

The banking *supervision agenda* in Latin America

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The banking sector reforms that the countries of Latin America undertook in the 1990s were an important step forward, but proved insufficient. Although it is true that the region as a whole progressed significantly, particularly in reducing the role of the State, and that market mechanisms and the regulatory framework in which banking institutions operated were improved, while at the same time the presence of foreign operators increased, it is no less true that most of the Latin American countries continued to experience systemic crises or severe banking instability. This shows that there are still issues that need to be addressed before the region can have a sound banking sector. They include in particular the need to do more to increase the real independence of supervisory bodies by separating bank supervision from short-term economic and political decision-making. Bank supervision needs to be regarded as a matter of State, which means giving priority to its technical and professional aspects; to overcome the difficulties involved, it is essential that there be a real political will to carry through the changes that are required. This article highlights the need to deal with some structural issues, such as the supervision of financial conglomerates, excessive market concentration among a few institutions nationally and region-wide, and the relationship between this and the safety nets which are supposed to contain systemic crises, but which are unable to do so adequately. As regards the regulatory aspects, this paper argues that transparency and market rules in general need to be improved, as do mechanisms for evaluating portfolio and related-party credit risk, especially where effective application of existing rules is concerned.

I

Introduction

Traditionally, policy recommendations for reforming the financial sector in the Latin American countries have not addressed issues relating to the role played by bank supervision. This changed in the 1990s, when experts began to treat them as a matter of key importance for economic stability and growth. Meanwhile, international financial organizations and governments focused their attention on aspects of bank supervision as the last stage in a sequence of reforms which included, among other things, market opening, tax reform, deregulation of the financial sector and privatization. Bank supervision was put on the agenda largely in response to the financial crises that broke out in a number of countries around the world.¹

The financial crises of the 1990s showed that bank liberalization needs to be preceded by regulatory and supervisory reform to provide the bodies responsible for these functions with the knowledge, tools and powers they require to carry out preventive supervision in a timely fashion. There also needs to be a properly structured and disciplined market that provides incentives for the different actors. Thus, the capital provided by

bank owners should reflect the risk profile that their institutions wish to adopt, and it is the owners that should suffer the consequences of bad management decisions. Depositors, meanwhile, should inform themselves about the situation of the banks they keep their money in, and likewise take any adverse consequences that may result from their decisions. Again, supervisors should provide agents with the information they need in a timely and appropriate way, a task in which they can be assisted by private agents such as external auditors and risk rating firms. Lastly, supervisors should have the powers they need and be able to exercise them independently, so that they can respond promptly and proportionately to situations as they arise.

This paper analyses banking supervision problems in Latin America. Section II examines the reforms carried out in the Latin American banking sector in the 1990s. Section III reviews the main effects of banking liberalization in the region. Section IV summarizes the problems currently besetting Latin American supervision systems and, lastly, section V sets forth the main conclusions.

II

Banking system reforms

In Latin America, the financial sector reforms carried out in the 1990s differed from one country to another. Thus, some countries opted for fundamental legal reforms: Bolivia, Chile, Ecuador, El Salvador, Honduras, Mexico, Panama, Paraguay, Peru and Venezuela. Others decided on reforms which, while partial, still led to major changes: Colombia and Costa Rica. In other countries again, only selected aspects of

the relevant legislation were amended, but this had a considerable impact: Argentina, Guatemala and Uruguay. Brazil, meanwhile, made significant changes in its market without amending the law (Aguirre, 1998).

Despite these differences, clear patterns can be discerned in the reforms undertaken in most of the region. Thus, State participation in the banking system was reduced in the leading countries. In Argentina, for example, between 1990 and 1996 the number of State banks fell from 36 to 20 (Leipziger, 1999). Again, most of the State banks in Brazil were restructured, privatization being one of the objectives that were kept in view.

Another striking aspect was the increase in foreign participation in the sector. In Brazil, for example, 20% of banking system assets were in foreign hands by early

¹ The absence of this issue from policy recommendations is surprising given the experience of countries such as Chile, which are often pointed to as examples of reform. The 1982 crisis in the Chilean banking sector was extremely costly and issued from a classic combination of inappropriate macroeconomic policies and very inadequate bank supervision (Marshall, 1991; Edwards, 1995 and Ffrench-Davis, 1999).

1999, as against some 5% in the mid-1980s. In Argentina, the figure is on the same scale; the number of foreign banks rose from 14% to 19% of the total and, what is much more significant, in 1999 foreign banks accounted for 25% of all lending. Four of the country's top 10 banks are now foreign.

One of the main purposes of the reforms was to increase the range of operations that banks could engage in. Thus, banks in all the countries were authorized to provide factoring, leasing and other financial services directly in their capacity as financial intermediaries. It was also made easier for banks to participate in stock market activities, particularly brokerage, underwriting and fund management. Banks do not generally carry out underwriting themselves, although in some cases they have been allowed to market insurance, albeit indirectly.

There are marked differences, however, in provisions governing the legal status under which banks can enter new areas of business. In some cases they can do it directly, while in others they can only act through subsidiaries or other types of legal entities.²

In the 1990s, not only did banking activities in the region expand as a result of financial system reforms, but State intervention in the banking system was drastically and systematically reduced, a development that is usually termed deregulation. All the countries freed up controls on interest rates (both lending and deposit rates, in most cases), reserve requirements and lending decisions, although some of them continued to subsidize certain types of development lending.

While the high reserve requirements that used to be the rule across most of the region have fallen, however, the reduction has been uneven. They have been lowered in many countries, but often by only a small amount.

A sound banking system is supported by two basic pillars (table 1), although other factors also count. The first pillar is the set of conditions under which the market operates; i.e., the existence or otherwise of restrictions on what banks can do and how they can do it. The second is the quality of bank supervision. It is important, therefore, to take steps to strengthen bank supervision before deregulation takes place, as

otherwise there is a strong possibility that the process may lead to crisis in the sector. Furthermore, stronger supervision is a prerequisite for continued expansion of the areas of business that banks can engage in (Goldstein and Turner, 1996).

It is interesting to consider what happened to bank supervision at the time the legislation relating to this sector was reformed.³ In Argentina, El Salvador, Nicaragua, Panama, Peru and Uruguay, changes in the banking sector were accompanied by the beginnings of major reform in supervision activities. In Bolivia, Colombia, Costa Rica, Ecuador, Guatemala and Honduras, changes to banking systems were not matched by reform on the same scale in the area of supervision.⁴

In a third group of countries –Brazil, Mexico and Venezuela– there were no changes to banking legislation or supervision, but deregulation did take place in the sector, involving the lifting of controls on interest rates, reserve requirements and lending decisions. In addition, foreign providers were allowed to enter local markets. Beginning in 1988, for example, Brazil authorized the entry of new providers, both local and foreign, and began to privatize a number of State banks. In 1989, Mexico also began to privatize the banks that had been nationalized after the 1982 crisis; in this case, deregulation was also stimulated by the North American Free Trade Agreement (NAFTA) negotiations, as the chapter on financial services meant that the Mexican market had to be opened up in stages to financial services providers from the member countries. These changes were not matched by stronger bank supervision, however.

An isolated case is that of Chile, which amended its bank legislation in the mid-1980s, the main planks of reform being the correction of the supervisory failings that had led to the 1982 financial crisis and the extension of business areas. In 1989, the law was amended again for the specific purpose of changing the terms and conditions agreed for the so-called “subordinated debt” maintained by the leading banks

² For a more detailed analysis, see Aguirre (1998). That author notes, for example, that in a sample of 17 countries banks could provide financial leasing services directly in 70% of cases and indirectly in 24% of cases. In 65% of cases they could provide direct underwriting services, while in 29% they could provide these services only through a subsidiary.

³ Assessments of whether or not supervision instruments and methods underwent any substantive change can be subjective in some cases. We have opted, however, to use the information contained in Lora's study (1998), as it provides a general assessment of the reforms in Latin America and the Caribbean.

⁴ According to Lora's information (1998), there was some progress in Bolivia, Ecuador and Guatemala. In Colombia, banking supervision was good before the amendment of 1990, while in Costa Rica no changes were made.

TABLE 1

Latin America: Banking reform and stronger oversight^a

		Stronger oversight	
		Yes	No
Banking reform in the 1990s	Yes	Argentina (1992), El Salvador (1990), Nicaragua (1990), Panama (1998), Peru (1990), Uruguay (1985).	Bolivia (1993), Colombia (1990), Costa Rica (1988), Ecuador (1992), Guatemala (1991), Honduras (1991).
	No	Chile (1986 and 1989).	Brazil (1988), Mexico (1989), Paraguay (1988), Venezuela (1989).

Source: Based on Lora (1998) and Aguirre (1998).

^a On the basis of information from Lora (1998) and Aguirre (1998), we have chosen to base the classification on whether or not oversight functions were strengthened in conjunction with banking reforms, where these were carried out. Cases in which modest improvements were made are classed as “unreformed”. No opinion is expressed regarding the quality of oversight prior to reform, the only criterion being whether or not oversight was improved in parallel with the legal reforms deregulating the sector.

with the Central Bank so that the issuing body could acquire the non-performing portfolio as part of its crisis rescue operation. Subsequently, in 1997, a wide-ranging reform was carried out in the sector, whereby banking activities were extended to new business areas and at the same time internationalized, while oversight mechanisms were strengthened.

It is interesting to consider whether the region’s banking supervision reforms took place before or during the process of deregulation in the sector, and whether or not this had consequences later. In table 2, we have classified the countries of Latin America by two criteria: whether or not they suffered some type of banking crisis, or saw their financial systems come under strong pressure that did not actually lead to crisis, and whether or not they strengthened banking sector supervision.⁵

As table 2 shows, of the countries that matched reform with stronger bank supervision, the only one to experience a crisis was Argentina. This crisis originated in an external shock, but was aggravated by the weakness of supervision in a key area, that of State banking. Three interrelated factors account for the severity of the crisis. Firstly, the non-performing loan portfolio of the provincial banks stood at close to 40%. Secondly, commercial banks had lent large sums to provincial banks that were not in a good financial

position; the latter and their operations were difficult to supervise for political reasons. And thirdly, policy constraints deriving from the currency system were also instrumental in exacerbating the crisis (Leipziger, 1999).

Table 2 shows that those countries which strengthened bank supervision during the reform process did not suffer systemic crises or serious problems. Not that there were not isolated episodes that severely affected individual banks, as happened in Peru in early 1999, but these were properly handled, with supervisors in some cases sending out the right signals by winding up struggling banks.

The cases of Mexico and Brazil are particularly important because of these countries’ weight in the region. The former’s banking crisis was the result of a combination of factors, including the handling of macroeconomic stabilization policy, particularly as it concerned the exchange rate. There were, however, also factors associated with financial sector and supervision policies, particularly the rapid creation of banks after the privatization process that began in 1989 and the failure to assess the asset position of purchasers adequately. There was also a surge in lending, especially for consumption, during which banks failed to apply proper credit risk analysis policies, and the supervisory authority failed to foresee the consequences.

Brazil, for its part, also saw the number of lending institutions grow rapidly, from 111 in 1988 to 214 in 1994, when the crisis broke out. In 1989 alone, 73 new licences were issued. According to Bydalek (1999), the Brazilian banking system displayed a number of weaknesses when the crisis began. There was a dearth of transparent information; for example, the only

⁵ The table does not seek to establish a causal link. As we reiterate throughout this article, banking crises have a variety of origins, among which macroeconomic shocks are of particular importance. Nonetheless, the good or bad quality of bank supervision is an essential factor in explaining why a crisis is triggered or subsequently worsens.

TABLE 2

**Latin America: Banking crises subsequent to reform,
and stronger oversight**

		Oversight strengthened at the time of reform	
		Yes	No
Banking crises or significant problems subsequent to reform ^a	Yes	Argentina (1995).	Bolivia (1994), Brazil (1994), Colombia (1998), Costa Rica (1994), Ecuador (1995), Mexico (1994), Paraguay (1995), Venezuela (1994).
	No	Chile, El Salvador, Nicaragua, Peru, Uruguay.	

Source: Lora (1998) and Frydl (1999).

^a By banking crises are meant runs on banks, sudden portfolio changes, bank closures or official intervention. By significant problems are meant failings that do not amount to a crisis, but that jeopardize the stability and integrity of the system. The years in which the crises began are shown in brackets.

information available on individual banks was what they published in their balance sheets. There were numerous gaps in the relevant legislation and the mechanism for applying it was weak, especially where the supervisory authorities were concerned, which encouraged risk-taking by managers and owners. As in the case of Mexico, Brazil's history of inflation had inhibited the creation of a lending culture that included proper risk analysis. Lastly, high turnover among the leading officials responsible for monetary and supervision policy created a serious stability problem. Both the Mexican and Brazilian crises revealed how deficient the accounting information available from banks was in terms of timeliness and quality.

In Colombia, the reform process included two legal changes, in 1990 and 1993, the aim of which was to

rectify the weaknesses that had arisen in the banking sector as a result of financial repression (see Steiner, Barajas and Salazar, 1998). It was made easier for new operators to enter the market, and bank merger, acquisition and liquidation rules were amended. Access for foreign providers was also liberalized. Between 1991 and 1996, the public sector's share of bank assets fell from 55% to 20% of the total, while the share of foreign providers rose only slightly, from 7.6% to 9.7% of all assets, despite easier access.

In Peru, a similar tendency towards lower public-sector participation in the banking system has been seen. In the 1990s, commercial banks raised their share of total banking sector deposits from 55% to 87%, while the share of the public sector fell to 12% and development banks disappeared (Rojas, 1998).

III

The effects of liberalization on banking activities

When the outcome of financial sector reform is evaluated, it needs to be remembered that the second half of the 1990s was a highly unstable period, specifically because of the Tequila crisis in the first instance, then the Asian crisis, and finally the Russian crisis, and this obviously affected the way the main variables evolved.

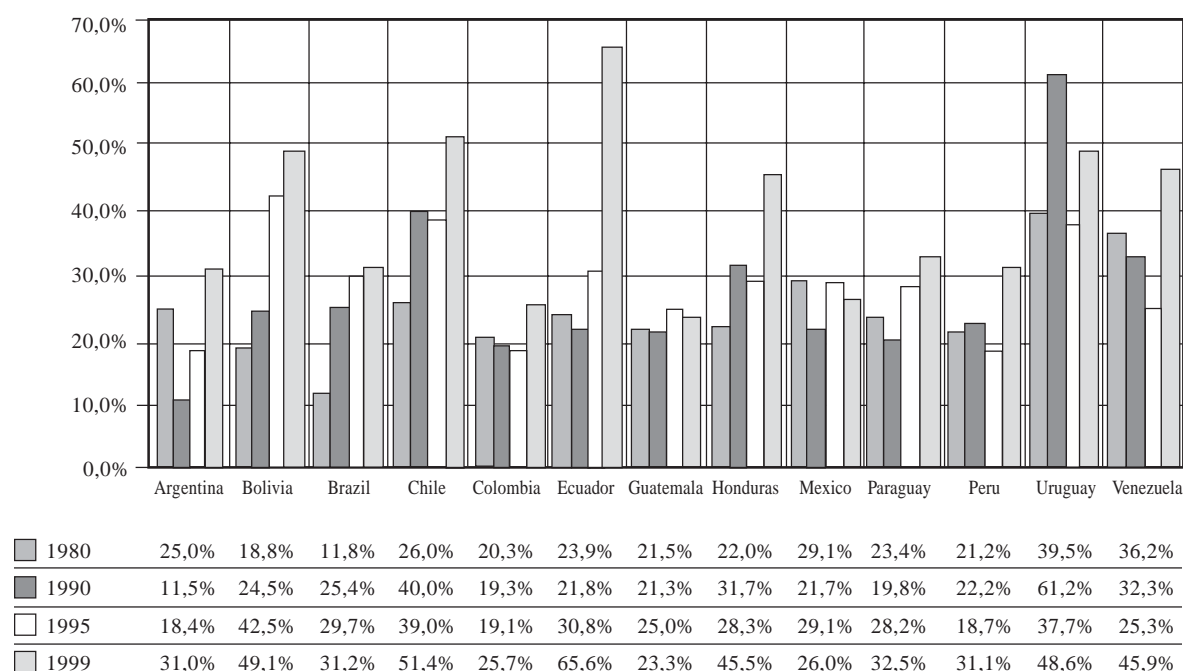
The depth of the banking sector (measured as the ratio of M2 to GDP) increased between 1990 and 1999.

Thus, for example, this ratio increased from 24.5% to 49% in Bolivia, from 25% to 31% in Brazil, and from 22% to 31% in Peru. The rise is greater still if 1999 is compared with 1980, as the ratio increased over this period from 12% to 31% in Brazil, from 26% to 51% in Chile and from 25% to 31% in Argentina, although in Mexico it remained virtually unchanged (figure 1).

When financial indicators are analysed, it transpires that portfolio quality has moved in different

FIGURE 1

Latin America: Banking depth, 1980-1999
(M2 as percentage of GDP)^a



Source: IMF, various issues.

^a M2 is the sum of lines 34 and 35 of the tables in the source referred to. The figures for Brazil and Ecuador are for 1998.

TABLE 3

Latin America: Main banking sector indicators, 1980-1999^a
(Percentages)

Country	Non-performing loans/ total		Provisions/ non-performing loans		Profitability		Capital and reserves/ assets	
	1980-87	1998	1980-87	1998	1980-87	1998	1980-87	1998
Argentina	25.2	10.4	19.9	65.2	28.7	2.3	10.1	11.5
Bolivia	20.6	4.5	44.4	57.9	-2.5	7.8	13.0	8.5
Brazil	1.1	7.4	87.7	113.3	62.3	6.9	7.4	8.9
Chile	4.5	1.6	136.4	133.9	4.3	11.7	5.8	6.4
Colombia	7.4	9.9	70.6	38.1	-14.6	11.6	5.6	10.5
Ecuador	13.4	5.3	...	138.5	20.7	7.7	5.5	15.2
Guatemala	...	4.4	...	46.5	8.2	13.3	8.2	8.1
Honduras	19.1	4.8	29.8	48.9	3.5	17.3	7.1	9.9
Mexico	1.6	9.1	60.0	67.4	40.3	6.3	2.0	8.8
Peru	3.7	6.9	148.8	92.0	25.5	9.5	6.5	9.0
Uruguay	26.0	9.7	4.8	68.2	-0.3	5.6	6.2	15.6
Venezuela	10.8	4.2	...	150.3	10.8	0.05	4.8	13.8

Source: Morris, Dorfman, Ortiz and Franco (1990), *Latin Finance*, various issues.

^a The figures are not necessarily comparable owing to changes in the definitions used by the countries.

directions in the region (table 3),⁶ improving in some countries and worsening in others. Where the non-performing portfolio index has worsened, this may be due to different factors, such as macroeconomic problems affecting borrowers' ability to pay, or stricter supervision rules established by the regulatory authorities, meaning that the index is more realistic and not necessarily that the portfolio has deteriorated. This was the case in Mexico after the Tequila crisis. Conversely, in some cases an improvement in the index needs to be treated with caution. In Ecuador, for instance, the 1998 index value was significantly better than the average for the 1980s, but the crisis the country went through in 1999 makes it clear that this value was not a true reflection of the system's non-performing portfolio situation.

The improvement in the ratio of provisions to non-performing loans in most of the countries shows that their systems have made efforts to secure the resources necessary to cope with possible losses associated with bank portfolio risk. Although the situation has got better, progress is still needed in some countries if bad debts are to be fully covered by provisions.

Where profitability is concerned, the figures in table 3 show a variety of situations in the countries of the region. In some of them, profitability in the late 1990s was clearly better than the average for the 1980s. In others, however, there was a marked deterioration (although it must be remembered that the figures show the situation in the year of the Asian crisis).

As regards levels of capital in these systems, there is a clear tendency for the ratio between capital and reserves and between capital and assets to strengthen,

which reinforces the beneficial effect that improved bad debt provision has had on solvency. This is a reflection of the restructuring seen in most of the countries, as the privatizations, mergers and acquisitions that have taken place in most markets have resulted in better capitalized banking systems. Similarly, implementation of the capital requirements recommended by the Basel Committee in 1988 has given rise to particular concern about bank asset coverage, and the standard originally designed for the Group of Ten has come into general use.

If supervision systems now have the essential tools they need for effective oversight, as regulators themselves affirm, it needs to be asked why most of the countries have had some type of crisis or serious problem in the sector. Comparative analysis of legal frameworks, and the opinion of supervisors themselves, show that the tools needed for adequate oversight are now in place. Theoretically, supervisors have the power to authorize the operation of new banks, establish and monitor the requirements that bank shareholders and/or managers have to comply with, approve transfers of ownership (except in Argentina and Paraguay) and carry out structural audits. Again, most of the region's countries have limits on lending in general and related-party lending in particular. Consolidated information is used in 70% of the countries, and all of them monitor solvency, asset quality, liquidity and currency positions, while 70% supervise off-balance sheet operations (Livacic and Sáez, 2000).

The reason for the apparent contradiction referred to is that, despite the progress made, a large working agenda still needs to be dealt with in the field of supervision.

IV

Policy considerations and recommendations

As was noted in the previous section, Latin America generally made significant progress with bank legislation and regulation in the 1990s, albeit the process differed in speed and depth among the various countries considered. Nonetheless, a number of difficulties will

need to be addressed if the shortcomings that still remain, or indeed those that have arisen from the reform process itself and from the changes experienced globally in the economy, the financial industry and technology, are to be corrected.

To facilitate analysis, we have grouped this pending work into four subject areas: market structure and operation, the powers and independence of supervisory bodies, better regulation, and stronger oversight.

⁶ The authors are grateful for the information that Raúl Romero of the Chilean Superintendency of Banks and Financial Institutions supplied for use in preparing this table.

1. Market structure and operation

In the 1990s, there was a tendency for the number of banks to fall in most of the region. This should be seen as a good thing on the whole, since to begin with there were a large number of very small institutions, and these tend to be less efficient than larger ones (i.e., have higher intermediation costs), less solvent and more unstable.

Many factors lie behind the fall in the number of banks. Firstly, the banking crises that followed one upon the other in the region over the decade resulted in some banks leaving the market altogether, either because they went bankrupt or because the authorities wound them up. Secondly, in that decade the region was caught up in the global process of acquisitions, takeovers and mergers that was also seen in the banking systems of the United States, Europe and Japan. Furthermore, much of the banking consolidation that took place in the continent was a consequence of mergers between two or more institutions in developed markets. Thirdly, consolidation in the Latin American banking industry was also driven by the macroeconomic stabilization processes that took place in the region (such as Brazil's 1994 Plan Real, which brought down inflation sharply and thereby changed the nature of the country's banking business, which before price stabilization had amounted to nothing more than collection of the inflation tax). Lastly, particular mention should be made of the efforts of some national supervisory authorities which, in their determination to see more efficient and solvent banks, "induced" a process of industry consolidation within their national jurisdictions, something that was facilitated by the international wave of mergers and acquisitions, and by the interest of foreign shareholders in entering the market. This process accelerated in the second half of the 1990s, and was particularly vigorous in Argentina, Brazil, Chile, Mexico and Venezuela.

In these circumstances (fewer but larger banks), there could be risks from a pendulum effect, such as excessive concentration in the industry. Since the last bank merger authorized in Mexico (bbva-Banamex), the largest bank in that country has had a market share of over 30%. A similar situation could arise in Chile (Santander-Santiago) and has obtained for a number of years in Peru (Banco del Comercio). The same process has begun in Brazil, Colombia and Venezuela, although it has not yet taken on the proportions seen in Mexico. What is worrying about a high degree of concentration is its possible negative impact on competition and the stability of the financial system (especially if certain banks are considered "too big to

fail"), and the excessive influence that a large bank could have on certain macroeconomic policies.

Another significant phenomenon that changed the structure of the Latin American banking industry in the 1990s was the large rise in foreign ownership of local banks. This development, which was part of world banking globalization, passed many countries by, particularly those that still had legal restrictions on the entry of foreign banks into their markets (Mexico until 1995 and Ecuador until 2000).

The presence of foreign banks in domestic markets helps to dynamize competition, bring in new technologies and products, introduce efficient management methods and strengthen the banking system capital base. What is more, in several systemic crises or episodes of severe financial instability, foreign banks operating in the country concerned have been a force for stability, with deposits being switched to them from local banks (the "flight to quality" effect), as they are perceived by the public as being safer (Paraguay in 1995, Argentina that same year and Chile in 1982). This has reduced capital outflows considerably.

It should be pointed out, however, that foreign ownership in Latin America is confined to a handful of banks, which tend furthermore to have high market shares in several of the region's countries. If one of these large banks, which have a global presence, were to fail or become unstable, there could be a regional or world banking crisis of unprecedented scale. At present, national laws and the international "safety net" architecture would be unable to cope with a situation of this kind. This mirrors the domestic situation that was seen in countries where deregulation was not preceded by measures to strengthen crisis prevention mechanisms (real oversight of bank stability).

Again, there are still countries in the region where State banks have a large market share. In Costa Rica and Uruguay, for example, the market share of State banks is some 50%, and in Argentina and Brazil, even after progress in privatizing certain provincial or state institutions, the two largest banks are still publicly owned.

Nonetheless, in the 1990s there were no mass nationalizations of banks in Latin America of the kind seen in Mexico and Peru the previous decade; furthermore, in the 1990s these two countries reprivatized all the banks that had been nationalized in the 1980s. Again, when the State took control of banks during the crises of the 1990s, this did not generally lead to nationalization, but only to temporary administration by some State body.

Although there is no consensus among specialists regarding the proper role of the State in bank ownership, the existence of State banks has been justified by the social and developmental function they are held to perform. It is clear that a high level of State involvement in the banking market brings difficulties, such as displacement of private-sector banks, political interference in lending decisions, the greater difficulty of achieving organizational efficiency and the provision of poorly targeted subsidies. From the point of view of bank supervision and regulation, it has been found in a number of cases that State-owned financial institutions have lower asset requirements and, in practice, cannot always be overseen with the same stringency as private-sector banks. In any event, it must be fully accepted that State participation in banking activities cannot be based on a discriminatory, less rigorous supervision code.

Lastly, one structural problem of the greatest importance that remains unsolved in Latin America is the difficulty that so many small businesses and microenterprises have in obtaining financing. The expansion of banking activity resulting from financial market deregulation has not yet reached these segments, owing in part to their informal nature, to biased lending policies and, at times, to regulations that discourage unsecured lending, and to the greater cost and higher risk that tend to be involved in these operations, which are for relatively small amounts. A similar situation obtains in respect of personal financing needs.

The difficulty small firms have in obtaining financing significantly constrains their ability to compete and acts as a brake on development, given that these sectors are relatively labour-intensive and account for the bulk of new employment. Again, the exclusion of vast sections of the population from access to financing is a barrier to opportunity and thus an obstacle to the real democratization of society.

2. The powers and independence of bank supervisory agencies

Over the last 10 years, bank supervision has evolved rapidly and dynamically in response to new conditions in the market and the new legal and administrative provisions that have allowed banking activity to expand.

One common feature of the legal changes made in Latin America in the 1990s was the inclusion in financial reforms of measures to improve banking supervision authorities. Thus, alongside measures to expand banks' areas of activity and remove constraints

on their operations, efforts have usually been made to endow bank supervisory bodies, superintendencies or commissions with greater legal powers and more human and material resources with which to discharge their functions. Both multilateral bodies and governments themselves are committing increasing resources to this end.

The growth in banking activities has been extraordinary, as has the rate at which banks have expanded their sphere of operations. As a result of this, and of the banking crises that have occurred, supervisors have had to show great adaptability and responsiveness to cope simultaneously with amendments to legislation, the situation of banks in difficulties and overhauls of oversight rules and methods.

Among further measures still needed, supervisory bodies should be granted real independence in the political, legal, economic and operational aspects of their work.⁷

Where the political aspect is concerned, perhaps the greatest problem is the degree to which the leaders of supervisory agencies generally depend on the political authority, regardless of what the law might say. Where banking systems are liberalized and decisions are taken by private-sector banks on the basis of market criteria, oversight is a highly technical public-sector function that protects the system from certain risks, particularly the fiscal cost of bank insolvencies.

One of the ways in which political interference manifests itself in banking supervision is the high turnover of agency heads, whose term in office is unlikely to be as long as that of the president, let alone survive a change of government. In the 1990s, on average, agency heads in the region remained in their posts for about two years. Combined with the low level of development that generally characterizes these institutions in Latin America, the departure of the head results in a large proportion of the higher technical staff being replaced as well, so that it is very difficult to preserve and consolidate the progress made under each administration.

A second factor that has prevented more dynamic development of supervisory agencies is the difficulty

⁷ Independence for bank supervision authorities should be regarded as an issue in its own right, regardless of whether or not they come under the central bank. Indeed, of the countries considered by this paper, only the Mercosur members have kept banking supervision within the central bank. The essential thing is to recognize the importance of this work and to provide the material and human resources and the legal powers that are needed for it to be carried out well.

of finding skilled staff who are able to adapt as rapidly and as thoroughly as is necessary to the changing conditions around them. The overstaffing seen in some of these agencies, the difficulty of removing officials, low pay, the influence of political criteria on appointments and the legacy of longer-serving staff who generally lack university education and are prepared only for supervision of a formal nature are the main obstacles that still need to be overcome in many countries if bank oversight is to be professionalized more quickly and become better able to respond to current and future needs.

Despite efforts to provide supervisory bodies with the financial resources they need to do their work properly, a number of them still face budgetary constraints that make it hard for them to perform. Besides the problem of pay referred to earlier, agencies need to have the resources to provide permanent, ongoing training and the technology and information systems that are indispensable to modern supervision. Again, political independence is underpinned by financial independence, but this in turn means there is a need for safeguards to ensure that funds are properly and transparently administered (external auditors, comptrollers, public management accounts, etc.). Looked at on a project assessment basis, supervision is a profitable activity, as it is much cheaper for the State to finance a good system of oversight than to pay the bill for crises resulting from inadequate banking supervision.

As regards legislation, lastly, steps need to be taken quickly to create forms of legal protection for supervisors in accordance with the international recommendations of the Basel Committee, so that they can carry out their work without fear of legal reprisals. It is par for the course for the leaders of supervision agencies in Latin America to have several lawsuits brought against them because of decisions taken in the performance of their duties. These lawsuits are brought by shareholders claiming to have been treated arbitrarily or with undue severity, normally during crises, or by depositors claiming in the wake of crises that the supervisor has been negligent and insufficiently zealous in performing his functions and that it is as a result of this that they have lost their savings.

While supervisory agencies should be made more independent, the grounds of the main rulings they arrive at should be subject to greater public scrutiny, and these rulings should be based on criteria that are known to the different agents involved, so that they can be satisfied that the agency is exercising its powers objectively.

3. Better regulation

Significant progress was also made in the legislative and regulatory field in the 1990s. There is a great deal still to be done, however, and further progress will require technical skill and, most importantly, great political will.

The most important of the tasks still pending is the regulation of financial conglomerates, which has many aspects. As the issue is most generally understood among specialists, regulation of financial conglomerates needs to be based on a body of laws covering the activities of business groups that act in different areas of finance –these may include banking, securities, underwriting and pensions– and perhaps in the industrial and commercial sectors as well. This approach to the regulation of conglomerates, which is the broadest and most comprehensive, has already been incorporated into legislation in some countries, such as El Salvador and Mexico and, to some degree, Ecuador and Venezuela. Almost without exception, however, these rules have yet to be applied effectively.

Nonetheless, this comprehensive view of conglomerate regulation is not the only one that the region should concern itself with. On the contrary, there are some far more serious and obvious deficiencies in the way conglomerates are regulated, such as the lack of thorough, consolidated regulation and oversight of what could be termed banking subconglomerates, which confine themselves to financial intermediation activities (deposit-taking and lending). In Latin America, there are in practice a whole range of organizations and mechanisms whose legal form is designed specifically to avoid regulation and which are used to carry out supervision-free banking activities that parallel, and are linked to, those of the parent bank.

The most commonly used mechanism is the unregulated offshore centre. A bank or its shareholders set up another bank in a different country that has fewer regulatory requirements and, in most cases, offers tax exemptions, where some of the banking activities they carry out in their country of origin are deemed to take place for accounting purposes. These offshore organizations are usually protected by very strong and wide-ranging banking secrecy laws, so that they are beyond the reach of the local supervisor. In some countries, operations carried out in this way now represent a very significant percentage of duly acknowledged local banking activity. Thus, for example, when banking crises occurred in Venezuela (1994) and Ecuador (1998), it transpired that a

significant proportion of banking activity was being recorded in the accounts of offshore subsidiaries.⁸ Something similar happened with some of the banks involved in the 1995 crisis in Paraguay.

Another method used to avoid regulation and supervision is to set up unregulated or very lightly regulated organizations that are artificially “separated” from the bank by various devices. Of these, the most common type of organization in various countries is the trust. These unregulated bodies have been at the root of crises at individual banks in El Salvador, Guatemala and Paraguay, to name just a few.

In the regulatory sphere, there are also deficiencies in the regulation of market risks (currencies and rates), country risk and liquidity risk. Of these risks, the most important in the very short term is currency risk, as a large proportion of bank assets are denominated in dollars (Argentina, Peru and Venezuela, and Ecuador before dollarization). This will depend, however, on the tendency followed by the region’s currency regimes.

Again, as banking markets continue to become more sophisticated and longer-term operations take on greater importance, there will need to be further progress with regulation of the risks inherent in these (rates and maturities).

Where the resolution of banking crises is concerned, some countries have launched worthwhile initiatives in recent years, and these need to be introduced in the rest of the region as a matter of urgency. The line followed has been that of the Federal Deposit Insurance Corporation (FDIC) in the United States, which aims to find the “lowest cost of resolution” for banks in trouble. In a lightning operation, which is usually carried out over a weekend, the struggling bank is divided into a “good bank” and a “bad bank”. The “good bank” (with the corresponding liabilities) is transferred to third parties, normally an existing bank, and carries on operating. The “bad bank” is wound up. The final losses are absorbed by shareholders and the deposit insurance, and the end cost is lower than it would have been had the whole bank been liquidated. Initiatives of this type, and reform of deposit insurance systems to allow for more flexible and efficient action that is pre-emptive rather than merely remedial in nature, are among the regulatory and legal challenges that should be addressed.

Lastly, the countries of the region need to achieve significant improvements in the transparency and

reliability of information. Substantial progress has been made, but more is needed. This aspect is vital if there is to be real market discipline. Agents need to have timely access to relevant information. Particular mention should be made here of accounting practices. Progress needs to be made towards information standards that facilitate comparisons among countries and, most particularly, that allow an accurate and reliable picture to be formed of the real situation at individual banks.

4. Stronger oversight

Where bank supervision is concerned, i.e., in the actual work of ensuring that prudential provisions are really complied with, progress in the 1990s failed to keep pace with the growing complexity of banking activities.

In every financial system in the world, the greatest banking risk still derives from credit. In Latin America, where the degree of sophistication is lower than in the developed countries, the preponderance of credit risk is even greater. Although a growing number of Latin American countries have brought in regulations that provide for credit risk to be assessed with reference to the projected payment capacity of the borrower, in practice delinquency –i.e., the discovery of payment difficulties after the event– is still the most commonly used procedure. When this happens, supervision loses much of its preventive character and consists rather in the retrospective surveying of asset problems.

Something similar is true of related-party or insider loans, i.e., loans made to persons who have an ownership stake in the bank. Legal provisions and regulations in this area began to be introduced in all the region’s countries in the 1980s. With a few exceptions, however, their application in practice has been quite limited, as serious information problems hinder the detection of these operations, and the subterfuges used by those carrying them out have hitherto defeated supervision capabilities. Again, the laws introduced have not provided supervisors with the powers they need to apply the rules effectively on the basis of a reasonable assumption that such a link exists.

The problem of related-party loans has a number of aspects and ramifications, but perhaps the most salient of them is that these loans, and the low credit quality that characterizes them, have been a factor in almost all the region’s banking crises.

When the related-party portfolio exceeds paid-up capital and reserves, one of the key components of a stable financial system, i.e., solvency, is eroded, as the

⁸ To resolve the crises, the authorities of these countries extended State insurance to such operations.

incentive to follow prudent risk policies that derives from the possibility of shareholders losing their capital is weakened.

The weaknesses referred to above—in portfolio risk assessment and related-party loans—are the most

obvious examples of a problem that is common in the region. This is the serious difficulty that the authorities have in applying existing regulations effectively, because of the above-mentioned constraints on their independence and lack of resources.

V

Conclusions

To sum up, it can be said that profound changes were made to Latin America's financial systems in the 1990s. Nonetheless, the reforms adopted were not always matched by stronger supervision in the sector. In a number of cases, this resulted in weaknesses that became evident when the economies concerned were subjected to some kind of external shock. The second half of the 1990s saw a transition towards sounder banking systems based on a good balance between market incentives and a regulatory framework involving preventive supervision.

Where market structure is concerned, Latin America still displays some old problems such as excessive State involvement, although clear progress has been made in this area. Again, new structural problems have emerged, among them a degree of market concentration that could become excessive not just in individual countries, but region-wide, where it would be beyond the purely domestic reach of "systemic safety nets".

Likewise, the rapid and dynamic development of the region's banking situation seen in the 1990s has still not made its effects felt sufficiently in the microenterprise and small business sectors, or among

individuals, the result being a serious constraint on growth in jobs, output and participation in the benefits of progress.

If most of the shortcomings pointed out in this article are to be overcome, particularly those connected with bank regulation and oversight and the autonomy of Latin America's supervisory agencies, there is one overarching requirement, and that is the political will to carry through the changes that still need to be made. For this to emerge, banking supervision should cease to be regarded as an integral part of short-term economic policy and as an instrument of political power. Instead, the work of banking oversight needs to be regarded as State policy, and supervisory agencies need to be given the freedom of action they require, with emphasis on their technical and professional character.

As regards bank regulation, the most important task facing Latin America is the regulation of both the domestic and cross-border activities of financial conglomerates, especially those carried out in offshore centres.

In the field of supervision as such, further work needs to be done on preventive monitoring of credit risk and exposure to related-party lending.

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