

# Banking Supervision in Developing Economies<sup>\*</sup>

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## I Introduction

Any thought given to the problems of supervising the banking industry in developing economies leads to the question of whether there are specific aspects of those economies that result in the need for an ad hoc regulatory and supervisory framework. The response to this query is less than evident, particularly since banking crises are not restricted to the developing world. In fact, they have hit hard and often in developed nations as well, as demonstrated by the Savings and Loan scandals in the US in the 1980s and a protracted period of financial instability associated with real estate loans in Japan that refuses to fade away. To one extent or another, the problems associated with credit exposure are a disconcerting common denominator in all of the world's banking crises. Furthermore, one may ask whether a paradigm exists to classify a developing economy. In fact, the economic and financial literature has coined the concept of the "emerging economy" to refer to a group of some 20 to 30 economies that in the recent past have experienced strong, consistent processes of economic reform combined with high, sustained rates of growth. These include such economies as Brazil, Chile, China, India, Taiwan, Korea, etc. In this context, it is difficult to compare the features of the financial systems in emerging economies such as Hong Kong and Singapore – with their well-consolidated, highly-competitive structures – with those of such developing economies as Honduras, Paraguay or Nigeria.

The author's view is that, at the level of "stylised events", a series of factors exists at the level of both market operations and public institutions that tend to be present to a varying extent in non-developed economies

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(emerging and developing) and that are unique to them. Abundant specialised literature exists to describe the features that characterise the problems of supervision in those economies, including the volatility of their markets, errors in the design of financial liberalisation programmes that have led to lending booms, institutional weaknesses, inappropriate accounting standards, etc.

This paper seeks to assess the primary factors behind financial instability and banking supervision in developing economies.<sup>2</sup> While recognising the macroeconomic origin of many of the problems that affect the banking system in developing economies, this study focuses on the microeconomic elements associated with both the quality of institutional management and the deficiencies in monitoring effected by the market itself, as well as on the institutional weaknesses of regulation and supervision in these economies.

In addition to this introduction, the paper consists of three sections. The first describes the financial markets and the weaknesses in supervision in developing economies, understood in the broadest sense. The second section makes policy recommendations designed to strengthen supervision in those economies and distinguishes between first and second-generation reforms. The former are primarily applied in recently privatised financial systems that are unsophisticated and where supervision is extremely precarious. Second-generation reforms are to be implemented in more developed and consolidated banking systems which have already benefited from the learning curve in the operation of financial markets in both the public and private sectors. The third section suggests what positions developing countries should take in international forums with respect to issues such as capital adequacy, operation of financial conglomerates, and consolidated supervision.

## **II Problems of Supervision in Developing Economies**

There are six key characteristics that determine the primary weaknesses of developing economies' financial systems. They are:

- (a) precarious public institutions;
- (b) a lack of tradition in market operations and an excessive weight of public ownership in financial institutions;

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<sup>2</sup> Unless otherwise noted, "developing economies" should be understood, in the context of this paper, to mean relatively less-developed economies, as well as emerging economies.

- (c) inappropriate accounting and portfolio classification systems;
- (d) a high concentration of ownership in financial and goods markets;
- (e) an expensive and inefficient financial system;
- (f) a lack of international diversification in banking portfolios.

These elements give rise to a series of problems that affect the stability of markets and weaken the quality of the supervision provided in developing economies. These include high credit risks, continuous operations among related parties, a lack of market support for institutional monitoring, inappropriate criteria for the entry and exit of financial institutions, etc.

Obviously, in applying these stylised facts to specific economies, the relative bearing of each element will be different. For example, one can expect that in the most backward economies, the most pressing problems will relate to basic asset supervision and related-party lending. In emerging economies, with better consolidated financial systems, it is likely that one of the most significant challenges will be posed by the lack of international diversification in the portfolio. For the more backward economies, on the other hand, given the precariousness of regulatory agencies, it is likely that the internationalisation of their loans would bring more costs than benefits. These distinctions are significant when recommending policy. Despite their importance, these aspects are very often overlooked during analysis.

#### *a. Precarious Public Institutions*

Perhaps one of the most decisive features of the weaknesses in supervision in the developing economies is the precariousness of their institutions. This problem is manifest at three levels: insufficient qualifications among the staff of regulatory agencies to identify the risks taken by private institutions; insufficient authority to take corrective action once problems have been identified; incorrect incentives for the supervisory authorities that often cause them to hesitate when taking measures in cases of potential bank insolvency (Larraín, 1994).

As noted by Corrigan (1996), the essential component of the process of banking supervision is the inspection that takes place on site with a sample of individual loans. This helps determine the current and future status of those loans and thus their potential for timely repayment. This type of review requires a high level of sophistication on the part of banking inspectors. This task is perhaps the weakest link in the supervision chain in developing economies, since without clarity on the future perspectives of a loan it is impossible to correctly assess a bank's condition.

Interestingly, these insufficiencies tend not to be concentrated at the level of senior officials at these institutions, but rather among those

charged with field inspections and/or desk supervision. The causes for this phenomenon are varied, yet it is important to highlight the big gap in income between supervisory agency staff and equivalent positions in private industry. This leads to a high turnover at these agencies. As a result, it is often quite difficult to acquire and retain the necessary staff experience and qualifications.

Furthermore, supervisory agencies' ability to identify losses is of limited use unless they have sufficient power to enforce corrective action. Supervisors should have enough authority to impose sanctions if compliance with prudential regulations wanes. Depending on the institutions being supervised, such sanctions can include: fines, dismissal from management posts in cases of imprudent practices, restrictions on the activities banks may undertake, proceeding in the extreme to liquidation (BIS, 1997). The problem is, however, that even when supervisory agencies have formal authority to take corrective measures, the administrative requirements as to the evidence they must gather are so exacting that it is extremely difficult for them to compel a bank to increase its capital reserves or apply more prudent policies in specific areas.

The third requirement for prudential supervision is for supervisory agencies to act decisively. However, the political and legal context often encourages banking supervisors to delay the liquidation of an insolvent institution or the application of corrective measures (Kane, 1989; Benston and Kaufman, 1988). The costs of failing to take timely measures can be high. When exit policies are weak and unstable banks are allowed to compete with solid ones, the former have an incentive to survive in the short term by competing aggressively. Clearly, this can debilitate financially secure banks and increase the cost of the solutions eventually required (Lindgren, 1996). Another weakness in many developing economies is that, given the greater involvement of the government in such economies and the scope of banking ties with industrial conglomerates, the pressure applied to banking supervisors to forestall corrective measures may be greater than in most developed economies. The liquidation or penalty on a banking operation may generate not only illegitimate protests from powerful lobbies but may also lead to a suit being filed against the supervisor (Goldstein and Turner, 1996).

### ***b. Lack of Tradition in the Operations of Financial Markets***

Quite clearly the solvency of the banking system does not depend solely on the role played by public regulatory agencies. Rather, it needs to be supplemented by responsible actions by bank management itself, as well as by monitoring by those institutions' shareholders and depositors. In other

words, market discipline is a must.

Despite the processes of financial liberalisation that commenced some years ago, in many developing economies the financial systems have not had the benefit of a learning curve<sup>3</sup> that allows them to perform their risk-assessment role properly. This is compounded by a traditionally strong presence of the public sector in the system's operation, and a lack of monitoring by depositors themselves to help discipline bank management.

The initial conditions for financial systems have been identified in the literature as a determinant factor in the success of liberalisation processes (Caprio *et al.*, 1993). A bank's net worth, the initial composition of its assets and liabilities, its available information, human capital, and incentives system, all reflect pre-existing controls that condition banks' response to reforms. When the system is devoid of qualified bankers and the incentives guiding banking operations revolve around governmental directives, an abrupt shift toward liberalisation could generate significant losses (*ibid.*).

Liberalisation policies have typically been associated with excessive expansion in lending. In fact, increased confidence stemming from the reforms can engender overly optimistic expectations about the future. Free of lending restrictions, banks respond to new potential demands from sectors previously subject to controls (most often consumer loans, real estate, etc.). Their experience in establishing prudent lending limits is limited since the restrictions previously in place barred them from the newly attainable levels. If all the banks attempt to do the same thing, price bubbles will emerge for assets. The deterioration in the quality of the loans will only become apparent when the bubble bursts as a result of a domestic or foreign shock (BIS, 1996).

Where the tradition of bank monitoring by depositors and shareholders is weak, managers have little incentive to temper their behaviour. Bad management of pre-crisis situations aggravates these negative incentives, since bank stockholders and large holders of bank liabilities have not always been forced to pay for their risk-taking practices. Government intervention can harm incentives for disciplined management, for example, by creating expectations of rescues among owners and creditors of financial institutions. Such face-saving measures include weak exit policies for troubled institutions and overly generous last-resort lender policies. Rojas-Suárez and Weisbrod (1996) conclude that the failure to punish shareholders is a key factor in explaining the weaknesses of banking restructuring processes in Latin America in the 1980s.

The real problem is that governmental support has been *de facto* rather

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3 The benefits of competition emerge over time and are the result of a learning curve. For an application to the financial system, see Arrau (1996).

than *de jure*, and has normally exceeded the explicit insurance involved. In fact, most developing economies offer only partial and limited formal coverage of banking deposits. In this vein, as Goldstein and Turner (1996) indicate, the problem lies in the discretionary nature of governmental support in coming to the aid of large creditors and/or bank owners to an extent far beyond the previously agreed levels. This generates higher moral hazard in the banking sector.

### *c. Accounting Standards and Asset Classification Systems*

Independent of the level of development attained by an economy, a realistic review of bank assets and an appropriate estimate of income and expenditures constitute fundamental aspects in determining those institutions' financial soundness. If most of the assets are in fact loans, an evaluation of the quality of the portfolio is crucial to ascertaining a bank's financial status. Typically, when the loan classification system fails, profits are overvalued and realistic provisions cannot be established to confront current or future losses. Furthermore, accrual of interest on non-performing assets cannot be suspended since very often bank managers are anxious to conceal their portfolio's real condition (Folkerts-Landau and Lindgren, 1997). This is one of the most problematic aspects of banking system operations in developing economies. Paradoxically, a large number of countries do have "formal" asset classification systems. Obviously, the catch is to be found in the implementation of such regulations.

The first problem lies in the poor quality of the information available. De Juan (1996) suggests that *in situ* supervision is essential in Latin America, given the lack of reliable financial bank statements. To systematically and efficiently review the portfolio classification prepared by a financial institution, a key element lies in computer-based informational support on which a sampling mechanism can be based (Ramírez, 1991). However, developing economies frequently lack historical databases containing financial statements, borrower databases, risk controls, and computer systems to apply and cross-check this information. All of these are vital in terms of guiding the *in situ* supervision process and focusing on those aspects presenting the greatest potential weakness and risk.

These problems are compounded by the practice of "evergreening", also a recurring problem in developing economies. In many countries, accounting standards for classifying uncertain or non-recoverable assets are not strict enough to prevent the banks that make bad loans from making themselves look good by lending more money to troubled borrowers. Where loan classification depends solely on the status of prior payments – more than on an evaluation of the debtor's exposure and the value of the collat-

eral – it will be easier for bankers and their clients to collude in disguising losses through a series of restructurings and interest capitalisations (Goldstein and Turner, 1996). Studies by a variety of authors (Gavin and Hausmann, 1996; Rojas-Suárez and Weisbrod, 1996) show that information on bad loans reported publicly in bank financial statements was a poor indicator of the real financial condition of banks in Latin America in pre-crisis periods.

A final important aspect has to do with the problem of the mismatch of currency that often affects banking systems in emerging economies. Normally, significant differences in interest rates exist, with the domestic rates in the developing economies being more attractive. As a consequence, there is a strong temptation for financial institutions to borrow in foreign currency and lend in domestic currency (Goldstein and Turner, 1996). The incentive to borrow in hard currency abroad is also present for non-financial-sector debtors, although this option is usually only open to the largest borrowers. In this context, an abrupt devaluation can generate significant losses for financial institutions and others, as witnessed in Mexico in early 1995.

Nonetheless, the problem is not resolved solely by having banks maintain balanced positions in foreign currency. As many borrowers who lack the ability to generate hard currency go into debt in dollars, a devaluation can make them insolvent. From the bank's perspective, the devaluation can create a serious problem in terms of credit exposure. This was a significant factor in the financial crisis that affected the Chilean economy during the early 1980s. Also in Thailand financial institutions were recently weakened by the impact of currency depreciation on customers with foreign currency liabilities (IMF, 1997).

#### *d. Loans to Related Parties and Conglomerates*

In developing economies, there tends to be a high concentration in ownership of property and distribution of income. The presence of large financial conglomerates with assets in both the real and financial sectors of the economy is a typical feature of those economies. As a result, executives rarely oppose concealed transfers of resources from the bank to a related company in which a bank partner participates because this would be seen as contrary to the interests of the other owners and endanger their individual reputations (in 1996).

Loans to related parties have been a source of severe problems in bank insolvency in Chile, Argentina, Indonesia and Thailand, among others (Morris and Goldstein, 1996; IMF, 1997). The problem, however, does not lie in a lack of limitations and legal statutes to regulate those limits. In

Latin America in particular, legislation has moved forward to establish caps on this type of lending. Studies by the BIS show that in developing economies, legal limits are often more stringent than in developed economies (BIS, 1996). The real problem lies not in a need to modify the legal limits but, once again, in the arena of practical implementation.

Problems of implementation tend to emerge at two levels. The most obvious is regulators' inability to identify or "map" the economic groups that own the banks. Although this is an essential element in enforcing the limits, the supervisory agencies in most developing economies are unable to comply with this basic requirement. Furthermore, banks tend to "disguise" the presence of connected loans by reaching agreements with other banks to create cross loans. In other words, bank X lends funds to the companies related to bank Y and bank Y lends to the companies related to bank X. Another traditional mechanism for concealing operations with related parties is through branches in tax havens which in turn provide loans to related companies in the domestic economy.

Another typical problem in emerging markets is that the approach used in the law to define related parties seeks to precisely define which company controls the conglomerate and, through exacting definitions and external indications, to determine what types of companies can be deemed to belong to that conglomerate. This system, apparently more legal and perfect, has proven to be disingenuous in practice. When the precise components for determining affiliation are known, it is not difficult to imagine ways to elude the law. Unlike the experience in other spheres, the evidence shows that discretionary power here is preferable to strict rules.

The problems associated with these conglomerates, nonetheless, do not end here. In developing economies there are numerous "de facto financial conglomerates" with a presence both in the banking industry and in such financial activities as stock brokerage, insurance brokering and investment funds. This situation poses a threat to the bank since the bankruptcy or insolvency of one of the financial companies associated with it can be passed along to the bank itself. The risk of contagion stems from the presence of common, controlling elements in the banks and other financial institutions belonging to the conglomerate and/or the fact that they share a corporate image, use a common infrastructure, share client bases, etc. In other words, a system of financial conglomerates appears to be in operation, even though the scope of the "fire walls" or consolidated supervision mechanisms have yet to be defined.

Similarly, the presence of a non-regulated parent company that controls banks makes it possible to acquire financial institutions abroad – even in poorly regulated locations – thereby generating a grey area for effective consolidated supervision by the regulator in keeping with the Basle para-



meters (Larraín, 1997). In fact, several Latin American conglomerates have internationalised across the region through their shareholders. This generates a non-covered risk of contagion for the domestic financial system should those institutions have problems in their international activities. Similarly, investments have been made by these conglomerates in tax havens, such as the Cayman Islands, where supervision is practically non-existent.

#### *e. Expensive, Inefficient Intermediation Margins*

In today's increasingly globalised world of financial market operations, banks' long-term viability and stability require that they remain competitive on the international level. This in turn requires efficient banking systems capable of evolving within a framework of "reasonable" margins of intermediation. In this sense, a bank sustained on the basis of oligopolistic revenues inherent to protected environments, becomes more vulnerable to losses and potential insolvencies when confronted by unexpected financial events or increased international competition (Lindgren, 1996).

In the current Asian crises, inefficiencies in financial systems, stemming partly from constraints on competition, may also have contributed to the scale of capital inflows because the spreads between lending and deposit rates in domestic financial institutions, wide by the standards of the industrial countries, contributed to relatively high lending rates that, together with exchange rate policies, encouraged borrowers to seek funds abroad (IMF, 1997).

A series of studies shows that intermediation margins in developing and emerging economies tend to be considerably higher than in developed nations. This is particularly true in Latin America. According to a BIS (1996) study, net interest margins were above 5% in the nations of Latin America (1990-94 average), significantly higher than the norm in more consolidated financial markets where the rate rarely runs at over 3%. The same study suggests that higher margins do not necessarily respond to a higher exposure and/or an inflationary context, but are more closely linked to high operating costs. It is not unusual to find that those costs come in at over 5% of assets in Latin America, as compared to levels below 2% in more consolidated markets such as Germany, Singapore or Hong Kong. In any case, the differences in intermediation margins often reflect different levels of banking efficiency rather than different risk conditions.

The main explanation for that inefficiency is that banks in developing economies operate in contexts that do not favour competition. The rates of concentration and oligopolisation tend to be very high – in most cases as a result of inappropriate criteria regulating entry rather than as a response to

any structural conditions in the market that favour concentration. According to data from the BIS (1996), banking concentration – measured as the percentage market share of the five largest banks – was over 55% in Mexico, Chile, Venezuela and Brazil, as compared to figures of under 40% in Hong Kong and Singapore, and under 15% in Germany and the US. Entrance regulations have often been used in a discretionary manner to discourage competition from foreign institutions. This has had a negative impact on the transfer of technology and know-how to those markets.

Another factor contributing to a lack of competition and efficiency in these financial systems is the continuing role of government ownership. The same BIS (1996) study indicates that the percentage of private ownership in the financial system in 1994 was just 58% in Argentina, 52% in Brazil, 77% in Colombia, and 13% in India, compared to 100% in all of the consolidated, competitive financial systems. Normally, the policies in place at publicly-funded banks result in an emphasis on targeted loans. This keeps banks from evaluating their exposure properly and causes them to operate with the strong implicit backing of the state. These factors generate unfair competition in the system and serve as an incentive for inefficiency.

#### *f. Lack of Portfolio Diversification*

A series of studies associated with the BIS, indicate that one of the important weaknesses in developing economies' banking systems is the absence of international diversification in their portfolios (BIS, 1996; Goldstein and Turner, 1996). Specifically, emphasis is placed on the case of small economies with exports concentrated in a few commodities that offer banks limited options for diversification. In these circumstances, the financial system can only be isolated from shocks in the domestic economy through international diversification. However, the presence of international lending in developing economy bank portfolios continues to be very low. In those cases where international diversification is present, it is usually due more to direct investment by foreign banks than to cross-border lending.

In addition to a lack of expertise in evaluating cross-border loans, international diversification has been hampered by the scarcity of international currencies and/or restrictions on the free flow of capital. Moreover, these loans constitute new challenges for supervisors, particularly in terms of country risk. This risk is naturally different from the exposure associated with the individual borrower and includes both sovereign and transfer risk (Dale, 1984). If a bank is unable to recover its cross-border loans, the result may be a direct, negative impact on its capital. This can lead to insolvency

unless proper reserves or diversification are in place. This thinking suggests that if minimum experience or expertise does not exist in a given country, the cost of international diversification may be higher than the benefits to be reaped from it.

### **III Policy Recommendations for Reinforcing Prudential Supervision in Developing Economies**

This section presents the reforms necessary to strengthen the stability and enhance the quality of supervision in developing economies distinguishing between first and second-generation reforms. First-generation reforms are essentially: the opening of the financial system to foreign institutions; the strengthening of prudential supervision; and, the strengthening of the role of the market in monitoring banking institutions as a necessary complement to public sector supervision. This “packet” of reforms is most applicable in less developed economies. Second-generation reforms include: international diversification of the banking portfolio; regulation of financial conglomerates; and, evaluation of the quality of bank management. Clearly, this type of reform is most justified among more complex markets – typically emerging economies – where supervisory agencies have the needed expertise. As such, they will be better poised to implement new supervisory instruments to cover the new risks. It does not make much sense for economies that have yet to resolve their basic problems of supervision, such as having a good portfolio classification system or controlling limits on lending among related parties, to implement this type of reform.

First and second-generation financial reforms should not necessarily be interpreted as being mechanical or strictly sequential; that is, finishing the first round is not a prerequisite to beginning the second. It is perfectly possible that second-generation reforms may be implemented alongside first-generation changes, depending on the characteristics of each specific market. For example, a supervisory law on consolidated financial conglomerates – a second-generation modification – can contribute to strengthening supervision and enforcement mechanisms for operations among related parties, a first-generation reform. Nor should second-generation reforms be interpreted as necessarily belonging to more developed economies. There may well be cases of less developed economies that have consolidated an institutional strength that will enable them to take additional steps, such as internationalising their banks. Similarly, it is also quite likely that some basic problems in supervision will remain in emerging markets, as demonstrated by events in South Korea, Thailand and Indonesia.

## FIRST GENERATION REFORMS

### *A. Improving the Efficacy of Prudent Supervision*

#### *Strengthening Institutions*

One of the first tasks in improving the effectiveness of supervision in developing economies is institutional strengthening. This means taking action to improve supervisory agencies' ability to identify problems, reinforcing their power to take corrective action, and establishing clear rules that reduce stonewalling in implementing necessary measures.

Firstly, such change requires an improvement to the qualifications and experience of the staff working for the supervisory agencies. Supervisors will need resources to train their staff in both *in situ* supervision and in analytical capabilities for desk-based reviews. Staff members must also be open to understanding new developments in the marketplace. They need to be sufficiently familiar with bank operations to know where to look and how to identify weaknesses below the surface. Supervision teams need to be skilled in evaluating lending systems, borrowers' ability to pay, the adequacy of provisioning, etc. (Folkerts-Landau and Lindgren, 1997). Given that a significant portion of the qualifications for these positions are not to be found in the formal educational system, it is essential that the supervisory agencies themselves be capable of training their staffs. This means providing the opportunity for a professional career, where meeting certain goals will lead to better job descriptions and pay. In this context, it is crucial that salaries at these agencies run not too far below pay for similar work in the private sector.

Secondly, supervisors need to be granted real power to take corrective action in problematic situations. Usually, when a bank's financial standing begins to deteriorate, supervisory agencies have a range of options to choose from in order to remedy the problem. For example, following each inspection, a bank's examiners may meet with management, including the board of directors, to discuss the bank's operations. These informal discussions are often enough to rectify the less serious sorts of problems. In more serious cases, regulators may have recourse to recapitalisation plans, or they may block outward transfers of funds, limit the bank's exposure in certain types of operations, restrict the payment of dividends, limit growth, make staff changes at management levels or impose a freeze on bank operations (Larraín, 1994). To limit banks' questioning of decisions made by the supervisor, these agencies must keep an updated log of the results of previous visits to each bank, as well as a copy of the commitments achieved in conversations with bank management. This way, corrective decisions by

the authorities will be perceived to be less arbitrary. Banking supervision can significantly affect the progress of the industry and the property rights of bank owners. While it should be possible for interested parties to appeal rulings by supervisory agencies, the process is more effective if the supervisors themselves are not personally liable for damages caused by any actions legitimately performed in the course of their duties.

Thirdly, banking legislation should establish clear rules that limit stonewalling by the supervisor in insolvent situations. This should not be construed to mean a mechanical law that seeks to cover each and every potential situation and defines regulators' responsibilities down to the very last detail. Rather, the idea is that the law should define clear, objective measures to be taken by the regulator with regard to banks confronting problems of solvency. How drastic those measures will be depends on the financial institutions' degree of under-capitalisation. Two good examples of banking legislation that includes the concepts expressed in the preceding paragraphs are the Chilean and US laws.

In the US, Prompt Corrective Action has been applied since 1993. This approach seeks to link supervision more directly to equity. For example, banks in Zone 3 with sub-minimum capital on hand are subject to penalties such as restrictions on the payment of dividends and risk-intensive activities, possible removal of management, etc. Banks in Zone 4 can be subject to more serious measures such as intervention or closure. The Chilean banking law of 1996 contains a similar approach. For banks failing to achieve required minimum capital adjustments (corrected for non-provisioned losses), an automatic mechanism has been established to adjust equity by requiring shareholders to provide fresh resources without delay. For banks with severe problems of insolvency, defined as a Cook Index below or equal to 5%, the law requires the board to call a "creditors' convention" as an alternative to straightforward intervention and/or liquidation.

### *Improving Asset Supervision Capabilities*

The ability to identify problematic situations of banking insolvency in developing economies requires overcoming one of their primary weaknesses: the ability to supervise assets. This means placing greater emphasis on *in situ* supervision than desk-based reviews. The poor quality of information in developing economies calls for supervisors to reinforce on-site inspections as a tool in identifying problematic situations early on (De Juan, 1996). Thus, if a bank has initially been classified simply as a "troubled" or "problem" bank and then fails within six months, it may be that it was not audited with sufficient frequency. Inspections should be conducted

at least annually, although the larger banks – with greater systemic exposure – should be reviewed biannually, at the minimum.

A second requirement for improving the ability to supervise assets is improvement in sources of information. No information should be kept from the supervisor that influences an inspectors' ability to prioritise the components of an on-site review. Inspection information support systems must select the loan samples to be reviewed in the field. For that purpose, at least a bare-bones system must be devised to provide data on the status of borrowers in the financial system as well as a historical file of borrowers and their ratings. That file will grow as experience is gained in classifying assets (Ramírez, 1991).

To correct the problem of “evergreening”, De Juan (1996) suggests that a loan should be classified as uncertain or non-recoverable whenever the borrowers' repayment ability is weak, even if he or she is up to date in the payments. In this case, banks should be required to provision up to the amount of the expected loss, the accrual of interest should be suspended and, most importantly, the bank should not be allowed to refinance loans to those borrowers.

In terms of the problem of mismatches, a comparison should also be made of the borrower's ability to generate hard currency and the denomination of the debt, and the result must be incorporated into the portfolio classification and evaluation systems. In any case, sufficiently detailed supervision should be maintained to ensure that bank mismatches stay within reasonable limits as a percentage of equity.

### *Problems in Lending to Related Parties*

In addition to clearly limiting the operations eligible for transactions with related parties and establishing drastic penalties for those who break those limits, regulators also need some leeway in defining and establishing additional presumptions of wrongdoing as market operations become increasingly sophisticated in finding ways to dodge the law. In this sense, discretionary powers seem to have several advantages over firmly-set rules. Supervisory agencies also need to create divisions capable of clearly identifying the composition of the primary conglomerates and their member companies. Without this ability, enforcing the limits contained in the law is impractical. One of the most serious shortcomings among Latin American supervisory agencies is precisely their tremendous ignorance of the morphology of these groups. This lack of familiarity with the composition of the business community permits private enterprise to continually overstep the limits established by law. In addition, supervisors should

ideally have a separate file or database on borrowers related by ownership or management to each financial institution.

## ***B. Strengthening Market Discipline***

Having a stable, solid financial system also calls for a strengthening of market discipline as a complement to adequate supervision. The primary components of that added strength are: limited insurance for deposits, greater market transparency, and a credible mechanism for allocating losses among the private sector. Market monitoring as a complement to supervisory activities requires that depositors and investors perceive that they may lose their funds and savings should a bank become insolvent. In developing economies, the state has traditionally stepped in when problems have occurred. This behaviour serves as a disincentive to market-imposed monitoring.

The first rule of market discipline is limited deposit insurance. The purpose of such insurance should be to protect only the small depositors, those who have neither the expertise nor the incentives to monitor the status of financial institutions (Folkerts-Landau and Lindgren, 1997). However, as noted earlier, the primary problem is the perception of implicit insurance that debilitates the credibility of this mechanism. In addition to limited deposit insurance, it is essential that in problematic cases the cost of insolvency be assumed by the banks' owners and, if necessary, by the non-guaranteed creditors. Unless the market has experienced this situation, incentives for disciplining activities by banking institutions are unlikely.

As part of a regulatory system that allows troubled institutions to normalise their situation early on – thereby reducing the potential of destabilising effects on financial markets – it is important to have a private mechanism that can serve as an alternative to state support. In this vein, special supervisory measures, provisional administration and liquidation, and intervention of guarantee funds have the common denominator of involving the state and leading to potential moral hazard. Furthermore, they tend to bring about strong noise or turbulence in the financial market. The experience in Latin America shows that, in practice, the problem of disorderly bankruptcy has typically been addressed by discretionary intervention in the troubled bank by the state, which nationalises it, either temporarily or permanently, and absorbs the resulting losses.

An example of a private mechanism to resolve insolvency can be found in Chile's banking legislation. When there are severe problems of insolvency or ongoing lack of liquidity that have not been resolved through the markets' usual means (capital repositioning, sale of loan portfolios or mer-

gers), the law allows creditors or depositors holding non-liquid liabilities (liquid assets are 100% guaranteed) to reach an agreement with the troubled institutions that will allow them to swap the debt for equity in the institution. This safeguards the institution's continuing operation and serves as an alternative to straight liquidation. Under the agreement, subordinate bonds are automatically capitalised up to an amount that enables them to reestablish a Cook ratio of 12%.

Furthermore, market discipline requires fostering transparency about the status of the institutions. For the market to operate in a framework of rewards and punishments, it needs to be able to distinguish between solid and potentially problematic banks, as well as to demand appropriate risk premiums. Transparent information should permit a careful evaluation of the banks' exposure profile, its profitability and the capital available to cover those risks. This can be accomplished through annual and quarterly financial statements, with certain information contingent upon certain events, such as an increase in provisions, expectation of significant losses or an increase in bad loans.

Nevertheless, the public disclosure of information on the financial institutions should not involve a classification or rating by the authorities, since this may bring more costs than benefits. In other words, if the supervisor rates a given institution well and that bank subsequently has trouble, the public may seek to blame the supervisor. Similarly, a bad rating could, at some point, generate instability for a given institution. These arguments, of a general nature, can be particularly relevant in developing nations given their strong dependence upon these institutions and the tradition of authorities stepping in to save banks.

### ***C. Opening to Foreign Investment and Access Standards***

One of the important challenges in modernising financial systems in developing nations is the need for greater openness to foreign investment. As financial institutions from more developed nations physically move into developing economies, growing competition will emerge. Under oligopolistic conditions, this will generate an increase in the supply of financial resources at a lower cost, to the direct benefit of credit users and depositors in the receiving nation. Perhaps more importantly, their physical presence results in the transfer of technology and know-how. This will help to develop new skills in more backward nations. Since foreign bank portfolios are less concentrated in lending to companies in the host nation, and because they usually have access to external sources of liquidity and hard currency (from their headquarters on out), they will be capable of confronting a shock in the local economy better than the domestic banks. In



addition, they will be less vulnerable to governmental pressure (Goldstein and Turner, 1996).

Despite allegations that discretion in access criteria has been intended to ensure the solvency of the system and protect local depositors, in practice it has been used in many developing nations to protect the domestic banking industry. However, there have also been cases in which indiscriminate access to the industry has generated destabilising competition. The challenge, then, is to generate access standards with clear and objective rules that serve to filter out not competition but rather unscrupulous businessmen. Although access rules alone cannot guarantee that a bank will be well managed once it has been granted access to the industry, they can be an effective method for reducing the number of at-risk institutions that endanger the system's stability.

The essential criteria that must form the basis for the regulation of access to the financial industry are, we believe: the financial strength of the major shareholders; capital contributed by the financial institution; the presence of a critical mass of technical qualifications and experience; the honesty and integrity of the shareholders, board members and manager; and, in the case of foreign banks or foreign bank groups, the capacity of regulators in the country of origin to engage in effective supervision. With some differences, a similar set of criteria for the regulation of entry of financial institutions is described in detail in the BIS' "Core Principles for Effective Banking Supervision" (Basle, 1997). As the recommendations of the Basle Committee indicate, the presence of clear and objective criteria reduces the potential for political interference in the granting of licenses, and ensures that strictly technical criteria prevail. The regulatory authorities should have the power to deny licenses to those who do not meet the requirements established by law.

## SECOND GENERATION REFORMS

### *A. International Diversification of the Banking Portfolio*

Country-risk provisioning is a common instrument in developing countries because it allows banks to reduce the impact of potentially negative external events which can arise in the process of cross-border lending. This form of provision should be done parallel to the granting of credit to a given country, independent of the particular characteristics of each credit situation (Larraín, 1995). Different models exist for country-risk provisioning schemes – e.g. that of the United States, which is highly dependent on the discretion of regulatory bodies; that of Britain, which is based on

matrixes; that of Spain, which emphasises private classification. It is crucial for developing countries to have such country-risk provisioning to complement individual loan assessments and classifications. For banks and for regulators, however, the aforementioned schemes represent a great challenge in terms of evaluating risk.

When authorising cross-border lending, individual financial institutions should be the ones who compile pertinent information on their borrowers and the country context for the lending, in such a way that a bank supervisor could go back and evaluate risk situations. If a loan, for example, does not comply with required criteria, it should be given a poor rating. Likewise, international lending situations should be consistent with the banks' general international development strategy. This requires a strong system of internal controls and information gathering to ensure adequate management. These criteria, which can also be applied in the case of domestic investments, are of fundamental importance to cross-border lending because regulators typically have much less access to information internationally than domestically. In many cases, developing economies receiving such loans do not have adequate regulations on providing reliable information. The recent banking law in Chile (1997) is a clear example of legislation intended to cover various risks that are associated with and originate from international banking.

### ***B. Supervision of Financial Conglomerates***

The operations of financial conglomerates are a significant part of the economic landscape in developing countries. As indicated above, their presence generates complications both domestically and internationally. The Basle Committee has proposed a series of minimum standards for the supervision of international banking conglomerates. Those worth highlighting include: the responsibility of the supervisor in charge of the home office, the need for simultaneous authorisation by officials in the host country and the country of origin, and the need for continual exchanges of information among regulators.

Although these recommendations seem like steps to an "ideal" regulatory scheme, it can be difficult to actually implement them in developing countries. One problem originates in the atmosphere within which bank shareholders make investments. That is, there are controlling groups in banks that on their own have diversified their investments in financial institutions in other countries, often through parent company ventures, rather than working through domestically-regulated ones. In such cases, regulators in investment-receiving countries have not had the proper resources to apply or enforce the Basle recommendations, since in effect

this procedure is not real internationalisation based on foreign banks.

Similarly, thorny complications arise when countries make accords on supervisory cooperation and information exchange which do not comply fully with bank secrecy laws or other accords. In these cases, discrepancies not only affect shareholder investments but also bank lending. The few countries that do have pertinent legislation regarding supervision agreements authorising the participation of their banks in the international market confront the problem that if these accords and agreements do not function properly, banks will be unable to invest internationally, and the incentive will rise for their shareholders to invest on their own in the international market.

Evidently, banks' participation in the international market through unregulated pathways brings with it clear risks for domestic banks. These risks originate in market perceptions that such activity will set off a chain reaction of collapse that spreads to local banks. In other words, although shareholders believe they are internationalising their investments and their exposure, in practice they are putting the financial systems of their own country in jeopardy. Moreover, the precarious situation of supervision makes it difficult for many nations to comply with the Basle consolidated supervision system. To think that countries that have not even been able to supervise adequately their domestic operations can be responsible for the international operations of a conglomerate is wishful thinking.

The obvious recommendation is that it is necessary for all nations to accept the Basle standards and in particular for home countries to block their poorly supervised banking groups from investing in international markets. A second-best recommendation is that when it is inevitable that non-regulated international investments will be made – either because the host country permits it or because it is not possible to prohibit such activity – a drastic “fire wall” should be erected, to totally separate financial, commercial or any other kind of domestic banking from the bank operating in international markets. Doing so will define the boundaries of responsibility of the various bank actors.<sup>4</sup> This policy will also push countries to protect their markets against unregulated banking groups.

Many times developed countries are reluctant to sign banking or financial accords with developing countries. In these cases, one possibility is to exempt from a given accord those investments in countries that, in accordance with protocols defined by regulators, are consistent with acceptable

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<sup>4</sup> In many developing nations, constitutional regulations make it difficult to prohibit international investing through bank owners. Chile and El Salvador are two examples, among many, of such cases.

supervision and risk standards. For example, the recent Chilean law exempts those countries which international risk classifiers have approved as acceptable for investment from such stipulations.

Domestically, the operation of conglomerates also presents significant challenges. More complicated than just dealing with their different operational structures – either the Anglo-Saxon, or holding, or the more European banking type – having a consolidated supervision system, is challenging. Perhaps the most complex part deals with those conglomerate operational structures that have less than transparent control systems, through either domestically or internationally unregulated parent companies, that make applying law difficult. Banking law requires the definition of a control threshold and/or minimum holding so that a financial group is forced to submit to consolidated supervision. In practice, however, conglomerates can avoid regulation by changing control thresholds or by controlling conglomerate activity indirectly. Dealing with this problem, which is similar to regulating related parties, represents an enormous challenge for supervisory agencies.

There is no universally applicable formula for the supervision of conglomerates. One scheme that can be applied to mixed investment groups typically operating in developing countries – controlling both financial and industrial activities through relatively “murky” ownership ties – is the holding model. This model relies on regulated parent companies to separate out all the financial arms of the conglomerate giving rise to an umbrella-type coverage with which it is possible to apply consolidated supervision. This regulated parent should be barred from investing in industrial sector activity, in which shareholders can invest directly, erecting a “fire wall” that separates the activities of the financial conglomerate from the rest of the economy.

Another issue that needs to be dealt with in developing countries is the absence of supervisory infrastructure that regulates companies taking advantage of synergies between different arms of a financial group. For example, such groups share names or corporate images, thereby increasing the risk of contamination for the bank, because there are no regulatory authorities with the resources to prohibit the use of a corporate image while that group is not under standard consolidated supervision. Likewise, clear regulations that permit the utilisation of a network of bank branches by other businesses within the conglomerate, like insurance companies, do not exist. It is crucial to make progress in regulating such operations, in order to avoid subsidies that can skew the level playing field of the financial system.

Developing countries have many gaps to fill to overcome the lack of legal institutions to regulate the structure and supervision of financial con-

glomerates. With the exception of Mexico, which has a comprehensive legal framework, and Chile and El Salvador, which are in the process of developing appropriate legislation, Latin America's system of financial supervision and law lags well behind that of more advanced parts of the world (Larraín, 1997).

### *C. Evaluation of Management Quality*

The first line of defense against problems of bankruptcy is administrative competence (Folkerts-Landau and Lindgren, 1997). This notion has been included in recommendations by the BIS (1997), in the "Core Principles" quoted above, and in recent work by the IMF (1997). One of the weakest areas in bank supervision in developing countries is the aforementioned evaluation of management, despite the fact that it is one of the crucial mechanisms that permit banks to make future projections. In effect, more than just figurative snapshots obtained by reviewing quantitative financial indicators, management evaluation is the determining variable in predicting a bank's future, particularly during times of economic turbulence. A solid internal auditing system, effective use of all management information systems, strategic development plans and continuing development of human resources are key essentials to good management. In many developing countries, putting these essentials into practice can be difficult.

To endow bank examiners with the skills they need, the focus should be on preparing them to conduct evaluations in the following areas: capital, assets, market risks, profits, and management. Flexible examiners who can see the big picture are preferable to specialists who analyse isolated trends within the bank.<sup>5</sup> Such preparations and skills tend to clash with institutional norms in the majority of developing countries, which lack the resources to employ inspectors who have the capacity to look past mere risk-management analyses. These policies are also fundamentally based on the idea that there can be compromise and cooperation between a bank's Board of Directors and its management. An examiner should identify problems and reveal them to the board with all available evidence, recommend changes, and then leave the bank to choose the best route to overcome the problems.

This is especially complex when a bank's financial indicators show a perfectly healthy outlook, but the bank has management problems. For example, a bank could be fulfilling minimum capital standards and showing high profits. However, a more thorough inspection could reveal that many of

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5 Nonetheless, examination teams specialising in highly complex subjects, like financial exposure or computer systems, can be useful.

these positive indicators are the result of irregular profits and/or aggressive lending policies that do not comply with acceptable standards. If this were the case, the bank would be undercapitalised. Given that management is responsible for defining appropriate policies for the bank's operation and establishing the necessary capital, this bank would receive negative marks for capital reserves, investment quality and management, even though it had apparently complied with all minimum banking rules. In all of this, the attitude of the inspector is essential since the idea is not to interfere in the bank's decisions.

Likewise, in those countries that have a shortage of high-quality, professional boards of directors, it is crucial for banks to reinforce a sense of commitment within the institution and avoid working solely for controlling groups or their interests. A better link between examiners and board members, including ensuring that the latter have access to the conclusions of inspections even when serious problems are not detected, permits more input "from above" and can help boards in many cases become better supervisors. Such cooperation can also improve basic management, which can be discussed in periodic meetings between examiners and boards.

The application of a strategy emphasising good management requires regulatory authorities to hire highly skilled and experienced personnel, who are provided with access to the necessary resources. These resources are not always readily available in developing countries, especially when we consider that boards of directors in such countries do not have a tradition of commitment or precedents for allowing supervisory authorities to interfere in the general operations of their banks.

#### **IV Developing Countries and International Regimes for Prudential Supervision**

The increasing international activity of banks from developed countries and the risks that have emerged in this practice have given rise to a series of agreements among these countries involving recommendations for their national regulatory authorities. The most active forum for discussion of such issues is the "Basle Committee" formed by the member countries of the Group of Ten (G-10). The Basle Committee has reached agreements on appropriate capital adequacy ratios for banks, consolidated supervision of international financial conglomerates, and the so-called "Core Principles for Effective Banking Supervision".<sup>6</sup>

<sup>6</sup> Given its importance and international legitimacy, this document is the central reference for this paper and it should be the base from which the developing countries continue to work.

This last one constitutes a document that synthesises the principal areas around which the Basle Committee has worked in the sphere of banking supervision, including such aspects as licensing, mechanisms for prudential supervision, responsibilities of regulatory bodies and supervision of international conglomerates. The document was prepared by representatives of the G-10 countries, consulting with some non-member countries such as Chile, China and the Czech Republic, among others. This consultation was a new and positive development permitting the broadening of its sphere of influence concerning minimum standards for banking to a wider range of countries.

The recommendations in the Basle document on core principles are useful as an ideal framework for banking supervision, within the context of well-established and independent public institutions in economies where market discipline plays an important role. However, this context is not that of developing economies today. Some of the problems dealt with in the Basle document have little relevance for the majority of developing economies, e.g. market risks and value at risk, while the recommended approach to some other issues is difficult to implement in their context, e.g. evaluation of the quality of management. Furthermore, as has been seen, there is great heterogeneity in the needs for reform among the developing countries, and it must somehow be incorporated into the discussions.

This section aims to contribute to the development of a position, for the developing and emerging countries, on the principal matters at issue in international banking supervision. Such a position should be based on a solid understanding of the specificity of the problems of supervision in developing economies and the most important courses of action to follow in matters of international policy. Taking the “Core Principles” document as representative of the kind of approach now being taken in international forums, the position of the developing countries should aim to: (i) establish certain priorities that better reflect the needs of developing economies; (ii) deal in greater depth with certain areas, now touched upon only superficially but of great relevance to developing economies; (iii) incorporate other subjects pertinent to developing economies but absent in current debates.

Below we discuss the principal areas around which the position of the developing economies about matters of banking supervision should be shaped, and some of its essential components, without entering into details of proposals already elaborated in previous sections of this paper.

### *Capital Adequacy*

One of the most important and widely implemented advances in matters of

international standards for banking is the 8% capital requirement. Some point to the need for developing countries to establish capital requirements greater than the 8% minimum, given the higher idiosyncratic risk of their economies relative to those of the G-10 countries. Likewise, there are proposals to increase capital requirements to compensate for the weaknesses in matters of portfolio classification and provisioning requirements frequently found in the developing economies.

It is evident that, in the short term, raising capital requirements can increase systemic stability. In the long term, however, the international competitiveness of the financial systems of developing countries can be damaged, as long as the developed countries keep the 8%, and that may also deteriorate the long-term stability of the system. A better solution was incorporated into the recently approved Chilean legislation: it establishes a minimum requirement of 8% but also gives incentives to the banks that have 10%, giving them greater opportunity to open new international and domestic business. This approach provides a better balance between the social and private benefits of capital requirements. In any case, indiscriminately raising the capital requirements for all developing economies does not seem appropriate.

### *Financial Conglomerates*

Up until now, clear recommendations exist in matters of minimum standards in the realm of international activities of conglomerates, but far more ambiguous standards are applied to the operation of conglomerates in the domestic field. The reality in the majority of developing economies is that the central problem exists with purely domestic conglomerates. There are few developing economies that have banking conglomerates whose main activity is internationally oriented (Chile is one such example). The big problem is the existence of *de facto* conglomerates created by investments by bank owners in other financial businesses, generating the risk of “contamination”. The central problem generated by this type of conglomerate is that it is produced by structures of concentrated ownership in which it is not the bank itself that diversifies, making it very difficult for regulatory bodies to intervene and supervise in a consolidated manner. Lack of transparency in respect of locating the centre of power of such conglomerates faces the regulatory body with a “grey area” that hampers supervisory work. The elaboration of specific proposals for dealing with this problem should be raised by developing country authorities.



## *Consolidated Supervision*

In the supervision of international conglomerates, among the key agreed principles are the responsibility of the regulator in the country of origin for the consolidated supervision of the group and the need for information exchange between the parent and the host countries. The central idea is to ensure that no part of the conglomerate is left outside the ambit of supervision.

Even if it is not a widespread phenomenon, there are a few emerging economies in which banks have internationalised. In these cases the application of the principle of consolidated supervision faces several complications. First, in countries with weak supervision capacity, to cede supervisory responsibility to the regulator of the head office may involve more costs than benefits. In many economies that have shown weak supervision capacity at the domestic level, it is difficult to imagine that their authorities may provide adequate supervision at the international level. The principle of consolidated supervision can thus generate a problem of moral hazard that, if not somehow offset, may eliminate the net benefits of banking internationalisation.

An obvious solution in these cases would be to prohibit the internationalisation of the bank. Once again, however, the problem may arise from foreign investments undertaken by the owners of the domestic bank. Faced with the impossibility of forcing such internationalisation to be done through the bank, the second-best solution is to give wide powers for the local regulator to impose a “fire wall” that totally isolates the local bank from all kinds of direct or indirect financial or commercial ties with owners’ investments abroad.

The need for information exchange between regulatory bodies is faced, in numerous cases, with national regulations on banking secrecy that prohibit such an exchange. These and other problems are almost absent from documents elaborated in current international forums. The idea would be for the principles of consolidated supervision to incorporate more options than they actually do now.

## *Internationalisation*

Recently, in organisations such as the World Bank, the Inter-American Development Bank and the International Monetary Fund, the recommendation of internationalisation as a tool for risk diversification in developing countries is acquiring growing strength. Such internationalisation usually involves foreign direct investment as well as international portfolio diversification.

However, for this internationalisation to have more benefits than costs, it must be backed by an adequate capacity for supervision, particularly in spheres that imply competencies different from those required in the corresponding domestic field, such as those relating to the analysis of country risk. These elements are often omitted from the debates among developed countries, where internationalisation processes rely strongly on the self-regulation mechanisms of the banks themselves.

One obvious recommendation in this field is to design an adequate legal framework that gives powers to the regulator to appropriately cover the new risks of international operations. This framework must deal with matters such as appropriate provisioning for country-risk limits for diversification by project and by country, requirements for internal controls within the banks themselves, limits to their maximum exposure as a percentage of capital, etc., all of which would facilitate a process of solid internationalisation. Without an appropriate legal framework and the capacity for implementation on the part of regulatory bodies, internationalisation may bring more costs than benefits to individual developing countries. In general this set of issues is insufficiently dealt with in international forums.

### *Management Evaluation*

The quality of management is a central element in financial system performance. But institutional weaknesses, inspectors' lack of expertise, and absence of professionalism in boards of directors which are often under the influence of economic groups and their interests make recommendations relating to its improvement particularly difficult in developing countries. To ensure that management evaluation becomes effective, these problems must be addressed in international discussions of supervision.

### *Credits to Related Parties*

Although most developing countries have legislation that imposes severe limits on financial sector operations with related parties, there are very few countries that have managed to establish an effective regime to control this type of operation in practice. This is a central problem for developing economies, which are characterised by a high degree of concentration in ownership of assets. It is essential that developing countries set forth their problems in this sphere at the pertinent international forums. They may be able to benefit from existing relevant expertise in developed countries so as to better translate principles into effective practice.

### *Entry Requirements*

The “Core Principles” adequately describe the central criteria that must govern the regulation of access of new institutions to the banking industry. This constitutes a useful tool for those countries that have not yet established such criteria within their domestic legislation. One of the frequent problems in the implementation of developing country legislation in this sphere, however, is the considerable discretion left to regulators. The absence of objective criteria is often used to restrict the access of foreign institutions to the market, as a result of pressure from domestic interest groups that enjoy great influence in many developing economies. In the same manner, on occasion, this discretion has allowed indiscriminate access of banking institutions to the system, under the aegis of the application of liberal principles, and consequent potential weakening of the stability of the system. Greater effort to develop objective requirements for access to the industry would be welcomed by many developing countries.

### *Exit Mechanisms*

Although it is one of the key issues for the long-term stability of any financial system, there are no internationally accepted standards concerning exit. The continued presence of precarious institutions that do not resolve their problems – whether through liquidation, intervention, merger or some other mechanism – weakens the financial system. This constitutes a prominent problem in developing economies, where regulatory bodies are very susceptible to pressures from interest groups which seek to avoid adequate correction measures. The establishment of clear exit rules – including automatic mechanisms for patrimonial adjustment, solutions permitting continuation of banking activity on the basis of private arrangements or liquidation – would represent a tremendous advance for the stability of financial systems in developing economies.

### *Supervision of Assets*

A good system of asset supervision, including appropriate classification of portfolio and provisioning requirements, is a high-priority objective that has not been achieved in many emerging economies. This objective, of crucial importance to developing economies, is insufficiently dealt with in current discussion of international standards. The main problem typically rests with implementation, including the absence of adequate systems of information, more than formal legislation. Unlike the situation in developed countries, where the process works mainly on the basis of self regula-

tion, the role played by regulatory bodies in this area, emphasising *in situ* supervision, is a key element. This issue should be strongly emphasised by developing country representatives in international discussions.

### ***Market Risks***

Recognising the weaknesses of the capital adequacy ratio of 8%, and the explosion of derivative instruments in developed countries, the Basle Committee has made great efforts to develop better measures of what is required to cover market risks. Its concept of “value at risk” aims at a common measurement standard so that institutions themselves can estimate the maximum loss of the value of a financial position in a given period of time. This new approach also comprises a series of qualitative standards that private institutions must face, such as an independent unit of risk control, etc.

Though the “value at risk” approach represents an important advance to complement the capital adequacy ratio of 8%, its pertinence in developing economies is debatable. In general, the exposure of developing country banks to market risks emanating from derivatives markets and other new instruments is far lower than that of developed countries’ banks, given the insufficient development of derivative markets and other coverage instruments. Moreover, some of the suggested methodologies are too sophisticated to guide coverage of financial risks in developing economies. Of much higher priority in developing economies is the development of simple techniques to limit the exposure of banks to exchange risks and the incorporation of the exposure of debtors to the risk of devaluation in the evaluation of credit risks and the classification of assets.

## **V Conclusions**

There are six key characteristics that suggest weaknesses in developing countries’ financial systems: (i) weak public institutions; (ii) lack of experience in the operation of financial markets and excessive emphasis on public ownership of financial institutions; (iii) inadequate accounting and risk-assessment standards; (iv) high concentration of ownership in financial institutions; (v) expensive or inefficient financial intermediation; and (vi) lack of an internationally diversified banking portfolio. These characteristics give rise to a series of problems that can affect market stability and weaken the quality of supervision in developing economies. They can also contribute to increased credit risk, a lack of market support in institutional monitoring, and inadequate standards for the entrance and exit of financial

institutions.

Although idiosyncratic events within financial markets generate specific obstacles to supervision in developing economies, the challenges of financial reforms are generally determined by the level of complexity and development in the financial market, and the ability and expertise of the supervisors. First-generation reforms are best applied to low and middle-income developing economies, in order to overcome the deficiencies that typify their financial systems. Second-generation reforms are better suited to more complex markets – typically emerging markets – in which regulatory agencies have the expertise necessary to create new methods of supervision to cover new and changing risk situations. It is illogical to think that developing countries that have not created fundamental regulatory mechanisms, such as basic systems of investment classification or loan controls, will be capable of implementing these types of reform, which require expert personnel to implement and oversee them. First and second-generation financial reforms should not necessarily be implemented in a mechanical or strictly sequential fashion, in which finishing the first round is a prerequisite to beginning the second. It is perfectly possible that second-generation reforms may be implemented alongside first-generation changes, depending on the characteristics of each specific market.

The position of developing and emerging countries in international forums should be based on a solid understanding of the specific problems of supervision and the principal required courses of policy action in those countries. The recommendations in the Basle documents constitute general principles, useful as reference to what makes an ideal framework for banking supervision, within a context of well-established markets and independent public institutions with the required authority and expertise. However, the reality of the majority of developing and emerging countries is far removed from such a context. Its supervisory weaknesses lie more in the implementation of agreed principles than in the definition of legal frameworks. The main issues on which the developing countries should concentrate as they develop their own positions in international forums are: capital adequacy, financial conglomerates, consolidated supervision, internationalisation, management evaluation, credits to related parties, entry requirements, exit mechanisms, supervision of assets and market risks.

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