BANKING SUPERVISION

Countries in Latin America and the Caribbean, like other emerging markets, have experienced banking system difficulties that have hampered growth and generated fiscal costs as high as 10 to 20 percent of GDP and even more. Many countries have improved their banking systems, but further reform is needed.

Robert Rennhack

ONE REASON banking crises have typically had a stronger adverse impact in Latin America and the Caribbean than in the industrial countries is that banks usually play a much more important role as financial intermediaries in the former. In many countries in the region, insurance companies and private pension funds are only in the early stages of development, and domestic bond and equity markets are still relatively small.

It has been argued that banks in Latin America and the Caribbean are more vulnerable than those in industrial countries for several reasons. Most deposits tend to be short term, because depositors have little confidence in the stability of countries' macroeconomic policies and the quality of the banks. Banks tend to place a larger share of their assets in loans, and the value of their holdings of government securities is more volatile. Also, banks' access to external financing is often reduced during a crisis, and raising capital during economic downturns can be complicated, especially because domestic securities markets are thin.

Many of the problems that have plagued banking systems in Latin America and the Caribbean were triggered by macroeconomic disruptions. The most prominent of these was the sharp depreciation of the Mexican peso in December 1994, which eroded the quality of the loan portfolios of Mexican banks while cutting off the banks' access to new funds. Banking systems in Colombia, Mexico, and Peru had difficulties adjusting after being liberalized or privatized, while those in Argentina and Peru in the early 1990s and Brazil in the mid-1990s encountered problems after inflation had been reduced from very high rates to moderate levels. Weak bank supervision was an essential ingredient of the difficulties in these countries, while in others—Paraguay, for example—it was the primary cause.

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Strengthening bank supervision

Many countries in Latin America and the Caribbean have therefore adopted reforms aimed not just at dealing with problem banks but also—and more important—at strengthening banking supervision to reduce the likelihood of future crises. They have firmed up prudential guidelines, establishing minimum capital requirements, adopting better systems to monitor asset quality and provisioning for bad loans, and imposing tighter limits on excessive concentration of risk. Many countries have also taken the crucial steps of giving banking supervisors more power and improving the flow of information about banks' financial health.

Requiring banks to hold a minimum amount of capital is intended to limit moral hazard by putting bank owners' money at risk. It can also help banks weather economic slowdowns and make problem banks easier to sell. The Basel Committee on Banking Supervision's capital accord, introduced in 1988 and modified in 1997, recommended a risk-weighted capital-asset ratio of 8 percent for banks in developed financial markets and a higher ratio for banks in more vulnerable economies. It defined a system of weighting assets by credit and market risk to avoid penalizing banks for holding low-risk assets. By 1998, many banks in Latin America and the Caribbean had capital-asset ratios well above the 8 percent Basel standard. In 1995, Brazil introduced regulations requiring a minimum risk-weighted capital-asset ratio of 32 percent for financial institutions just starting up, to be reduced to 16 percent over their first six years of operation. Argentina supplements its capital-asset ratio requirement with a liquidity ratio of 20 percent, because its currency board arrangement places strict limits on the central bank's ability to act as a lender of last resort. Most countries weight assets for credit risk, as recommended in the original 1988 Basel accord, but fewer also weight assets for market risk.

Tightening provisioning requirements on nonperforming loans is essential to ensuring that banks remain liquid during economic downturns. Many countries (including Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela) divide loans into five categories. Normal loans are in the first category. Nonperforming loans (generally defined as loans between 30 and 90 days past due) are divided into four categories; the provisioning required increases with the length of delays in loan repayment. In many cases, this framework allows for significantly lower provisions on secured loans or different provisioning levels for certain types of loans, such as consumer loans.

Excessive concentration of risk contributed to many of the banking difficulties of the past two decades. As a result, countries such as El Salvador, Guatemala, Mexico, Peru, and the members of the Eastern Caribbean Central Bank tightened limits on loans to single borrowers or related parties to a specified share of bank capital. Net foreign exchange exposure is also limited in most countries. However, there are typically no limits on the concentration of lending in specific sectors of the economy.

In many cases, banking difficulties spread and became more costly because supervisors either lacked sufficient authority to insist on early corrective action when banks fell out of compliance with prudential norms or had limited tools for handling problem banks. Based on this experience, legislation has been enacted that widens the scope of supervisors' authority. For example, in November 1995, at an early stage of bank restructuring, Brazil gave its central bank the ability to change the ownership of private banks through mergers, acquisitions, and other forms of restructuring, and subsequently updated its banking legislation several times. Peru revised its banking law in 1993, 1996, and 1999 to allow the overhaul of its banking sector; changes included giving the bank superintendent more oversight powers. Among its many reforms, Mexico completely revamped its on-site and off-site inspection procedures in 1995. The reforms in many countries, including Argentina, Chile, and Colombia, have given supervisors a high degree of independence from undue political influence or interference by bank owners.

Inaccurate information about the financial condition of banks also played a role in past banking difficulties. Most countries, including Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela, introduced or strengthened requirements to report key financial information—such as balance-sheet and off-balance-sheet statements and cash-flow and income statements—to bank supervisors and to disclose this information to the public. In many cases, financial reports conform to internationally accepted accounting principles. Some countries, such as Argentina, Brazil, and Peru, have established credit information bureaus and require banks to obtain frequent external audits or private credit ratings.

Many other financial reforms have been implemented. The deposit insurance schemes established in most countries, including Brazil, Colombia, El Salvador, Peru, and Venezuela, have been designed to enhance the confidence of small depositors while minimizing moral hazard by leaving large depositors at risk. Colombia, El Salvador, Mexico, Peru, and Venezuela have eased restrictions on foreign ownership of banks to foster competition. Peru privatized state-owned banks and closed some development banks while converting others into second-tier banks. Brazil, which has large commodities and futures markets, also introduced extensive regulation of derivatives transactions. Argentina and Peru have moved to real-time gross-settlement payment systems.

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Issues for the coming decade

Countries in Latin America and the Caribbean have made important gains in the past 20 years—banking supervision, on the whole, is more effective. Nonetheless, they remain vulnerable to fluctuations in terms of trade and investor sentiment and cannot afford to ease the pace of structural reform in the financial sector. A sound financial system is essential to give countries more breathing room to manage the effects at home of events elsewhere in the world. Brazil's banking sector was able to weather the depreciation of the real in early 1999 at least in part because of the extensive financial sector reforms launched in 1994.

At one end of the spectrum are a few countries, such as Argentina, Brazil, and Chile, that have adopted virtually all major reforms; at the other end are countries that have made very little progress. The large group of countries in the middle have adopted many important reforms but need to make further progress. One important challenge will be to bring definitions of capital and other accounting procedures, such as valuation of assets, in line with international practice. While supervisors in a number of countries enjoy stronger legal authority, in many countries such as Argentina, Bolivia, Colombia, Guatemala, and Venezuela they remain legally liable for the effects of their professional decisions, which compromises their independence. Also, more effective bank supervision can spur the growth of nonbank financial intermediaries (such as savings and loan associations, credit unions, and building societies) that can act like banks but are subject to less stringent oversight. In Jamaica, for example, in the mid-1990s, insurance companies were issuing short-term liabilities very similar to bank deposits. For this reason, all financial intermediaries need close monitoring and supervision.

Once upgraded legislation and regulations are on the books, the difficult and essential task of implementing a stronger financial framework begins. For the new system to limit moral hazard, bank owners and senior managers must lose their stakes if their banks become insolvent. Well-trained on-site inspectors are key to ensuring that banks comply with the new regulations. Strong supervision must ensure that banks conduct careful credit analyses of their borrowers to avoid an important pitfall—the tendency to overstate the safety of collateralized lending. Secondary markets for the assets that serve as collateral are usually very thin, making it hard to assess the value of collateral at the time a loan is made, and asset prices usually collapse during banking crises. In some cases, deposit insurance schemes should be better funded.

Supervision can also be improved by the development of better leading indicators of banking health. Many of the current prudential indicators, such as the ratio of nonperforming loans to total loans, are backward looking or can be manipulated by weak banks through techniques such as the "evergreening" of loans (for example, converting overdue loan principal and interest payments into new loans). Bank supervisors would benefit from systematic information on the prices of houses and land (because real estate booms often precede banking problems) and on the economic outlook for key sectors. Balance sheets should reflect market values as closely as possible.

Most countries in Latin America and the Caribbean also need to improve their ability to supervise the cross-border operations of banks. Supervisors need information on the health of an entire financial institution to avoid surprises. Strong consolidated supervision means monitoring, and applying prudential norms to, all bank operations, including those of foreign branches, joint ventures, and subsidiaries, and exchanging information with supervisors in the other countries in which the banks operate. Also, host-country supervisors must hold foreign banks to the same standards as domestic banks. Consolidated supervision is especially important in countries like Costa Rica that have offshore financial sectors to ensure that onshore and offshore activities remain separate. F&D

Suggestions for further reading:

Basel Committee on Banking Supervision, 1997, Core Principles for Effective Banking Supervision *(Basel).*

Liliana Rojas-Suárez and Steven R. Weisbrod, 1996, "Banking Crises in Latin America: Experience and Issues," in Ricardo Hausmann and Liliana Rojas-Suárez, eds., Banking Crises in Latin America *(Washington: Inter-American Development Bank).*