Building Effective Banking Systems in Latin America and the Caribbean

Tactics and Strategy

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INTRODUCTION

Over the past ten years, many countries, in all stages of economic development, have experienced major problems within individual banking institutions or entire banking systems. While there are many reasons for these developments, and while those reasons vary from country to country, several common denominators have been present in virtually all such episodes. Among those are the following:

- rapid changes in the macroeconomic and macro-financial environment,

- inadequate internal controls and procedures, together with lapses in official supervision or poorly developed official supervisory policies and practice, and

- concentrated patterns of credit or market risk exposure.

In almost all cases, the proximate cause of the banking sector problems can be traced to large credit losses. This has been true in highly developed countries with mature systems of banking supervision and regulation such as the United States and Japan, as well as developing countries with relatively untested systems of banking supervision such as Mexico, Brazil and Argentina. As will be developed further in this paper, this experience clearly suggests that even well-developed and mature systems of banking supervision alone do not provide assurances that severe banking problems can be avoided.

The direct and indirect costs of banking sector crises have been astonishingly high. Such costs are reflected in several ways, including:

- *Direct Fiscal Costs.* Even though countries have used a variety of devices to spread costs over a long period of time, direct fiscal costs ranging from 5% to 10% of GDP have not been uncommon.

- *Lost Domestic Savings.* Literally tens, if not hundreds, of billions of dollars of precious domestic savings have been poured into the black hole of bad credits in a setting in which such savings are in very short supply. This is especially troubling in Latin America and the Caribbean, where the presence of low domestic savings rates is perhaps the largest single barrier to sustained high rates of economic growth.

- *Reduced Growth.* The paralyzing effects of banking crises on both lenders and borrowers have severely restrained GDP growth.

- *Adverse Incentives.* Moral hazard problems growing out of decisions by governments to protect depositors and other creditors have been considerable.

- *Erosion of Public Confidence.* A particularly insidious cost imposed by banking crises is the erosion of public and political confidence in the banking system. This erosion of confidence can stand in the way of precisely the kinds of reforms that are needed to remedy the prevailing problems and build the progressive banking and financial systems that are so vital to the long-run success of the countries in question.

In many emerging markets countries, including Argentina, Brazil and Mexico, banking sector problems have been especially acute despite the presence of very wide net interest margins. On the surface, these wide margins should provide ample cash flow to absorb credit losses, but in fact, not only have such interest margins not been *remotely* adequate to cushion credit losses, they have also imposed extraordinarily heavy interest cost burdens on many borrowers.

While the symptoms and costs of banking sector problems are widely recognized, the magnitude of the remedial task is often significantly underestimated. To put that task in some perspective, the following three observations should be kept in mind. First, the acute and costly nature of the problem in most developing countries primarily reflects a host of historical institutional weaknesses that severely complicate the relationships between creditors and debtors. The resulting absence of a "credit culture" almost ensures a high incidence of credit problems, especially in the face of volatile economic and financial conditions. Second, under the best of circumstances, including solid economic performance, it will take a number of years to remedy these institutional problems, even as largely successful stopgap and damage control programs have been put in place. Third, building progressive and profitable banking systems in these countries will entail a mix of short-term and longer-term initiatives on the part of the banks, the authorities and the governments at large, as well as enlightened support and leadership from the international community, including the IMF, the World Bank and the regional development banks.

THE ROLE OF THE BANKING SYSTEM AND CHARACTERISTICS OF NATIONAL BANKING SYSTEMS

An effective domestic banking system is one of the most basic prerequisites for robust economic performance over time for all countries. This is especially true for countries that require relatively high rates of GDP growth in the face of massive infrastructure needs, high levels of poverty, and young and rapidly growing populations

In a globally integrated market economy, national banking systems -- and the individual banks that make up such systems -- must be capable of attracting the capital necessary to support the risk-taking activities inherent in the conduct of the banking business. Such capital resources will only be forthcoming in a setting in which investors -- domestic or foreign -- can reasonably project returns on that capital that are sufficiently attractive, relative to alternative investments, to justify the deployment of capital to this purpose. This probably implies that rates of return on equity capital at viable banks in emerging market countries will have to average at least 15% over time.

In turn, achieving rates of return that will be sufficient to attract the very large amounts of capital needed to support healthy banking systems will require a regulatory and a political environment that accepts the central proposition that prudential standards associated with safety and soundness can and must be framed in a manner that promotes efficiency, flexibility and profitability in the banking sector. In other words, the imperative of profitability in the banking sector cannot be ignored, especially in a setting in which there is a danger that naïve political considerations can result in a business environment that is fundamentally incompatible with the high rates of profitability that are essential for success.

Core Functions of National Banking Systems

Against that general background, a useful point of departure is to briefly review the nature of the three core functions of national banking systems. The first core function is the mobilization of domestic savings in a safe and efficient manner. This, of course, is the deposit gathering function, which must be rooted in the conviction on the part of the public that deposit balances — especially current account balances — will be paid at par and on demand. The second core function is the channeling of those savings, through the credit

decision-making process, to their most efficient uses. To this end, the credit decision-making process must be rigorous, objective and impartial; only then will national savings be channeled into the most productive investments. This will, in turn, promote growth and permit borrowers to service their debts in a timely fashion, thereby ensuring the safety of depositors' funds. The final core function is the provision of an efficient, low cost, safe and widely available means of making and receiving payments. Public trust in the banking system will only flourish in a setting in which bank clients — small and large — have virtually complete confidence that they can make and receive payments on a safe and timely basis. Here, achieving absolute payment finality in the shortest time possible is essential. Interbank and large value payments, in particular, should be final and irrevocable on the same day they are initiated.

While these core functions of the banking system are conceptually simple and straightforward, they are often overlooked or, even worse, confused with social or political objectives which seek to encourage or direct banking activities — especially credit extension — toward particular industries or classes of activity. More generally, there is often a tendency to view any one of these core banking system functions in isolation from the others. Any such tendency is both misguided and counterproductive, because these core functions are a mutually dependent "package deal." In other words, a failure to achieve any one of them will ultimately produce failure in the other two.

Characteristics of National Banking System

These essential functions of a progressive and profitable banking system imply certain key characteristics or traits which should be associated with the structure and workings of the national banking system. Those characteristics are described below.

- Cost-efficient and safe banking services should be broadly available to all segments of society. This implies the presence of smaller, more specialized banking institutions that can serve narrow segments of the market such as agriculture, small businesses and rural communities.

- Interest rates for virtually all financial instruments should be market driven. This presuppose the absence of internal and external credit controls and the conduct of monetary policy through indirect policy instruments (i.e. open market operations).

- Critical to achieving the highest degree of impartiality in the credit decision-making process and creating a competitive, level playing field is the widely distributed private ownership of all banking institutions. As an extension of this, government-owned banks should be discouraged and, where present, phased out over time.

- The presence of a competitive, level playing field for all banking institutions, domestic and foreign. This implies that all regulations, taxes, and other government-imposed mandates that affect the cost or ease of doing business should not discriminate against or in favor of individual institutions or classes of institutions, except where necessary for prudential reasons.

- A progressive and profitable banking system requires the presence of efficient, safe and liquid money, debt and equity capital markets, with particular emphasis on state-of-the-art interbank and national government securities markets. In the short run, the priority rests importantly on interbank and government securities markets, which are the bedrock upon which all other money and capital markets will ultimately rest. The development of these markets presupposes a major operational and regulatory role for the central bank.

- In order to ensure the absolute finality of all financial transactions in the shortest time

possible, the banking sector requires a widely available, efficient and trusted payment, delivery and settlement systems. Achieving this will, of necessity, entail a very high degree of coordination and cooperation between the public and private sectors.

- Financial markets require a suitable regulatory, legal and judicial framework that establishes, with the highest degree of certainty possible, the rights and obligations of parties to financial transactions and provides appropriate disclosure and other requirements, with particular emphasis on the need to protect small and unsophisticated depositors and investors. Particular emphasis must be place on the legal and institutional framework for resolving problem credit situations, since a relatively high incidence of problem loans is likely to remain a characteristic of emerging economies' banking systems for some time to come.

- A firm but flexible system of prudential supervision, the goal of which is to ensure the safety and stability of the banking system, must cover eight closely interrelated tasks. It must *grant charters* for all banking institutions and approve major changes in activities, ownership or other important structures of such institutions. It must also *establish essential prudential norms* in such areas as capital, liquidity, lending limits, etc., as well as rules for the regular reporting and disclosure of key statistical information. Another task of the prudential supervision system is the *regular and systematic analysis of statistical information* performed by the in-house experts of the central bank or other supervisory authorities. Supervisory authorities shold carry out *annual on site examinations* or inspections of all banking institutions. Particular emphasis should be placed on the *credit quality of loans, the adequacy of internal controls and the adequacy of internal and external audits.* (This is the most difficult and most important feature of an effective system of banking supervision.) The results of examinations and other supervisory initiatives should be *communicated to the top management and boards of directors of all banking institutions in a regular, systematic and timely maner*. Finally, the prudential supervisory system should include a well defined *framework for initiating timely remedial actions* against banks that have or are developing problems that might threaten their viability, as well as clear rules and procedures for dealing with insolvent banks.

National banking systems should have a suitable system of deposit insurance administered by a body other than the central bank or prime supervisory authority and a well-defined emergency liquidity or lender-of-last-resort facility at the central bank. The central bank liquidity facility should be used only for short term credit extensions against high credit quality collateral. Finally, the banking system requires a strong and independent central bank that is engaged in all aspects of the central banking trilogy; namely, the conduct of monetary policy, the supervision of banking institutions and the oversight and operation of the payments system. As an extension of this, there must be clear rules as to which institutions have direct access to the account, payment and credit facilities of the central bank.

As with the three core functions of a banking system, these key characteristics of an effective banking system are another interdependent "package deal." Having said that, it is clear that practicalities require the establishment of national priorities in deciding the rank order in which efforts to achieve these characteristics are planned and executed. The setting of such priorities requires, in the first instance, a rigorously objective analysis of where each country's banking system currently stands relative to each characteristic. This analysis should be performed jointly by representatives of the banking industry, the supervisory authorities, and an independent third party. With that analysis in hand, the priorities and initiatives set for the

future must be viewed in the context of a clear vision as to the desired structure of the banking system over the long run. Such a vision, as described below, is necessary to ensure that short-run initiatives are consistent with a coherent longer term view of the desired future structure of the banking and financial system.

THE STRUCTURE OF THE BANKING SYSTEM

Decisions regarding the desired structure of a national banking system entail the careful analysis of a host of complex and often competing issues, including, but not limited to:

- the characteristics of the persons or legal entities that should be permitted to own and control banks;
- the scope and range of activities the banks should be empowered to conduct;
- the competitive environment within which banks must function;
- the class of institutions that should have direct access to the account, payment and credit facilities of the central bank;
- the design and reach of the so-called official safety net, including deposit insurance, the lender of last resort, and the *de facto* protections provided by official supervision; and
- the approach taken by the government with respect to the manner in which it chooses to provide financial support for policy-based lending activities.

In order to rationalize these issues in a coherent manner, there must, in the first instance, be a clear and workable definition of a "bank." This seemingly straightforward issue of defining a bank is not an easy task, especially in a highly competitive environment in which very close substitutes for specific bank functions, such as taking deposits or making loans are widespread. The most practical — but hardly perfect — definition of a bank is one that is built around the dual criteria of taking deposits from the public and extending credit. The term "deposit" is given meaning by applying it to any obligation that is payable at par on demand or at maturity durations falling within some specified threshold, and/or applying it to any obligation that is covered in whole or in part by deposit insurance. If the term "deposit" is properly specified, the terms "loan" and "credit" can be more loosely specified, so long as both terms are incorporated into the definition of a bank.

With that in mind, individual countries can choose between several banking structure models in a setting in which it is important to recognize that there is no right banking structure for all countries at all times. Broadly speaking, however, countries can choose between the four models.

In the so-called "universal bank" model, banks can engage in a wide range of financial activities, including the full range of traditional banking and securities activities. This model is typical of the arrangements followed in most European countries and is widespread in most emerging market countries. The "specialized bank" model, (the case in the United States and Japan), features the prohibition of the coexistence of banking and securities activities within the same institution. In practice, the narrowly defined specialized bank models in the United States and, to a lesser degree, in Japan, have largely been displaced by market and competitive forces. In a "holding company" model, particular classes of financial activity must be conducted in a separate subsidiary of a holding company rather than directly in the bank or

subsidiary of the bank. Finally, in a "mixed system", stand-alone banks performing traditional banking activities coexist with more diversified universal banks and/or bank holding companies.

Given an acceptable and workable definition of a bank, individual countries can choose the model that best suits their own situation, recognizing that, for all practical purposes, the specialized bank model is largely a thing of the past. While the exact model chosen may not be of overriding consequence, the manner in which the model is applied can matter a great deal. In this regard, several key points should receive particular attention.

Application of Banking Model

First, under any approach, the scope of activities for the institutions in question should be restricted to lines of business that are distinctly financial in nature. Even there, the blending of insurance with banking and securities activities raises a host of difficult managerial and regulatory issues. Second, reflecting this, industrial groups should not be allowed to own and control banks or banking groups and vice versa. Where such arrangements already exist, they should be phased out and, in the interim, very restrictive regulations should be adopted to limit or prevent the direct or indirect extension of credit from a bank, its holding company, or its affiliates, to the industrial concern in question. Third, government ownership of banks should be phased out.

Fourth, all banks and banking groups should be subject to full-scale consolidated supervision. The central bank should play an important role in such supervision of banks and banking groups. Fifth, only banks or banks within bank groups should have direct access to the account, credit and payment facilities of the central bank. Sixth, a nonbank financial institution should not be permitted to: (1) take deposits; (2) represent itself as a bank; or (3) have direct access to the account, payment and credit facilities of the central bank, even though it may extend credit. Nonbank financial institutions should be regulated by an entity that is clearly separate from the central bank and other bank regulators. The scope of regulation for such institutions may be less intense than that of the banks, but the regulators should be politically independent along the lines of the Securities and Exchange Commission in the United States or the Securities and Investment Board in the United Kingdom.

Seventh, exchanges, clearinghouses, net settlement systems and securities depositories should all be regulated. To the extent that they have direct access to the central bank for final settlement services, the regulator should be the central bank. Finally, the deposit insurance fund and the entity responsible for the liquidation of insolvent banks should be independent public instrumentalities removed and separate from the central bank and banking supervisors.

This eight-point list of banking structure "dos and don'ts" is not intended to be exhaustive, nor is it to deny that a great deal of fine-tuning will be associated with their application in a given country. However, the list, when taken in the context of a clear and workable definition of a bank, does provide a broad framework within which an individual country can develop a vision of a desired structure of the future and seek to ensure that actions in the short run are compatible with that long-run vision.

Policy Based Lending

In the discussion of banking structure outlined above, there is one glaring omission. Namely, how to address the difficult issue of policy-based lending? Starting in the 1930s and continuing throughout the postwar period, virtually every government has created special vehicles or modalities to help foster politically or socially desirable forms of credit extension. In the United States, for example, government owned or sponsored policy-based credit institutions have

played a major role for many years in such areas as housing, agriculture and small business finance. In most countries, and in most areas of policy-based lending, the government, either directly or indirectly, provides substantial subsidies for such activities.

Given the pressing economic needs of specific sectors of emerging market economies, and given the experience of all of the major industrialized countries, it would be wholly unreasonable to suggest that developing countries refrain from programs that encourage policy-based lending. However, there are guidelines that can be followed with regard to the workings of government owned or sponsored financial institutions that are engaged in policy-based lending. Such guidelines should include the following:

- All startup and net ongoing costs, including interest subsidies, should be clearly reflected in the government's fiscal accounts.

- The management of such institutions should be independent, private-sector practitioners and should be compensated accordingly. A majority of the board of directors should also come from the private sector.

- The institutions should be subject to all relevant accounting and disclosure standards and to rigorous and regular audits by private, independent auditors. Summary audit reports should be made public.

- If at all possible, a fraction, however small, of the initial capital should come from private investors.

- The institutions should be specialized. That is, if a country decides to sponsor policy-based lending institutions in, for example, housing and agriculture, these functions should not be commingled in a single institution but rather they should be housed in two specialized institutions.

- A date certain should be set to begin the gradual privatization of the government ownership of such institutions.

- Such institutions should not be permitted to take deposits from the public. Their funding should take the form of capital market debt, even if such debt must carry partial or full government guarantees.

- Finally, and most importantly, the government should have no influence, direct or indirect, on the day-to-day management of the institution, especially as it pertains to the credit decision-making process.

Obviously, there is no easy way to design a banking structure that provides for government owned or sponsored policy-based lending financial institutions. The suggestions outlined above are an attempt to provide room for these institutions in a manner that does not materially compromise the objective of the development of a banking structure that is dominated by market-based principles aimed at the emergence of a progressive, profitable and stable banking and financial system over time.

The preceding discussion of banking and financial structure does not, cover the wide range of issues associated with the development of national capital markets. Its omission should not, however, be interpreted to imply that local capital markets are unimportant. To the contrary, they are very important, especially with respect to the critical building blocks in the form of short-term money markets and local currency government securities markets.

THE NATURE AND CAUSES OF BANKING SECTOR PROBLEMS

Broadly speaking, the problems associated with weak and unstable banking systems in many emerging market economies fall into two major categories. The first is the widely recognized problem associated with massive losses and resulting weak or insolvent banks, which can generally be traced to asset quality and related problems. Those problems will be discussed shortly.

The second major problem, which receives little attention, is the extent to which banking systems in emerging market economies fail to measure up to the key characteristics of effective banking systems previously discussed. To provide some perspective on the nature and depth of these shortcomings, an effort has been made to grade the current status of the banking systems in the major Latin American and Caribbean countries that are experiencing serious problems relative to the ten characteristics discussed earlier. While reasonable men and women can debate the accuracy of these grades, especially as they apply to any one country, there can be no serious dispute that there are areas in which major weaknesses exist more or less across the board. To put this in perspective, each of the ten characteristics is listed in summary fashion in Table 1 with a grade of "low," "medium" or "high" assigned to each, along with brief explanatory observations.

In looking at the summary grades above, and recognizing in full their subjective nature, several things stand out. First, all things considered, the countries in question have made real progress in a number of areas despite major obstacles to progress. Second, in several key areas, individual countries are lagging significantly behind their peers. Third, the "low" grades in the areas of banking services, legal framework and bank examinations are especially troubling, because all three areas are so basic, and all three are so very difficult to improve significantly even over the long term. For example, unless progress is made in the ability and willingness of national banking systems to provide cost-effective and safe banking services to all segments of society, the political support for other necessary reforms will be very difficult to muster. Even worse, the tendency to rely on government-owned banks will persist and might even grow.

To summarize, while much attention has been paid to the destabilizing and costly problems associated with failing and insolvent banks in the countries in question, such problems are only part of the story. Indeed, it is unlikely that there can be any permanent solution to the banking sector problems unless efforts to deal with the insolvent bank issue are coupled with efforts to cope with the development of banking systems along the broader lines suggested by the preceding analysis.

The above analysis notwithstanding, it remains true that the core problem associated with the banking crises in Argentina, Brazil and Mexico is plain and simple — a credit problem. As in other countries, some of the credit problems are firm-specific, growing out of blatantly poor management and/or cases of fraud or other forms of misconduct by bank officials. More generally, the problems in Latin America and the Caribbean have been aggravated by factors such as: (1) heightened macroeconomic instability; (2) the large-scale presence of government-controlled banks; and (3) a high incidence of connected lending and investing to related industrial or commercial groups. While these and other factors are relevant to an understanding of the anatomy of the Latin american and Caribbean banking crises, the problem, in a nutshell, is the pervasive and systematic presence of bad loans.

Table 1

Latin American and Caribbean Banking Systems
"Graded" Against Ten Characteristics of Effective Banking Systems
(as of 1996)

Characteristic	Grade	Observations
1) Banking Services	**Low**	To greater or lesser degree, major problem in all countries
2) Financial markets	Medium	While problems exist, major progress has been made by all countries
3) Wide ownership	**Low**	Problems in all countries, even where government-owned banks is not major problem
4) Level playing field	Mixed	Varies considerably from country to country
5) Money and capital	Medium	Progress being made, but major efforts still markets needed
6) Payments system	Mixed	Taking account of current status and programs under development, progress reasonably good, but some countries lag behind considerably
7) Legal framework	**Low**	Major problems in all countries that add considerably to credit costs
8) Banking supervision	Medium	Considering starting point, significant progress has been made, but major problems remain, especially with bank examinations, which, by itself, would be rated "low" in all countries
9) Deposit insurance, etc.	**Incomplete**	Cannot be judged at this time since crisis environment has forced hand of authorities
10) Independent central banks	Medium	Major progress has been made, but appreciation of central banking trilogy mixed at best

Myths Regarding Credit Problems

Having said that, there are a number of myths about the credit problems in the Latin American and Caribbean banking systems that need to be shattered. It is a myth to suggest that the banking crisis in Mexico and, indirectly, the crisis in Argentina, were "caused" by the Mexican peso crisis of early 1995. To be sure, the peso crisis made things much worse, but the evidence is overwhelming that the core problem was building rapidly even before the peso crisis. The same can be said in Brazil, where the advent of relatively low inflation simply brought to the surface problems that were being papered over by inflation. It is a myth to suggest that the widespread credit problems are simply the result of the lack of experience or expertise on the part of Latin American and Caribbean bankers in extending credit. The incidence of very serious credit problems at foreign banks in the region provides ample testimony to this myth.

It is also a myth to suggest that seemingly high interest rates and interest spreads are symptoms of a lack of competition or other structural imperfections in banking markets. High rates and spreads are a reflection of the need to cover very high credit costs as an integral part of the cost of doing business. Indeed, it is high credit costs that explain the apparent anomaly of high spreads and low profits. Finally, it is a total myth to suggest that Latin American and Caribbean banking problems will be solved by improved banking supervision, even if it is clear that improved supervision is needed. As discussed below, the core of the asset quality problem in most Latin American and Caribbean banks reflects a complex interaction of a series of deeply-rooted institutional problems. Unless these problems are addressed, improved supervision will either (1) reveal a continued high incidence of bad loans or (2) result in a broad-based stoppage of credit flows to large segments of the economy, the result of which can only be slower growth or recession, together with heightened economic and political instability.

Credit Life Cycle/Supervisory Oversight

To put the Latin American and Caribbean credit problems in perspective, it is necessary to consider the dynamics of the cradle-to-grave life cycle of bank credits and the interplay of that cycle with the critical elements of the bank supervisory process. In an effort to illustrate this phenomenon, boxes 1 and 2 provide a stylized schematic of the credit life cycle and its interaction with the supervisory process. What follows is a brief discussion of the schematic with emphasis on: (1) The points where institutional problems inhibit the workings of the credit cycle and, therefore, produce high credit costs; and (2) the points in the life cycle where supervisory practices are especially weak in monitoring developments over the credit life cycle.

The credit life cycle (Box 1) starts with a list of the components of a supervisory policy overlay which should guide the credit cycle for both the bank and the supervisor.[1] The left side of the first schematic traces a simple case of a typical loan which, in this instance, is serviced and repaid on schedule. The two shaded boxes on the left side of the schematic identify the first two areas in which institutional considerations impinge on the effectiveness of the credit cycle.

- Except for large corporate borrowers, there are major impediments standing in the way of even the most elementary forms of credit due diligence on the part of the banks. Independent information on credit histories is either limited or nonexistent; financial statements are often not available or are of little value; even tax returns may be hard to come by. In such circumstances, effective, much less timely, due diligence is not easy to achieve. Obviously,

[1] In considering these elements of supervisory policy, it must be stressed that, for the most part, the Latin American and Caribbean authorities have made great progress in the development of such policies. The problem, therefore, is not so much a matter of policy as it is a matter of practice and execution.

where there are major institutional impediments to the credit due diligence process, the incidence of bad loans will be high and/or creditworthy borrowers will be denied access to credit.

- Credit due diligence should occur not only when a loan is made, but also during the period in which the loan is outstanding. In the countries in question, the same institutional barriers that stand in the way of effective initial due diligence also limit after-the-fact due diligence, with the result that the creditor bank is limited in its ability to anticipate problems and take steps to cope with problems before they become serious.

Supervisory practices are shown on the right hand side of the box. As can be seen, there are problems in this area from the outset. First, one of the most basic tasks of the bank examination process consists of a detailed review of an individual bank's internal credit systems, policies and procedures. Such review requires a high level of sophistication on the part of bank examiners, in a setting in which the reviews can only be conducted on site at the bank. For understandable reasons, the frequency and quality of such reviews in many banks falls far short of the norms needed. Second, the key to the bank supervisory process is the on-site examination of a sample of individual loans to determine the current and future prospects for timely servicing and repayment. The loan-by-loan review of individual credit files is an extraordinarily difficult task that requires an enormous amount of experience and judgment on the part of the examiner. This is, unquestionably, the weakest link in the supervisory process in all emerging market countries, since without some credible insights into the future status of loans, it is impossible to have a meaningful insight into the condition of a bank. Similarly, while it is widely recognized that both the banks and the banking supervisors need new and forward-looking loan classification schemes, the only way the supervisors can implement such loan classification schemes is through the loan-by-loan review that occurs as a part of the on-site examination process. Recruiting, training and retaining the experienced examinations personnel to rigorously and objectively perform this task is probably the greatest challenge facing the central banks and other supervisory bodies in virtually all emerging market countries throughout the world.

Impact of Economic or Financial Shocks

Box 2 is a continuation of the diagram of the credit life cycle which introduces economic or financial shocks. Four hypothetical cases identify how these shocks may affect the quality of credit and the behavior of both the bank and its supervisor are traced.

In Case I, the borrower is strong enough to continue to service and repay the loan on schedule. The key point in this case is that even with the loan current and performing, the bank examiner (or the bank) might still downgrade the loan because there is a greater risk that it may not be serviced in a timely manner. This is clearly an example of a situation in which experience and judgment on the part of the examiner is critical.

In Case II, the bank and the borrower enter into a voluntary restructuring -- perhaps even before the debtor stops paying interest on the loan. In this case, it is assumed that the restructuring works and, under the new terms, the loan is serviced and repaid on a timely basis. In many instances in Latin America and the Caribbean, the restructuring vehicle of choice is interest capitalization, which can create the illusion that all is well with the loan in question when, in fact, it should be downgraded and provisions taken for lost principal and/or interest. In all such cases, however, the identification and proper classification and accounting treatment of restructured loans, especially those involving interest capitalization, is a demanding task for both the bank and the bank examiner. It is particularly difficult to judge when, and under what circumstances, a restructured loan should be classified as "performing."

The situation becomes much more complex in Case III. Even after restructuring, the debtor cannot service the loan and the bank must resort to extraordinary measures to minimize its losses. In this case, major questions first arise with regard to the timeliness with which both the bank and the supervisor recognize the need for reclassification of the loan and the need to establish the necessary reserves to cover the likely loss. Unfortunately, in most Latin American and Caribbean countries, the loss rate on such loans tends to be quite high, because the institutional, legal and judicial frameworks for resolving these problems are uncertain, making the process very time consuming.

Case IV is the worst case in that the borrower simply walks away from the debt obligation. Regrettably, this is not an unusual phenomenon, especially in the face of a major economic shock and in circumstances in which the debtor believes, rightly or wrongly, that there will be no sanction or penalty for his or her unilateral action. Needless to say, in these cases, the potential for loss is very high, especially in the face of the problems associated with the institutional, legal and judicial setting in which the bank must seek relief.

The specifics of the four cases aside, there are major points of vulnerability with regard to the effectiveness with which both the bank and the supervisor are able to anticipate, recognize, and properly respond to problem loans in all cases. On the supervisory side, only the effective on-site examination process can provide reasonable assurance that the loan classification process and the system of reserves and provisions are working in a satisfactory manner. In turn, this implies the presence of a large and skillful team of examinations personnel, something that is very difficult to achieve even over the long run. And, as we have seen in the United States, even the presence of a large and well-trained examination staff does not provide failsafe protections against major banking problems.

In Latin America and the Caribbean (and elsewhere) the problems associated with the credit life cycle are severely complicated by the historic lack of a "credit culture" that firmly establishes in law, tradition and custom, the relationships, duties and responsibilities between creditors and debtors. One particular and very costly aspect of this lack of a well-established credit culture is the enormously complex set of issues surrounding the collection process for bad loans. These problems tend to ensure that ultimate losses on bad loans will be very high, if for no other reason than the fact that the passage of time usually means larger ultimate losses.

The main purpose of the credit life cycle diagram is to illustrate that permanent solutions to the region's credit problems are complex, multi-faceted task that can only be achieved over time and will not be solved simply by improved supervisory policies and practices. Indeed, what is needed are basic reforms that will help build, over time, a true credit culture.

THE BUILDING BLOCKS FOR COMPREHENSIVE REFORM

The final section of this report provides an outline of the major components of a comprehensive, multi-year reform program that is capable of bringing the performance standards of the major Latin American and Caribbean banking systems up to industrial country or OECD standards in a time frame of five to seven to seven years. Obviously, the needs will vary from country to country such that some of the building blocks may not be relevant for one country while being critically important for another. In what follows, the building blocks are described only in the most general terms. As such, the summary descriptions do not begin to do justice to the enormous complexities associated with the various initiatives implied by each building block.

Reform Architecture: Vision and Goals

A necessary first step in deciding on an overall reform strategy is the rigorous review of the current state of the banking system relative to the key characteristics of an effective banking system as outlined earlier.[2] The group performing the review should consist of representatives of the private sector banks, the central bank, the ministry of finance, and an independent third party. The purpose of the review is to set priorities and shape a vision of the desired banking structure of the future.

The second step is the development of a coherent overall statement outlining the desired legal and operational characteristics of the future banking system, including the design of the official safety net. The safety net should include the supervisory framework, access to the account, payment and credit facilities of the central bank, and the system of deposit insurance. In some countries, this review will suggest that little or no major change in structure is needed. In others, however, major change may be necessary.[3] Finally, in some countries, consideration of banking structure issues may entail the need for sweeping legislative changes and the always difficult task of building political support for such changes.

The third step in building the architecture for reform consists of developing specific goals to be achieved over the next five to seven years. While some of these goals will be qualitative, some can and should be quantitative and easily measurable.

With the reform architecture in place, the next set of tasks involves the establishment of short-term priorities. While priorities will differ from one country to another, certain items are likely to be common to most countries.

Short Term Priorities

- Redouble efforts to ensure that the full scope of insolvent bank situation is fully understood and that the likelihood of further bank failures is very low. The authorities should leave no stone unturned in their efforts to satisfy themselves that the risks of further adverse surprises are well understood.
- Accelerate the final resolution of banks intervened by the government or central bank through liquidation, mergers or other means, including the development of a plan or an

[2] The list of criteria can be amended as needed to suit the needs of individual countries.

[3] The discussion of banking structure may provide some useful grist for the mill in addressing the complex questions that arise when considering major modifications of the banking structure.

approach to begin the privatization of government-owned banks that are insolvent.

- Commence a vigorous program of monitoring the condition of restructured banks, including newly merged banks, to ensure that financial recovery is occurring as contemplated.

- Develop and make public a comprehensive plan whereby the banking system will be brought into full compliance with all internationally accepted accounting, disclosure and supervisory standards by a specific future date.

- Develop comprehensive estimates — using base case, best case and worst case scenarios — of the total fiscal and public sector borrowing impacts of the bank resolutions, and put in place a quarterly system for tracking and monitoring actual costs relative to estimated costs.

- Take immediate steps, through regulation or legislation, to curtail, if not eliminate, interconnected lending or investing by banks to affiliated companies or entities.

- Take the necessary steps to accelerate the development and effectiveness of private credit bureaus, including providing a regulatory or legal framework to protect the rights of individuals and legal entities.

- Take the necessary steps to accelerate the training of bank supervisory personnel, especially bank examiners, while at the same time seeking to augment the size and professional qualifications of bank supervisory personnel.

Longer Term Programs

- Develop a comprehensive program for the liquidation, sale or other resolution of the vast quantity of bad loans that, in *de facto* terms, are owned by the government and/or central bank. While such a program will probably have to rely on a vehicle such as the U.S. Resolution Trust Corporation for its execution, it is very important that private sector experts — including experts drawn from the international community — play a major role in the disposition of the bad assets. The task of seeking to maximize recovery rates on bad bank loans is difficult under the best of circumstances, and in the institutional setting of the countries in question, this task will be even more difficult. Qualified and experienced institutions and individuals (probably working for the government in an agent capacity) are essential to achieve even modest recovery rates on the loans in question.

  The program for the disposition of bad assets must be organized and managed according to the highest standards of management, controls and audits. While high standards are always desirable, in this area they are especially critical because the potential for manipulation or abuse is high. Needless to say, mismanagement or scandal in connection with asset disposition programs would be extremely embarrassing for the government. Even worse, it could contaminate the environment within which the overall reform effort must proceed.

- While conditions vary greatly from country to country, the accelerated development of financial infrastructure, including wholesale and retail payments systems, net settlement systems for various classes of financial instruments, exchanges and clearinghouses, are an area of need in all countries. It must be stressed that while financial infrastructure development is important to the development of liquid money and capital markets, it is critical in terms of the ability of the banking system to deliver low-cost, and high-quality banking services to all segments of society in all regions of the country.

- The privatization of large government-owned banks (or their conversion into non-deposit-taking policy lending institutions structured along the lines previously described) is clearly not something that will occur in the near term. Having said that, and recognizing that successful privatizations may entail considerable lead time and preparation, the process of planning for such major privatization should begin in the not-too-distant future.

- The last and surely the most difficult item on the list of longer-term programs is to promote, over time, the emergence of a deeper credit culture. The reason that this is so difficult lies in the fact that credit culture, for both lenders and borrowers, is in part much more a state of mind or a stream of consciousness than it is a collection of practices, regulations and laws. The essence of a credit culture lies in the unspoken understanding among debtors and creditors that each has duties and responsibilities to the other.

However, it is also true that the foundations of the credit culture are to be found in a coherent and consistent set of laws, regulations and judicial practices. Therefore, in a number of countries, there would seem to be a need to conduct a fresh review of commercial codes, bankruptcy laws, and other administrative rules and procedures that help give meaning to the rights and obligations of both sides of the credit process with a view toward rewriting, where necessary, the laws, regulations and administrative rulings governing these critical relationships.

International Coordination and Cooperation

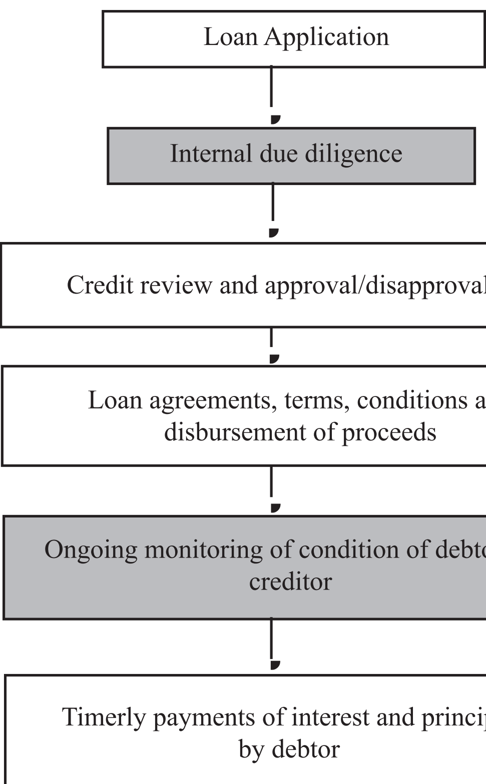
Given the complex and costly efforts that will be required on the part of so many countries throughout the world to bring their domestic banking systems up to contemporary standards, it is clear that most, if not all, such countries will need outside help. Some of that help is taking the form of enhanced technical and financial assistance from the IMF, the World Bank, the Inter-American Development Bank and other regional development banks. In that regard, and looking at the list of tasks outlined above, there is no shortage of areas in which still greater technical and financial assistance can be forthcoming from these official institutions. On a similar note, individual central banks from the industrial countries and institutions such as the Bank for International Settlements can be of great assistance as improving banking supervision and building financial infrastructure in payments, clearance and settlement systems. Finally, at the level of the G-7 or the G-10, and in collaboration with the IMF, further consideration should be given to (1) what kinds of bilateral or multilateral assistance might be mustered in support of these efforts and (2) what further steps might be taken to help reduce the vulnerabilities of relatively small and open emerging market economies from highly destabilizing external shocks, recognizing, of course, that the primary responsibility in that regard lies with the countries themselves.

BOX 1

LIFE CYCLE OF BANK CREDITS

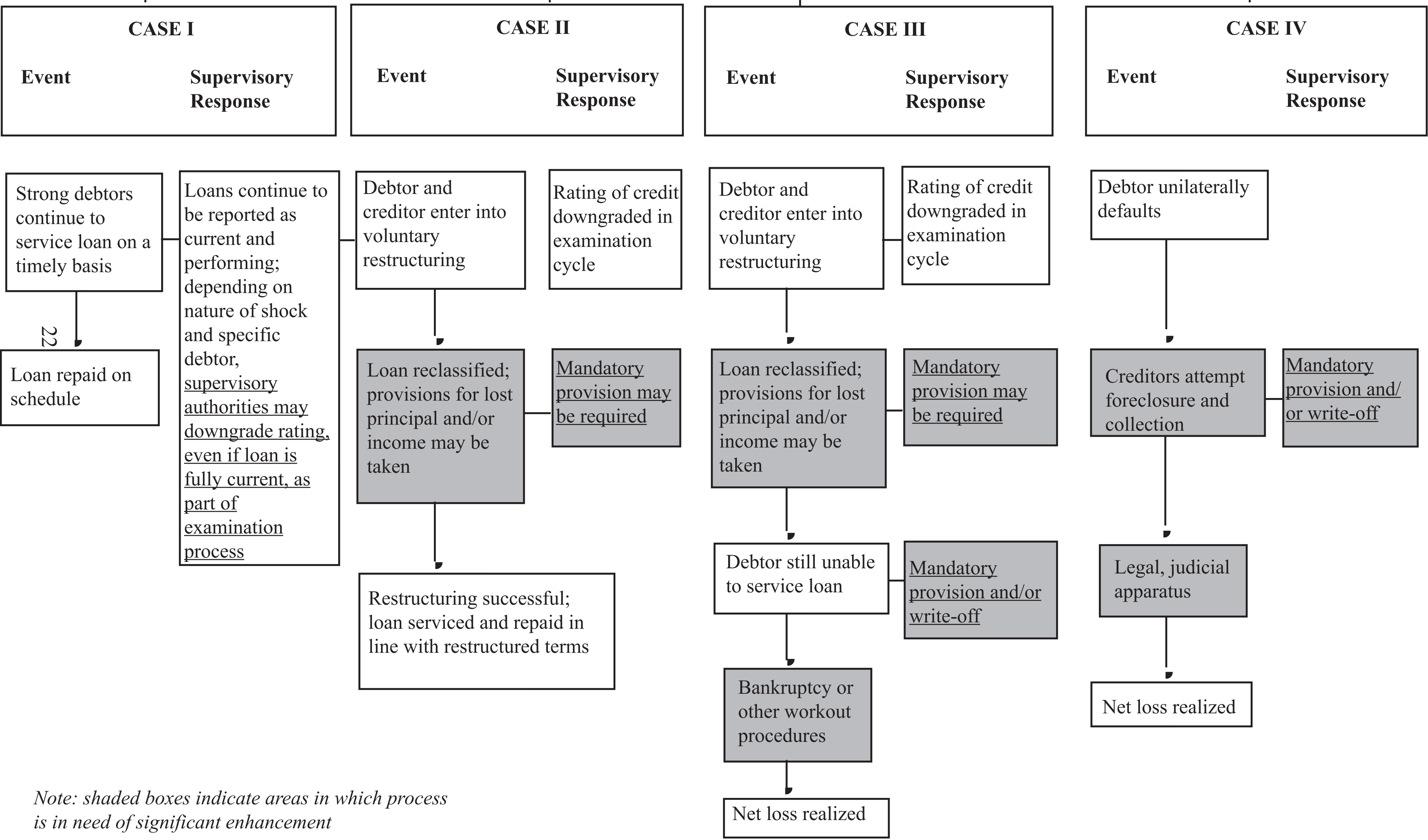
Supervisory Policy Overlay

- Banking law
- Licensing policies
- Prudential policies, accounting standards, provisioning policies, etc.
- Statistical reporting requirements
- Off-site analysis
- On-site examination



Note: shaded boxes indicate areas in which process is in need of significant enhancement

Box 2



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