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

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WHY IS IT THAT BANKS ARE NO LONGER LENDING IN LATIN AMERICA?

In Latin America there is general concern with respect to the paucity of bank credit growth. The Latin American Shadow Financial Regulatory Committee [LASFRC] has analyzed the various aspects and causes of this phenomenon identifying their origin, whether macroeconomic, regulatory or institutional versus derivatives of the constant evolution and innovation inherent to the nature of financial markets. Based on this analysis the Committee presents the ensuing recommendations:

In order to restore conditions that will enable credit retrieval, it is essential to:

- Remove obstacles and create a favorable scenario for the development of new financial instruments and vehicles that promote more efficient risk management and allow for the funding of those sectors which are currently excluded, within a framework exclusive of eventual rescue by the treasury.
- Ensure strict application of the law. Regulations on insolvency and bankruptcy proceedings should be updated in line with best international practices, strengthening the rights of creditors by regulating foreclosure of collaterals in a manner such that it become the rule in case of debtor default.
- Recognize that bonds issued by the public sector are market- risk assets and as such should be weighed when calculating bank capital requirements.
- Design prudential regulations so as to mitigate impact of abrupt relative price changes on bank credit derived, among other factors, from volatility of capital flows. The Committee does not recommend application of capital controls.

1. Introduction

Bank deposits are, in the majority of countries, the financial asset *par excellence* and banks capture funds from the public for the purpose of investing, to a large extent, in short-term public debt securities and other liquid assets. Vast segments in the private sector have no access to bank credit. For example in Mexico, as from 1994 to date, commercial bank credit has fallen from almost 80% of third parties funding to companies, to approximately 40%. In

Brazil, commercial bank credit represents between 12 and 28% of company funding sources depending on their size. The remainder is supplied by domestic sources [profit reinvestment, own funds, other income], supplier credit and other minor sources.

This is a matter of concern because in the aftermath of the banking crises which occurred in many countries in the region, regulator efforts were directed to strengthening their banking systems and putting them on a sound footing so that they be less vulnerable to systemic risk.

Concurrently, many countries adopted policies aimed at achieving greater depth in financial markets. Company privatization, public utilities and state-owned banks increased the number of open capital companies and hence the potential offer of bonds and shares. Reform of social security systems gave rise to private pension funds thus increasing potential demand for private bonds and shares. The regulation of capital markets, also improved with more stringent standards being imposed on market reporting and transparency. Nonetheless capital markets have not responded with the dynamism that was expected of them, with the exception of Chile.

Given the fact that the majority of private companies have no easy access to capital markets, the concept that banks should cater for the largest share of credit demand in our countries, is still prevalent. This generates inconformity in society for there are many who feel frustration at being unable to obtain funding for their projects. There is also increasing pressure on regulators to prevent slacking of standards and have banks open to the possibility of assuming greater risk.

2. Credit limiting factors

The Committee believes that it is important to distinguish, on the one hand, between the low average level of credit to the private sector in Latin America, and its recent downturn on the other. The first perceptible fact is based on structural aspects, while the second applies mostly to the situation at the time of occurrence. The main structural limitations identified by the Committee consist in some aspects of banking regulation, the legal set-up and the effective application of creditor rights, as well as reassignment of private sector credit towards the public sector [crowding-out]. The Committee identified retraction of net capital flows to the region and low growth as the more relevant factors occurring during the recent credit tightening observed in various countries

2.1. Banking Regulation

Many countries in Latin America have seen important progress during the last decade with respect to strengthening their regulatory framework and banking supervision. To a large extent this progress has reflected the recent international harmonization in this field, which has lead to generalized adoption of international standards in the matter of prudential regulations and risk evaluation of banking activities. Recognizing the greater volatility of the economies in the region, various countries have adopted even stricter criteria than is generally applied in the larger industrialized economies.

The primary objective behind this process was to reduce eventual financial crises and consequently develop financial institutions of a more sound and safer nature, with more prudent risk evaluation policies. This process has been offset by the fact that the financial institutions themselves, in adopting stricter criteria with respect to risk management, have

turned into entities which are more risk-averse and even more cautious in granting credit, concentrating on larger and/or lower risk customers, as well as in the shorter term. The result has been that a segment of the borrowers are no longer served by the banks.

The Committee believes that the adoption of a tighter prudential regime is a positive improvement with respect to the soundness of financial systems. The problem derives from its combination with an inadequate development of the institutional and legal framework that is supposed to sustain credit relations among private sector economic units, beyond the banking scenario.

In particular, the convergence of region towards more prudential and regulatory international standards has been tantamount, in the opinion of the Committee, to limiting the role of the State as implicit supplier of insurance to such risks as are inherent to the banking business. This fact, combined with the adoption of risk-weighted capital requirements, has drawn attention to the importance of legal institutions which ensure compliance with credit relations.

2.2 Legal scenario and effective exercise of creditor rights.

Bank credit is affected by a weak or obsolete legal framework concerning the protection of creditor rights, as well as by the application of standards, supposing the latter to be adequate.

In point of fact, the lack of a generalized application of the law, both in credit contracts and in contractual agreements among partners, suppliers, buyers, etc., conforms a formidable barrier to the extension and multiplication of business and to the effective operation of such business as are already under way.

This takes the form of very high collateral requirements which freeze assets that might be available for other purposes, of disproportionate performance and supervision which affect the day-to-day operation of enterprises or, in extreme cases, in the rejection by the banks of credit applications their risk-aversion having increased within the last few years due to the effect of banking crises and the new regulatory framework

2.3 Crowding out by public sector

Public expenditure, financed partly through debt placement, competes with the private sector for the limited resources available [particularly in the light of the sporadic and volatile access of emergent countries to international capital markets], crowding out private expenditure, particularly investment expenditure, through very high real domestic interest rates. In the opinion of the Committee this crowing-out of the private sector by the public sector is one of the factors that explain the very low levels of bank credit for the private sector found in many Latin American countries.

This crowding out is exacerbated by existing regulations in the region. Almost all Latin American countries apply the Basel recommendations concerning banking capital. Nevertheless, when these recommendations are applied to Latin American countries, the regulations in the majority of countries stipulate that bonds floated by their own governments must be weighed at zero-risk. That is to say, banks in Latin America treat liabilities issued by their own governments as “non-risk” assets,” an assumption which is not valid throughout, particularly if one bears in mind the large number of crises episodes which have occurred involving public debt, including those of Ecuador and Argentina. The problem with this

regulatory practice is that in order to avoid capital requirements, banks are strongly incentivated to concentrate a considerable part of their assets in government instruments.

2.4. The reversal of capital flows and economic activity

It is obvious that the recent contraction of lending in many Latin American countries dates back to 1999. The frequency of the ***credit contractions*** in Latin America tripled between 1998 and 1999, reaching the highest figure since 1982. Deterioration of the terms of trade subsequent to the Asian crisis and the contraction of capital flows originating in the Russian crisis initially caused a marked downturn in bank liquidity and a large increase in interest rates. Later, as usually happens, interest rates fell, but so did lending. This indicates that even if in the beginning the reversal of capital flow generates a shortage of funds available for lending purposes, the recession that follows brings about a downturn in the expected yield of projects and a reduction in the real value of company collaterals with consequent downturn in real credit demand.

3. Recommendations

Based upon the factors discussed hereinabove, the Committee has identified the following recommendations:

3.1 To remove obstacles and create a favorable scenario for the development of new financial instruments and vehicles that promote more efficient risk management and allow for the funding of those sectors which are currently excluded, within a framework exclusive of eventual rescue by the treasury.

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The Committee recommends that obstacles be removed, thus creating a scenario which favors development of new financial instruments and vehicles, having the capacity to meet the funding needs of investment projects which – due to their return on capital, risk and scale characteristics -- go unattended by both the banking system and the capital market. These have to be developed within a framework exclusive of eventual rescue by the treasury.

These vehicles may eventually take any of various juridical forms. Reciprocal collateral corporations may prove to be particularly useful in facilitating access to bank funding of micro, small and medium enterprises and investment projects that have no collateral, by transferring credit risk to the former. The development of vehicles that supply financing in the form of loans but are funded through securities and financial sources other than deposits, render possible the capture of benefits derived from extending credit -- similar to that provided by banks -- in well diversified portfolios, without being subject to liquidity risk associated with the transformation of short-term deposits to long-term loans or to costs consequential to banking regulations

3.2 To ensure strict application of the law. Regulations on insolvency and bankruptcy proceedings should be updated in line with best international practices, strengthening the rights of creditors by regulating foreclosure of collaterals in a manner such that it become the rule in case of debtor default.

The Committee recognizes that a fundamental element to revert the constraints observed on credit in the region is to establish a culture and discipline of constant observation of the law, and to guarantee the rights of all the participants in the economic process, *de jure* as well as *de facto*. For this purpose it is essential that standards governing conflicts of rights and bankruptcy be updated and aligned with best international practice.

Likewise, the capacity to seize collateral must be normalized so that is becomes the norm in case of debtor default. This includes the protection of property rights and securities, the right to sue and the possibility of being sued for breaching contracts, and the expectation that one will be compensated for any damage suffered, and that the sentences will be carried out.

And finally, the Committee recognizes that the above not only includes enforcement of the letter of the law, but also the daily interpretation and the operation of the law, including the performance of the judicial system.

3.3 To recognize that bonds issued by the public sector are market- risk assets and as such should be weighed when calculating bank capital requirements.

The fiscal discipline continues to be one of the important preconditions for sustained growth of bank lending. The fiscal discipline is especially important, not only because it mitigates the phenomenon of crowding out, but also because of its positive impact upon inflationary expectations and interest rates, and by the fact that banks tend to concentrate their liquid holdings in public debt.

There exists a series of alternatives for establishing adequate risk weighting, and they range from adopting risk categories from the current Basel recommendations that recognize the volatility of public bonds observed in the region, to the implementation of some of the alternatives proposed in Basel II where the risk weighting constitutes a continuity instead of discreet categories. The Committee does not recommend a specific risk weighting of government bonds as it recognizes that there are specific factors in each country that will influence these policy recommendations.

3.4 To design appropriate prudential regulations so as to mitigate impact of abrupt relative price changes on bank credit derived, among other factors, from volatility of capital flows. The Committee does not recommend application of capital controls.

In periods with large capital inflows, one typically observes a significant increase in the external indebtedness of local banks. In the context of current regulations, this capital inflow generates an incentive for banks to increase their lending in dollars. Thus arises the problem discrepancy between the currency of the bank loans (dollars) and the income of the borrowers (local currency). When the capital inflows stop or become outflows, the exchange rate tends to depreciate, adversely affecting the capacity to pay of the sectors that have loans in dollars but income in the local currency. This, in turn, compromises the quality of the banks' credit portfolios. It is important to stress that it is not sufficient for the banks to have an adequate match between the currencies of the assets and liabilities to guarantee bank solvency, because the dollar loans to sectors whose income are in local currency generate a mismatch that is not controlled by banking supervisors.

The problem associated with this currency mismatch can be attenuated by prudential regulation reform. There exists a series of alternatives for dealing with this problem. One proposal is to restrain the influence of capital flows by means of capital controls. The Committee does not support this recommendation. Another possible solution is to design an adequate provisioning regime that takes into account the exchange risk (which is transformed into credit risk when capital inflows come to a sudden stop) of bank loans to different sectors of the economy. Presently, in Latin America, the provisions are calculated ex-post, i.e. based on time periods, arbitrarily designed, in which a loan is in default. The Committee recommends that this regulatory mechanism be replaced by a risk-based provision.

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