

Systemic Bank Risk in Brazil

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Plan of the Discussion

- Preliminary Comments
- Comments on the Analyses Presented
- Comments on Bank and Sovereign Risk
- Comments on Brazil

Preliminary Comments

- We are witnessing good times in Latin American Banking systems
- Strong credit growth, ample liquidity
- This is a good time to also consider the risks
- Retail and credit cards are growing very fast, do we really know the risks?
- Sovereign risk remains important in several countries – see IDB's 2005 IPES Publication
- Ample evidence for twin crises : banking and fiscal
- Applaud the authors for attempting to quantify banking sector risks, this is not easy

This Paper

- A sophisticated and detailed study of bank risk in Brazil
- Represents a very significant amount of work over an extended period of time
- Considers banking sector risk and impact of sovereign risk on banking sector risks

Analyses Presented

- Individual banks, no Government default
- Individual banks with Government default
- Systemic Risk in banking system

Individual banks, no Govt default

- Simulation of macro parameters and credit portfolios
- Issues:
 - Credit-risk transition probabilities (system vs individual, crisis vs normal)
 - System vs individual interest rates
 - Choice of 99% rule?
 - What is required capital given VAR rule?
 - What can we say about Basel calibration?
 - Majnoni and Powell (Economia 2005) claim Basel II may call for higher capital requirements, 99.9% of Basel too strict, correlation assumption in Basel too low
 - Emerging countries should reconsider calibration

Sovereign Default

- In addition to private sector lending, banks may lose 0%, 10% or 25% of value of Government loans.
- Issues:
 - What are public sector loans exactly?, Volatility of Brazilian bond prices
 - Use of history) as to analyze what would happen in a default? E.g.: Argentina.
 - What would effect of depositors be on sovereign default?
 - Should an individual bank have capital to withstand the default of its sovereign?
 - Underlying problem is that these assets represent such a large percentage of banks' assets, moral hazard created.

Systemic Risk

- Multiple bank failures, 3 groups
- Issues:
 - Interbank relations are complex, not just interbank loans, what is effect on depositors?
 - If failures put financial system at risk, Government intervention will occur.
 - Could consider riskiest individual bank's effect on next two riskiest individual banks.
 - Only the channel from the sovereign to banks is considered, not the opposite.

Bank and Sovereign Risk

- This paper draws attention to risk of public sector lending in emerging economies
- There is a clear need for a *Standard* here
- Likely that a capital requirement approach not enough, need for an absolute limit
- Limit for public banks should be close to zero
- Basel needs to consider emerging market issues like this head-on to be a useful global standard

Final thoughts on Brazil

- Banks are heavily exposed to sovereign
- Credit to corporate sector from private banks small and expensive
- Corporate credit then subsidized through public sector banks
- The highly segmented credit market implies monetary policy thru' high and variable interest rates
- This maintains the segmented credit market and high bank exposure to the Government
- Need for greater coordination between monetary and credit policy and move to a better equilibrium