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Tunneling when Regulation is Lax: The Colombian Banking Crisis of the 1980s[1]

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The resilience of firms to industry-wide shocks has positive externalities in industries with systemic risk, such as banking. We study the resilience of banks to macroeconomic slowdowns in a context of lax microprudential regulations: Colombia during the 1980s. Multiple banks performed poorly during the crisis due to practices that tunneled resources from depositors to shareholders and board members. Such practices —related lending for company acquisitions, loan concentration, and accounting fraud— were enabled by power concentration and links with political power among local banks. In contrast, foreign-owned banks performed relatively well during the crisis due to three factors: (i) foreign-owned banks imported governance institutions and lending procedures from their headquarters, (ii) foreign-owned banks were not part of local business groups with concentrated ownership, and (iii) foreign-owned banks were ex-ante less likely to receive a bailout from the government. These factors continued to be relevant into the 1980s, even though the Colombian government had forced foreign banks to become minority stakeholders of their subsidiaries in 1975.

Keywords: Banking, Tunneling, Related Lending, Financial Crises, Foreign Banks
JEL: N26, G21, G28, G30, G33.

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1. Introduction

The bankruptcy of FTX, the third largest crypocurrency exchange by volume, featured multiple characteristics of unregulated financial markets: power concentration, lack of transparency, related lending, and, eventually, a run.[5] The growth of unregulated financial markets highlights the need for a better understanding of their shortcomings, their mechanisms of self-regulation, and their role as propagators of macroeconomic turmoil. Such understanding requires detailed information about market intermediaries over long time periods, but this information is often difficult to obtain in unregulated markets. In this paper, we use detailed information on a banking sector with lax regulations against tunneling —"the transfer of assets and profits out of firms for the benefit of their controlling shareholders" (Johnson, La Porta, Lopez-de-Silanes, & Shleifer, 2000). Tunneling enabled a large banking crisis in Colombia during the 1980s.

The Colombian banking crisis of the 1980s entailed the liquidation or bailout of banks that controlled 31% of the banking system's assets. [6] The crisis started with the bankruptcy of *Banco Nacional* in 1982 but exploded in late 1983 with the government's takeover of *Banco de Colombia*, the largest bank in the system. By 1985, non-performing loans and seized collaterals in the banking system amounted to 14% of assets (Villegas, 1990, p. 55). Consequently, the banking system's return on assets fell from 1% in 1980 to -5% in 1985. By the end of the crisis, the Colombian government had spent between 3% and 6% of GDP on bailouts (Urrutia, Caballero-Argáez, & Lizarazo, 2006, pág. 120; Klingebiel & Honohan, 2003). The crisis motivated new restrictions to related lending, increased penalties for tunneling, the creation of a deposit insurance system, and the enactment of formal procedures for seizing and administering banks in distress.

We show that unsound practices by local banks worsened the crisis: loan concentration, accounting fraud, and related lending for company acquisitions and risky projects. These practices were used for tunneling resources from depositors to controlling shareholders,

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[5] FTX Tapped Into Customer Accounts to Fund Risky Bets, Setting Up Its Downfall (2022, November 11). The Wall Street Journal. Retrieved on 2022/11/28 from: https://www.wsj.com/articles/ftx-tapped-into-customer-accounts-to-fund-risky-bets-setting-up-its-downfall-11668093732
The downfall of FTX's Sam Bankman-Fried sends shockwaves through the crypto world (2022, November 14). NPR. Retrieved on 2022/11/28 from: https://www.npr.org/2022/11/14/1136482889/ftx-sam-bankman-fried-shockwaves-crypto
[6] In Colombia, the bail-out and nationalization process after 1985 was known as officialization. We explain the differences between pre-1985 nationalizations and post-1985 officializations below.

especially in banks with concentrated ownership and links with government officials. In contrast to modern-day regulations in developed economies, Colombian regulations at the time were ineffective at preventing tunneling (Gallón, 1986). Hence, our study allows for a better understanding of tunneling and related lending in the banking sector when regulation is lax.

A major finding in our paper is that performance during the crisis was better for former subsidiaries of foreign banks than for local banks. Foreign banks had been forced by regulation to become minority stakeholders of their subsidiaries in 1975, seven years before the crisis. These former subsidiaries, henceforth called foreign-owned banks, had a lower share of non-performing loans than local banks during the crisis. Furthemore, foreign-owned banks were less likely to tunnel resources through related lending, concentrate their loan portfolio on a few borrowers, and use accounting tricks to lie in financial reports. We argue that three factors explain this behavior. First, foreign-owned banks imported lending procedures and technologies from their headquarters. Second, foreign-owned banks were not part of local business groups with concentrated ownership. Instead, foreign banks shared their ownership with companies and individuals from the real sector. Power-sharing, together with controls to foreign exchange flows, hampered the ability of foreign owners to tunnel resources. Third, due to their weaker links with local politicians and regulators, foreign-owned banks were ex-ante less likely to receive a bailout from the Colombian government. A bailout from their headquarters was also unlikely because further foreign investment was prohibited in the banking sector. The fact that foreign-owned banks were resilient to the crisis thanks to these factors highlights the role of the opposite factors in increasing tunneling at local banks.

Our point is not that managers, board members, and shareholders at foreign banks are more virtuous than at local banks. We show evidence on the contrary. Furthermore, the headquarters of foreign banks lent recklessly to Latin American governments during the 1970s (Devlin, 1989; Marichal, 2013, pp. 179-224; Altamura & Zendejas, 2020). The literature on rogue trading at multinational banks provides another case in point (Schenk, 2017). Rather, our point is that foreign banks were exposed to incentives and technologies that prevented tunneling. These incentives and technologies continued to operate even though the government had forced foreign banks to become minority stakeholders of their subsidiaries in 1975.

Three sources support our analysis. First, the balance sheets of every private bank in the Colombian market from 1965 to 1990. We digitized these balance sheets from the bulletin of *Superintendencia Bancaria*, the Colombian bank regulator. Second, the board members for each bank during the 1980s, which we obtained from annual reports published by the banks. Third, multiple qualitative sources: (i) explanatory memoranda of laws and decrees (ii) reports by bank regulators, government bureaus, and business associations of the time, (iii) essays by presidents and policymakers, (iv) newspaper articles, and (v) the existing academic literature on the Colombian banking sector of the 1970s and 1980s.

Lending to shareholders, board members and sister companies was an important mechanism for tunneling resources from depositors, minority shareholders and, eventually, Colombian taxpayers. The use of related lending for tunneling has been studied in multiple contexts, including banking crises (Morck & Nakamura, 1999; La-Porta, Lopez-de-Silanes, & Zamarripa, 2003). Yet, related lending can be advantageous for banks and economies because it reduces informational asymmetries and transaction costs with borrowers (Hoshi, Kashyap, & Scharfstein, 1991; Rajan, 1992; Lamoreaux, 1994; Maurer & Haber, 2007). This positive effect tends to dominate in countries with legal controls on tunneling (Masulis, Pham, & Zein, 2011; Buchuk, Larrain, Muñoz, & Urzúa, 2014; Johnson, Boone, Breach, & Friedman, 2000; Cull, Haber, & Imai, 2011). In countries with weak legal controls, such as Mexico between 1888 and 1970, corporate governance practices might still prevent tunneling (Maurer & Haber, 2007; del Angel, 2016). In our context, corporate governance differed widely across banks: local banks with concentrated ownership and links with politicians were looted by their owners; foreign banks performed relatively well thanks to their imported lending practices and their improbability of being bailed out.

This paper also contributes to the literature on foreign banks' performance relative to local banks in developing countries. Foreign banks face high default rates unless they use design contracts and score credits to overcome their lack of familiarity with local institutions and firms (Dell 'Ariccia, Friedman, & Marquez, 1999; Stein, 2002; Sengupta, 2007; Beck, Ioannidou, & Schäfer, 2018). We show that this lack of familiarity with local institutions and firms had a positive effect in the Colombian case: foreign-owned banks were unlikely to engage in related lending to tunnel assets from depositors, minority shareholders, and taxpayers. As a result, foreign-owned banks outperformed local banks during the crisis of the 1980s.

The literature on banking during the Latin American crisis of the 1980s has emphasized capital flows, export prices, mismatches in maturity, mismatches in currency, exposure to government debt, dependency on foreign funding, financial liberalization, international political support, and reputation as explanations for the crisis (Diaz-Alejandro, 1985; Frieden, 1987; Devlin, 1989; Bértola & Ocampo, 2012; Marichal, 2013; Ocampo J. A., 2014; Álvarez, 2015; Álvarez, 2017) (Álvarez, 2018; García Heras, 2018; Caselli, Faralli, Manasse, & Panizza, 2021; Álvarez, 2021). However, less attention has been paid to the role of tunneling in worsening the crisis.[7] In the Colombian case, tunneling was the most important mechanism in transforming macroeconomic turmoil into a full-fledged banking crisis.

Hence, our paper contributes to the literature on the Colombian crisis of the 1980s, which is summarized in Hernandez and López (2023). Colombia experienced a large banking crisis despite the implementation of capital controls during the 1970s, low external debt relative to other Latin American countries, international political support, and uninterrupted payments of sovereign debt (Devlin, 1989, pp. 53, 101, 180; Garay, 1991, pp. 613-620; Ocampo J. A., 2014; Ocampo J. A., 2015, pp. 84-102) (Caselli, Faralli, Manasse, & Panizza, 2021)[8] The existing literature studies the macroeconomics of the crisis, the role of the government, and the performance of the banking system as a whole (Montenegro, 1983; Herrera, 1983; Junguito, 1985; Kalmanovitz & Tenjo, 1986; Misas, 1987; Garay, 1991; Salazar & Lora, 1995; Barajas, Steiner, & Salazar, 2000; Villar, Salamanca, & Murcia, 2005) (Sánchez, Fernández, & Armenta, 2005; Urrutia, Caballero-Argáez, & Lizarazo, 2006, págs. 101-123; Ocampo J. A., 2015, págs. 84-102; Caballero-Argáez, 2019; Perez-Reyna & Osorio-Rodriguez, 2021; Caselli, Faralli, Manasse, & Panizza, 2021). Rather than studying the banking system as a whole, we explain the heterogeneous performance of banks during the crisis of the 1980s using novel information at the bank level collected from primary sources.

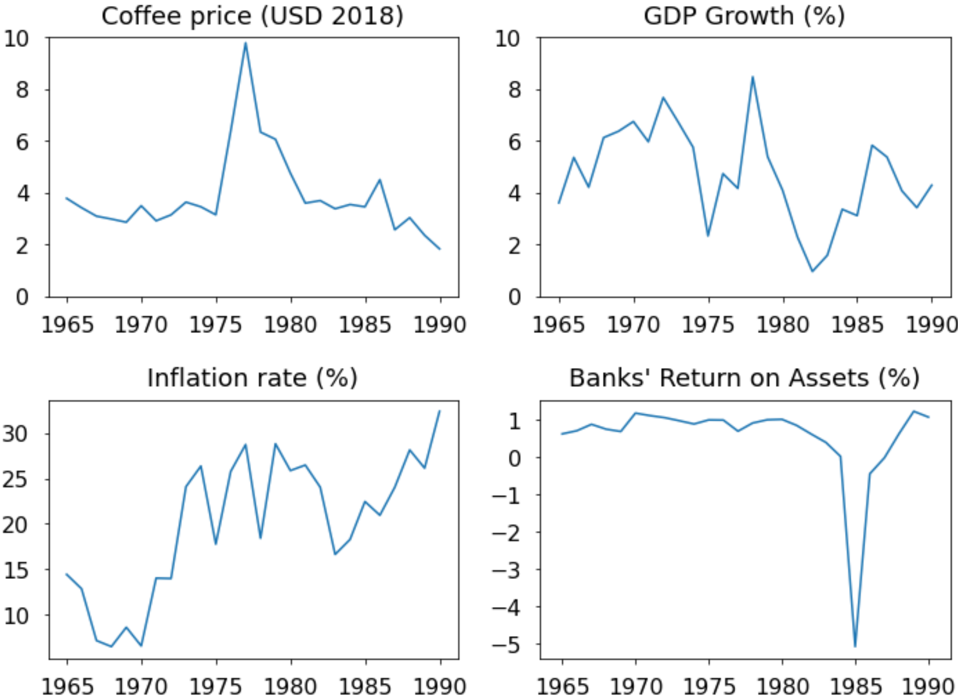
[7] For example, Díaz-Alejandro (1985) briefly mention that Chilean banks used Panamanian subsidiaries to circumvent legal limits to related lending and used false transactions to increase the value of loan collaterals. Nevertheless, he does not discuss nor quantify the relationship of these practices with tunneling, nor the role of tunneling in magnifying the crisis, as we do in this paper. del Angel (2016) shows that insider lending was widespread and did not increase credit risk for Mexican banks before the 1980s, but his study does not cover the debt crisis. Rodríguez-Satizabal (2021) shows that owners and senior managers at Colombian business groups became board members of banks in the 1960s and 1970s, but does not discuss the impact of this practice on the crisis of the 1980s.

[8] The external debt advantage of Colombia relative to other Latin American countries at the start of the crisis is disputed in the literature (Devlin, 1989, pp. 53, 101, 180; Garay, 1991, pp. 613-620; Ocampo J. A., 2014; Ocampo J. A., 2015, pp. 84-102) (Caselli, Faralli, Manasse, & Panizza, 2021)

2. Before the crisis: Economic boom and economic policy

Colombia entered an economic boom in 1976 thanks to an increase in the price of coffee, the main Colombian export[9]. The increase in exports induced economic growth, foreign exchange inflows, and increases in foreign exchange reserves at the central bank (Figure 1). This economic boom reinforced the high inflation rate that Colombia had experienced throughout the 1970s (Figure 1). In contrast with these macroeconomic variations, banks' return on assets did not have major changes in the aggregate during the 1970s (Figure 1).

Figure 1. Macroeconomic indicators and ROA for the banking sector



Sources:
GDP: Banco de la República and DANE. Inflation: DANE.
Coffee Price: Federación Nacional de Cafeteros (2019), deflacted to USD of 2018 using US urban CPI from the Minneapolis Fed.
Return on Assets: Own calculations from balance sheets.

Policymakers attempted to control inflation and exchange rate appreciation by raising the marginal reserve requirements over checking accounts to 100% and restricting the average reserve requirements over liabilities in foreign exchange to between 18% and 100 (Garay, et al., 1998; Ocampo J. A., 2015). There were also interest rate controls over loans, a prohibition

[9] Coffee accounted for 65% of exports in 1977, the year in which coffee reached a peak of 9.78 dollars of 2018 per pound.

of increasing foreign debt, and increased capital controls. These controls were added to previously existing regulations that increased lending costs, such as forced investments on central bank bonds that were a fixed share of bank loans (Caballero-Argaez, 1988).

The regulations implemented by the government reduced the profitability of borrowing and lending money through standard channels for both the banks and their clients. Clients responded by lending and borrowing money in the informal market, which thrived in consequence. Banks responded by finding new financial instruments and practices that would allow them to elude the new regulations (Ortega, 1979; Villegas, 1990, p. 14).

In addition, Colombian banks had been opening subsidieries overseas since the 1970s, especially in the Caribbean and Panama (Avella & Caballero-Argáez, 1986, p. 33). Ten Colombian banks opened subsidiaries in Panama between 1971 and 1982 -the largest subsidiaries belonging to Banco de Colombia, a private bank, and Banco Cafetero, a quasi-public bank (Caballero-Argaez, 1988). Subsidiaries allowed Colombian banks to obtain liquidity from international markets, avoid the Colombian capital-reserve requirements, and avoid Colombian regulations on transactions with foreign exchange (Caballero-Argaez, 1988). In fact, the liabilities of the subsidiaries in Panama were often backed by their headquarters in Colombia, which became a potential source of currency mismatch for Colombian banks (Avella & Caballero-Argáez, 1986). By 1982, most foreign debt by Colombian banks had been obtained through their subsidiaries in Panama (Avella & Caballero-Argáez, 1986, p. 35).

At the same time, owners and senior managers at Colombian business groups became board members of banks in the 1960s and 1970s (Rodríguez-Satizabal, 2021). As a result, by 1975, 67% of the firms affiliated with business groups had common board members with financial institutions (Rodríguez-Satizabal, 2021).

3. The Banking Crisis of the 1980s

Two factors coincided in the early 1980s to reduce economic growth. First, the price of coffee fell 63% in real terms between 1977 and 1981 (Figure 1, above). Second, international interest rates increased in response to U.S. monetary policy and the debt defaults of other Latin American countries (Caballero-Argáez, 2019). GDP growth in 1982 was a meager 1% —much

lower than the 8% growth that the Colombian economy experienced in 1977. Low economic growth took a toll on the ability of companies and households to serve their debts. Multiple banks faced financial difficulties. Return on assets for the banking system fell from 1% in 1980 to -5% in 1985 (Figure 1, above).

A banking crisis exploded in 1982 when the government took control of Banco Nacional and forced its liquidation based on insolvency.[10] The same year, the government bailed out and nationalized Banco del Estado.[11] Four more banks, including the largest, were bailed out and nationalized in 1986 and 1987 (Table 1).[12] By the end of the crisis in 1987, the government had nationalized 29% of the assets of the banking system in 1980 (Table 1, column 7).

Table 1. Banks liquidated or bailed out during the crisis

Bank	Year of intervention	ROA in previous year	Share of non-performing loans in previous year	Share of assets denominated in foreign exchange (1980)	Share of liabilities denominated in foreign exchange (1980)	Market share of assets (1980)
Nacional*	1982	0%	3%	16%	18%	2%
Estado*	1982	1%	5%	9%	10%	3%
Colombia	1986	-35%	68%	13%	19%	16%
Trabajadores	1986	-16%	44%	11%	12%	1%
Tequendama**	1986	-41%	34%	40%	45%	1%
Comercio	1987	-7%	18%	4%	8%	8%

*Banco Nacional and Banco del Estado incurred in accounting fraud, overreporting earnings and underreporting non-performing loans, as we discuss below.

Source: Own calculations from balance sheets.

Bank failure was driven by non-performing loans (Table 1, column 4). Non-performing loans were higher than 18% of total loans for four out of the six banks that failed during the crisis. The two remaining banks underreported their non-performing loans, as we will discuss below. Currency mismatch among failing banks was only important for Banco de Colombia, for which

[10] Resolution 3259 of 1981

[11] Executive resolution 203 of 1982. See also: Banco del Estado, A Salvo Nacionalización (1995, October 14). *El Tiempo*.

[12] The nationalization process after 1985 was known as officialization. We explain the differences between pre-1985 nationalizations and post-1985 officializations below.

liabilities in foreign exchange were 45% larger than assets in foreign exchange (Table 1, ratio of columns 5 and 6). We discuss the case of Banco de Colombia below. Exposure to government debt was not an issue for private banks at the time: every private bank in the Colombian market had less than 0.8% of their assets consisting of non-performing public debt in 1985.

Non-performing loans resulted from practices that transferred assets and profits out of local banks for the benefit of their controlling shareholders – tunneling, as defined by Johnson, La Porta, Lopez-de-Silanes and Shleifer (2000). Before the crisis, banking regulations preventing tunneling were lax (Gallón, 1986). The prevailing banking law, enacted in 1923, only provided administrative sanctions and fines if banks incurred risky practices.[13] The mild sanctions and lack of enforcement meant that some banks broke the law, for example, by lending a single debtor more than 25% of the bank's equity.

In response to early signs of the banking crisis, the government implemented new prudential regulations. In 1981, the government capped loans to shareholders to 10% of the bank´s equity, prohibited loans to shareholders controlling more than 10% of the bank, and banned the use of the public's deposits to acquire companies.[14] In 1982, the government substantially increased penalties, including jailtime, for breaching regulations to related lending.[15] In 1982, the government also enacted a procedure to nationalize banks in distress by injecting equity until the current shareholders' stake was diluted.[16] After 1985, a new nationalization process, named *officialization*, was enacted. Under *officialization*, share prices were first reduced to their nominal value —one cent if the bank's losses were greater than shareholders' equity.[17] This additional step guaranteed that shareholders lost their stake in the bank and did not benefit from the banks' recapitalization by the government.

By then, however, local banks had already tunneled resources from depositors to the banks' owners and board members. It was common for domestic banks to make large loans to their top officials or owners —a practice known as *self-loans* (Villegas, 1990, p. 24). Such loans were

[13] Law 45, 1923
[14] Decree 3604 of 1981.
[15] Decree 2920 of 1982, chapter 3.
[16] The nationalization process involved the government's takeover of the bank's administration and the suspension of dividend payments. In addition to dilluting the existing shareholders' stakes, the government was allowed to buy the bank from existing shareholders before injecting equity. Decree 2920 of 1982, chapter 2.
[17] Law 117 of 1985, articles 6 and 7. Decreto 32 de 1986.

often used to acquire companies, including the banks themselves. Yet another practice was to invest in ventures that generated foreseeable losses to the bank but profits for other companies in the same business group (Villegas, 1990, p. 24). Banks also used fake transactions and accounting fraud to fulfill regulatory requirements (Superintendencia Bancaria, 1987, pág. 28). In what follows, we discuss the case of each bank that was liquidated or nationalized during the crisis.

Banco de Colombia

Colombia's largest bank, *Banco de Colombia*, was owned by *Grupo Grancolombiano*, a business group controlling 168 companies, including five financial institutions (Comisión Nacional de Valores, 1986). The bank's loan portfolio was concentrated on companies belonging to the same conglomerate (Comisión Nacional de Valores, 1986). In fact, by 1984, 22% of overdue loans were concentrated in 17 companies of the same group (Palacios, 1985).[18] It was common for loans to fund company acquisitions, including the acquisition of shares of the bank itself by companies of the same business group. The group avoided regulatory constraints by interlocking ownership among dozens of companies, many created for the sole purpose of blurring property relations from the point of view of regulators (Comisión Nacional de Valores, 1986).

In addition, the bank used its Panama subsidiary to borrow foreign exchange to bailout investment funds managed by its business group in Colombia (Caballero-Argaez, 1988). This practice eluded foreign exchange regulations, which only allowed foreign debt for the primary purpose of funding foreign trade (Avella & Caballero-Argáez, 1986, p. 7). The subsidiary of Banco de Colombia in Panama had larger losses than the subsidiaries of other Colombian banks when international conditions deteriorated and the Colombian peso depreciated (Caballero-Argaez, 1988).

In 1983, the regulator forcefully changed the bank's management team because the bank was bailing out companies of its own business group (Comisión Nacional de Valores, 1986, p. 205). By 1985, 41% of the bank's assets were non-performing (Comisión Nacional de Valores, 1986, p. 218). In 1986, the government bailed out and nationalized the bank.

[18] An additional 29% of overdue loans were concentrated in 33 companies not belonging to the group.

The president and main shareholder of the bank was sentenced to jail in the 1990s, despite his strong ties with political power (Donadío, 1984, págs. 20, 65).[19]

Banco Nacional

The first bank to fail, *Banco Nacional*, was owned by *Grupo Colombia* since 1978 (Donadio, 1983, pág. 46). *Grupo Colombia* controlled 60 financial and industrial firms (Donadio, 1983, pág. 18). Three firms were at the core of the group: *Banco Nacional*, a bank, *Financiera Furatena*, a financial company, and *Correa Acevedo*, a company that had no legal permission to accept deposits from the public —but did anyways. Thousands of depositors believed that they were depositing their money at *Financiera Furatena*, but their funds got funneled towards *Correa Acevedo* instead (Donadio, 1983, pág. 19). Given that *Correa Acevedo* had no legal permission to accept deposits, *Correa Acevedo* was not under the supervision of financial regulators. Hence, it took time for financial regulators to uncover *Correa Acevedo's* scheme of using depositors' money for company's acquisitions (Donadio, 1983, pág. 19). It was in 1981 when the high concentration of loans from *Banco Nacional* to *Correa Acevedo* alerted officials to audit the latter (Donadio, 1983, pág. 20).

Between 1978 and 1982, *Banco Nacional* concentrated its loan portfolio on the owners and companies of Grupo Colombia (Donadio, 1983, págs. 39-64). In turn, the companies made loans to their owners and their families, who used the loans to acquire other companies (Donadio, 1983, pág. 50). In some cases, the owners pledged assets that did not exist as collateral for the loans received (Donadio, 1983, pág. 35). It was complicated for financial regulators to discover these transactions because the loans were often made in the name of other people. Sometimes, the debtors were unaware of the loans taken in their name –an example of identity fraud (Donadio, 1983, pág. 33).

Banco Nacional faced financial difficulties when, in 1981, the companies and owners of *Grupo Colombia* started to default on their debts. Nevertheless, the bank continued lending money to the same companies and owners (Donadio, 1983, pág. 56). When the fraud at *Financiera*

[19] *51 meses de carcel a Michelsen* (1990, September 27). *El Tiempo*.
Ayer, segunda condena en contra de Michelsen Uribe (1992, September 9). El Tiempo

Furatena was discovered in June 1982, the public initiated a bank run on *Banco Nacional* (Donadio, 1983, pág. 39). The bank run forced the liquidation of the bank in the same year. The president of Banco Nacional was eventually sentenced to six years in jail for accounting fraud.[20]

Banco del Estado

A regional bank founded in 1884, Banco del Estado was private since 1958 (Castrillón Arboleda, 1983, págs. 15, 45). A coalition of shareholders, led by Jaime Mosquera, owned 40% of the bank by 1976 (Castrillón Arboleda, 1983, pág. 56). Mosquera became president of the bank in 1978 after the bank launched a public offering of new shares. Mosquera used a loan from the bank to buy 74% of the new shares, which gave him full control of the bank (Castrillón Arboleda, 1983, págs. 61-63; Donadio, 1983, pág. 70)[21]. Next, Mosquera founded 25 companies that took large loans with the bank (Castrillón Arboleda, 1983, pág. 65). In August 1982, journalists discovered that the loan for the public offering had been obtained through identity fraud (Donadio, 1983, pp. 65-79). This discovery induced a bank run that forced the bail-out and nationalization of the bank in October 1982.[22] Jaime Mosquera was sentenced to jail in 1996.[23]

Jaime Mosquera likely learned his modus operandi while working for Unibank, a Panamanian bank owned by World Finance Corporation, an American financial group. He was president of Unibank between 1973 and 1977. Unibank acquired 20% of Banco del Estado in 1973, a stake that Unibank sold to Mosquera in 1977 (Donadio, 1983, p. 83). Later in 1977, the Panamanian banking commissioner took control of Unibank in response to large financial losses.[24] Unibank borrowed from investors and other banks in the U.S. and the United Arab Emirates and made loans in South America. However, the loan repayments never entered Unibank's books but were laundered into bank accounts of World Finance Corporation, its companies, and its

[20] Condena por crisis financiera de 1982 (1996, June 20). *El Tiempo*.
[21] The transaction was part of a public offering of new shares
[22] Executive resolution 203 of 1982.
[23] Condena por crisis financiera de 1982 (1996, June 20). *El Tiempo*.
[24] First National Finds Venture in Panama Less than Success. (1978, January 15). *The Courier-Journal.*

owner.[25] World Finance Corporation was liquidated after a federal investigation revealed these irregularities in 1978.[26]

Banco de los Trabajadores

Founded by labor unions and cooperatives in 1974, *Banco de los Trabajadores* was eventually acquired by the Cali Cartel.[27] The leader of the Cali Cartel, Gilberto Rodríguez Orejuela, owned 67% of the bank and was part of its board of directors by 1980.[28] In addition to the bank, the Cali Cartel owned multiple financial companies in Colombia, a distributor of automotive parts, a chain of drugstores, a radio network, an educational institution, a football team, and a bank in Panama.[29] The bank in Panama, used to launder money from narcotics sales, was seized by the Panamanian Banking Commission in 1985.[30] In 1980, Rodríguez Orejuela sold *Banco de los Trabajadores* to a real estate developer, government contractor, and politician (Rodríguez Olarte, 2013). Rodríguez and the new owner used the bank to make large loans to their companies.[31] As these loans were prohibited by the late 1980s and the bank was becoming insolvent, the government bailed out and nationalized the bank in 1986.[32]

Banco Tequendama

Founded by Colombian and Venezuelan investors in 1976, *Banco Tequendama* was part of a financial group specialized in insurance services.[33] Multiple companies of the group were in financial difficulties throughout the 1980s (Superintendencia Bancaria, 1987, pág. 106 and 111;

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[25] Arab Sheiks sue Exile over 37 million. (1978, March 8). *The Miami Herald.*
Fortune Built on paper, Telex. (1980, May 11). *The Miami Herald.*
U.S. Readies Indictment on Bank Scam Charges. (1980, May 11). *The Miami Herald.*
[26] Ibid
[27] Por $ 3.225 Millones Se Vendió Bantrabajadores. (1991, August 31). *El Tiempo.*
[28] Nexos de 'narco' y un rector. (2008, January 22). *El Espectador.*
Banco de los Trabajadores. Annual Report. 1980.
[29] El Diario Oculto de Alberto Giraldo. (1995, June 4). *El Espectador.*
Nexos de 'narco' y un rector. (2008, January 22). *El Espectador.*
Así influyó el cartel del Cali de los Rodríguez Orejuela en el fútbol colombiano (2022, June 1). *El Espectador.*
[30] El Rodríguez Modelo 83. (2008, January 22). *Semana*
Colombians' bank seized by Panama. (1985, March 13) *The Miami Herald*
U.S. Freezes Colombian Bank's Accounts. (1985, April 5) *The Miami Herald*
[31] Por $ 3.225 Millones Se Vendió Bantrabajadores. (1991, August 31). *El Tiempo.*
[32] A Subasta, El Banco de los Trabajadores. (1991, June 5). *El Tiempo.*
[33] Recupérase el hemisferio. (1976, May 30). *El Miami Herald.*

Uribe Escobar, 2012, pág. 74). The bank used fake transactions disguised as construction repairs to bailout other companies of the group.[34]

In addition, the bank's board was interlocked with a different business group that produced textiles, auto parts, and automobiles.[35] The group experienced financial difficulties throughout the 1980s, which weakened the bank because its loan portfolio was heavily concentrated into the group (Superintendencia Bancaria, 1987, p. 88).[36]

By 1985, 34% of the bank's loan portfolio was non-performing, so the bank regulator ordered an increase in stockholder equity (Superintendencia Bancaria, 1987, p. 86). The stockholders did not comply (Superintendencia Bancaria, 1987, p. 86). As a result, the government nationalized and bailed out the bank in 1986 (Superintendencia Bancaria, 1987, p. 86). By that year, 88% of the loan portfolio was non-performing, out of which 71% was not backed by collaterals (Superintendencia Bancaria, 1987, pág. 88). After nationalizing the bank, the Colombian government found that "the Venezuelan branches were sacked; there were no ledgers nor promissory notes".[37]

Banco del Comercio

Founded in 1948 by the National Merchants Guild, the bank remained fully in Colombian hands until 1967, when Chase acquired a 35% stake (Granados, 2019). Another 37% belonged to companies controlled by board members of the bank (Donadio, 1983, págs. 124-125; Ordoñez, 1989, págs. 24-26). The bank had been making loans to board members and their companies since, at least, 1979.[38] In 1982, such loans amounted to 300% of equity, had subsidized rates,

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[34] Banks Dubious Deals Deter Outsiders; Corruption Makes 16 Banks Tecnically Bust (1984, August 31). *LatinNews.*

[35] Banco Tequendama. Annual Reports, 1980 and 1982.

[36] Colombia: Fiat sale may have hidden component (1982, August 27). *LatinNews.*
Los bancos aceptan el reto japonés (1986, June 15). Semana
¿Solución Salomónica? (1986, July 27). Semana
No a los Kassin (1987, July 13). Semana
Superintendencia de Sociedades (2012, pág. 26)

[37] Statement by the chair of FOGAFIN during a debate in the House of Representatives, August 10-30, 1988 Cited by Child and Arango (1988, pág. 267).

[38] Statement by the chair of FOGAFIN during a debate in the House of Representatives, August 17, 1988. Cited by Ordoñez (1989, págs. 27, 99)

and often were not backed by adequate collaterals.[39] Furthermore, the bank used accounting tricks to overestimate its income from non-performing loans.[40] In addition, the bank overreported the quality of its loan portfolio (Superintendencia Bancaria, 1987, p. 85).

In 1982, a Chase employee denounced that the loan portfolio of Banco del Comercio was concentrated on its own shareholders and board members, including the Chase representative on the board.[41] The same employee also revealed that some loans were approved in exchange for bribes.[42] Furthermore, he revealed that the Chase representative on the board: (i) made a proposal to over-report expenses and split the difference with the employee (Donadio, 1983, págs. 128-129), and (ii) tried to bribe him in exchange for not reporting his findings to the headquarters of Chase in New York.[43] The whistleblower, a Chase employee since 1974, was fired, and Chase did not change its representative on the board.[44] A Colombian congressman later denounced that the family of the Chase representative owned stakes in companies that in turn owned Banco del Comercio shares and received loans from Banco del Comercio (Ordoñez, 1989, págs. 25-26). The Chase representative became the president of Banco del Comercio in 1984.[45] The regulator eventually fined the Chase representative for approving larger and riskier loans than regulations allowed.[46]

By 1986, 18% of the loan portfolio of the bank was non-performing (Superintendencia Bancaria, 1987, p. 85). In 1987, the government proposed a relief program in which the government would purchase toxic assets from the bank through a repurchase agreement expiring five years later.[47] This relief program was not proposed to other banks with financial problems during the crisis. A plausible explanation for this special treatment is that a shareholder and former board member had a high position within the Colombian government. Pressure from the press and the Colombian congress prevented the relief program from being implemented. The bank regulator ordered an increase in stockholder equity, to which the

[39] Report to the superintendent of banks by an employee of the Superintendency of Banks, November 24, 1982. Transcribed in Ordoñez (1989, pág. 45).
[40] Statement by the chair of FOGAFIN during a debate in the House of Representatives, August 17, 1988. Cited by Ordoñez (1989, pág. 94)
[41] Autopréstamos en Banco del Comercio revela publicación en EE.UU. (1982, October 4). *El Tiempo.*
[42] Ibid
[43] Ibid
[44] Ibid
[45] Annual Report, 1984
[46] Multados exdirectivos del Bancomercio (1989, September 22). *El Espectador*. Reproduced by Ordoñez (1989, págs. 154-155)
[47] Editorial (1987, June 8). *El Tiempo.* Cited by Ordoñez (1989, pág. 14)

shareholders did not comply (Superintendencia Bancaria, 1987, p. 85). In consequence, the government bailed-out and nationalized the bank in 1987.

There are multiple regularities among the banks that failed during the crisis. First, all banks failed due to unperforming loans to their shareholders and boardmembers, or their companies and family members. Second, shareholders and boardmembers used fraud to obtain such loans or hide them from regulators and minority shareholders. Third, the banks were part of local business groups with concentrated ownership. Fourth, three out of the six banks had strong links with political power that plausibly explain delays in government intervention and attempts at bailouts from which shareholders would have benefitted.

4. Relative performance of foreign-owned and local banks

This section shows that foreign-owned banks performed better on average than local banks during the crisis. We study multiple explanations for this result, including differences in bank size, market niche, access to capital, currency mismatches, technology adoption, ex-ante probability of a bail-out, loan portfolio concentration, and non-performing loans.

4.1. Foreign-owned banks in Colombia

Foreign banks set up local subsidiaries in Colombia during the early twentieth century, when a boom in coffee exports increased the demand for credit by coffee growers and distributors. Before the arrival of foreign-owned banks, coffee growers obtained loans from trading houses that served as intermediaries with foreign banks.

We define a bank as foreign if its headquarters were located abroad and foreign entities owned more than 50% of the bank in 1975, when foreign ownership in Colombian banks was capped at 49%, as we will explain in section 4.3. That year, there were 7 foreign-owned banks in

Colombia (*Table 2*). Foreign-owned banks accounted for 7% of assets, 8% of equity, 7% of loans, 8% of deposits, and 4% of branches in the bank system.[48]

Table 2. Foreign-owned banks in the Colombian market, 1975

Bank	Share of assets in 1975 (%)	Number of branches in 1976	Year of arrival
First National City Bank	2.7	32	1916
Banco Francés e Italiano	1.3	21	1920
Banque Nationale de Paris[49]	1.0	9	1955
Banco de Londres y Montreal	0.5	19	1922
Bank of America	0.5	6	1968
The Royal Bank of Canada	0.4	9	1920
Real	0.2	1	1975

Sources: assets: balance sheets; branches: DANE (1981, pág. 193); arrival: Granados (2019a) and Bonin (2005, pág. 197).

Foreign investors had a minority stake in two additional banks. Banco del Comercio had Colombian origins and majority shareholders, so we do not include it in the set of foreign-owned banks but in a separate category. Banco Tequendama, founded in 1976, was owned by Colombian and Venezuelan investors -with a 52% stake owned by the Colombians.[50] Since the headquarters and nine out of ten branches of the bank were in Colombia, we include Banco Tequendama as a domestic bank.[51]

Foreign-owned banks focused on the corporate market, both local and foreign. *City Bank*, for instance, described its market segment as follows: "Multinational and local corporations that need sophisticated banking services, both international and local".[52] The share of assets and

[48] Own calculations from balance sheets. In turn, banks accounted for 85% of the assets of the financial sector in 1975 (Ocampo J. A., 2015)

[49] Opened as a branch than later became a subsidiary of Banque nationale pour le commerce et l'industrie (Bonin, 2005, pág. 197)

[50] Recupérase el hemisferio. (1976, May 30). *El Miami Herald.* Venezuelan participation remained the same in 1980 (CEPAL, 1986).

[51] Banco Tequendama, Annual Report, 1979.

[52] Banco Internacional, Annual Report, 1980.

liabilities denominated in foreign exchange was similar in the aggregate for foreign and local banks in 1980 (*Table 3*). In fact, some foreign-owned banks were involved in consumer banking as well. For example, the Royal Bank of Canada had a branch in *Corabastos*, the largest wholesale market for perishable food in Bogotá.[53]

Table 3. Share of assets and liabilities denominated in foreign exchange in 1980

Bank	Assets (%)	Liabilities (%)
First National City Bank	4	4
Banco Francés e Italiano	22	25
Banque Nationale de Paris[54]	21	24
Banco de Londres y Montreal	14	18
Bank of America	23	33
The Royal Bank of Canada	11	8
Real	16	15
Total foreign-owned banks	16	18
Total local private banks	14	16
Total private sector	14	16

Source: Own calculations from balance sheets.

4.2. The Colombianization of foreign-owned banks

This section presents the historical, political, and regulatory context that prevented foreign-owned banks from accessing foreign capital during the financial crisis of the 1980s. Thus, access to foreign capital is not an explanation for the relatively good performance of foreign-owned banks that we will demonstrate in section 4.3.

Colombia adopted a market-friendly approach to foreign investment until 1967, when the liberal government tightened its management of the exchange rate through multiple controls: a crawling peg system, mandatory report of investment inflows to the central bank, mandatory

[53] Banco Royal Colombiano, half-yearly report, December 1980.
[54] Opened as a branci and later subsidiary of Banque nationale pour le commerce et l'industrie (Bonin, 2005, pág. 197)

intermediation of investment inflows and dividend outflows by the central bank, and the need of government permission to invest in Colombia from overseas[55]. These restrictions applied to most economic sectors. In the case of the banking sector, new investments had to be authorized by three institutions: the central bank's monetary board, the banking regulator, and the National Planning Department.

The liberal government of the time developed guidelines for decisions on foreign investment requests.[56] The guidelines generally favored investments in which a Colombian partner would retain a majority stake in the venture. In the specific case of the financial sector, the guidelines recommended the rejection of (i) share acquisitions without increases in equity, (ii) share acquisitions that implied the foreign control of Colombian banks (e.g., buyouts), and (iii) the creation of new banks that created "unfair competition" to Colombian banks. The guidelines also prohibited the foreign capitalization of foreign-owned banks already operating in Colombia. For example, in 1969, the government rejected the entry of the First National City Bank of Chicago and a capital injection at the Royal Bank of Canada. [57]

The guidelines were coherent with the Colombian government's efforts to join Andean countries in a common investment regime. The resulting agreement was enacted in 1970 by representatives of Colombia, Venezuela, Chile, Ecuador, Peru, and Bolivia.[58] In principle, the agreement imposed tight restrictions on foreign-owned banks: it prohibited new foreign investment in the banking sector and the collection of new deposits by incumbent foreign-owned banks. Furthermore, the agreement ordered foreign-owned banks to sell 80% of their stock to investors from the Andean countries. [59] Still, the agreement allowed national governments to exempt sectors from the common regime.[60]

With the agreement enacted in 1970, a new, conservative government came to power. The new government exempted the financial sector from the Andean common investment regime and

[55] Decree 444 of 1967
[56] DNP (1969)
[57] DNP (1969)
[58] Decisión 24 de la Junta del Acuerdo de Cartagena, Acuerdo Subregional de Integración Andina, 1970.
[59] Article 42. Decisión 24 de la Junta del Acuerdo de Cartagena, Acuerdo Subregional de Integración Andina, 1970.
[60] Article 44. Decisión 24 de la Junta del Acuerdo de Cartagena, Acuerdo Subregional de Integración Andina, 1970.

allowed foreign investment in the financial sector to increase between 1972 and 1974 to a peak of USD 22 million in the latter year (Boyce & Lombard, 1976, p. 32).

Policy swung back towards nationalism with the election of a liberal government in 1974. The government intended to "recover the autonomy of [Colombia´s] financial sector and to reduce the interference of foreign-owned banks in the productive sector of the Colombian economy" (Botero, 1981, p. 316)[61]. In 1975, the government reenacted the Andean common investment regime for the financial sector. In addition, it created a commission to negotiate with foreign-owned banks their transformation into 'national companies'.[62] This commission included the Finance minister, the chief of the National Planning Department, the governor of the central bank, the superintendent of banks, the president of the National Banking Association, and the president of the National Association of Financial Institutions.

The government's intent was not to nationalize banking, but to ensure that Colombian nationals were in control of the banks (Asociación Nacional de Instituciones Financieras, 1976, p. 71). The government leveraged its bargaining power on the licenses that foreign-owned banks needed to operate in Colombia. The president informed banks that "the government had no intention to extend these licenses but instead offered the opportunity to continue operations in Colombia under a new structure: that of mixed companies with national investors in which the assets of the subsidiary were passed over for a value not in excess of 49% of the total capital, or through the transformation of the subsidiary into a Colombian open company in which, by some future date, at least 51% of the capital should belong to Colombian investors by subscription" (Asociación Nacional de Instituciones Financieras, 1976, pp. xvi-xvii).

The intent to transform foreign-owned banks into national companies induced diverse reactions from bankers. While foreign bankers were concerned about the economic consequences of such a decision, national bankers were worried about the potential retaliation by foreign authorities

[61] Botero Montoya was the Minister of Finance that defended the restrictions to foreign investment in Congress. For minister Botero, there was a risk that foreign banks could control the means of production through their loans to companies in the real sector. Another justification for this policy was to equalize capital requirements for foreign and local banks. Capital requirements for foreign banks were lower because liabiities of the subsidiaries with their headquarters were not taken into account in the calculation of the liabilities/capital relationship imposed by the Colombian regulation. Madriñán, Ramón Eduardo, "Informe del Superintendente Bancario al señor Ministro de Hacienda sobre la Colombianización de la Banca", January 31, 1976. Transcribed in ANIF (1976, p. 365)

[62] Decree 295 of June 1975.

regarding their interests overseas. Bankers were also concerned about the high financial leverage required by national investors to acquire foreigners' shares, the risk of deepening ownership concentration among a small number of Colombian economic groups, and the possibility that the new policy was the government's first steps in a strategy to nationalize the banking sector (Boyce & Lombard, 1976, pp. 34-47).

Negotiations concluded when six out of the seven foreign-owned banks agreed to transform themselves into mixed companies where Colombian shareholders would own at least 51% of each bank by June 30, 1978 (Asociación Nacional de Instituciones Financieras, 1976, p. xvi). The only bank that did not reach an agreement was the First National City Bank of New York. Instead, the bank offered to close its subsidiary and establish an agency in Colombia, a proposal that the government rejected (Asociación Nacional de Instituciones Financieras, 1976, p. xviii).

In response, the government presented a bill to Congress to force City Bank to reach the property threshold. Congress approved Law 55 in December 1975. [63,64] Law 55 compelled foreign-owned banks, insurance companies, and all other financial intermediaries to transform into mixed companies -i.e., 51% of Colombian ownership- by December 31, 1976. This transformation from foreign to mixed banks was known as the *Colombianization* of banks.

Colombianization occurred through the sale of stocks from foreign banks to Colombian nationals. Crucially, the stocks were not sold to other banks nor financial groups. Rather, the banks were sold to individuals and companies linked to the real sector (Herrera, 1983, pp. 139-143). In fact, foreign banks remained the largest shareholders, even though their stake was lower than 49% (Herrera, 1983, pp. 139-143).

Under the terms of Law 55, existing foreign-owned banks became the following banks: *Banco Internacional de Colombia* (formerly City Bank of New York); *Banco Royal Colombiano*

[63] While there was no open confrontation in Congress regarding the passage of Law 55, conservative lawmakers left a formal note discussing the convenience of the government proposal and the validity of the arguments presented by the government. Moreover, they complained that the government did not consider their opinion, nor tried to convinced them of the benefits of the initiative. The liberal government relied on its majority in Congress. "*Constancia de Senadores Conservadores*". Transcribed in ANIF (1976, pp.123-124).

[64] The two bank associations, ASOBANCARIA and ANIF, had different positions regarding Law 55, but neither of them radically opposed to the initiative. ASOBANCARIA noted that additional comments were redundant because foreign banks had already accepted the government proposal. ANIF supported the government`s action on merely political grounds.

(formerly Royal Bank of Canada); *Banco Sudameris Colombia* (formerly Banco Francés e Italiano); *Banco Franco Colombiano* (formerly Banque Nationale de Paris); *Banco Colombo Americano* (formerly Bank of America); *Banco Anglo Colombiano* (formerly Banco de Londres y Montreal); and *Banco Real de Colombia* (formerly Banco Real de Brasil).[65] In 1978, Banque Nationale de Paris transferred their stock in *Banco Franco Colombiano* to a Venezuelan bank, *Banco Provincial*, which Credit Lyonnais partially owned.[66]

In addition, Law 55 forbade any new foreign investment in the financial sector. Hence, the ex-ante probability of a bailout from headquarters during a financial crisis was plausibly low. Indeed, once the crisis of the 1980s started, banks that performed poorly such as *Banco Colombo Americano* and *Banco Real de Colombia* did not receive capital injections from their foreign headquarters.

4.3. Statistical results

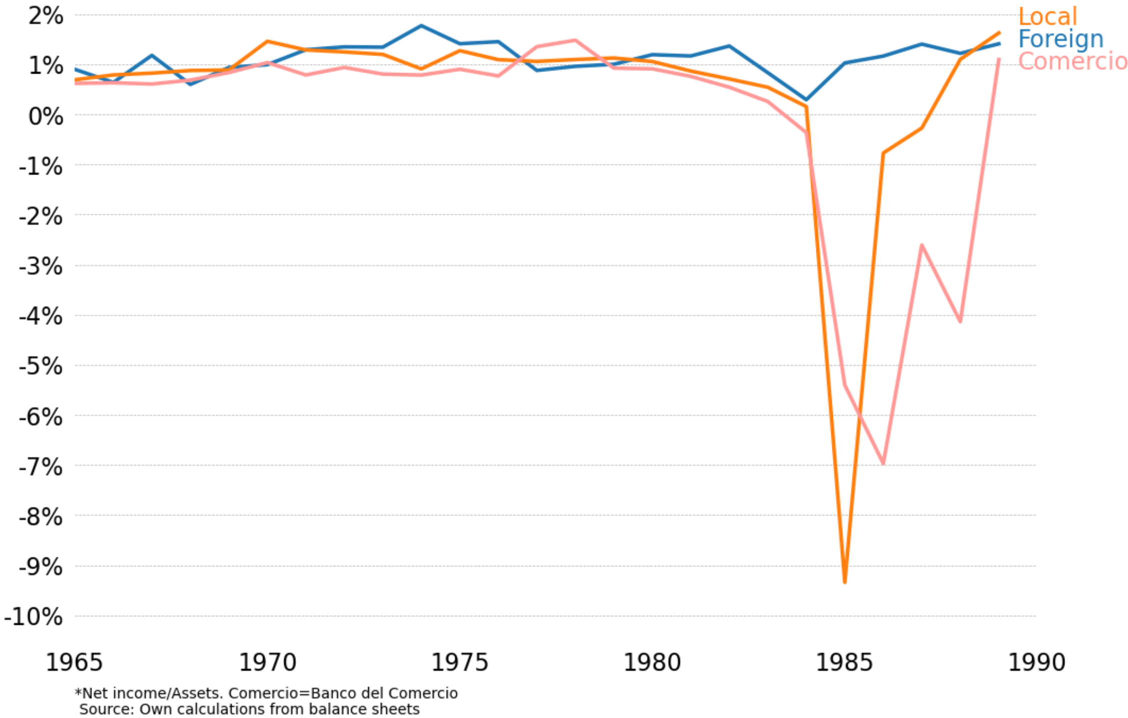
No foreign-owned bank was liquidated or nationalized during the crisis, i.e. between 1982 and 1987. In this section, we provide further evidence of the better performance of foreign-owned banks, relative to local private banks, during the crisis. *Figure 2* shows the return on assets ratio (ROA) of foreign and local banks, with *Banco del Comercio* as a separate category. Before the crisis, in 1980, the return on assets was near 1% for all bank categories. In the middle of the crisis, in 1985, the return on assets was 1% for foreign-owned banks, -5% for *Banco del Comercio*, and -10% for local banks. As a share of equity, returns were 13% for foreign-owned banks, -57% for *Banco del Comercio*, and -125% for local banks in 1985. In other words, losses were larger than equity for *Banco del Comercio* and local private banks.

We use a difference in difference strategy at the bank level to better quantify the differential performance of foreign-owned banks during the crisis. A standard assumption of the difference-in-difference approach is that the difference in performance between local private and foreign-owned banks would have remained constant had the crisis not occurred - the parallel trends' assumption. While this assumption is always impossible to test formally, *Figure 2* suggests that

[65] Banco del Comercio, in which Chase Manhattan Bank owned 35% its capital, was not transformed since it was already operating as a mixed company.
[66] Half-Yearly Report, Banco Mercantil, December 1979. Also Plessis (1994, pág. 215)

the assumption holds: pre-existing trends do not explain the gap between local private banks and foreign-owned banks during the crisis.

Figure 2. Return on Assets by Bank Type



For our estimation, we use an event study specification at the bank-year level:

$$ROA_{it} = \eta_i + \gamma_t + \sum_{t \neq 1980} \beta_t Local_i \times \gamma_t + u_{it} \qquad (1)$$

where ROA_{it} is the return on assets bank i in year t, η_i is a fixed effect by bank, γ_t is a fixed effect by year, and $Local_i$ takes the value of 1 if the bank is local and zero if the bank was foreign before the *Colombianization* of banks in 1975. In our robustness tests, we also include *Banco del Comercio* as a separate category. The base category of our estimation consists of foreign-owned banks. Our base year is 1980 because the system's ROA began to decrease in 1981 (Figures *1* and *2*). Our difference in difference coefficient is β_t: the difference in performance between local banks and foreign-owned banks in that year, relative to their difference before the crisis.

Figure 3 shows our difference in difference estimates (β_t). On average, the ROA fell 8 percentage points more for local banks than for foreign-owned banks in 1985. Figures 2 and 3 show that the crisis had the largest impact on balance sheets in 1985, once the Colombian government increased regulation and supervision, forcing banks to write off loans that had been non-performing since the start of the crisis. Figures 2 and 3 also show that the crisis did not have apparent effects on net incomes in 1981 and 1982. This result is surprising because of the liquidation of *Banco Nacional* in 1982, the nationalization of *Banco del Estado* in 1982, and the seizure of *Banco de Colombia* in 1983. Indeed, all three banks reported profits in 1981, the year previous to the liquidation of *Banco Nacional* and the bailout of *Banco del Estado*, whereas *Banco de Colombia* reported profits in 1982 and 1983. The lack of effects in 1981, 1982, and 1983 in Figure 3 is further evidence of the accounting tricks and fake transactions that plagued the balance sheets of failing banks before the government interventions and regulatory changes in 1982 and 1983. For the remainder of this section, we focus on 1985.

Figure 3. Difference in Difference estimates. Return on Assets

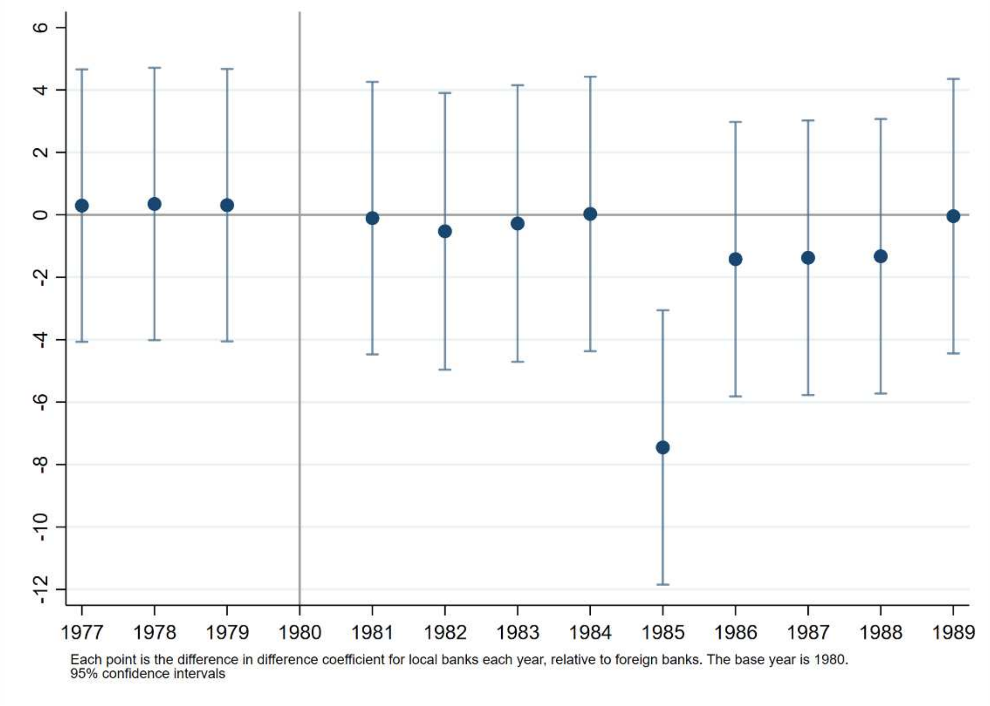


Table 4 presents robustness checks for the results in Figure 3. While we include separate coefficients for every year between 1981 and 1989 in the estimation, the table only shows the coefficients for 1985. Column 1 uses the same specification as Figure 3, but pooling 1977 – 1980 as a single pre-treatment period. The interaction of *Local bank* and *d1985* shows that the ROA fell 7.7 percentage points more for local than for foreign-owned banks in 1985. The coefficient of *d1985* is small and statistically non-significant, suggesting that the crisis focused on local banks.

The results still hold when including *Banco del Comercio* as a separate category (Column 2). Column 3 uses market share in 1980, as measured by assets, to control for the smaller size of foreign-owned banks. The differential effect of the crisis is smaller after controlling for bank size, it is still large and statistically significant: on average, the ROA fell 5.6 percentage points more for local relative to foreign-owned banks in 1985. Hence, the better performance of foreign-owned banks is not explained by the smaller size of foreign-owned banks or the more differentiated niches in which foreign-owned banks might have operated in the years before the crisis.

Table 4. Difference in difference estimation on return on assets.

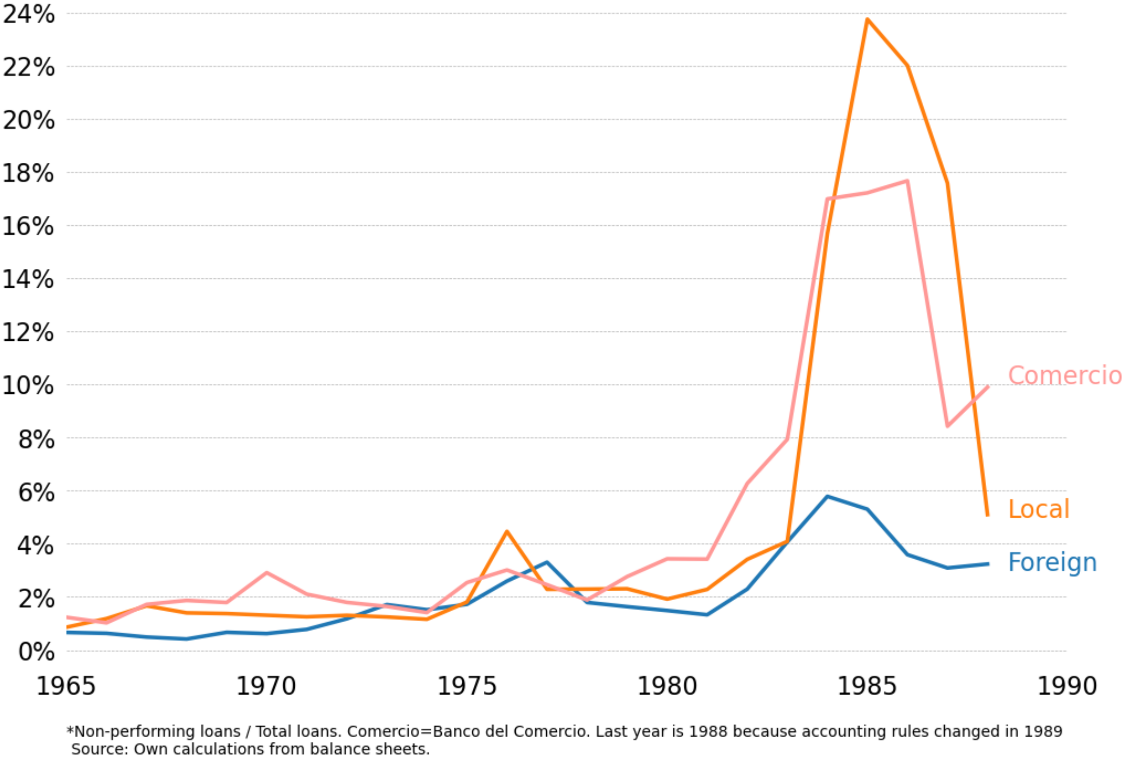
	(1)	(2)	(3)
Local bank x d1985	-7.69***	-7.69***	-5.55***
	(1.75)	(1.74)	(1.86)
d1985	-0.73	-0.73	-0.03
	(1.41)	(1.40)	(1.41)
BanComercio x d1985		-5.84	-1.25
		(3.96)	(4.21)
Assets Share in 1980 x d1985			-0.65***
			(0.21)
Fixed effects by bank	Yes	Yes	Yes
Fixed effects by year*	Yes	Yes	Yes
Fixed effects by year* x Local bank	Yes	Yes	Yes
R^2	0.37	0.39	0.42
N	263	276	276

Notes: Standard errors in parentheses. *Binary variables for each year between 1981 and 1989. The base category are foreign banks between 1977 and 1980.

4.4. Explaining Heterogeneous Performance

The difference in performance between foreign-owned and local banks was driven by non-performing loans. Figure 4 shows the share of non-performing loans by bank category. In 1985, the share of non-performing loans was 5% for foreign-owned banks and 24% for local banks.

Figure 4. Share of non-performing loans



Nonperforming loans at failing banks resulted from related lending, loan concentration, accounting fraud, identity fraud, and conflicts of interest, as we described in section 3. All these practices occurred at local banks—regulators, judges, and journalists did not report similar practices among banks that were foreign-owned up to 1975 and *Colombianized* since.

We do not claim that foreign-owned banks are intrinsically virtuous relative to local banks. Indeed, the practices of Mosquera at Banco del Estado were likely a replica of similar practices in World Finance Corporation, where Mosquera had worked in the 1970s. World Finance Corporation tunneled resources from depositors and investors in the United States, the United

Arab Emirates, Costa Rica, Guatemala, El Salvador, and Panamá.[67] Had it not been for the intervention of American and Panamanian authorities in 1977 and 1978, it is likely that World Finance Corporation would have tunneled resources from Colombian depositors as well. The intervention of authorities forced Mosquera to act on his own. Furthermore, the headquarters of foreign banks overlent to Latin American governments during the 1970s, partially because they expected their home governments or the IMF to bailout their borrowers in the event of a macroeconomic crisis (Devlin, 1989; Altamura & Zendejas, 2020).

We propose three reasons for the lack of tunneling among foreign-owned banks in Colombia, relative to local banks. First, foreign banks had transferred practices and technologies to their Colombian subsidiaries. These practices and technologies prevented loan concentration and non-performing loans. For example, *Banco Internacional* still used the Citibank's credit handbooks in 1981, six years after *Colombianization* and one year before the banking crisis began.[68] This is consistent with the literature's finding that foreign banks use design contracts and score credits to overcome their lack of familiarity with local institutions and firms (Dell 'Ariccia, Friedman, & Marquez, 1999; Stein, 2002; Sengupta, 2007; Beck, Ioannidou, & Schäfer, 2018).

In fact, the subsidiaries continued to receive advice, training, and technologies from their headquarters, even after the *Colombianization* of 1975. For example, *Banco Mercantil* had a cooperation agreement with *Credit Lyonnais* that included "advise on banking techniques" and a program to "change the management of information systems within the bank".[69] One motivation for the agreement was that "*Credit Lyonnais* has designed technologies that allow for greater efficiency in the provision of banking and financial services".[70] The cooperation agreement was in place since 1979, four years after *Colombianization* and three years before the start of the banking crisis.

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[67] Arab Sheiks sue Exile over 37 million. (1978, March 8). *The Miami Herald.*
Fortune Built on paper, Telex. (1980, May 11). *The Miami Herald.*

[68] Private conversation with Bernardo Noreña, who started working at Banco Internacional in 1981 and later became president of the same bank.

[69] Half-Yearly Report, Banco Mercantil, December 1979
Half-Yearly Report, Banco Mercantil, December 1980

[70] Half-Yearly Report, Banco Mercantil, December 1979

The case of *Banco del Comercio* further supports the effectiveness of imported governance practices at preventing non-performing loans, as Chase was a minority shareholder. By the time Chase acquired its stake, the bank had been a local private bank for 19 years. Hence, Chase had to adapt to existing governance practices from the power position of a minority shareholder. For example, when a whistleblower denounced the loan concentration and corruption at *Banco del Comercio* in a U.S. court, the judge claimed that lending money to members of the board "might be something that Chase has to accept given the customs and practices [of Colombia] and the needs of making business overseas".[71] Unlike the rogue trader at the Lugano Branch of Lloyds bank in 1974 studied by Schenk (2017), the Chase representative in *Banco del Comercio* was not an isolated case within *Banco del Comercio*; rather, he was colluding with the Colombian members of the board.

A second reason for the relatively successful performance of foreign-owned banks during the crisis relates to their lower gains from tunneling in the Colombian context. Foreign-owned banks were not part of local business groups that could use the public's deposits to fund company acquisitions within Colombia. Instead, ownership was dispersed: because of colombianization, foreign banks remained as the largest shareholders, but had a stake lower than 49% (Herrera, 1983, pp. 139-143). Hence, the largest shareholders had less decision power within foreign-owned banks than within the failed local banks.

Furthermore, due to capital controls, it would have been difficult to transfer the public's savings out of the country to acquire foreign companies. A similar mechanism explains the good performance of local housing-focused banking institutions during the crisis.[72] Due to their regulations, these institutions could only make loans for building, developing, or acquiring housing.[73] Hence, they could not tunnel the resources of the public toward company acquisitions or sister companies not related to the construction sector. Therefore, these institutions performed much better than other financial institutions, including banks, during the crisis. In 1985, the share of non-performing loans for housing-focused institutions was lower than at the start of the crisis and 20 percentage points lower than for banks (Lora & Salazar, 1995).

[71] Autopréstamos en Banco del Comercio revela publicación en EE.UU. (1982, October 4). *El Tiempo*.
[72] In Spanish: Corporaciones de Ahorro y Vivienda
[73] Decree 678 of 1972

Third, foreign-owned banks were ex-ante less likely than local banks to receive a bailout in case of financial difficulties. Board members of local banks had strong links with politicians and regulators. These links might have been perceived as leverage for bailouts in case of financial difficulties. In fact, the government attempted to bailout *Banco del Comercio* in 1987 by acquiring non-performing assets of the bank[74]. When this bailout attempt failed, the government nationalized and capitalized the bank as it had done with the other banks. In contrast, foreign-owned banks had fewer political contacts and could not receive additional capital from their foreign owners, given the restrictions in place since 1975. The lower likelihood of a bailout might have worked as a hard constraint that induced responsible behavior on the part of the foreign-owned banks.

Differences in market niches do not account for the large differences in the share of non-performing loans between foreign-owned banks and the failed banks. Non-performing loans in the latter resulted from concentrated lending to owners and board members, not from lending to the general public. Furthermore, the differences in returns between foreign-owned and local banks during the crisis, which we showed in Table 4, are robust to the inclusion of market share as a control variable.

5. Epilogue

In 1985, Congress created FOGAFIN, an institution in charge of providing deposit insurance and administering the banks that the government had nationalized.[75] Four of the five banks that had been nationalized throughout the 1980s were privatized during the 1990s: Banco de los Trabajadores and Banco Tequendama were sold to Venezuelan banks, whereas Banco del Comercio and Banco de Colombia were sold to Colombian financial groups (Ocampo J. A., 2015, pág. 124). Banco del Estado was merged to another public bank that was later sold to a Colombian financial group in 2006.[76] Multiple bankers that supervised tunneling operations during the crisis of the 1980s ended in jail, convicted of fraud charges.[77]

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[75] Law 117 of 1985
[76] Final del Banestado (2000, June 30). *El Tiempo.*
Davivienda adquirió el Bancafé por 2 billones 207 mil millones de pesos (2006, October 11). *El Tiempo.*
[77] 51 meses de carcel a Michelsen (1990, September 27). El Tiempo.
Ayer, segunda condena en contra de Michelsen Uribe (1992, September 9). El Tiempo
Condena por crisis financiera de 1982 (1996, June 20). El Tiempo.

In 1986, the entering new government presented a bill that would allow foreign investment into a bank if the bank was insolvent, was in extreme need of additional equity, or was being privatized. The need to capitalize local banks was taking precedence over the nationalistic concerns that motivated the restrictions on foreign investment in the mid-seventies. The law, however, was not approved by Congress.

In 1987 the Andean Commission established a new regime for treating foreign capitals in the Andean region. The new ruling gave back to country members their autonomy and competence to legislate on foreign investment. Nevertheless, the restrictions to foreign investment in Law 55 of 1975 were still in force.

In 1988, the government proposed a new bill in Congress to allow foreign investment in the financial sector. By then, there was a political consensus on the need to abolish Law 55 of 1975 in order "to stimulate the competitiveness of the financial sector and to increase the solvency and the size of credit companies" (Superintendencia Bancaria, 1989, pág. xiii). This project became Law 74 of 1989, which sought to attract and regulate foreign investment from international financial companies of good reputation. Nevertheless, new foreign investment in banks was still capped at 40% of the sum of equity and convertible bonds of the bank.[78]

This restriction was finally dropped in 1990 when a new government and congress approved Law 9 of 1991. This new law prohibited "discriminatory treatments against foreigners" and dropped controls on foreign exchange flows that had been in place since 1967. Moreover, CONPES' Resolution 40 of 1990 "authorized foreigners to invest in Colombian banks without any limit and dropped the restrictions that had forced foreign investors to share ownership of the banks with national investors" (Hommes, Montenegro, & Roda, 1994, pp. 56 and 65-66).

Five out of the seven colombianized banks were reacquired by their former foreign owners (Barajas, Steiner, & Salazar, 2000). Other foreign banks entered the Colombian market throughout the 1990s and 2000s (Barajas, Steiner, & Salazar, 2000). Foreign ownership increased operative efficiency and competition in the banking sector during the financial

[78] Law 74 of 1989, Article 5.

liberalization period that bridged the crises of 1985 and 1999 (Barajas, Steiner, & Salazar, 2000).

Law 9 of 1991 ended the cycle initiated in 1967 when restrictions on foreign investment were put in place. Since 1982, when the banking crisis broke out, authorities had intended to open the financial sector to foreign investment again. The approval of Law 9 of 1991 effectively killed the idea of *Colombianizing* foreign-owned banks.

6. Conclusions

This paper studies the role of insider lending, loan concentration, and accounting fraud in the Colombian banking crisis of the 1980s. These practices allowed bank owners to tunnel resources from depositors, minority stakeholders, and eventually taxpayers. The effect of tunneling on bank performance was not salient while interest rates were low. When international interest rates rose and the price of coffee fell in the early 1980s, however, the effects of tunneling became evident: one bank was liquidated, and five banks were bailed-out and nationalized by the government. By the end of the crisis, the government owned most of the banking system, as measured by assets.

A common denominator among failed banks was power concentration and links with political power. Power concentration enabled tunneling. Links with political power delayed government intervention and increased the ex-ante probability of a bail-out. We highlight these factors by using foreign-owned banks as a comparison group. None of these foreign-owned banks was bailed-out or liquidated during the crisis. Furthermore, the share of non-performing loans was 18 percentage points lower among foreign-owned banks than among local banks during the crisis. In consequence, the ROA during the crisis was 8 percentage points higher for foreign-owned banks than for local banks, even though their performance was similar before the crisis.

Foreign-owned banks performed better than local banks for three reasons: First, they imported technologies and practices that prevented nonperforming loans. Second, they were not part of local business groups with concentrated ownership. Instead, ownership was shared between foreign banks and the local real sector. Power-sharing, together with controls to foreign exchange flows, hindered tunneling. Third, ex-ante, foreign-owned banks were less likely to receive a bailout.

Central to the banking crisis was the lax regulation on tunneling and related lending that applied in Colombia before the 1980s. Lax regulation still occurs in important financial markets of the 21st century, like cryptocurrency exchanges. Our results suggest the need for microprudential regulations that prevent accounting fraud, loan concentration, and the abuse of insider lending. These regulations are particularly important in preventing and alleviating banking crises.

Our results also suggest that the restrictions to foreign investment enacted in 1975 were detrimental to the Colombian banking system for two reasons: (i) they stalled the introduction of institutional practices that were successful during the crisis ahead and (ii) they obstructed the capitalization of the system after the crisis. In a context of lax regulations to tunneling and strong links between business groups, politicians, and regulators, the presence of foreign-owned banks in the local market has the potential to reduce systemic risk.

7. References

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