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

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THE NEW BASEL CAPITAL ACCORD AND FINANCIAL STABILITY IN LATIN AMERICA

Introduction

The Latin American Shadow Financial Regulatory Committee considers the January 2001 proposed New Capital Accord as an important step towards improving regulations on bank capital requirements, especially because it brings about a better incentive structure in banking regulations, promotes better risk assessment, enhances the role of market discipline, provides the context for sound supervisory reviews and brings corporate governance to the forefront of the regulatory process. These features are especially relevant for Latin America as recent experience shows that capital requirements alone have not been too effective in containing excessive risk-taking by banks. However, the Committee identifies some important weaknesses in the proposed Accord, explained below. Additionally, the Committee is concerned about the implications that the adoption of the New Accord may have on Latin America if implemented as proposed.

1. The New Accord may increase systemic risk on a global scale

In the proposed Basel Committee framework internationally active and/or large banks can choose between either using ratings provided by external agencies or their internal rating systems as a basis for classifying the credit risk of a particular loan and for calculating the regulatory capital requirement.

The adoption of either of these two approaches in industrial countries may exacerbate the already high volatility of capital flows to Latin America and emerging markets in general. There are two reasons. First, international banks adopting the internal rating based (IRB) approach will have a much larger discretion to assess the risks involved in lending to Latin American clients, in contrast to current practices in which all loans to non-OECD corporations and governments carry a 100% risk weight. Therefore, in the event that an underestimated (overestimated) risk from a credit to the region materializes, international banks will quickly reverse (increase) the flows to micro-manage capital requirements, thus widening the swing in economic cycles.

The adverse effect to the stability of capital flows to the region will be even higher if loans come from international banks adopting the standardized approach. In this case, risk weights will be assigned according to the credit assessment of rating agencies, which already have a track record of lowering ratings to emerging markets after the emergence of problems in these countries. Therefore, international bank lending to Latin America will become more pro-cyclical than under current circumstances. Moreover, *de facto* sovereign ratings often constitute a ceiling for ratings to the private sector. A deterioration in the perceived quality of assets issued by a Latin American government resulting in a lowering of sovereign ratings, will thus lead international banks to reduce their exposure to both the public and private sectors of that country for regulatory reasons.

The second factor adversely affecting the stability of capital flows to Latin America relates to the more favorable treatment of capital requirements for short-term inter-bank lending. The current Accord already requires lower capital charges for short-term inter-bank lending. The New Accord lowers even further the maturity of inter-bank loans subject to this preferential treatment. For all practical purposes, this implies that international banks will have an incentive to shorten the maturities of loans extended to banks in Latin America making the efforts of Latin American governments to extend the maturity structure of foreign liabilities more difficult.

Although it can be argued that the preferential treatment given to short-term inter-bank lending aims at strengthening banks in industrial countries as shorter maturities carry less risk, this argument misses the adverse systemic consequences of such a measure. Policymakers from industrial countries are well aware of the emerging market fragilities caused by short-term indebtedness; short-term exposures have in fact been identified as a key cause of recent crises in emerging markets. Shortening maturities for loans subject to preferential treatment thus contradicts the efforts of policy makers in industrial countries to avoid the eruption of systemic crises.

2. Further shortcomings of the proposed New Accord

A structural concern with respect to the use of external ratings in the process of determining the required amount of capital is that such a scheme is likely to create a huge demand for new ratings by companies, both in Latin America and elsewhere. At this time, only few companies directly accessing capital markets are rated. The New Accord will thus generate a new demand for ratings because companies borrowing money from a bank will have a strong incentive to obtain a favorable rating in order to lower the capital requirement for the bank and, thereby, be charged a lower interest rate on the loan.

This new and huge demand for ratings cannot be satisfied by existing rating agencies, implying that supervisors will have to license a large group of new rating agencies in a relatively short period of time. In this process it will be hard for supervisors to distinguish “good” from “bad” rating agencies: the good ones will enter the rating market with the intention to provide fair assessments and build up reputation, while the bad ones will enter with the purpose of maximizing short-term profits through the provision of relatively favorable ratings. Companies intending to borrow from banks will shop around among rating agencies for the most favorable rating. A likely consequence of this process is a “race to the bottom”, implying ratings which are too low and not representing the true credit risk profile of the borrower.

Rating agencies serve their purpose in the case of independent investor-driven ratings, i.e. ratings required by investors in capital markets. The ratings that will be in demand as a result of the Basel Committee proposal will not be investor-driven but rather demanded by borrowers seeking bank loans, and will thus not serve as a building block for market discipline. Under such conditions, using an internal rating based (IRB) approach, supplemented by an appropriate regulatory framework, effective enforcement and a credible form of market discipline on the banks, might be better than external ratings.

The Committee also identifies a distortion in the proposed weighting system under the standardized approach of the New Accord. While unrated companies carry a risk weight of 100%, companies that are rated below B- carry a 150% risk weight. Under this system, banks will have an incentive to lend to unrated companies rather than to one with a rating below B-. This generates an incentive for weak companies not to be rated and for banks to lend to unrated companies. The Committee recommends the elimination of the 150% bucket.

3. Implementation problems in Latin America

The proposed New Accord is a complex and challenging regulatory framework requiring stronger enforcement capabilities by supervisors and more powerful and professional corporate governance in the banks to ensure prudent risk management and compliance. Many countries in the region lack appropriate accounting and reporting procedures needed to make risk-weighted capital-to-assets ratios work. Furthermore, in contrast to industrial countries, the limited development of domestic capital markets severely constrains the ability of markets to assess the quality of capital reported by banks. In situations where asset ownership, both financial and real, is very concentrated, supervisors face difficulties in determining whether shareholders' wealth is really at risk when they supply equity capital to a bank, since shareholders can finance their capital contribution from a related party, including non-financial corporations. Accounting capital, therefore, does not necessarily reflect the "true" riskiness of banks.

In spite of advancements in Latin American banking regulation and supervision, the Committee strongly feels that basic weaknesses still need to be addressed. Latin American countries need to improve the regulatory framework, implement the Basel Core Principles and enhance market discipline to make any capital regulation work. Additionally, there is a need to supplement capital requirements with the use of indicators of bank risk based on signals provided by markets that work.

The Committee stresses the importance of the following issues:

a) <u>Strong and independent bank supervisors.</u> Supervisory reviews, Pillar 2 of the New Accord, can only be effective if carried out by a supervisory agency that is independent and has the skills, resources and legal protection to carry out its tasks. This is of utmost importance in many Latin American countries and deserves special attention.

   Furthermore, in order to enhance the effectiveness of supervisory reviews, many Latin American countries must enact and enforce prompt corrective action-type rules as a structured system. Otherwise, bank weaknesses might be off the supervisor's radar screen until problems are too deep and costly.

b) No regulatory discrimination in favor of state-owned banks. Many Latin American countries have applied lax rules to state-owned banks as a means to promote development, distorting competition in their domestic financial sector, and hindering the efficiency of banks as intermediaries in the savings-investment process. State-owned banks must be subject to the same rules as private institutions. They should not be given unfair competitive advantages and must also be subject to the same strict disclosure as private banks in order to enhance the role of Pillar 3.

c) Stronger corporate governance. Poor corporate governance has hindered the development of sound banking systems in many Latin American countries. The Latin American Shadow Financial Regulatory Committee sees the implementation of the New Accord as an opportunity for Latin American supervisors to enhance corporate governance in banks and make shareholders and management their natural partners in the quest for stronger banks. Regulations creating the proper incentives for shareholders and management, stating the responsibilities and liability of directors, dealing with conflicts of interest issues and making all of them fully accountable will strengthen the banks from within and allow for more effective enforcement of the regulatory framework.

d) Keeping connected lending at bay. As already acknowledged in the December 2000 Latin American Shadow Financial Regulatory Committee statement, connected lending practices are still at the root of banking sector weaknesses in many Latin American countries and should be avoided. Higher capital charges and/or collateral requirements for connected loans along with disclosure of beneficial ownership and risks associated to connected parties, would allow Latin American supervisors to use the three Pillars of the New Accord to put a check on one of the most important problems for Latin American banks. In many countries, the rules exist but are improperly enforced.

e) Contract enforcement. Weak judicial enforcement, poor bankruptcy laws and unreliable property registries limit the incentive for borrowers to repay. This is an issue that deserves special attention by governments and regulators in Latin America in order to reinforce market discipline.

4. Planning the transition

Planning an appropriate transition from the current system to a proper New Accord is a major challenge for Latin American supervisors. The approval of the New Accord in G-10 countries will most likely unleash pressures by internationally active banks operating in Latin American markets, and also by many Latin American banks, to quickly move to the internal rating based (IRB) approach for the sake of a level playing field. Neither banks nor supervisors might be ready for this substantial change in the region. Additionally, Latin American supervisors might favor the standardized approach as a compromise with modernization and flexibility, because of the complexities of the IRB approach.

The Committee strongly believes that Latin American supervisors must resist the pressures. It might be more appropriate to remain within the existing framework and to move to IRB regulations when they are convinced that they are prepared to assess the systems that will be applied by banks and can make sure that these systems are sound and reliable. As explained above, IRBs are better than a system based on external ratings.

Supervisors must also assess the impact of the New Accord on the market structure and competition in their respective countries, ensuring that competitiveness and efficiency will not hinder stability and the soundness of the banking systems.
During the transition, Latin American supervisors must also be prepared to maximize their ability to conduct meaningful supervisory reviews, as foreseen in Pillar 2, and to enhance the role of market discipline in order to build the strengths of Pillar 3.

Market discipline also needs to be enhanced during the transition in Latin America. In the absence of liquid and developed capital markets, signals of bank strength can be obtained by encouraging the offering of certificates of deposit. To ensure that the pricing of certificates of deposit effectively reflects the market's perception of bank strength, this instrument needs to be credibly uninsured, implying that it is not covered by any form of explicit or implicit official guarantee. Encouraging the development and appropriate functioning of the inter-bank market is an additional tool to enhance market discipline.

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