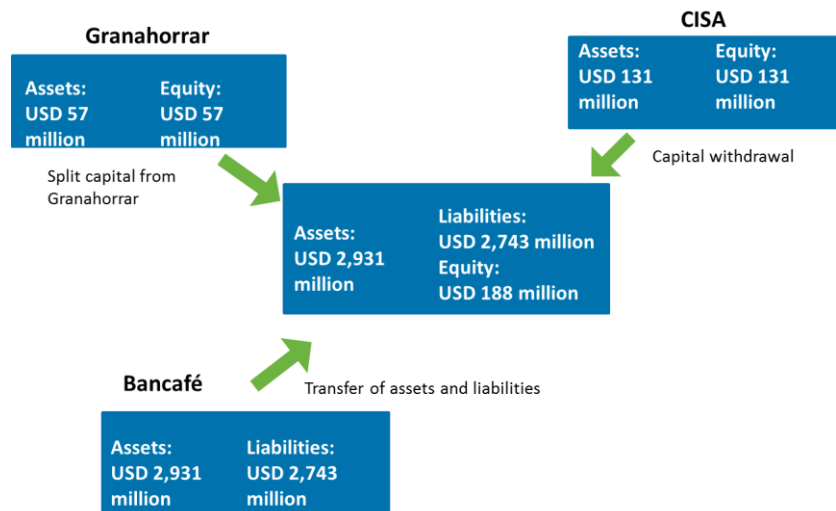
What remains in Bancafé enters into liquidation (the bad bank), in March 2005, after Fogafin withdraws the guaranteed capital (for the amount of USD 87.5 million) (Table 3). One of the main problems was the pension liabilities of Bancafé, and before the liquidation decision, there is a need to make a provision by the amount of USD 87.5 million (that was withdrawn from its own capital) and the central government commits to any difference that would remain. From 2011 and 2015, the Ministry of Finance has had to pay USD 158 million for Bancafé pension liabilities.

In May 2006, Fogafin begins again the process of selling, this time, Granbanco. However, prior to the operation it was necessary to split a small amount of capital to finance a new policy of interest to the government called “Banca de las Oportunidades”. The idea was that to get the support of the cabinet and the president himself to sell the new bank, two new entities (SIAM and Inversiones Gran) were created to promote microcredits. At the end, none of the entities developed their business and later they were liquidated.

Finally, in February 2007, 99.1% of the shares of Granbanco were sold to Banco Davivienda for the amount of USD 1.1 billion. The operation was made possible thanks to a contract that gave the new owner guarantees to some contingent liabilities of the subsidiaries, possible adverse legal rulings, and others unknown at the moment of the transaction. The way it was written has not given any concern to the Ministry of Finance since it has not been under any obligation to disburse resources.

If we take into account all the money spent under all mechanism used during the more than 7 years that lasted the whole operation of Bancafé, total money needed was USD 1.1 billion. The first intervention of Fogafin was in September 1999, when it was first capitalized. The remaining bank entered liquidation in 2005 and Granbanco was sold in February 2007. The liquidation of Bancafé was finished in 2010.

Figure 5: The story of Bancafé



Source: Authors' elaboration.

Table 3: Transfer of assets and liabilities – Bancafé

Balance Sheet (USD million)	Assets	Liabilities	Equity
Before the transfer	3,174	2,955	218
Transfer to Granbanco	2,743	2,743	
After the transfer	342	300	42

Source: Authors' elaboration.

Bancafé is a good example to take some conclusions related with the powers to use resolution mechanisms available to the Colombian authorities. First, there is a broad range of tools and powers to act and it is very clear that they use it within the needed formality of the Colombian legal framework. By the way all operations took place, we can see that they were solidly legal since the decisions nor the public servants involved (which is a big issue in our country) were in legal risks. Second, because the bank was a public bank to start with, decision making is more difficult because it involves a political instance as it was the bank of an important part of the Colombian population. Under these conditions, the decision to give the bank open bank assistance instead of the alternative to close the bank, meant that the intervention took several years to be resolved and lots of scarce monetary and human resources for more than 6 years. Under the current international standards, it would have been necessary to compare the total gross cost, USD 1.1 billion, of the intervention with the amount that would be needed to pay to reimburse depositors. However, as we know, even if the bank was not a major bank, it could be called a systemic one because of the clients that it served and because the whole system was in state of weakness. Third, nor Fogafin or the Government had the resources available to act in a more decisive way. Although the counterfactual is difficult, we want

III. Costs of the crisis – an update

The financial crisis at the end of 1990's had deep consequences to the Colombian economy in terms of economic growth, weakness of the financial system and private economic activity. The crisis implied the commitment of important budgetary resources, at a moment when the Government was going through a difficult situation. As it is going to be shown later, total gross outlays were 7.4% of 2005 GDP.

Colombia was facing the worst economic crisis in a century. In 1999, its rate of growth was negative at a level of 4.2% and the fiscal deficit reached a negative balance of 6.5% of GDP. International markets were closed to the country and the central bank had to change its foreign exchange policy as it moved from managed floating inside a band to free floating. In the context of great liquidity needs, it is worth remembering that only after the country reached an agreement with the IMF, multilateral banks were able to give the Colombian government support and later international markets started to be open to buy Colombian bonds. On top of everything, the Deposit Insurance Fund was very far from having the needed resources to react to the evolving situation.

For this paper, we collected information from the balance sheet of Fogafin and the minutes of its board of directors. With this information, we updated the fiscal cost of the crisis. We have taken into account all the flow of funds from Fogafin to the financial institutions and the recoveries during and after the crisis. We also add the resources that went directly from the Ministry of Finance to the banks. In this way, the fiscal cost of the crisis amounts to 3.6% of 2005 GDP. However, to have a complete view, we need to add some other expenditures directed to mortgage borrowers that were hardly hit by the crisis and the cooperative sector through Fondo de Solidaridad de Ahorradores de Entidades Cooperativas (Fosadec), Fondo de Garantías de las Instituciones Cooperativas (Fogacoop)¹². If we add them, total costs increase to 3.8% of 2005 GDP.

To build the numbers, we considered the following:

- Everything that was given to the banks either in the way of cash or bonds (government's bonds or Fogafin bonds)
- Reimbursement to depositors
- Interests of the Fogafin bonds
- Other administrative expenses by Fogafin for liquidation or sale of banks

As it can be seen in Table 4, four resolution mechanisms took USD 5.5 billion. 57% of the resources were used to inject capital to the failing banks (through partial capitalization or officialization) and that 19% of the resources were used to give to liquidity support.

As it was said before, 26 banks received support through an open bank assistance mechanism. 15 of them were private banks, 6 public banks, 2 cooperatives and 3 nationalized banks. In terms of resources, public banks got 54% of them, while the nationalized bank received 21% (Figure 7).

¹² Those 2 funds were the safety net to accounts in cooperative institutions. During the crisis, cooperatives were in a weak situation and it created an additional problem to the government since they attended small accounts of millions of the poorest people of the country.

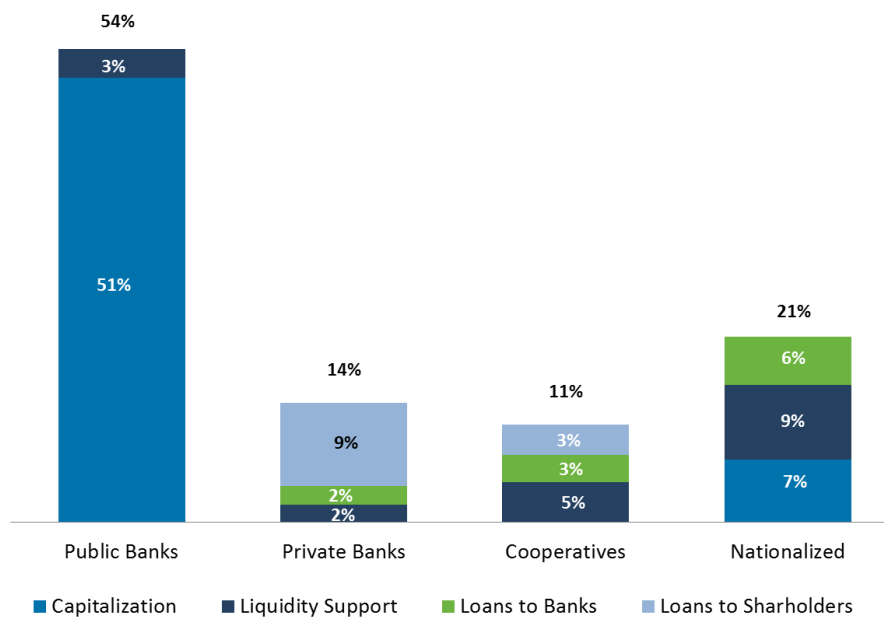
Table 4: Open bank assistance

Mechanism	USD million	Share	% 2005 GDP
Capitalization	3,142	57%	2.9%
Liquidity support	1,022	19%	0.9%
Loans to shareholders	710	13%	0.7%
Loans to banks	594	11%	0.6%
Total	5,468	100%	5.1%

Source: Authors' elaboration based on information from Fogafin.

As it can be seen in the chart, public banks took resources through injections of capital. Meanwhile, the mechanism mostly used with private banks and cooperatives was through loans to shareholders and liquidity lines. Nationalized banks not only received resources through loans and liquidity lines even before they were taking over by the government, but once in the hands of Fogafin more resources were needed for capitalization.

Figure 7: Open bank assistance (% of the total resources)

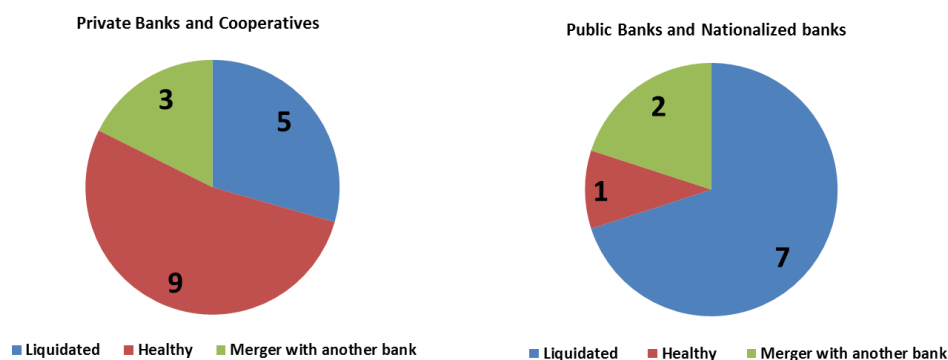


Source: Authors' elaboration based on information from Fogafin.

The decision to use resolution mechanisms for open banks is based on the fact that it is considered that closure of the bank will put into risk the whole system. It is for this reason that we try to follow up with the banks that were at the time in trouble and that received support from the authorities. As it can be seen in Figure 8, in the case of the 17 private banks and cooperative, 9 are today healthy banks, 3 were merged with another bank and 5 enter liquidation. For the public and nationalized

banks, 7 entered liquidation, 2 merged with another bank and 1 is today the public bank that serves the agricultural sector (el Banco Agrario)¹³.

Figure 8: Current situation of the institutions



Source: Authors' elaboration based on information from Fogafin.

Besides the expenditures for open bank assistance, we need to add interest payments of Fogafin bonds (USD 2 billion), costs for the liquidation of the Caja Agraria (the initial public bank for the agricultural sector) and the resources needed by new Banco Agrario needed (USD 1 billion). For Fogafin, administrative costs and others amounted to USD 79 million. Reimbursement to depositors in this context needed a small amount of resources (USD 45 million) and the Banco Cafetero pension liability took resources by the amount of USD 158 million (Table 5).

Table 5: Other costs

	USD million	% 2005 GDP
Interest payment of Fogafin bonds	2,003	1.3%
Liquidation of the Caja Agraria	1,060	0.7%
Pension liability of the Banco Cafetero	158	0.1%
Administrative costs	79	0.1%
Reimbursement to secured depositors	45	0.1%
Other expenses	88	0.0%

Source: Authors' elaboration based on information from Fogafin.

Table 6 shows a summary of gross expenditures of the crisis.

¹³ For details of the transformation of the Colombian financial system, see Clavijo (2000), Gandur (2003) and García and Gómez (2009).

Table 6: Summary of gross costs of the crisis

	USD million	% 2005 GDP
(1) RESOLUTION MECHANISM	5,468	5.1
Capitalization	3,142	2.9%
Liquidity support (rep operations)	1,022	0.9%
Loans to shareholders	594	0.7%
Loans to banks	710	0.6%
(2) INTEREST PAYMENTS	2,003	1.3%
(3) OTHER	1,385	0.9%
Liquidation of the Caja Agraria	1,060	0.7%
Pension liability of the Banco Cafetero	158	0.1%
Administrative costs	79	0.1%
Other	88	0.0%
(4) REIMBURSEMENT TO SECURED DEPOSITORS	45	0.1%
TOTAL (1+2+3+4)	8,902	7.4%

Source: Authors' elaboration based on information from Fogafin.

Meanwhile, there were several sources for recoveries. Table 7 shows that the main source of funds came from selling the banks (privatizations) by which the authorities got the amount of USD 1.5 billion. Then we can see that recoveries of the loans to shareholders amounted to USD 981 million, while recoveries of the liquidity line amounted to USD 726 million. In a smaller proportion, USD 498 million came from loans to institutions, and some income was received in the form of dividends, mainly from the Banco Agrario.

Table 7: Recoveries

Concept	USD million	Share	% 2005 GDP
Privatizations	1,547	29%	0.9%
Loans to shareholders	981	19%	0.7%
Liquidity support	726	14%	0.7%
Dividends	584	11%	0.4%
Loans to banks	498	9%	0.4%
Residual capital after liquidation	417	8%	0.3%
Loan portfolio administration	325	6%	0.3%
Capital withdrawal	131	3%	0.1%
Other	46	1%	0.0%
Total	5,256	100%	3.77%

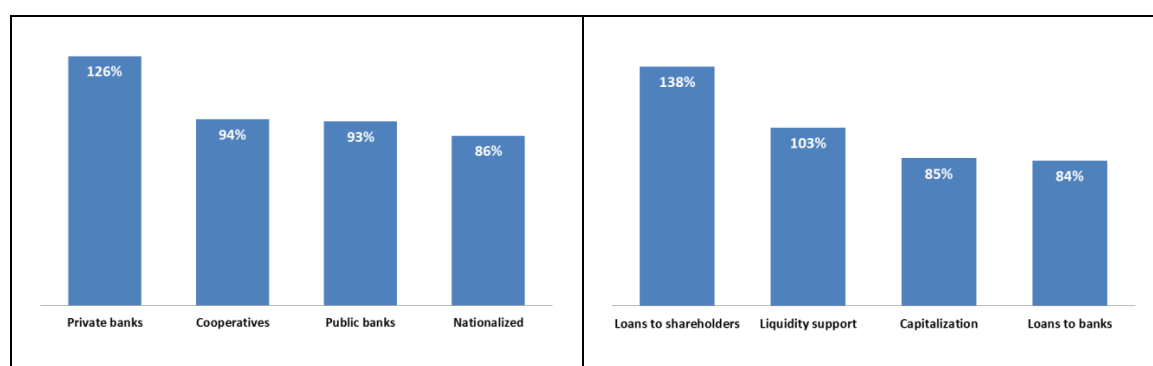
Source: Authors' elaboration based on information from Fogafin.

One approach to measure the efficiency of intervention in the crisis of the late 1990s is computing the resources recovered as a share of expenditures by each mechanism. We found that of the USD 744 million spent in the form of loans to private banks, 126% was recovered, that is, the entire capital

and interest's payments. In the case of cooperative sector, which received USD 619 million, only 94% was recovered, while in the case of the nationalized banks, the recovery rate was 93% (Figure 9).

A view of the recovery rate by the mechanism used shows that the highest rate is loans to shareholders, with 138%, which is correlated with the previous observation since it was the preferred mechanism used to solve private banks. The situation of liquidity supports has the same reading, with a recovery rate of 103%. In the case of capitalization, the recovery rate is 85%, which is explained by the fact that the main beneficiaries of this resolution mechanism were the cooperative and official sectors. To close this analysis, we see that the loans to banks have a recovery rate of 84%. All this shows that the public banks and nationalized banks were the costliest institutions to tax payers.

Figure 9: Recovery rate by sector and mechanism



Source: Authors' elaboration based on information from Fogafin.

There were other sources of income. When Fogafin pays the deposit insurance it takes the place of the depositors in the liquidation to recover its funds. And there are still some assets in the balance sheet of Fogafin that have been difficult to sell for different reasons. With all that in mind, we arrive to the total sum of USD 5.3 billion. Table 8 shows a summary of total recoveries.

Table 8: Total Recoveries

	USD million	% 2005 GDP
(1) RECOVERIES	5,256	3.8%
Capital withdrawal	131	0.1%
Liquidity support	726	0.7%
Loans to banks	498	0.4%
Loans to shareholders	981	0.7%
Loan portfolio administration	325	0.3%
Privatizations	1,547	0.9%
Dividends	584	0.4%
Residual capital after liquidation	417	0.3%
Other	46	0.0%
(2) DEPOSIT INSURANCE REFUND	42	0.0%
(3) OTHER	19	0.0%
TOTAL (1+2+3)	5,317	3.8%

Source: Authors' elaboration based on information from Fogafin.

So, the updated value of the net fiscal cost of the financial crisis is USD 3.6 billion or 3.6% of 2005 GDP (Table 9). This is a low net cost if we compare with the international numbers. Laeven and Valencia (2008) show that for 40 financial crises, cost raised up to 12.8% of GDP on average, with some countries reaching almost 50% of GDP.

Table 9: Net fiscal cost

	USD million	% 2005 GDP
Costs	8,902	7.4%
Recoveries	5,317	3.8%
NET COST	3,585	3.6%

Source: Authors' elaboration based on information from Fogafin.

IV. Sources to finance the crisis

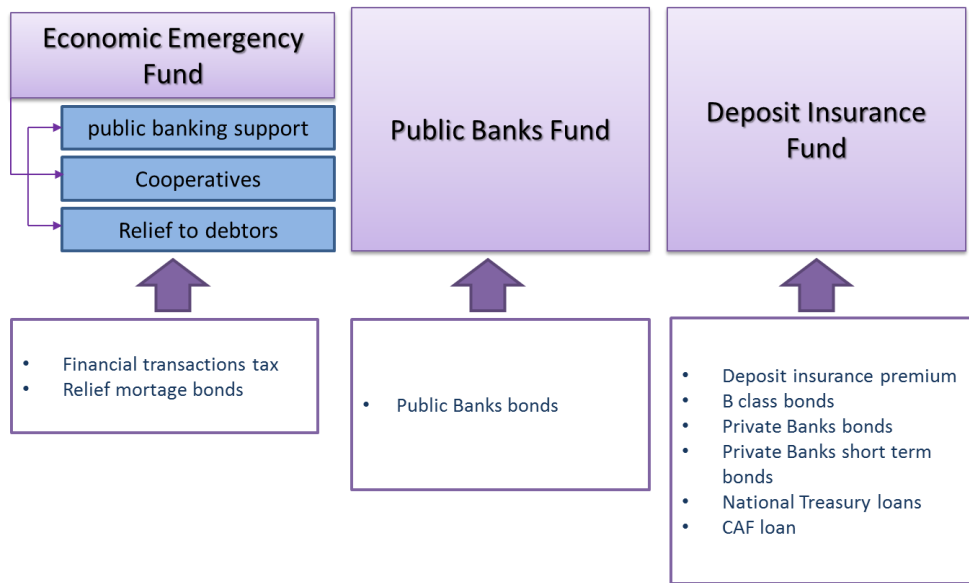
At the start of the crisis, mid 1998's, the only resources available were the ones in the Deposit Insurance Fund of Fogafin. With this in mind, it is remarkable that the authorities could find a way to finance a financial crisis of a magnitude never seen in Colombia. It was a real challenge. To find the needed resources, the Ministry of finance and Fogafin took the following decisions:

- The Deposit Insurance Fund, at then of 1997, had USD 473 million, 5.9% of the total needed resources. Funds come from premiums (0.3% of total insured deposits) that banks pay every three months to Fogafin. In the middle of the crisis, Fogafin decided to increase the premium rate to 0.6% in 2001, then reduced it to 0.5% from 2002 to 2006 and only in 2007 in was set back to its normal level of 0.3%.
- Fogafin issued bonds of different kinds depending of the uses of the funds:
 - Public Bank Bonds: issued to finance the intervention of public banks. Total service of those bonds was the responsibility of the National Government.
 - Class B Bonds: to finance Fogafin needs
 - Private Banks Bonds: to finance the line of credit to shareholders. Bank shareholders received the bonds and they could sell them in the secondary market. The service of those bonds was a responsibility of Fogafin.
 - Relief Mortgage Bonds: to finance mortgage borrowers for the increase in interest rates prior and during to the crisis.
- The 1998 decree 2331, issued under the legal declaration of economic emergency, created a new tax, the financial transactions tax, that was set at 0.02% of all financial transactions. The aim was to give support to mortgage borrowers, the financial cooperative sector and public banks.
- With the same decree, the government took over of inactive accounts. The money was used to finance Fosadec, (Fogacoop) and an unemployment insurance.
- The National Treasury and CAF (Corporación Andina de Fomento) lend money to Fogafin.

- The Central Government directed budgetary resources to pay for the liquidation of Caja Agraria and the pension liability of the Banco Cafetero.

To manage all those sources of funds, Fogafin set 3 different accounts, that were managed like a trust account. The idea was to have a clear accounting process that linked the source with the designated uses, in a manner that could be audited by the National Comptroller and everybody else (Figure 10).

Figure 10: Scheme of resource management



Source: Authors' elaboration.

V. Lessons and conclusions

The idea of this paper is to link what was done during the last significant financial crisis in Colombia with the standards that have been set by the FSB to deal with systemic crisis. The intention is not to have an assessment of the Key Attributes but to encourage a discussion that is needed in our country in that respect. Our deep believe is that strong resolution framework and institutions reduce the probability of occurrence of systemic crisis as the correct message to the bankers should reduce moral hazard and that if it happens the duration of the crisis should be shorter with lower economic consequences. Remember that intervention by authorities lasted almost four years during the last financial crisis of significant proportion in Colombia.

Resources

The Deposit Insurance Fund has the legal support to use its resources to repay secured depositors and to resolve member banks, in any of the ways discussed above. That is not a common feature of a deposit insurance fund. In many countries, the fund can only be used to repay depositors and

resolution funds have been financed by the government¹⁴ or the central banks since it deals mainly with systemic financial institutions. As it was said, at the start of the crisis in 1998, the balance of Fogafin Deposit Insurance Fund was USD 473 million, clearly a deficient amount of money to deal with a crisis of such proportions. When the crisis finished in 2002, the balance of the Fund was USD 586 million. The first lesson is that, during the worse moments for banks, the deposit insurance was not only collecting premiums to pay for current outlays but it was also stoking the Fund. The reason is that the Colombian law is written in a way that makes premium collection procyclical, as it only allows to increase premium rates when the Fund is depleted.

We can argue that the original idea of the Law was to have an ex-post funding of a crisis. Although there are pro and cons for an ex-ante vs ex-post financing, taking into account the Colombian experience and not forgetting that a middle-income country has restricted access to markets when in need, we believe that a well-funded resolution fund increases the possibility of using resolution tools in the most efficient way. For instance, as with the example of Bancafé, it took the authorities many years to have a final solution because the financial situation of the bank was so complicated that it needed a considerable amount of money that was not available in Fogafin, nor in the national budget. In addition, an ex-ante funding makes the whole industry to pay for the crisis, instead of the banks that survive it. In a perfect world, it should induce market discipline.

By October 2016, the Deposit Insurance Fund balance was 4.3% of insured deposits. Fogafin, sets the target for the Fund at a range between 5% and 6% of insured deposits. Since recoveries are important after the crisis, as it was shown above, there is no need to have full funding ex-ante. Fogafin could issue some debt if needed, to be repaid with the recoveries. In this sense, today's stock of the Fund would provide better conditions to deal with a systemic crisis.

However, even with this good balance, we would suggest that the law needs to be changed to migrate from a procyclical policy to a counter-cyclical one. The resolution authorities should be able to raise premiums not when the fund is depleted, but to prevent been caught without the needed resources at the moment the crisis starts.

Reimbursement

As we have mentioned earlier, the way Fogafin responded to secure depositors during the crisis was not appropriate for the circumstances, mainly because depositors were not reimbursed on time. Our hypothesis is that, if the reimbursement could start much earlier (as it can be done today when, at the most, 3 days after the liquidation of the bank), the authorities would have been able to close more banks and in this way the costs of the crisis would have been smaller. Of course, it is a hypothesis that cannot be tested but at least for small banks it could have been an option. For example, for Coltefinanciera and Multifinanciera, among others.

The importance of having a well design process for the reimbursement sends the right message. Secured depositors will not suffer the closure of a bank, but unsecured depositors, administrators and shareholders will face the consequences, as they should be accountable for the financial disaster.

¹⁴ After the financial crisis, the European Union set a Single Resolution Fund in 2014, to ensure the efficient application of resolution tools and the exercise of the resolution powers.

Public awareness

The public should have a clear understanding of how the deposit insurance fund works. The level of the coverage, the accounts that are covered by the insurance, and the institutions that are members of Fogafin should be clear for all account holders. Even today, in Colombia the level of knowledge of this is low, since less than 50%¹⁵ of account holders have heard of Fogafin, and for a complete understanding of the deposit insurance system this percentage is even lower. During the 1990's crisis, this kind of information was almost non-existent.

Bail-out

The gross fiscal cost of the financial crisis of late 1990's was 7.4% of 2005 GDP. In a moment where the fiscal balance was going through its own crisis, this amount of resources is significant and put the question on the convenience of rescuing all those banks. Out of the 42 banks that were under one of the resolution tools available, only 16 were allowed to fail and depositors received their deposit insurance. All others went to the process of open bank assistance with the use of tax payer's money and funds from Fogafin Deposit Insurance Fund. Some would argue that only in the case of 2 banks there was a clear bail out (Granahorrar and Interbanco) because all others were originally public banks. But even if public, banks should be allowed to fail and secure depositors paid their insurance.

The main objective of the Key Attributes is to minimize or even prevent bailing out. For that, it sets a set of principles that resolution authorities should have in hand to act when needed. For example, one of them is that the industry itself should cover the costs of the failure of one bank or of the whole system. That is the case now with the Deposit Insurance Fund of Fogafin, the Fund is at the same time the depositors' insurance and a resolution fund to banks.

In addition, the legal arrangement for failure should be clearly set and bank failures should be allowed in a market that operates under competition. In this respect, the Colombian legal framework for the authorities' intervention gives strong powers and the process is clearly defined. However, there is no obligation to evaluate the less costly option. And it seems that officialization is an option that the Law considers viable as a way to react in a systemic crisis. During the crisis, bailing out failing banks was the preferred option.

What we have today

In an informal way, at the end of the crisis, there were regular meetings of safety net institutions. In 2003, the law formalized those meetings and made them compulsory at least once every three months¹⁶. In those meetings the heads of SFC, the Banco de la República (the Central Bank of Colombia), Fogafin and the Ministry of Finance meet to discuss about the current situation of the financial sector and to discuss appropriate regulation in both areas, supervision and resolution. It is a forum for coordination since it does not have legal powers to act but it is an effective one to respond to difficult situations of different depth. Within a strong safety net framework, early detection and

¹⁵ According to a study contracted by Fogafin.

¹⁶ See Decree 1044 of 2003.

timely intervention would lead to reduce disruptions of vital economic functions. In this way, the market and the participants should be protected against losing confidence.

Other two important issues for a strong resolution framework are legal protection for the authorities taking decisions and independence of the SFC and Fogafin. None of them are easy questions in the Colombian legal and political environment. With respect to legal protection, there is a belief that it can be the same as immunity and for that reason, the congress has not allowed that authorities that oversee the financial system should have this kind of protection. With respect to independence the issue is a constitutional one. The Colombia Constitution gives the responsibility to the president to oversee the financial system. That implies that by definition, there is no possibility of independence. However, within this restriction, a decree was issued that commits the president to appoint the head of the SFC for a fixed term of four years that coincide with the presidential period.

Recently, the Congress voted for an expansion of the tools available for the resolution authorities as they can now use a bridge bank to solve banks of significant size, as it can be done in most countries. A bridge bank has a license to operate for a temporary period and its sole purpose is to bridge the gap between the failure of an existing bank and the time taken to find an appropriate buyer or another resolution option. During the crisis, this would have made the work of the authorities much easier. As Figure 4 shows, when there was a need to transfer good assets to another institution they only could do it if they found another bank that they consider it able to receive them or split capital from an institution that has excess of it (which was strange given the circumstances) or found a license that was not been used by a working bank.

In the same recent law, Congress makes it possible to use a P&A (purchase and acquisition) mechanism as an option to the reimbursement of secured deposits. This is a new idea in Colombia but a very important one in other countries like the US, as for the FIDC¹⁷ it is the preferred option. The idea is to reduce to the minimum the disruption to account holders as over a weekend insured accounts from the failing bank move to another sound bank. This can even be the least costly option to the deposit insurance fund.

A good resolution framework should be able to allow intervention in an effective way in any financial institution of any size. And resolution tools should not be limited to reimburse depositors. Legal powers should allow authorities to act within a strong institutional framework where the scope should be as broad as needed to react in coordination in the most efficient way. As the crisis of late 1990's has shown, all this is in Colombia although the lack of resources and of some tools made the execution of the plans more difficult.

What we don't have

The most recent discussion about effective resolution frameworks talk about some issues that are far from the Colombian discussion. Two of them are leaving wills and cross border issues. Colombia is not home of a global systemic financial institution but it is host of at least 1 of them (Citibank). That

¹⁷ FDIC: Federal Deposit Insurance Corporation of the United States.

could suggest that there is no need of leaving wills since they were thought first for GSIFIS¹⁸. However, rightly, the idea has moved to local systemic financial institutions. In that sense, we could argue that today more than one Colombian bank fall into this category and in that sense the authorities could address the need for those banks to build resolution plans as it has been going on for GSIFIS. The idea of a bank's leaving will is to have a plan to resolve the bank in an orderly manner and without the need to use tax payer's money.

Finally, Colombian banks have been expanding to other countries in the Latin-American region. This expansion should be accompanied by some kind of arrangements between supervisors and resolution authorities of each country by which they can share information and coordinate actions. We know that some form of them exists only between supervisors.

To conclude

Colombia has not faced a financial crisis of systemic importance for almost 20 years. When the last one started there were 108 banks in the Colombian financial system, 26 of them received open bank assistance and 16 of them would be closed. That means that more than 38% were in trouble during the four years that the crisis lasted. Today there are only 45 banks, which means that the system is much more concentrated. In dealing with any trouble that may surge ahead, the Colombian authorities have in hand a broad range of tools that could be used to resolve the situation even if it is of big proportions and the 1990s experience shows a good management of them. Although more legal tools were added recently, there are still some areas to strengthen as living wills or cross border cooperation. If we get there as a country, and with the right amount of ex-ante funding, we could argue that Colombia would manage a crisis in an effective and efficient way.

¹⁸ A global systemically important financial institution (GSIFI) is a bank, insurance company, or other financial institution whose failure might trigger a financial crisis. The FSB first publish a list of institutions that fall into this category in 2011. It updates it regularly.

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Appendix A. Legal powers to intervene

Legal resolution powers to the government are defined in a statutory law (Estatuto Orgánico del Sistema Financiero – EOSF), in Decree 2555/2010 and in resolutions issued by Fogafín. A recent IMF¹⁹ evaluation concluded that the Colombian authorities have a well-defined and effective set of powers and tools to address failing and failed banks. Moreover, the IMF concluded that the government can show a good record of using them. Although Colombia has not seen systemic problems in recent years, it has a good record managing small failing institutions with effectiveness, in compliance with regulations that give legal support to the job done by authorities, in particular, Fogafín and the SFC. Never, in those cases, was tax payer's money been used.

The EOSF has several chapters that are related with the issues of this paper. Article 113 sets the circumstances under which the SFC could avoid taking over the financial institution and reacts under timely intervention. When the SFC considers it necessary, it can decide to put the financial institution in trouble under special surveillance, ask for injection of capital by shareholders, put the financial institution under a trust account for administration, design and execute an adjustment program, command a partial or full transfer of assets and liabilities or a phasing out the financial business. Fogafín participates when the SFC mandates a merger with another financial institution and when a transfer of assets and liabilities takes place. In this last case, Fogafín can issue subordinated debt to balance a trust account where assets and liabilities are transferred.

If these preventive measures do not work, article 114 determines the circumstances under which the SFC takes control of the financial institution in trouble. The main goal of taking over is to establish if the failed institution should enter liquidation or if it is possible to go through an adjustment process that will put it under the conditions needed to do business again, or to design the best way for insured depositors and others to get their money back. It is expected that a resolution decision could be taken in at most 4 months. In this case, Fogafín can participate by injecting capital (less than 50% of it), by providing loans to the institution, by buying assets, or by providing guaranteed capital and liquidity through lines of credit.

Then articles 116 and 117 set the parameters for the liquidation. In this case, Fogafín reimburses insured depositors (they are all depositors in one of the 10 insured accounts²⁰). The amount insured is today COP 50 million (around USD 16,500).

The final option arises when the failed institution would risk the payments system and in this way the economic stability of the country. Article 320 gives power to the official takeover of the failed bank through an injection of capital from Fogafín or the national government in an amount larger than 50% of the paying capital. The decision should be taken after the shareholders fail to capitalize the bank.

¹⁹ International Monetary Fund (2016).

²⁰ The most common accounts are current accounts, savings accounts and time deposits.

