PN-ABN-789 81777

Case Study

BANCO DE SANTIAGO and POPULAR CAPITALISM

Final Report

Price Waterhouse

August 3, 1992

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Ms. Rebecca Maestri
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Dear Ms. Maestri:

Attached please find five copies of the Final Report Banco de Santiago and Popular Capitalism prepared by Price Waterhouse, prime contractor under FSDP.

It has been a pleasure working with USAID on this important assignment. We look forward to further collaboration with the Chilean Mission.

Sincerely,

J. Richard Breen
Project Director. FSDP

Enclosures

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I. Introduction

In 1973 Chile launched an economic liberalization and privatization program encompassing the rapid deregulation of the country's financial sector. The liberalization and privatization effort contributed to a six-year economic boom for Chile. However, in 1981, macroeconomic disequilibrium and external shocks drove Chile into its worst economic crisis in 50 years. Domestic real interest rates increased from 15.7% in 1980 to 42.4% in 1981. Capital flight accelerated so that between October 1981 and December 1982, the Central Bank lost US $1,445 millions in reserves. The government was unable to maintain its fixed exchange rate policy, by the end of 1982 the Peso had suffered an 88% devaluation. By the end of 1982, real GNP declined 14% and annual inflation reached 20%.

The economic crisis profoundly affected the financial sector. Between 1981 and 1983 the Superintendency of Banks took over the management of 22 insolvent institutions, representing about 60% of total funds in the financial markets. By December 1984, the Superintendency estimated that the banking sector was expecting losses for which no provisions had been made equal to 200% of capital plus reserves, or about 18% of the Chilean GDP for the year.

The economic crisis left Banco de Santiago, Chile's second largest private commercial bank, in bankruptcy by accumulating losses equal to 2.3 times its equity. In an effort to save the institution, the government included Banco de Santiago in all its financial sector restructuring programs. The restructuring of Banco de Santiago culminated with its participation in Popular Capitalism, a recapitalization and reprivatization mechanism set up by the Government of Chile.

A researcher under the USAID-sponsored Financial Sector Development Project conducted this case study to bring together all the facts relating to the offer and the role of Chile's Popular Capitalism Program. The case explores the issues at the time, how they were resolved, and the impact of these actions, in light of some five years experience. In addition, the case explores the access to these loans made by qualifying citizens, their experience with them, default rates, profitability of the shares to the investor, redemption rates and other essential information for replicating this method in other countries.

II. Background

In 1970 Salvador Allende was elected President of Chile. As the first marxist government in Chile, the Allende regime sought to change the economic structure of Chile and rapidly redistribute income. Between 1970 and 1973 Allende nationalized 14

1965 to 39% in 1973. Chile's economy failed to absorb the radical transformation attempted by Allende's government. By 1973 annual inflation reached 1,000%, black market exchange rates for the Peso were 1,000% higher than official rates, and the fiscal deficit grew close to 25% of GDP.

As economic conditions deteriorated, the military decided to intervene. On September 11, 1973, General Augusto Pinochet took over the government. Pinochet established the first non-democratic government in Chile in over 70 years. The military instituted a right-wing government that lasted until early 1990 in which Pinochet and the Armed Forces centralized political power.

Starting in 1973, Pinochet's civilian technocrats set up an economic program based on liberalization and deregulation. The new policy attempted to reverse the policies of the Allende regime by opening the economy to foreign competition and increasing the role of the market in resource allocation. Import duties were reduced and simplified. For example, in 1979 the government introduced a uniform 10% nominal tariff. The government eliminated price controls including controls on commodity prices, a major component of Chile's domestic product. Pinochet's government also eliminated all quantitative restrictions on external capital flows by 1980.

Pinochet's economic policies led to a period of rapid economic expansion. Between 1976 and 1981 real GDP grew at an average rate of 7.2% a year. The Chilean Government had trouble controlling the rate of inflation. In an attempt to bring domestic inflation down to international levels, in June 1979, the Chilean Government established a fixed exchange rate regime. The government fixed the peso at 39 pesos to the dollar. Both domestic inflation and interest rates lagged in adjusting to international levels. High domestic real interest rates combined with access to international markets increased the attractiveness of foreign borrowing. Between the end of 1979 and the end of 1981, Chile's private external debt grew from US $4,693 million to US $8,726 million.

The overvalued Peso decreased the competitiveness of Chilean exports. Economic conditions further deteriorated as copper prices plummeted in the world market (Chile's main export), international interest rates increased and the Latin America debt crisis erupted. Chile's current account deficit grew from 6% of GDP in 1979 to 18.9% by 1981. In 1982, the government devaluated the peso, unemployment reached a record level of 20% and GDP fell by 14%. (See Exhibit 1 for Chile's Economic Indicators)

III. Privatization Policy

A major component of Pinochet's economic program featured privatization of state-owned enterprises. The goal was to return to the private sector companies that had been brought under state control during the Allende government. Between 1974 and 1980

Chile privatized more than 500 companies. During this first phase, the government used privatization to reduce deficits, reduce the size of the public sector and improve its efficiency. Raising revenues to finance the government's deficit, through the proceeds of privatizations, became a primary objective.

In pursuit of its strategy the government overlooked the issue of ownership concentration. The government established flexible requirements for investors. Payments were accepted in installments (5 to 7 annual installments after cash payment of 10 to 20%). No limits were set on the proportion of equity an economic agent could buy. During this phase, the most common privatization techniques were returning enterprises to their previous owners, bidding auction and direct sale of assets.

The second phase of privatization started in 1985 after the economic crisis. In this round, broad ownership distribution became the government's primary goal. The government reasoned that ownership dispersion would develop capital markets through the availability of new investment instruments and the participation of more economic agents. The government's objectives also included reduction of foreign debt through debt equity swaps, generation of widespread support for privatization, and increasing the efficiency of state enterprises.

During the second phase, the government expanded its privatization techniques in order to address its new objectives. The new privatization methods included

- labor capitalism,
- institutional capitalism
- popular capitalism and
- bidding at auction.

Under *labor capitalism* the government offered workers strong incentives to buy market-priced shares of their own companies. This mechanism was suitable in companies where a private minority already owned and traded shares in the stock market. *Institutional capitalism* involved the sale of packages of shares, usually of public utilities, to private pension funds. *Popular capitalism* consisted of selling shares at fixed prices which were highly favorable to the public and emphasized individuals rather than institutions. Banco de Santiago as well as other financial institutions and pension fund management organizations were privatized through this method.

IV. The Banking Sector

A. Reforms under Pinochet

In 1974, twenty-one commercial banks and fifteen savings and loans institutions comprised Chile's financial sector. Fifteen of the commercial banks were state-owned (Fourteen were nationalized under Allende). Commercial banks controlled 88.2% of financial assets. The twenty-one savings and loan institutions controlled the remaining 19.7% of financial assets.

Pinochet's privatization and financial deregulation programs transformed the structure of the financial sector. By 1981, 45 commercial banks operated in Chile, only one remaining state-owned and 18 foreign-owned. Private commercial banks (local and foreign) controlled 72.7% of financial assets. The state commercial bank controlled 17.8%, savings and loan financial assets fell to 7.4 and the rest were held by financing companies.

Pinochet's policies included the deregulation of the financial sector. The government eliminated controls on interest rate ceilings, reduced restrictions on allocation of credit, and gradually lowered banking reserve requirements to 10% for demand deposits and 4% for time deposits. The Central Bank began to control the money supple through open market operations. The government allowed banks direct access to foreign credit. By 1979 all legal limits on foreign borrowing by financial institutions were eliminated. The only limit was the requirement of a maximum debt to capital ratio of 20:1.

New access to international funds and rapid economic growth lead to a period of intense financial deepening. Between December 1977 and December 1980 financial assets grew at an average annual rate of 40%, five times faster than the growth in domestic product. Financial assets grew from 14.9% of GNP in 1973 to 39% in 1981. Bank assets grew from UF 413,213,000 to UF 713,322,000.[1] From 1978 to 1980, net income for all commercial banks grew from UF 3,538,000 to UF 7,993,000, an increase of 126%. (See Exhibit 2 for financial ratios of commercial banks and Banco de Santiago.)

The deregulation of the financial markets, in conjunction with the government's privatization drive, contributed to the creation of financial/industrial conglomerates. The conglomerates used credits to finance the acquisition of companies being privatized. A loose bank regulatory environment permitted conglomerates to use the shares of newly acquired companies as guarantees for more loans to buy more companies, developing a web of related and highly leveraged companies.

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[1] Unidad de Fomento (an indexed monetary unit)

B. Regulation

The Banking Superintendency, under the Ministry of Finance, was responsible for regulating Chile's financial sector. The Banking Superintendency had no clear rules regarding the concentration of loans to companies owned by the same owners of the lending institutions. Most of the regulations centered on individual credit limits, minimal capital requirements and maximum limits on debt-capital ratios. Provisions for non-performing loans were regulated on broad categories and not on a loan by loan basis. No regulation existed that allowed the Superintendency to perform a preventive evaluation of a bank's loan portfolio.

Even though no legal framework existed, the Chilean public perceived an implicit commitment by the Central Government to guarantee their deposits in financial institutions. The government reinforced this perception by bailing out two financial institutions that failed during the 1970s.

V. Banco de Santiago

A. History

Grupo Forestal, under the control of Manuel Cruzat, pursued an aggressive expansionist strategy, taking advantage of the government's economic liberalization and privatization policies. On October 31, 1977 Grupo Forestal founded Banco de Santiago. Grupo Forestal distributed the bank's shares amongst its different companies. Grupo Forestal viewed Banco de Santiago as an important link in its aggressive expansion drive. The bank contributed to Grupo Forestal by channelling resources to finance investments and acquisitions of companies being privatized. Simultaneously, Banco de Santiago benefitted by providing financial services to all those companies.

During the period of 1977 to 1982 Banco de Santiago's market strategy focused on corporate clients. Only later did the bank begin to expand into consumer banking. The Bank's management placed a strong emphasis on keeping the bank at the technological leading edge of Chile and differentiated the institution as the "modern bank" of the system.

Banco de Santiago grew at a phenomenal rate in its first four years of operations. Between 1979 and 1982 deposits (current account and time deposits) grew from UF 13,170,000 to UF 25,709,000. Net income grew from UF 41,000 in 1978 to UF 352,000 by 1980. The net income to equity ratio grew from 4.8% to 13.7% for the same period. Banco de Santiago became the second largest private commercial bank in Chile. In 1978, Banco de Santiago controlled 3.6% of all financial assets. By 1981 the proportion had grown to more than 10%. (See Exhibit 3 for Banco de Santiago's financial statements for 1979-1990.)

Since the Banking Superintendency did not regulate loan concentration Grupo Forestal channeled resources from the bank to other related companies. By 1983 more than 40% of Banco de Santiago's loan portfolio consisted of loans to companies owned by Grupo Forestal, whose shares served as collateral for the loans.

B. Organization

As a commercial bank incorporated in Chile, Banco de Santiago's main body is the Board of Directors elected by the stockholders and headed by the President of the bank. The Board of Directors elects a General Manager who in turn appoints the managers of the different divisions. In theory, the General Manager is responsible to the Board of Directors. In reality, however, the Board of Directors in Banco de Santiago played more of a symbolic role. Real authority was held by the Holding Company of Grupo Forestal. The General Manager of Banco de Santiago reported directly to the financial manager at the Holding Company.

C. Personnel Policies

Both Grupo Forestal and Banco de Santiago were known to attract the best talent in the country. This was accomplished by offering generous compensation policies. Salaries at the Banco de Samtiago were at the top range of the banking industry. However, despite excellent compensation policies, Banco de Santiago lagged the industry in worker benefits. There was no collective health or life insurance plans or other benefits considered standard at big institutions in Chile.

As the economic crisis neared and profits began to slip, employee relations started to deteriorate at Banco de Santiago. In 1980 personnel of the Grupo Forestal Holding started a review of all operations at Banco de Santiago. In an effort to reduce costs and adjust to the deteriorating economic environment, the bank reduced annual compensation by 20%. Workers reluctantly accepted the new policy as fears of unemployment increased.

D. Banco de Santiago in Crisis

By 1981 the slowdown in the Chilean economy began to affect the Banco de Santiago. Net income in 1981 fell 35% to UF 229,000. In 1982 all of Banco de Santiago's net income was used to buy back non-performing loans from the Central Bank. On January 13, 1983 the Central Bank intervened Banco de Santiago and 4 other financial institutions including Banco de Santiago. The Minister of Finance, Rolf Luders, named Julio Barriga as Interventor to Banco de Santiago. Barriga worked as General Manager

of Banco del Estado, a state-owned bank. The government perceived him as knowledgeable of banking operations and capable of handling the delicate assignment of dealing with Grupo Forestal, the owners and major debtors of Banco de Santiago. As soon as the Superintendency intervened Banco de Santiago, Grupo Forestal stopped payment on all its outstanding loans, further deteriorating Banco de Santiago's financial situation.

According to Chile's Banking Law, the Interventor assumed all the responsibilities of the Board of Directors and the General Manager of the intervened institution. Grupo Forestal immediately lost all control over decisions at Banco de Santiago. Barriga's job as Interventor consisted of several assignments. First, he would evaluate the bank's loan portfolio to determine the real damage to the institution. Second, he would negotiate with the bank debtors to recuperate the maximum amount of funds from outstanding loans. Third, he would determine the capital needs of the bank to continue in operation. All of these objectives had to be met while simultaneously administrating the day to day affairs of the bank and reestablishing the confidence of its customers.

In order to minimize the damage of the financial crisis and begin to restore confidence in the system, the government took two measures almost simultaneously to the intervention. First, foreign loans held by all financial institutions were guaranteed by the Central Bank. Secondly, the Central Bank provided emergency loans to financial institutions in order to honor deposits.

VI. Restructuring of the Banking System

The Government of Chile followed a four-part strategy in restructuring its financial sector. First, non-performing loans held in portfolios of insolvent banks were sold to the Central Bank. Second, the Central Bank established mechanisms for restructuring outstanding loans, providing longer payment periods and lower interest rates. Third, the government set up a program for recapitalizing failed institutions. Finally, new banking regulations were established to set up a "shared risk" program in which depositors, the government and the financial institutions would share the burden and responsibility of supervising the riskiness of banks.

A. Sell off Non-Performing Loans

Starting in 1982, the Central Bank began buying non-performing loans from commercial banks in exchange for a non-interest earning draft note. This procedure allowed banks to clean their balance sheets and reduce their provisions for non-performing loans. In April 1985, the economic situation deteriorated and the major banks were intervened. In April 1985 the Central Bank modified the mechanism by paying for non-performing loans with cash and draft notes. The procedure followed the following rules:

a) Bank could sell risky loans to the Central Bank for an amount of 2.5 times their the total capital. (Later changed to 3.5 times).

b) The Central Bank paid 60% of those loans in cash and 40% with a draft note. The portion paid in cash was charged a 5% annual interest rate. Interest changes were capitalized annually.

c) The 60% cash payment must be used to pay Central Bank emergency loans and to buy a promissory note from the Central Bank due in four years and earning a 7% real interest rate.

d) The Draft Note is non-interest-bearing and is amortized when the bank buys back its loans. The draft is claimable by the Central Bank in case of default.

e) Those banks that increased their capital base through December 31, 1986 under the Popular Capitalism Law (Banco de Santiago participated in this process) were authorized to sell their non performing loans up to 3.5% their capital base.

f) The banks selling loans would continue to be agents for the Central Bank in the collection of the sold loans.

g) All transactions were denominated in Unidades de Fomento.

Banco de Santiago sold a total of UF 11,741,666.77 under the mechanism set up in 1982, receiving a non-interest earning draft from the Central Bank. The only benefit for the Banco de Santiago was that it reduced its loan loss provisions.

Starting on April 30, 1985 the new mechanism went into effect under this mechanism the Central Bank would start paying 60% in cash for non-performing loans. The UF 11,741,666.77 outstanding from the previous mechanism became part of the new program. Furthermore, Banco de Santiago sold a total of UF 27,310,464.77. In return, the Central Bank paid UF 23,445,631 in cash and UF 15,606,500.54 in a non-interest earning draft note. Banco de Santiago, as stipulated in the rules set up by the Central Bank, immediately used the cash to repay the emergency loans provided by the Central Bank for UF 14,464,228.59and used the remaining, UF 8,981,402.41,to buy a promissory note from the Central Bank.

The equity structure of Banco de Santiago was too small to allow the institution to get rid of all non-performing loans under the conditions established by the Central Bank. In May 1986, Banco de Santiago participated in a capitalization program, Popular Capitalism (discussed further in the next section), that allowed it to sell loans for up to 3.5 times its capital. The Central Bank authorized Banco de Santiago to sell non-

performing loans prior to the completion of the capitalization program. It sold UF 11,816,805.50 of which the Central Bank paid UF 7,090.472.56 in cash by and the remainder in a promissory note.

Banco de Santiago, through the Popular Capitalism program sold a portion of its shares at a higher than anticipated price. This allowed Banco de Santiago to sell more non-performing loans. This last sale was for UF 1,752,218.15. UF 1,053,360 was paid in cash and invested in a promissory note from the Central Bank.

Banco de Santiago continued to operate as agent for the Central Bank for the collection of the sold non-performing loans. However, since the "real" owner of the loans was now the Central Bank, any agreement reached with the creditors would have to be approved by the Central Bank.

B. Loan Rescheduling

The Central Bank set up five different loan rescheduling mechanisms, providing creditors with better terms by reducing real interest rates and extending payment terms. Approximately 26% of outstanding loans in the financial system were restructured through one or more of these mechanisms.

a) A preferential exchange rate was established to buffer the effects of the devaluations on those loans denominated in foreign currencies. The Central Bank covered the difference between the preferential rate and the new rate.

b) In 1983 the Central Bank gave instructions to financial institutions to reschedule loans to "productive" borrowers. Productive borrowers were those with loans other than consumer loans, mortgage loans or loans to related companies. This constituted an effort to help the small and medium size industries. Maturities were extended to ten years with a year of grace and a 7% real interest cap. In 1984 the terms of the 1983 rescheduling were further eased. Real interest ceilings were reduced to 5% for the first 2 years, 6% for the nest three years and 7% for the remaining years.

c) Mortgage and consumers loans were also restructured in 1983. Real interest rates were lowered to 6% or 4% depending on the size of the loans.

d) Small and medium size borrowers were allowed to exchange their dollar-denominated debts with a new loan denominated in Pesos.

The Central Bank absorbed all the financial costs of these mechanisms and paid an 8% real interest to attract new funds.

C. Recapitalization through Popular Capitalism

The government designed Popular Capitalism specifically to address the recapitalization and privatization of weak financial institutions. However, subsequently the government set up Popular Capitalism programs in other industries. The mechanism consisted of selling new shares of the intervened institutions to the general public under generous financial and fiscal incentives. Through Popular Capitalism, the government intended to recapitalize the banks and disperse their ownership.

The government implemented the program by having the Central Bank transfer the outstanding emergency loans to CORFO (Corporación Nacional de Fomento), the government's agency responsible for implementing privatization. The intervened banks then issued stock in payment to CORFO for the emergency loans it now owned. CORFO proceeded to sell the shares to the public providing generous financing conditions. Ninety-eight percent of the shares were purchased through loans made by CORFO, the remaining 2% were purchased in cash. Only 10% of the shares were bought by institutions. The loan conditions established by CORFO were the following:

a) The loan was denominated in UF and had a 15-year maturity. The amount of the loan for individuals was 95% of the stock purchase and 90% for institutions. The loan could not exceed an amount equivalent to the total income and real state taxes paid during the last three years (1982 - 1984). The amount of taxes were computed in UFs.

b) The loans had zero percent real interest, 30% discount on the principal for prompt payment.

c) Investor could cancel the loans at anytime by turning in their shares to the government. Investors were not personally liable for defaulting on the loans. If a default occurred, CORFO was required to sell the corresponding shares in the market. The government could not retain ownership of any shares.

d) To guarantee the wide ownership of the stock, no individual or institution was permitted to hold in shares more than 2% of the total capital.

e) The shares were held by CORFO as guarantee for the outstanding loan.

The terms of the agreement varied for institutions and foreign investors. (See Exhibit 4 for different loan terms.)

Banco de Santiago participated in the Popular Capitalism program in an effort to increase its capital base and return ownership to the private sector. The Banking Superintendency and Banco de Santiago established that the bank needed to raise capital in the amount of UF 7,980,000 in order to continue operating. In June 1985, with Citibank as underwriter and an intense marketing campaign, Banco de Santiago issued 11,400,000,000 shares. By December 31, 2,666,869,162 had been sold at UF 0.000656 per share. The government became concern that the financial benefits provided by CORFO were not enough to attract investors. In December 1985, the government provided tax credits to investors as a further incentive. In 1986 the remaining shares were sold; 4,173,130,838 at UF 0.000656 and 4,560,000,000 at UF 0.000766. The new capital would allow the bank to further sell non-performing loans to the Central Bank and thus improve its asset base.[2]

In addition to the incentives provided by the government, Banco de Santiago reached an agreement with its workers. The bank advanced from workers' severance payment the amount equivalent to the 5% required cash payment. Ninety percent of Banco de Santiago employees took advantage of this mechanism and became Popular Capitalists.

After the completion of the recapitalization program, Banco de Santiago had a total of 12,000,000,000 shares outstanding: 11,400,000,000 were series B and 600,000,000 series A. The series B shares were own held by approximately 15,000 individuals and institutions (approximately 10 % of Popular Capitalists are institutions).

Popular Capitalists have all the rights and responsibilities of shareholders in Chile. They elect the Board of Directors and its President. Also, any modifications in the capital structure of the bank must be approved at the annual shareholders meeting. After the conclusion of the capitalization process, Popular Capitalists elected Julio Barriga, the interventor, as the new President of Banco de Santiago.

The series A shares were owned by Grupo Forestal or its affiliated companies. Through an agreement with a subsidiary of Grupo Forestal that had outstanding loans with Banco de Santiago, series A shares were used as payment. Today, series A stock makes up approximately 2.5% of Banco de Santiago's capital. Series A shares do not earn any dividends until Banco de Santiago repurchases all non-performing loans from the Central Bank.

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[2] According to Chile's labor law, workers are entitled to severance pay if they are fired without cause. It is equal to one month of pay for every year of service plus a month of pay for warning and a month of pay for unemployment.

D. Regulatory Reform

The Government of Chile not only wanted to restore its financial sector but wanted to guarantee that a similar crisis would not occur in the future. In an effort to meet this objective, the government introduced a new General Law for Banks in 1986. The main highlights of that law are the following:

a) Conflict of interest between owners and lenders was eliminated by limiting loans to related institutions and individuals to a maximum of 25% of the bank's equity, provided the proper collateral is provided. The Banking Superintendency could declare void contracts between the bank and related parties.

b) The Banking Superintendency would follow a detailed procedure to measure the riskiness of the loan portfolios of financial institutions. Provisions would be made from the institution's capital base to cover the risk of its portfolio.

c) The New Banking Law established a high level of transparency for financial institutions. The Superintendency was given the responsibility of publishing a table three times a year that indicated its assessment of the loan portfolios of all financial institutions. The concept of "banking secrecy" was reduced to protect only the privacy of the depositors. In order to provide alternate evaluations to the Superintendency, private companies that evaluated the level of risk of banks were established.

d) Clear parameters were established to determine the conditions under which an intervention by the Superintendency would occur. For example, losses not provisioned for in an amount greater than a relation of 20:1 debt to equity are considered moderate problems that can be solved by the shareholders. However, an institution will be considered insolvent if the expected losses not covered by provisions are greater than, or equal to 60% of the bank's equity.

e) In the event of a new financial crisis, the losses were to be absorbed by stockholders, depositors and the government. Thus, the government's implicit 100% government's guarantee on deposit was eliminated.

VII. Subordinated Debt

In August 1989, during the final days of the Pinochet government, the terms of the agreement on the debt for non-performing loans of the banks with the Central Bank were modified. The Central Bank returned to the banks the previously sold non-performing loans in exchange for a contract of payment for the same amount. The contract obligation became denominated a "subordinated obligation." The "subordinated obligation" has an indefinite pay period. It is to be serviced with 75% of the bank's yearly net income.

The "subordinated debt" would not appear in the bank's balance sheet. In case of liquidation of the bank, "subordinated debts" would be paid after all liabilities and before shareholders. The agreement was established through a contract that cannot be modified without the consent of both parties. The contract is not with Banco de Santiago but with its shareholders. Banco de Santiago only has the obligation of fulfilling an agreement of its shareholders: "to use a portion of its net income to pay a debt of the stockholders with the Central Bank."

Of the total "subordinated debt", in accordance with the previous agreement, only the 60%, originally bought with cash by the Central Bank is charged with an annual real interest rate of 5%. The remaining 40% is interest free.

Banco de Santiago's Subordinated Debt

The subordinated debt contract between the Central Bank and Banco de Santiago's shareholders states that part of the repurchased loans will be paid in cash. On November 10, 1989, Banco de Santiago owed the Central Bank UF 57,035,681.91 for non-performing loans sold. Banco de Santiago paid UF 721,763 in cash, equivalent to the present value of the non-performing loans certified by the Bank Superintendency. The difference, UF 56,313,918.91, became the subordinated debt. UF 38,252,557.54 would be charged 5% annual interest and UF 18,061,361.37 would be non-interest earning. This latter portion would only be amortized after the non-interest part is canceled.

The following table shows the payments made by Banco de Santiago to the Central Bank from its annual net income.

Year	Payment UF
1987	1,000,150.68
1988	1,338,420.14
1989	1,738,053.54
1990	2,593,976.15

In addition to servicing the "subordinated obligation" with a portion of its net income, Banco de Santiago used funds recovered from some of the non-performing loans to reduce the debt with the Central Bank. Some loans have also been recuperated and thus the "subordinated debt" was reduced. On December 31, 1990, including the capitalization of accumulated interest, Banco de Santiago's "subordinated obligation" totaled UF 13,729,331.68 non-interest bearing and UF 40,482.023.44 that is charged a 5% annual interest rate. The subordinated debt was equivalent to 5.84 Banco de Santiago's equity. During the period 1987 to 1990, Banco de Santiago consistently increased its net income as a result of extraordinary gains from debt equity swaps, and return on equity averaged 23.8%. This was an extraordinarily profitable period for the banking industry in general as a result of financial gains of debt equity swaps transactions.

VIII. Implications for Banco de Santiago

Banco de Santiago has returned to the private sector and has performed above the industry's average since its recapitalization. It has provided excellent returns to its investors and is reducing the subordinated debt. In addition, the Popular Capitalists have received high returns on their investment. New investors have been attracted and have benefitted from the free market model implemented in Chile.

A. Financial Performance

Since the completion of the capitalization process in 1985, Banco de Santiago started to generate positive net income. Net income has been used to pay dividends and reduce the subordinated debt. (Exhibit 2 compares the financial performance of Banco de Santiago to the industry.)

Sixty percent of Banco de Santiago's shares were sold at UF 0.000656 and 40% at UF 0.000766. Investors paid only 5% cash. The following analysis calculates the rate of return through December 1990 on the investment for the 0.000656 price.

Discount rate: 8% is the risk-free rate assumed for this analysis since the Central Bank pays to attract new funds.

Price:	0.000656	
Dividend Payments:	1986	0.0000199
	1987	0.0000273
	1988	0.0000372
	1989	0.0000488
	1990	0.0000733

Price Per Share
Dec. 30, 1990: UF 0.00003759

Rate of Return: 8.95%; For those that paid UF 0.000766 the rate of return is 4.68%. However, on a cash for cash basis, investors have received a return greater than 100 %. Another perspective on the return to investors is that by 1988 dividends had been already paid for the price of the share.

B. Servicing the Subordinated Debt

A long term issue for Banco de Santiago is whether or not it will ever be able to pay the subordinated debt. The last 3 years have been extraordinary years for the industry. In the years 1989 and 1990 return on equity average 31%. However, extraordinary gains from debt equity swaps have already been realized. The funds that will be available for servicing the debt can be expected to be less in the future.

In order to determine whether Banco de Santiago can effectively service its debt, the ratio of income available for paying the debt (75% of net income) over the subordinated debt must be equal to or greater than the interest rate on the debt. As of December 1990 the subordinated debt was UF 13,729,331.68interest free and UF 40,482,023.44 charged a 5% annual interest rate. The effective rate is 3.73%.

.05 x 40,482,023.44 = 2,024,101.17

(2,024,101.17/ (40,482,023.04 + 13,729,331.68)) x 100 = 3.73 %

The average income available for servicing the debt over the subordinated debt has averaged 2.93 %. Therefore, interests have been being capitalized and the debt has been growing. If Banco de Santiago was not able to cover the interest payments on the subordinated debt during extraordinarily profitable years, it will never be able to do so under the current agreement. Therefore, the government will eventually have to make a decision on recognizing the loss of at least part of the subordinated debt.

C. The Incentive Structure of the Subordinated Debt

Since the government has been locked into an unserviceable and growing debt, this could lead to the wrong incentives for managers at Banco de Santiago. Some have argued that the wide dispersion of ownership of Banco de Santiago and the limitations on ownership concentration (no one can own more than 2%), have made Banco de Santiago "hostage" to its management. Since 75% of net income is destined to paying the "subordinated debt", there could be an incentive for management to increase its expenses (perks, high salaries, etc.) and decrease net income.

An effective way to determine whether management has actually behaved in this fashion is to compare the efficiency of Banco de Santiago to the rest of the industry. Operating Margin over assets is an indicator of operational efficiency. Exhibit 2 provides this ratio for both Banco de Santiago and the industry. The numbers show that Banco de Santiago has actually increased its efficiency since 1988. Furthermore, its ratio is higher than the industry average in 1990.

This indicates that Banco de Santiago's management has behaved responsibly to date. A possible explanation for their behavior could be the increasing public attention to the subordinated debt issue. As the new government took office in early 1990, political leaders were calling for a modification of the subordinated debt contract. Banco de Santiago's managers might be trying to keep political pressure down by showing that their institution is one of the most efficient in the country.

IX. The Aftermath

The original Popular Capitalism law stated that the shares would be held as collateral by CORFO for the outstanding loans used to finance their purchase. In October 1989, the government modified the law so that stockholders would be allow to liberate the number of shares equivalent to the proportion of the loans that had already been amortized. This modification accelerated the trading of stock from banking institutions that participated in the Popular Capitalism program.

Only series B shares are traded in the Chilean Stock Market, and only approximately 32% of these shares are tradeable (i.e. not held as guarantee for loans by CORFO). As of June 1991 Banco de Santiago series B shares were quoted at UF 0.0005235. (Exhibit 5 provides information on the stock market and Banco de Santiago's series B shares).

Banco de Santiago's ownership dispersion has remained stable since the completion of the recapitalization program. The financial performance of Banco de Santiago has allowed stockholders to service their loans through dividend payments. There have been no defaults on CORFO's loans by Banco de Santiago's Popular Capitalists.

Recently, public debate on the "subordinated debt" has brought into question the wisdom of Popular Capitalism. Political leaders have expressed that the "subordinated debt" is a subsidy from all taxpayers to Popular Capitalists.

Objectives such as ownership dispersion, spreading the costs of the crisis over time, and a desire to pursue a particular development strategy, lead the Government of Chile to reprivatize/restructure Banco de Santiago through Popular Capitalism. The restructuring process left the Government of Chile with a debt that cannot be recuperated (a hidden deficit) under the current capital structure of Banco de Santiago.

X. Lessons Learned

The government of Chile provided strong incentives to make Banco de Santiago an attractive investment for Popular Capitalists. It designed mechanisms that limited the risk of the investors. However, it did not design any mechanisms that would allow the government to take advantage of highly profitable periods in the future. For example, there could have been a scale that determined the percentage of net income destined to the subordinated debt depending on the profitability of the institution. The 75% of net income to service the debt should have been flexible under certain predetermined conditions.

Another issue that the government could have addressed is their control over management at Banco de Santiago given the large amount of subordinated debt. This could have been addressed through several mechanisms. For example, certain performance requirements could have been included in the subordinated debt contracts on ratios such as Net Income to Assets or Operating Margin to Assets. In addition, the contract could have included a requirement for representatives of the government to be part of the Board of Directors of Banco de Santiago while the institution had a subordinated obligation.

The Government of Chile successfully reprivatized its financial sector. The performance of the financial sector has been better than prior to the economic crisis of 1981. Ownership has been dispersed and a new banking law has increased efficiency and transparency in the financial sector. The cost of restructuring the financial sector has been a subordinated debt that might not be paid in full and the subsidized loans provided through CORFO to Popular Capitalists.