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GLOBALIZATION AND ITS EFFECTS ON THE BANKING SUPERVISORY SYSTEM

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Contents

1 - DEFINING GLOBALIZATION

As the globalization process involves and influences many areas: economy, policy, legal, social, it's not easy to find only one description that reaches all aspects. However, Renato Baumann in an article, "An Economic Globalization View", explores several definitions involving globalization under economic aspects.

1.1 - Finance

Financial globalization depends on the increase of quantity of capital (C), the velocity of circulation of capital flows (V), and the interaction between effects of (C) and (V) upon the economies. The analysis of this international financial integration is a controversial issue. We can consider it positive because the national regulatory barriers against the free capital movements have been reduced. But, capital mobility has also brought more concerns about risks in a global financial system, such as the speculation power in large scale.

1.2 - Trade/Production

The globalization process can be explained by the increase of similarity in demand structure and homogeneity in supply structure, in many countries. The consequences are listed: economic scale gains, standardization in production and management techniques, reduction of the production cycle and the competitiveness moving its focus, from product to technology. In such a way that the new competition around the technology results in more investments in Research & Development. The competitiveness takes place on a global scale, with companies changing their activities frequently and taking the comparative advantages of other companies and countries competitiveness.

The production view observes a movement toward convergence in many economies. It has been resulting in similar in the production techniques and management strategies. Meanwhile, at present there is no consensus about globalization effects on the production structure. While many people argue that it has stimulated the consolidation of oligopolies in the world, there is some evidence that contradict this new tendency.

Both in OECD (1992) and UNCTAD (1994) publications, the description of globalization focused on the production process. Supply frameworks linked around the globe have compounded a rising share of world production, and it involves cooperative agreements among the companies. Through them, this framework becomes possible to enter specific markets, to enlarge access to technologies and to share risks and financial costs. Therefore, the transnational corporations -- units of this supply structure -- have the best conditions to reap the advantages in this value-added network. Then, as the convergence advances it will probably end with the predominance of few companies. But, in spite of the interaction among countries in the production process, there are some doubts about this power concentration process. In 1993, "The Economist" observed that the number of companies would decrease, but in the last twenty years, the number of large companies has increased and they have tended to concentrate their activities regionally, so the ascendance of universal companies have been minimal.

In this vein, Paul Hirsute explains that the world economy remains dominated by the three major blocs of wealth, TRIAD (Europe, Japan, North America). Outside the TRIAD, industrial growth is concentrated in a limited number of successful but relatively small developing countries, or in specific regions of larger countries such as China. Together with the OECD countries, the elite of newly industrializing countries represents a small portion of the world’s population. Close examination shows that few companies are truly transnational, rather, most are multinational and operate from a distinct basis in one of the three blocs of the TRIAD.

But according to Martin Wolf, the big change in recent years is a shift in the motivation for companies to move production overseas. Historically, companies have located production abroad in order to overcome natural or artificial barriers to trade. If production efficiency were the only criterion, it would have made sense for many companies to locate all their production at a single base to maximize economies of scale. In practice, however, governments in consuming countries have pushed them to distribute production more widely. Others barriers to centralize production were inherent in the nature of business. For example, in the service sector, face to face contact facilities trade.

Many of these trends are changing. Trade liberalization makes traditional protection-jumping production unnecessary. Improvements in communication and transportation eliminate natural barriers. Technological changes make globalization feasible and liberalization allows it to happen. The growing role of export in multinational products is proof of this trend.

1.3 - Institutional

According to the institutional view, the globalization process means more similarity in national system configurations and it tends to standardize the regulatory systems. Then, it has been resulting in increased homogeneity among countries. We can see that the importance of bilateral cooperation agreements has diminished and the judicial relationships between companies and nation-states have tended to become more uniform. At the international scenario, group agents have been developing a large capability to influence the nations, to the detriment of their national power of decision.

1.4 - Economic policy

Globalization implies loss of economic and political sovereignty for a rising number of countries, including developing one and OECD’s members. The result of this process is that some traditional political instruments of control have become harmless. The recent effects of foreign capital flows on Latin America exchange policy and the parity movements between the US dollar and other healthy currencies.

As another consequence, external factors are increasingly important in the determining national political agendas. The wage policy is limited by external competitiveness requirements that demand the maintenance of a minimum ratio between exchange rates and wages. The fiscal policy has been determined by the need to maintain subsidies in some commercial goods and the interest tax levels have often limited the budget deficit size. Simultaneously, some international issues, like environment questions, bi-tributary treaties and the monitoring of transnational corporations in order to avoid practices of transference prices, have been included compulsorily in national economic and political agendas.

With this multiplicity of views, it's not surprising that literature confers on globalization so many definitions. However, the meaning most frequently related to globalization may be the international financial effects.

This paper will try to explore the financial aspects of the globalization process, mainly their influence in the banking regulatory and supervisory systems and their effects on United States and Brazil systems. Finally, the 25 Core Principles (Basle Committee) for effective supervision will be described, with a brief explanation of their importance.

2 - MOVEMENT TOWARD FINANCIAL GLOBALIZATION

In the last twenty years, globalization of financial markets has been advancing very rapidly. There are some important factors that have been contributing to this process:

a. Domestic financial markets are becoming progressively more integrated and influenced by external factors. The increase of capital flows in developed and developing countries.

b. The markets and their influence on financial system have been growing in almost every nation. The financial market incomes, as a share of GDP, have risen from 4.5% in 1950 to 8.9% in 1990, in the group of eight principal OECD countries (BIS Annual Bulletin).

c. We can observe in many economies a remarkable tendency to dissolve the barriers between banking and other financial intermediary activities. But, countries such as United States and Japan have insisted on maintaining the distinction between the different agents and functions in the financial system ("Chinese Wall" theory).

d. The steady decrease in international telecommunication costs has facilitated the transactions between debtors and creditors. The cost of international rate decreased from one-dollar in 1945 to one-cent in 1990.

e. The rise of financial instruments (derivatives and others) and the institutionalization processes of savings as a consequence of the expansion of private pension funds also drive the process.

f. The intense competition and the deregulation process of financial intermediary activities, dealing, more and more, with non-banking liabilities (stock, debenture, derivatives, etc.), encourage the integration.

g. The internationalization process requires absolute confidence in the validity of the contracts. In this sense, we should consider the significance of the Pax Americana to ensure the legal framework.

Until the liberalization of capital movements in the early 1980's, governments retained a real power over the financial markets; exchange controls limited external dealing mainly to the facilitation of trade and long-term investment. Now the daily volume of trading on the global market exceeds $1 trillion -- dwarfing the exports of the OECD countries and their equivalent GDP (about $40 billion). In 1994 the total principal outstanding on trade in financial derivatives came to $20 trillion -- greater than the combined GDP of North America, Western Europe and Japan in 1993. It is widely accepted by economists that central banks can no longer dictate exchange rates and control the foreign exchange markets, that interest rates and levels of inflation cannot diverge greatly from those deemed appropriate by the markets. Nations are no longer privileged borrowers in domestic capital markets, but are viewed by global markets in the same way as municipalities and companies are in terms of their ability to service debt. Hence, a significant degree of autonomy in macroeconomic policy has been lost, and states can no longer control certain key economic variables.

In recent years, financial markets around the world have experienced significant structural changes. Some of the more important changes are the growing role of capital markets in credit intermediation, the emergence of markets for intermediating risk, changes in the activities and risk profiles of financial institutions, and the increasingly global nature of financial intermediation. More than ever, banks face competition from other financial institutions. Many business are turning away from banks and other depository institutions and heading directly toward capital markets and non-bank intermediaries for their funding needs.

Intermediation has expanded in scope from credit intermediation to risk intermediation. In particular, growth in the markets for both off-balance and non-balance sheet derivatives has skyrocketed. These markets allow banks to intermediate risk by unbundling the total risk of an asset into its component parts and then transferring combinations of those components to those who are most willing and able to bear the risk. And the market also provides opportunity to arbitrage. As a result, both financial institutions and non-financial corporations are more able to actively manage the risk characteristic of their portfolios.

The increased competition in traditional lines of business and the opportunities in capital and derivatives markets have led the largest domestic and global banks to significantly alter their activities and products. Among the most significant of the new activities are trading and market-making in money markets, capital markets, foreign exchange, and derivatives.

Institutions have to use these new instruments to meet their obligations to depositors, pensioners, and life insurance policyholders. International trade thus recycles a substantial portion of its output back into the domestic financial system. Ultimately, most of the capital used in these markets is no-free floating and must be returned into them. This does not mean that the international markets are unproblematic or that they can be easily controlled. People buy financial products like pensions or life policies to guard against personal risks, often completely unaware that they are a very risk system. The international markets add little to real long-term economic performance that is determined by domestic saving, productivity growth and competitiveness in trade. Yet they have the ability to distribute short-term shocks around the system, and the potential -- especially considering the vast obligations in the derivative markets-to produce dangerous instability. Regulation and stabilization are a strong necessity, but they will only work if the major states are willing to cooperate in order to impose common rules on the system. The Baring and the Sumitomo scandals show the dangers of failure in a fragile and independent system.

Effective public action to control the economy needs to be coordinated among nations and, as in the case of trade openness or common economic standards, overseen or implemented by supranational bodies. Such concerted action does not necessarily weaken states; rather, it can strengthen them by stabilizing the external economic environment and thus giving them greater scope to pursue national policies.

The belief that the international economy is now virtually ungovernable and that national policies are powerless before world market forces is common among politicians, bankers, business leaders, and economists. Yet there are urgent economic problems that need to be tracked by extending the agenda and scope of public governance. Such problems can be tackled by a mixture of appropriate policies and a division of labor in governance between international agencies, interstate agreements and national governments.

In the next four items it will be described the banking supervision system in Brazil and United States and their recent evolutions.

3 - THE CENTRAL BANK OF BRAZIL

3.1 - Objectives

- To ensure the adequate liquidity of the economy
- To maintain the Brazilian international reserves at an adequate level
- To encourage the savings in order to achieve adequate level of investments
- To carry out stability and improvement of the national financial system

3.2 - Functions

Created under the Law n° 4.595/64, which became into effect in March 1965. The Central Bank of Brazil is under the supervision of the Ministry of Finance.

The Central Bank performs several functions.

a. To issue money. As in other countries, it is the sole body empowered to issue paper money and coin.

b. To implement the nation's monetary policy. In order to increase or reduce the money supply, it determines the value of reserve requirement, the quantity of federal securities in the market, and indicates the level of the interest and discount rates. It also has the authority to issue securities.

c. To work as the bank of the banks, receiving deposits (in form of money and securities) from others banks (reserve requirement and voluntary reserves) to operate as a clearing-house bank and a lender of last resort.

d. To control the credit operations in all its aspects.

e. To establish, conduct and monitor exchange policy. The international reserves and inflows are controlled by the Central Bank; which means the responsible for the management of all reserves of gold and foreign currencies as well as the regulation of the exchange market.

f. To supervise the financial system. It aims to guarantee the stability and the regular functioning of the financial institutions (banks, brokers, etc) and seek their improvement as well.

g. To represent the Brazilian Government in International Organizations.

   Finally, the Central Bank also works as a government advisor, providing economic and financial statistics, and providing specific studies, surveys and reports to several public management segments.

3.3 - Organizational Chart

The administrative structure is organized in specific units:

- Board of Directors
- Executive Secretariat of the Board of Directors (SECRE)
- Central Units (Departments)
- Regional Offices

1. The Board of Directors is located in Brasilia (Federal District) and is constituted of following members:

- Governor
- Directors responsible for: Administration, International Affairs, Supervision of Financial System, Regulation and Organization, Monetary and Economy Policy, and Restructuring of State's Financial System and Public Debt of States, Federal District and Municipalities.

1. The Executive Secretariat of the Board of Directors (SECRE) consists of advisory bodies such as:

- Secretariat for Administrative Affairs (SUBAD)
- Secretariat for Board of Directors and National Monetary Council Affairs (SUCON)
- Secretariat for Institutions Relations (SUREL)
- Secretariat for House of Representatives' Affairs (SUPAR)

1. The Central Units (in Brasilia) are responsible for the conception of and overlooking of the functions, and are arranged by issues:

- Internal Administration:

  Financial Administration Department (DEAFI), Department of Special Studies and Financial System Analysis (DEASF), Internal Auditing Department (DEAUD), Department of Information System Management (DEINF), Currency Management Department (MECIR), Planning and Organization Department (DEPLA), Human Resource Administration (REPES), Legal Department (DEJUR).

- Supervision.

  Department of Records and Information (DECAD), Department of Supervision and Inspection (DEFIS), Department of Control and Administrative Process and Special Systems (DEPAD)

- Regulation and Organization of the Financial System.

  Department of Financial System Regulation (DENOR), and Department of the Financial System Organization (DEORF).

- International Affairs.

  Foreign Exchange Department (DECAM), Department of International Reserves Operations (DEPIN), Foreign Capital Department (FIRCE), External Debt and International Organization Department (DERIN).

- Monetary Policy.

  Banking Operation Department (DEBAN), and Open Market Operation Department (DEMAB).

- Economy Policy.

Economy Research Department

- Internal Debt.

Domestic Public Department

1. The Regional Offices are divided into 10 areas: Belem, Belo Horizonte, Brasilia, Curutiba, Fortaleza, Rio de Janeiro, Porto Alegre, Recife, Salvador, and Sao Paulo, capitals of some states. The location of these offices are determined by the size of regional financial markets and the need for Central Bank services (such as distributing currency, supervising institutions, managing banking deposits, issuing authorizations, etc.)

The offices are linked directly to the Governor and are executor units. They also represent the central units to ensure more efficiency and objectivity in the decision process.

3.4 - The Supervisory Function

The main objectives of supervision are:

- To look after the strength of financial institutions and maintain the stability in the national financial system.
- To check the efficacy of regulation in the financial system and oversee observance of these rules.
- To provide an up-to-date information system with analyses of the financial and economic status of the institutions.
- To seek professional improvements and preserve ethical principles.

The Central Bank supervises about 5,253 financial institutions and other non-financial entities; both of them require the Central Bank authorization to operate in the market.

Type of Institution	Number of institutions
"Buyers group" managers	443
Brokerage companies	252
Commercial banks	38
Credit Unions	1,088
Credit, financing and investment companies	49
Distributing companies (securities)	279
Financial Conglomerate	194
Investment banks	23
Investment funds	2,855
Leasing companies	77
Multiple banks (full-service banks)	189
National Banks of Economic and Social Development	1
Real estate credit companies	23

Savings banks	2
State Development banks	7

Another duty is to oversee the agricultural credits and the "marginal" market (non-financial companies that work illegally as financial one).

Source: The Banker

4 - THE FINANCIAL SYSTEM ADJUSTEMENT IN BRAZIL

4.1 - Evolution

Until 1994 we faced a difficult period of high inflation and macroeconomic imbalances. Those years led to the creation of a large number of financial institutions, which, in order to benefit from float, used a wide network of branches to attract deposits and investments, despite the high costs. From the 1940s until the early 1990s, transfer from the non-banking sector to the banking sector may have represented, in average annual terms, nearly 2% of GDP. In the 1990, banks' inflationary revenue grew to about 4% of GDP (an average from 1990 to 1993), sinking again to 2% of GDP in 1994 and then a nominal amount in 1995. Based upon the average from 1990 to 1993, this represented, at 1994 figures, something close to R$ 19 billion in losses for banks deriving from price stabilization in the Brazilian economy.

The Real Plan, established in July 1994, introduced a scenario of macroeconomic stabilization; and the Brazilian financial system had to undergo major changes, such as reviewing its dimensions and redirecting its activities towards new forms of financing.

In order to compensate for the loss of inflationary revenue, before closing offices and carrying out necessary adjustments, the bank system had expanded credit operations. Deposits at sight, for instances, showed a 165.4% of increase during the first six months of the Real Plan, and deposits grew by almost 405 times in that same period.

On other side, the Central Bank increased the ratio of reserve requirements, bank deposits moved from 48% to 100%, savings deposits from 10% to 30% and a new ratio was established, equal to 30% of the time deposit balances. Despite all procedures, the total loans of the financial sector to the private sector grew 58,7% in the first year of the Real Plan. The revenue from the loan operations had compensated partly for the loss of the float, postponing the adjustment of the financial system.

Nevertheless, the institutions, private and state ones, had not taken the necessary caution in authorizing these loans and, in many cases they did not consider the payment capability of the debtors. Delayed loans and loan losses had grown startling until mid 1996, when default in the banking sector reached its peak.

Though the increase in delayed loans and loan losses was not the sole case of banking problems, it does help to explain the deterioration of the quality of the assets of some institutions, which were already vulnerable before the Real Plan. This can partially explain what happened to Banco Economico and Banco Nacional, which started the most delicate period of the adjustment of the Brazilian Financial System.

Since the government has acted, through an institutional framework, to facilitate and restructure the financial system in the fast and safe manner possible for Brazilian society. In early November 1995, the government began to adopt several measures:

- To adopt the Basle Committee regulation on minimum capital and capital adequacy (legally required ratio of capital to assets) (Resolution n° 2,099 – 08/17/94).
- To set up fiscal incentives for mergers and acquisitions of financial institutions (MP n° 1,179, 11/03/95), allowing the taking-over company to deduct:

a. the loan losses of target company and the taking-over;

b. as a premium the difference between the capital and the value of acquisition, this amount could be compensated in coming fiscal years.

- To set the Incentive Program in order to Restructure and Strength the Domestic Financial System (PROER – Resolution n° 2,208, 11/03/95). It established a special credit for financial institutions interested in joining this program. The expenditures with restructuring, reorganization and modernization could be deferred, until 10 semesters and they also could remain temporally out of the Basle Committee capital requirements.
- To establish a new regulation for deposit insurance, creating the Credit Guarantee Fund (FCC - Resolution n° 2,221, 11/16/95). This fund insures the bank deposits up to R$ 20,000, each person can require up to this amount from each financial conglomerate.
- To change the requirements for opening new financial institutions (Resolution n° 2,212, 16/11/95). It increased the required capital ratio of new banks and other financial institutions.

The PROER also has determined as a primary condition the transference of the control (shares) of the target institution to other managers. The PROER was not planned to be a rescue program for banks, but a program to grant stability for the financial institutions, in order to avoid the systemic crises that could jeopardize all sectors of the economy. The Central Bank also introduced procedures based on preemptive action, allowing the supervisor to intervene whenever banks do not comply with the legal requirements and/or face major financial problems, such as:

- Increasing the intervention power of Central Bank in financial institutions (MP n° 1,282, 11/17/95). The Central Bank can demand increase of capital, the transference of control, and corporate reorganizations through merger, acquisition or split. Before the Real Plan, the Central Bank had its action restricted to intervention and liquidation of financial institutions.
- Creating responsibility for the external auditing companies and auditors in case of irregularities in the financial institutions (MP n° 1,334, 03/03/96).
- Changing the regulation of branches, subsidiaries and other direct and indirect ventures abroad. (Resolution n° 2,302, 07/25/96). It increased the minimum capital and the capital ratio for banks with branches/ventures abroad and also introduced the inspections of these branches or parent institutions (Consolidated Global Supervision).

- Allowing the institutions to charge fees for services (Resolution n° 2,303, 07/25/96). Before the Real Plan the service fees were not charged because the banks had earned too much with the inflation.

- Creating the Credit Risk Center (Resolution n° 2,390, 05/22/97). The National Monetary Council decreed that all financial institutions should provide information to the Central Bank on the volume of debts and liabilities for client guaranties. The financial market also will be able to consult the data since the clients authorize the information access.

In short, the program of adjustment of the Brazilian financial system did not restrict itself to measures geared to the management of mergers and acquisitions. Government strengthened bank legislation and supervision, and furnished the Central Bank actual with tools for preemptive action.

4.2 - Adjustment Program for Federal and States Banks

One of the main characteristics of the fragility of public financial institutions relates to the high numbers of employees, which brings about a high load of human-resource expenditures in the cost structure of public banks. The ratio of personnel expenditure to production value for public banks reached above 100% in 1992 and 1993 while in the private banks this ratio remained close to 30% through the period 1990-1994.

The adjustment first affected the public banks, such as Banco do Brasil, Caixa Economica Federal.

In the case of Banco do Brasil; the process began with the acknowledgment losses due to accumulation of unredeemable credits throughout several years. The streamlining and cleaning of the credit portfolio and temporary increase of Government's participation in the bank's equity meant a capitalization of R$ 8 billion. This capitalization was made through the issuing of federal public bonds.

It must be emphasized that the Banco do Brasil restructuring was actually greater than the R$ 8 billion used in its capitalization. The National Treasury had a corresponding increase of its equity in the bank, which it was able to sell later on to the private sector.

The Caixa Economica Federal already has in ongoing structural movement. In fact, some of the problems faced by this institution are a consequence of the bankruptcy of the Real Estate Financing System. The adjustment process was based on changes in the legal framework that regulates financing and execution of collateral in real-estate contracts, and also has been carried out by setting a new system for real estate financing.

Other public banks such as, Credireal (state of Minas Gerais) and Banerj (state of Rio de Janeiro) had already been privatized.

4.3 - Intervention, Liquidations, Mergers and Acquisitions

From the outset of the Real Plan, the financial market has been undergoing a broad process of reforms. Even before the institution of PROER, in November 1995, the Central Bank had intervened in several financial institutions.

From the beginning of the Real Plan until March 1997, the Central Bank intervened in 37 banks, (7 states/ 30 privates). This indicates that the process of adjustment of the financial system has been intense and that the Central Bank has promptly intervened when it has been necessary.

The following table demonstrates this process:

Liquidated banks/intervention or temporary special administration (March/97)

Type of bank	Number of institutions involved

Commercial bank	4
Investment bank	1
Multiple Bank (with foreign participation)	2
National Multiple Bank	23
Public Multiple Bank	3
State Commercial bank	3
State Development bank	1
TOTAL	36

Source: Central Bank/DEPAD

Made by SPE/Monetary Policy coordination Office

From the total of 36 institutions, 26 were liquidated, 4 had gone bankrupt, 6 were under a regime of temporary special administration and 1 was under intervention (Banco Bamerindus - already purchased).

A large share of intervened banks had had lots of branches and depositors, which indicates that they had a franchising value derived from long actions in the market and well-structured distribution networks. In such cases, the Central Bank, after interventions and before the liquidation, had found buyers for these financial institutions, using resources from PROER to facilitate the sale of part of these assets and liabilities even without resorting to PROER.

From the beginning of the Real Plan until March 1997 (including already authorized operations and those under study by the Central Bank) there were:

- The transference of stockholder control of 18 banks,
- The acquisition of 5 national bank, and
- The sale of part of the assets and liabilities of 3 banks,

In sum, we had 27 banks sold or taken over without using resources of PROER. Out of this total, 6 banks had already started the transference process before the July 1994, and the 20 remaining ones started after the Real Plan. Based on these numbers, it is possible to assert that important changes were managed by the private sector itself, without resources from PROER.

From a total of 271 existing banks in March 1997, 68 of them have already been subject to some process of adjustment (transfer of stockholder control, intervention, or liquidation) by the Central Bank, and mergers and acquisitions by other banks. This indicates that the adjustment of financial system vis-à-vis a background of macroeconomic stability has been relatively swift.

One indicator shows a major adjustment had already occurred in the Brazilian financial system is the noticeable drop of its participation in GDP, which reduced from 12.7% in 1990 to 6.9% in 1995.

Loans released by PROER until March 1997 reached a total amount of R$ 15.1 billion. However, with the release of PROER loans for the sale of Banco Bamerindus, the total value released rose to R$ 20.8 billion.

4.4 - Entrance of Foreign Banks into Brazil

From early 1977, several foreign banks have been operating in Brazil. Generally, this entrance takes places through increases of capital in financial institutions in which foreign banks were already minority shareholders. In addition, new banks are operating in domestic financial markets, such as the Korean Exchange Market.

The presence of those banks in the domestic market brings several advantages. First, considering that banking crises arise from the conjunction of microeconomic factors (individual characteristics of financial institutions) and macroeconomic factors (shocks that also mean pressure on the financial system) the stronger the financial system in the economy, the greater its capacity to absorb macroeconomic imbalance.

The introduction of foreign banks increases competition within the financial system and brings about a reduction of spreads and fees for banking services. The reduction of spreads, in turn, leads to a reduction of interest rates, which stimulates increased levels of investment in the economy.

Foreign banks have helped to restructure the domestic financial system by purchasing the financial assets of banks under liquidation and purchasing the Brazilian banks that faced asset imbalances. In the beginning of 1997, the London based HSBC purchased the Banco Bamerindus. That acquisition, along with smaller investments such as the Santander purchase of middle-tier Banco Geral do Comercio, reflects a growing interest in Brazil as an essential part of plans for regional expansion.

The process of adjustment has not been completed. During 1997, acquisitions have taken a new direction that will accelerate the trend towards the emergence of three to six dominant universal banks vying for a share in the national market (BANCO ITAU, BRADESCO and UNIBANCO). Smaller institution face heightened pressure to consolidate their regional retail bases or focus more tightly on lucrative niches in corporate credit, investment banking, funding management and capital markets.

The Ministry of Finance announced in August 1997 that it aims to wrap up the bank privatization process by June 1998. That program should afford fresh opportunities for foreign financial institutions to establish a wider foothold in the increasingly attractive market.

What may explain the strong interest of foreign banks in the Brazilian economy, among other factors, is the potential growth of the Brazilian banking industry, no longer present in developed countries where the role of banks in financial intermediation has been substantially reduced. The Brazilian financial system has a low ratio between bank deposits and GDP (24%).

> In Brazil, bank credit for the private sector in terms of GDP is still low (33,4%), compared to that in other countries. The United States, for example, has a ratio of 64,5% of GDP and credit for the private sector from non-banking financial institutions corresponds to 104% of GDP. Banks in Brazil are still the most important agents for grating credit to the private sector. This indicates that in Brazil there is still a strong potential for expansion of bank credit for the private sector.
>
> It’s also important to remember that too much competition can cause low spreads, as a consequence the banks will take too much risk enhance profits. The exposure of their portfolio will increase the necessity of monitoring the systemic risk.

4.4 - Supervision Challenges

Supporting this process, the Central Bank’s supervision and regulation are facing new challenges. There are some points that should be mentioned, such as:

- Overseeing risk management system of the banks - examiners need to develop the expertise to understand and keep pace with the continuing evolution of assets valuation models and the risk management process.

- Enforcing the tools for prompt corrective actions and avoiding regulatory forbearance, which allows banks to keep on operating as usual despite noncompliance with regulation in the hope that the bank's problem will go away with time.

- Improving mechanisms for supervision of universal banks, including its domestic and foreign, banking and non-banking subsidiaries/branches. (Global Consolidated Supervision)
- Creating a bank rating system based on the CAMEL model and other international standards.
- Developing more interactions with other central banks and international organizations.
- For these purposes, the bank regulatory and supervisory agencies need adequate resources to do their job effectively, it includes investments in human resources and technologies

In order to illustrate a development country example, it will be explicated the United State financial system evolution and the roles of regulation and supervision.

5 - THE FEDERAL RESERVE SYSTEM

5.1 - Objectives

The Federal Reserve System is the central bank of the United States. In 1913, Congress founded it to provide the nation with a safer, more flexible, and more stable monetary and financial system. Over the years, its role in banking and economy has expanded.

Today, the Federal Reserve's duties fall into four general areas:

- Conducting the nation's monetary policy by influencing the money and credit conditions in the economy in pursuit of full employment and stable prices.
- Supervising and regulating state members, banking institutions and bank holding companies to ensure the safety and soundness of the nation's banking and financial system and to protect the credit rights of consumers.
- Maintaining the stability of the financial system and containing systemic risk that may arise in financial markets.
- Providing certain financial services to the US Government, to the public, to financial institutions, and to foreign official institutions, including playing a major role in operating the nation's payments system.

The Federal Reserve System is considered to be an independent central bank. However, it is independent only in the sense that its decisions do not have to be ratified by the President or anyone else in the executive branch of government. The entire system is subject to oversight by the U.S. Congress because the constitution gives to Congress the power to coin money and set its value, and Congress delegated this power to the Federal Reserve in the 1913 act. The Federal Reserve must work within the framework of overall objectives of economic and financial policy established by the government, and thus the description of the System as "independent within the government" is more accurate.

5.2 - Structure of the System

The Federal Reserve System has a structure designed by Congress to give it a broad perspective on the economy and on economic activity in all parts of the nation. It is a federal system, composed basically of a central, Board of Governors, which site in Washington D.C., and twelve regional Federal Reserve Banks, located in major cities throughout the nation. These components share responsibility for supervising and regulating certain financial institutions and activities, for providing banking services to depository institutions and the federal government, and for ensuring that consumers receive adequate information and fair treatment in their business with the banking system.

A major component of the System is the Federal Open Market Committee (FOMC), which is made up of the Board of Governors, the president of the Federal Reserve of New York, and presidents of four other Federal Reserve Banks, who serve on a rotating basis.

Two other groups play roles in function of the Federal Reserve System. The first are: depository institutions, through which the tools of monetary policy operate, and the second are advisory committees, which make recommendations to the Board of Governors and to the Reserve Banks regarding the System's responsibilities.

The Board of Governors of the Federal Reserve System was established as a federal agency. It is made up of seven members appointed by the President of the United States and confirmed by the U.S. Senate. The Chairman and the Vice-Chairman of the Board are also appointed by the President and confirmed by the Senate.

The Board has regular contact with the members of the President's Council of Economic Advisers and other key economic officials, and the Chairman meets from time to time with the President of the United States and has regular meetings with the Secretary of the Treasury.

The Chairman has formal responsibilities in the international arena as well. He or she is the alternate U.S. member of the Board of Governors of the International Fund, a member of the board of the Bank for International Settlements (BIS), and a member, along with the heads of the other relevant U.S. agencies and departments of international organizations.

5.3 - The Federal Reserve Banks

A network of twelve Federal Reserve Banks and their twenty-five branches carries out a variety of System functions, which include operating a nationwide payments system, distributing the nation's currency and coin, supervising and regulating the nation's currency and coin, supervising and regulating member banks and bank holding companies, and serving as banker for the U.S. Treasury. A letter and a number identify each Reserve District. All U.S. currency carries the letter and number designation of the Reserve Bank that first puts it into circulation. Each Reserve Bank acts as a depository for the banks in its own district and fulfills other district responsibilities.

The twelve districts are in Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, St. Louis, Minneapolis, Kansas City, Dallas, and San Francisco.

5.4 - Supervision and Regulation Roles

The Federal Reserve has supervisory and regulatory authority over a wide range of financial institutions and activities. It works with other federal and state financial authorities to ensure safety and soundness in the operation of financial institutions, stability in the financial markets, and fair and equitable treatment of consumers in their financial transactions.

Although the terms bank supervision and bank regulation are often used interchangeably, they actually refer to distinct, but complementary activities. Bank supervision involves the monitoring, inspecting, and examining of banking organization to assess their condition and their compliance with relevant laws and regulation. Bank regulation entail making and issuing specific regulations and guidelines governing the structure and conduct of banking, under the authority of legislation.

The Federal Reserve has primary responsibility for supervising and regulating several types of banking organizations:

- All bank holding companies, their non-bank subsidiaries, and their foreign subsidiaries.

- State-chartered banks that are members of the Federal Reserve System (state member banks) and their foreign branches and subsidiaries.

- Edge Act and agreement corporations, through which U.S. banking organizations conduct operations abroad.

Other supervisory and regulatory responsibilities of the Federal Reserve include:

- Regulating margin requirements on security transactions

- Implementing statutes that protect consumers in credit and deposit transactions

- Monitoring compliance with the money-laundering provisions contained in the Bank Secret Act.

- Regulating transactions between banking affiliates.

The Federal Reserve's supervision and regulation of the international operations of banking organization that are members of the Federal Reserve System entail four principal statutory responsibility:

- Authorizing the establishment of foreign branches of member banks and regulating the scope of their activities.

- Chartering and regulating the activities of Edge Act and agreement corporation.

- Authorizing overseas investments by member banks, Edge Act and agreement companies, and regulating the activities of foreign firms acquired by such investments.

- Establishing supervisory policy and practices with respect to foreign lending of member bank.

The international Lending Supervision Act of 1983 directed the Federal Reserve and other U.S. banking agencies to consult with the supervisory policies and practices with respect to international lending.

The International Banking Act of 1978 (IBA) created a federal regulatory structure for the U.S. branches and agencies of foreign banks. The IBA established a policy of "national" treatment for foreign banks and operating in the United States to promote competitive equality between them and domestic institutions.

The Federal Reserve shares supervisory and regulatory responsibilities with the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) at the federal level, with the banking agencies of the various states, and with foreign banking authorities for the international operations of U.S. banks and the operations of foreign banks in the United States.

The OCC is responsible for supervising nationally charter banks and their subsidiaries, plus federally licensed branches and agencies of foreign banking institutions. The Federal Reserve Board has jurisdiction over bank holding companies and their non-bank subsidiaries, as state-chartered bank, member of the Federal Reserve System. The Federal Reserve Board also exercises broad jurisdictional authority over the establishment of foreign bank branches, agencies and subsidiaries doing business in the U.S. And finally, the FDIC supervises state-chartered banks and saving and loans that are insured by the FDIC without being members of the Federal Reserve System.

Some regulations issued by the Board apply to the entire banking industry, whereas other apply only to members banks, that is, states bank that have chosen to join the Federal Reserve System and national banks, which by law are automatically members of the System. The Board also issues regulation to carry out major federal laws governing consumer credit protection, applied to various lenders outside the banking industry as well as to banks.

This structure has evolved partly out of the complexity of the U.S. financial system, which its many kinds of depository institutions and numerous charting authorities. It has also resulted from a wide variety of federal and state laws and regulation designed from a wide variety of federal and state law and regulations designed to remedy problems that the U.S. commercial banking system has faced over its history.

Although the sophisticated system created along decades, the US regulatory system is too complex and should be simplified.

6 - U.S. BANKING INDUSTRY

6.1 - Deregulation of Supervision

The Division of Research and Statistics of the FDIC have analyzed the 1980's and early 1990's, and a summary of supervision aspects is given here.

Effective supervision can be accomplished in two ways. First, problems can be identified early, so that corrective measures can be taken and the bank returned to a healthy condition. Second, supervision can limit losses by closely monitoring troubled institutions, limiting their incentives to take excessive risks, and promptly closing them when they become insolvent or when their capital falls below a critical level.

Decisions to change examination policies by some banking agencies during the late 1970s and early 1980s probably had an important impact on the outcome and severity of the banking crisis that followed this period. Most important were two key policy changes embraced primarily by the OCC and FDIC, but also, to some extent by the Federal Reserve System. The banking agencies decided to (1) place relatively more emphasis on off-site supervision and less upon on-site examination and (2) concentrate examination resources on those institutions, which posed the greatest insurance risk. These changes were made in part because of the belief that comprehensive call report data and the use of computers models would give the agencies the ability to develop extensive use of off-site surveillance. At that time, off-site monitoring seemed as the way of the future, holding the potential to greatly reduce on-site examination visits, examination costs and the regulatory burden on banks. Furthermore, the decision to concentrate more resources upon problem banks and larger-sized organizations and to decrease the frequency of examination of more highly-rated and/or small sized banks was seem as an optimal allocation of resources for maintaining stability losses to the deposit insurance fund.

These decisions, because they ultimately resulted in reduced levels of field examiners and examinations for most 1980s, arguably weakened the ability of the banking supervisor to detect problems for significant portion of the remaining decade. Several factors contributed to the cuts in examination staff. First, most banking agencies believed that increased utilization of off-site supervision meant fewer examiners would be needed, and so were able to begin reducing their examination staffs in 1980 and subsequent years. Second, the Carter administration in the 1970s followed by the Reagan administration in the early 1980s froze federal hiring in an attempt to reduce the size of federal government.

There is no way to determine how much of the FDIC's large losses in some U.S. regions (mainly in Texas and Southwest) can be attributed to the declined in examiner resources available to the banking agencies in the early 1980s. It is reasonable to assume however, that had the reduction in examiner resources and examinations not occurred, problems would have been detected earlier and cost reduced as a result.

The number of bank failures increased more than twelve-fold between 1980 and 1985 and the number of problem banks grew from approximately 200 to 1,100 over this period.

The analysis of supervisory actions also indicates that timely enforcement actions were reasonably effective in forcing corrective actions when examinations were conducted frequently. The enforcement actions brought against troubled banks generally reduced risk-taking in these institutions and therefore losses to the bank insurance fund.

No one could have anticipated the regional recession on the attendant problems that it produced during this era. However, the policy of reducing staff was high-risk and ended up misfiring. Second, frequent on-site examinations are necessary for the early identification of risk in the system and to ensure the integrity of banking financial reports. Third, the examination system needs to systematically capture more risks including those posed by regional and national economic problems.

Banking legislation was also an important influence in the bank failure experience in the 1980s and early 1990s. The legislation was largely shaped by two factors. The early 1980s were dominated by actions to deregulate the product and service powers of thrifts and, to lesser extent banks. Because these actions were generally unaccompanied by actions to restrict risk-taking, they contributed to bank and thrift failures. As failures mounted, the emphasis shifted to recapitalizing the depleted deposit insurance funds and providing regulators with stronger tools, while restricting their discretion.

The Federal Insurance Corporation Improvement Act of 1991 was largely aimed at limiting regulatory discretion in monitoring and resolving banking problems. I prescribed specific "prompt corrective actions" to be taken. It has imposed capital ratio of banks and thrifts decline to certain levels, mandated annual examinations and audits, prohibited the use of brokered deposits by under -capitalized institutions, restricted states activities, revised least-cost standards for failure resolutions, and mandated a risk-based deposit insurance system.

The final chapter of the saving and loan emergency legislation was completed in October 1996 with the enactment of the Deposit Insurance Funds Act that provides for the capitalization of the Savings Association Insurance Fund.

The tension between the objective of deregulation of depository institutions and the growing concern about failures was apparent not only in legislative activity but also in the policies of the various federal bank regulators. In a number of areas, the position of the OCC leaned toward allowing banks more freedom to compete and seek profit opportunities, while the FDIC leaned toward preserving safety and soundness and protecting the insuring agency. This introduced the basic problem inherent in bank regulation of striking a balance between encouraging innovation and competition and preserving stability and safety. The Federal Reserve Board often took a middle-of-the-road position, although it was clearly sensitive to issues of safety and soundness.

6.2 - Banking Regulation : New challenges

The traditional approach to maintaining financial stability and to protecting government safety nets is safety and soundness regulation, which primarily aims to maintain the health of individual institutions. According to this view, if institutions are protected from failure through regulation of capital and prudential supervision, the health of the system is to ensure these potential risks to the safe system nets are minimized. For example, in the United States the creation and improvement of deposit insurance have solved the most problems of bank runs.

The regulatory changes of the past decade have largely been within the context of this traditional approach. The raising of capital requirements and the incorporation of risk into capital requirement in accordance with the 1988 Basle Accord on capital standards are examples of how the traditional approach has been extended.

More recently, discussion in the United States and abroad has turned its attention to how regulation should respond to the ongoing changes in financial markets and to the Baring and Daiwa incidents. The discussion has focused on extending the traditional regulatory system by substantially increasing the degree of oversight of a bank's risk management and internal operations, especially for large, globally active institutions. In the United States, for example, the Federal Reserve and the Office of the Comptroller of the Currency have both started "supervision by risk" programs that increase the focus of bank examination on risk management processes.

Another attempt to ensure financial stability is to prevent the failure of an individual institution from spreading through the payments system and becoming an economic and financial crisis. The current approach to curbing the propagation of financial disturbances is to try to prevent problems from occurring at individual institutions in the first place by regulating the activities of banks and other financial institutions.

The Unites States has made some progress in reducing the vulnerability of the payments systems to the failures of individual financial institutions. In the large-dollar payments system, the protection employs combination of fees on daylight overdrafts, collateral requirements for institutions using the payments system (well-defined loss allocation formulas to ensure settlement in case of default and over draft), and net debit caps. In addition the FDIC Improvement Act sets caps on some inter-bank deposits.

And other development is the reduction of quantity of banks. The number of commercial banks in the US has dropped from more than 14,000 a few years ago to fewer than 11,000 in 1997. Analysts have opined that the bottoming out of these numbers won't take place until the number of commercial banks drops to 5,000 - 7,000.

Unlike the early consolidation phase, which involved commercial banks acquiring failing thrifts, the present consolidation matches institutions in good shape. The FDIC recently announced that the Bank Insured Fund (BIF) had reached an all-time high of $25.8 billion by mid-1996, and had a net income of $375 million. That income was achieved in spite of near zero assessments on most BIF members for that period.

When the banking system is an excellent shape and the deposit insurance fund is also in excellent shape, it is possible for regulators to be more expansive in their thinking about opportunities they should providing for the industries.

The Federal Reserve, the OCC and the FDIC are all reviewing their regulations in response to congressional direction, and each of these offices has expunged out-of-date and redundant regulation.

For instance, the Federal Reserve Board has proposed sweeping changes to its rules that govern banking acquisitions and the conduct of non-banking activities by bank holdings companies (BHC) and their subsidiaries. The proposal (which would amend Regulation Y under the Banking Holding Act of 1956) would strip away red tape that for many years has entangled US BHC as well as foreign banks with US branches or agencies seeking to expand their banking operations. It would eliminate restrictions on many important non-banking activities, including investment advice, private placement, management consulting, and other activities, and it would relax non-typing rules. The Fed proposes to reduce emphasis on the practices of using its rulemaking powers to specify limits on particular non-banking activities and, instead, intends to rely upon "supervisory policy statements" to provide guidance to BHCs with regard to the conduct of particular activities.

7 - THE 25 CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION (BASLE CORE PRINCIPLES)

Weaknesses in the banking system of any country, whether developing or developed, can threaten financial stability both within that country and internationally. The need for strong financial systems has attracted growing international concern. Several official bodies, including the Basle Committee on Banking Supervision, the Bank for International Settlements, the International Monetary Fund and the World Bank, have recently been examining ways to strengthen financial stability throughout the world.

7.1 - The Bank for International Settlements

The Bank for International Settlements (BIS) is an international financial institution whose special role is to promote the cooperation of central banks; in this capacity it also fulfills the function of a "central banks bank". It is thus both a bank and an organization intended to serve as the focal point for cooperation among central banks. The BIS commenced its activities on May 17, 1930 in Basle. It is, therefore, the oldest international institution in the financial word.

The BIS performs four primary functions:

- To carry out a range of banking operations, which derive in the main from its task of assisting central banks in managing and investing monetary reserves. At present (1997) around 120 central banks have deposits with the BIS.

With a view to further central bank cooperation under the aegis of the BIS, the Board of Directors decided on 9th September 1996 to invite nine additional central banks to become member of the Bank. As a result, the Banco Central do Brasil, The People's Bank of China, the Hong Kong Monetary Authority, the Reserve Bank of India, The Bank of Korea, the Banco de Mexico, the Central Bank of the Russian Federation, the Saudi Arabian Monetary Agency and The Monetary Authority of Singapore were invited to subscribe shares of the third tranche of the capital of the BIS. All nine institutions had taken up the Board's offer, thereby becoming members of the BIS.

- To be a forum for international monetary cooperation.
- To act as Agent and Trustee in the execution of international financial agreements, as it did for the European Payments Union.
- To act as a center for research in the monetary and economic fields.

7.2 - The Basle Committee

The Basle Committee on Banking Supervision is a committee of banking supervisory authorities, which was established by the central bank governors of the Group of Ten countries in 1975. It consists of senior representatives of banking supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, United Kingdom and the United States. It usually meets at the Bank for International Settlements in Basle, where its permanent Secretariat is located.

The most known multilateral negotiation is the historical agreement in December 1997, where bank supervisors from G-10 countries plus Switzerland, meeting under a framework laid down by the BIS, announced an international convergence of capital measurement and capital standards on July 1988. It was the first time a single accord had been proposed to apply multilaterally to the leading developed countries.

Over the last few years, the Basle Committee on Banking Supervision has progressively extended the focus of its activities beyond the G-10 countries. This process was taken further at committee’s the biennial International Conference of Banking Supervisors, held in Stockholm in June 1996 and attended by supervisors from around 140 countries. Conference participants welcomed the Committee' declared goal of intensifying its efforts towards strengthening prudential supervision in all countries.

The Basle Committee has recently made further progress in building a truly worldwide network of banking supervisors and promoting the dissemination of Basle Committee documents, recommendations, guidelines and standards. Two new initiatives to strengthen relationships with non-G-10 supervisors are: (1) the holding of regular joint meetings with groups of these supervisors at each of the Committee's quarterly meetings, and (2) a significant increase in supervisory training undertaken by the Basle Committee Secretariat, mostly in cooperation with regional groups of banking supervisors.

In September 1996, the Committee decided to build on its earlier work by preparing two separate publications: a comprehensive set of Core Principles for Effective Banking Supervision applicable in both G-10 and non-G-10 countries; and a Compendium that brings together the existing Basle Committee recommendations, guidelines and standards. Both documents were released in April 1997 with the strong endorsement of the G-10 central bank Governors.

In developing the Principles, the Basle Committee has worked closely with non-G10 supervisory authorities. The document has been prepared in a group containing representatives from the Basle Committee and from Chile, China, the Czech Republic, Hong Kong, Mexico, Russia and Thailand. Nine other countries (Argentina, Brazil, Hungary, India, Indonesia, Korea, Malaysia, Poland and Singapore) were also closely with the work.

The Basle Core Principles comprise twenty-five basic principles that need to be in place for supervisory system to be effective.

7.3 - Core principles

Preconditions for Effective Banking Supervision

1. An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banking organizations. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking organizations and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

   Licensing and Structure

2. The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word "bank" in institution’s name should be controlled as far as possible.

3. The licensing authority must have the right to set criteria and reject applications for establishments that do not meet its standards. The licensing process, at a minimum, should consist of an assessment of the banking organization's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base; where the proposed owner or parent organization is a foreign bank, the prior consent of its home country supervisor should be obtained.

4. Banking supervisors must have the authority to review and reject any proposal to transfer significant ownership or controlling interests in existing banks to other parties.

5. Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

6. Banking supervision must set prudent and appropriate minimum capital adequacy requirements for all banks. Such requirements should reflect the risks that the banks undertake, and must define the components of capital, bearing in mind their ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the Basle capital accord and its amendments.

7. An essential part of any supervisory system is the evaluation of a bank's policies, practices and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investments portfolios.

8. Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loans loss provision and loans loss reserves.

9. Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups or related borrowers.

10. In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's-length basis, that such

extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.

11. Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in international lending and investment activities, and maintaining appropriate reserves against such risk.

12. Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor and adequately control market risks. Supervisors should have powers to impose specific limits and/or a specific capital charge on markets risk exposures, if warranted.

13. Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, monitor and control all other material risks and, where appropriate, hold capital against these risks.

14. Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the banking, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audits and compliance function to test adherence to these controls as well as applicable laws and regulations.

15. Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict "know -your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the banks being used, intentionally or unintentionally, by criminal elements.

Methods of Ongoing Banking Supervision

16. An effective banking supervisory system should consist of some form of both on-site and off-site supervision.

17. Banking supervisors must have regular contact with bank management and thorough understanding of the institution's operation.

18. Banking supervisors must have a means of collecting, reviewing and analyzing prudential reports and statistics returns from banks on a solo and consolidated basis.

19. Banking supervisors must have a means of independent validation of supervisory information either through on-site examinations or use of external auditors.

20. An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis.

Information Requirements

21. Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable supervisors to obtain a true and fair view of the financial condition of the bank and the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflects its condition

Formal Power of Supervisors

22. Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way. In

extreme circumstances, this should include the ability to revoke the banking license or recommend its revocation.

Cross-border banking

23. Banking supervisors must practice global consolidated supervision over their internationally-active banking organizations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organizations worldwide, primarily at their foreign branches, joint ventures and subsidiaries.

24. A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.

25. Banking supervisors must require local foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.

The Basle Core Principles are intended to serve as a basic reference for supervisory and other public authority in all countries and internationally. National supervisory authorities should use the attached document to review their existing supervisory arrangements and to and to initiate a program designed to address any deficiencies as quickly as is practical within their legal authority. The Principles have been designed to be verifiable by supervisors, regional supervisory groups, and the market at large.

The Basle Committee will play a role, together with other interest organization, in monitoring the progress made by individual countries in implementing the Principles. It is suggested that the IMF, the World Bank and other interested organizations use the Principles in assisting individual countries to strengthen their supervisory arrangements in connection with work aimed at promoting overall macroeconomic and financial stability. Implementation of the Principles will be reviewed that the International Conference of Banking Supervisor in October 1988 and biennially thereafter.

The Basle Committee believes that achieving consistency with the Core Principle by every country will be a significant step in the process of improving financial stability domestically and internationally. The speed with this objective will be achieved will vary. In many countries, substantive changes in the legislative framework and in the powers the statutory authority to implement all of the Principles. In such cases, The Basle Committee believes it is essential to ensure that the principles can be applied in all material respects.

8. CONCLUSION

Deregulating and liberalization of the financial system have been strongly promoted, mainly in developing countries. Although these are desirable objectives, deregulation and liberation can be disastrous if not managed properly, as the deregulation and liberalization can be disastrous if not managed properly. If the proper bank regulatory and supervisory structure is not in place before liberalization, risk-taking behavior will not be adequately constrained. Bad loans are the likely out-come, with calamitous consequence for bank balances sheets at some point in the future. Financial deregulation and liberalization also often lead to a leading boom, both because of increased opportunities for bank lending and because of a financial deepening that brings more funds into the banking system, opening up more new lending opportunities that may result in loan portfolio of very poor quality. And although financial deepening is a positive development for the economy in the long run, in the short run the lending boom may outstrip the information resources of the financial system, helping to promote an eventual financial collapse.

These dangers do not mean that developing countries should avoid liberalization. To the contrary, financial liberalization is critical to efficient functioning of financial markets. Financial deregulation and liberalization thus need to be pursued actively and managed carefully. That means getting the proper bank regulatory and supervisory structure in place before liberalizing the financial system. It means providing sufficient resources to bank supervisors, installing adequate accounting and disclosure requirements, encouraging bank supervisors to take prompt corrective action, and insulating bank supervision from the political process.

To compare the process of adjustment of Brazil and U.S financial markets is a complex task that will not take place in this paper. The description of both processes illustrates different evolutions, in different periods of time. The U.S. regulatory and supervisory system is much more consolidated but also faces problems of monitoring the domestic and, mainly, global banks. The U.S. experience should be considered a source where developing countries can based upon their own regulatory and supervisory changes, regarding the specific characteristics of each financial market.

However, the Brazilian financial market still express serious problems of risk exposures, as we could observe in the recent international crisis of the stock markets in November 1997. It has illustrated that several banks in Brazil were dealing excessively with financial instruments, which instead of reducing the risk exposure had increased it. In a very simple way, the importance of the supervisory and regulatory roles is to monitor banks well enough to keep them from engaging in inappropriate risky activities or to see that they have the appropriate management expertise and controls to manage risk and sufficient capital to keep in check the moral hazard incentives to take on excessive risk. It will probably help replacing the confidence in Brazilian financial market.

The Basle Core Principles are the first attempt by the Basle Committee on banking supervision, which groups regulators from only the leading industrial and financial centers, to expand their rules to the rest of the world.

Some banker questions whether the Basle capital adequacy ratios are appropriate for countries with still developing banking system. Many Latin American supervisors, for example point out that some of the biggest failures in their regions have been of banks which oblige a bank to keep a capital cushion equivalent to 8 percent of its assets, weighted according to risk, with at least half of that in equity capital. They often impose additional liquidity requirements on the banks that they supervise.

But most central bankers believe the prize is worth playing for. It was what they demonstrated in September 1997, during the annual meeting of the World Bank and the International Monetary Fund.

These principles have already been in operation for years in most developed banking markets. In the emerging markets where the new principles could bring about a change in the style and degree of regulation they have given a caution welcome.

One central issue for supervisors will be staffing and remuneration - the difficulty of keeping good supervisors when they could double their salaries overnight in the private sector.

Bankers in some central Europeans countries, for example, warn that one of the biggest constraints in speaking honestly to their supervisors is the fear that their secrets will be conveyed to the competitors.

Basle committee officials acknowledge that their principles are not the ultimate answer, and caution, in particular, that their adoption will not prevent future bank failures. Still they argue the cost of banking crises over the last two decades means that any improvement in general supervision standards must be worth trying for.

The key challenges of Central Banks in the years ahead will be to continue to adapt policy to the rapidly changing environment in order to preserve monetary and financial stability. Given the intimate connection between the two tasks, this will cal for mutually consistent and reinforcing in the two spheres. Owing to reach of the transformation under way, developments in the financial system will play a major role in shaping policy.

As confirmed by recent policies, the best safeguard is arguably a political mandate to pursue price stability allied with the autonomy in the execution of the assignment and accountability for the achievement of the objective. Nevertheless, these arrangements are hardly sufficient. Stability in the domestic and international value of national currencies call for supporting policies in other areas, notably sustainable fiscal position and greater flexibility in labor markets.

The key policy challenge in securing financial stability is to complete the adaptation of the framework of checks and balances to the new financial realities. The urgency of the task is uncovered by the fact that, looking ahead, the emergence of further strains cannot be ruled out: the sectors in the financial industry still requiring restructuring are simply too large, the need for continuing adaptability to the evolving environment is too demanding, and the remaining obstacles to an effective and orderly exercises of market discipline are too numerous and too strong.

Meeting the challenges involves intensifying efforts in the two main directions, which have been identified in recent years. The first concerns the means to strengthen the framework's market orientation. The second, which concerns the ends, is to sharper its systemic orientation.

Strengthen the market orientation implies enlisting and up-grating the market disciplinary mechanisms. Three areas seem to provide considerable scope for further improvement: enlarging the domains and improving the quality of public disclosures; designing regulatory constraints, such as capital standards, so as to make them less vulnerable to financial arbitrage; and limiting the impact of those forms of intervention that provide protection without commensurate oversight, thereby numbing incentives to prudent behavior.

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