TOWARDS MULTIBANKING IN COLOMBIA:
FROM ‘PATCHWORK’ TO FINANCIAL HOLDINGS

(Abstract)

The financial system of Colombia has been evolving from specialization towards a scheme of subsidiaries, aiming timidly at multibanking. In spite of recent reforms (Law 510 and 546 in 1999) which promote fusion of commercial banking and mortgage activities, the system remains impaired to consolidate a multibanking system. Overcoming the current patchwork structure will reduce excessive financial wedges and promote competition among better-capitalized financial holdings that could exploit “economies of scale and scope.”

We propose that commercial banks further absorb the tasks currently being performed by mortgage institutions (CAVs), near-banks (CFCs) that deal with consumer credit and leasing operations, and the mutual funds (Fiduciaries). Financial holdings should consolidate around multibanks, insurance and broker companies, while investment banks (CFs) and pension funds administrators (AFPs) focus on medium and long-term projects and portfolios. Stronger prudential regulations and a proper setting of a “fire-wall” will then be required, as well as higher solvency indicators.

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I. Introduction

During the last two decades, the financial system in Colombia has been evolving towards a system that has some features of multibanking. In the early 1980s, lending activities were deregulated so that commercial banks could operate with different sectors of the economy. However, some saving instruments continued to operate according to their specialization by economic sectors: those indexed to inflation (UPAC) were the monopoly of mortgage institutions (CAVs), while consumer activities had to be funded through CDs denominated in pesos, offered by commercial banks and the near-banks (CFCs). Demand deposits remained the monopoly of the commercial banks. The result over the 1980s was a hybrid system, which pointed to a “universal treatment” in the asset side of the balance sheet, while maintaining a certain degree of “specialization” in the liability side.

In the early 1990s, crucial reforms were approved (Laws 45 in 1990 and 35 in 1993) aiming at a gradual movement towards multibanking by recurring to the scheme of subsidiaries and financial holdings. Unfortunately, the fear of cross-operations and improper financial leverage led the authorities to strongly regulate the operations of near-bank dealing with mutual funds, leasing and consumer credit. This setting impaired an adequate exploitation of the existing economies of scale and scope.

The financial system in Colombia experienced a credit boom over the 1993-97 period, which ended-up with a financial crisis during 1998-2000. The over-expansion of the financial system through subsidiaries and branch-outs resulted in a costly scheme, which combined with real asset depreciation resulted in capital losses of about -32% for mortgage institutions and 21% for banks. The average overhead of the banking system was close to 8% over the years 1988-95, maintaining undue pressure on the financial wedge. In turn, the average banking wedge was 6%, significantly higher than the 2.7% observed in developed countries. As the crisis erupted, the financial wedge had to be compressed and the operational costs made several institutions non-viable.

New regulations have been implemented (Laws 510 and 546 in 1999) to cope with this crisis, particularly in the mortgage system. As a result, commercial banks are in the process of absorbing all mortgage institutions, while a significant number of near-banks have gone out of business. From 1997-2000, a total of 70 financial institutions (about one third of total bank/non-bank financial institutions) have been closed, merged or taken over, generating a better possibility of reaching and optimal size.

In spite of these recent reforms, the system remains impaired to consolidate a real multibanking structure. Further changes in regulation will be required to overcome the current “patchwork quilt of rules and exceptions,” to use the expression of Mr. Brady (1990 p.5) when referring to the American financial system. If implemented, it will be possible to reduce excessive financial wedges and to promote higher competition among better-capitalized financial holdings that could exploit “economies of scale and scope.”

In this paper, we propose that commercial banks further absorb the tasks currently being performed by mortgage institutions (CAVs), near-banks (CFCs) that deal with consumer credit and leasing operations, and mutual funds (Fiduciaries). Financial holdings would consolidate around multibanks, insurance and broker companies, while the investment banks (CFs) and the pension funds administrators (AFPs) focus on medium and long-term projects and portfolios. Stronger prudential regulations and a proper setting of a “fire-wall” will then be required, as well as higher solvency indicators.

In section II we explore the current structure of the Colombian financial system and some of the implications of recent legislation. Section III is devoted to analyzing the economies of scale and scope in Colombia and the rationale for multibanking. Finally, section IV provides concluding remarks.

II. "Cross-Roads" in the Colombian Financial System0

A. Subsidiaries and Branch-outs: The Exhaustion of the early 1990s Scheme

During 1996, the Colombian government explored the possibility of introducing legal changes that aimed at expanding the opportunities of multibanking. At that stage, it was not yet evident the "speculative bubble" that was being inflated through rapid credit expansion since 1993. Later, it became evident that actions taken by the Central Bank resulted insufficient to avoid a deep crisis (Banco de la República, 1999 p.32; Urrutia, 1999 p. 5). The crisis first hit the near-banks in 1996, extended towards savings and loans in 1997, and generated systemic effects on the banking system in the period 1998-2000. It is now clear that stringent supervision is required, particularly over the mortgage system, where financing should not surpass 75% of the commercial value or committing more than 25% of the personal monthly income (Ministerio de Hacienda, 1998; Urrutia, 2000 p.20).

In the mid-1990s, the perception of the financial system in Colombia was that it lacked the degree of competition required to spur better and cheaper services. The owners of financial institutions were aware of these problems, but were confident that foreign investment would help to promote more competition and technological progress. However, the system of subsidiaries and branches had topped its expanding capabilities and operational costs were mounting. In the early 1990s, the rationale for not going directly towards multibanking was the following:

> "(This system of subsidiaries) is a more fortunate development than multibanking, given the fact that it provides the benefits of universal banking (like the one developed in Germany) and avoids the structural problems of supervision and regulation that 'full-financial-services' have shown." See Martínez (1994, p.56).

In short, the system of subsidiaries adopted in Colombia brought some confidence regarding "cross-operations" and "vested interest," but at the cost of not being able to fully exploit the existing economies of scale. The regulators pointed out three main difficulties with multibanking in Colombia:

1. Possible "moral hazard" problems between owners of financial institutions and owners of firms. Only a proper setting of a 'firewall' between the financial and the real sector would have precluded this problem, and authorities felt they were not ready for such a task.
2. Avoiding financial contagion problems. The system of subsidiaries was certainly a good device for the early 1990s. Regulators, however, were aware that financial holdings and group operations were difficult to track. In the future, supervision had to be built-up at the level of the financial holdings, to be in a good position of understanding systemic risks.
3. Avoiding excessive financial leverage. This had been a serious problem during the early 1980s crisis, when the financial cost amounted to almost 6% of GDP. In fact, Law 510 in 1999 aims at increasing the autonomy of the Superintendency of Banks, so that better *in-situ* surveillance can be performed.

The financial crisis of 1998-2000 has revealed that subsidiaries and branch-outs adopted in Colombia induced over-costs and relatively high overheads. For example, over the period 1988-95, the net interest margin for banks (=Net interest income /Assets) was 6% in Colombia (Demirgüc-Kunt and Huizinga, 1999 p.384-88; ASOBANCARIA, 2000 p.27). Such a margin resulted similar to that of Latin America (6.2%), but it is significantly higher than the 2.7% observed in developed economies. Additionally, high net interest margins coincided with high operational costs in Colombia (an overhead of 8.3% with respect to a 6.2% observed in the region). When the crisis exploded, there was not financial room left for increasing provisions as required; in fact, provisions were only 0.9% of total assets, about half of what international standards would advise, and even below the regional average (1.1%).

More recently (1998-99), net interest margins declined slightly to 5% of total assets as a result of deterioration in non-performing loans. Financial expenditures also declined as a result of lower reserve requirements and some efforts in downsizing the banking system (Urrutia, 2000b). In fact, the number of banking offices (excluding 'Banco Agrario') had reached a pick of 2,800, while mortgage offices (CAVs) numbered about 1,000 by end-1997. Due to take-overs, mergers and foreclosures, banking and mortgages offices had been reduced by 350 as of March 2000. Many institutions have announced between 20-50% operational cost-reductions for the coming years. Public financial entities are minimizing losses, while getting ready to bring them all upto the point of sale during the next two years. It is estimated that net costs of divesting public financial entities could reach about 4% of GDP.

As recently expressed by the Banking Association of Colombia, “it is urgent to continue this process of cost-reduction in order to minimize losses resulting from a fall in the net interest margins and increases in non-performing loans portfolio … In spite of the efficiency gains over the 1990s, last year saw some setbacks” (ASOBANCARIA, 2000a p.3). In fact, such setbacks are happening at a time when the quasi-fiscal burden has been reduced from 25% to 12% of the liabilities during the 1990s. The transaction tax has represented about 2 percentage points of the 12% quasi-fiscal burden experienced over the years 1998-99. These figures imply that the reduction in the reserve requirements and the lowering to one digit inflation over the 1990s (Clavijo, 1991; Fernández, 1994 p.203) has more than compensated the cost-effect of such transaction tax.

Another reason to continue an effort in streamlining the financial system has to do with the fragility that arises from capital flows volatility (Catáo and Rodríguez, 2000 p.4). In fact, recent economic literature emphasizes how the “credit transmission mechanism” is particularly acute when financial wedges are being pressured by high overhead costs. The “Tequila effect” and the “Asian Crisis” illustrate how coping with globalization requires to water-out financial wedges and avoid using them as a cushion in times of financial turbulence.

In synthesis, the structure of the financial system in Colombia needs to be revisited in order to find its optimal size. The current crisis began in 1996 with a significant downsizing of the near-banks (CFCs), and continued during 1997 by redirecting leasing and mutual fund operations, and took a drastic change in 1999 when the fusion/merger of mortgage institutions with commercial banks took place. It has been estimated that losses in the financial system along with the need to recapitalize private institutions will entail investments representing about 4% of GDP over the years 1997-2000.

The structure and legal framework in which such investments take place will dictate the possibility of reinstating profits for private investors in the near future. In the following section we will briefly discuss the performance of the financial sector over the 1990s and propose a new institutional framework for the new decade.

B. The Financial Framework and the Crisis

Even before the crisis of 1998-2000, there existed some concerns about the characteristics of the financial system:

- It was a rather small financial sector, where banking and mortgage assets amounted only to 45% of GDP;
- Financial wedges were, on average, high in relative terms (6% of financial assets);
- Operational costs were also high, representing 8% of overhead;
- Basic financial transactions were difficult to perform and time-consuming. This was aggravated by the imposition of the transaction tax of 0.2% over the years 1998-99. However, the government has insisted that such a tax (representing about 0.7% of GDP) avoided systemic risks that otherwise would have triggered a wide spread financial crisis (Restrepo, 1999). In spite of a 4.5% GDP contraction and serious problems of public order, financial panics or run-offs in the Colombian financial system have not taken place.

Foreign Direct Investment (FDI) in Colombia’s financial system now represents about 18% of total assets. The so-called "reconquista" has generated new concerns about the difficulties in effectively adopting cost-saving technology in Colombia and the effects of “collusion.” It has also spurred a debate about ownership concentration. In fact, as of March 2000, two economic groups represented about 37% of financial assets and the aggregation of other two groups explained almost 47% of total assets. The remaining 22% belong to governmental institutions and only 31% of the assets belong to private institutions no associated with any particular economic group.

The issue of ownership concentration somehow has been surpassed by historical events, as near-banks and mortgage institutions quickly resort to mergers and take-overs as the only way to survive in the system. With the benefit of hindsight, it is now clear that such a process could have been more orderly, reported better efficiency gains, and caused less capital concentration, if needed legal changes had been adopted in 1996. Some of those changes took place in late 1999, when the process was almost completed.

During the 1990s, several private institutions purported the image of “multibanks,” while having to operate behind wooden-boards (“triplex”). The system of subsidiaries impaired the operation of “centralized treasuries” and ended-up duplicating operational costs. The knowledge of customers was poor, disperse, and costly.

Politicians sacked public banks and their administrators violated legal codes for providing loans, particularly during 1995-98. BANCAFE, Banco del Estado, BCH, Caja Agraria, la Previsora, and Fondo Nacional del Ahorro have all generated significant losses for the public budget. The idea of divestiture of all financial public entities (except for second-tier banks that operate at no direct risk) is now a national purpose and should be a reality by end-2001.

As shown in table 1, in the years 1995-99, there were foreclosures, mergers and take-overs of 7 Banks, 5 mortgage institutions (CAVs), 14 Financial Corporations (CFs), 10 near-banks (CFCs), 24 leasing y 10 fiduciaries. Although late, the financial system has sensed that it is oversized and has taken the decision to reduce by 70 the number of institutions in these areas. When considering other financial institutions, the reduction is from 438 in 1995 down to 349 in 1999. Assets in the financial system increased significantly during the first half of the 1990s, passing from 52% of GDP in 1991 to 70% in 1995. However, by end-1999 there has been some stagnation at the level of 72% of GDP.

Table 1: Indicators of the Financial System of Colombia

	NUMBER OF ENTITIES				ASSETS / GDP				SOLVENCY INDICATOR *			
	1991	1995	1999	FUTURE	1991	1995	1999	FUTURE	1991	1995	1999	FUTURE
Banks	26	32	26	15	24.1	28.5	35.8	60.0	13.3	13.4	10.9	15.0
Mortgage(CAVs)	10	10	5	0	9.7	13.3	10.3	0	10.2	10.2	9.1	0
Financ. Corp.	22	24	10	5	4.4	6.9	6.3	10.0	18.1	15.6	13.4	15.0
Near- Banks	73	74	40	0	3.3	5.9	2.6	0	na.	na.	na.	na.
Generals	30	31	21	0	2.8	3.3	1.4	0	15.4	12.4	17.6	na.
Leasing	43	43	19	0	0.5	2.7	1.2	0	na.	17.4	20.7	na.
Other Entities	240	298	268	130	10.5	15	16.7	21.0	na.	na.	na.	na.
Pension (AFPs)	0	14	8	5	0	0.1	0.2	1.0	na.	na.	na.	na.
Fiduciaries	20	47	37	0	0.1	0.2	0.3	0.0	na.	na.	na.	na.
Other **	220	237	223	125	10.4	14.7	16.1	20.0	na.	na.	na.	na.
TOTAL	371	438	349	150	51.9	69.7	71.7	91.0	na.	na.	na.	na.

* : (Thecnical Capital / Assets weighted by Risk)
** : Includes Insurance and Brokers, Credit Unions, and other minor institutions, but excludes the Central Bank, Exchange houses, and Foreign Banks representations.

na.: Not available

Sources: Super-Intendency of Banks and own computations

It is now clear that the financial system requires further grouping in order to be able to exploit the existing "economies of scale and scope." Additional legal changes are required to move swiftly towards a multibanking system that would take advantage of synergies in the system. Currently, it is difficult to imagine the existence of more than, say, 15 multibanks competing in a dynamic market (after absorbing the tasks of the near-banks, plus the mortgage business). This could well imply that the total number of financial entities could be reduced from the current 350 down to, say, no more than 150. This consolidation of financial institutions should imply a capital strengthening of the remaining entities.

We imagine that a good mark to strive for is that by the end of the current decade total assets in the financial system in Colombia should be heading towards 92% of GDP. This would imply a capital deepening of about 20 points of GDP, similar to the gain attained over the 1990s. Only then would be the Colombian financial system in a position to compete on equal footing with the emerging markets of Southeast Asia, where prudential regulations also need to be improved. Current solvency indicators also need to be increased, say to 15%, taking into account that larger business opportunities also entail bigger risks.

Table 2 shows three phases of the financial system in Colombia over the 1990s. During the years 1990-92, the banks reported profits over capital of 20.2% and of 2.2% with respect to assets (almost double the average figure reported by Spaniard banks). During the period of consolidation (1993-97), the banks maintained their good performance, reporting capital profits of 12.2% y and 1.8% with respect to assets. In the meantime, mortgage institutions (CAVs) reported similar figures (20% and 1.5%, respectively). During all these years, solvency indicators for banks were close to 13%, almost five percentage points above the 8% required by the Basle Agreement, and mortgage institutions reported around 11%.

Table 2: Financial System Performance Indicators (Annual Averages)

	1990-92	**1993 –97**	**1998-2000(I)**
Banks (exc. Caja Agraria)			
Profits / Capital	20.2	12.2	-21.2
Profits / Assets	2.2	1.8	-2.4
Solvency Indicator *	12.5	13.0	10.3
Mortgage Inst. (CAVs)			
Profits / Capital	24.6	21.5	-32.1
Profits / Assets	1.4	1.6	-2.5
Solvency Indicator *	10.3	10.6	9.8

* (Technical Capital / Assets Weighted by Risk)

Source: Superintendency of Banks, Colombia

The speculative bubble created over the years 1993-97 finally exploded in 1998, reverting most of the above mentioned indicators. Banks reported capital losses of 21% and 2.4% with respect to assets during the period 1998-2000(I). Mortgage institutions lost about 32% of their capital or 2.5% of their assets. Furthermore, solvency indicators declined to an average of just 9.8% for mortgage institutions and to 10.3% for banks.

The trend of the financial system has not been a good one in the last five years, as the downturn in economic activity cut most financial institutions oversized and with limited capacity for reaction over the business cycle (details in Clavijo, 2000). It is then useful to revisit the current structure of financial businesses in Colombia and to sketch possible reforms that aim at reducing costs and increasing solvency indicators.

III. Brief History of Multibanking and the Case of Colombia

A. Multibanking in the Developed World

In the early years of the XXth Century and before the great depression (1929-33), the developed world exhibited cohabitation of multibanking and specialized banking. However, regulators reacted to the great depression by curtailing the possibilities of multibanking, particularly in the Anglo-Saxon world.

The so-called Anglo-Saxon model had a history of specialized banking services, as a result of links between internal and external trade, based on short-term financing. Barriers erected over the 1940-50s were firmly maintained up to the early 1970s, when a deregulation process was re-ignited. In the case of the United States, the lagging in financial services had many legal explanations (Fry, 1988 p.281ss):

- Demand deposits were not allowed to recognized explicit interest yields
- McFadden's Law had limited, since 1927, inter-state mortgage operations; additionally, geographical barriers were erected which hampered branching developments of the financial services
- Glass-Steagall's Law had segmented, since 1933, developments of financial services with respect to stock markets.
- Regulations of bank holdings had limited, since 1956, the development of insurance services and futures markets.

By contrast, the German Model of multibanking was a historical result of strategic alliances between the industry and the financial sector, servicing different economic sectors and at different horizons. It has been said that the great economist Schumpeter emphasized that the “innovative entrepreneur” was the perfect blending of a “banker with vision for industrial business.” Several historians concluded that the industrial development of Germany was induced by this symbiosis between the bankers and the multipurpose vision of the firms. The latter, without the opportunity for concretion with the former, would have not generated such an immense industrial wealth in Germany (Mülhaupt, 1976).

There has been a historical link between non-innovative industrial processes and specialized banking in less developed countries, with the notable exception of Japan. Vernon’s theory about “product-life-cycle theory” fits quite well with this evidence, particularly in Latin America, whereas “research & development” processes require tight relations between industry and banking that multibanking tends to provide with better results (Khatkhate and Riechel, 1980).

In the case of Japan, specialized banking also coincided with high State intervention, including administrative controls on interest rates and government lead-projects. However, the 1997-98 crisis made evident that such a system was not only inefficient but also prone to crony schemes and lacked minimum standards of supervision and prudential regulations.

During the 1970s and early 1980s, multilateral agencies supported general schemes that aimed at consolidating multibanking in emerging markets. However, due to unwanted effects on financial property concentration and difficulties in the surveillance of financial conglomerates, by mid-1980s priority was giving to prudential regulations, ending-up in the adoption of the Basle Agreement in 1988.

Financial deregulation continued in the early 1990s and received special support from Europe, after the EU approved in 1992 a global scheme for modernizing financial services in that continent. The United States reacted quickly, but in a disorganized manner, ending-up in a "patchwork" scheme (Brady, 1990). Multibanking has encountered several difficulties in the United States, but the most demanding problem arises from concentrating risks around a deposit insurance (FDIC) which is too generous (Breeden, 1990). At present stage, American megabanks are "reading" market forces to gauge a proper balance between retailing, investment banking, and securities. Most banking strategists are betting on a consolidation of multibanking, where specifics would depend on regulations around the "H.R.10" system, approved in November of 1999. The Fed and the Treasury have yet to strike a good balance between their regulatory and supervision tasks to expedite this movement towards multibanking in the United States (The Economist, 1999).

Table 3 summarizes the systems that have so far prevailed in some developed economies, where United States and Japan have been important exceptions regarding multibanking. In Europe, some countries are re-directing and re-sizing their financial services, after learning that "cross-subsidies" are not paying their rapid expansions. Outsourcing is in fashion, but there is a clear tendency to consolidate financial groups. In the meantime, the United States keeps moving towards "underwriting," as a way of adopting innovative schemes that point towards multibanking.

Table 3 : Banking Arrangements in Some Developed Countries

	Banking Services	**Non-Banking**
A. Specialized : U.S.A.-Japan	Subsidiaries	Non-Financial Subsidiaries
B. Semi-Specialized : U.K. – Canada	Banks	Subsidiaries-Subsidiaries
C. Multibanking : Germany-Switzerland	Universal Banking	Universal Banking (Dpts.)

Source: Based on Fry (1988) and Brady (1990).

In the following section we will discuss how recent trends in the Colombian banking structure, particularly in light of recent reforms (Law 510 in 1999), can be ascribed within the world tendency towards multibanking.

B. Financial Structure in Colombia: Changes Towards Multibanking

It has been said that since the origins of the financial system, rooted in Law 45 in 1923, the banking system in Colombia was flexible enough to allow for universal banking (ASOBANCARIA, 1997). In fact, commercial banks and mortgage operations could operate jointly. However, the lack of dynamic markets and different group interest generated segmented markets which represented a hybrid system, with elements of competition in the liability side, but with specialization by sectors in the lending side of the balance sheet (Clavijo, 1992; Melo 1993). In this regard, Colombia was not an exception with respect to the Anglo-Saxon tendency to avoid multibanking up to the early 1990s.

Law 45 in 1990 opened the possibility of operating through financial conglomerates based on expanding financial services by means of creating subsidiaries. Law 35 in1993 further extended consumer credit towards mortgage institutions (CAVs) and also permitted these institutions to turn into mortgage banks (allowing them operate demand deposits).

However, near-banks (CFCs) were over-regulated and forced to undergo additional specialization in order to deal with leasing operations. This had negative effects on the financial structure and distorted reserve requirements regulations. Additionally, Law 454 in 1998 allowed special treatment for "credit unions" entering the financial system, which latter proved to be another factor of weakness and financial contagion during the crisis.

Some new regulations approved through Law 510 in 1999 were aimed at further promoting competition in the financial system:

- The use of branch offices was further flexibilized to cover fiduciaries and broker operations, allowing the exploitation of some "economies of scope."
- Investments in real sector assets by the Financial Corporations were deregulated and the "notion of the firm" became more general.

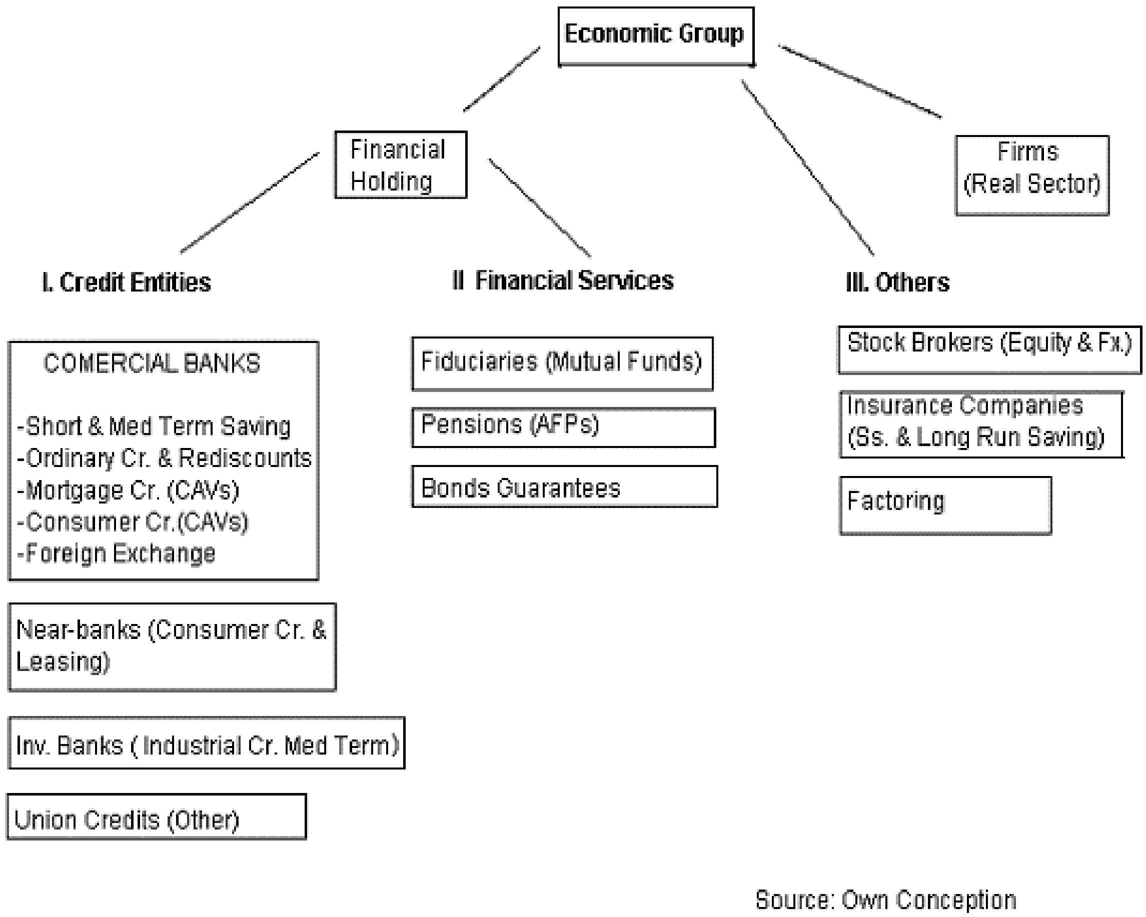
- Complementary, Law 546 in 1999 linked mortgage-indexation to recent CPI-performance and opened the use of such unit of account to any financial instrument. This law also reinstated the mandate to turn mortgage institutions into banks before end-2003 (in practical terms this conversion should be over before end-2001).

However, several obstacles remain so as to be able move further into multibanking in Colombia:

- There is no proper legal separation between “own” and “delegated” operations, so mutual funds and fiduciary operations can not be passed onto banks.
- Leasing operations are limited to near-banks (CFCs) and their consumer credit continues to be artificially separated from those offered by commercial banks.
- Stringent regulations are required to attain a proper setting of a ‘firewall’ between financial entities and real sector firms.

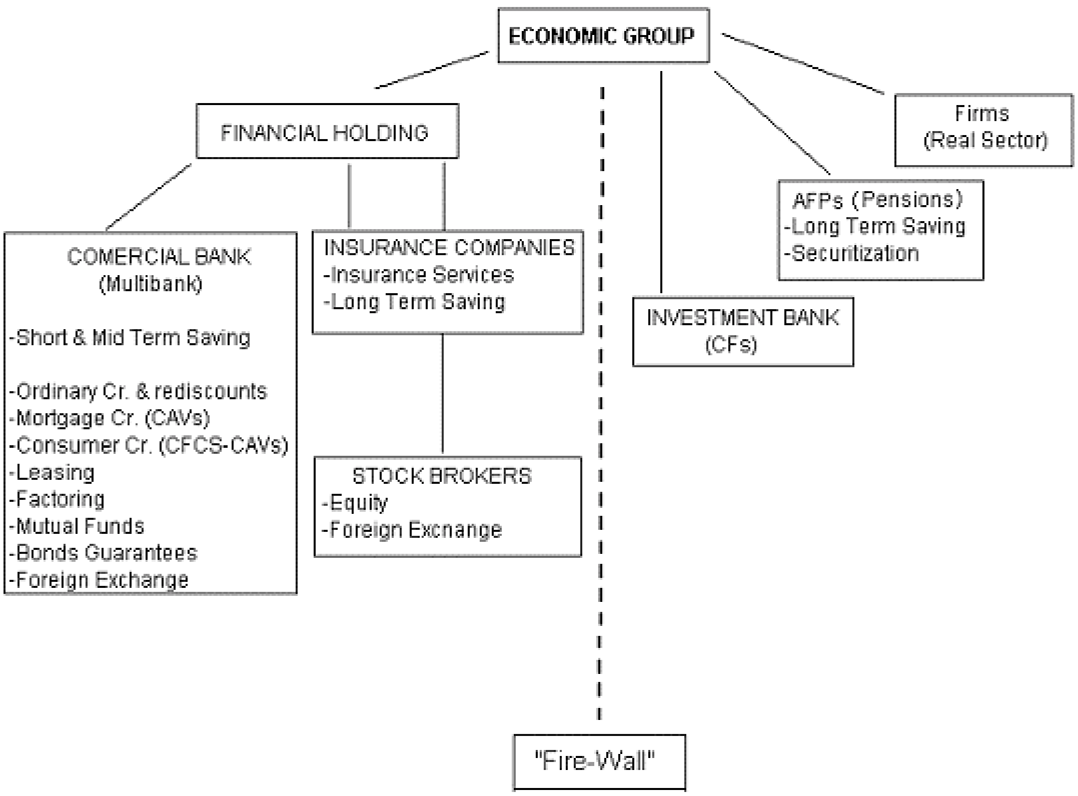
Graph 1 illustrates the current structure of the financial system under Law 510 in 1999. It is clear that, in spite of the conversion of mortgage institutions into banks, the market continues to be segmented regarding near-banks and fiduciaries, generating operational over-costs.

Graph 1 : Current Structure of the Financial System under Law 510/99



Graph 2 depicts how the system could be turned to operate under a multibanking system, with better possibilities of exploiting existing economies of scale and scope. Besides absorbing operations of mortgage institutions, the idea is to also bring all consumer credit, leasing, mutual funds and some broker operations "under the same roof." This should permit significant reductions in net margins and lower real costs for consumers.

Graph 2: Financial System of Colombia under a Multibanking Proposal



Source: Own Conception

However, such agglomeration of financial services would also entail a concentration of risks. Consequently, banking supervision and prudential regulations should be enhanced, particularly at the level of the financial holdings (centered in the new multibanks). From the perspective of the regulator, it is better to have dynamic financial competition among a few multibanks, than continue to struggle for additional capitalization in an atomized and small ~~system. A crucial issue in allowing the consolidation of financial holdings is the prope~~r setting of a firewall between the real and the financial system, in order to avoid contamination at times from economic recessions.

Another key element in the case of Colombia is to further enhance the role of Financial Corporations as investment banks, while pension funds concentrate on medium and long-term portfolios (including their crucial role in public assets divesting). In this regard, the recent example of the AFPs in Argentina deserves attention, while some useful lessons could be learnt from difficulties arising in Mexico and Brazil with respect to the short-term role-played by banks and mutual funds.

In the following section, we briefly discuss the empirical findings regarding the “economies of scale and scope” in Colombia, which seem to be significant.

IV. Economies of Scale and Financial Structure in Colombia

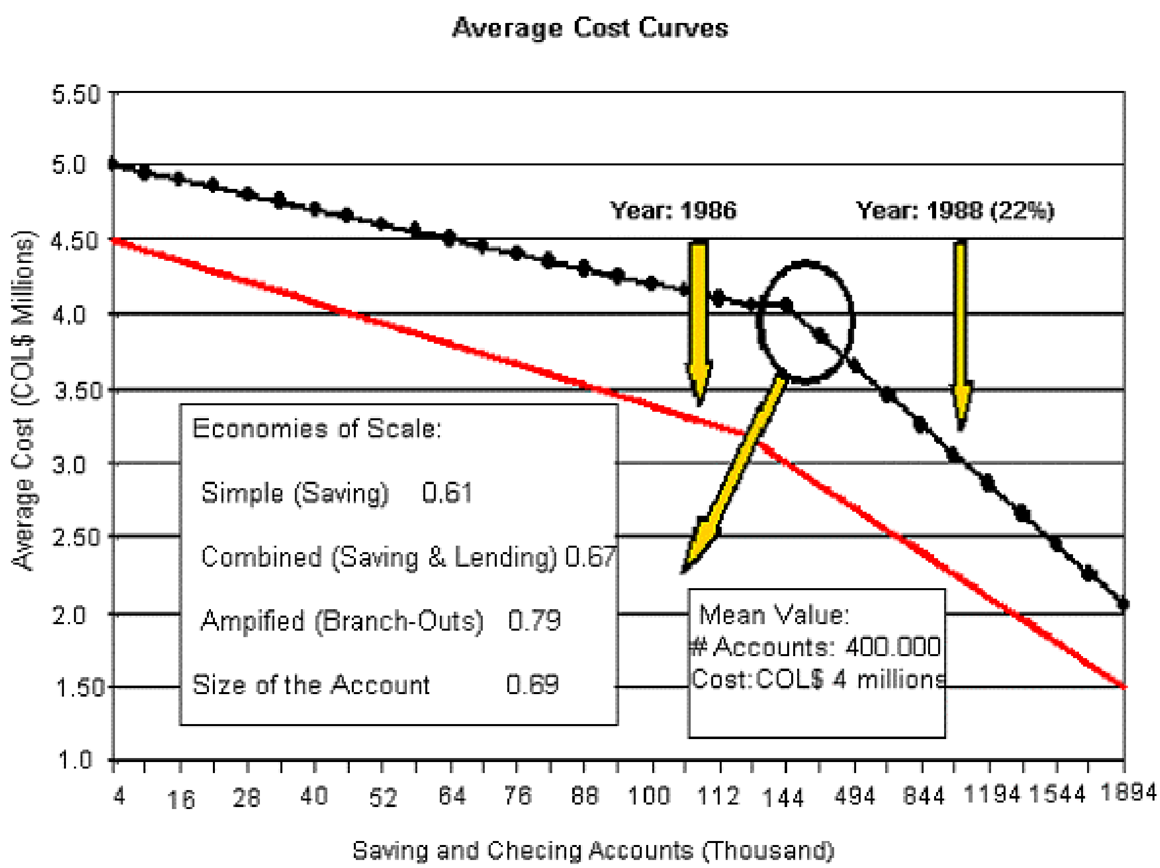
A. Economies of Scale and Scope

One necessary condition (although not sufficient) for the existence of economies of scale is that the average cost curve exhibit a descendent shape. A practical difficulty arises, however, when attempting to define the banking product relevant for such an average cost.

Ferrufino (1991) found an average descending cost curve for the banking system, for 1986 and 1988, when the product was defined in terms of the number of checking and savings accounts (see graph 3). The average cost for the bank was of the order of COL$4 million per-annum (equivalent to COL$32 million or US$16,000 per-annum at current prices), when the banks operated in the range of 150,000-400,000 accounts. She also found that simple economies of scale with respect to the number of savings accounts (0.61) was not much different from combined (savings and lending) economies of scale (0.67). When considering the average size of the savings accounts, the result increased to 0.69 (maintaining average costs savings close to 30% when expanding savings and/or lending). Finally, if expansion took place through branch-outs, the “amplified” economies of scale were reduce to 20%, with a rapid decrease in savings above 500,000 savings accounts.

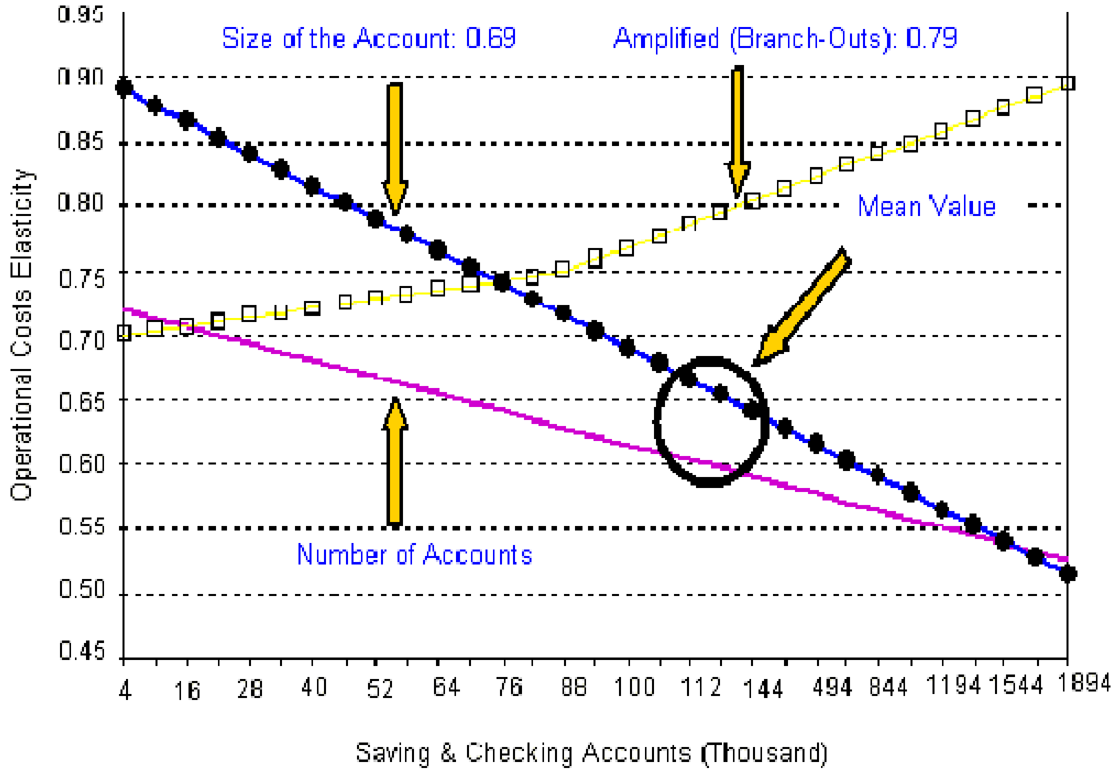
Graph 3 : Economies of Scales: Banks

Operational Costs in Terms of Saving and Checking Accounts 1988



Graph 4 shows the different results that banks obtained in cost-savings if the expansion occurred "under the same roof" (about 40%) or through branching (between 10-35%).

Graph 4: Evolution of Economies of Scale: Banks
In terms of Saving and Checking Accounts 1988



These figures illustrate that in the early 1990s there was an ample scope for exploiting economies scale, which could only be partially used by the system due to the adoption of subsidiaries. Although these studies need to be revisited in line with recent events, particularly with the conversion of mortgage institutions into banks, our intuition is that significant overheads could be further reduced if changes were introduced in the financial system to expedite the consolidation of multibanking in Colombia. Additional estimates for the years 1994-96, carried out by Avendaño (1997), also give support to the existence of significant economies of scale that could be used by the system.

B. The Debate about "Financial Inefficiencies"

Maurer (1993) has criticized the above-mentioned results on grounds of deficiencies in econometric procedures. However, this seems to be a general difficulty when dealing with economies of scale. More recently, Suescun and Misas (1996) adopted an alternative methodology by attempting to distinguish between the "financial environment" and the self-reaction of banks to those business conditions. The efficiency-X framework adopted by these authors led them to conclude that administrators of Colombian banks were not able to reduce costs, although the "environment" permitted them to do so. Using panel-data for the period 1989-95, they found inefficiencies that represented about 31% of operational costs (representing about 4 percentage points of the financial wedge), where nearly 27 points (85% of the total inefficiency) was explained by lack of effective administrative controls.

This evidence would support the idea that there has been some "collusion" for not operating at the efficient banking-production-frontier in Colombia during those years. This X-inefficiency approach would then be recommending the adoption structural changes to foster better competition. Moving towards multibanking certainly seems to be a superior alternative than maintaining the current scheme that hampers the exploitation of economies of scale and scope.

In short, the main objectives of the financial reforms over the last decade have not yet been accomplished in Colombia (Carrasquilla and Zarate 1997, p. 66), namely:

i) Increasing real savings in the economy;
ii) Reducing net financial margins in order to reduce the cost of credit;
iii) Increasing the selection of investment projects based on real returns and their low risks.

Moving towards multibanking would certainly increase the probability of reaching such objectives by the end of this decade, while promoting capital deepening. The regulator, however, has an immense task in terms of increasing surveillance and prudential regulations to cope with the concentration of risks that this new optimal size of the financial system implies.

V. Conclusions

In this paper, we have proposed that commercial banks further absorb the tasks currently being performed by mortgage institutions (CAVs), near-banks (CFCs) that deal with consumer credit and leasing operations, and mutual funds (Fiduciaries). Financial holdings would consolidate around multibanks, insurance and broker companies, while the investment banks (CFs) and the pension funds administrators (AFPs) focus on medium and long term projects and portfolios. Stronger prudential regulations and a proper setting of a “fire-wall” will then be required, as well as higher solvency indicators.

As discussed, the financial system of Colombia experienced a credit boom over the years 1993-97, which ended-up with a financial crisis during 1998-2000. The over-expansion of the financial system through subsidiaries and branch-outs resulted in a costly scheme, which combined with real asset depreciation resulted in capital losses of about -32% for mortgage institutions and 21% for banks. The average overhead of the banking system was close to 8% over the years 1988-95, maintaining undue pressure on the financial wedge. In turn, the average banking wedge was 6%, significantly higher than the 2.7% observed in developed countries. As the crisis erupted, the financial wedge had to be compressed and the operational costs made several institutions non-viable.

New regulations were implemented (Laws 510 and 546 in 1999) to cope with this crisis, particularly concerning the mortgage system. As a result, commercial banks are in the process of absorbing all mortgage institutions, while a significant number of near-banks have gone out of business. During the 1997-2000 period, a total of 70 financial institutions (about one third of total bank/non-bank financial institutions) have been either closed, merged or taken over, generating a better possibility of reaching and optimal size.

In spite of these recent reforms, the system remains impaired to consolidate a real multibanking system. Further changes in regulation will be required to overcome the current "patchwork quilt of rules and exceptions." If implemented, it will be possible to reduce excessive financial wedges and to promote higher competition among better-capitalized financial holdings that could exploit "economies of scale and scope."

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