

RESUMO

Este projeto insere-se em uma pesquisa mais ampla sobre a supervisão bancária em alguns países da América Latina, realizada por solicitação do Banco Mundial. Tomando como referência o marco conceitual do projeto original, o trabalho descreve a situação atual da supervisão bancária no Brasil, mencionando, entre outros, os seguintes pontos: padrões de organização e propriedade da indústria bancária no país, restrições legais e regulamentares para a aquisição e propriedade de bancos, exigências de capital mínimo, organização da supervisão bancária, políticas e práticas de supervisão. O trabalho encerra com algumas sugestões para o aperfeiçoamento das práticas de supervisão bancária no Brasil.

PALAVRAS-CHAVE

Supervisão bancária no Brasil; Bancos; Regulamentação bancária.

ABSTRACT

This paper is part of a larger World Bank project on banking supervision in some Latin American countries. Taking into account the framework applied to the larger project, the paper describes the present situation of banking supervision in Brazil. The following points are mentioned: the present structure of the banking industry in Brazil, patterns of ownership, regulations concerning bank acquisition and ownership, capital adequacy standards, policies and procedures of banking supervision. The paper also presents some recommendations to improve current practices and policies of banking supervision in Brazil.

KEY WORDS

Banking supervision in Brazil; Banks; Banking regulation.

SUMMARY

I.	Introduction: the objectives of the paper.....	3
II.	The structure of the Brazilian banking system	4
III.	The international aspects of the Brazilian banking system.....	7
	1. The foreign participation in the Brazilian banking system	8
	2. The “international” segment of the Brazilian banking system.....	10
IV.	Patterns of ownership: banks versus non-financial firms.	11
V.	Legal regulation of bank acquisition and ownership	13
VI.	Capital adequacy standards.....	15
	1. Basle capital standards	15
	2. Minimum capital requirements	17
VII.	Supervisory structures and practices.....	18
	1. Overview of the supervisory apparatus in Brazil.....	18
	2. The practice of banking supervision	20
VIII.	Conclusions	25
IX.	Bibliography.....	28

A STUDY OF THE BANKING SUPERVISION IN BRAZIL¹

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I. INTRODUCTION: THE OBJECTIVES OF THE PAPER

In recent years, financial and banking crises become worldwide phenomena, in both developed and developing countries, in almost all geographical areas of the world. According to Lindgren, Garcia and Saal, since 1980, over 130 countries, comprising almost three fourths of the International Monetary Fund's member countries, have experienced significant banking problems. (Lindgren, Garcia and Saal). On one hand, banking crises can amplify the impact of shocks on the economy or they can be by themselves a source of turbulence with damaging effects on the productive sectors, leading to dramatic decline in economic activity. (Mishkin). On the other hand, banking regulation and supervision can help preventing financial crises or minimizing their impacts on the economy and society.

The Brazilian banking system is undergoing a deep process of restructuring as a result of many different forces: the successful stabilization program which led to a dramatic drop in the inflation rate and to a sharp reduction in the floating gains retained by banks; the tensions imposed upon the system by the restrictive monetary

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and credit policies which followed the introduction of the Real Plan; the competitive pressures arising either from the controlled opening of the domestic banking market to foreign banks or from the non-banking financial intermediaries or yet from non-financial companies fetching resources directly in both the national and in the international capital markets; the need to keep pace with the rapid changes in the financial markets; and so on. Moreover, recent gyrations in international financial, capital and foreign exchange markets due to the Asian turmoil have had a non trivial impact on Brazilian financial markets and institutions. To ease those tensions and to avoid a banking crisis, a restructuring program for private banks has been implemented since the final months of 1995, with funds from the Central Bank and from the National Treasury. More recently, the government has launched a similar program to reduce the size of state and federal banks in financial markets. Naturally, an important part of those programs consists of changes in the current policies and practices of banking regulation and supervision in the country. Therefore, there will be a great deal of changes in these subjects in the next few years.

The objective of this paper is to review the current situation of the banking supervision in Brazil. It is more descriptive than analytical. Yet, it is not a complete description since it tries to focus on some and not all questions raised in the memorandum which set the guidelines for the comparative study of banking supervision in Latin America.

II. THE STRUCTURE OF THE BRAZILIAN BANKING SYSTEM

As of June 1997, the Brazilian financial system was composed by the following types of institutions:

Table 1**Brazilian Financial Systemⁱ**

1. Banking system:	
universal banks with commercial banking functions	170
commercial banks	37
savings banks with commercial banking functions	2
sub-total 1	209
2. Non-banking financial institutions:	
universal banks without commercial bank functions	17
investment banks	22
finance companies	47
development banks	6
housing finance companies and savings associations	22
sub-total 2	114
3. Other “quasi” financial institutions:	
securities houses	201
broker-dealers	259
foreign exchange brokers	38
leasing companies	73
mortgage companies	3
sub-total 3	574
4. Total (banking, non-banking and “quasi” fin. Institutions)	897

Source: Central Bank

As far as the structure of ownership, the Brazilian banking system comprises official and private institutions. This study will concentrate on the commercial banking system, that is to say, on that part of the financial system responsible for

the creation and destruction of demand deposits and banking credits and also for the administration of the one important part of the payment mechanism in the national economy. In the Brazilian situation, the commercial banking system comprised of 209 institutions (as of June 1997), with 170 universal (or “multiple”) banks, with commercial bank activities; 37 pure commercial banks; and 2 savings banks having commercial bank functions.

The official component involves 4 banks controlled by the National Treasury and 27 state-controlled intermediaries. The private segment is made up of 199 banks, of which 166 under control of domestic residents, and 33 controlled by foreign interests. The system’s composition, in terms of total assets, total deposits and net worth , at the end of 1996, is shown in Table 2.

Table 2

Brazilian Banking System: Main Financial Aggregates

Dec. 31,1996, in US millions

Types of banks	Assets		Deposits		Net worth		Number	
	US	%	US	%	US	%	US	%
Private								
national	214,8	43.8	75,8	37.6	25,0	58.8	159	68.5
foreign	53,9	11.1	14,4	7.1	4,7	10.9	40	17.6
sub-total	268,7	54.9	90,2	44.7	29,7	69.7	199	85.8
Official								
federal	167,1	34.1	86,8	43.0	10,3	24.0	5	2.1
state	53,83	11.0	24,7	12.3	2,6	6.3	28	12.1
sub-total	221,0	45.1	111,5	55.3	12,9	30.3	33	14.2
Total	489,7	100.0	201,7	100.0	42,7	100.0	232	100.0

Source: Central Bank

From the above paragraphs, it can be concluded that the Brazilian financial system is a relatively complex structure, in which one can observe the coexistence of entities with the following pair of characteristics: private and state-owned institutions; domestic and foreign banks; universal banks and specialized financial intermediaries; wholesale and retail organizations; financial conglomerates and independent institutions; national and regional organizations, large and small intermediaries.

The “core” of the system, however, is made up of the seven large retail multiple banks, both private and officially owned, which remain the most important component of the payment mechanism in the Brazilian economy and which have branches geographically located throughout the country. (Banco do Brasil, Caixa Econômica Federal, Banco Brasileiro de Descontos, Banco Itaú, União de Bancos Brasileiros, Grupo Banco Real, Banco HSBC Bamerindus).

There is a relatively high degree of concentration in the private banking system and this concentration is increasing over time. The Herfindahl index, calculated for total deposits, increases from 0.022 in 1946 to 0.055 in 1987. More recent figures for total assets show again increasing concentration between 1991 (0.0467) and 1997 (0.0482).ⁱⁱ In 1996, 25% of the total assets of the private banks were held only by the two largest private banks. For details, see Meirelles.

III. THE INTERNATIONAL ASPECTS OF THE BRAZILIAN BANKING SYSTEM

This item will deal with two sides of the external component of the Brazilian banking system: on one hand, regulations concerning the foreign participation in the domestic banking system and on the other, the size of the Brazilian banking abroad and its regulatory and supervisory framework.

1. THE FOREIGN PARTICIPATION IN THE BRAZILIAN BANKING SYSTEM

Foreign banks can be organized in three forms of ownership in the Brazilian banking system, depending on the authorization granted by the Central Bank: representative offices, branches of a foreign bank, and subsidiaries under control of a foreign group. While representative offices are not authorized to make financial transactions, foreign branches and subsidiaries can operate on equal conditions with domestic banks. As a result of the regulatory changes in 1989, which gave origin to the concept of universal (or “multiple”) bank, foreign banks were then allowed to transform their Brazilian branches into subsidiaries, operating as “multiple” banks under foreign control. Yet, there are foreign banks which maintain both a branch network together with an universal bank subsidiary.

Article 192 of the 1988 Federal Constitution states that the functioning of the financial system shall be regulated by a law yet to be enacted by the Brazilian Congress. Until this is done, the share of the foreign participation in the domestic financial system is to remain constant, that is to say, there are legal obstacles to the increase in the value of equity investment in the Brazilian financial market by either foreign individuals or companies. This prohibition also applies to the increase in the number of branches and agencies held by the foreign banks operating in the country.

However, that very same article opened one narrow door for the possibility of increasing the foreign participation in the domestic financial system. In fact, the permission to augment the share of external capital in the Brazilian financial markets will be granted in two situations: when it is part of international agreements and when it is considered to be in the national interest of the country.

In those cases, the President, with the advice of the Conselho Monetário Nacional (CMN, the National Monetary Council), can issue a decree making it possible for foreign investors to participate in the Brazilian financial system.

Since the 1994 stabilization plan, (Real Plan) that permission has been used selectively by the Central Bank to foster a much needed restructuring of the private and official components of the Brazilian financial system. Inflows of foreign direct investment were allowed to enter into the domestic banking system in order to solve a so-called banking problem. In another words, that permission would be granted provided the external investor would either assume assets and liabilities of an institution already under liquidation by the Central Bank or it would participate in an assisted purchase and assumption transaction to prevent the failure of a troubled bank. The recent acquisition by HSBC Holdings, B.V. of 100% of the shares of HSBC Bamerindus, (a bank that had entered into an assisted purchase and assumption for certain assets and liabilities of Banco Bamerindus do Brasil, the fourth largest Brazilian banks in asset size), is a conspicuous example of the type of permission granted by the Brazilian government to a well-known international banking group to control 100% of a domestic retail bank with a large network of branches. Incidentally, this was the first time a foreign bank was allowed to enter the then highly protected Brazilian retail banking market.

The same authorization will be given to foreign investors willing to participate in the privatization of federal or state commercial banks.

Another possibility of foreign participation in the domestic financial markets is through the permission granted by a recent Presidential decree to Brazilian banks with negotiable shares in the stock exchanges to issue “depository receipts” (DR’s) based on preferred shares. Thus, the sale of those DR’s in the international capital markets increases the fraction of banking equity held by external investors. As of now, two large Brazilian banks have been allowed to issued DR’s in the US capital markets.

2. THE “INTERNATIONAL” SEGMENT OF THE BRAZILIAN BANKING SYSTEM

In June, 1996, there were 67 Brazilian financial institutions operating abroad, the vast majority of them being commercial or universal banks. They were delivering international banking services under the following format: 94 overseas branches, 32 representative offices and 87 foreign affiliates or subsidiaries. Geographically, the international segment is distributed within 32 countries, with a high concentration of branches in the off-shore centers: these represented 40,4% of the total overseas branches and 64,3% of the number of foreign affiliates and subsidiaries.

Their total assets (loans and investments, excluding fixed assets) were equal to US\$ 57,1 billion or to 17,1% of the total assets of the banking system. There is also a high asset concentration in the off-shore centers: 12,4% of the total banking assets are booked there, which, in June 1996, represented 72,5% of the total assets held abroad by the Brazilian banking system.

The first steps towards the supervision of the international component of the Brazilian financial system were established by the National Monetary Council's Resolution 1974, (dated December 1992). Among other things, this decision required:

- previous Central Bank authorization for establishment of foreign branches or equity participation abroad;
- presentation of financial statements to the Central Bank on a consolidated basis, to include operations from branches and participation abroad; the same rule must be observed with respect to regulatory limits;
- submission to independent auditors of the accounting and financial statements related to foreign operations.

In 1995, following the suggestions put forward by the Basle Committee on Banking Supervision, the Central Bank started a program of on site supervision of the branches of Brazilian banks abroad. Branches in the US have already been supervised by bank examiners and this program is supposed to be applied to other countries in a regular basis from now on. Moreover, in order to implement the consolidated comprehensive banking supervision, the National Monetary Council has approved regulations requiring foreign branches or subsidiaries of Brazilian banks to disclose to the domestic supervisors information on its main assets and liabilities held abroad.

IV. PATTERNS OF OWNERSHIP: BANKS VERSUS NON-FINANCIAL FIRMS

Traditionally, the Brazilian regulations concerning ownership by bank of stocks in other financial or non-financial firms in general have been very opaque. Law 4595, of December 1964, the general banking act which still provides the legal structure governing the Brazilian financial system, requires the approval of the Central Bank for any equity participation by banks in other financial or non-financial firms. Based on its discretionary powers, the Central Bank has been very restrictive in only granting banks permission for holding risky equity investments in companies, which main activities are somehow related to the providing of financial services, such as credit cards, insurance, asset management, data processing etc. In fact, equity investment by any financial institution, except investment banks, is regulated by Central Bank's Circular 126, dated March, 1969. According to the latter, authorization for equity participation will only be granted for the following kinds of subsidiaries: other types of financial institutions; providers of technical services to banks; manufacturing companies producing inputs used in the banking activities; managerial and economic consulting firms; insurance company (one per financial group); communication and transportation firms; warehouse companies; firms

organized to take advantage of regional or sectoral fiscal incentives; and state companies of general public interests.

However, the Central Bank restrictive attitude towards equity investments by banks in non-financial firms were somehow by-passed by the association of commercial and investment banks in the same financial conglomerate, or by the creation of an investment bank subsidiary or, more frequently, by the transformation of many financial intermediaries into universal (or mixed) or multiple banks, according to the Brazilian legislation. The latter were created after the changes in the regulations which took place in 1989 aimed at liberalizing the entry rules into the banking sector. Multiple banks can combine in one institution at least two of the following financial activities: commercial banking, investment banking, development banking, real estate lending, consumer credit, leasing operations, one of them being necessarily either a commercial or a investment banking function. As it happens elsewhere, one of the primary activities of Brazilian investment banks is to engage in underwriting operations for new issues of corporate securities (stocks and bonds) in the capital markets. Therefore, the combination of commercial and investment banking activities under the same roof does provide the regulatory protection for a widespread characteristic of the Brazilian financial markets, that is to say, commercial and universal banks holding fractions of their capital invested in long term equity participation in a variety of non-financial companies in many sectors of the national economy. Needless to say, if one bank concentrates its non-financial equity investment in particular firms or sectors, holders of its banking liabilities may face problems if that investment goes sour, affecting the financial health of the parent company.

Another instance in which the banks take shares of non-financial firms refers to 'involuntary' conversions of debt into equity, in situations of distressed borrowing, in which bankers as main creditors of a non-financial company convert their credit into equity positions, to avoid the likely insolvency of the borrower. In most cases,

such so-called temporary investments become permanent participations in risky activities.

As a result of these factors, Brazilian financial conglomerates in general maintain relevant long term equity investments in non-financial companies. This fact poses a problem if the authorities decide to change their current view on equity investments by banks in non-financial firms. In at least one of the largest private bank failures in Brazil recently, this kind of risky investment was said to have affected negatively the financial soundness of the parent banking company.

The ownership issue can also arise in relation to what types of companies can control private banks in Brazil. Generally, there are no restrictions concerning this issue and in fact empirical evidence shows that Brazilian banks are controlled by firms organized under different controlling structures such as: individual investors, holding companies, (financial or otherwise), non-financial companies, and even the so-called “non-profit” associations for social assistance (“foundations”). Of course, the risk question mentioned earlier can also affect the stability of financial institutions controlled by non-financial conglomerates.

V. LEGAL REGULATION OF BANK ACQUISITION AND OWNERSHIP

No shares of Brazilian firms can be held on bearer instrument, therefore, shares in general can only be held on nominative form and this also applies to bank stocks. Transfers of shares implying changes in the control of financial institutions require the prior approval of the Central Bank and also from the Brazilian Securities and Exchange Commission (the regulatory agency for securities and capital markets: CVM, Comissão de Valores Mobiliários) if the changes involves publicly traded shares. There is no formal threshold for the notification to the Central Bank, since

what is important is any share transfer which shifts control in the financial institution.

The issue of “related parties” in relation to ownership of financial institutions is not well defined in the Brazilian legislation. The Central Bank regulations establish a somewhat loose definition of what is considered an “economic group”, which is characterized by at least one of following three conditions: a structure of common shareholder control; an unified administrative or managerial structure and/or operational associations. Notwithstanding, there are restrictions on operations between a financial institution and “related parties”, if the latter is taken to mean any equity participation higher than 10%, above or below the bank. Indeed, financial institutions may not grant loans to or provide guarantees to any company which holds more than 10% of the institution’s capital or to any company in which the bank holds more than 10% of the share capital (except in the case of leasing subsidiaries). Similar restrictions are applied to loan and guarantee transactions between a financial institution and its board of directors, executive officers and their relatives. The prohibition against banks lending to their board members and executive officers, including their immediate and extended family, also apply to any company in which those people and their relatives hold more than 10% of the share capital.

The functioning of any financial institution in Brazil depends on the prior authorization from the Central Bank. Such an authorization, according to the previously mentioned Article 192 of the 1988 Federal Constitution, will be given free of charges, provided that the future owner of a banking firm complies with three pre-requisites: “irreproachable” reputation, technical competence and economic capacity compatible with the size of the business. The latter consists of a condition in which the potential participant (be it an individual investor or another company) in a financial firm’s equity has to disclose to the Central Bank that the amount of his/her net worth (excluding the value in the new investment) is equivalent to a minimum of 220% of the value of the equity participation. The new

entrant also has to disclose the source of his/her capital. The issue of reputation is dealt with the publication in a widely read newspaper of a “declaration of purpose” in which the potential owner states his/her intentions to acquire a controlling interest in a financial firm. This statement is not required from controlling shareholders of existing financial institutions. The above regulations also apply to the process of ownership transfer of financial intermediaries.

Of course, acquisition of control of a domestic financial intermediary by a foreign investor follows a different route, as mentioned in earlier paragraphs. Another interesting issue refers to the composition of shares in the capital of a financial institution. The Banking law requires an equal division between ordinary (voting) and preferred (non voting) shares in the capital of a financial intermediary, which has to be organized as a corporation according to the Brazilian law.

VI. CAPITAL ADEQUACY STANDARDS

In Brazil, financial institutions have to comply with two capital adequacy requirements: the Basle standards and the minimum capital requirements.

1. BASLE CAPITAL STANDARDS

The Central Bank of Brazil has applied the Basle capital adequacy since January, 1995 to all financial institutions (banks and non-banks) and has required the latter to maintain at least a 8% ratio of capital to risk-weighted assets, following Resolution 2099 (August,1994) from the National Monetary Council, the leading regulatory body in the country for the whole financial system. That ratio has been recently (May 1997) raised to 10%, and financial institutions were given a 6-month period to comply with the new ratio. However, to start a new financial company, the Basle

ratio has been set at 32%, which gradually declines until it reaches 10% in two years time. Only Tier 1, or core capital, may be counted towards fulfilling the Basle minimum capital requirement.

Insurance companies are not regulated by the Central Bank and therefore are not subjected to Basle-type of capital adequacy. However, they have to comply with their own minimum capital requirements (which depend on the activities and regions in which they operate) plus solvency margins (which are defined only for non-life insurance operations). Both capital requirements are determined by the correspondent regulatory authority, the National Council for Private Insurance, (Conselho Nacional de Seguros Privados, CNSP, the regulatory agency for insurance companies).

Brazilian financial institutions are very active in the domestic derivatives markets, in which they trade futures, options and swaps contracts in interest rate, foreign exchange, stock market index, and gold. In particular, banks are relevant players in the negotiations with swap contracts, whose notional value has reached R\$ 460,9 billions, in mid-June 1997. Due to this fact and again following the Basle directives, the Central Bank has required financial institutions to hold additional capital for credit risks arising from unsecured over-the-counter swap operations. The ratio for this type of operations was set at 16%, and such transactions are to be registered on the bank's balance-sheet.

The Basle capital requirement can only be met with capital, barring any type of debt instrument to comply with that regulation. For that matter it is worth mentioning that deposit-taking institutions in Brazil are not allowed to issue debt instruments (debentures, for instances) but this restriction does not apply to other intermediaries.

2. MINIMUM CAPITAL REQUIREMENTS

Besides establishing capital needs according to risk-weighted assets, the Central Bank also requires companies to hold minimum capital as a pre-requisite to operate in the financial markets. This requirement, which works as a sectoral barrier to entry, varies according to the type of financial institution and also according to the number of branches it holds and it can be changed each two-year period. Moreover, the maintenance of required minimum capital is a pre-condition for the Central Bank to grant authorization for Brazilian banks to open foreign branches. Table 3 indicates the amount of minimum capital in absolute terms and its relative value in comparison with the requirement for commercial banks.

Table 3

Minimum capital requirements

(in US\$) - June 1997		
commercial banks*	8,678,330,55	100
commercial banks**	12,397,614,83	143
investment banks	7,438,569,05	86
finance companies	3,765,713,87	43
housing fin. companies	7,438,569,05	86
leasing companies	3,765,713,87	43
securities houses	743,856,90	8.6
broker-dealers	247,952,30	2.8
for. exchange brokers	247,952,30	2.8
*without authorization for foreign exchange operations		
** with authorization for foreign exchange operations		

VII. SUPERVISORY STRUCTURES AND PRACTICES

1. OVERVIEW OF THE SUPERVISORY APPARATUS IN BRAZIL

In Brazil, there is a clear separation between normative and executive instances for regulation and supervision of banking, financial, capital markets, foreign exchange, derivatives and insurance institutions. There are two main policy-making, or normative, councils: the National Monetary Council (Conselho Monetário Nacional, CMN), which establishes regulations for financial, capital, foreign exchange and derivatives markets, and the previously mentioned National Council for Private Insurance (Conselho Nacional de Seguros Privados, CNSP), the normative body for the insurance market. Likewise, there are different agencies to implement decisions from both the CMN and CNSP. The responsibility for supervision of banking, non-banking and capital markets institutions is divided among the following agencies: Central Bank (Banco Central do Brasil, BCB) and the Brazilian Securities and Exchange Commission (Comissão de Valores Mobiliários, CVM). The Private Insurance Superintendency (Superintendência de Seguros Privados, SUSEP) is the agency responsible for implementing CNSP decisions, that is to say, regulation and supervision of both insurance companies and open-ended pension funds. Administrative control of the three executive agencies falls under the Finance Ministry's responsibility. The following scheme tries to present a simplified picture of the regulatory/supervisory apparatus in Brazil.

	Institutions			
	Banking	Non-banking	Insurance	Non-financial
Operations				
Financial markets	CMN/BCB	CMN/BCB	CMN/SUSEP	*
Capital markets	CMN/CVM	CMN/CVM	CMN/SUSEP	CVM
Insurance	*	*	CNSP/SUSEP	*
Derivatives	CMN/BCB/ CVM	CMN/BCB	CMN/SUSEP	*

* non-applicable

The BCB is responsible for the supervision of both the banking system and the non-banking financial intermediaries, (including mutual funds, but not equity funds), that is to say, it covers all institutions that it has authorized to operate. Due to the condition that most banks in Brazil are in general leaders of financial conglomerates, the Central Bank becomes “de facto” the lead supervisor in the country. This means that all activities related to the life-span of a financial institution are accompanied by the Central Bank: it authorizes its functioning; it supervises its operations and, if necessary, it decrees its “extra-judicial” liquidation or intervention. For supervisory purposes, a financial conglomerate is defined as a set of companies, with direct or indirect links through common ownership of shares, which contain at least two institutions authorized to operate by the BCB, either domestically or abroad.

As mentioned earlier, the insurance industry is regulated and supervised by CNSP/SUSEP. However, regulations concerning portfolio composition of the statutory reserves of the insurance companies are set by the National Monetary Council.

Supervision of capital markets operations falls under the domain of the Securities and Exchange Commission (CVM), which encompasses regulation and surveillance on financial intermediaries, stock exchanges, investors, and corporations which issues publicly traded securities. CVM is also responsible for the promotion of capital markets instruments and institutions. It is worth noting that Law 6.385 (12/07/1976), which gave origin to CVM, provides a definition of what is considered to be securities, (“valores mobiliários”) under Brazilian legislation. The latter lists as securities the following instruments: shares; debentures; founder’s share (“partes beneficiárias”), coupons, warrants, subscription bonus, certificates of deposits of securities, and any other type of tradable debt instrument authorized by the National Monetary Council (CMN) and issued by non-financial corporations (for instance, corporations were authorized to issue commercial papers in 1991). However, the supervision of other financial instruments were gradually included

under the CVM responsibility, such as equity funds, real estate funds, share options and stock index futures.

Both BCB and CVM share the responsibility of regulating the derivatives market, depending on the type of the underlying assets: while the former is concerned with commodity, interest rate and foreign currency futures, the latter monitors stock and stock index futures.

Despite its perceived comprehensiveness, since it encompasses all aspects of the banking, financial, capital, futures, and insurance markets, there is almost no coordination among the various agencies responsible for supervision in those markets. In some cases, there is formal consultation between BCB and CVM in relation to specific authorizations which overlap both regulatory domain. For example, issues of debentures by a non-banking subsidiary of a banking group requires the approval of both BCB and CVM. In limiting situations, when the Central Bank intervenes in a financial conglomerate, with non-banking subsidiaries, it simply communicates its decision to other regulatory agencies “ex-post facto”.

2. THE PRACTICE OF BANKING SUPERVISION

The Brazilian legislation confers to the Central Bank many responsibilities normally not associated with typical monetary authorities’ functions. Besides being in charge of supervising the banking and non-banking financial intermediaries, it is also responsible for the following activities:

- supervision of rural credit operations;
- supervision of credit cooperatives;
- supervision of buyer’s clubs (the so-called “consorcios”);
- supervision of mutual funds (except equity funds);

- portfolio regulation of pension funds and statutory reserves of insurance companies;
- advisory functions to the Senate in relation to domestic indebtedness of states and municipalities;
- agent for the National Treasury for internal and external public debt.

Due to this amplitude of duties, the Central Bank's supervisory activities cover all institutions, financial or otherwise, the functioning of which depend upon its authorization. Therefore, the quantity of institutions under BCB supervision far exceeds the number indicated in Table 1. In June 1997, that number was equal to 2420 entities, with the following composition (excluding mutual funds):

1. banks, non-banks and "quasi" fin. Institutions	897
2. buyer's clubs	439
3. credit cooperatives	990
4. in process of liquidation	94
Total	2240

In Brazil, the activities generally associated with banking supervision are divided between two different offices headed by two members of the Board of the Directors of the Central Bank. On one hand, the Office for Financial System Regulation is responsible for the formulation of the rules and directives to assure an orderly functioning of the financial system, given the legal framework governing the banking system. On the other hand, the Office for Banking Supervision implements the banking supervisory policy, including monitoring the compliance with the rules and assessing the soundness and safety of individual institutions, through auditing procedures. This paper shall only deal with banking supervision insofar auditing is concerned. This function is centered in the Central Bank headquarters in Brasilia and also coordinates the activities of 10 regional offices, located in the major

Brazilian cities, which supervise the financial institutions with headquarters based on those regions.

Supervision is a two stage process: an off-site monitoring and on-site direct inspection. The former consists of three monitoring systems, based on the banks' balance sheet and income statement, which provide information on various aspects of a bank economic and financial condition. They calculate for each institution and for its peer group, a large number a ratios to measure liquidity, profitability, capital adequacy, efficiency, and so on, as well as the regulatory limits applicable to each institution. Another system calculates deviations from certain parameters and automatically highlights major changes in individual positions for each financial institution.

The on-site inspection is conducted in a decentralized manner by each supervisory unit to verify four main aspects of a financial institution: evaluation of its economic and financial situation; compliance with legal rules and banking regulations; banking operations; and reliability of its internal control methods and accounting standards. Each supervisory unit issues a summary report on the condition of each institution at least once a year. Direct inspection is decided on a case by case basis, in accordance with a semi-annual supervision program built upon needs indicated by on-site supervisors or by information provided by the off-site analysis. However, there is no formal requirement to perform annual inspection for each bank, unless the institution is considered to present "imminent risk". During inspections, performance of intermediaries are evaluated following 16 examination modules, which cover the main operational aspects of a financial institution (loans and commitments, foreign exchange operations, bond trading, stock trading, leasing, real estate loans, demand and time deposits, solvency analysis, and so on). An institution is considered to be "in evidence" for supervisory purposes in two situations: first after a direct inspection originated from market noises, from a retrospect of its economic situation or from claims against it, and second, when in

routine situations, the institution is perceived to lack adequate controls, working capital or because of grave misconduct.

All the relevant information of a particular financial institution or a financial conglomerate are gathered in a permanent file to be used by inspectors in planning their work. Moreover, data from indirect monitoring are combined with reports based on on-site inspections to generate an “information report” for each institution, which is made available on line via Central Bank information system for access to key managerial level at the Central Bank.

In terms of report requirements, all financial institutions have to provide a lot of information to the Central Bank. Given the fact that the regulatory and supervisory responsibilities of the Brazilian Central Bank far exceed those of a typical central bank, its demand for reports and data from all entities under its supervisory power is vast. A total of 44 entities have to submit information to the Central Bank, including banks, non-banks, mutual funds, pension funds, credit card companies, buyer’s club companies, stock exchanges, credit cooperatives, exporters, importers, travel agencies, cargo companies, and so on. This makes for an estimate number of 578 documents which in principle, could be received by the Central Bank, considering those on a known interval of time (daily, weekly, monthly, etc.) and those received occasionally. A typical multiple bank has to supply to the monetary authorities 68 reports with the following distribution of frequency over time: daily: 15; weekly: 10; monthly: 25; quarterly: 4, half-yearly: 9 and yearly 5 plus a total of 148 reports which are sporadically sent to the banking supervisors. Thus, there is no lack of information available to the Central Bank on the financial system. There is however very little utilization of that enormous amount of data to provide a timely analysis of either an individual financial institution or the banking system as a whole.

One of the deficiencies of this supervisory framework was its main concern with compliance with regulations. These difficulties became apparent after the successful stabilization program (Real Plan) revealed blatant weakness in conditions of three

large private banks, caused by, among other things, poor asset quality, loan concentration, connected lending or even fraud. iii A program of bank restructuring was then launched to avoid the systemic consequences of a banking crises: the Program for the Restructuring and Strengthening of the National Financial System (Proer, Programa de Estímulo à Reestruturação e ao Fortalecimento do Sistema Financeiro Nacional). This program consisted of three interrelated parts: first, loans and lines of credit from the Central Bank to permit the acquisition of banking operations from distressed banks by other banks in good economic and financial condition, in a purchase and assumption framework; second legal changes to give the Central Bank more powerful instruments to intervene in financial institutions preventively; and third a more favorable fiscal treatment for the amortization of expenditures related to banking restructuring.

Simultaneously, the banking safety net was enlarged with the creation of a privately run deposit guarantee fund. In a parallel initiative, the Brazilian Central Bank is engaged in a complete reformulation of the supervisory missions, objectives, functions, including a new approach to on-site inspections. The latter will focus more on the large financial conglomerates, the core components of the financial system and will be less concerned with compliance with existing regulations. It will center on evaluation of internal mechanisms of control, analysis of asset quality, relationships with subsidiaries, both domestic and foreign, managerial quality, strategic positioning of the bank, and so on. Some regulatory changes are also being planned, especially in relation to loan classification according to risk levels and provisioning methods.

A final point about the role of external auditors. Generally, regulations concerning standards and procedures for independent auditors are established by the Securities Exchange Commission (CVM), except in the case of financial institutions, where that task is conferred upon the National Monetary Council (CMN). Also due to the problems mentioned in the previous paragraph, the CMN has increased the role and responsibility of independent auditors in expressing their professional opinion in

relation to the soundness conditions of financial institutions. They have to prepare reports of the audited financial statements and also have to report on the quality of internal control procedures, including the bank's systems of electronic data processing and risk management. A compulsory rotation of auditors, after a four-year period, was established, as well as the need to communicate to the Central Bank any event that may materially affect the audited institution's financial condition and furthermore any break in the contract between a financial firm and its independent auditor. All audited reports are available for supervisors who have also the authority to review the auditor's working papers. Under this new regulation, auditors are treated in a manner similar to controlling shareholders and administrators, as far as their responsibility in the failure of a financial institution: in fact, they become liable for civil and criminal law-suits for neglecting to indicate the true economic condition of an intermediary which was later doomed to fail.

VIII. CONCLUSIONS

This paper has reviewed the main regulatory and supervisory aspects of the Brazilian banking system, concentrating on the current policies of practices of banking supervision in that country. This survey did not go into the analysis of recent difficulties faced by individual Brazilian banks, which became apparent in the early phase of the recent stabilization program. In this context, our experience with banking problems in the post-Real period is not much different from what other countries have gone through in similar situations. They may have been aggravated in the Brazilian framework by the mix of macroeconomics policies applied to the anti-inflation program, with its heavy reliance on anchors based on foreign exchange, monetary and credit control policies. Yet, this macroeconomic aspect only explains the intensity of the banking problems, but not their causes and developments over time.

The stabilization program also demonstrated that the country's supervisory framework was not well equipped to deal with the banking problems which were disguised by the accommodating monetary policy during the inflationary years (except for periods of very high interest rates which followed previous and failed experiments in stabilization policies). As mentioned earlier, such typical banking problems were among others, the following: inadequate levels of loan loss provisioning, sectorial and geographical concentration of credit, lax rules for interest accrual standards, lack of adequate internal controls in banking organizations, connected lending, equity investments by banks in non-financial companies, difficulties in monitoring the situation of non-financial bank-holding companies, premature liberalization of entry rules to the banking system (a directive largely advocated by the World Bank missions in the eighties, which in Brazil gave origin to the transformation of many broker-dealers into multiple banks iv) and fraud.

The lessons to be drawn from this experience call for a modification in the supervisory framework, besides the changes already being implemented by the Central Bank (creation of a credit risk bureau which will provide information on the total credit exposure of the banking system vis-à-vis the main borrowers, loan classification according to credit risk and provisioning rules compatible with the risk level of each loan, concentration of scarce supervisory resources on the monitoring of the largest retail banks, assignment of more responsibility to external auditors, and so on). Some recommendations which could go in the same direction of strengthening the financial system are the following:

- apply more stringent requirements for the entry into the financial system, including an examination centered on financial and capital markets laws and regulations and on consumer protection norms for future executives of financial institutions;
- concentrate scarce supervisory resources particularly on the few banks which are at the center of the payment mechanism. Supervisors should have a through

knowledge about these institutions, including a permanent monitoring and evaluation of their more frequent counterparts in transactions in every segment of financial, capital, foreign exchanges and futures markets;

- establish a limit for commercial and universal banks' holdings of equity investments in non-financial companies. This restriction should apply to existing banking groups as well as to new entrants;
- require financial institutions especially banks to provide better information to depositors/investors and to bank analysts in their periodically published balance sheets and income statement;
- press for changes in the legal framework so as to increase the Central Bank supervisory powers to bank-holding companies (whether financial or non-financial companies);
- press for changes in the legal framework to prohibit the control of financial institutions to be exercised by the so-called "non-profit associations for social assistance" given the diffuse ownership of such institutions;
- rotate supervisors responsible for on site examinations to avoid the establishment of close relations between supervisor and supervised;
- in a world of increasing linkages between markets, coordination and cooperation among the domestic supervisory agencies will help achieving systemic stability for the financial system. Also, a closer cooperation with supervisory entities in other countries and in off-shore centers is critical to monitor the financial soundness of the international segment of the Brazilian banking system.

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ⁱ The classification of financial institutions in this paper is not the one used by the Central Bank. In Table 1, institutions which can issue any type of financial securities are classified as banks or non-banks. “Quasi” financial institutions generally do not enter into the primary borrowing and lending process and therefore do not issue securities, except debentures, which can be issued by leasing companies. Securities houses and broker-dealers can also eventually lend money to their clients but this is not their main economic function.

ⁱⁱ For references, see Meirelles, A. C. (1998): *A estrutura da indústria bancária brasileira: 30 anos de evolução*. (mimeo)

ⁱⁱⁱ Since the Real Plan, the Central Bank has intervened in almost 100 financial institutions; the majority of them were or became insolvent following the credit boom in the early phase of the stabilization program.

^{iv} 72% of the total banks liquidated by the Central Bank after the stabilization program were small institutions created after the liberalization of the entry rules into the universal banking system.