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*Maria Laura Patino L*

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I. Introduction

This article is divided into three main sections. The first section deals with general background that surrounded the financial crisis in Ecuador in 1999. The second section concentrates on specific characteristics that weaken state capability to deal with

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a financial crisis. The third focuses on specific legal and institutional arrangements that underpinned the financial regulatory and supervisory bodies and governmental intervention.\textsuperscript{1} The crisis background provides a good context to discuss ongoing concerns regarding good governance in an emergent country and its efficient regulation and supervision of its financial system.

A. Political Background

Ecuador's recent history is characterized by political, economical, and social distress. It comprises several presidential replacements (four since February 1997), significant economic mismanagement, El Niño damage to key export sectors, and a banking system collapse in 1999. Until 1999, Ecuador had not faced a generalized banking crisis since the early twentieth century. The more significant recent case of bank failure was overcome by the seizure of Banco Continental (Continental) by Central Bank of Ecuador (CBE) in 1996, albeit through a controversial subordinated loan. To improve limited existent mechanisms to manage a systemic crisis, a controversial law passed in the Congress in December 1998 created the Deposits Guarantee Agency (DGA) and established an unlimited deposits state guarantee. Although Mahuad, President during 1999, also expressed interest in an International Monetary Fund (IMF) agreement, this was not achieved on time. The major obstacles were political objections to reform and mismanagement of the emerging banking crisis.

The Mahuad government was short-lived. After an obscure intervention in Banco del Progreso (Progreso) in March 1999—a one-year freeze on most bank deposits in an attempt to save the banks and huge national currency depreciation—general discontent and dissatisfaction grew. This exacerbated macroeconomic instability and threatened to trigger hyperinflation in a country victim to inertial inflation reaching the highest levels in Latin America. Since 1998, fourteen banks—accounting for about 65 percent of the system's assets\textsuperscript{2}—had to be seized by the State. This was done via the controversial DGA. In September 1999, Ecuador became the first country to default the Brady deal that restructured recently around U.S. $6 billion of public commercial debt.

As an extreme and desperate measure to control inflation and regain exchange stability, in January 2000, Mahuad announced a Dollarization program (Dollarization), which introduced the dollar as legal tender for the country. This was the basis of an economic program targeted to stabilize the out-of-control exchange rate and obtain the IMF's support that the country needed desperately.

Before this was implemented, a military coup took place on January 21, 2000, forcing the presidential succession by Vice-President Noboa, who immediately announced the continuation of the Dollarization program. In March 2000, the Congress approved what is known as the Trolebus Law, including the Dollarization scheme among other important economic reforms.\textsuperscript{3}

\textsuperscript{1} The legal framework analyzed for this purpose was that applicable in Ecuador as of July 1, 2000.

\textsuperscript{2} See IMF Representative Statement, The Ecuadorian Recovery Program (May 16, 2000).

The effects of this economic and political crisis have been catastrophic. After already poor results during most of the last two decades, real GDP growth for 1999 was a negative 7.3 percent. In June 2000, inflation reached a record 100.3 percent. Private sector credit was reduced by 25 percent in 1999, with an additional 5 percent decrease expected in 2000. Non-performing loans averaged about 42 percent of the total loan portfolio and external credit lines have dropped by more than a half to U.S. $0.8 billion. The estimated fiscal cost of the banking crisis appears to be about U.S. $2.7 billion, 24 percent of GDP in 2000.

B. ECUADOR AND DEVELOPMENT MODELS I AND II

This work will distinguish two trends of economic development. The first, called Development Model I, refers to what, since the late 1940s, the Economic Commission for Latin America and the Caribbean has called the "developmental model." The second, Development Model II, is related to the "Washington Consensus" recommendations from the late 1980s. The last two decades have seen the spread and generalization of Model II for Emerging Economies, focused originally and principally in economic policies. It is implemented in these emerging economies with aid and funding subject to the conditionality of structural adjustment programs first applied after the 1980s debt crisis.

Development Models I and II are characterized theoretically by opposite principles. In the first, the major elements are a state-planned and public-ordered economy that relies on extended public enterprises, pervasive economic regulation, and closed economies with import substitution and industrial protection measures. Development Model II, in contrast, relies on a market-driven and private-ordered economy. It requires privatization of public enterprises and the actual deregulation and liberalization of the economy.

Development Model II relies on market instruments. The market participants need transparent and explicit rules of the game, expressed in different kinds of legal norms and also through customary practices and proper information disclosure. An efficient dispute resolution system is also necessary, not only, but principally, through the judiciary. This creates the stability needed by this system and generates fair and certain precedent. It is precisely this rule of the law that permits generalized confidence in such a market system.

7. See supra note 2.
Many emerging economies are attempting to move from Model I to Model II. This move, however, affects the role of the law in the relationships between individuals and, especially, between individuals and the State. Legislation in Model I was used to weaken the institutions of private property and to endow the State with increased power. Relevant public law (public enterprise laws, foreign investment and currency control regulation, nationalization decrees, price, and financial regulation) were usually extensive, overlapping, and often contradictory, and thus, did not promote a transparent legal system. On the other hand, in Development Model II, the focus is on the private and proper framework for market-driven policies. Primary is a well-defined, inalienable private property rights system and a formal system of contract law. Corporate law and tax regimes are means to attract capital investment. Finally, this Model requires insolvency regimes and bankruptcy rules as part of the framework.¹⁰

Ecuador has, since the early 1980s, been trying actively to adopt Development Model II. It has struggled to implement the stabilization and structural adjustment programs, however, according to its own timetable and specific economic, social, and political characteristics.

C. DEREGULATION IN THE FINANCIAL SYSTEM IN ECUADOR

The transition from Model I to Model II involves the deregulation of the different economic sectors. Deregulation is the mechanism used by the state to retreat from former practices of intervention in private relationships, and from over-regulating transactions that should be controlled by market forces under Development Model II principles. Economic deregulation, however, does not mean the absence of law. Rather, a legal framework for transparent and efficient market transactions is important. This is particularly true for emerging economies where underdeveloped markets are generalized, monopolies and oligopolies concentrate resources and information, and inequalities of wealth distribution do not allow extensive participation from new actors.

The IMF and other multilateral organizations have used conditions precedent to the disbursement of funds to encourage emerging economies to adopt such deregulation programs. Ecuador is no exception. Many of the major elements considered part of the deregulation process in the financial system have been required of Ecuador, including expanded and deepened financial intermediation activities and the development of capital markets. This was to be accomplished by (a) fostering a more efficient and competitive financial system, (b) establishing adequate prudential oversight of financial institutions, (c) encouraging the emergence of new mechanisms to attract medium and long-term savings, as well as developing the infrastructure and financial instruments needed to channel these savings toward private sector investment, and (d) expanding access to financial services, especially for small-scale savers and borrowers. These reform principles were introduced with the enactment of the new Monetary Law in May 1992,¹¹ the

¹⁰. See Davis & Trebilcock supra note 9.
Banking Law in June 1994, and the country's first Securities Law in 1993. The bank supervisor and regulator, Superintendence of Banks (SB), lost many of its discretionary powers. There were no major changes in the insurance and pension funds fields.

Monetary and banking reforms reduced direct government control over basic banking practices, such as the setting of interest rates and the allocation of credit. Central Bank of Ecuador (CBE) discontinued direct allocation of credit. This task was mainly assumed by the financial system. Addressing credit allocation, former Governor De la Torre noted the following: "The central bank is not qualified ... to assess the viability, efficiency and yield of thousands of investment projects. This task should be assumed by the financial system, including the banks and the capital markets ..." Since January 1993, the Monetary Board fully liberalized interest rates. Permits for operations and transactions of banks were widened. Also, early in the 1990s, CBE introduced market instruments as its main tool for controlling prices. This kept the banking system as the major participant for monetary purposes, thus avoiding retail operations. These developments show that Ecuador has proceeded significantly with banking deregulation in a short period of time.

The securities market reform was especially important. For the first time, Ecuadorian law addressed its shallow market. Regulatory responsibility was allocated into a separate entity, the Superintendence of Companies/National Securities Council.

This process has not been a smooth one. The first stage of deregulation was very aggressive, resulting in many arguments and concerns about the impact of deregulation. The state intervention in the financial system under Model I had been responsible for low volumes of saving and capital accumulation, and for stimulating inefficient and unprofitable allocation of investments. This had a corresponding effect on the possibilities for expanding productive capacity. Indeed, since many believed government intervention created uncompetitive banking sectors in many developing and transition countries, financial deregulation was emphasized as a means to correct deviations in

14. About intervention disappearance, see infra Section III.
17. See e.g., Banking Law, supra note 12, at art. 51.
19. However, at the same time of the introduction of the deregulation process in the structural adjustment programs, there was already broad discussion about grounds and possible effects of the deregulation process. See e.g., Adrian Hamilton, The Financial Revolution, Chs. 9–10 (1986). B.
the financial markets and to increase the competition of the banking system. These were the elements upon which the initial legal reform efforts concentrated.

Notwithstanding the general reform process, the recurrence of banking crisis in emergent economies during the last decade is not uncommon, and has been analyzed by scholars around the world, especially in Venezuela and South Asian countries. How effectively banks perform their specific functions depends, in turn, on competition in the banking system and the general state of the macroeconomy. Referring specifically to Ecuador, there were also macroeconomic conditions that have to be taken into account in relation to the crisis. However, this cannot ignore that the "structural weakness of Ecuador's banking sector was exposed by the sharp deterioration of economic conditions in 1998..." As noticed by many analysts, a major reason for Ecuador's current distress is also its weak banks.

Some common conclusions and recommendations are of particular interest when studying the banking crisis in Ecuador, particularly those related to the weak regulatory and supervisory institutions existent in the affected countries and problems regarding credit allocation. Moreover, at the time of the reform, all "countries tried to improve prudential regulation and supervision, but progress in these areas was, in all cases, slower than expected and weaker than needed to ensure the safety and soundness of the financial system." There have been also incompatibilities of the model in the context of improper institutional framework and weaknesses in the political and economic structure of many emergent economies. As Lal and Mynt stated: "The economic forces in the form of the world market demand, capital accumulation, population growth, and technological changes would operate on our underdeveloped economy through the filter of its initial institutional conditions."

Some of these generalized concerns over the financial crisis have been faced by the official sector at a time of new financial architecture discussion. In this context appears what has been called the necessity of a Second Generation Reform, which would include


24. See ECN 99 Mar 20, "Down but not out: Latin America's ills require several cures. For some countries, one may be to adopt the dollar." (761)


27. The term has been adopted from the "Conference on Second Generation Reforms" held by the IMF Institute in Washington, DC, on November 8-9, 1999. See http://www.imf.org/external/pubs/ft/seminar/l999/reforms/.
some of the old, but also many innovative elements, especially those related to a deep institutional and legal framework reform. They are: (a) strengthening governance and the quality of government institutions as an essential prerequisite for the continuation of stability in terms of the macroeconomic and growth policies and strengthening the capacity of Government themselves; (b) enhancing the legal and judiciary systems, since it is difficult to get protection for the poor on an equitable basis without it; (c) overturning the question of financial supervision and control through an appropriate framework in terms of bank supervision, supervision of capital markets, integrity, consistency, and transparency; (d) fighting corruption, as it is something that pervades each of these former areas, there by creating the environment for a virtuous economic circle; and (e) reforming the social framework in a way that deals with people who fall out of the loop.

II. The Weakness of the State and the Rule of Law

Major reform, as previously described, occurred especially in the financial sector. This affected public and private participants in different ways. Multilateral organizations have recognized that these reforms have greatly reoriented the state's role in Latin American and the Caribbean economies and are transforming governance in the region.29 As crises of earlier periods are important in explaining the economic and political relationships that emerged and characterized the next several decades, so responses to this new era of crisis are the basis on which state-economy and state-society relations in many countries will be constructed for the next several decades. Thus, it is important to understand the complex social and political components of the crisis, the quality of governments, and the causes for Ecuador's ineffective implementation of the reform. It should be noted that government, for these purposes, should be understood as State, in the legal sense.

For reform to work, each country must design and implement its own reform considering its political, economic, and social context. It must also implement the reform at its own pace. The new Ecuadorian banking law, however, was modeled on Chilean law. This was a law introduced at the final stages of Chile's deep banking crisis; a crisis that required massive use of public resources. Thus, the Chilean law focused on the prevention of crisis and deterrence of public intervention (with public resources). De la Torre noted that, for reform to be effective in Ecuador, it was necessary to rely on some macro- and microeconomic conditions that have not characterized the Ecuadorian environment. In between macro conditions, it was desirable to have not only disciplined monetary and fiscal management, but also protection against exogenous shocks to decrease the


general vulnerability of the banking system. As for micro conditions, first-class supervision and regulation and a transparent disclosure of information was indispensable. He also deemed necessary the existence of a basic institutional framework comprised by an efficient, independent, and trustworthy judiciary to impede the offense of banking laws and frauds.\textsuperscript{30} It is clear that these conditions are absent in Ecuador. They lead to another field of interest: the capabilities of any State to apply such reform and to what extent the arisen weakness is merely the cost of implementing other core elements of the same structural adjustment— the relaxing of state regulation.

The Ecuadorian financial reform process may be perceived as having been imposed from abroad. It was related closely to the conditionality of the multilateral financial institutions (IMF, World Bank, IBD, etc.) established in the arrangements and loan agreements executed by Ecuador during the last decade. This conditionality was applied widely in this context, not only in Ecuador.\textsuperscript{31} These institutions, however, are actually interested in the problems that confront the reform processes and have identified two major areas of concern: (a) an inadequate institutional framework, and (b) the absence of a domestic ownership of reform (in a wider sense).

Usually, the reasons given for this ineffective institutional framework relate to administrative constraints and corruption. The term weakness is preferred to corruption, since it broadens the scope of the analysis, not confining it to the public sector, nor to individual behaviors. Let us assume that the weakness of the state, defined as the inability to implement its policy choices, creates the conditions for the failure of the institutional framework. Here, the problems that confront the public regulatory and supervisory bodies could be interpreted as a lack of institutional, political, technical, and administrative capability to perform effectively and efficiently their duties.

There is a renewed interest in state capacity and the relationship between the state and economy. During the last few months, the official sector referred to recent efforts to overcome poor results of the prior process as second generation reform. It has been noted that "second generation issues focus around the questions of the structure of the right institutions, of the improvement of the administrative, legal, and regulatory functions of the state, addressing the incentives and actions that are required to have private sector development, and to develop the institutional capacity for reforms."\textsuperscript{32} These second generation reforms include financial, judicial, and public sector reform.

This has encouraged scholars to pay greater attention to institutional structures and the way that such institutions affect the course of economic development.

While the private sector correctly assumes a leadership role in the economy, it needs the support of strong state institutions, the rule of law, effective public and private market institutions as well as active political participation of civil society in democratic processes. Good governance is now recognized as a necessary and sometimes missing ingredient in the reform process... \textsuperscript{33}


\textsuperscript{32} Wolfensohn, supra note 28 (emphasis added).

\textsuperscript{33} De la Terre, supra note 30.
There is likely general agreement that the policy choices and implementation of the reform reside not only in its design, but also in the state's ability to enforce it. Thus, how crises are played out in individual countries depends, in large part, on the strength and durability of existing institutions for conflict resolution, the skills and orientations of political leaders, using the expanded space available to them to define new strategies for economic development, and to build new and durable coalitions of political support. The first condition could be described as responsiveness; the second as legitimacy. But both of these conditions have to be applied in an appropriate framework that ensures transparent accountability.

A. Ownership of the Reform

The problem of ownership of the reform may be manifest in two main areas: (a) inadequate adaptation of the legal systems to the requirements of the reform, and (b) insufficient legitimacy of the objectives of the process with an ensuing lack of sociopolitical consensus.

In Ecuador, the adoption of model financial legislation, which does not necessarily reflect the nation's own legal traditions, has not been accompanied by a relevant commercial law reform. This has retained major Napoleonic civil-code traditions with characteristically complicated mechanisms to create security interests, and especially, to transfer them proper assignments duly notified to debtors. There also remains excessive taxation for transferring assets, which considerably affects the efficiency of the financial system as a whole with regard to transparency of information and accurate determination of creditworthiness; accompanied by the overcharging of debtors with non-transparent commissions added to active interest rates. Practical solutions to these legal problems only added, therefore, to the lack of transparency of the financial operations.

In contrast, English law (and in some cases, Anglo-Saxon law) provides a broader spectrum and greater flexibility for these matters. Some examples are: universal corporate floating charges, informal security over investment securities without registration of the pledgee in the books of the issuer, corporate non-possessory chattel mortgages, and self-help enforcement by possessory management through a receiver and private sale, as opposed to a judicially-ordered public action. Rights of substitution, e.g., for collateralized investment securities, in English jurisdictions do not destroy the charge, but may demote it to a floating charge. In Franco-Latin countries, this dominion by the pledgor may destroy the security interest altogether.

The accelerated pace of financial innovation also has forced bankers and practitioners to adopt "innovative" legal instruments to overcome gaps, without analyzing the general implications for the legal system. An important example is the use of the commercial Anglo-Saxon Trust, introduced together with the securities law, which has become rapidly and broadly popular as it provides a more flexible range of securities.

34. See Merilee S. Grindle Challenging the State: Crisis and Innovation in Latin America and Africa 45-46 (1996).
35. Assets remain undervalued for this reason.
36. E.g., undervaluation or extensive use of "trusts."
transfers, securitisation of assets, and avoids the generally inefficient requirement of judicial enforcement. However, this has brought new conflicts related to its enforcement, as judges were not prepared appropriately to accept legal innovation on financial matters, thus increasing legal uncertainty and credit risk. From the point of view of supervisors, legal innovation has also brought new challenges, as the regulatory framework has not been able to comprise all these new legal institutions and forms.

Legal systems (the rules of the game) have to be carefully established, as they are supposed to last for a long period of time. Wood suggests that it is true that some legal systems do undergo great creative shifts and then “settle down to stability, minor adjustments, occasional tinkering, the filling out of the detail.” He considers also that “[s]table change has its advantages: the law is a known quantity and is predictable, it does not overreact to an episode or to a transient political philosophy or to some fad or fashion of the day. There is time for reflection, for a historical consensus to be reached.” (emphasis added). It is precisely the latter that accentuates the requirement of reform “ownership” as a main quality for its ultimate success.

The reform has been blamed permanently as a major cause of fragility of Ecuador’s financial system and the abuses of the bankers. However, for others, “Ecuador is in the process of a meltdown—not because it is fighting a war, but because it has avoided reform” or lacked adequate reform or even, because deregulation has been reversed. But it is not possible to blame the reform itself, nor the lack of it as the main cause of the crisis. First, there are other economic, political and social conditions that affected its implementation. Secondly, it is impossible to have successful economic results by just transplanting the liberalization “recipe” from one country to another to pursue macroeconomic positive results. Lastly, reform requires a proper institutional framework in order to be implemented successfully.


The importance of ensuring efficient governance for implementing economic reform seems to be related directly to the spread of the social beneficial effects of the whole liberalization process, not only in the specific countries, but also in the globalized world. Good governance is related to the roots of conformation of the States and the type of them. The social contract underlying such State conformation has been provided to societies, theoretically, as a means to achieve a general public welfare not attainable outside

38. Trusts in other European France-Latin jurisdictions are still a matter of analysis, whereas in Latin America they are already common.
39. Wood, supra note 37, at 55.
42. Deconstructing Latin Ills: Not All of the Region is in as Bad a Mess at it Seems, THE ECONOMIST, Sept. 4, (1999).
43. A. Pachano, Regular, No Imponer, EL COMERCIO, Nov. 26, 1999.
44. The IMF Institute Conference (supra 28) has produced many interesting papers related to this field. See Wolfensohm, supra note 28.
such a form of organization. Thus, good governance is expected to fulfill this objective, regardless of its political orientation.

The communist and the market-oriented State concepts began to be discussed just at the end of nineteenth century, but the core objective of State conformation has never completely differed from the original. The lack of state capability might also be a cause for failure in the development process itself. However, measuring state capability to meet this objective is difficult. A capable state is one that exhibits the ability to establish and maintain effective functions in four main fields: institutional, political, technical, and administrative.45

When measuring the rule of law, control of corruption, government effectiveness, and quality of the regulatory environment provided by the States, Latin America ranked behind Asia and far behind the most developed countries. Opinion polls show that Latin Americans are dissatisfied with the quality of their governments and think corruption is getting worse. IDB has also noted that inequality in Latin America is the most pronounced of any region in the world, and by most indications, getting worse. “In Latin America, the top twenty percent of the population earns twelve times what the bottom twenty percent make.”46 Often, economic stagnation or decline went hand in hand with widespread questioning of regimes in power and a generalized delegitimization of the state, as an agent of economic growth.47

Ecuador is immersed in a general concern about the region. It has also engaged, during the last few decades, in muddling towards an economic stabilization program and a structural reform process. Continually painful economic measures, together with constant reductions in public money spent on social services and welfare in order to control public deficits, have increased wealth distribution inequalities instead of bringing an improvement in social welfare.48 Deep frustration and dissatisfaction are natural responses to an exhausting program of reform without improvement in social and economic standards. All of this suggests that there is decreased authority and legitimacy of governments to set authoritative standards for individual and group behavior, or increased challenges to the state's policy choices, especially in the economic field.49

There are two main models of State: autonomous and factional.50 A regime or government having objectives of its own determines the autonomous state. The factional state, on the other hand, serves the economic self-interests of the coalition of pressure groups that succeed in capturing it. Ecuador easily could be assessed as a factional state, in which not only powerful economic groups have addressed the policy choices, but also other interest groups (like the public syndicates and, now, the indigenous movement)
that have been allowed to share pieces of it. This is despite ongoing allegations by some coastal sectors, during the periodic regional confrontation, about the maintenance of a centralist model that serves only the capital public officials' interests.\(^{51}\)

Instead of implementing calculated and centered policies with a long-term public welfare vision, the government, during the last two decades, has been forced to shift decisions rapidly and readdress economic programs and policy choices to contain and keep political support and avoid social confrontation.\(^{52}\) With particular reference to the Ecuadorian financial banking crisis, there is the perception by many national and international analysts that a commitment from the former government to the banking sector exists, in order to manage the financial crisis in 1999, without putting overall public welfare over particular economic interests.\(^{53}\)

A factional state could also be considered as a corruption driven state. This is because of the clandestine and undue influence of the economic power over the political power. Structural corruption characterizes factional-states.

Critics of Development Model I concentrated on the ways in which public action can distort markets and create disincentives for productive investment and behavior, as is the case with financial repression. This supported financial liberalization and conformed major grounds for what could be called the minimalist-state role. As a result, the naturally weak institutional framework prevailing in a developing country could have been affected directly and adversely not only because of quantitative reduction, but mainly by a qualitative weakening and even some reversion of state powers. Indeed, deregulation could have been underpinned by a wrongful perception of all developing countries being conformed as autonomous predatory states\(^{54}\) and might not have taken into account the existence of factional states, like Ecuador.

Institutional capacity, or legitimacy, is described as an ability to assert the primacy of national policies over those of other groupings. This is difficult to obtain in a factional-state. Often, economic stagnation or decline went hand in hand with widespread questioning of regimes in power and generalized de-legitimization of the state as an agent of economic growth.\(^{55}\) In Ecuador, continually painful economic measures, together with constant reductions in public money spent on social services and welfare in order to control public deficits, have increased wealth distribution inequalities instead of bringing an improvement in social welfare and economic standards.\(^{56}\) This suggests that there is decreased authority and legitimacy of governments to set authoritative standards for

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51. Indeed an autonomous-depredatory state characteristic, which involves self seeking extraction of the maximum continuing flow of resources for the members of the government and its associates. \(Id.\)

52. \(E.g.,\) several recent drawbacks in gas-price increase.

53. See generally, Chaos, Continued: Ecuador, \(The\ \ Economist,\ \) Mar. 20, 1999; Jamil’s Jam, \(The\ \ Economists\ \) June 19, 1999. See several editorials in Ecuadorian main newspapers from late 1999, \(e.g.,\) by Andrés Vallejo; Leon Roldos; Alberto Acosta; Raul Vallejo; Washington Herrera; Rene Maugé; Oswaldo Hurtado; and Simon Espinosa.

54. \(E.g.,\) Mexico was controlled during almost the entire century by only one political party.

55. Grindle, \(supra\ \ note\ 34,\ \ at\ 2.\)

56. \(See\ e.g.,\ \ Program\ of\ The\ Nations\ United\ for\ Development,\ \ supra\ \ note\ 48,\ \ at\ Ch. 3.\)
individual and group behavior, or increased challenges to the state's policy choices, especially in the economic field.  

Political capacity is considered to be an effective and legitimate channel for societal demand-making and representation. Unable to claim broad-based legitimacy due to the poor results of the reform, or the loyalty of traditional support groups, political regimes demonstrated their inability to dominate and lead civic society as they had done in the past. Government responses to the crisis in Ecuador, such as decreased spending during most of 1999, and especially the freezing of bank deposits, have been undone by popular anger. Moreover, political parties have not given proper support for concrete actions of state leaders and hinder their effectiveness. Indeed, political parties are also distrusted because of the faction-driven perceptions about them.

Most of these demands will be reflected through the production of law. The absence of this political capability also turns into a conflictive, and even contradictory legal system. The law exists in layers of conflicting legislation, reflecting very different conditions and political outlooks and interests of the groups that backed the political representatives in the Congress. It is very difficult for a State to put in place the necessary regulatory and supervisory infrastructure under such conditions. In the end, this disarrayed legal system could also be a cause for the financial crisis in Ecuador, due to the lack of proper instruments and tools for opportune state-intervention.

Technical capacity encompasses the ability to set and manage effective macroeconomic policies, through appropriately placed units for policy analysis, and an important role for technical input and information in decision-making. This is important to policymakers who will have to design and introduce the reform, and technocrats, who will implement and in some cases even administratively enforce it. Technocrats also take care of the "institutional memory" that ensures implementation of long-term projects, without any direct link to a specific regime. This does not mean that technocrats eventually get involved directly in the selection of policy choices; rather, they get involved from a different and concentrated perspective.

Ecuador show increased numbers, visibility, and the influence of economic and financial technocrats mainly during the 1990s. This includes increased presence of international technocrats in national policy-making. During the decade, technical analysis units became more important in national policy making, often to the detriment of cabinets, legislative institutions, party leaders, lobby groups, and traditional ministries such as interior, public works, and foreign affairs.

Grindle also highlighted the surge of an evident tension between technocratic and participatory policy making. In Ecuador, technocrats create a type of "conflict of interest" between officials in the State who promote the factional state, and those who are concentrated in building such a technical capability for the long-term. Notwithstanding such technical capability, however, its technocrats have been isolated from major political decisions with the result that important projects and programs ended, uselessly wasting scarce economic and human resources.

57. The 2000 military coup in Ecuador has followed the announcement of the Dollarization process.
58. Grindle, supra 34, at 35–36.
59. Id. at 7–10.
Moreover, regional confrontation, accentuated during the banking crisis, has also affected the credibility of these technocrats, as their work has been naturally concentrated in and identified with one region, the capital. On the other hand, there are also no proper and accurate channels to feedback design and implementation of technical programs with societal results. This also hinders obtaining the political and social support fundamental for a successful implementation of any technical program.

The administrative capacity is the ability to perform basic administrative functions essential to economic development and social welfare and will be reviewed extensively in Section III.

Summing up, States must be capable if they are to be effective in managing tasks of economic and political development and reform. This is especially true if they are to face the challenges that a factional state causes, and to avoid a constituents economic interest group-driven reform. Without proper development and maintenance of such capacities, the resulting changes in policies, and the introduction of a reformed legal and institutional framework can result in further exacerbation of the natural weaknesses that are common characteristics in developing and emerging States.

C. Allocation of Credit in Ecuador

To produce the maximum benefit for society, credit funds would need to flow to projects offering the highest returns for a given level of risk. Resource allocation efficiency will determine the efficiency of the economy as a whole. Defects in the operation of repressed financial systems hinder this market allocation of resources. State-driven allocation of credit policies benefited mainly restricted sectors of the society, with strong political connections. Post-stabilization financial developments in Latin America did not imply changes in the oligopoly and segmented characteristics of the financial system that restrict credit access to smaller enterprises and producers not related to the banks. The impossibility of introducing any effective competition policies is another outstanding side effect of inefficient allocation of credit with devastating results on the confidence of the participants in the market.

In Ecuador, government intervention in the banking system was characterized during the 1970s and the 1980s by prizing boards, such as the interest rate determination by the Monetary Board, and especially by administrative allocation of credit. In this period, factional-state has driven allocation of credit mainly to sectors that have supported it, rather than to those more efficient for the economy as a whole. De la Torre also noted that there has been a pattern over the management of these resources toward reorienting these policies with regard to the presently particular circumstances.

During the 1970s, the major bulk of the available resources were governmentally driven, not necessarily to the more efficient sectors of the economy. After the debt crisis in the early 1980s, central bank credit became the major source. In the 1990s, specifically after the major monetary reform that broadly restricted access to central bank resources

60. Id.
61. Id.
and conferred central bank independence,\textsuperscript{63} the main source of funding for large economic groups came from the private banking system.\textsuperscript{64} Somehow confirming this, Lasso, the former Ministry of Economy, recently highlighted that Ecuadorian corporations have had higher availability of credit than other more developed Latin American countries. He considered decreases in private corporation leverage levels and equity democratization as a major means to achieve economic reactivation nowadays.\textsuperscript{65}

While examining bank capital standards in Latin America, there are conclusions that the region's high levels of concentration of wealth and thin equity markets make it unlikely that such standards can be enforced effectively. These conditions enable bank owners to dilute their real capital stake by making loans to themselves, either directly, or by borrowing from each other.\textsuperscript{66} Rodrik, in relation to effects of decision-making market discipline in emerging economies asserts: "What goes under the name 'market discipline' is not a neutral political force. It empowers financial markets—both domestic and foreign—over other constituencies in society. Hence it can be seen as serving the needs of particular social groups at the expense of others."\textsuperscript{67}

Over time, the inefficiencies associated with protection to those who supported the factional-state will lower the efficiency of the economy.\textsuperscript{68} De la Torre also observed that if allocation of credit in Ecuador is a function of the public entity that monopolizes the issue of money, rather than the role of a professional banking system supported by market rules, and enhanced by transparent disclosure and efficient supervision, then there is no real market process, but a political process that will breed clientelism.\textsuperscript{69} This could be applied extensively to the issue of state-driven allocation of credit and the supervisor difficulties to control concentration on connected lending over the limits permitted by the law.\textsuperscript{70} There is a vicious circle that structural adjustment and financial liberalization cannot break easily. Rather, as has been explained before, the deregulation of the banking sector and the fast pace of the implementation of the reform has helped to increase the natural weaknesses of developing states, building up or accentuating the incapability to supervise and regulate efficiently. And these conditions, instead of enlarging market participants on the demand side, have restricted them as a consequence of increased poverty during the same period.\textsuperscript{71}

\textsuperscript{63} Despite that central bank independence was only introduced with the Constitution amendment in 1998, in the practice of independence was significantly increased after the 1992 monetary reform.

\textsuperscript{64} See De la Terre, supra note 15.


\textsuperscript{66} Lilianan Rojas-Suarez & Steven R. Weisbrod, \textit{TOWARDS AN EFFECTIVE REGULATORY AND SUPERVISORY FRAMEWORK FOR LATIN AMERICA} (1996).


\textsuperscript{68} DEEPAK LAL, supra note 51, at 269–271.

\textsuperscript{69} De la Torre, supra 15.

\textsuperscript{71} E.g., Continental, Progreso, Filanbanco, Prestamos.

\textsuperscript{71} From forty percent in the 1980s to eighty percent in the 1990s, see PROGRAM OF THE NATIONS UNITED FOR THE DEVELOPMENT, supra note 48.
In the end, state-intervention in the banking system has transplanted the costs of private inefficiencies to the public sector. The banking system overhaul by the DGA depended exclusively on Ministry of Finance funding. At the time liquidity was unavailable, therefore, the resources were provided by the direct discount of public bonds in the Central Bank or, indirectly, by freezing deposits declared in March 1999 after the bank holiday. As highlighted by The Economist, "depositors, who see themselves paying the cost of bankers’ mismanagement and the government’s reluctance to offend political allies by closing some banks that are near to collapse." Furthermore, depositors have also paid inefficiency costs of the private sector and high leverage permitted by a banking system without suitable risk assessment.

One way to overcome this situation is the strengthening of financial regulation, despite strong political and interested interference. The case of external regulation depends on circumstances in which the private sector, left to itself, produces market failure, or at least sub-optimal results. These results are arguably worse than public sector regulation, even with all the biases and failings that such regulation may entail. Without proper regulation in place, interested “pressure” groups will be able to impose their own “rules” over those that should attend to society’s general welfare. Next, financial reform will be forced to confront this allocation of credit reality and the existence of this factional state. Indeed, re-regulation should not be confused with further financial repression, as state-driven policies in a factional-state will not break the vicious circle. Orientation might rest mainly on proper responsiveness of the State, by enhancing its capability as a whole, in order to concentrate efforts on general public interest and to avoid efficiently, such pressures.

Responsiveness also will arise through better assessment over personal, technical, and moral conditions of owners, managers, and directors of banks. This will have to be built under public, transparent, and non-discretionary general rules to be efficient, perhaps through a public registry with an opposition process, if necessary. Indeed such technical and moral assessment should include the regulatory and supervisory officials and personnel.

Without proper regulation, gridlock could be boosted. Gridlock is the moral hazard that occurs when good firms are induced to behave badly because the firms witness bad behavior in others, or have no assurance that competitors will behave well. The problem is enhanced in a competitive market where all the participants, in order to make profits, adopt risky conduct with short-term goals. The major cause for the surge and persistence of gridlock is the supervisors’ inability to enforce regulation. As competitors cannot be sure about general regulatory compliance, they are encouraged to keep risky behavior in order to ensure personal profits.

73. C. Goodhart et al., The Rationale for Regulation in, WHERE, HOW AND WHAT NOW? 4-9 (1998).
74. Ongoing bank secrecy rules deter this.
D. The Judiciary and the Financial System

As a condition for law enforcement, the core of the settlement is comprised of a well-functioning judicial system, providing efficient, rational outcomes and adequate remedies. The absence of efficient enforcement mechanisms in a market-driven State gives rise to legal uncertainty. The extent of judiciary deficiencies and, alternatively, the practical possibility to remedy them will directly bias the amount and extension of these costs.

The Ecuadorian judicial sector has suffered from a lack of financial and technical resources, administrative inefficiencies, and a growing backlog of cases. On the other hand, strong political intervention has transformed many courts and judges into another instrument for managing the formerly described factional state. In addition to systemic bribery, there is also the corruption of personal relations.76 The enforcement of contracts, the enforcement of laws against rule breakers, and the ability to carry on economic functions without recourse to bribery and subornation become increasingly difficult under such conditions.77 Remedies can be incomplete and delayed until they are innocuous.78 Therefore, personal punishment is evaded by prescription.

The judiciary is important for the financial system, but the former has generally resulted in the sector’s inability to meet the requirements of the private and public sector. In the microeconomy, creditors are affected by difficulties in ensuring opportune or fair payment, and application of proper insolvency mechanisms. Moreover, small, weak debtors can be affected adversely by the abuses of their creditors. In the macroeconomy, enforcement of law and regulation in the financial system has been extremely poor. Most, if not all, cases filed during the 1980s by the banking supervisor against financial institutions have been decided for the financial institutions, resulting in damages and compensation being covered by the State and personal risks for public officials.79 The absence of trustworthy judicial review results in hidden costs for the financial system that can be classified in two types: first, purely economic costs that, due to uncertainty, are difficult to calculate. The second type is probably more important but less evident: the moral hazard costs.

Economic costs can be: (a) direct, such as bribery, or even the necessity to access more costly alternative disputes resolution mechanisms, for instance, arbitration or submission to foreign courts, when possible or, (b) indirect, mainly the legal risk taken into account to assess credit risk, very difficult to determine, as uncertain results do not provide objective measurement tools. Indeed, legal risk is increased in the case of powerful and politically influential debtors. These economic costs promote a subjective and non-transparent creditworthiness assessment over debtors. Risk managing has to introduce a subjective judicial risk assessment that can make it inoperative. Without taking into account such risk, capital adequacy requirements might be insufficient to measure the soundness of the financial system, particular institutions, or even particular creditors.

76. World Bank programs and reports regarding Judicial Modernization in Ecuador are major source of information and background.
77. Deepak Lal, supra note 50, at 33.
78. High inflation significantly affects economic remedies.
79. E.g., Financiera de los Andes, Banco Industrial y Comercial and Banco de Descuento, most of them judged during the 1990s.
The private financial institutions transfer these economic costs into the system, whether as a generalized increase in interest rates, or as an unequal transference of losses to society—in the case of a banking failure. On the other hand, these economic costs are a burden difficult to overcome for public supervisors and regulators, in order to ensure efficient defense of the public interest. As rules of public funds use hinder any kind of direct bribery required by courts and judges, public lawyers confront a diminished position with regard to private practitioners. Foreign courts or arbitration, as a more efficient alternative dispute settlement tool, are restricted in the public sector also by institutional weakness and lack of economic and technical resources.

Moral hazard costs refer directly to the behavior of the individuals, firms and public entities in light of the non-existence of efficient enforcement of the rules of the game. Debtors and creditors behaviors in routine financial transactions are less transparent as legal uncertainty and inefficient enforcement of laws significantly encourage a non-payment culture and boost the degree of tolerance in society for corrupt behaviors. This problem is more significant for supervisors and regulators of the system as inefficient and impractical litigation and defense tools have to be added to institutional and political weakness. It is noteworthy that the absence of an agile and trustworthy judiciary system can even boost financial fraud. The shareholders of a nearly collapsed bank, encouraged by perception of little risk for financial frauds to be punished properly, might find fraudulent means to rescue their equity and avoid absorbing losses before depositors and other creditors. Additionally, the gridlock problem formerly described will create the ideal environment for systemic financial fraud.

Ecuador's Continental case provides an empirical example of this "judiciary" moral hazard. A criminal judicial prosecution in Ecuador, opportunely impelled by banking and monetary authorities against former managers and shareholders, shifted into a politically driven trial. Instead of determining the responsibility of private bankers, the judge concentrated into the accuracy of the monetary policy and the existence of cause for the adoption of systemic prevention measures by the regulators. Solorzano, the President of the Supreme Court of Ecuador at the time, considered the accountability of the economic and human resources used by the Central Bank to support the legal procedures filed against former shareholders, rather than the fraudulent actions denounced by the authorities in detailed reports introduced in the discovery. In 1997, imprisonment orders were issued against former Superintendent of Banks' and Central Bank authorities, together with some of the former shareholders and managers of the Bank. Although the imprisonment orders and syndication of the authorities were removed a year later, after a Judiciary reform, there was serious damage to the public confidence in the monetary and banking authorities. A former manager of the bank and external auditors were called for definitive judgment in the criminal procedure in Ecuador, but was restricted to the grounds of public documents and balance sheet forging and double gearing. In this context the General Attorney's role conflicted with the other State officials. Rather

80. Defined as generalized society behavior to pay as little as possible (or not pay), or just to delay compliance of duties. Delay is equivalent in inflationary environment.
82. Continental was seized by Central Bank.
83. Decision does not consider most of CBE observations with regard to fraudulent disposition of assets and mismanagement of liquidity credits granted by Central Bank.
than supporting legal actions against the bankers, he suggested the imprisonment orders for the authorities. Paradoxically, but explainable under the conception of factional, the State prosecuted the State.

The Bahamian jurisdiction was selected by the Central Bank of Ecuador in 1996, as an alternative forum to impel the impartial treatment of part of the financial fraud and to get some economic remedies. The defendants expressly alleged the "laxity" of the authorities and the gridlock problem (other Ecuadorian banks do the same) within their major defense exceptions. Furthermore, the bankers initiated a libel action in the Southern District of Florida alleging defamation and psychological stress caused by Central Bank's public exposure of the case. Resolutions about the criminal case issued by the Supreme Court of Justice in Ecuador, especially the imprisonment orders against the authorities, were an important defensive means, further weakening and affecting the credibility of the regulators. There are no definitive results in any of the cases to date. Indeed the poor results of the more important recent banking case in Ecuador, may have induced the moral hazard and gridlock problem referred to above and generated the precedent for the 1999 banking crisis; as many analysts have observed. Effectively, many of the 1999 failed banks cases have had similar characteristics with this precedent, not only due to poor judiciary treatment, but also because there is a pattern of behavior between the different failed banks. Connected lending, double gearing, poor provisions, utilization of foreign jurisdictions and off-shore banking for fraudulent purposes, conformation of special purpose vehicles, etc. are also common.

The Continental case shows that supervisory laxity is not only a question of a lack of administrative capability, but also a result of political interference, judicial inefficiency, and corruption. Financial regulation is difficult to enforce, even with the willingness of authorities and the existence of appropriate alternative litigation resources. Another problem that arose from judicial deficiencies in the Continental case, is the public officials' extensive legal risk, addressed in next section, that might also affect efficient enforcement of regulation and accountability. However, the more dramatic threat is definitely the gridlock problem with its systemic risk implications. There is nothing as sensitive to public confidence as a financial system. The effects of loss of confidence in a bank have been duly studied in the context of bank runs and systemic risk. Sound banks can fail solely for this reason. Legal uncertainty generated by an inefficient judiciary is a major source of loss in confidence; judicial muddle can have important systemic resonance.

The evaluation of the relevance of the judiciary's problems in the financial crisis is that there is a need to determine the next steps of any judicial reform in Ecuador, in general, and, in particular, with respect to the financial system and its overhaul. Any serious judiciary reform takes time, to adapt its instruments, institutions and practices, and to ensure independence from political influence. Capacitating programs for judges and other officials, and the introduction of technology in courts also requires reasonable terms to produce any beneficial results. Thus, it is important to establish a temporary regime to overcome the time mismatch, with politically independent bodies, which at the same time will encourage the rest of the strengthening process and avoid the present moral hazard and gridlock effect caused by diversion of justice.

Beyond a general strengthening program, there are also some particular conditions related to the financial system. First, the independence of the judiciary from political intervention or even economical bribery is essential. Economic interests in the financial sector are very important, but so are the losses to the State and public. Second, the
accountability of judges and recusal in cases of conflict of interests has to be monitored carefully by a technical and impartial forum. Third, judiciary reform has to include the General Prosecutor and Attorney, institutional frameworks, and other public entities that provide judicial services or support for any case in the financial field.

An urgent introduction of financial task teams or financial courts, provided with proper endorsement through political, institutional, economical, and technical support, could be a useful mechanism for the general restructuring of the financial system. Another temporary solution might be to entrust banks, and in general, public entities involved in the financial sector matters, with broad extra-judicial procedures for the enforcing and executing of financial obligations. Indeed, to accomplish these main objectives, it is necessary to implement an aggressive capacitating program over financial systems, economic reform, and deregulation.

Financial innovation and, moreover, financial globalization raise another challenge for judges. Innovation causes any judicial review to confront not only naturally existing judicial deficiencies, but also scarce technical, economic, and human resources available for these purposes in the country. Access to foreign jurisdictions, when possible, could not only be a voluntary choice, but also the only means to enforce and especially execute judgments. Deregulation also has facilitated international investments. For local investors, the necessity for access to some international jurisdictions is another hidden cost and risk, not necessarily transparent, at the time of the investment. How to evolve and gain access to an international efficient judiciary system is the future question for financial systems of emergent economies.

E. BALANCING PUBLIC ACCOUNTABILITY AND LEGAL RISK

Disclosure and transparency are considered the main conditions to ensure efficiency in a market-oriented economy. Transparency can be understood as a type of accountability. It ensures that market participants and investors are provided with accurate information to assess their risk and costs, in order to make an efficient decision. Financial system regulators in Ecuador are public officials, thus such transparency is reached through public accountability.

Public institutions and officials are capable of making and enforcing decisions that may affect individuals, communities, and the general public. Evaluation of responsiveness of a State is only possible through fitting and efficient accountability. Public accountability is the compulsory duty of a public institution or official, to give account, justify or explain actions, decisions or omissions related to their public function. Accountability also relies on direct actions or omissions of public officials accountable rather than third-party actions. There are three major types of accountability: judicial review of administrative resolutions, administrative accountability (for instance, regular presentation of reports to Congress), and general public accountability.

84. Procedural law reform can be implemented for ongoing cases.
85. E.g., in Ecuador offshore investments related to Popular failure.
Accountability implies an obligation to comply with certain standards in the exercise of power or to achieve specific goals. However, the more complex the activity, the more difficult it is to establish clear standards of conduct and specific outcomes. This is the case for financial regulation. Financial regulators have to exercise their rule-making powers and set policies in a way that is compatible with the regulatory objectives: financial stability and consumer protection. A good example of accountability difficulties arises from banking bailout in order to contain systemic risk. Assessing justifications, intentions, and costs can be subject to political considerations and multiple technical interpretations as well. In the context of a factional state, interested interference considerably increases personal and organizational risks and shuffles public accountability with bankers and shareholders sole responsibilities and actions.

Ecuador during the 1999 financial crisis, and even before, had a chronic problem of lack of public accountability. Problems arise from the difficulties in determining such standards and goals in the context of overlapping and conflictive legal and institutional arrangements, or from inaccurate and uncompleted banking-failure legal framework that forced “legal-stretching” to cover several cases. Moreover, financial information is addressed generally to specialized recipients, so partial disclosure without acceptable interpretation could have also influenced a further lack of confidence in the system in general. Last, but not least, judiciary inefficiency is another element that hinders confidence in fitting outcomes as a result of public accountability and creates moral hazard. Courts and the General Prosecutor’s Office can provide a powerful tool for accountability. However, one of their key characteristics is that they are essentially reactive to public pressure, and in such a contentious setting, the necessity of objective public accountability has been shuffled with politics. Poor accountability also boosts inefficient defense of the interests of the State by public officials.

Personal legal-risk definitely can affect the efficiency of responsiveness. Omission of responsiveness will result if the individual holder of the power considers that compliance of the standards will have a personal, more damaging effect than such omission. Systemic risk considerations and political implications overburden regulators and central bankers, especially in the presence of an inefficient or bribed judiciary. Therefore officials have to measure administrative decisions against the personal legal-risk involved. A supervisor will refrain from reporting detection of irregularities if the personal burden of such a decision does not have an acceptable legal umbrella of protection. Moreover, personal legal-risk is increased in the context of a factional State, where the judiciary and other public authorities can react adversely to the interests of the State, whether by bribery, or just in accordance with particular economic interests of supporters of the government. This element has a special relevance in Ecuador for financial regulators and supervisors, including central bankers because bankers might finance political campaigns. Pervasive effects of personal-legal risk are not restricted to Ecuador and have been felt by several Latin American central bankers and supervisors.

In Chile, under general principles, all public officials have a right to be broadly defended, in civil and criminal procedures that arise in the context of any public acts, by

87. E.g., Progreso.
88. See e.g., papers of CBE Seminar CEMLA (Center for Latin American Monetary Studies), “Crisis Financiero y Riesgo Legal para la Banca Central,” Quito, July 1997.
their institutions for acts in compliance with a specific public function. To balance this protective umbrella with private particular interests, Chilean public law also determined that public institutions are accountable for damages caused to private individuals in the exercise of their official duties. However, to ensure accountability, the institutions do have a "right of repetition" against the public official, in the case of excesses in the exercise of their functions. In Ecuador, the IMF has also confirmed the importance of the need for legal-risk umbrella protection for efficient responsiveness of the State. The introduction of an effective legal framework for this purpose has been included as performance criteria for the recently approved 2000 Ecuador Letter of Intent. This legal-umbrella, together with reasonable accountability, provides a better framework for institutions to perform their activities efficiently and achieve their goals, and for individuals to do their duties accurately.

The treatment of the Continental case, previously described, is a good example of the legal risk incurred by central bankers, regulators, and supervisors. The DGA-law introduced a special procedure restricted to criminal procedures against high-level officials and related essentially to compliance of the overhauling procedures determined in the DGA-Law. However, the protection was given by the requirement of a special previous report issued by representatives of the National Banks Association, the DGA, and the General Prosecution Office, which did not actually ensure any kind of real legal protection.

A second and more general intent to introduce such kind of legal-umbrella came more recently. It created Supreme and Superior Court special jurisdictions for high-level officials and for managers, intervenors, receivers, and auditors of seized institutions. However, it still concentrates on criminal cases and does not cover medium- and lower-level officials. As a protection, it requires the previous confirmation of financial experts qualified by the General Controller about the material existence of the criminal offenses before filing any action against them. However, this rule is too restricted, as it does not cover all the personal risk involved (specifically civil actions), all of the public staff that can be involved, or other financial supervisors, for example, the Superintendence of Companies and CBE. Because of these considerations, the umbrella may be mostly ineffective. More effective might be the introduction of a Chilean-like scheme aimed at personal litigation protection, without hindering public accountability.

Another source for lack of transparency and personal legal risk for central bankers, regulators, and supervisors arises from broad banking secrecy rules. Management of bank secrecy information generates another burden for regulators that can be used by the regulated institutions to impose pressure and threats about its disclosure. Although secrecy over banking liabilities can be justified in some circumstances, the grounds for secrecy over asset accounts (banking reserve) determined in Ecuadorian Banking-Law are not very clear. There are some jurisdictions where bank asset information is publicly available and commercially distributed, which also can contribute to the further transparency between market participants: it gives clear signs of the creditworthiness

89. Nancur, M.A., (1997) "Responsabilidad Legal de los Consejeros del Banco Central Chileno y del Superintendente de Bancos e Instituciones Financieras-Principios de Derecho Publico Chileno," Off Print, CBE.
90. In March 2000, with Trolebus Law.
of individuals and allows other participants to duly assess credit risk in their transactions with financial debtors. Actual exceptions in Ecuador are too restricted to enhance transparency and attenuate legal risk. They only provide for banking reserve and secrecy release in the context of a judicial procedure. More recently, a particular release for audit reports presented to few other public bodies provided the existence of previous requirements and restrictions placed on certain institutions. It has to be highlighted that no CBE information is comprised in these exceptions.

The extent of discretion entrusted to a public official or institution is a final factor that can affect accountability. Objective accountability is feasible over non-discretionary acts, whereas discretionary performance is difficult to standardize. Accountability over discretionary powers can raise two main problems. First, the introduction of subjective elements for evaluation of the compliance of goals and performance, such as the intention of an institution or an individual, contradicts the essential objectivity that transparency requires. Second, it increases substantially the legal risk involved for the official, as the subjective elements will depend on third-party assessment, by judges and other accountees, rather than on duty, performance, and goal achievements. The problem is significant in the context of a complex technical field such as financial system regulation and supervision.

In Ecuador, the veto-power of the Superintendent of Banks, discussed later, adds another complex element for transparency and accountability in the field.

III. Financial System Regulation and Supervision: The Administrative Capability of the State

Banks perform the key financial functions of allocating credit and operating the clearing and payments system and foreign exchange market. Because of these diverse functions, a sound banking sector is the single most essential element of a healthy financial system. Banking regulation and supervision has a significant role to ensure soundness. This will require governments putting in place necessary infrastructure, in order to support and limit the activities of institutions and individuals in the financial service marketplace. Essential elements of financial infrastructure are laws and regulations, accounting and auditing standards, transparency, disclosure, accountability, regulatory compliance supervision, payments, clearing, and settlement systems.

Financial markets can misbehave anywhere, but emergent economies like Ecuador are much more susceptible as result of the weak state capabilities formerly described. Rodrik wisely observes that today's developed countries did not get their regulatory and legal institutions overnight. "It would be nice if third-world countries could somehow acquire first-world institutions, but the safe bet has to be that this will happen only when there are no longer third-world countries." The Ecuadorian financial crisis shows how costly administrative weaknesses in institutions can be.

91. Indeed, implies judicial files overburden.
92. Deepak Lal, supra note 50, at 3.
93. ld. at 13.
Laws and regulations ensure fair and equitable treatment of all players, be they owners, managers, borrowers, depositors/creditors, etc. In order to generate public confidence, the main asset of a financial system, the governmental role of financial supervision, should ensure that financial institutions operate within the rules of the game and engage only in practices that are managed within reasonable tolerances of risk. Market discipline, even with good public disclosure and transparency, indeed not precisely characteristics of an emergent country, cannot substitute for such a role.

Probably the best period to assess the efficiency of regulators and supervisors is in the aftermath of a systemic crisis. The organizational arrangements and legal framework have been tested at maximum stress. However, immediate reactions to solve particular cases, usually expressed by tightening regulations or amending the law, do not necessarily contribute to improved institutional-administrative capability. In May 1999, legal amendments with an impractical complete ban confronted the evidence of connected lending abuses, thus creating new conditions for laxity or overriding. On the other hand, the discipline that markets exert in the aftermath of crises can be excessive and arbitrary. To rebuild market confidence is not an easy challenge. However structural-accountability, an objective evaluation of the operation of the institutional framework, constitutes a good starting point to achieve such a goal.

A. SUPERINTENDENCY OF BANKS AND SUPERINTENDENCY OF COMPANIES

Ecuador has divided the regulatory and supervisory powers and functions over the financial system between two institutions. The Superintendency of Banks regulates the banking and insurance businesses. Since 1993, the Superintendency of Companies/Securities Commission has had the control and regulation of securities houses and fund-companies administrators. Institutional arrangements have to ensure compliance of four major objectives of financial system regulation: systemic risk prevention, prudential regulation enforcement, consumer protection, and prevention of fraud. The importance of each of these objectives is connected to the nature of the supervised business. This dissertation is not oriented to discuss the general legal framework for financial supervision. It is important to note, nonetheless, several restrictions that surfaced during the crisis and hindered effective responsiveness.

There has been a blurring of the distinctions between different kinds of financial services, businesses, banks, holding societies, investment firms, insurance companies, and others. This has further added to the complexity of financial regulation. On the other hand, financial conglomerates have become significant in this sector. The bulk of domestic security houses and fund-companies have been closely related to the banking system and, indeed, acted with little independence of their holdings. While these subsidiaries have been important for financial innovation, some have used this innovation to defraud.

An additional problem is the operation of offshore-banks within a bank and, also, other companies regulated by local and foreign non-financial supervisors. These firms

94. Id. at 22.
96. E.g., trusts and adaptive forms of “securitization.”
have taken advantage of limitations in coordination between the separate supervisory bodies, domestic and foreign. Provisions introduced by the Trolebus Law recognized the importance of properly coordinated and consolidated supervision over financial conglomerates. They tried to attenuate defects in information flows that arise with extended bank secrecy rules. However, this did not overcome all the problems.

Domestically, in the context of a factional-state, the existence of separate institutions might be the source of conflicts between different agencies. On the other hand, the emergent Ecuadorian capital market and the lack of technical and human resources does not justify keeping the responsibilities and powers in separate institutions, especially if it does not ensure better quality of supervision. The great synergies between the roles of prudential supervisors of different financial activities increase the need for them to cooperate to improve understanding of the financial institutions they supervise and, hence, improve the effectiveness of overall supervision. This increasing need for co-operation and co-ordination may justify the establishment of a single prudential supervisor on the grounds of effectiveness.\footnote{97}

Single supervision is also seen as an appropriate response to the uneven quality of supervision and consumer protection across the various financial sector's traditional lines of business: banking, securities, and insurance. A fragmented regulatory structure might generate inconsistencies in approach, insufficient communication, or an inadequate overview of regulated firms as more financial conglomerates emerge.\footnote{98}

Cross-border supervision creates challenges difficult to overcome. Legal framework is restricted to the domestic level, and there exists no such system as a formal supervisor for international banking institutions. It thus requires effective coordination and harmonization of regulatory and supervisory standards\footnote{99} and flows of quality information between regulators, and the introduction of other tools like lead regulator arrangements and formal agreements between supervisors.

B. RESPONSIVENESS OF THE STATE TO BANKING FAILURE: RESTRICTIONS ON ADMINISTRATIVE AND LEGAL INSTRUMENTS

To provide adequate state capability to deal with individual banks, a legal framework has to establish clear and transparent rules over four major fields. They are: lender of last resort (LOLR) preventive measures, a clear treatment for institutions in the event of definitive closure, and a deposit guarantee scheme. Finally, it requires accurate rules and efficient tools and powers for intervention of the State in potential systemic closures.\footnote{100}

These include balanced coordinating instances among the different governmental agencies involved and transparency about allocation of public resources. This is significantly


\footnote{99. Indeed, implemented through national legislation.}

\footnote{100. The “too big to fail” principle.}
important for Ecuador, with a weak banking system which has confronted periodic eco-
nomic crisis that might decrease financial stability.

At the same time, an intervention of the State, and specifically the use of public
resources, require that the legal framework cope with three major criteria, in order to
ensure its optimal use.\textsuperscript{101}

Those who benefited from risk taking in banking activities, namely former share-
holders and managers, should absorb public intervention costs in order to avoid an
"unethical" benefit. Establishing this as a precondition for any public intervention and
directly charging former shareholders’ equity against the losses generated under their
administration accomplishes this task. Indeed, this needs clear and express legal pro-
visions to divide the public and private interests on the matter and avoid the risk of
counter-arguments or legal actions by former shareholders or managers that can weaken,
even neutralize, the intended positive effects of a public intervention. This ethical divi-
sion must be transparent in order for any banking overhaul program to bring discipline,
and to produce a sound and strong financial system, in the long term.\textsuperscript{102} However,
this division is difficult to achieve as bankers significantly influence public
opinion\textsuperscript{103} and also have considerable political
influence.\textsuperscript{104} To avoid gridlock, there also should
be proper accountability over previous corporate governance,\textsuperscript{105} including the estab-
lishment of criminal offenses and civil damages. These respective preventive measures
should include severe restrictions on the operation of undercapitalized banks, with a
special focus on increases in high-risk credit or restructuring of defaulted loans, and
moratoriums on interest through fresh loans, taking advantage of public resources.

More important than the assignment of public funds might be the opportune inter-
vention of the State endowed by proper failure-instruments. This is relevant for banks,
because resource depletions can be overturned, for instance when there is an increase of
equity, or with the proper management of the risky assets that caused such depletion;
or can been further drained, in the event of a fraud.

However, both require major and costly political decisions (a) because politicians
are not aware that delay in government action only increases the fiscal and even political
and social costs\textsuperscript{106} of the final resolution of the crisis,\textsuperscript{107} and (b) because the State
should also allow some banks to fail. This is important for market discipline,\textsuperscript{108} given the
existence of practical and efficient mechanisms to avoid systemic risk (e.g., LOLR, deposit
guarantee schemes, etc.). Finally, assessing the soundness of a particular institution is

\textsuperscript{101} De la Torre, (1997) quotes these criteria extracted from Rojas-Suarez and Weisbrod (1996).
\textsuperscript{102} In Ecuador, e.g., complex "securetization and compensation procedures in the 1980s. These
non-transparent bailing-out procedures, in the middle of an undetected banking crisis, did
not show reality of financial system or supported opportune necessary strengthening pro-
gams at the regulatory and corporate level.
\textsuperscript{103} E.g., ongoing concerns about communications control by former failed bankers, e.g. Filan-
banco and Progreso.
\textsuperscript{104} Directors, managers, and even inferior officers.
\textsuperscript{105} Directors, managers, and even inferior officers.
\textsuperscript{106} Intervention timing relies on the technical and administrative responsiveness.
difficult because there are significant technical difficulties at the time of the decision. Indeed, the decision should be made independently of the existence or suspicion of fraud, which will enhance legal-risk. However, the practical impossibility at the time of intervention to determine fraudulent conduct should be covered by the requirement of proper accountability, suggested in the first criterion.

After the enactment of the banking-law in 1994, there have been several amendments that affected banking restructuring in Ecuador. Analysis of legal framework to the different fields requires some precise respect for its timing.


Three main reasons are put forward to justify regulation of the financial system: (a) to protect customers against monopolistic exploitation, (b) to protect smaller, less informed investors or depositors and, (c) to ensure systemic stability. In the first two cases, it is clear that the main interest of the regulators is consumer protection, which is made through prudential regulation. Goodhart notes

[P]rudential and systemic regulation need to be distinguished, although both adopt a similar approach. Systemic regulation is about the safety and soundness of financial institutions for purely systemic reasons (i.e., because the social costs of the failure of an institution exceed the private costs). On the other hand, prudential regulation is about the safety and soundness of financial institutions vis-à-vis consumer protection, in that the consumer loses when an institution fails, even if there are no systemic consequences.

Systemic regulation concentrates on potential runs from lack of confidence that even solvent banks can suffer. A bank run might have contagion effects, which can throw other solvent banks into insolvency. This risk justifies systemic regulation.

The probability that the failure of a single bank will induce a systemic problem may be low, but, if systemic failure were to occur, it could be serious and the costs could be high. Thus regulation to prevent systemic problems may be viewed as an insurance premium against a low-probability occurrence.

The low-occurrence probability and high costs mean that determination of systemic risk might lack objective measurement. It will depend on the personal evaluation of regulators. Illiquidity in a particular bank can be avoided with confidence recovery, provided opportune liquidity supply (through LOLR), and that professional and transparent banking governance has appropriately managed risks. This is precisely the engaging point between systemic and prudential regulation. Systemic regulation has been practically administered by central banks mainly through the LOLR function. LOLR implies, among other issues, that central banks should prevent temporarily illiquid, but solvent banks

109. See LASTA BOOK, supra note 107, at 125.
110. Goodhart, supra note 73, at 5.
111. Id. at 9.
from failing through short-term lending and make clear its readiness to lend freely to the financial system.\textsuperscript{112}

While the regulations imposed for systemic and prudential reasons may be similar (e.g., the establishment of capital requirements), they do not need to be (nor should they be) conducted by the same agency. In the event of separate institutions, both will share common concerns about financial system stability but their approach will be different: systemic versus prudential; general macroeconomic concerns versus a strictly consumer protection bias (microeconomic).

Although it is still most common for the central banks to also be banking supervisors, over the last decade a number of countries have moved this function outside the central bank.\textsuperscript{113} Many scholars count several advantages and disadvantages of both models but do not have definitive conclusions.\textsuperscript{114} The recent developments in international and financial markets have forced consolidated financial regulation (over banking, securities, and insurance) in one supervisory body outside central banks.\textsuperscript{115} In the specific case of developing countries, however, there are suggestions to keep the banking supervision role as the central bank's responsibility. Lastra argues that the scarcity of economists and financial analysts in most developing countries could justify having the supervisory agency under the umbrella of the central bank.\textsuperscript{116} The difficulties to create efficient and politically independent governmental agencies and their huge costs also confirm the rationale for consolidation of systemic and prudential capabilities in emergent economies in central banks. Hawkesby counts other factors in determining the feasibility of the separate or single model of banking and systemic regulation. Among them are the extent of activity by financial conglomerates and the size of the financial sector, objectives of supervision, degree of independence of the central bank, technical ability, eventuality of conflicts with monetary policy, and lastly, political considerations like the degree of uncertainty that surrounds the economic costs and benefits of alternative regimes, which mainly depend on the recent history of the country in question.\textsuperscript{117} Goodhart (1998) argues that if there have been recent problems in the banking industry, for whatever reason, there may be a temptation for the government to make changes to supervisory responsibilities.\textsuperscript{117a} By doing this, they are seen by the public to be addressing the problem, regardless of whether the reform redresses any weakness there was in


\textsuperscript{113} For international practices see, e.g., Hawkesby, supra note 97.

\textsuperscript{114} See, e.g., Lastra, supra note 107, at 148.

\textsuperscript{115} U.K. Financial Service Authority ongoing conformation has become a model. In this case, Bank of England transferred bank supervisory functions and clearly kept the LOLR and the systemic-regulation.

\textsuperscript{116} See LAstra BOOK, supra note 107, at 149.

\textsuperscript{117} Whereas the separation model in South America was restricted to countries with Kemmerer performance in the Pacific coast, British missions visiting the Atlantic coast (e.g. Argentina) encouraged former "Bank of England" model, with supervisors just as a unit, thus ensuring close coordination among monetary and financial policies.

\textsuperscript{117a}
the old regime, and regardless of whether the old regime contributed to the original problems.

In the 1920s, Kemmerer suggested establishing two separate institutions in Ecuador. The CBE was created in 1927, with stability of prices as a constitutional main goal. Until March 1999, monetary policy and the LOLR function have been the CBE's major instruments to perform its constitutional functions. Meanwhile, the SB is responsible for prudential regulation and consumer protection. This separation, as noted, cannot evade strong boundaries between both institutions, thus the law has established mechanisms to coordinate the separate model: the SB assists the CBE Directory sessions while the CBE Governor is a Banking Board member. The existence of this separation model, by itself, might even weaken regulatory and supervisory capability in the event that legal and institutional framework overlaps, distorts or even overrides the separate functions. This might be the case in Ecuador.

Until March 2000, LOLR legal provisions were contained in articles twenty-four and twenty-five of the Monetary Law. In order to be effective, LOLR has two operational principles: LOLR's role is discretionary, not mandatory, and the central bank assesses not only whether the situation is of illiquidity or insolvency, but also whether the failure of an institution can trigger, by contagion, the failure of other institutions. However, in Ecuador, legally the SB was empowered with assessing the illiquidity or insolvency of the borrower, as a previous requirement for the loan concession, so that discretion over LOLR assistance was restrained extensively. CBE opposition to this external interference could be considered irresponsible, if not illegal. Additionally, under banking-law provisions, the lender does not have the availability to make any direct surveillance of the resources, allocation, and borrowers performance, and has to rely on site supervision made directly or indirectly through qualified external auditors, by the SB. Other problems arose from limited tools and legal instruments for the CBE to intervene in banking overhaul and financial stability programs, in particular from the veto-power discussed below.

This is despite the evident interactions and boundaries between LOLR/systemic regulation and prudential supervision. Financial instability definitely threatened independent monetary policy function. In other jurisdictions (the U.K., for instance), the law provides not only that central banks effectively intervene in financial policy, but also that the financial regulators are accountable to the central bank for their actions. The consequence of overlapping and overriding operations is the definite weakening of both institutions. All this affects regulatory transparency and shuffles accountability. In March 1999, the SB assessed Progreso for credits, but the CBE did not grant them immediately within insistent requirement of further information. Taking advantage of the opportunity, Progreso publicly denounced CBE's illegal acts. Progreso unilaterally

118a.
118b.
118. See Lastra Article, supra note 112.
119. Recently, the Superintendent of Banks intervened in the Central Bank in order to override an administrative resolution of the CBE Board, despite a law that provides that he does not have the right to vote in the Directory.
120a.
120b.
suspended payments, moreover, without an immediate intervention of the supervisory authority and seizure by the DGA, as the law expressly provided, thus boosting generalized concerns about the fairness of the regulators procedures. Uncertainty around the current banking system and the surprise closure of the largest bank in the country triggered a systemic problem that directly affected other institutions that were confronting stability threats. Neither systemic risk prevention nor prudential supervision protected consumers. The lack of public confidence in the institutional arrangements triggered generalized financial panic.

The Trolebus Law and the Dollarization program in March 2000 have eliminated the CBE's monetary policy capabilities and the old LOLR-function. Additionally, a liquidity fund, originally to be administered by the CBE, was also introduced. However, at the time of concluding this dissertation, it had not yet been implemented, and there is still discussion about the proper administrator of the fund.

A bill in the U.S. Congress, the International Monetary Stability Act of 1999, designed to encourage emerging-market countries to use the dollar as their official currency explicitly states that the United States would have no obligation to serve as a lender of last resort to dollarized countries or to exercise supervision over their financial institutions. This confirms that, even in the context of Dollarization, efficiency with regard to the LOLR-mechanism (whatever it is) and capable regulatory bodies are still essential to ensure financial stability. On the other hand, CBE is still entrusted with the management of the system of payments. Thus CBE systemic-risk prevention responsibilities have not been removed. However, the Trolebus Law has not addressed the complexities regarding the arrangements referred herein.

2. Preventive Measures

There should be sufficient preventive measures, rules and powers to address: deficiencies in applicable capital adequacy standards, other corporate or administrative irregularities that can increase the failure risk of a financial institution, and the committing of fraud. These should be of a non-discretionary nature, to eliminate abuses by the authorities, but also to give them unquestionable legal support to enforce decisions.

Prior banking statutes provided broad discretionary rules, including the appointment of intervenors. Deregulation was restricted to a minimum. SB was allowed to impose restrictions on investments and new credits, but only in the case of inadequacy of capital standards. Suspension of payments of a bank, until July 1996, was not even a cause for the SB to intervene or for liquidation. SB powers were given only through the concession of short terms (ninety and thirty days) in order for the institutions to properly adjust equity.

The creation of the restructuring-program by the DGA-Law, in December 1998, reinserted some Banking Board discretion for preventive measures, but restricted it to

120. Formal intervention was delayed for almost three months.
121. Several banks already have failed and in early March, deposits were ordered frozen.
122. Dollarization implies CBE cannot issue domestic currency, so LOLR depends exclusively on fiscal sources.
123a. See Trolebus Law.
123. Instead, the standard was a “clear insolvency warning.”
restructuring-program institutions. In May 1999, another incomplete reform reinstated the SB's capability to appoint broad-powered intervenors, albeit without improving the general preventive-measures framework.

The Trolebus Law (March 2000) has provided further and broader reform. It included discretionary measures and regularization programs to be exercised by the authorities, in particular, a duty to intervene in any undercapitalized institution and, for the first time, a valuable mechanism to temporarily control bank stakes until the bank solves the problem. However, due to the range of discretion provided, it expands legal risk for authorities, as treated in section II.E, and room for legal actions that might neutralize the same measures.

3. The Deposit Guarantee Scheme

It is necessary to count with clear treatment for institutions in the event of definitive closure, in order to ensure ordered and efficient liquidation, and even winding-up procedures. Until December 1998, the only mechanism supplied in the event of a failure was closure followed by an administrative winding-up of the institution. Despite the 1994 bank reform's introduction of a creditors-board for its administration, the mechanism had been kept controlled strictly by the SB, which appointed liquidation-administrators and was even empowered to conform such creditor-board. Historically, liquidations have generated long bureaucratic administrative procedures, which have not been accounted publicly and transparently. Nor have cost-benefit analyses been applied to evaluate results.

The expectation of negative results from the closure of a bank has increased permanently, the lack of confidence in the system. For example, in 1996, if Continental, the fifth in the system at the time, had fallen, the opportunities to rebuild such public confidence would have been limited in the scope of the regular liquidations. Therefore, to give some comfort to customers and prevent the instability caused by mass withdrawal, a proper deposit guarantee scheme is also required. This might take the form of a restricted state guarantee for small savers, a priority for depositors over other creditors, or a deposit insurance. Its existence, at the same time, forces the improvement of regulation to avoid pernicious moral hazard.

Over the course of Ecuador's history, all three forms have been adopted, either independently, or in combinations. First, between 1994 and July 1998, there was a limited small-savers priority over the rest of the depositors and other creditors, and up to 2000 UVC were always paid in full. Then, a short-lived Deposits Guarantee scheme was enacted in July 1998. This scheme was not even initially endowed by the financial system, as was provided by the law. However, even if it had been duly financed, a longer period (up to two years) was needed to fully capitalize the fund. Small savers were still protected under the former priority scheme.

The lack of a proper deposit guarantee scheme probably upgraded the uncertainty that already yielded the financially unstable environment of the last months of 1998. The

124.
126a.
126b. See Trolebus Law, supra note 123
126. A UVC is an accounting unit linked to inflation rates.
consequences of the failure, closure and liquidation of another medium-sized institution, Prestamos, in September 1998, might have induced urgency for the authorities to fill the existing practical gaps. The result was the introduction of the DGA-Bill to Congress, which originally considered a state-guarantee, which protected up to 3000 UVC and restricted its application to a three-year period. The proposed guarantee was going to be covered initially and immediately with public resources, in order to attenuate the social impact of the forecasted systemic crisis. The State, through an independent agency, the DGA, was going to be repaid in full with the efficient and effective disposal of assets of the closed financial institution. The law, passed by the Congress in December 1998, broke this theoretical framework and may have caused even further financial instability and uncertainty.

First, Congress enacted an unlimited period and an unlimited amount for the state to guarantee. In the context of insolvency, no unlimited guarantee scheme could be properly financed, as the reason for such insolvency is precisely the existence of insufficient assets to cover all liabilities. Therefore, the losses (simply, the excesses of liabilities over assets) were transferred to the guarantor, in this case, the State. Moreover, the law introduced a central bank duty to discount fiscal bonds (the DGA-bonds) in order to ensure the availability of public resources at anytime. The latter created a significant distortion to constitutionally, recognized central bank independence, and forced the monetary authority to provide unrestricted resources to cover the losses of the financial system in the context of a systemic crisis. Most international and national analysts now consider that this was the trigger for the inflation spiral and unstoppable exchange devaluation that was followed by the Dollarization. At the same time, after natural restrictions imposed by the central bank, at first voluntarily, but ultimately under the stringent rules of the Dollarization program, the absolute inefficiency of such a scheme to protect consumers was proved. In March 2000, the Trolebus Law also moved back to the initial proposal, albeit this will be possible only within specific terms.

A second unexpected change, introduced by Congress in the Bill, related to the independence of the DGA to effectively dispose of assets. The composition of its directory board was amended, and the Superintendent was empowered with an unexplainable veto power that surrendered the financing members to the banking regulatory authority.

The third unusual element was the restructuring-programs not included in the original bill, to be discussed next.

4. Intervention of the State

Ecuador has not had mechanisms for intervention with public resources that fulfill the three above referenced criteria, even before the bank reform of 1994. Until August 1998, subordinated loans were the only possible mechanism to intervene with public funds. This was the case in 1996, when the Central Bank intervened on behalf of the State. In order to frame this intervention to meet the first criteria, the loan conditioned the whole bank's stake to be transferred to a Trust, for two main purposes: (a) to ensure the control of the bank by the State, and (b) to make certain that losses caused by former management were going to be charged directly to shareholders, thus not affecting public funds.

127.
This legal-stretched public intervention structure had several problems. First, the loan and the trust agreement had to be negotiated forcibly with the administration involved in the failure. The law at the time did not contain any provision for authorities to take immediate control, nor even to impose an intervention (not even in the event of the suspension of payments). The state was overburdened by obtaining a voluntary agreement from the shareholders, in order to avoid the forecasted systemic risk. Second, after the intervention, the central bank administration revealed that the equity was negative at the time of the State's intervention. It was forced to conduct further investigations in order to prepare and initiate effective legal actions for remedies. Although there was sufficient evidence of fraud for prosecution under the RICO Act of the United States, Ecuadorian law did not provide sufficient instruments, neither civil nor criminal, to impose proper penalties without repeating damage to the concerned companies.\textsuperscript{129a} Third, and probably the most damaging for the administrative capability of the State, was the shuffling of responsibilities of former managers and shareholders with public officials by the Supreme Court President in 1996.\textsuperscript{129b} This promoted judicial interference and conflicted with the technical and discretionary powers of these authorities. Fourth, the bank cannot be properly overhauled if the subordinated lender is restricted in owning the resulting stake.\textsuperscript{128} The December 1998 DGA-Law introduced two new forms of intervention: the first, contemplated in the original bill, was the overhaul-proceeding (saneamiento).\textsuperscript{131a} The second, introduced by the Congress was the restructuring-programs (restructurazion).\textsuperscript{131b}

In the first, the criterion regarding former shareholders assuming costs was met, as the State could immediately control the stake, even canceling it if necessary. However, due to the distortions of the unlimited guarantee, there were no means to keep inflationary controls in place (third criterion). There was an excessive concentration of responsibilities over the Superintendent. More significant were the overlapping and overriding caused by the veto-power.\textsuperscript{129} Other major difficulties were the restrictions to proper management of assets and the avoidance of banking closures, which deterred rapid and effective responsiveness to redress public confidence and spare public funds.

The conditions of restructuring-programs have not varied, except for non-compliance with first criterion: public funds were able to be invested, but former managers and shareholders have kept their rights to them. This was applied in practice to only one case: Filanbanco.\textsuperscript{130} In May 1999, Congress removed public resource allocation through restructuring programs. However, there were no major changes to improve responsiveness in the case of failure, except the reposition of the intervenors appointment. In July, another Bill was prepared to strengthen supervision and ensure

\textsuperscript{129b.}
\textsuperscript{128.} A special law in 1997 allowed CBE to keep this stake up to seven years.
\textsuperscript{131a.}
\textsuperscript{131b.}
\textsuperscript{129.} See next section.
\textsuperscript{130.} In Filanbanco, however, the shareholders voluntary resigned their rights and consigned some personal assets in order to cover the losses of the Bank. This case continued to be the subject of public controversy and legal actions during June 2000.
the existence of an independent agency and more effective instruments of intervention; but it failed, and further legal-stretched interventions occurred over the next few days (Previsora, Pacifico and Popular). These interventions were underpinned, again, on a subordinated loan, with the only difference that it was possible to directly appoint intervenors. Since March 2000, the Trolebus-Law has broadened the conditions related to the subordinated loan and established clearer procedures to repeat damages from connected companies and former shareholders. However, this evidently depends upon the efficiency of the judiciary.

There are major problems derived from this legal-stretched state-intervention framework. First, Ecuador shows several cases where delayed or weak intervention has allowed former corporate governance to make an inadequate accounting of legal documents and even to divert resources. Second, further legal risk is added, especially because there is no clear dividing-line between the regulators and the bank managers. Third, without an independent body to manage such state intervention, there is either lack of coordination or overlapping of functions. The objectives of a public intervention, to prevent systemic risk and regain public confidence are lost, if the rules are not clear. The conflicts that the DGE-law aimed to avoid, were not only kept, but increased through the introduction of three major changes: the unlimited guarantee, the restructuring-programs, and the veto-power.

C. The Relative Powers of the State Vis-À-Vis the Superintendent

The requirement of an individual favorable vote for the validity of a collective decision-making process is deemed a veto-power. The Superintendent does have veto-powers in both major collective-boards entrusted with financial regulation and overhauling: in the Banking-Board and in the DGA-Board. The effects of a veto-power are the following: (a) it distorts democratization of collective decision-making vis-à-vis the individual (other board members are only entitled to oppose), (b) it complicates the decision-making process and sometimes renders the reaching of a decision impossible, and (c) impartiality is lost, as the veto-empowered personal opinion might deter a free decision-making process.

Objective accountability and responsibility among board members is distorted, overburdened, and shuffled. It will be necessary to consider individual decisions to determine the degree of responsibilities. A veto-empowered impartial negative vote might be seen as an obstacle for a majority decision, instead of as a means to restrict personal responsibility. On the other hand, veto-power implies that the majority cannot object to unfair decisions, so that they might be accountable for the omission of the collective body.

The Ecuadorian framework offers a successful form of collective decision-making. The CBE-Board decision-making process requires majorities, without any privilege for any member. On the other hand, monetary law distinguishes policy-maker’s from executor’s capabilities. The executor does not have a vote in the CBE-Board, so the board constitutes the real policymaker. This separation, on the other hand, ensures the

131. Entrusted to the CBE-Board.
132. Charged to the Governor and officials of the CBE.
existence of an impartial and technical accountee, in the event of non-compliance of specific policies by the executor.

Meanwhile, the SB policy-maker is a Five-Member Banking-Board, which includes a veto-empowered and executor superintendent.\textsuperscript{133} Then the Banking-Board is not a real independent policy-maker body, nor a proper accountee, because the veto-power turns the Superintendent into judge of its own actions, in the context of routine financial system supervision.

The situation in the DGA is more relevant: DGA was conceived as an independent body provided with tools to efficiently manage financial instability. This requires coordination of three different policymaking processes: monetary, fiscal, and financial. In the first case, a system of payments might be affected by systemic risk, thus affecting monetary programs. A banking crisis, on the other hand, forces use of public-funds or its reorientation, in order to restore stability. Moreover, the unlimited DGA-guarantee formerly discussed primarily depended on fiscal-sources. Finally, stability restoration evidently requires special financial regulation and strengthening of the supervision capability.

The introduction of the veto-power submitted monetary and fiscal policies to the actions and omissions of the Superintendent\textsuperscript{134} and unfairly shuffles accountability among all institutions involved. This also deters impartial accountability over financial stability policies. Another practical effect is that in the event of a systemic crisis, state-responsiveness is confined to a solely non-accountable official. In the context of the factional-state, it is easier to control a single public official than multiple private institutions and individuals.

IV. Conclusions

This essay has dealt with the recent, and to some extent ongoing, financial crisis in Ecuador. It has analyzed the institutional underpinnings surrounding the crisis and has examined the weakness in the country’s financial system.

Two explanations of this crisis exist. The simple and superficial cause is a decade of macroeconomic instability and the lack of economic reform. The second explanation is more plausible. While the general poor condition of the economy during the last decade cannot be ignored, the underlying origin of the crisis comes from structural weakness, not only in the financial system, but also in the interactions between the political and economic forces that have prevented public confidence from building. These structural weaknesses and interactions are so powerful that they alone may explain the poor macroeconomic results and financial instability Ecuador has experienced recently. The ongoing Dollarization process is a recognition of the State’s failure to achieve politically independent monetary control due to interminable interference by particular economic interests. The Brady default is also the result of a lack of structured and long-term governmental policy choices that might have ensured reliable economic growth and equitable wealth distribution.

\textsuperscript{133} This is nowadays shuffled, as Trolebus-Law entitled Superintendent with many discretionnal policy-maker functions.

\textsuperscript{134} This also infringed upon the constitutionality of the central bank independence.
Abuses in the allocation of credit are not new in Ecuadorian history however, their effects have virulently surfaced in the context of an open and globalized competitive international market. At the time of crisis, rather than having a private sector assuming responsibilities about decision-making, further political pressures have been imposed in order to socialize their losses at the expense of the whole society. In the context of the economic reform in Ecuador, building capabilities and regulation enforcement cannot be taken for granted. Governmental responses addressed by political considerations and private interests have added complexities to the ongoing financial crisis, rather than redressing existing conflicts and strengthening regulator capacities.

In order to ensure proper enforcement, financial regulator capability requires other elements beyond just improving technical and economic resources, or successfully introducing international financial standards. Judiciary deficiencies on financial matters imply huge, but hidden, moral and economic costs that might also be transferred to society. Legal risk is increased in the context of a factional-state and extensive bank secrecy rules. Institutional overlapping and overriding is another way to increase factional-state deficiencies.

Complete and balanced accountability and disclosure of public and private actions is the best way to back-feed legal framework, and to improve legitimacy and responsiveness of the State in the financial system. Without transparency and fairness, it is not possible to bring improvement to the ongoing structural anarchy.