

FELABAN

Introduction

FELABAN comments can be organized into three broad areas. The first deals with issues related to the operation of subsidiaries of foreign banks in Latin America. The second discusses the implications for financial inflows to Latin America derived from the adoption of the New Accord by large internationally active banks. The third focuses on prospects for implementing the New Accord in domestic Latin American banks.

I. Issues and Recommendations related to Foreign Banks operating in Latin American Markets

As clearly indicated in the CP3, the New Accord is intended to be applied to internationally active banks. FELABAN recognizes that the actions of regulators and banks from industrial countries (where the parent institutions of the majority of large internationally active banks are located), in response to the New Accord, will have a significant impact on Latin American financial systems. This is because of the large integration of Latin American financial systems to international markets through two main channels: (a) the large and increasing participation of foreign banks in local markets and (b) the importance of international financial inflows to meet the financing needs of governments, banks and corporations in Latin American countries. In each of these two areas, FELABAN's members have identified important concerns and wish to advance recommendations aimed at safeguarding the financial integrity of Latin American banks within the framework proposed by the Committee.

1. Similar banks under Different Regulatory Frameworks Create Incentives for Undesirable Effects from Regulatory Arbitrage

Regarding the scope of application, the CP3 proposes that the Accord be applied on a fully consolidated basis to internationally active banks, including their subsidiaries. Although FELABAN sympathizes with the motivation behind this proposal (eliminating double gearing), we are highly concerned regarding the potential uneven playing field that might emerge as a result of this proposal. For example, subsidiaries of foreign banks might be required by their parent institutions to follow the IRB approach while local supervisors might decide to continue applying the current Accord to domestic banks in the short and medium term. This would introduce a regulatory distortion since banks with similar characteristics, except for origin of ownership, would be subject to different regulatory procedures. In turn, this regulatory distortion might create two forms of undesired incentives that would weaken domestic financial systems. The first is the migration of the best corporate borrowers to foreign banks since the IRB approach requires lower capital requirements for the less risky corporate borrowers than the current Accord. The second is the pressure to local banks and supervisors to move quickly to the

IRB approach, even if a large number of domestic banks and supervisors are not ready for this sophisticated framework.

Given the large differences in structure and degree of development between financial systems in Latin America, FELABAN recommends that *a case-by-case approach be followed in the region with an emphasis on minimizing undesirable regulatory arbitrage. In cases where a significant proportion of banks are not ready to adopt the IRB approach, and the authorities decide to continue with the current Accord, the Committee should urge local supervisors to take an active role in enhancing the mechanisms of market discipline by publishing comprehensive information about the soundness of banks, especially with respect to compliance with capitalization requirements (Pillar 3 of the New Accord). This will facilitate the access of sound domestic banks to attractive sources of funding and, therefore, contribute to lessen the competitive disadvantages to domestic banks that might arise by the adoption of the IRB by subsidiaries of foreign banks.*

FELABAN also recommends that *appropriate guidance and incentives be given to domestic banks to improve their risk-management techniques. Specifically, FELABAN believes that the Committee needs to actively promote agreements between local supervisors and home supervisors of foreign subsidiaries regarding training and sharing of expertise. Prompt implementation of these agreements could help reduce the gaps in technology, management, and governance between some domestic banks and the more sophisticated and internationally active foreign banks.*

In addition, FELABAN recommends that *the possibility of introducing “reciprocity clauses” in agreements between supervisors, as a supplementary mechanism to avoid competitive distortions, be analyzed.*

2. Dealing with Issues on Home/Host Supervision for Subsidiaries of Foreign Banks

A related concern deals with the issue of home/host supervision for subsidiaries of foreign banks operating in Latin America. The recent Committee’s document on “High-level principles for the cross-border implementation of the New Accord” (August 2003) attempts to mitigate the problems that subsidiaries might face in simultaneously satisfying requirements from their home and host supervisors by: (a) calling for increased coordination between home and host supervisors, (b) allowing home supervisors to have the responsibility to oversee the implementation of the New Accord and (c) calling for a clear communication to banking groups of the specific roles of home country and host country supervisors.

FELABAN agrees with the Committee’s recommendations listed above, but *feels that coordination between authorities should include not only supervisors, but also the central banks in their role as lenders of last resort.* Latin American banks are increasingly engaging in cross-border activities within the region. As assessed by a number of analysts, in recent systemic banking crises in Latin America, the absence of coordination

between central banks resulted in solvent institutions lacking access to liquidity support.¹ FELABAN *recommends that the Committee promote enhanced cooperation among central banks in order to provide clear rules regarding lender of last resort responsibilities for the banks that engage in cross-border activities. Central bank coordination should, therefore, be added to the Committee's principles for the cross-border implementation of the New Accord.*

II. Issues and Recommendations related to the Impact on Financial Flow Volatility in Latin America Stemming from Implementation of the New Accord

Over the last couple of years, a number of representatives from governments and banks in emerging markets, as well as analysts, have stressed the risk of a potential increase in the volatility of financial flows to emerging markets resulting from G-10 banks adopting the New Accord.² FELABAN subscribes to this view and argues that increased financial flow volatility will result from both the increased procyclicality in regulatory capital requirements, and the incentives in the New Accord for shortening the maturity of interbank lending from G-10 countries to emerging markets.

1. Increased Regulatory Procyclicality and Non-Recognition of Diversification Increases the Volatility of Financial Flows to Latin America

FELABAN recognizes that increasing the risk sensitivity of capital requirements would most likely increase the procyclicality of bank loans since default risk tends to be correlated with the business cycle. However, currently most internationally active banks from G-10 countries with exposures to Latin America estimate their *economic* capital taking into account the risk of these exposures. Moreover, adequate provisioning techniques and global portfolio diversification are components of banks' internal models of credit risk management. In a large number of occasions, when an unanticipated risk in a Latin American exposure materializes, the combination of these risk-management instruments allows international banks to stand the shock without the need to recourse to a full and quick reversal of the net lending flows to the Latin American borrower.

In contrast, under the New Accord there is a large degree of regulatory micro-management in the formulae for estimating capital requirements under the IRB approach. There is also insufficient recognition of banks' portfolio diversification across countries and regions as a credit-risk-management tool. It is the view of FELABAN that these features of the New Accord would hurt Latin America by increasing the volatility of flows to the region and by creating incentives to reduce international bank lending to Latin American borrowers.

¹ See, for example, Latin American Shadow Financial Regulatory Committee, "Foreign Banks: Do they Strengthen the Financial Systems of Latin America?", Statement No. 7, November 18, 2002; www.claaf.org

² See, for example, Latin American Shadow Financial Regulatory Committee, "The New Basel Accord and Financial Stability in Latin America", Statement No. 2, April 2001, www.claaf.org

Joining the statements from a number of affected parties from emerging markets, FELABAN strongly recommends that the Committee reassess its views regarding the treatment of international diversification before completion of the final version of the New Accord.

2. Incentives for Shortening the Maturity of Interbank Lending Increases the Volatility of Financial Flows to Latin America

Under the current Accord, there is an incentive for international banks to lend short term to banks in most emerging markets. The reason is that loans to non-OECD banks with a maturity of over one year carries a risk weight of 100 percent, while loans to these banks with a maturity of one year or less carry a risk weight of only 20 percent. Consistent with this incentive, cross-border claims of BIS reporting banks on most Latin American countries tend to be concentrated on short-term maturities. As it has been widely recognized, short-term indebtedness is an important cause behind the volatility of financial flows to emerging markets. The New Accord exacerbates this problem by changing the definition of “short-term” from one year to three months. This problem is also present in the IRB approach where capital charges increase significantly as the maturity of loans increase. In addition, results from the Quantitative Impact Study 3 (QIS 3) also show increased capital charges for interbank lending, creating additional incentives for international banks to reduce this important source of external funding for Latin American countries

FELABAN members are deeply concerned about the adverse effects on the stability of Latin American financial markets derived from this policy proposal. Moreover, in the view of FELABAN, the proposed change in the definition of “short-term” goes against the Committee’s objective of improving global financial stability. By increasing the fragility of financial systems in emerging markets, the overall soundness of the international financial system is compromised.

Therefore, FELABAN *requests further consideration of the Committee’s proposal to change the definition of “short-term.” FELABAN recommends that the definition be set at twelve months.*

III. Issues and Recommendations Regarding the Implementation of the New Accord in Latin American domestic banking systems

While the New Accord is mostly intended for internationally active banks, the Committee has also indicated its expectations that the new framework be suitable not only within the G-10, but for countries around the world to apply to their domestic banking systems. A large number of comments on specific features of the New Accord have already been raised by representatives from developing countries.³ FELABAN agrees with those

³ The most frequently mentioned comments to the New Accord include, among others: (a) the need to de-link, in the standardized approach, the risk weighting of banks from the credit rating of sovereigns since

comments, but on this occasion, wants to focus on two issues of implementation that are critical for the stability of Latin American banking systems. The first relates to the multiplicity of options available under the New Accord. The second deals with issues of timing and sequencing.

1. Too many Options may Dilute the Assessment of Adequate Capitalization

Although the Committee outlines three basic approaches for minimum capital requirements (the standardized approach, the Foundation IRB approach and the Advanced IRB approach), the discretion given to national supervisors in a large number of components of the New Accord implies that, *de facto*, there are multiple options available to estimate capital requirements.

While FELABAN agrees that eliminating the one-size-fits-all approach is the correct way to determine capital requirements, we also fear that excessive flexibility could result in increased opaqueness rather than improved transparency about the adequacy of individual banks capitalization. Moreover, excessive discretion for national supervisors could also obstruct the maintenance of a level playing field among banks in different countries. This is especially worrisome given with the large differences in methods of accounting standards and legal procedures among Latin American jurisdictions. As mentioned above, regulatory arbitrage could also result in undesired portfolio composition in banks.

FELABAN urges the Committee to provide strict guidelines regarding the use of “options” available in the New Accord. Moreover, FELABAN recommends that the Committee conduct additional calibration of the models taking into account the specific characteristics of emerging financial markets.

2. When and How to Implement the New Accord in Latin America

The move from a capital standard characterized by its extreme simplicity to a highly complicated framework presents serious challenges for banks in Latin America. Not only do financial systems differ significantly among countries in the region, but also banks with very different levels of sophistication co-exist in every country. As of today, the dialogue between banks and supervisors regarding the goodness of the proposed New Accord for individual Latin American countries, the timing of its implementation and the availability of alternative approaches for measuring capital requirements is still in its infancy in many countries in the region.

this linkage favors weak banks operating in strong jurisdictions; (b) the problems derived from relying on credit rating agencies to determine risk weights under the standardized approach; especially given the lack of a supervisory and regulatory framework for these institutions; (c) the need to eliminate the distortion created in the risk weighting system under the standardized approach where unrated banks and corporations carry a lower risk weight than that assigned to banks and corporations with a rating below B-; and (d) the lack of clear definitions allowing to distinguish between small and medium enterprises and retail loans.

FELABAN recognizes that much work remains to be done before recommending that a particular approach or the full menu of approaches for minimum capital requirements be made available to banks in individual Latin American countries. In particular, FELABAN *holds the view that banks and supervisors in the region should not be rushed by the international community towards the implementation of the New Accord.*⁴ Thus, FELABAN *urges the Committee to support the efforts of banks in the region in identifying preconditions necessary for the successful implementation of the New Accord.*

⁴ For example, issues such as the appropriate “confidence intervals” in the models used to estimate capital requirements in emerging markets deserve further consideration and analysis before implementation of the New Accord.