Financial Restructuring in Chile

In the early 1980s, Chile's financial system was nearly bankrupt and the country was suffering from its worst economic crisis since the 1930s. Ten years later, Chile had not only recovered economically, but had emerged as one of the most sought after capitals for investment. A major force behind Chile's turnaround was the government's handling of policy and institutional reforms. The government moved immediately to halt the banking crisis and then followed through by implementing a comprehensive set of reforms. In this it was aided by high levels of Bank lending. Four Bank operations carried out during this period helped achieve this success story.

Recent OED audits* of the four operations underscore the difficulty of designing and implementing projects in times of crisis and uncertainty, when there is often little experience to guide project designers. In Chile, the first two projects, identified at the height of the crisis, suffered from overly complex designs. But with each operation, performance improved as lessons of earlier projects were used to improve the design and implementation of those that followed.

Background

In 1982, Chile suffered its worst recession since the Great Depression. Its gross domestic product (GDP) dropped 14 percent, the value of its currency plunged, and a large external debt threatened its creditworthiness. The external debt problem was compounded by insolvency in the banking system caused largely by widespread defaults of industrial enterprises. The government responded swiftly to the banking crisis by intervening to guarantee deposits and by providing emergency liquidity assistance to most private banks in the country. But foreign exchange was still in short supply.

At the same time, the government sought Bank assistance to address Chile's economic crisis. It was at this time of great uncertainty that the Bank appraised the Industrial Finance Restructuring Project (IFRP) and the Small and Medium Industry Project (SMIP), both approved in 1985. Parallel dialogue with the government led to the formulation of three successive structural adjustment loans (SALs), which helped create a positive economic environment for the two related operations that were approved in 1989: the Industrial Finance Project (IFP) and the Financial Markets Loan (FML).

Project goals

The four Bank projects—three industrial finance operations and a financial sector adjustment loan—had broadly similar goals: (1) helping the government cope with a deepening recession that threatened to undermine the financial sector, (2) addressing a persistent market failure in medium- and long-term financing, and (3) providing support for structural adjustment in the financial sector.

- The main goal of the $100 million IFRP was to help in the financial restructuring of industrial enterprises and to provide financing for fixed investments and permanent working capital. A small technical assistance component helped set up a technical unit in the central bank to manage corporate restructuring and financing of eligible firms.
- The $40 million SMIP was designed to help reduce Chile's then high unemployment through assistance to small and mid-size enterprises (SMEs).
- The goal of the $75 million IFP was to provide medium- and long-term financing for industrial enter-

*Performance audit reports:
Growth of leasing companies

Leasing companies have existed in Chile since the 1970s but were severely undermined by the 1982-83 crisis. A change in banking law in 1986 allowed banks to establish leasing subsidiaries. This law, coupled with improvements in the economy, led to the rapid expansion of the leasing sector. Leasing grew in popularity because of its considerable advantages vis-à-vis bank lending: ownership of goods was retained by the leasing company, contracts were simple, collateral requirements were less onerous, and there were tax advantages because of accelerated depreciation of leased assets.

To finance acquisition of machinery and equipment, a leasing company has to issue medium-term commercial paper, bonds, and other financial obligations. But Chilean leasing companies faced considerable constraints in obtaining term financing. The FML supported reforms to allow greater flexibility in bank lending to leasing companies and to increase the ability of leasing companies to issue bonds in the local market.

As a result of the reforms, the number of leasing companies doubled from 13 in 1989 to 28 in 1993, of which 19 are bank subsidiaries. The value of outstanding contracts is estimated to have grown more than sixfold, from $180 million in 1989 to $1.3 billion in June 1994. In 1993, leasing activity amounted to about 15 percent of gross domestic investment, up from 5 percent in 1988. Transport, industrial, and office equipment make up about 50 percent of leased goods.

The $100 million FML sought to help the government introduce alternative medium-term financing schemes and to strengthen the securities markets. The project contained a quick-disbursing policy-based component aimed at deepening financial markets, a component to provide medium-term funds to the leasing sector, and technical assistance for related studies.

Design and implementation

The IFRP was identified in 1983, when Chile was still in the midst of the recession and the industrial sector was thought to be on the brink of bankruptcy. The project was thus designed to combine a financial restructuring operation with financing of investment in plant and equipment. In effect, the design was based on the assumption that financially weak industrial enterprises would be able to undergo restructuring while receiving new loans to expand their plants. From the start, this unusual design hindered the implementation of the project.

It took almost two years to proceed from loan identification to loan approval. By the beginning of 1985 signs of economic recovery were already evident, but the project was not redesigned to reflect the improved environment. It was not until May 1987 that, at the request of the borrower, IFRP was modified to allow financing of standard industrial projects without requiring them to go through financial restructuring. Before this modification, there were few requests for loans through the IFRP, but following the amendment, the loan was quickly committed and disbursed.

Like that of the IFRP, the design of the SMIP was overly complex. Moreover, it relied too heavily on the government development bank, Corporación de Fomento de la Producción (CORFO), to channel subloans to beneficiaries. But the project correctly assessed market failure as the main obstacle to SMEs' access to capital markets. And its assistance in filling the gap in medium- and long-term lending contributed to the development of a vibrant SME sector.

Although the design of the first two projects had flaws, the lessons derived from them added significantly to the improved design of the two subsequent projects, the IFP and FML. Also, Chile's economy, which had shown some signs of recovery since 1985, became particularly vibrant in 1987, with GDP growing at more than 7 percent a year. These two factors—greater experience and the renewed economic activity—formed the basis for the highly successful outcome of the two later projects.

Outcomes

Impact on firms

The four projects supplied critical financing to Chile's industrial firms, helping to trigger the rebound in economic activity. Both the IFRP and the SMIP provided long-term financing of viable investment projects at a time when no other significant sources of financing existed. During the period 1988-90, total revenues of industrial firms receiving financing under the IFRP grew by 50 percent a year in real terms. Return on equity was also positive, although it declined during the period, largely because of the drop in demand for exports caused by the slowdown in the world economy. The SMIP reached a wide spectrum of SMEs in need of financing. It benefited 598 mi-
croenterprises and about 1,090 SMEs. And estimates by subloan beneficiaries suggest that their investments were generally quite profitable.

The two follow-up operations (IFP and FML) benefited industrial enterprises in much the same way, although they were aided by the improved economic environment. By making dollar-based financing available, the IFP helped sustain the investment momentum in the private sector, and the companies it helped were generally profitable. Moreover, some firms that had mainly concentrated on the domestic market began looking at opportunities in other markets, such as the Southern Cone Common Market (MERCOSUR) and Peru. FML contributed to the fast growth in investment in leasing, which grew from 5 percent of gross investment in 1988 to 15 percent in 1993. (See box.)

Impact on the financial sector

Strengthening the financial sector and deepening its capabilities were tangible outcomes of the four Bank operations, but not to the degree that was originally expected. The IFRP helped commercial banks recover from the 1982-83 crisis. But the loans benefited the weaker banks most. To them, it provided an indirect subsidy, since the banks did not have to pay the risk-adjusted cost of borrowing directly in the financial market.

Participation of commercial banks in the SMIP was very low. Only 28 loans to SMEs were channeled through commercial banks. Although the reasons point mostly to problems with the banks themselves, poor promotion of the program and excessive processing demands by the implementing agency also hindered their involvement. CORFO was ill prepared to handle the loan's implementation. The bank was barely profitable at the time, and its poor track record in loan collections undermined the quality of the loan portfolio.

IFP's experience with the banking system was similar to that of the IFRP. Overall, participation by commercial banks was lower than expected; 14 banks used the funds, only slightly more than the 11 that participated through the IFRP. FML's impact on the banking sector was small, which was to be expected given that its focus was on the development of capital markets.

Impact of FML on capital markets

By reinforcing the markets' institutional infrastructure, the FML encouraged strong growth and development in three major areas of the capital markets: (1) pension funds, (2) life insurance companies, and (3) the securities exchange. The growth of the domestic equity market, which was supported by FML, has also been impressive (see figure). The project's success owes much to the growing experience and good management capabilities of the participating institutions.

Pension funds. Propelled by Chile's compulsory saving scheme, pension fund assets almost tripled in real terms during 1989-94. About 42 percent of the increase was in equities. This development was in part the result of the new regulations (supported by FML) that gave pension funds greater flexibility in making their investment policies.

Life insurance companies. Life insurance company assets also grew by more than expected. And with the support of the FML, the assets have been greatly diversified, with an increasing share going into corporate equities.

Securities markets. The introduction of computerized trading has reduced trading commissions, and the newly established central securities depository is expected to become fully operational in 1995. In recent years the number of stocks issued has increased considerably, but the number of locally issued corporate bonds has stagnated. The slower bond market is partly due to Chilean companies' increasing ability to tap directly into international capital markets, such as the market for Euronotes and bonds.

Impact on market failures

Until the late 1980s, Chilean banks were reluctant to provide medium- and long-term financing to industry. First, small firms were usually undercapitalized, lacked
experience, and had very few assets to use as collateral. And second, bank lending in Chile was typically short term, mostly unsecured, and available only to the top tier of corporate clients. Partly because of the volatile macroeconomic environment, banks had difficulty obtaining long-term deposits or lines of credit. Lack of adequate loan collateral—itself the result of a weak institutional and legal infrastructure—was another major obstacle to medium- and long-term financing.

A common thread in the design of the four Bank operations was the need to respond to this market failure. The IFRP, SMIP, and IFP alleviated market failures in terms of commercial bank lending, but they did not adequately address the underlying causes of the problem. That was partly done by Chile's return to a stable macroeconomic environment, which improved the ability of financial intermediaries to tap longer-term funds. At the same time, the FML's support of financial sector reforms contributed to a moderate improvement in the access of large- and some medium-size industrial enterprises to medium- and long-term financing.

Because of structural weaknesses in the banking system, some problems persist. For example, a number of banks received large loans from the central bank to restore their solvency. Until the loans are repaid, the banks are likely to have difficulty obtaining medium- and long-term funds in either the domestic or international capital markets. This factor also puts these banks at a competitive disadvantage with respect to nonbank financial intermediaries or new commercial banks.

Lessons

- Loan appraisals should be updated when conditions change. In the case of the IFRP, the Bank should have reappraised the project on realizing that preparation would take longer than 18 months and that country conditions were changing. The reappraisal would have allowed the Bank to question, or update, some of the assumptions made when the loan was originally proposed.

- Improper instrument selection can lead to delays and underutilization of resources. In the case of the IFRP (the first project) a quick-disbursing, policy-based loan such as a SAL may have been more appropriate in view of the country's pressing need for foreign exchange. The SAL could have been followed by an industrial finance project once the crisis had subsided.

- The success of financial sector reforms and operations depends critically on initial conditions. The success of the FML can be traced to the following: (1) sound macroeconomic, financial, and industrial policy framework; (2) full government commitment to project objectives; (3) implementation by competent officials; and (4) a sound base of prior sectoral and institutional knowledge in areas covered by the projects.

- Temporary use of directed credit is justified while market failures are being corrected by financial sector liberalization. But, at the same time, it is important to find viable creative solutions to market failures. For example, the design of a risk capital fund in the SMIP to help SMEs obtain equity was unrealistic. The absence of a track record for venture capital in Chile at a time when financial intermediaries were emphasizing risk-averse lending doomed the fund from the start.

- Availability of reliable, timely information is important for adequate supervision. In the case of project loans, the Bank should require regular reports on foreign exchange gains and losses (both accrued and realized) and on arrears by final borrowers (in this case industrial enterprises); better financial information on participating financial intermediaries, backed by adequate analysis; and data on the economic and financial results of projects.