COMMENTS ON SESSION 2

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Thank you. I would like to begin by stressing a couple of points that José María and Rogério mentioned. Essentially, they told us that the financial safety net in Latin America has good quality in many important aspects: regulation, supervision, management, corporate governance, lender of last resort, deposit insurance, resolution mechanisms—everything is working as it should. However, José María pointed out that this is not enough: you can't have a solvent banking system in an insolvent economy.

I think there are some additional aspects that have to be considered that can make our financial safety net as good as they described it. As Liliana Rojas pointed out, the problem is closely related to the limits imposed by our financial regulation. Now I'll try to show some of these issues.

I'd like to begin with what I consider a major problem with the traditional supervisory tools for controlling risk: loan loss provisions, associated with expected losses, and capital requirements, used for unexpected losses. In most Latin American countries, provisions are still static and backward looking. This means that banks assessment of risk is made based on historical information, missing the information on the expected losses that exists from the moment the credit is granted, which in turn depends crucially on the loan selection process. Under these circumstances banks tend to underprovision. Capital requirements can be biased too essentially because of a lack of liquid capital markets in Latin America.

Let me turn to some other aspects that also explain the underestimation of loan loss provisioning and capital requirements. The first point I'd like to stress is what is called migration risk. When we issue regulations that control interest or exchange rate risks, we are essentially transferring those risks from the banking to the corporate sector. This is a serious problem in our markets because corporations do not have the instruments or the markets available to diversify or to insure their positions against those risks. The problem in this scenario is that, eventually, this market risk will be transformed into credit risk from the point of view of the banks. Provisioning should reflect this particular fact. As long as such risk transference is not considered, both the expected loss and the variance of the loss are underestimated. In regulatory terms, this implies that we are underestimating loan loss provisions as well as capital adequacy. In statistical terms, this means that tails are fatter in the loan loss distribution, which is biased to the left side. In the accumulation of shocks that have occurred, the probability mass accumulated in the extreme values is higher than was expected.

My second point concerns adopting the Basle Accords in Latin American countries. There are several themes of the accord that are not consistent with the characteristics of emerging markets. Among the most important are the crowding out of the private sector and the rules on interbank lending.

Under the current accord, loans to the public sector carry a 0 percent risk weight. In practice, most countries consider a 0 percent risk weight for their own government paper, which is not consistent with the large episodes of government debt crises that have occurred in Latin American countries. This practice gives banks an incentive to shift credit from the private sector to the public sector in times of recession in order to make their portfolios less risky, deepening the recession through the credit channel. In Argentina, for example, banks have around 30 percent of their total assets in government paper, which represents two times equity. If we mark those securities to market, we might conclude that capital adequacy is far from what is needed. The proposed regulations, both Basel I and Basel II, do not take into account the nonexistence of markets to diversify risk and the characteristics of our governments that issue bonds in foreign currency. On the other hand, interbank lending would exacerbate the volatility of capital flows to emerging markets because the accord attaches less risk to shorter maturities.

Now I'd like to turn to some empirical facts that let me make some supervisory suggestions for Latin America. First, I want to stress the consequences of the banking crises that occurred in Latin America between 1997 and 1998 because of both domestic and external shocks: el Niño as well as the Asian, Russian, and Brazilian crises. The cost of these crises was highly heterogeneous across countries. Because the same shocks affected all the countries, if we control for macroeconomic and microeconomic factors, the extent of these differences can be attributed to the legislation and regulatory background, specifically in the damage control aspects. There have been a lot of studies about how to prevent banking crises ex ante. However, very little has been done about the ex post situation. I think contingency plans or damage control plans to apply in case a crisis occurs are very important. I'm sure that this is a crucial point in the explanation of the huge differences in the costs of the 1997–98 crises among Latin American countries.

Another important fact I want to point out is that the increasing participation of foreign banks from industrial countries has proved to be very positive in our domestic banking systems. This has helped to import best practices, better controls, and better bank supervision from the country of origin. It has also helped in the reduction of related lending activities, as well as in the diversification of liquidity and capital sources for our banks. If this is making our systems more resilient, I would recommend encouraging the process of financial internationalization.

Finally, I would like to stress that even though our financial safety nets have improved remarkably during the last decade in Latin America, there's still a lot of hard work to be done so that provisions and capital requirements are accurately estimated and risk is entirely considered.

Thank you very much.