

Crisis in the financial systems: a view from Ecuador

Crisis en los sistemas financieros: una mirada desde el Ecuador

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ABSTRACT

The objective of this article is to analyze the role of the financial system in Ecuador based on different scientific theories that support the capitalization of financial institutions through the internal control evaluation process and the Basel III regulatory framework. The methodological approach responds to an exhaustive literature review and systematization of the main theories on the financial crisis considering the chronological sequence of events and processes of change over time from different events, sectors of society and variables. As a result, we obtained the contextualization of the financial system and the elements that affect them, recognizing the antecedents, contemporaneity, causes and consequences of the crisis. Concluding that the destabilization of the financial sector is a product of the impact of financial crises,

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recognizing the importance of financial control processes in aspects of efficiency and profitability to mitigate serious economic consequences, hence the importance of considering the principles of the Basel III regulations promulgated by the Basel Committee on Banking Supervision to update the internal control processes, its governing regulations and its impact on the financial entity, enabling them to develop new strategies of financial intermediation.

Keywords: Financial Crisis, Financial Institutions, Financial System, Ecuador

RESUMEN

El objetivo del presente artículo es analizar el rol del sistema financiero en el Ecuador a partir de diferentes teorías científicas que sustentan la capitalización de las entidades financieras mediante el proceso de evaluación de control interno y marco regulatorio de Basilea III. El abordaje metodológico responde a una exhaustiva revisión de la literatura y sistematización de las principales teorías sobre la crisis financiera considerando la secuencia cronológica de los sucesos y procesos de cambio en el transcurso del tiempo a partir de diferentes eventos, sectores de la sociedad y variables. Obteniendo como resultado la contextualización del sistema financiero y los elementos que inciden en ellas, reconociendo los antecedentes, contemporaneidad, causas y consecuencias de la crisis. Concluyendo que la desestabilización de sector financiero es producto del impacto de las crisis financieras, reconociendo la importancia de los procesos de control financiero en aspectos de eficiencia y rentabilidad para mitigar graves consecuencias económicas, de ahí, la importancia de considerar los principios de la normativa de Basilea III promulgados por Comité de Supervisión Bancaria de Basilea para actualizar los procesos de control interno, su normativa regente y su impacto en la entidad financiera, posibilitándolas para desarrollar nuevas estrategias de intermediación financiera.

Palabras clave: Crisis Financiera, Entidades Financieras, Sistema Financiero, Ecuador

INTRODUCTION

Throughout history, various problems and serious consequences can be seen in the economic sphere that converge in financial crises in several countries worldwide due to precarious financial control processes. In Mexico the "Tequila Effect" of 1994, in Thailand "The Dragon Effect" of 1997, in Russia the "Vodka Effect" of 1998, in Brazil the "Samba Effect" of 1998, in Argentina the "Tango Effect" of 2001 and the "Corrida Bancaria" of 2002 in Uruguay (Acuña, 2011; León-Manríquez, 2015; López, 2006; Sotelo, 2009), are some examples that denote how fundamental it is to evaluate the impact of the financial

crisis at the global level in terms of efficiency and profitability in the financial sector (Erfani & Vasigh, 2018).

By virtue of this, access to other markets facilitated by economic globalization forces financial institutions to forecast macro and microeconomic behavior of the economy in order to react to problems that could lead to losses (Martínez, Rivas, Martínez, & Treviño, 2015) that could cause distrust in the financial sector (Priscila, Guevara, & Cortez, 2019).

In the Ecuadorian context, in the banking crisis of 1999, a 5-day suspension of the Ecuadorian financial system was announced, where the President of the Republic of Ecuador, Jamil Mahuad, by means of Decree No. 685, froze for one year the deposits in checking accounts with more than 2 million sucres and savings accounts with more than 5 million sucres. 685 freezes for one year the deposits in current accounts with more than 2 million sucres and savings accounts with more than 5 million sucres and, announces on January 9, 1999 the dollarization of the Ecuadorian economy anchoring the price of foreign currency to fluctuations between 25 thousand and 35 thousand sucres, measures that contributed to precaution the withdrawal of deposits, the international monetary reserve, the increase in prices and the instability of the exchange market (Romero, 2017).

However, the problems of fiscal, monetary, financial management and the deficient management of the Deposit Guarantee Agency make it difficult for customers to recover the deposited values (Camacho, Ciclio, & Erráez, 2015), being the biggest banking crisis in Ecuador (1988-1999), which currently still evidences repercussions due to incongruent credit and investment policies implemented without adequate financial maturity, which at the time contributed to the loss of \$8.6 billion and the closure of more than 26 financial institutions due to liquidity problems.

In this context, the actions of the Basel Committee on Banking Supervision, which, by updating internal control processes, seeks solutions to the crisis by promoting the strengthening of the financial system in terms of risk management, capital requirements, liquidity regulations, adjustments in the reaction capacity and good supervisory practices of the control body (Caruana, 2010). Thus, in order to guarantee the financial stability of the economy, it is necessary an adequate capitalization of the banking entities (Ikapel, Namusonge, & Sakwa, 2020), vigilant of the fulfillment of objectives of effectiveness, efficiency, reliable financial information and compliance with laws by all the members of the institution (Blanco, 2015).

Therefore, the objective of this article is to analyze the role of the financial system in Ecuador distinguishing its fundamental role in the Ecuadorian economy, considering that its financial stability in the face of a possible economic crisis will depend on strengthening

methodologies, internal control regulations and the various operational processes with efficiency, efficacy and effectiveness in accordance with Basel III regulations in order to regain confidence in the country's financial sector.

MATERIALS AND METHODS

Crisis in financial systems: a view from Ecuador, is a descriptive review study with a qualitative approach. It is based on a systematic literature review of articles extracted from journals indexed in scientific databases recognized by the epistemic community, with advances in the analysis of the main theories on the financial crisis considering the chronological sequence of events and processes of change over time based on different events, sectors of society, concepts or variables.

The search criteria were based on the descriptors of the Ecuadorian financial system crisis according to its changing behavior resulting from social events and phenomena. Ninety-five articles and literature reviews were analyzed, 34 have been selected for the relevance and pertinence of the contents to the subject of study. The relevance of the literature review aims to take stock of the existing information on the topic and establishes what others have written on the subject, revealing the scope of the research on the crisis faced by Ecuador and the impact on its financial system.

RESULTS

Contextualization of the crisis in the Ecuadorian financial system

The banking crisis of 1998 and 1999 exacerbated by the dollarization of the Ecuadorian economy brought monetary losses and the closure of 26 financial institutions due to liquidity problems (Romero, 2017), in addition, even today the different strategies and payment commitments unfulfilled by the control entities have caused nonconformity of their creditors with a direct affection to their quality of life.

Thus, the management of problems referred by the operational processes of financial institutions in Ecuador is key, and the Basel Committee on Banking Supervision is the answer to the control of the financial system (Mínguez, 2011).

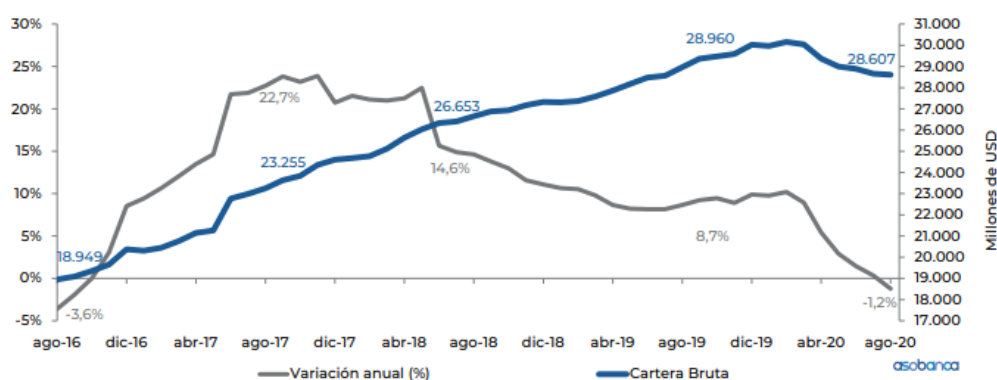
Currently in Ecuador there are 63 financial institutions registered, 25 corresponding to Private Banking, 7 to Public Banking and 31 Savings and Credit Cooperatives of Segment I (Superintendencia de Economía Popular y Solidaria, 2019), all of them regulated by Art. 308 of Title IV Development Regime that determine financial activities as public services authorized by the state with the purpose of preserving deposits by intermediating them efficiently to strengthen national productivity, social consumption being environmentally responsible, observing the financing needs oriented to meet our development objectives (Constitution of the Republic of Ecuador, 2008).

In addition, with respect to the financial situation of the Central Government, income between \$1,200 and \$2,000 million U.S. dollars and outflows of \$3.200 million between 2018 and 2019 revealing a deficit in the financial situation (Central Bank of Ecuador,

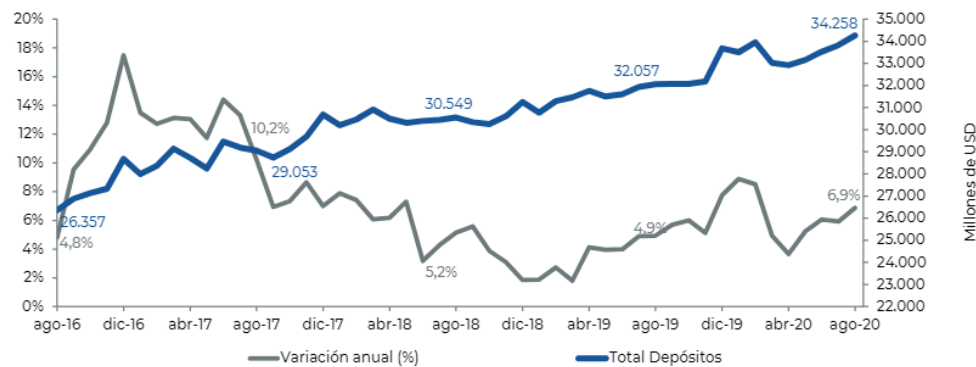
2020), recognizing that different events have affected the financial system conformed by the Banking and Savings and Credit Cooperatives motivating considerable changes in the economy of Ecuador, it is from the year 2015 with the Organic Monetary and Financial Code the Financial Institutions (IFIs) must develop new strategies to consolidate the activities of financial intermediation (National Assembly of Ecuador, 2014).

The Association of Private Banks of Ecuador (2020) maintains that by the end of 2019, the non-performing loan portfolio of the Private Banking and the Savings and Credit Cooperative sector in terms of placements maintain a tendency to grow, and the Central Bank of Ecuador (2020) asserts that the deposits component in Private Banking remains around \$8 million, in time deposits and government bonds between \$15,000 and \$19,000 million and due to labor issues and price variation, the savings and credit sector tends to decline.

On the other hand, the total balance of the gross portfolio decreased by 0.2% monthly, reaching \$28,607 million at the end of August 2020, but grew by 1.2% annually (see Graph 1). Deposits grew by 1.3% compared to the previous month and by 6.9% compared to the same month of the previous year, with a closing balance of \$34,258 million at the end of August 2020 (see Graph 2).



Graph 1: Gross portfolio at the end of August 2020. Source: (Asociación De Bancos Del Ecuador, 2020).



Graph 2: Bank deposits at the end of August 2020. Source: (Asociación De Bancos Del Ecuador, 2020).

Financial phenomena affecting Ecuador's economic development

The banking crisis resulting from mismanagement and poor execution and control of financial activities is considered one of the main financial phenomena that generated serious consequences in the political, economic and social sphere (Cubero, 2009), costs assumed by the state for the closure of several financial institutions generating greater losses due to the lack of ethics, efficiency and effectiveness in their administration, making it impossible for the Ecuadorian people to recover their funds (Corredor, 2015), efficiency and effectiveness in their administration making it impossible for the Ecuadorian people to recover their funds (Corredor, 2015), consequently it can be asserted that the lack of control by regulatory agencies is one of the main factors of the crisis in financial institutions and creditors.

Supported by a historical review, we can explore what happened in Banco El Progreso, where the liberal administration of the deposits of the non-financial public sector triggered an over liquidity concentrated in some banks of the country, considering that due to the crisis of Banco El Progreso, the financial sector was more profitable and even speculated with the US currency to obtain short-term exchange gains of 10% to 20%.

Likewise, Filanbanco, considered as the first bank in the country, presented liquidity and solvency problems, where the government of the day started with the bailout to mitigate a systematic bankruptcy, the same situation was faced by Banco de Prestamos, Tungurahua and Finagro, actions by the National Government that lead to increase financial repression, affecting its financial stability, efficiency and effectiveness, limiting the development and soundness of the banking sector (Igan et al., 2019; Romero, 2017).

On the other hand, when trying to qualify what was executed by the Deposit Guarantee Agency, it can be argued that its work was extensive and even overlapped with the Central Bank and the Superintendency of Banks, exceeding the regulations of the General Law of Financial System Institutions.

However, banking crises weaken the internal control processes (Laeven & Valencia, 2018) carried out by the boards of directors of the entities minimizing the achievement

of objectives framed in the effectiveness and efficiency of operations, reliability of financial information and compliance with legal regulations (Blanco, 2015).

DISCUSSION

Internal control seeks to ensure the assets of the organization by maintaining reliable records with an effective administration (Estupiñan, 2015), in effect, the internal control processes of the financial sector are related to management activities and operations that seek to meet the objectives set out in the internal and governmental policies with efficiency, effectiveness, effectiveness in order to improve the quality of service of the financial system, which is why the need to anticipate and ensure security against events such as banking crises weaken the control processes of the regulatory bodies is demonstrated.

Therefore, it is key to identify and manage the financial institution's operational problems. In response to the global financial crisis, the Basel Committee on Banking Supervision, based on the principles of the Basel III regulatory framework, requires financial institutions to integrate operational risk control into their activities in order to achieve a resilient banking system, hence, the Committee of sponsoring organizations or COSO report applies a systemic approach to identify, measure and monitor risks to define actions to be executed oriented to mitigate the risks of financial institutions, such internal control methodologies are considered non-traditional by having as a basis good business risk practices and active monitoring (Mantilla, 2018).

CONCLUSIONS

From evaluating the impact of the financial crisis that managed to destabilize the financial sector, the importance of the control processes that the financial system deserves in terms of efficiency and profitability in order to mitigate the serious economic consequences that could develop in the country becomes evident. In the case of Ecuador, the banking crisis and non-compliance with regulations resulted in monetary losses and 26 financial institutions closed due to liquidity problems.

Hence the importance of considering the principles of the Basel III regulations promulgated by the Basel Committee on Banking Supervision to integrate in its activities the risk measurement of segments such as systems, processes, human resources, internal and external fraud, policies and regulations. Specifically, the Basel III regulatory framework makes it possible to update internal control processes that are currently insufficient, their governing regulations and their impact on the financial institution, enabling them to develop new financial intermediation strategies.

Therefore, it is necessary for financial institutions to work under ethical and moral principles, concerned about the optimal functioning of their activities and the control of their management oriented to be efficient and effective, complying with international regulations and those of the country's governing bodies in order to avoid corruption in the Ecuadorian financial system.

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