Comité Latinoamericano de Asuntos Financieros
Comitê Latino Americano de Assuntos Financieros
Latin-American Shadow Financial Regulatory Committee

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TOWARDS FINANCIAL STABILITY IN LATIN AMERICA

In its first statement, the Latin-American Shadow Financial Regulatory Committee (LASFRC) recommends improving the quality of Latin America's integration to the international capital markets through the following actions:

- Strengthening fiscal discipline and institutions.
- Establishing the independence of all financial regulatory and supervisory institutions; institutional governance should prevent political interference.
- Adopting and implementing effectively the Basel Core Principles on banking regulation and supervision.
- Adapting the risk assessments embodied in the current standard Basel approach to reflect the true nature of asset risk in Latin America, recognizing that both government bonds and private securities are vulnerable to international capital market volatility.
- Strengthening liquidity management by requiring banks to hold an appropriate level of liquid high-grade foreign assets and hedge the associated foreign exchange risk exposure.
- Implementing effective consolidated supervision to avoid connected lending practices.
- Adopting prompt corrective action–type rules calling for pre-specified supervisory actions triggered by declining thresholds of bank capital ratios.
- Speeding up privatization of state-owned financial institutions.
- Avoiding government interference in the pricing of bank assets and liabilities, which should be left to the markets.
- Fostering competition in the national financial systems.

General Background

Emerging market economies, and Latin America in particular, have undergone an extraordinary period of turbulence in capital markets during the period 1997-1999. Recent events in Argentina and Turkey provide a reminder that volatility remains a salient feature of the financial landscape.

In the view of the LASFRC it is unlikely that the region will see a restoration of capital flows to exceptional levels preceding the Asian crisis in the foreseeable future, due to a number of factors. These include: relatively high external private and public debt levels, generally tighter risk-control procedures applied by international financial institutions, the unresolved discussion on the role of private sector involvement (PSI) in crisis prevention and resolution, along with increasing awareness of the relative underdevelopment (or weakness) of political, legal, and economic institutions in many countries of the region. At the same time, we recognize that industrial countries' official assistance bilaterally or through multilateral institutions could be less forthcoming in the years ahead.

In response to these events the LASFRC does not advocate more extensive regulation. Rather, it believes that reforms of the financial system at the national and international level should be market-oriented, aimed at facilitating the effective working of markets while minimizing the adverse effects of distortions and interference.

A central lesson of this period of capital market turbulence is the crucial role of financial markets and institutions, domestic and international, in explaining economic fluctuations, growth and development. In this respect, we believe that financial policies remain a central piece in any strategy to reduce an economy's external vulnerability and to restore *sustainable* capital flows to the region while keeping open the capital account.

The LASFRC also favors a continuous and fluid dialogue between Latin-American governments, banks and private companies and foreign investors and creditors. Constructive dialogue contributes to crisis prevention by increasingly making available relevant information.

Views on the International Financial Architecture

Considering the above context, LASFRC members discussed the relevance and direction of current work on the international financial architecture for Latin America. This process has produced significant recommendations summarized in the following actions:

1) a call for transparency in the provision of timely economic and financial information on data as well as on policy;

2) development on standards and codes on key policy areas;

3) a mechanism to promote implementation of the recommendations across emerging market economies; and

4) the IMF's contingent credit line (CCL). Less of a consensus has been reached regarding PSI.

The Committee believes that the above-mentioned multilateral work on the various aspects of the international financial architecture contributes significantly to the goal of restoring sustainable capital flows to the region and agrees with the general thrust of the recommendations emanating from this process. In the course of the following meetings the Committee will analyze and discuss in more detail a number of related topics of specific interest for the Latin-American region.

In the meantime it recommends that the consultative discussions have adequate representation from Latin-American economies. In this respect the Committee believes that it would be more productive if the Financial Stability Forum and other relevant bodies converge at least to the same membership as that of the recently created Group of Twenty (G20).

Improving the Quality of Latin America's Financial Systems

To improve the quality of Latin America's integration to the international capital markets and, hence, become a more credible partner in the global economy, the LASFRC recommends actions in the following areas.

1 - Institutional Framework

Fiscal institutions and discipline

Financial markets cannot work well in an environment where the government crowds out the private sector. Establishing effective fiscal institutions capable of ensuring sustainable fiscal positions would significantly contribute to macroeconomic and financial stability in Latin America.

Fiscal discipline however goes beyond simply achieving structural budgetary equilibrium. The fiscal system must be made less vulnerable to external shocks and contingent costs of problems in the financial services industry should be explicitly recognized.

Independence of all financial regulatory and supervisory institutions

The LASFRC favors continued efforts to build up the independence of all the institutions in the domestic financial safety net, including the central bank and the supervisory bodies of all providers of financial services. Institutional governance should be designed to prevent political interference.

Central banks should be vested with the clear authority to pursue the anti-inflationary objective and the proper functioning of the payment system. This includes a meaningful role in managing systemic risk.

2 - Financial Regulations

Banking

National banking regulation and supervision should adopt and effectively implement the Basel Core Principles, recognizing that special efforts should be made to effectively enforce prudential regulations.

Bank safety and soundness should rest on asset quality, appropriate provisioning and a capital base that is effectively available for write-offs in the event of banking problems. Several issues are particularly relevant to LASFRC in this context. First, in order to appropriately manage the true risk and volatility of asset values, Latin-American countries must adapt risk assessments embodied in the current standard Basel approach. Second, it must be recognized that both government bonds and private securities are vulnerable to international capital market volatility and deserve appropriate capital requirements. Banks' investments in government bonds do not ensure the long-term stability of the financial systems in Latin America.

The LASFRC favors the adoption of liquidity rules requiring banks to hold an appropriate level of liquid high-grade foreign assets whose market value will not be impaired by domestic financial and/or macroeconomic instability. The associated foreign exchange risk exposure should be adequately hedged.

Connected lending practices are at the root of the banking sector weaknesses in many Latin American countries and should be avoided. Furthermore, in revising the regulatory and supervisory framework, special efforts must be devoted to properly measure risk on a consolidated basis. In countries that have not yet implemented effective consolidated supervision, bankers and supervisors should devote special efforts to identify and properly measure the risk that non-financial companies may pose to the soundness of financial conglomerates.

The LASFRC strongly favors competition in the national financial systems. Entry rules have been modernized in many countries to include proper licensing provisions. However, exit rules often continue to be too loose and subject to discretionary decisions by political authorities. The LASFRC recommends the adoption of prompt corrective action–type rules calling for pre-specified supervisory actions triggered by declining thresholds of bank capital ratios as a means to avoid regulatory forbearance and minimize the potential cost to the tax payer.

Privatizing state-owned financial institutions needs to be a priority. As experience has shown over and over, governments have no comparative advantage in running financial institutions and providing financial services.

Capital markets

Banking soundness is a necessary condition for capital market development. However, financial regulations should evolve in accordance with market developments. New players are becoming increasingly important in Latin-American capital markets, including pension funds, insurance companies and mutual funds. At the same time, the financial services industry is becoming increasingly consolidated in some countries. The LASFRC recommends establishing institutional arrangements that facilitate coordination among different regulatory agencies in order to assure transparency and avoid regulatory arbitrage.

3 - The Role of the Private Sector

The LASFRC welcomes and encourages the development of enhanced corporate governance and risk management practices in financial institutions throughout the region.

Market discipline enforced by depositors, other creditors and shareholders should play an increasing role as an incentive for banks to improve the quality of their assets and their capital base. Regulators should therefore enhance disclosure and transparency.

Banking soundness is primarily in the hands of the private sector. Bank directors and management must be liable and take effective responsibility over the bank's risk practices.

Pricing of bank assets and liabilities should be left to the markets. Interest rate regulations, setting minimum and/or maximum rates, and directed lending rules tie the hands of bank management and force decisions that are based on political rather than efficiency considerations.

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