"REGULATION AND SUPERVISION OF BANKS AND FINANCIAL INSTITUTIONS"

CASE STUDIES IN LATIN AMERICA AND THE CARIBBEAN

Santiago, 3-5 December 1990 and 22-23 August 1991
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INTRODUCTION

Case studies on bank and credit institution regulation and supervision were performed in Argentina, Colombia, Costa Rica, Chile, Dominican Republic, Guatemala, Mexico, Paraguay, Peru, and Venezuela. The first four studies were presented at a Seminar held at ECLAC Headquarters, in Santiago, 3-5 December 1990. The six remaining studies were analyzed in a Seminar held in the same place, 22-23 August 1991. All studies were prepared by expert consultants from their respective countries and were coordinated and edited by the joint ECLAC/UNDP regional Project, "Financial Policy for Development".

These studies and the seminar debate highlighted the following points of view, conclusions and recommendations on the issues of regulation and supervision of banks and credit institutions.

* The final version of the study of Colombia was not available for this report.
CONCLUSIONS AND RECOMMENDATIONS

In spite of the progress made in bank and financial system regulation and supervision in various countries of the region, these systems still suffer important lags and shortcomings in many countries. This situation was attributed to two main factors. First, the high degree of "dirigisme" in the allocation of credit and in the setting of interest rates which prevailed in the region in the past. In that context, bank regulation and supervision played a subordinate role. Second, the stabilization and adjustment policies implemented in the region in the last decade often left the modernization of the institutional framework of bank and financial institution regulation and supervision outside its scope or for a latter stage.

Regulation and supervision systems have proven to be of decisive importance for the success of liberalization and financial reform policy. Countries which have liberalized credit and interest rates without adequate regulatory and supervisory mechanisms have tended to experience solvency crises and loss of financial control. Several of those crises have been very severe, committing substantial public resources to bank, financial institution and debtor salvage programmes. However, the true significance of regulatory and supervisory systems is found at a more general level of analysis. System failings have caused financial problems even in countries which have not entered into processes of financial liberalization, indicating that the liberalization and financial reform policy implemented by countries of the region ought to strengthen bank and financial institution regulation and supervision systems substantially from their inception.

At the same time, such policy should anticipate solutions for bank, financial institution and debtor solvency problems inherited from the past and be implemented within adequately stabilized and restructured macroeconomic contexts. The solution of inherited solvency problems is essential in order to avoid lagged financial crises in the course of financial liberalization processes. Moreover, macroeconomic disequilibria, involving high and variable inflation together with interest and exchange rates outside reasonable bounds, impede smooth financial system operations because they create uncertainty, give erroneous signals to economic agents and stimulate capital flight.

Three different regulatory structures through which the State may establish the bank and financial institution "rules of the game" for deposits and loans are: prudential regulation; financial regulation, and organizational regulation.

Prudential Regulation seeks to control the risks of bank and financial institutions insolvency and illiquidity. Its main objective is to achieve financial system stability, avoiding the transfer to depositors or to the public sector of losses arising from excessive risk taking by banks. This type of regulation is mainly concerned with the following factors:

- Conditions of entry into the market: minimum capital and property requirements for major shareholders, Directors and the Chief Executive Officer.
- Regimen of guarantees or deposit insurance.
Solvency control mechanisms, especially, portfolio quality control norms, the regimen of provisions and of capital requirements for banks and financial institutions as functioning companies, and procedures for dealing with problems of solvency, including bankruptcy.

Financial Regulation is basically oriented toward interest and exchange rates, the currency denomination, periods for instrument maturity, and other conditions related to the price and value of assets and liabilities, including credit allocation. The main objective of this type of regulation is to ensure the fluidity and competitiveness of domestic financial instruments (with respect to foreign funds), within a regulatory framework which will preserve an adequate balance between bank and financial institution assets and liabilities.

Organizational Regulation pursues bank and financial institution operational efficiency through economies of scale, the integration of economic activities and the promotion of competition among financial institutions in the market. To that end, it employs norms which affect the size and degree of specialization of banks and financial institutions and the conditions of entry into different segments of the credit and capital markets.

The supervision of banks and financial institutions entails the verification of compliance of the set of prudential, financial and organizational norms and rules which frame their activities as financial intermediaries. The issue of supervision concerns the role and the factors determining the performance of the public institution responsible for ensuring compliance with the established norms and rules.

Although bank and financial institution management was not studied as such, safe and secure management has always been a prime factor for the solvency and stability of these entities. In this context, prudent management has been the hallmark of banks and financial institutions which have remained solvent over the years.
PRUDENTIAL REGULATION

1. Regime of guarantees or insurance on deposits

The regime of guarantees or insurance for deposits is an essential component of banking regulatory and supervisory mechanisms. State guarantees for deposits can be either explicit or implicit. Implicit guarantees arise mainly from a lack of transparency with respect to the solvency of financial institutions. In these conditions, depositors are unable to discriminate between different institutions as regards the risk to which their funds will be exposed. For this reason, the State is practically obliged to back deposits in cases of insolvency.

Although the lack of transparency with respect to the solvency of banks and financial institutions encourages depositors to perceive an implicit State guarantee for deposits, the public sector has not always responded in the event of bank or financial institution solvency problems. In those cases, extreme distrust in the financial system has been generated, causing significant declines in deposits.

Regimens of guarantees or insurance for deposits severely limit depositors concern for the solvency of financial institutions and encourages them to make deposit decisions exclusively in function of the interest rates paid. On the other hand, the guarantee encourages risk-taking behavior on the part of financial institutions given that the likelihood of deposit withdrawals is relatively low when granting risky loans. For these reasons, a regimen of guarantees or insurance for deposits places the full weight of financial institution regulation and supervision on the authority in charge of this task.

There was considerable agreement that State guarantees for deposits should be limited to small depositors and the saving public, given that these agents generally have less information about the solvency of banks and financial institutions. However, the backing of deposits in situations of insolvency ought to be limited to a certain portion of its amounts of capital and be subjected to a per person limit which reflects the size of the deposits of small savers. Among the measures recommended was a precise specification of guarantee coverage, limited to natural persons, with maximum amounts for specific periods (for example, a calendar year), covering banks and financial institutions as a whole.

If the option is made for a deposit guarantee fund banking, financial institution contributions should be obligatory and prorated in terms of their respective risks. Moreover, it was indicated that the financial institutions themselves should participate actively in the administration of the fund. That participation would encourage more conservative behavior in the face of risk by subjecting the institutions to the scrutiny of the other participants.

The extension of the faculties of the guarantee fund to cover the recuperation and debt adjustment of insolvent financial institutions raises several problems. When the financial system suffers severe problems of solvency, the role of the fund as a "bank clinic" may lead to a situation in which a large part of the financial system would be administered by the public sector. Such interventions tend to halt declarations of bankruptcy and the liquidation of banks as normal procedures for facing insolvency in a market economy. Moreover, once interventions have occurred, the tendency has been to preserve the intervened institutions as they were, instead of reducing their size, and to retain them within the public sector longer than necessary. These characteristics have created conditions of unequal competition for those banks which remained in the private
sector, both because the intervened banks have benefitted from bad credit reductions and because they enjoy an implicit State guarantee on their deposits.

An explicit State guarantee for deposits may be necessary in situations in which the stability of the financial system as a whole is at risk. However, such a guarantee should be withdrawn or limited as soon as possible in favor of a regimen of financial market competition which would allow for bankruptcies and the liquidation of financial institutions with severe problems of solvency.

2. Rules for portfolio quality control

The establishment of mechanisms for solvency control by the regulatory and supervisory agency should begin with a timely and adequate evaluation of the portfolio (and other) risk of banks and financial institutions. Measuring those risks forms part of a process of learning and experience accumulation which may take considerable time. For this reason, asset risk appraisals should be initiated as soon as possible in those countries which have not as yet begun them, and amplified and deepened in those which have already made progress in this direction.

The financial institutions themselves should play a leading role in the assessment of their own risks, subject to adequate supervision by the Superintendency or the authority charged with comptroller responsibilities. In that case, the supervisory agency should ensure that the risk assessments of the financial institutions themselves are trustworthy and comparable among each other. Private appraisal firms can play an important role in the achievement of this last objective.

The definition of credit norms and limits geared to diversify credit portfolios among debtors, productive sectors, regions and economic activities has proven to be very important for the control of bank and financial institution portfolio risk. The correct definition of what is understood by persons and firms linked to the ownership and management of financial institutions and the establishment of limits to the loans involved are particularly important. The idea is not to eliminate these loans but to restrict them to levels compatible with the risks which banks and financial institutions can take, considering the high leverage (or debt-capital ratio) of the latter.

The synchronizing of active and passive financial operations as regards currency denomination and time structure is important for controlling the "mis-matching of funds" risk of banks and financial institutions. These risks refers to the "mis-matching" in the denomination of currencies, that is, lending in one currency having accepted deposits in another, and to the risk involved in interest rates variation arising from the "mis-matching" between the maturation dates of assets and liabilities (for example, lending for longer periods than those established for deposits). The high leverage of banks and financial institutions indicate their low tolerance to these risks and, therefore, the importance of norms to limit them.

Guarantees play a decisive role in the credit process, not only constituting the main source of loan repayment in the event of debtor illiquidity or insolvency but also conditioning debtors' "willingness to pay". When guarantees are insufficient or are poorly established, that willingness tends to weaken. For this reason, bank and financial institution solvency depends directly on guarantees fulfilling all legal requirements which make their selling to third parties possible and on their adequate valuation, both at their constitution and as long as credits are due.
3. Regimen of capital provisions and requirements for banks and financial institutions as functioning companies

A basic principle preserving the solvency of financial institutions is that their known risks be fully covered. If that condition is met and financial institution assets are appraised at their market prices, the capital and reserves of these institutions as shown in their balances, will also represent their real patrimony.

Increasing real patrimony requirements and not merely of capital and reserves figures on balance sheets, is an important way of encouraging conservative and prudent behavior in the granting of loans and in the management of funds by banks and financial institutions. The significant periodic fluctuations of the foreign sectors and of the economic activity in the countries of the region, are an additional factor in favor of increasing effective capital requirements or patrimony of those institutions.

Capital requirements for banks and financial institutions refer to the minimum capital necessary to enter the market and to the capital requirements as functioning companies. As regards the first, it was noted that it should imply an important initial capital contribution but that it should not be so high as to deter entry into the market. The minimum amount should be established in function of the size of the market so as to provide for a number of banks and financial institutions which will ensure competition. As such, the minimum capital requirement is both a requisite of prudential regulation and of organizational regulation. Unless there are already too many banks and financial institutions, the entry of new competitors into the market should always be possible. If too many exist, it was thought preferable that entry should occur through the purchase of already existing banks or financial institutions.

It was judged appropriate to define capital requirements for banks and financial institutions as functioning companies according to the recommendations of the Basel Accord. These recommendations define capital requirements according to generic risks assigned to each asset category. However, it was noted that these capital requirements should be complemented with requirements on provisions which will completely cover the risk of losses arising from periodic evaluations of the quality of asset portfolios.

If initial risk evaluations indicate that financial institutions are deficient in those provisions, a reasonable period should be established in which they would have to comply with the principle of full provision of risks. If this principle is ignored, there will be financial institutions functioning with underlying solvency problems.

Once the process of appraisal and provision for risks has been completed, it will be possible to inform the public about risks and the patrimonial situation of banks and financial institutions. If the option has been made for an explicit State guarantee on deposits, it will be possible to limit guarantee coverage (to small depositors and/or certain funds). However, even in this situation depositors and savers may still behave as though the State banks and, presumably, the large private banks were covered by an implicit State guarantee on deposits. This situation ratifies the full validity of the indispensable regulatory and supervisory role of the public authority responsible for the solvency and liquidity of financial institutions.

There was agreement on providing information about the financial and patrimonial situation of banks and financial institutions. However, there were diverse opinions with respect to the kind of information to be provided. One opinion favored the publication of synthetic, easy to understand solvency indicators. Another favored the publication of a great amount of information so that depositors and investors could draw their own
conclusions. It was noted that in both cases the objective is the same, that is, to promote conservative behavior by banks and financial institutions in the management of their portfolios.

4. Norms for dealing with solvency problems

One of the less developed area of bank and financial institution regulation in the countries of the region is the systematic treatment of solvency problems. In some cases, liquidation or bankruptcy norms are ill defined or are difficult to apply in practice. In others, options for financial recovery in the face of solvency problems of a certain magnitude are lacking. This makes the adoption of timely measures difficult, magnifying current solvency problems and favoring liquidation as the solution for facing difficult financial problems. However, the latter alternative generally increases losses and may affect the stability of other financial institutions.

An important alternative preventing solvency problems is the "self-regulation" of banks and financial institutions. The principle of self-regulation has two main objectives: first, to encourage conservative and prudent behavior by these institutions in the management of funds and allocation of credit; second, to introduce timely procedures for the recovery of patrimony by banks and financial institutions faced with problems which threaten their financial stability.

Achieving the first objective depends mainly on withdrawing the State guarantee on deposits and on providing public information about the solvency situation of banks and financial institutions. Achieving the second objective requires, moreover, the definition of problematic financial situations and the measures to be automatically adopted to face them. Thus, for example, in the face of moderate losses of patrimony, the shareholders would be obliged to provide fresh capital. If the losses were to become greater, certain deposits could be capitalized. Finally, if losses threaten the institution's entire patrimony and recovery measures have not been implemented an orderly liquidation should take place.

In the context of self-regulation, liquidation or bankruptcy are extreme alternatives to face severe problems of solvency which cannot be solved by other means. As such, it is hoped that, timely and intermediate alternatives for recovering patrimony will make liquidation and bankruptcy infrequent occurrences.
FINANCIAL REGULATION

1. The competitiveness of deposit and loan financial instruments of banks and financial institutions in several countries of the region declined as a result of high reserve requirements, obligatory investment in low-yielding public sector financial instruments, restrictions on certain financial operations, selective loan allocation, and/or inadequate establishment of interest and exchange rates. This frequently led to the financial "repression" of regulated financial institutions. It was noted that this situation encouraged the proliferation of non-regulated or informal financial companies, which appeared in significant numbers in several countries of the region in the last decade in order to extend short term loans to persons and small businesses. By their very nature, these companies cover higher risk segments of the market, operate with high interest rates, and have few liquid reserves. This led these financial companies to solvency crises of diverse magnitude in several countries, especially in the face of stabilization and adjustment policies which restricted liquidity and the level of economic activity.

2. The proliferation of informal financial companies also arose from the bias of established financial institutions against small businesses and lower income families because of the small scale of their operations, high transaction costs and the absence of adequate guarantees. To counteract that bias, the importance of creating institutions and financial instruments which will satisfy the specific financial needs of those agents, such as guarantee or insurance funds backing these credits, capital risk funds and others, was noted.

3. The strengthening of the competitive position of regulated financial institutions was indicated as the main way of limiting the activity of informal financial institutions. However, it was noted that lower reserve requirements and obligatory investments, and the progressive liberalization of credit and of interest rates within the formal financial system, were subject to the following conditions: public sector financial discipline, macroeconomic ordering, and active regulation and prudential supervision.
ORGANIZATIONAL REGULATION

1. As an organizational principle, multi-purpose banking was preferred instead of specialized banking. It was thought that banks with multiple services could better diversify their risks and are in a better position to expand into new areas in response to their own dynamics and the progressive globalization of financial processes. Moreover, specialized banking is exposed to the systematic risk inherent in the activities it serves. Its role in the credit process has declined as well in the face of the progressive abandonment of selective credit allocation schemes in which they played an important role.

2. The fusion of specialized banks is an expeditious way to proceed toward multi-purpose banking. It was noted that progress toward multi-service banking is made easier in practice by the presence of conglomerates which simultaneously manage a network of specialized financial institutions. The recommendation was made to proceed with fusions on the basis of solvent or previously recapitalized banks and financial institutions. Otherwise, multi-service banking would be established on a weak footing. It was also recommended that the number of multi-purpose banks be gauged with a view to ensuring adequate competition in the market.

3. Although development banks were not the specific subject of study, the importance of strengthening their patrimony and of organizing them on the basis of the multiple-purpose principle was indicated. To that end, a redefinition of the “market position” of those banks was recommended on the basis of the following principles: i) linking the savings of businesses and persons in these banks with their access to credit for investment projects such as projects for new businesses and housing purchases; ii) diversifying the asset and liability operations of these banks and developing financial instruments able to satisfy the financial needs of small businesses as regards investment projects; iii) creating instruments for mid- and long-term deposits geared to limit bank dependency on public and foreign funds.

4. In the case of development banks, it was also recommended that their activity be oriented in function of their own profitability. Priority given to general economic objectives, such as the creation of employment and income, and the use of selective subsidized loans, were indicated as factors which had contributed to the financial problems currently affecting these banks.
SUPERVISION OF BANKS AND FINANCIAL INSTITUTIONS

1. The regulatory framework of norms which govern the supervision of banks and financial institutions call for clear, complete, and sequentially correlated legal dispositions and instructions. Voids in the legal framework and frequent changes of rules introduce confusion and diminish the efficacy of the supervisory authority.

2. It was considered beneficial to have a supervisory authority of banks and financial institutions which is independent of the Central Bank. It was argued that the latter had its own vital functions to fulfill, including the establishment of financial norms and regulations. The high regulatory and normative content of financial activities and the complexity of the tasks linked to the control of solvency justify the creation of a specialized public supervisory institution. However, experiences were also mentioned in which the Central Bank fulfilled that function adequately through a specialized division or department.

3. It was observed that supervision should cover the different types of regulations and norms which affect banks and financial institutions. In this area, the importance of going beyond mere verification of compliance with accounting, tax and financial norms was highlighted. The central issue was lending attention to the evaluation of the quality of assets, risks and the patrimonial situation of the institutions under supervision.

4. Proper functioning of the public institution responsible for bank supervision requires that it be independent; that it has political support from the Executive to carry out its tasks; that it is able to levy fines on persons engaged in the management of banks; and to intervene and/or liquidate banks and financial institutions, in accordance with situations foreseen in the respective regulations and norms.

5. Supervision itself requires intense training of personnel of the supervisory institution, especially, in the area of bank and financial institution risk appraisal, with wages commensurate with their important functions.

6. When the supervisory institution is weak in the fulfillment of its tasks and, moreover, when there is either an explicit or an implicit State guarantee on deposits, neither the authorities nor depositors exercise quality control of bank and financial institution portfolios. That situation encourages "loss-of-control" of credit allocations and problems of solvency, putting processes of financial liberalization at risk.

7. If there is a Deposit Guarantee Fund, it was recommended to clearly define the roles of the Fund, of the public supervisory institution, and of the Central Bank, in situations of intervention and liquidation of banks and financial institutions.
SUMMARIES OF COUNTRY CASE STUDIES

1. REGULATION AND SUPERVISION OF BANKS AND FINANCIAL INSTITUTIONS IN ARGENTINA

Elias Salama

The first part of this study describes the regimen of deposit guarantees, examining both normative and financial aspects. The policy of explicit guarantees on deposits has been modified over time, especially with respect to the amounts guaranteed. At the same time, a more implicit policy was developed through "cautionary" interventions of banks, which maintained broader guarantees on deposits.

The second part describes the main liquidity and solvency norms which have been applied in Argentina. Because the law of financial institutions grants ample normative faculties to the Central Bank, frequent changes in these norms have occurred. There is also little transparency on portfolio risk and the patrimonial situation of banks. This is due both to lax norms on provisioning and which grant too long periods for its constitution, and to the extension of the principle of bank secrecy to asset quality.

The third section covers the supervisory activity of the Central Bank in recent years, highlighting the shortcomings which have hindered its role. Banks and financial institutions have, on average, been visited only once every two years. The lack of qualified personnel and unattractive wages made supervision more difficult.

Finally, recommendations are made in function of the following objectives: a) to lower the cost to the State of the system of deposit guarantees; b) to limit the discretionary powers granted by the law of financial institutions to the Central Bank; c) to modify Central Bank norms with respect to provisions and accrued interests, and; d) to ensure greater financial system transparency by publishing more data about each financial entity.

With respect to the guarantee fund, it was proposed to make the participation of all banks obligatory, to set the contributions of participating banks to the fund in relation to their risks, and to incorporate the banks into the administration of the fund. Such participation would encourage banks to a more conservative risk taking behavior by subjecting them to the scrutiny of the other participants. Furthermore, it was argued that the guarantee deposits should be limited to small depositors since the latter had generally less information about the solvency situation of banks.
The main characteristic of the Colombian bank system has been the progressive concentration of banks in the hands of the State. There are currently eight official banks which handle 65% of sector assets. That process may continue through the practice of preventing the liquidation of insolvent banks. The recovery and administration of these banks in an officialized sector has given rise to an undesired process of State control of the banking sector.

The Financial Institutions Guarantee Fund (FOGAFIN) was created at a time when an instrument was needed to attend problems of generalized bank insolvency and to inspire confidence to foreign creditor banks. However, the "bank clinic" function of that fund has been extended beyond its initial limits by including the administration of banks which ought to have been liquidated.

The banks which now form part of the officialized bank system operate in fact with an implicit deposit guarantee. Moreover, they have been subjected to a process of financial redress. Those factors have placed them in an advantageous competitive position by discriminating against banks which have remained in the private sector.

Thus, an essential issue of the system of regulation and supervision of colombian banks is the redefinition of the role of FOGAFIN. That role should extend State guarantees only to small depositors, allowing for bankruptcy and the liquidation of banks.

Excessively large officialized banks should be reduced to a manageable size and then be returned to the private sector. As in any activity subject to risk, insolvent banks should leave the market. It is argued that in the case of isolated situations of insolvency, there is no reason why the liquidation of a bank should affect the stability of the financial system, or cause greater social losses than those brought about by the bankruptcy of a firm located in the real sector.

Changes in the role of FOGAFIN require mechanisms for detecting and revealing the banks’ problematic financial situations. To this end, the Superintendency of banks introduced a system for the classification of credit by categories of risk with levels of provisions for each category. Since the second half of 1988, the supervisory entity publishes a series of indicators of financial institutions. In the second half of 1990, capital norms were implemented which depend on the weighted risks of the different types of assets. However, up to now, these indicators are not well known by the public and have been published with considerable delay. For this reason, there is inadequate transparency as regards bank solvency.

On the other hand, in order to limit the implicit State guarantee on deposits in favor of officialized banks, they should be returned to the private sector. Although the reprivatization of those banks has been announced several times, toward the end of 1990 little progress had been made in this direction.
3. REGULATION AND SUPERVISION OF BANK SOLVENCY IN COSTA RICA

Rafael Díaz Arias

The takeover of banks by the State which took place in 1948 established the framework of the financial system of Costa Rica in the following decades. Financial and credit policy followed a "conductionist" scheme in which the Central Bank set the amount, the distribution and the cost of credit. Within the context of an eminently State banking system, the regimen of bank supervision was designed to verify compliance with the norms and credit allocations established by the Central Bank.

Financial and credit policy suffered a profound change in the 1980’s when financial agents were given greater responsibility and independence in the administration of the credit programme and in the setting of deposit and loan interest rates. At the same time, the role of private banks as lenders of financial services and as intermediaries of funds was strengthened. These changes required adjustments in regulatory and supervisory functions for the purpose of establishing risk prevention mechanisms for financial institutions operating in basically free credit markets.

In 1985, the General Auditing office of Financial Institutions (AGEF) introduced procedures to evaluate and classify credit portfolio risk and began the systematic analysis of the situation of banks and financial institutions. Toward the end of 1988, changes in the legal framework granted the supervisory entity greater autonomy as regards the Central Bank and strengthened various of its faculties. Currently, AGEF has achieved reasonable coverage of the practices and procedures proper to preventive auditing and supervision. This point of view is supported by the fact that the financial debacle of the last months of 1987 and the first months of 1988 brought about the bankruptcy of all financial intermediaries not supervised by AGEF, while, on the contrary, none of the supervised institutions became insolvent.

The main areas in which prudential supervision can be improved in Costa Rica are: i) providing depositors with adequate information about the solvency situation of financial institutions so that they can choose properly among these institutions when making their deposits; ii) extending the provision mechanism to all loans classified as uncollectible; iii) evaluation of banks’ financial investments in accordance with their risks and by requiring timely provisions on these risks; iv) complementing the financial analysis of banks and financial institutions with the inclusion of qualitative variables, especially, those related to managerial capacity; v) making AGEF’s recommendations for the preservation of solvency compulsory for supervised institutions; vi) putting into practice the project for an integral information system, already being implemented, which seeks to provide systematized information about diverse aspects of the financial system to the supervisory entity, the public, the Central Bank and the banks themselves.
4. EVALUATION AND CLASSIFICATION OF ASSETS:
THE CHILEAN EXPERIENCE

Guillermo Ramírez

The Chilean experience of financial liberalization which began in 1975 has produced very positive and enduring results. However, this process unfolded in a situation of marked lack of control, with a gap between the speed of growth of the financial system and the adoption of improvements in banking regulatory and supervisory procedures. This reality, together with the sharp recession which affected the economy during 1982-1983, as a result of the massive adjustment of aggregate expenditure and of the exchange rate which brought about the so-called "foreign debt crisis", led the greater part of Chilean banks to a severe insolvency. Yet, the advances made after 1980 as regards supervision, albeit late, allowed the diagnosis of the magnitude of the problem and the application of refoataion and recapitalization measures which were indispensable for reestablishing sector solvency.

The Chilean experience is decisive in indicating the importance of creating regulatory and prudential supervision mechanisms, among other conditions, to ensure the success of measures liberalizing credit and interest rates. Ample bank liberty, without preventive regulation, pose important risks which must be avoided.

In 1980, the Superintendency of Banks of Chile began a pilot plan to evaluate the 30 largest debtors of each financial institution, later broadening the analysis to include, in 1988, all debtors whose credits represented at least 75% of the total of each institution. In that process, it is important that the financial institutions themselves carry out the evaluation and classification of their own debtors, according to clearly established common guidelines and criteria, whilst the supervisory organism periodically reviews these classifications.

These periodic reviews by the Superintendency required the creation of a team of highly qualified portfolio analysists. The latter were trained through an intensive professional programme. In Chile, the option was made to classify risk portfolio according to the overall loan balances maintained by a given company or debtor instead of evaluating each loan individually. In order to evaluate the different types of credit of a given company or debtor, loans were divided into commercial loans or those made to companies, consumer loans or those made to persons, and housing loans. Debtors were classified according to certain categories of risk, with five categories being found sufficient in practice.

In the mid 1980s, the Superintendency extended risk evaluation to cover financial investments. Although the greater part of the financial instruments held by the banks are issued by the Central Bank or the General Treasury of the Republic, their tenancy can mean severe losses to the extent that the market interest rate rises whilst the instruments mentioned carry a fixed interest rate. The ideal is to be able to determine the market value of each financial instrument on the basis of the prices of transactions realized in some secondary formal market, such as the Stock Market. If the capital market is not sufficiently developed, the adjustment of the price of financial instruments with respect to their
book prices could be established on the basis of the current value of these instruments, discounting their coupons at the average market rate of return used in transactions of instruments with similar characteristics.

The procedures for the classification of assets seek to compare the face value of assets with an estimate of what their recovery or market value would be, the latter serving as a basis for judging the adequacy of provisions or of the patrimony of the banking entity. Even though those procedures have been efficient in the detection of solvency problems, it is necessary to incorporate methods which will improve their capacity to gauge the intensity with which they ought to be applied to one or another financial institution. It is also desirable that these procedures take into account more rapidly the effects on portfolio risk arising from important changes in the immediate economic context.

The Chilean experience indicates that the setting up of a reliable system of portfolio evaluation and classification ought to be given very high priority in the procedures of bank supervision in Latin American and Caribbean countries. All the essential aspects of a modern system of control can be derived from this system. Such control include the early detection of portfolio problems; the insufficiency of provisions and requirements of capital replacement; public information on assets risk and on the patrimonial situation of banks for the purpose of dismantling State guarantees deposits; and a drastic limitation of "bank secrecy" in the sense of making asset appraisals and the adequacy of the banks' capital public, in order to encourage conservative banking practices.
5. REGULATION AND SUPERVISION OF BANKS IN GUATEMALA

Edgar Balsells Conde

The study describes the principal characteristics of the regulation and supervision of the formal banking system during the 1985-1990 period, on the basis of a given macro-financial environment. The latter experienced an important change in August, 1989, when interest and exchange rates were liberalized.

The study analyses the legal framework of regulation and supervision in broad terms, highlighting its underdevelopment and inflexibility in the face of the demands of financial modernization. The issue of the state guarantees on deposits is illustrated with three examples of institutions intervened during the period studied, revealing faults in the guarantee regimen and delays in the adoption of timely measures to facilitate recovery of bank patrimony.

In its final section, the study presents proposals for the reform of the institutional framework of regulation and supervision. The proposals are mainly related to improving the regimen of guarantees on deposits, to the introduction of methods to assess the quality and risk factors in loan and asset portfolios, and to defining and limiting risky loans to companies and persons related to banking institutions.
6. REGULATION AND SUPERVISION OF BANKS IN MEXICO

Alberto Martínez Rincón

Since the reorganization of the Mexican bank system of 1925, the country has not suffered generalized bank crises. Yet, situations of insolvency of particular credit institutions have occurred more frequently in 1960-1975, when various financial societies experienced problems. The factor which triggered these problems was almost always risk concentration and deficient loan administration.

In 1987, when banks were already nationalized, a Fund of Preventive Support was put in place with the costs of financial assistance to banks in trouble being charged to the banking system itself. Up to 1990, only eight institutions had received transitory support from this Fund.

The legal and regulatory norms which govern banking, the regulatory dispositions of the Bank of Mexico and the inspection and vigilance of the National Banking Commission have operated with reasonable efficiency to safeguard the solidity and solvency of the system as a whole. However, in some cases, vulnerable areas have been detected in supervisory mechanism which prevented the timely detection of anomalous situations in some banks, especially in their loan portfolios. It is hoped that these shortcomings will be overcome by the recent creation of mechanisms of preventive vigilance which will operate through automated systems and the periodic evaluation and classification of risks of loan portfolios, together with global provisions for the higher risk categories, as well as other measures to improve the quality of supervision. These procedures were introduced in 1990.

Since 1989, banking in Mexico is in a process of accelerated change. The regulatory and reserve requirement regimen has been liberalized, banks have been reprivatized, and a new legal framework has been put in place which allows for the creation of financial conglomerates. The latter entities may operate banks, brokerages, insurance companies, underwriters and other non-bank financial intermediaries, such as auxiliary credit organizations.

The creation of financial conglomerates requires a new strategy of financial system regulation and supervision. Independently of each individual institution, it will be necessary to take into account the group as a whole in terms of its real nature: as one economic-financial unit. This will require, among other measures, to make homogenous normative and regulatory procedures for the different sectors, to extend the procedure of risk classification to all institutions managing credit; and to ensure their adequate portfolio diversification. Further, accounting and evaluation criteria need to be homogenous to put in place reliable procedures to consolidate figures in order to assess and evaluate with a reasonable degree of certainty the situation of the conglomerate as a whole. This will require, in turn, close coordination of the diverse supervisory bodies.
7. REGULATION AND SUPERVISION OF BANKS IN PARAGUAY

Beltrán Macchi

Up to 1989, the financial system of Paraguay was subjected to a policy of financial repression. Among the factors which hindered the efficient functioning of the financial system were: regulated interest and exchange rates; direct credit allocation through re-discounts; prohibition of granting loans in foreign currency to residents; excessive reserve requirements; taxes on financial transactions; and the lack of adequate saving instruments.

The interventionist framework led to financial disintermediation and a fragmented financial system, to concentration of loans and credit diversion, to distortions in the availability and the price of money; and to a strong growth of the informal financial sector.

Since 1989, measures have been taken to counteract this situation. The more important of these have been: liberalization of exchange rates; gradual liberalization of active and passive interest rates; adjustment of re-discount rates of the Central Bank toward market rates; the gradual reduction of legal reserve requirements; and the introduction of modern instruments of monetary control. However, a lag has been detected between these reforms and adequate bank regulation and supervision as well as on the situation of the solvency of national banks. The study highlights the importance of moving rapidly in the latter directions in order to create solid foundations for the current process of financial liberalization.
8. REGULATION AND SUPERVISION OF FINANCIAL SYSTEM
SOLVENCY IN PERU

Gerardo Gonzales Arrieta

The study analyses the regulatory and supervisory system of the solvency of the financial system in Peru; examines the impact of faults in that system revealed by the emergence of solvency problems in recent years; comments the recent reforms of regulation and supervision; and presents proposals for improving the system.

The system of regulation and supervision applied until recently was characterized by an implicit State guarantee on deposits and controls of the risks of banks and financial institutions. In that system, all responsibility as regards solvency fell on the supervisory institution because the implicit guarantee led depositors to ignore risk and the solvency situation of financial intermediaries. For this reason, during the 1980s, norms were introduced to limit and evaluate portfolio risk and to require provisions which would safeguard bank and financial institution patrimony.

Several factors limited the implementation of a system of preventive regulation and supervision of solvency problems. The respective norms were too vague; there was insufficient transparency as regards the risks and the patrimonial situation of intermediaries; and compliance with loan limits and provisions for risks suffered lags.

The recent promulgation of the new General Banking Law ordered the legal norms as regards regulation and supervision. Those norms established an explicit regimen of guarantees for deposits, limiting that guarantee to "small depositors". The law also formalizes preventive regulatory and supervisory mechanisms, some of which were already in effect.

The study makes suggestions to improve the regimen of regulation and supervision in the following directions: making precise the explicit guarantee on deposits; improving the methods of portfolio risk evaluation; establish explicit provisions for each risk category; adjustments in the minimum capital requirements lending to real increases in the patrimony of financial institution; and ensuring greater transparency of these patrimonies.
9. REGULATION AND SUPERVISION OF THE FINANCIAL SYSTEM IN THE DOMINICAN REPUBLIC

Héctor Guilliani and Jaime Aristy

The financial sector of the Dominican Republic experienced strong growth in the 1977-1987 period, especially in the informal or non-regulated sector. In 1989, the expansion culminated with the bankruptcy of various banks and financial institutions. The authors argue that this crisis is characterized by a marked illiquidity of financial intermediaries arising from over-investment in fixed assets.

Several factors explain the solvency crisis which has affected various banks and a group of financial institutions. Among these, both the regulation and supervision of banks and financial institutions are important. Regulation is weak in terms of portfolio quality control mechanisms. Yet, in the face of solvency problems, the authorities have not guaranteed the public’s deposits. Supervision has also suffered from shortcomings and ineffectuality, stemming from frequent changes of supervisory authorities and from poorly trained and poorly paid personnel. These conditions have eroded public confidence in regulated financial institutions.

The current regulatory framework has also been used to intervene the financial intermediation process by setting interest and exchange rates, and by selective allocations of credit. These interventions have undermined the competitiveness of banks of the regulated sector. This situation and the distrust mentioned above, played a decisive role in the growth of informal financial societies and of an important non-regulated credit market.

The Central Bank recently liberalized interest and exchange rates within the context of an economic stabilization and adjustment programme. The persistence of high real interest rates has raised additional issues with respect to the solvency of the financial system.

The authors argue that reforming the bank regulation and supervision regimen is urgent and should not be postponed. Reform options are presented in the final section of the study, related both to substantial strengthening of solvency control mechanisms and to active supervision of banks and financial institutions.
10. REGULATION AND SUPERVISION OF BANK SOLVENCY IN VENEZUELA

Ricardo Hausmann

The study analyses the Venezuelan system of regulation and supervision of banks through a deposit guarantees regimen and control mechanisms of solvency and liquidity. It also examines the principal cases of bank insolvency during the 1985-1989 period.

Regulation and supervision of the banking system in Venezuela is shared by three institutions: the Central Bank of Venezuela; the Superintendency of Banks; and the Fund for Deposit Guarantees and Bank Protection (FOGADE). The latter institution was created to assist financial intermediaries with solvency problems.

The legal framework which establishes the participation of the aforementioned institutions in bank regulation and supervision has been revised in the last five years. However, there are still overlapping functions and competence voids which limit its efficacy. The Central Bank of Venezuela (BCV) has considerable weight in providing assistance to financial institutions with problems, in spite of the existence of FOGADE. This is due, in part, to the fact that there are no clear procedures to determine when a bank enters into transitory liquidity problems, in which case Central Bank assistance is appropriate, or when the liquidity problems are structural, in which case FOGADE should evaluate the possibility of assisting the bank in question. For its part, the Superintendency of Banks lacks sufficient faculties such as the power to remove the management of institutions in trouble, thus producing their intervention, or to authorize or withdraw bank and financial institution operating licenses.

The study envisages of vital importance redefining the role of the public institutions responsible for regulation and supervision in the face of the liberalization of the financial system currently under way. Along those lines, four laws which would reform the financial system are analyzed. At the same time, the authors' and World Bank experts' recommendations to improve the bank regulatory and supervisory institutional framework are presented.

* With the collaboration of Roberto Rigobón and Carlos Jaramillo.