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Brazil and the International Convergence of Banking Regulation and Supervision

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Summary

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1. Introduction

To the attentive reader, documents originating from nearly every multilateral financial organization or international economics think-tanks over the past decade have underlined the necessity of sound financial systems and prudential regulations to discipline them. The Basle Committee for Banking Supervision has been the main source of such discussions, but in current days they permeate G-7, G-22, regional and bilateral negotiations all over the world.

There has been no question on whether better financial systems are more desirable, nor as a matter of fact on what makes them sounder. There is far less consensus on exactly how far should regulators and supervisors go on imposing rules and sanctions, and how much should be left for market self-discipline to sort out. The quest against global systemic risk – encompassing as many definitions as one can possibly think – has incorporated the issue of convergence of banking regulation and supervision worldwide, which recent financial crisis have only emphasized. The matter, however, poses some difficult problems for those engaged in it: what should be converged? Which countries should adhere to convergence? How could convergent rules be enforced?

Since the 1988 Basle Accord it has become clear that banking systems, however integrated, differ enough from country to country so that only more general recommendations and guidelines could really apply to a broad spectrum of countries. At the time the Accord was released, it was meant to be enforced by G-10 countries, whose financial systems were relatively integrated and leveled. As the need of convergence expanded beyond the G-10, the need for more general rules and a more global channel of enforcement became evident. The issuance of the 25 Core Principles for Banking Supervision and the increasing involvement of the Bretton Woods institutions in their enforcement respond to those problems. These developments have made such convergence of banking regulation and supervision a pressing subject for the millennium discussions on economic stability and new archicteture for the international financial system.

Brazil has been involved in the debate on convergence from the outset, and the size of the Brazilian financial system has brought the need for convergence even more into the public and international view. Also, recent developments in emerging economies have been able to show the connections between a sound financial system and economic stabilization and growth – plus the contagion effects derived from the lack of it. Moreover, pressure on the Brazilian currency resulting from the Asian crisis and the assistance program put in place by the International Monetary Fund and World Bank at the occasion have highlighted deficiencies in the banking sector and the steps needed to solve them.

Much has been said by these international organizations, the Brazilian Government and the press on the subject of financial system reform within the process of general economic restructuring of the country. However, it is not clear to many that this financial system reform is in fact part of a greater process taking place on a worldwide scale, in which Brazil is involved not only as an emerging country in an IMF program: it is in fact an important international actor in an globalized and highly correlated financial system and a major player in Mercosur and Latin America.

This work intends to place recent regulatory reform in Brazil in the context of international convergence of banking supervision, as set out by the Basle Committee of Banking Supervision. To that end, it seeks to bring some background understanding to the main evolutions in the convergence process, which includes a brief discussion on the proposal for the substitution of the Accord. Finally, it inserts an overview of the banking regulation in Brazil under a brief evaluation of the level of compliance of Brazilian regulation and practice to the 25 Core Principles – in accordance with the new assessment methodology released by the Committee in October 1999.

It must be noted that this paper draws on several unpublished materials from the Central Bank of Brazil, which have been partially incorporated in different assessments made public by organizations such as Mercosur, IMF, World Bank, CEMLA and the Basle Committee itself. Nevertheless, the evaluations and views expressed in it do not represent the official views or assessments of the Brazilian Government or the Central Bank of Brazil, but rather independent and individual opinions of the author. For this reason, the paper also avoids detailed regulatory and legislative reference that might be interpreted as official critique to Brazilian laws and Central Bank rules.

2. The Basle Committee for Banking Supervision

2.1 From the *Concordat* to the Accord

The 70-decade was one of changes for financial markets and their regulators. The American financial instability, which brought about the dissolution of the Bretton Woods system of fixed exchange rates in 1973, carried along with it much more than just flexible exchange rates. There was also rising inflation, caused mainly by the oil shocks of 1974 and 1979, in virtually all industrialized countries. In addition, the oil crisis also boosted the petrodollar recycling through Eurodollar denominated certificates of deposits issued by major commercial banks. As a result, interest rates climbed up in all countries and the whole financial scenario became much more volatile.

Most importantly, Banks increased their international banking operations (both on the asset and on the liability side of their balance sheets), and the line that divided national and foreign savers and borrowers thinned and blurred. In that context, financial institutions developed new instruments that added up to the general leverage of the system, as well to its volatility. Among these important innovations, there was the growing use of securitization[1] and off-balance-sheet operations. Off-balance-sheet operations

[1] The word securitization, broadly, includes two phenomena: the issuance of debt instruments directly by firms and the transformation of assets into negotiable instruments.

(OBS) – such as swaps, options and future contracts – were created to smooth risk, basically by dissociating credit risk and market risk[2].

That fact, combined with additional problems caused by unstable exchange rates, made liquidity and solvency risks associated to banking to become truly international, posing a real challenge for national supervisory and regulation authorities. Bank regulatory philosophy, since the banking crash crisis before the 1930's Great Depression until the expansion of the Euromarket in the 60's, was mainly preoccupied with the soundness of individual financial institutions, and much care was taken on preventing overlapping interests in financial institutions and widespread competition. This approach was to change after the Herstatt Bank bankruptcy in 1974, when time zone risk and exchange risk awakened regulatory authorities to the need of a multilateral approach to bank supervision. Thus the G-10 Central Bankers created the Committee for Banking Regulation and Supervision.

The Basle Committee for Banking Supervision (BCBS) started its meetings in 1975 at BIS (Bank for International Settlements) headquarters, and included representatives from the Central Banks and supervision authorities of Canada, France, Germany, Italy, Japan, the Netherlands, Belgium, Luxembourg, Sweden, Switzerland, United Kingdom and United States. The Committee's main goal was to eliminate the differences between supervision structures, improving the knowledge and quality of supervisory activities. At that time, it basically meant aiming at improving the exchange of information on international banking activities between authorities, establishing a few standard requirements, and developing new approaches to international banking supervision.

Only six months after its creation the Committee was able to put together and agree on a document, later known as the *Concordat*. The Concordat described how different parts of the banking supervision process should work together and established a

[2] In aggregate terms, and if arbitrage worked perfectly in price and time expectations, market risk would be totally offset.

set of principles for that. It prescribed that no banking institution should be excluded from bank supervision, and to that end it incorporated the concept of *home-country control*.

The *Concordat* identified international activities of banks as made through branches, subsidiaries and joint ventures. Home countries were responsible for overall supervision of international banking activities of their banks and foreign branches, and should deal with solvency problems related to them. Host country authorities, on the other hand, should be responsible for supervising subsidiaries operating in their territory.

From the outset, it was clear that authorities from both host and home countries should work together and share information, but there were many difficulties on implementing that. It was especially complex when it came to secrecy requirements and interpretation and matching of balance sheets among parent companies, branches and subsidiaries scattered in several countries. By 1981, the Committee had conducted a revision of the Concordat, and added to it the important concept of *consolidated supervision*. It lifted the extra weight posed by the Concordat on host countries' shoulders, as it established the requirement of consolidating balance sheets of banks and their subsidiaries and branches. Therefore, host countries' authorities had a better understanding of the level of risk exposure and concentration involving institutions operating in their territories.

The world debt crisis in the 80's gave the banking supervision requirements a totally new perspective. After Mexico's default, international banks feared other indebted countries would follow the same path, and the risk of a generalized solvency crisis was real. The US Federal Reserve concentrated its efforts in assuring liquidity to the payments systems, involving the IMF and multilateral banks in loans and financial aid to Mexico. As a part of the overall strategy, the IMF capital was strengthened and new modalities of policy-based loans were created.

Nevertheless, there was a confidence crisis affecting the banking systems. As profits went down, so did shares prices, and the ability of banks to raise capital. The

United States started, unilaterally, to work on improved supervision regulation and capital adequacy requirements, focusing basically on strengthening country risk evaluation and limiting country exposure. Though the idea of minimum capital requirements made sense to US politicians and regulators, it soon became clear that the unilateral adoption of capital requirements would result in a domestic credit crunch and a loss of competitiveness of American banks vis a vis foreign banks or non banking institutions.

The idea of an international convergence of capital requirements was then presented first under IMF auspices, as the US Congress attached the participation of the US in the organization quota increase to a general call on international banking regulators to coordinate and raise capital requirements. Subsequently, the same call was made in Basle in 1984.

The BCBS started to work on international comparisons of capital adequacy regulations, concentrating on different definitions of capital and methodologies to calculate capital-to-asset ratios. At that time, US regulators used fixed capital-to-asset ratios, which did not take varying risks into consideration and ignored off-balance-sheet operations, while several European nations already used a risk-based approach.

The first step into convergence was actually taken by US regulators, that in 1986 presented a new regulation on capital adequacy using a new risk-based methodology, which basically approximated US regulation to current European practices, such as those in use by the United Kingdom. The impact of this proposed regulation on US banks was as expected, and the pressure to keep US banks competitive increased. As negotiations within the Basle Committee countries had not progressed, the American authorities approached the UK regulators in order to establish a bilateral capital adequacy agreement that would have a strong demonstration effect on European Community countries.

The Federal Reserve System and the Bank of England announced a common capital adequacy framework in January of 1987, very much similar to the British system.

Though that did include risk-based considerations, a common definition of capital and off-balance-sheet operations in computations, it did not establish a minimum capital requirement level. The effect of the announcement caused great turmoil among US banks and accelerated negotiations within the BCBS. Japan, which at first was opposed to convergence due to the treatment given by the UK-US agreement to hidden reserves and corporate equities, came to an compromised agreement with those countries in that same year. The three countries also agreed that the risk-based approach to capital requirements would be enforced gradually for the next five years. Not coincidentally, deadline for compliance was the same as for the deadline for compliance to the Single European Act and the Second Banking Directive of the European Community.

The Committee, under pressure, finally agreed to a double tiered definition of capital. Tier 1 capital would be basically composed of equity. Tier 2 was to be composed of loan-loss reserves, hybrid capital instruments and subordinated debt. Most importantly, a minimum capital adequacy requirement, based on a risk-weighted capital-to-asset ration, was established. The so-called Accord attributed different risk weights to different types of assets, and off-balance-sheet operations were first converted into corresponding assets in order to be risk-weighted. The final document was agreed on and issued on July 15 1988, titled *“International Convergence of Capital Measurement and Capital Standards*”.

2.2 The 1988 Basle Accord

The Basle Accord incorporated the use of capital requirements as a tool to prevent systemic failure. The idea is that more capitalized banks are able to absorb unforeseen losses without bringing the financial system into sequential failures. Stressing the need for more capital has, therefore, the obvious advantage of diminishing the probability of losses to society. Nevertheless, one of the first effects of leading banks to keep more capital is that such capital may have to come from sources that are not too closely related to the banking business, creating corporate governance problems.

Making capital requirements based on risk perception also has side effects: while they supposedly force the banks to take on less risk, on the other hand they create an incentive for capital arbitrage, inducing banks to choose the riskier and more profitable operation within the requirement weight range. The structure of the risk weights may lead to over-securitization and disintermediation, getting out of banks balance sheets higher quality assets or lower risk negotiable items.

The very first criticism to the 1988 Basle Accord was that, however, all it considered in order to risk qualify assets was credit risk, overlooking the importance of market risk and liquidity risk. It took a few years until the Committee finally decided to incorporate a capital cushion to cover the risks arising from market movements. In 1993 the Committee produced guidelines for measuring bank's exposure to interest and exchange rate risk, in which a standardized approach to assess market risk incurred by banking institutions dealing with some derivatives was introduced. In 1995 a preliminary document on market risks was issued for comments, and in 1996 an amendment to the Accord was agreed on.

The document proposed to cover (i) risks in "the trading book of debt and equity instruments and related off-balance-sheet contracts" and (ii) foreign exchange and commodities risk. Its main focus, however, was to regulate on the use, by banking institutions, of internal risk measurement systems, the so-called proprietary models. The document applied some standards to the risk management process that must be present in institutions using in-house models to base their capital requirements. Moreover, it established qualitative criteria to guide the use of such models.

Basically, the Committee required the use of value-at-risk daily estimates, a 99% confidence interval and a minimum price shock equivalent to ten trading days. It was also required that proprietary models incorporated a historical observation period of at least one year. The capital cushion was defined as the higher of the previous day's value at risk or 3 times the average daily value at risk of the preceding 60 business days[3]. It was also added to the multiplication factor the *plus factor*, which was an ex-post comparison of the risk measure generated by the model and the variation that in fact took place in the portfolio. Therefore, if the backtesting results were satisfactory, the plus factor should be zero. The use of backtesting to assess the quality of internal models by supervisory authorities was detailed in a separate document (*Supervisory framework for the use of backtesting in conjunction with the internal models approach to market risk capital requirements* - Jan 1996).

To meet the capital requirements imposed by market risk, banks were allowed to use short-term subordinated debt as a Tier 3 capital level. That was limited to 250% of the bank's tier 1 capital used to support market risk. The bank's capital ratio was adapted to reflect market risk so that the measure of market risk is multiplied by 12.5 and added to the sum of risk-weighted assets computed for credit risk. Eligible capital comprised tier 1, tier 2 limited to 100% of tier 2, and elements of tier 3 as allowed by each national supervisory authority (it means it may add up to tier 2 cap).

One of the main reasons why the Amendment took a long time to be put into place was in fact the rapid changes occurring in the financial markets scenario in this decade. Though several internationally active banks were using internal models to assess market risk, modeling methods and backtesting techniques had (and still have) many potential limitations and frequently do not capture various price movement patterns, intra-day trading risk nor are able to cover for exceptional market circumstances. These potential weaknesses became especially important in defining capital requirements because of the growing use of derivatives and other off-the-balance-sheet operations in banking.

[3] The use of the multiplication factor brought about some adverse comments from the banking industry. Though the Committee made clear that the purpose of the factor was to provide a "sufficient cushion for cumulative losses arising from adverse market conditions over an extended period of time", what it is really intended to cover is for weaknesses in the model structures themselves. These may be unrealistic assumptions or simply the intrinsic vulnerability of using value at risk, which only accounts for past behavior and is a poor approximation for the future.

As a matter of fact, all during this current decade banks have been swirled away from the deposit/lending business. Investors have found profitable niches for their money, such as mutual funds, while on the other hand it has become easier and cheaper for companies to harvest funds in capital markets directly. Banks margins have decreased sharply in the last few years, and banks have been expanding their activities to expand revenues. Lending to emerging markets or big companies became less profitable business, so banks have syndicated or securitized such loans. Securitized loans are a great arrangement for banks on capital requirement perspective: loans get out of the balance sheet and the capital requirement, and the banks gain fees for the service. In the United States, 40% of banks' revenues are derived from fees or commissions from such off-balance-sheet services.

The market-risk amendment focused on the trading portfolio, and did not consider the entire bank balance sheet. The Accord has been much criticized for, in that sense, pushing banks into looking for risk-adjusted returns. As it is, the Accord provides a premium for those banks lending to worse quality borrowers, as it not differentiate, for example, a loan to a blue-chip company from a loan to an unrated one. That provides a competitive advantage to other lenders, such as mutual funds or capital markets. The Accord requires full 8% capital/asset ratio for loans to companies, but only 20% of that for loans to OECD countries' banks and no capital for sovereign loans to OECD countries – which include Mexico and South Korea (both of which have had non-investment grade ratings). It has also driven banks to capital markets, where businesses such as issuing and trading debt and equity, derivatives and asset management are able to provide better returns.

Another great criticism has really a lot to do with how the Accord has been unevenly implemented across countries, that go from very different reserve requirements to penalties imposed when banks do not meet capital requirements. The supervision of risk-management has become even more important as financial markets become more volatile, as it seems to be the case. There are arguments for allowing extra capital for trading and investment operations of banks so that unforeseen risks could somewhat be offset, but that would again reduce banks returns and create other disincentives.

Both on credit risk and market risk lie several measurement and enforcement difficulties. Though risk management has greatly developed during this decade, recent financial turmoil such as the one caused by the near-collapse of LTCM has shown any sign of panic sets sparks that overrun many risk models. Volatility in financial markets skyrocketed, as all traders run to security. Banks could not clear their positions, as markets tightened. Even portfolio diversification, which should provide some protection, didn't work quite as expected as all of the sudden all markets became highly correlated and liquidity risk more important. Furthermore, risk models did not allow for such long lasting and deep moves as reality brought about[4].

On the credit risk perspective, times have also been revealing weaknesses. Financial crisis in Asia and Russia in recent years imposed high losses on many banks, which means their credit risk evaluation was not very accurate. There was not as much portfolio diversification, world wise, as it would seem sound before crisis erupted. Counterpart risk also suffers from lack of information, and that was also highlighted by the LTCM crisis, as many lending banks did not really know much about the destination of the money lent to the fund. Diminishing margins and competitive markets have made some banks more lax on their credit qualifications, sometimes relying on insufficient information, as it was the case. The BCBS has been examining these questions, and a proposal to amend the Accord has been put forward in June.

[4] One of the reasons for these deep movements is the great number of funds and institutions that pursue absolute returns, which obliges positions to be cleared quickly in case of contrary movements – otherwise losses, due to leverage, are unbearable. Risk management models as value-at-risk also require trades to trim their positions or raise capital to maintain risk level. However, when all trades run through the same doors, it becomes increasingly difficult to cut positions, and the cycle feeds itself (Interesting comments on that issue can be seen on the *International Banking Survey*. The Economist. April 17th 1999).

2.3 A new capital adequacy framework

The BCBS's evaluation of the Accord concluded that the capital requirements established by it have played an important role in promoting the stability of financial systems and more effective banking supervision. Apparently, all efforts were taken to maintain the level of minimum capital requirement as established by the 1988 Accord, basically pushing away the discussion on whether that level was sufficient or excessive. Instead, the proposed structure creates two extra "pillars" besides the minimum capital requirement, which are meant to make it more flexible in a number of ways. These two pillars are the review, by the supervision authority, of the capital adequacy of each institution individually, and market discipline.

The idea behind the **review pillar** is that supervision must be able to evaluate whether the capital position of a bank is compatible with its risk profile. Supervisors, consequently, must be given power to adapt the recommended capital requirement as the risk profile of the bank's activities change. It becomes especially important, as there is the intention of giving more room for banks to define their own capital adequacy strategy through internal assessment, as will be seen below[5]. This pillar supposedly makes it possible for supervisors to act early on prudential revision of capital requirements, which may come handy as liabilities of financial institutions are increasingly short-termed, while assets may be long-termed and frequently quite illiquid.

The pillar titled **market discipline** focuses on transparency. The rationale is that a bank that is perceived to be sound and safe by the market obtains better terms and conditions for its operations. It means there is a market incentive for disclosure and transparency as counterparts will require higher premiums as risk perceptions rise. Supervisors may help imposing qualitative and quantitative disclosure requirements on the capital structure and risk exposure of banks, but market itself would push for more discipline.

[5] As declared by the BCBS Chairman, William McDonough, the goal to be achieved is that banks themselves can be made responsible for their own capital adequacy (Gazeta Mercantil June 7/99, B2)

The **first pillar** is the capital requirement itself. The modifications made on the first pillar, though widely expected, still contain some striking elements. The approach to *credit risk* was changed in order to allow the use of internal ratings and credit risk models besides the standard approach suggested, somewhat similar to the approach used for market risk. The standardized approach was modified, and the BCBS has surprised many in allowing the use of external credit assessments to determine the risk weights of several kinds of assets.

The expected changes relate to the proposal of new weights to attribute a better sensitivity to risk, allowing a lower capital requirement for well-rated corporations. Sovereign and bank loans are also to be weighted according to ratings given by rating agencies or G-10 countries export insurance agencies. This issue raises eyebrows in Europe and elsewhere – rating agencies use is widely spread in the United States, but not quite so in Europe and emerging markets. This could mean American corporations are given a much better coverage – which explains why the Committee has attributed a 20% weight for highest rated corporation credit and 100% for all other corporation credit (including non rated)[6]. There is more variation in weights given to sovereign and bank credit, and that is also likely to raise questions from emerging markets – for which rating agencies' capability of measuring risk was tremendously defied during recent financial crisis.

The Committee refused, in principle, to accept credit risk models such as the ones currently used to estimate market risk exposure (such as VAR models), but admitted the possibility of their use for institutions believed to be able to run sophisticated models. However, it is still to be discussed and developed exactly how internal credit risk evaluation will be used for capital requirement purposes. Considering recent problems arising from the defeat of market risk models to foresee failures, the Committee's cautious approach to the use of credit risk models (which are far more complicated than market risk models) for capital adequacy assessment seems quite reasonable.

[6] Corporation credit rated under B- is in fact attributed a 150% weight

There are a few other novelties in the capital requirement pillar which are also worth noting. The Committee tried to lift some restrictions on the use of risk mitigation techniques and types of hedges accepted for capital reduction. The current structure of the Accord does not create incentives for such risk reduction techniques and instruments[7], and the proposed document invites suggestions on how this could be done while, at the same time, keeping rules simple for supervisory oversight. Another main concern was how to deal with residual risk arising from imperfect hedging, and it is understood that a really accurate method of risk weighting for capital purposes would probably be very complex.

On these risk mitigation techniques, the document discusses the issues of residual risk arising from maturity mismatch, changes in market price and asset mismatches, in a generalized way. For some specific instruments – namely collateral, guarantees, and on-balance-sheet netting – there is a further discussion on what needs to be changed, and at that point the Committee is very careful in inviting comments. It does propose, however, to expand the scope of on-balance-sheet netting to all assets and liabilities on the banking book, and eligible collateral to all financial assets that attract a risk weight lower than the underlying exposure.

Furthermore, the Committee also intends to develop capital charges to cover interest risk in banking books of banks "where interest rate risks are significantly above average (outliers)". In identifying outlier banks, supervisors must also take into consideration qualitative aspects such as the characteristics of the bank's internal risk management processes and compliance to market interest rate risk capital adequacy requirements.

Finally, the Committee has also recognized that the differences given by the Accord to the treatment of banking and trading books gives an incentive for banks to pursue capital arbitrage between them – as requirements for credit risk are lower in the

[7] In fact, the Accord was amended to recognize legally enforceable netting agreements

trading book. The treatment to be given to repo transactions is also to be analyzed and changed, as there is the intention of equating capital requirements to better reflect price volatility in the securities involved in repo operations.

The three-pillar approach of this new Accord Structure seems to be much more market friendly in a number of ways, and reflects many of the conclusions reached by regulators and supervisors in the aftermath of recent financial crisis. It has become obvious that accuracy and comprehensiveness of risk evaluation structures, though possible, are increasingly complex. Leaving all control to supervisors could prove to be a heavy burden and a costly one and may lead to deeper country differences, therefore the idea of creating as much market incentive as possible for transparency and disclosure may just be the needed breakthrough.

Even so, the supervision review pillar as proposed still implies in higher cost and a new approach for supervisors and regulators. This higher cost comes not only from the complexity of a permanent new task for supervision, but from the added cost of creating and implementing a new type of supervision.

The approach is much dependent on the international cooperation of supervisors, and that poses additional costs as well. There is also the underlying issue on how supervisors and regulators will relate to rating agencies and assess their reliability and impartiality – rating agencies, after all, are paid by those they rate. Also, domestic rating agencies may treat differently national and foreign corporations, again creating a hint of bias into the weight system to be enforced by each country. The document provides suggestions for criteria to be used by regulators and supervisors in the assessment of rating agencies, for instance – one more issue to be taken into consideration on the path to convergence of banking supervisory standards.

3. The Core Principles for Effective Banking Supervision – making the Accord global

The Basle Accord and its amendments, as all recommendations issued by the BCBS, apply to G-10 member countries, and have no real regulatory power in them. They need to be put in place and enforced by national regulators and supervisors. However, in a truly globalized financial world it is very important for these countries that some banking principles – including capital requirements – converge and no great gap of enforcement exists. After all, internationally active banks may be incorporated anywhere in the world, and the linkages existing in international operations, as recent financial crisis have clearly pointed out, may have a strong effect in the stability of national financial systems. Furthermore, it is the concern of all G-10 countries that their financial institutions can compete on a level field with foreign institutions.

The Basle Committee, in 1997, issued a document entitled Core Principles for Effective Banking Supervision. The texts, though elaborated by the Committee, also were developed in consultation with the supervisory authorities of emerging market economies[8] - and from their inception were intended to be as internationally acceptable as possible. The Basle Committee recommendations and work papers on prudential regulation, by 1997, already had widespread repercussions and deep effects on regulation in several non G-10 countries. Nevertheless, it was the endorsement of such recommendations by international agencies such as the IMF and the World Bank that has really pushed forward the interest for convergence of standards.

The Core Principles are minimum requirements and basic reference for effective prudential supervision and regulation over the banking system. They do not set specific rules such as the Accord – the minimum requirements outlined are to be ruled by each national regulatory authority, adapted as needed. They also provide a common

[8] Chile, China, the Czech Republic, Hong Kong, Mexico, Russia and Thailand participated directly. Nine other countries (Argentina, Brazil, Hungary, India, Indonesia, Korea, Malaysia, Poland and Singapore) were also involved in the work. The drafting also received inputs from individual supervisors, the International Monetary Fund and the World Bank.

framework for international bodies such as the IMF to assess the quality and strength of supervision and regulation, and have effectively been used as such. Both the IMF and the World Bank have included compliance to the Principles as a standard conditionality in their assistance programs.

The Principles were intended to be widely applicable by these organizations because they start from the viewpoint that effective banking supervision is an essential component of sustainable economic development. National supervisors must basically ensure that banks operate in a safe and sound way, maintaining enough capital to cover for risks inherent to their business. National authorities must also aim at the protection of individual depositors, and the overall stability of the financial and payment systems so that banks can continue to intermediate funds, mobilize savings, and provide credit for development and economic growth. With these very basic concepts in mind, the Committee was able to put together 25 Principles to be observed by national supervisory authorities in order to improve the strength of financial systems.

The Principles were aggregated in seven broad areas:

a) preconditions for effective banking supervision;

b) licensing and structure;

c) prudential regulations and requirements;

d) methods of ongoing banking supervision;

e) information requirements;

f) formal powers of supervisors; and

g) cross-border banking.

Compliance to the Principles has been stressed by international organizations and leaderships over and over since their issuance, but their implementation and assessment have been a challenge in themselves. In 1998 the Basle Committee formed a Core Principles Liaison Group and a Core Principles Consultation Group to discuss “more problematic issues related to the implementation of individual Principles” and to identify which kind of support countries needed for such implementation.

In April of 1998 the BCBS started preparing an evaluation on the level of compliance of different countries to the Principles. The survey was initially aimed at providing information for the International Conference of Banking Supervisors in Sydney in October 1998. To that end, the Committee elaborated a standardized questionnaire to be filled out by supervisory authorities in member and non-member countries, to which over 120 countries replied. At the same time, driven by a deeper concern about financial sector stability, the IMF and the World Bank were ready to pressure for a more effective supervision of banks, and included their own assessment of the compliance to the Principles in their programs in several countries. Some regional organizations, such as the Mercosur, also conducted their assessment on compliance to the Principles as a useful tool to coordinate convergence strategies.

The simultaneous realization of different individual assessments is a good evidence of how useful the international community perceives supervision standards to be. However, the results of these preliminary assessments made clear that the Principles – perhaps because they were designed to adapt to various supervisory regimes - allowed a wide range of interpretations both by the authorities and the assessing agency, which sometimes lead to conflicting or inconsistent advice. Therefore, in October 1998 the Committee decided to elaborate a document to be used in compliance assessments.

The document **Core Principles Methodology** was finally released in October 1999, and includes guidelines for assessments to be made as objective and as uniform as possible, limiting the diversity of interpretation. The document is very interesting in the sense that it has now identified two types of criteria for compliance: **essential** and **additional**. These are identified for each principle (and their subdivisions), and the methodology includes an evaluation of what is necessary for a supervisory agency to implement them (skills, resources, etc.). Moreover, the document makes considerations on how the assessments should be conducted, so that there should some harmonization of standards, be it through self-assessments, peer reviews or multilateral surveillance.

4. Brazil – Implementation of the Core Principles

Brazil was one the original countries consulted for the elaboration of the Principles, and was soon to endorse them – though it was known they were not fully implemented nationally. The efforts for compliance were somewhat subdued by more pressing economic issues for some time, but Brazil's active involvement in Mercosur and the Association of Banking Supervisory Authorities of Latin America and the Caribbean kept the subject underlying all major discussions on financial system stabilization. The Central Bank of Brazil, as supervisory and regulatory authority, included full compliance to the 25 Core Principles as a major strategic planning goal for 2001. The stabilization program arranged with the IMF represented a further incentive for compliance efforts, as some of the programmatic conditionalities involved are directly related to the Principles.

The first assessment of compliance made by the Central Bank was the reply to the questionnaire of the BCBS in 1998. Simultaneously, Mercosur included the 25 Principles as a new item in the harmonization agenda, and new quarterly assessments are carried out for that purpose. It is interesting to notice that both assessments differ in a number of aspects. The reply to the BCBS was conducted under a supervisory authority point of view, while the Mercosur assessment was carried out mainly with regulatory harmonization in mind, so some interpretations are more restrictive in one assessment than the other. This difference absolutely outlines the problems encountered by national and international assessments of compliance, and emphasizes the importance of a standardized methodology of assessment.

This work will attempt to review the existing assessments of compliance in the light of the new methodology proposed, specially with a view to verifying in what extent essential criteria are being met. The review will necessarily be superficial in the sense that a full evaluation of compliance requires a comprehensive analysis of the legislative framework and expertise knowledge on specific issues. It will, though, seek to outline assessment problems and provide a reasonable idea of how far Brazil's financial system is from full compliance to the Core Principles. It must be noted that the Central Bank has formed a multi-disciplinary working group to carry on an extensive assessment and delineate next steps for full compliance.

4.1 Preconditions for Effective Banking Supervision

Principle 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.*

1 (1): An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banks.

Essential criteria

1. Laws are in place for banking, and for (each of) the agency (agencies) involved in banking supervision. The responsibilities and objectives of each of the agencies are clearly defined.
2. The laws and/or supporting regulations provide a framework of minimum prudential standards that banks must meet.
3. There is a defined mechanism for coordinating actions between agencies responsible for banking supervision, and evidence that it is used in practice.
4. The supervisor participates in deciding when and how to effect the orderly resolution of a problem bank situation (which could include closure, or assisting in restructuring, or merger with a stronger institution).
5. Banking laws are updated as necessary to ensure that they remain effective and relevant to changing industry and regulatory practices.

Previous assessment considered this item fully implemented, and that should be maintained. In fact, in the case of Brazil legislation makes it very clear that the

Central Bank is responsible for both supervision and regulation of the banking system. The Central Bank defines minimum prudential standards that banks must meet, and has the power to decide on and enforce penalties and the orderly resolution of problem banks. Financial system regulations are updated as frequently as necessary by Resolutions of the Conselho Monetario Nacional and other regulation issued by the Board of the Central Bank.

Though there is some possibility of the creation of a supervisory agency, separated from the Central Bank, after Article 192 of the Constitution is regulated[9], scarce resources and expert capacity to supply two separate agencies make it unlikely and unwise to happen in the short and medium run.

> 1 (2): Each such agency should possess operational independence and adequate resources.

Essential criteria

1. There is, in practice, no significant evidence of government or industry interference in the operational independence of each agency, and in each agency's ability to obtain and deploy the resources needed to carry out its mandate.
2. The supervisory agency and its staff have credibility based on their professionalism and integrity.
3. Each agency is financed in a manner that does not undermine its autonomy or independence and permits it to conduct effective supervision and oversight. This includes, inter alia: (i) salary scales that allow it to attract and retain qualified staff; (ii) the ability to hire outside experts to deal with special situations; (iii) a training budget and program that provides regular training opportunities for staff; (iv) a budget for computers and other equipment sufficient to equip its staff with tools needed to review the banking industry; and (v) a travel budget that allows appropriate on-site work.

This item is considered partially implemented. Though the Central Bank is a semi-autonomous agency with its own separate legal identity, it is in fact hierarchically attached to the Ministry of Finance, and its President reports to the Minister and not to the President of the Republic or Congress. This lack of independence is connected to budgetary aspects as well, being the Central Bank budget subject to the Ministry's appraisal and approval. There are severe budgetary constraints, at the moment, affecting training, equipment, travel and salary scales – which affect Government as a whole. On the other hand, staff is hired by technical expertise and professional skills in open public

[9] Article 192 of the Brazilian Constitution provides for a sound financial system that can add to the sustainable development of the country. The enforcement of the Article is still dependent on complementary legislation, which has not yet been decided upon by Congress.

examinations, and receive tenure against unjustified dismissal, all of which attach credibility and professionalism to the supervision operation. New independence to the Central Bank may be granted when Congress regulates Article 192.

> 1 (3): A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision[10].

Essential criteria

1. The law identifies the authority (or authorities) responsible for granting and withdrawing banking licenses.
2. The law empowers the supervisor to set prudential rules administratively (without changing laws).
3. The law empowers the supervisor to require information from the banks in the form andfrequency it deems necessary.

This item is fully implemented, as by law the Central Bank is given all the powers described above.

> 1 (4): A suitable legal framework for banking supervision is also necessary, including… powers to address compliance with laws as well as safety and soundness concerns[11].

Essential criteria

1. The law enables the supervisor to address compliance with laws and the safety and soundness of the banks under its supervision.
2. The law permits the supervisor to apply qualitative judgement in forming this opinion.
3. The supervisor has unfettered access to banks' files in order to review compliance with internal rules and limits as well as external laws and regulations.
4. When, in a supervisor's judgement, a bank is not complying with laws and regulations, or it is or is likely to be engaged in unsafe or unsound practices, the law empowers the supervisor to: (i) take (and/or require a bank to take) prompt remedial action; (ii) impose a range of sanctions (including the revocation of the banking licence).

Fully implemented. The National Monetary Council issues regulations that enable the Central Bank to execute inspection of financial institutions; apply penalties; authorize operations and issue licenses, require remedial action of problem institutions (such as capital requirements, mergers and splitting, transfer of stock control, etc). To that end, banks and financial institutions are obliged to disclose all needed information to the

[10] This component of Principle 1 is amplified considerably in the Principles dealing with *Licensing and Structure* (2 to 5), *Prudential Regulation and Requirements* (6 to 15), *Methods of Ongoing Banking Supervision* (16 - 20), and *Information Requirements* (21).

[11] This component of Principle 1 is amplified in Principle 22 which addresses *Formal Powers of Supervisors*

Central Bank. There is still some scope for improvement in penalties procedures, in order to make them speedier and more effective.

> 1 (5): A suitable legal framework for banking supervision is also necessary, including... legal protection for supervisors.

Essential criteria

1. The law provides legal protection to the supervisory agency and its staff against lawsuits for actions taken while discharging their duties in good faith.
2. The supervisory agency and its staff are adequately protected against the costs of defending their actions while discharging their duties.

Though this item had been considered fully implemented because, by law, Central Bank supervisors were given the right of legal assistance provided by the Central Bank, the new methodology makes it clear that it is only partially implemented. Supervisory action can only be contested at federal court level. However, the way the legal system in Brazil is organized allows inferior courts or lower level judges to order, for instance, seizure of a supervisor's personal assets until the federal court makes a final decision. Supervisors have been exposed to public embarrassment and losses before it could be established they acted in good faith and in discharge of their duties. The problem is unlikely to be solved until the judicial system is restructured or new laws are approved to provide more specific protection for supervisors.

> 1 (6): Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

Essential criteria

1. There is a system of cooperation and information sharing between all domestic agencies with responsibility for the soundness of the financial system.
2. There is a system of cooperation and information sharing with foreign agencies that have supervisory responsibilities for banking operations of material interest to the domestic supervisor.
3. The supervisor: (i) may provide confidential information to another financial sector supervisor; (ii) is required to take reasonable steps to ensure that any confidential information released to another supervisor will be treated as confidential by the receiving party; (iii) is required to take reasonable steps to ensure that any confidential information released to another supervisor will be used only for supervisory purposes.
4. The supervisor is able to deny any demand (other than a court order or mandate from a legislative body) for confidential information in its possession.

Fully implemented. Secrecy laws keep information provided to supervisors confidential, and these can't be release unless by court order or Congress mandate. There are also provisions for the cooperation between domestic agencies responsible for the supervision of the financial system as a whole (not only banks), as well as keeping confidentiality. The law also allows for international and cross border supervision agreements.

4.2 Licensing and Structure

Principle 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 names should be controlled as far as possible.*

Essential criteria

1. The term "bank" is clearly defined in law or regulations.
2. The permissible activities of institutions that are licensed and subject to supervision as banks are clearly defined either by supervisors, or in laws or regulations.
3. The use of the word "bank" and any derivations such as "banking" in a name are limited to licensed and supervised institutions in all circumstances where the general public otherwise might be misled.
4. The taking of proper bank deposits from the public is reserved for institutions that are licensed and subject to supervision.

Fully implemented. The permissible activities of institutions subject to supervision are defined by the Conselho Monetario Nacional and the Central Bank, and the use of the word "bank" is legally defined.

Principle 3: *The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the banking organisation'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 organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.*

Essential criteria

1. The licensing authority has the right to set criteria for licensing banks. These may be based on criteria set in law or regulation.
2. The criteria for issuing licenses are consistent with those applied in ongoing supervision.
3. The licensing authority has the right to reject applications if the criteria are not fulfilled or if the information provided is inadequate.

4. The licensing authority determines that the proposed legal and managerial structures of the bank will not hinder effective supervision.
5. The licensing authority determines the suitability of major shareholders, transparency of ownership structure and source of initial capital.
6. A minimum initial capital amount is stipulated for all banks.
7. The licensing authority evaluates proposed directors and senior management as to expertise and integrity (fit and proper test). The fit and proper criteria include: (i) skills and experience in relevant financial operations commensurate with the intended activities of the bank and (ii) no record of criminal activities or adverse regulatory judgements that make a person unfit to uphold important positions in a bank.
8. The licensing authority reviews the proposed strategic and operating plans of the bank. This includes determining that an appropriate system of corporate governance will be in place.
9. The operational structure is required to include, *inter alia*, adequate operational policies and procedures, internal control procedures and appropriate oversight of the bank's various activities. The operational structure is required to reflect the scope and degree of sophistication of the proposed activities of the bank.
10. The licensing authority reviews pro forma financial statements and projections for the proposed bank. This includes an assessment of the adequacy of the financial strength to support the proposed strategic plan as well as financial information on the principal shareholders of the bank.
11. If the licensing authority and the supervisory authority are not the same, the supervisor has the legal right to have its views considered on each specific application.
12. In the case of foreign banks establishing a branch or subsidiary, prior consent (or a statement of "no objection") of the home country supervisor is obtained.
13. If the licensing, or supervisory, authority determines that the license was knowingly based on false information, the license can be revoked.

Partially implemented. New regulation for licensing has greatly improved discretionary powers of the Central Bank as licensing authority, and in fact full compliance would apparently have been achieved with it. However, it is still too early to assess how well new licensing requirements are going to be enforced. There is still much to be done in the area of licensing staff training to fully evaluate the new type of information to be provided, specially adequacy of strategic and operating plans of new banks and transparency of ownership structures.

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

Essential criteria

1. Law or regulation contains a clear definition of "significant" ownership.
2. There are requirements to obtain supervisory approval or provide immediate notification of proposed changes that would result in a change in ownership or the exercise of voting rights over a particular threshold or change in controlling interest.
3. The supervisor has the authority to reject any proposal for a change in significant ownership or controlling interest, or prevent the exercise of voting rights in respect of such investments, if they do not meet criteria comparable to those used for approving new banks.

Partially implemented. Though the Central Bank has powers when it comes to changes in controlling interest or investments that drive the bank below standards required of a new bank, if there is a significant change in ownership without transfer of control there is not much scope for Central Bank action. New regulation is currently under analysis.

Principle 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.*

Essential criteria

1. Laws or regulations clearly define what types and amounts (absolute and/or in relation to a bank's capital) of acquisitions and investments need supervisory approval.
2. Laws or regulations provide criteria by which to judge individual proposals.
3. Consistent with the licensing requirements, among the objective criteria that the supervisor uses is that any new acquisitions and investments do not expose the bank to undue risks or hinder effective supervision. The supervisor determines that the bank has, from the outset, adequate financial and organizational resources to handle the acquisition/investment.
4. Laws or regulations clearly define for which cases notification after the acquisition or investment is sufficient. Such cases should primarily refer to activities closely related to banking and the investment being small relative to the bank's capital.

Partially implemented. Financial institutions must communicate with the Central Bank in order to receive approval for investments (these rules do not apply to investment banks), but in practice the capability of supervision to assess the risks arising from new acquisitions is limited. Some improvement has been made in what concerns supervision and the assessment of investments in non-financial businesses by financial institutions.

4.3 Prudential regulations and requirements

Principle 6: *Banking supervisors must set minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. For internationally active banks, these requirements must not be less than those established in the Basel Capital Accord.*

Essential criteria

1. Laws or regulations require all banks to calculate and consistently maintain a minimum capital adequacy ratio. At least for internationally active banks, the definition of capital, method of calculation and the ratio required are not lower than those established in the Basel Capital Accord.
2. The required capital ratio reflects the risk profile of individual banks, in particular credit risk and market risk. Both on-balance-sheet and off-balance-sheet risks are included.
3. Laws or regulations, or the supervisor, define the components of capital, ensuring that emphasis is given to those elements of capital available to absorb losses.
4. Capital adequacy ratios are calculated and applied on a consolidated bank basis.
5. Laws or regulations clearly give the supervisor authority to take measures should a bank fall below the minimum capital ratio.
6. Regular (at least semi-annually) reporting by banks to the supervisor is required on capital ratios and their components.

Though the first assessment considered this Principle to be fully implemented, in fact it has been only partially implemented because current regulation does not comprehend all market risk as prescribed by the BCBS. There was some improvement in 1999, with the adoption of new rules for exchange rate risk, and interest rate risk rules should be implemented before year-end. Components of capital were clearly defined in 1998, but there are still some edges to be smoothed on secondary capital definitions (such as specifically what can be considered subordinated debt and hybrid instruments for capital purposes).

Principle 7*:* *An essential part of any supervisory system is the independent 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 investment portfolios.*

Essential criteria

1. The supervisor requires, and periodically verifies, that prudent credit-granting and investment criteria, policies, practices, and procedures are approved, implemented, and periodically reviewed by bank management and boards of directors
2. The supervisor requires, and periodically verifies, that such policies, practices and procedures include the establishment of an appropriate and properly controlled credit risk environment, including: (i) a sound and well-documented credit granting and investment process; (ii) the maintenance of an appropriate credit administration, measurement and ongoing monitoring/reporting process (including asset grading/classification); and (iii) ensuring adequate controls over credit risk.
3. The supervisor requires, and periodically verifies, that banks make credit decisions free of conflicting interests, on an arm's-length basis, and free from inappropriate pressure from outside parties.

4. The supervisor requires that a bank's credit assessment and granting standards are communicated to, at a minimum, all personnel involved in credit granting activities.
5. The supervisor has full access to information in the credit and investment portfolios and to the lending officers of the bank.

Partially implemented. The Central Bank's regulations and practices are coherent with the Principle and criteria, but the information provided to supervisors is still quite dispersed among different forms and systems. This hampers the effectiveness of supervision and makes it more difficult to cross-reference data provided to various sectors of the Central Bank. Much improvement has been achieved since the adoption of Consolidated Global Inspection procedures, and supervisory staff is now keen on requesting that institutions observe certain principles on credit granting and administration. There are now specific requirements regarding the preparation of operational manuals, clear definition of loan approval and management policies, client exposure and limits, credit monitoring and internal control systems. A further improvement has been the creation of the Credit Risk Bureau, which gathers credit information on major borrowers and helps banks and supervisors to better assess exposure to credit risk.

Principle 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 loan loss provisions and reserves.*

Essential criteria

1. Either laws or regulations, or the supervisor, sets rules for the periodic review by banks of their individual credits, asset classification and provisioning, or the law/regulations establish a general framework and require banks to formulate specific policies for dealing with problem credits.
2. The classification and provisioning policies of a bank and their implementation are regularly reviewed by the supervisor or external auditors.
3. The system for classification and provisioning includes off-balance-sheet exposures.
4. The supervisor determines that banks have appropriate policies and procedures to ensure that loan loss provisions and write-offs reflect realistic repayment expectations.
5. The supervisor determines that banks have appropriate procedures and organizational resources for the ongoing oversight of problem credits and for collecting past due loans.
6. The supervisor has the authority to require a bank to strengthen its lending practices, credit-granting standards, level of provisions and reserves, and overall financial strength if it deems the level of problem assets to be of concern.
7. The supervisor is informed on a periodic basis, and in relevant detail, concerning the classification of credits and assets and of provisioning.
8. The supervisor requires banks to have mechanisms in place for continually assessing the strength of guarantees and appraising the worth of collateral.

9. Loans are required to be identified as impaired when there is reason to believe that all amounts due (both principal and interest) will not be collected in accordance with the contractual terms of the loan agreement.
10. The valuation of collateral is required to reflect the net realizable value.

Partially implemented. Though there are rules for the periodic reviews of individual credits and provisions, the current regulation for write-offs and provisions does not take into account the need to classify credits – the only criteria is time since loans become overdue. This deficiency is about to be partially solved by new proposed regulation for loan loss provisions, which will require banks to classify their credits in accordance with the likelihood of recovery, strength of collateral and real value of guarantees.

Principle 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 of related borrowers.*

Essential criteria

1. A "closely related group" is explicitly defined to reflect actual risk exposure. The supervisor has discretion, which may be prescribed by law, in interpreting this definition on a case-by-case basis.
2. Laws or regulations, or the supervisor, set prudent limits on large exposures to a single borrower or closely related group of borrowers. "Exposures" include all claims and transactions, on-balance sheet as well as off-balance sheet.
3. The supervisor verifies that banks have management information systems that enable management to identify on a timely basis concentrations (including large individual exposures) within the portfolio on a solo and consolidated basis.
4. The supervisor verifies that bank management monitors these limits and that they are not exceeded on a solo and consolidated basis.
5. The supervisor regularly obtains information that enables concentrations within a bank's credit portfolio, including sectoral and geographic exposures, to be reviewed.

Partially implemented. The use of the Credit Risk Bureau by banks and supervisors is crucial for the full enforcement of this principle. As utilization is still preliminary, there is yet much room left to improve the observance of exposure limits set out by regulation. Newly implemented regulation on internal controls requirements have assisted the creation of a new culture of internal auditing and risk and policy management. Regulation is also considering the definition of related companies to include all financially related companies and physical persons.

Principle 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.*

Essential criteria

1. A comprehensive definition of "connected or related parties" exists in law and/or regulation. The supervisor has discretion, which may be prescribed in law, to make judgements about the existence of connections between the bank and other parties.
2. Laws and regulations exist that exposures to connected or related parties may not be extended on more favorable terms (i.e., for credit assessment, tenor, interest rates, amortization schedules, requirement for collateral) than corresponding loans to non-related counterparties.
3. The supervisor requires that transactions with connected or related parties exceeding specified amounts or otherwise posing special risks are subject to approval by the bank's board of directors.
4. The supervisor requires that banks have procedures in place to prevent persons benefiting from the loan being part of the preparation of the loan assessment or of the decision itself.
5. Laws or regulations set, or the supervisor has the mandate to set on a general or case-by-case basis, limits for loans to connected and related parties, to deduct such lending from capital when assessing capital adequacy or to require collateralisation of such loans.
6. The supervisor requires banks to have information systems to identify individual loans to connected and related parties as well as the total amount of such loans, and to monitor them through an independent credit administration process.
7. The supervisor obtains and reviews information on aggregate lending to connected and related parties.

Fully implemented. Current regulation is strict, forbidding loans or advances to individuals or corporations that hold more than 10% of the institution's capital, as well as to corporations in which the bank holds more than 10% of capital. As stated above, there are also limits imposed to client and related parties' exposures.

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

Essential criteria

1. The supervisor determines that a bank's policies and procedures give due regard to the identification, monitoring and control of country risk and transfer risk. Exposures are identified and monitored on an individual country basis (in addition to the end-borrower/end-counterparty basis). Banks are required to monitor and evaluate developments in country risk and in transfer risk and apply appropriate countermeasures.
2. The supervisor verifies that banks have information systems, risk management systems and internal control systems to comply with those policies.
3. There is supervisory oversight of the setting of appropriate provisions against country risk and transfer risk. There are different international practices which are all acceptable as long as they lead to reasonable, risk-related, results. These include, *inter alia*: (i) the supervisor (or some other official authority) decides on appropriate minimum provisioning by setting fixed percentages for exposures to

each country; (ii) the supervisor (or some other official authority) sets percentage intervals for each country and the banks may decide, within these intervals, which provisioning to apply for the individual exposures; (iii) the bank itself (or some other body such as the national bankers' association) sets percentages or guidelines or even decides for each individual loan on the appropriate provisioning. The provisioning will then be judged by the external auditor and/or by the supervisor.
4. The supervisor obtains and reviews sufficient information on a timely basis on the country risk/transfer risk of individual banks.

Not implemented. As yet, there are no capital requirements or provisions imposed to banks based on country or transfer risk. Supervision has generally overseen country exposure in internationally active banks only on the basis of internal control management issues. As there are very few Brazilian banks active in international credit granting, this issue has not been perceived as pressing as other risk-based requirements.

Principle 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 market risk exposures, if warranted*.

Essential criteria

1. The supervisor determines that a bank has suitable policies and procedures related to the identification, measuring, monitoring and control of market risk.
2. The supervisor determines that the bank has set appropriate limits for various market risks, including their foreign exchange business.
3. The supervisor has the power to impose a specific capital charge and/or specific limits on market risk exposures, including their foreign exchange business.
4. The supervisor verifies that banks have information systems, risk management systems and internal control systems to comply with those policies, and verifies that any limits (either internal or imposed by the supervisor) are adhered to.
5. The supervisor satisfies itself that there are systems and controls in place to ensure that all transactions are captured on a timely basis, and that the banks' positions are revalued frequently, using reliable and prudent market data.
6. The supervisor determines that banks perform scenario analysis, stress testing and contingency planning, as appropriate, and periodic validation or testing of the systems used to measure market risk.
7. The supervisor has the expertise needed to monitor the actual level of complexity in the market activities of banks.

Partially implemented. The Central Bank has the power to establish limits for various market risks, to impose capital charges and to determine that banks periodically test and measure their systems. Recent regulation covers foreign exchange risk, and a proposed regulation on interest rate risk capital charges is about to be enforced. These regulations basically incorporate the standard models proposed by the Basle Committee and allow a limited scope for the use of proprietary models. As yet, there is no proposed regulation on operational risk requirements. A major limitation for the implementation of market risk control and capital charges is that the Central Bank is still in the process of building expertise to adequately monitor the information to be provided by the banks, specially in what relates to stress testing and reliability of models[12].

Principle 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, measure, monitor and control all other material risks and, where appropriate, to hold capital against these risks.*

Essential criteria

1. The supervisor requires individual banks to have in place comprehensive risk management processes to identify, measure, monitor and control material risks. These processes are adequate for the size and nature of the activities of the bank and are periodically adjusted in light of the changing risk profile of the bank and external market developments. These processes include appropriate board and senior management oversight.
2. The supervisor determines that the risk management processes address liquidity risk, interest rate risk, and operational risk as well as all other risks, including those risks covered in other Principles (e.g., credit and market risk). These would include:
   (i) Liquidity: good management information systems, central liquidity control, analysis of net funding requirements under alternative scenarios, diversification of funding sources, stress testing and contingency planning. Liquidity management should separately address domestic and foreign currencies.
   (ii) Interest rate risk: good management information systems and stress testing.
   (iii) Operational risk: internal audit, procedures to counter fraud, sound business resumption plans, procedures covering major system modifications and preparation for significant changes in the business environment.
3. The supervisor issues standards related to such topics as liquidity risk, interest rate risk, foreign exchange risk and operational risk.
4. The supervisor sets liquidity guidelines for banks, which include allowing only truly liquid assets to be treated as such, and takes into consideration undrawn commitments and other off-balance-sheet liabilities, as well as existing on-balance-sheet liabilities.
5. The supervisor determines that limits and procedures are communicated to the appropriate personnel and primary responsibility for adhering to limits and procedures is placed with the relevant business units.
6. The supervisor periodically verifies that these risk management processes, capital requirements, liquidity guidelines and qualitative standards are being adhered to in practice.

Partially implemented. As stated above, the Central Bank only recently started to issue and to execute regulation related to capital requirements covering market risks, and is still to build on capacity to assess the risk management processes of financial institutions. Regulation on internal controls has approached some aspects of minimum risk management standards and procedures to be observed by banks, but until regulation

[12] There are ongoing projects partially funded by the World Bank for training of supervisors, and the Central Bank has

on all market risks is implemented assessment of such controls will continue to be deficient.

Principle 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 bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations*.

Essential criteria

1. Corporate or banking laws identify the responsibilities of the board of directors with respect to corporate governance principles to ensure that there is effective control over every aspect of risk management.

2. The supervisor determines that banks have in place internal controls that are adequate for the nature and scale of their business. These controls are the responsibility of the board of directors and deal with organizational structure, accounting procedures, checks and balances and the safeguarding of assets and investments. More specifically, these address:

   (i) Organizational structure: definitions of duties and responsibilities including clear delegation of authority (for example, clear loan approval limits), decision-making procedures, separation of critical functions (for example, business origination, payments, reconciliation, risk management, accounting, audit and compliance).

   (ii) Accounting procedures: reconciliation of accounts, control lists, information for management.

   (iii) Checks and balances (or "four eyes principles"): segregation of duties, cross-checking, dual control of assets, double signatures.

   (iv) Safeguarding assets and investments: including physical control.

3. To achieve a strong control environment, the supervisor requires that the board of directors and senior management of a bank understand the underlying risks in their business and are both committed to, and legally responsible for, the control environment. Consequently, the supervisor evaluates the composition of the board of directors and senior management to determine that they have the necessary skills for the size and nature of the activities of the bank and can address the changing risk profile of the bank and external market developments. The supervisor has the legal authority to require changes in the composition of the board and management in order to satisfy these criteria

4. The supervisor determines that there is an appropriate balance in the skills and resources of the back office and control functions relative to the front office/business origination.

5. The supervisor determines that banks have an appropriate audit function charged with (a) ensuring that policies and procedures are complied with and (b) reviewing whether the existing policies, practises and controls remain sufficient and appropriate for the bank's business. The supervisor determines that the audit function:

   (i) has unfettered access to all the bank's business lines and support departments; (ii) has appropriate independence, including reporting lines to the board of directors and status within the bank to ensure that senior management reacts to and acts upon its recommendations; (iii) has sufficient resources, and staff that are suitably trained and have relevant experience to understand and evaluate the business they are auditing; (iv) employs a methodology that identifies the key risks run by the bank and allocates its resources accordingly.

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identified the consolidation of market risk requirements as a priority target to be achieved by mid-2000.

6. The supervisor has access to the reports of the audit function.

This Principle has recently been implemented by the issuance of regulation regarding requirements for internal control and segregation of management duties. There are requirements on internal and external audit checks, top level reviews, continuous assessment and updating of control systems, and specific rules determining that the nomination of the directors and senior management should be submitted to the approval of the Central Bank. These new regulations were elaborated on the basis of Basle recommendations, so they comply with most of the criteria proposed by the new methodology. It must be observed, however, that supervision is still in the process of learning and developing skills to fully evaluate the level of banks' compliance to these new obligations. Senior management must also be educated in the sense of developing a control culture within the corporation. Furthermore, managerial information systems must be expanded to cover all the risks to which institutions are exposed.

Principle 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 bank being used, intentionally or unintentionally, by criminal elements.*

Essential criteria

1. The supervisor determines that banks have in place adequate policies, practices and procedures that promote high ethical and professional standards and prevent the bank from being used, intentionally or unintentionally, by criminal elements. This includes the prevention and detection of criminal activity or fraud, and reporting of such suspected activities to the appropriate authorities.
2. The supervisor determines that banks have documented and enforced policies for identification of customers and those acting on their behalf as part of their anti-money-laundering program. There are clear rules on what records must be kept on customer identification and individual transactions and the retention period.
3. The supervisor determines that banks have formal procedures to recognize potentially suspicious transactions. These might include additional authorization for large cash (or similar) deposits or withdrawals and special procedures for unusual transactions.
4. The supervisor determines that banks appoint a senior officer with explicit responsibility for ensuring that the bank's policies and procedures are, at a minimum, in accordance with local statutory and regulatory anti-money laundering requirements.
5. The supervisor determines that banks have clear procedures, communicated to all personnel, for staff to report suspicious transactions to the dedicated senior officer responsible for anti-money laundering compliance.
6. The supervisor determines that banks have established lines of communication both to management and to an internal security (guardian) function for reporting problems.

7. In addition to reporting to the appropriate criminal authorities, banks report to the supervisor suspicious activities and incidents of fraud material to the safety, soundness or reputation of the bank.
8. Laws, regulations and/or banks' policies ensure that a member of staff who reports suspicious transactions in good faith to the dedicated senior officer, internal security function, or directly to the relevant authority cannot be held liable.
9. The supervisor periodically checks that banks' money laundering controls and their systems for preventing, identifying and reporting fraud are sufficient. The supervisor has adequate enforcement powers (regulatory and/or criminal prosecution) to take action against a bank that does not comply with its anti-money laundering obligations.
10. The supervisor is able, directly or indirectly, to share with domestic and foreign financial sector supervisory authorities information related to suspected or actual criminal activities.
11. The supervisor determines that banks have a policy statement on ethics and professional behavior that is clearly communicated to all staff.

This Principle has been partially implemented basically because it is necessary that new legislation may impose stricter criminal and pecuniary penalties for the illegal use of and fraud in financial institutions. There are already several laws and regulations requiring management and supervisors to report on suspicious activities, obliging banks to identify large transactions, and inflicting sanctions and fees for non-compliance to anti-money laundering procedures. Know-your-customer regulation could also be complemented by the elaboration of a Code of Ethics for National Financial System institutions.

4.4 Methods of ongoing banking supervision

The following principles regard the methods of supervision itself[13]. They make it clear that supervision must be based on off and on-site inspections, and that supervisors must seek to closely follow the development of banking operations, in a consolidated approach.

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

Essential criteria

1. Banking supervision requires an in-depth understanding, periodic analysis and evaluation of individual banks, focussing on safety and soundness, based on meetings with management and a combination of both on-site and off-site supervision. The supervisor has a framework that (1) uses on-site work (conducted either by own staff or through the work of external auditors) as a primary tool to: (i) provide independent verification that adequate corporate governance (including risk management and internal control systems) exists at individual banks; (ii) determine that information provided by banks is reliable; (iii) obtain additional information needed to assess the condition of the bank.
2. And (2) uses off-site work as a primary tool to:
   (i) review and analyze the financial condition of individual banks using prudential reports, statistical returns and other appropriate information, including publicly available information;
   (ii) monitor trends and developments for the banking sector as a whole.
3. The supervisor checks for compliance with prudential regulations and other legal requirements through on-site and off-site work.
4. The appropriate mix of on-site and off-site supervision is determined by the particular conditions and circumstances of the country. In any event, the framework integrates the two functions so as to maximize the synergy and avoid supervisory gaps.

This Principle is fully implemented – regulation and practice require supervisors to carry out direct and indirect supervision with a consolidated approach. Central Bank supervisors have much expertise in on-site inspections, and models and procedures for efficient off-site supervision have developed quickly in the past two years. The requirements of prudential-sort data and forms, and a better integration of on and off-site inspections have allowed supervisors to have a much broader and deeper view of developments within the banking sector.

Principle 17: *Banking supervisors must have regular contact with bank management and a thorough understanding of the institution's operations.*

Essential criteria

1. Based on the risk profile of individual banks, the supervisor has a program of regular meetings with senior and middle management (including the board, non-executive directors and heads of individual units) to discuss operational matters such as strategy, group structure, corporate governance, performance, capital adequacy, liquidity, asset quality, risk management systems etc.
2. The supervisor has a thorough understanding of the activities of its banks. This is accomplished through a combination of off-site surveillance, on-site reviews and regular meetings.
3. The supervisor requires banks to notify it of any substantive changes in their activities or any material adverse developments, including breach of legal and prudential requirements.

[13] Within the Banco Central do Brasil, there are three separated functions which could be generally be considered "supervision". Issuance of regulations and guidance is a separate function of licensing and structure and also of banking institutions' inspection. Principles 16 to 20 are much related to the inspection function of supervision, while the first have a more regulatory approach.

4. As part of the licensing process, and on an on-going basis during routine supervision, the supervisor considers the quality of management.

Partially implemented. Recent regulation changing the licensing process included a thorough analysis of the quality of management, and banks are required to notify the supervisor of any major change in the nature of their activities or adverse developments. However, supervision has not yet adopted as standard procedure the scheduling of regular meetings with senior and middle management.

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

Essential criteria

1. The supervisor has the legal authority to require banking organizations to submit information, on both a solo and consolidated basis, on their financial condition and performance, at regular intervals. These reports provide data on matters such as on- and off-balance sheet assets and liabilities, profit and loss, capital adequacy, liquidity, large exposures, loan loss provisioning, market risk and deposit sources.
2. Laws and regulations establish, or the supervisor has the authority to establish, the principles and norms regarding the consolidation of accounts as well as the accounting techniques to be used.
3. The supervisor has a means of enforcing compliance with the requirements that the information be submitted on a timely and accurate basis. The supervisor determines that the appropriate level of senior management is responsible for the accuracy of supervisory returns, can impose penalties for deliberate mis-reporting and persistent errors, and can require that inaccurate information be amended.
4. The information that is required to be submitted includes standardized prudential and statistical reports, and detailed balance sheets and income statements, as well as supporting schedules that provide details concerning on and off balance sheet activities and on reserves included in capital. Inclusion of data on loan classification and provisioning is also required.
5. The supervisor has the authority to request and receive any relevant information from banks, as well as any of their related companies, irrespective of their activities, where the supervisor believes that it is material to the financial situation of the bank or the assessment of the risks of the bank.
6. The supervisor has an analytical framework that uses the statistical and prudential information for the ongoing monitoring of the condition and performance of individual banks. The results are also used as a component of on-site supervision planning. This requires that the supervisor has an adequate information system.
7. In order to make meaningful comparisons between banking organizations, the supervisor collects data from all banks and all other relevant entities within a banking organization on a comparable basis and related to the same dates (stock data) and periods (flow data).
8. The supervisor collects data from banks at a frequency (e.g., monthly, quarterly and annually) commensurate with the nature of the information requested, and the size, activities and risk profile of the individual bank.

The Principle has been implemented, as the Central Bank has all the powers described above and effectively uses them to request information and enforce regulation. Nevertheless, information is at the moment provided through several forms and computer systems, which creates some overlapping of information and an extra burden for those responsible for collecting and analyzing that data. New efforts are in course to develop an information matrix to consolidate all needed data for supervisory purposes. There is also an ongoing process of improving the quality of information provided by financial institutions to the Central Bank.

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

Essential criteria

1. The supervisor has in place a coherent process for planning and executing on-site visits, using either in-house examiners, or making use of the work of external auditors, as appropriate. There are policies and procedures in place to ensure that examinations are conducted on a thorough and consistent basis with clear responsibilities, objectives and outputs. The supervisor holds meetings with banks and their auditors to discuss the results of work by the external auditors and to agree on the responsibilities for corrective work.
2. The supervisor has the authority to monitor the quality of work done by external auditors for supervisory purposes. The supervisor has the authority to directly appoint external auditors for conducting supervisory tasks or oppose the appointment of an external auditor that is deemed to have inappropriate expertise and/or independence.
3. The supervisor can also make use of external auditors to examine specific aspects of banks' operations, provided there is a well developed, professionally independent auditing and accounting profession with skills to undertake the work required. The respective roles and responsibilities for the supervisor and the auditors in these circumstances are clearly defined by the supervisor.
4. The supervisor has the legal right of full access to all bank records for the furtherance of supervisory work. The supervisor also has similar access to the board, senior management and staff, when required.
5. The supervisor has a program for the periodic examination of supervisory returns by examiners or through the work of external auditors. There is a requirement that certain key supervisory returns such as that for capital adequacy be examined at least annually by the auditors and a report submitted to the supervisor.

The use of independent auditors has been a requirement of financial institutions for long. Only recently, however, has the Central Bank imposed requirements **on** the activities of external auditors, making them more accountable for the information rendered and reports produced. Auditors are now obliged to inform the Central Bank of all facts that may lead to the interruption of an institution's activities, and must produce reports on the efficacy of internal controls, information systems and risk management besides the usual reports based on generally accepted accounting principles. Financial institutions must replace the external auditor every four years, and must indicate a director in charge of accounting and auditing requirements. There is still some scope for improvement in the relationship between external auditors and the supervisory authority, which would fine-tune the quality and targeting of their work.

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

Essential criteria

1. The supervisor is aware of the overall structure of banking organizations (i.e., the bank and its subsidiaries) or groups and has an understanding of the activities of all material parts of these groups, including those that are supervised directly by other agencies.
2. The supervisor has a supervisory framework that evaluates the risks that non-banking activities conducted by a bank or banking group may pose to the bank or banking group.
3. The supervisor has the legal authority to review the overall activities of a bank, whether the activities are conducted directly (including those conducted at overseas offices), or indirectly, through subsidiaries and affiliates of the bank.
4. There are no impediments to the direct or indirect supervision of all affiliates and subsidiaries of a banking organization.
5. Laws or regulations establish, or the supervisor has the authority to impose, prudential standards on a consolidated basis for the banking organization. The supervisor uses its authority to establish prudential standards on a consolidated basis to cover such areas as capital adequacy, large exposures and lending limits.
6. The supervisor collects consolidated financial information for each banking organization.
7. The supervisor has arrangements with functional regulators of individual business vehicles within the banking organization group, if material, to receive information on the financial condition and adequacy of risk management and controls of such business vehicles.
8. The supervisor has the authority to limit or circumscribe the range of activities the consolidated banking group may conduct and the overseas locations in which activities can be conducted; the supervisor uses this authority to determine that the activities are properly supervised and that the safety and soundness of the banking organization is not compromised.

Financial institutions are required to send consolidated information to the Central Bank on a half-yearly basis – including data on the positions of their foreign facilities and stocks – and all regulatory limits apply on a consolidated basis for financial conglomerates. Nevertheless, current legislation does not give the Central Bank power to supervise over non-financial related companies. There is ongoing work toward lifting this barrier to effective consolidated supervision, and the Central Bank has included in regulation under its responsibility provisions in that direction, but legislation still needs improvement.

4.5 Information requirements

Principle 21: *Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor 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 reflect its condition.*

Essential criteria

1. The supervisor has the authority to hold management responsible for ensuring that financial record keeping systems and the data they produce are reliable, and that supervisor-required reports are submitted on a timely and accurate basis.
2. The supervisor has the authority to hold management responsible for ensuring that the management report and financial statements issued annually to the public receive proper external verification and bear an external auditor's opinion.
3. The supervisor ensures that information from bank records is verified periodically through on-site examinations and/or external audits.
4. The supervisor ensures that there are open communication lines with the external auditors.
5. The supervisor provides report instructions that clearly establish the accounting standards to be used in preparing supervisory reports. Such standards are based on accounting principles and rules that command wide international acceptance and are aimed specifically at banking institutions.
6. The supervisor requires banks to utilize valuation rules that are consistent, realistic and prudent, taking account of current values where relevant, and that profits are net of appropriate provisions.
7. Laws or regulations set, or the supervisor has the authority, in appropriate circumstances, to establish, the scope and standards to be achieved in external audits of individual banks, and to make public issuance of individual bank financial statements subject to its prior approval.
8. The supervisor has the ability to treat as confidential certain types of sensitive information.
9. The supervisor requires banks to produce annual audited financial statements based on accounting principles and rules that command wide international acceptance and have been audited in accordance with internationally accepted auditing practices and standards.
10. The supervisor has the right to revoke the appointment of a bank's auditors.
11. Where supervisors rely primarily on the work of external auditors (rather than on their own examination staff), banks are required to appoint auditors who are recognized by the supervisor as having the necessary professional skills and independence to perform the work.

This Principle has been fully implemented. The Central Bank has a standard account plan for financial institutions to comply with, which is based on Generally Accepted Accounting Principles. There must be a director responsible for accounting and financial record keeping, and information received is verified by on and off-site inspection and also by external auditors. The accounting system is well know and is going through some improvement to make it even more transparent.

4.6 Formal Powers of Supervisors

Principle 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.*

Essential criteria

1. The supervisor has the authority, backed by legal sanctions, to take an appropriate range of remedial actions against, and impose penalties upon, banks, depending on the severity of a situation. These remedial actions are used to address such problems as failure to meet prudential requirements and violations of regulations. They range from informal oral or written communication with bank management to actions that involve the revocation of the banking license.
2. The range of possible actions available is broad, including, in addition to the others mentioned, restricting the current activities of the bank, withholding approval of new activities or acquisitions, restricting or suspending payments to shareholders or share repurchases, restricting asset transfers, barring individuals from banking, replacing or restricting the powers of managers, directors, or controlling owners, arranging a take-over by or merger with a healthier institution, and imposing conservatorship.
3. The supervisor ensures that remedial actions are taken in a timely manner.
4. The supervisor applies penalties and sanctions not only to the bank, but, when and if necessary, also to management and/or the board of directors.

Current regulation clearly defines corrective measures to be taken when requirements are not met. These penalties vary from fees to revocation of banking licenses. The Central Bank has powers to initiate punitive administrative proceedings, and also to take measures aimed at the protection of depositors and stability of the financial system. When risk situations are identified there are a number of measures that can be taken for early remedial actions, which may affect management and/or capitalization.

4.7 Cross-border banking

Principle 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*.

Essential criteria

1. The supervisor has the authority to supervise the overseas activities of locally incorporated banks.
2. The supervisor satisfies itself that management is maintaining proper oversight of the bank's foreign branches, joint ventures, and subsidiaries. It also satisfies itself that the local management of any overseas offices has the necessary expertise to manage those operations in a safe and sound manner.
3. The supervisor determines that bank management's oversight includes: a) information reporting on its overseas operations that is adequate in scope and frequency and is periodically verified; b) assessing in an appropriate manner compliance with internal controls; and c) ensuring effective local oversight of foreign operations.
4. The home country supervisor has the authority to require closing of overseas offices, or imposing limitations on their activities, if it determines that the supervision of a local operation by the bank and/or by the host country supervisor is not adequate relative to the risks the office presents.

The Central Bank has the authority to supervise overseas activities of locally incorporated banks, but in practice this supervision is hindered by the lack of cross-border agreements and secrecy legislation with some countries. As information of internationally active banks is to be provided on a globally consolidated basis, assessment of compliance sometimes needs to be made exclusively off-site.

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

Essential criteria

1. For significant overseas operations of its banks, the home country supervisor establishes informal or formal arrangements (such as memoranda of understanding) with host country supervisors for appropriate information-sharing on the financial condition and performance of such operations in the host country. Information sharing arrangements with host country supervisors include being advised of adverse assessments of such qualitative aspects of a bank's operations as the quality of risk management and controls at the offices in the host country.
2. The supervisor can prohibit banks or their affiliates from establishing operations in countries with secrecy laws or other regulations prohibiting flows of information deemed necessary for adequate supervision.
3. The home supervisor provides information to host country supervisors concerning the specific offices in the host country, concerning the overall framework of supervision in which the banking group operates, and, to the extent appropriate, concerning significant problems arising in the head office or in the group as a whole.

As stated above, there are some formal and informal arrangements with other countries for cross-border supervision. However, it is known that some countries do not cooperate on information sharing. Though the supervisor has powers to limit operations of national banks in those countries by the imposition of sanctions, negotiation has been the way to sort out most supervision problems related to that issue.

Principle 25: *Banking supervisors must require the local operations of 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*

Essential criteria

1. Local branches and subsidiaries of foreign banks are subject to similar prudential, inspection, and regulatory reporting requirements as domestic banks.
2. For purposes of the licensing process as well as ongoing supervision, the host country supervisor assesses whether the home country supervisor practices consolidated global supervision.
3. The host supervisor, before issuing a license, determines that approval (or no objection) from the home supervisor has been received.
4. The host country supervisor can share with home country supervisors information about the local operations of foreign banks provided its confidentiality is protected.

5. Home country supervisors are given on-site access to local offices and subsidiaries for safety and soundness purposes.
6. The host country supervisor advises home country supervisors on a timely basis of any material remedial action it takes regarding the operations of a bank from that country.

Essential criteria 1, 2, 4, 5 and 6 hold. However, the approval of home supervisors has not been requested – mainly due to lack of response and delay in approval licensing proceedings.

5. Conclusion

The convergence of banking regulation and supervision standards is a result of both the need for stability and the desire of promoting fair competition in a highly globalized sector. Financial innovations and technology have turned financial markets across continents increasingly correlated, making the urge for convergence more pressing and drawing to it the attention of policy makers and multilateral institutions.

The BCBS's first goal of eliminating the differences of supervision structures among countries is unlikely to be completely achieved, but much progress has been made in converging principles and concepts. The proposal of the new capital adequacy framework, from my point of view, has come to outline the fact that international standards in the financial sector, to be broadly applicable, must be flexible enough to allow for some national accommodation and reflect rapid developments in the field. The new structure, which incorporated a market-disciplined approach to capital adequacy, allows for more differentiation across institutions and grants the supervisory authority more discretionary power in the application of standards.

On the other hand, in these market-reliance and flexibility lie its major setbacks: the use of private rating agencies to set capital requirements is yet to be tested on dependability and applicability, and the supervision pillar may prove to be too heavy a burden for many supervisory agencies across the world. It may turn out that the new structure is just too costly to be implemented, despite the promises of technical and financial assistance by the IMF and World Bank – which, on their turn, have their share of demand for reform assistance quite unmatched by the resources made available to them.

Brazil had been lagging behind its major commercial and financial partners in compliance to several internationally agreed supervision standards. In a retrospective look over Mercosul targets, it is very clear that Argentina was much quicker in reforming its financial regulation to cope with new standards. What really draws the attention is the speed that, once started, changes in regulation have been taking place in Brazil. The Accord was internalized only in 1994, by the issuance of Resolution 2.099, and few regulations were really put in force until the 25 Core Principles were released.

The year of 1998, however, was one of many regulatory changes, and the establishment of a World Bank program with the Central Bank to enhance supervision practices gave the issue of compliance a new thrust. The conditionalities imbedded in the IMF assistance program further pressed the case for compliance, and that effort can be observed in a quick comparison between the June 1998 compliance assessment to the Core Principles and the June 1999 one carried out by the Central Bank.

On preconditions for effective banking supervision, the country can be considered nearly fully implemented: the only setback is some lack of independence of the supervisory authority. As it is a Constitutional matter, its solution is not expected to be as simple and as straight-forward as some issues which only require Central Bank resolutions to be put in place. Licensing principles are mostly enforced, with the issuance of some very modern regulations – however, more discretionary power given to licensing staff on that aspect needs to be matched by training. Prudential regulations, to be considered fully implemented, need to incorporate all market risks prescribed by the Core Principles, which is already an ongoing project of the Central Bank. On principles guiding methods of supervision and inspection guidance, much progress has been made – sound accounting and reporting systems, consolidated on and off-site supervision, and cross-border supervisory agreements exist and really need mostly fine-tuning and training.

It rests to be seen whether the pace of financial regulation reforms in Brazil will keep with the pace of reforms of the standards for banking supervision themselves – before Brazil is in full compliance with BCBS principles, their structure is already about to change and become increasingly complex to adopt and monitor. This rapid evolution makes a clear case for more resources and attention to the reforms needed for Brazil to achieve full compliance with no further delays. Moreover, it emphasizes the need for constant observation and discussion of the adequacy of internalizing ever-changing international standards. Such internalization, if carried out simply because of external impositions from regional and international forums, may be inadequate to the particularities of the Brazilian financial system and, mainly, lack proper ownership that ultimately should make it legitimate to Brazilian society.

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