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Eva Holz

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*Dra. Eva Holz**

I. Introduction. Why the Integration Process Requires Reforms.

In general, countries organize and regulate their banking and financial systems at different times and in line with varying conceptions and domestic needs. Thus, we frequently find that even neighboring countries having similar traditions or practices–including the social sphere–have adopted very dissimilar solutions for their banking systems. These differences hinder implementation of integration agreements, particularly in agreements involving free trade in services, including financial services.

In implementing integration agreements, banking systems require two different but equally important types of reforms or adaptations. First, regulatory discrepancies preventing integration relative to free trade in services–specifically in the financial area–must be reduced. For example, members must permit establishment of financial institutions in each member nation of the other members of the agreement. Also, members should offer financial services provided by institutions of the other member countries. Furthermore, members should seek convergence of the range of financial services that can be offered in each of the member countries.

Second, integration processes require intense and active coordination of policies and strategies relative to basic banking sector risks–not only to move ahead in free trade of financial services, but also as a substantial element for macroeconomic stability. By so doing, the group of integrating countries reinforces the solvency and liquidity of the regional banking system, improving these parameters in each country while curbing the possibility of banking crises' spreading from one member country to the rest. Also, such action strengthens the region's positioning to mitigate or avoid contagion or shocks from crises outside the region. Today, taking into account the major world financial crisis, this second set of necessary reforms is clearly paramount. Without them the integration underway may lack one of its substantial supports–the integrity of the region's banking systems.

Beyond their relevance for increased well-being, both types of reforms–and in general, systematic efforts toward policy and strategy coordination, implementation of timetables for convergence in the financial sector so important to the economy–are especially useful tools for mitigating the negative effects of globalization. Today's financial markets are almost totally globalized, and while the benefits of globalization are clearly significant, globalization also implies new problems and risks that can be at least partially limited by coordinating basic financial policies. This coordination is generally dealt with in integration agreements including financial services.

* Advisor to the Minister of Economy and Finance, Uruguay.

I must note that both phenomena, globalization and integration, lead to growing inter-penetration of financial systems, and thereby intensify the competitive pressures the sector's institutions face in national and international markets. These competitive challenges are more acute for entities operating in more restrictive regulatory environments because the regulatory differences between countries become competitive asymmetries in globalized and integrated markets. In such markets, lenders and borrowers can inexpensively look outside national borders for other services or products. Therefore, institutions limited by regulation as to the services they can offer are at a competitive disadvantage vis-à-vis less-restricted institutions of other countries–institutions that can carry out a broader range of transactions.

Governments in the integrating region must take into account another aspect of globalization. Primarily, such governments must note that the effectiveness of national rules decreases when the barriers isolating financial systems from one another are torn down. Discrepancies between requirements in different financial markets subject to an integration agreement can create externally induced supervisory difficulties, beyond the differences in the entities' competitiveness. Also, private financial sector deregulatory pressure must be limited in order to maintain rules that protect the solvency of the institutions and the stability of the system of each of the countries and of the region as a whole. This gives rise to the need for international cooperation and harmonization.

This paper will further explore the two sets of banking system reforms already mentioned. In all cases we refer to "reforms" as "changes." This concept includes modifications of a broad range of texts, from constitutional or legal to lower-order regulatory provisions. On occasion, the changes do not involve regulations per se, but how they are applied. For reasons of proximity, our examples will refer to MERCOSUR (an integration agreement involving Argentina, Brazil, Uruguay and Paraguay involving the Asunción Treaty of 1991; Chile and Bolivia were added, though not as full members, in 1996). I will also comment on directives and guidelines adopted by the European Union, an essential reference point in financial services integration, insofar as it is a concrete and probably the most far-reaching example in the implementation of banking integration afforded by comparative reality.

II. Common Asymmetries To Be Corrected in Banking Regulation in Countries Who Are Members of an Integration Agreement.

A. Establishment of One Member Country's Financial Institutions in the Others.

This basic aspect of financial services integration derives from free trade in services. It is also one of the points generating the most difficulties for coordination. For example, it is here that we find the greatest regulatory asymmetries among the MERCOSUR member countries.

Brazilian regulations create a highly restrictive system for the establishment of new foreign entities and for the increase of foreign participation in financial entity capital, defined as such based on the country's constitution. Also, capital requirements are doubled for foreign entities setting up in Brazil. The Paraguayan system requires submission of information to evaluate the solvency and possibility of supervision, local equity, and several liability of the foreign parent for all operations undertaken by its branch in Paraguay.

Argentine and Uruguayan provisions do not explicitly outline different requirements for establishing foreign entities beyond those to be met for all new financial institutions. Yet Uruguayan rules limit the number of new authorizations the Executive Branch may grant yearly for operation of financial institutions to ten percent of the total number of banking institutions existing during the previous year.

Clearly, coordination of criteria for authorizing operation of financial entities of one member country of an integration agreement in the others also implies a degree of coordination of the criteria each country applies domestically for establishment of new financial institutions. It also implies achieving a significant level of confidence in the supervision each country applies to its financial institutions. This is an essential aspect for moving forward with free trade in financial services, given the sector's importance for overall functioning of each country's economy.

The difficulty in moving toward adoption of measures authorizing operation of financial institutions of one country in the other member countries of an integration agreement is confirmed by the fact that only as of the 1980s was a serious attempt made in the European Union to implement free trade in services, including financial services. The first step forward was included in the First Banking Directive, under which the countries of the Community, upon receiving a request by a banking entity of another Community country to set up business in their countries, were bound to authorize and allow the entity to perform the same operations under the same requirements as domestic banks. In 1988 the Second Banking Directive modified this system and established the principle of mutual recognition, whereby the institutions authorized to operate in one member country are on that basis authorized to establish branches in any other Community country. The principle of mutual recognition is based on "single license" supervision. Evidently, the "single license" can only work among countries who reciprocally trust in the quality of the supervision applied to financial entities.

B. Financial Services Banking Institutions Can and Cannot Offer.

This subsection presents another highly important aspect shaping the integration of financial services. The financial services banking institutions provide also help sustain free trade in those services. In general the MERCOSUR countries' banks are authorized to perform only a certain range of financial transactions (specialized banking). As a result, there are commercial banks, investment banks, mortgage loan banks, etc. This is the situation in Uruguay and partially in Brazil and Argentina as well. Nevertheless, since 1988 and 1994 Brazil and Argentina, respectfully, also permit universal banks, that is to say, banks involved in multiple lines of business. In Paraguay, in turn, as of the 1996 legal reform, banks are only universal. This clearly shows that the trend in MERCOSUR is toward broadening the range of transactions each bank can perform.

The countries' regulations allow banks to participate in the securities market, but in diverse forms. Brazil allows banking institutions to participate directly in the securities market including as stockbrokers. Paraguay, Argentina, and to some extent Uruguay, require such activities to be undertaken indirectly by participation of financial institutions in the capital of stock exchange companies.

Finally, only Paraguay and Brazil allow financial institutions to invest in securities of non-financial companies and thus, indirectly perform commercial or industrial activities. In the European Union, on the other hand, once a financial institution obtains authorization to operate in the country of origin, it can perform any of the activities enumerated in the Second Banking Directive (which permits universal banking and participation in non-financial companies) in all Community countries.

MERCOSUR must harmonize the content of its authorizations for operation of financial entities in order for free trade in financial services to have real meaning. The range of activities to be included in the banking sphere will depend on whether Brazil, which allows universal banking, can prevail over Argentina's position. Argentina would probably prefer to maintain some level of restrictions on financial entities' activities similar to those governing its banking system today. Despite the advisability of prudence in the current world context, the drive toward globalization and the broadness of cross-border financial services will encourage looseness of the definition in the MERCOSUR context.

C. Regulatory and Supervisory Body.

At a more advanced stage of financial services integration, a question arises as to the need or the advisability of establishing a community body in which at least the most relevant aspects of integrated banking system regulation and supervision converge. Nothing has been provided on this subject in the MERCOSUR context to date.

In the European Union, harmonization of banking activity does not imply standardization. Each country maintains its own national banking regulation and the process and scope of its authorization to operate are governed by the principle of mutual recognition. Because of this, the definition and creation of the European Central Bank was overwhelmed by questions and difficulties. For example, should the Bank be a money-issuing and currency-stabilizing body and nothing more? Should it have powers as lender of last resort? Should it have all the powers that the majority of European central banks currently have? As we all know, article 51 of the European Union Treaty establishes the European System of Central Banks (ESCB) to regulate price stability, monetary policy, currency arbitrage, reserve management, payment systems, and coordination of banking supervision policies. In any event, it is relevant to ask to what extent the existence of a Community body–for example a Central Bank–is specifically significant for free trade in financial services.

III. Convergence and Reform Toward Strengthening the Integrated Banking System.

A. Accounting Standardization.

Standardization of format and terminology for financial statements submitted by financial institutions in the member countries of an integration agreement substantially improves the real possibility of comparing their accounts and analyzing their evolution and projections. Additionally, accounting information, including not only annual statements, but also other more specific information generated on a quarterly or four-month basis, must be disclosed and circulated periodically and frequently among supervisors of the member countries.

In MERCOSUR, each Central Bank has chosen its own accounting plan. Comparing member countries' accounting plan formats has not been possible. The annual financial statements of financial institutions are disclosed and published. In addition to the annual information, each Central Bank requires submission of supplementary periodic information.

European Union Directive No. 86/365 standardized the format, terminology and nomenclature of balance sheets and income statements, consolidated accounts and notes to financial statements obligatorily used by banks. Later, Directive No. 89/117 unified accounting treatment for branches. These branches do not submit their own financial statements but instead have their accounts included in the consolidated statements of the institution as a whole.

B. NET WORTH REQUIREMENTS.

Net worth requirements conceptually include the initial capital requirements for obtaining authorization to operate, and maintenance of a minimum ratio between capital and assets–weighted for credit risk—for the entire time of operation of each entity. The need and usefulness of coordinating net worth requirements, fundamentally expressed as the entity's capital, lie in the latter's function, in a financial institution, to cushion or absorb the losses the entity may face. This capital will allow the financial institution to get back on keel and return to a profit-making position. Thus, confidence in the institution is maintained. In an integration context, generating confidence is fundamental for each country's supervisors. This fact remains especially true with regard to regulation, supervision, and relations with other countries, although under any hypothesis generating public confidence is fundamental for banking system stability.

It is advisable for financial institution net worth requirements in any integration context to be quantified and expressed as a minimum in keeping with the Basel Committee requirements for determining the composition of capital, its relative elements and proportions, and for fixing the risk-weighted asset capital levels for institutions. Adoption of such guidelines will be a fundamental factor for better understanding the standard established and, thus, for the reliability of the institutions and the banking systems in question. This is what has taken place in the European Union through the Own Funds (the first of which is from 1989) and the Solvency Ratio Directives. In this sense we are seeing gradual convergence of provisions in the MERCOSUR countries. In this case, considering the world context, it will be useful for the demands even to exceed the minimum risk-weighted asset capital requirements set by the Basel Committee.

Another possible measurement of capital adequacy is leverage. Although today this measurement is not required with such intensity in developed countries given the imposition of levels of capital adjusted for asset (loan) risk, it may take on a more important role in the near future given its link to the liquidity of a financial institution's position.

In relation to the liquidity of banking systems, which is so significant in the current global crisis, one way to mitigate problems is by imposing higher capital requirements. It can also be done by establishing higher (remunerated) reserve requirements against short-term or more volatile deposits. Liquidity problems decrease, in turn, for banking systems where international banks predominate because their subsidiaries or branches will have easier access to sources of financing through their parents than through local banks.

C. GUIDELINES FOR CREDIT RISK LIMITS.

This section considers the diverse credit risk elements useful to regulate, given their potential impact on financial entity solvency. One such element is limitation of the entity's credit concentration with a single client or group. European Union Directive No. 92/121 provides that institutions must periodically report exposures exceeding ten percent of the institution's own funds. This provision also limits individual exposures to twenty-five percent of own funds and 800 percent of such funds for total exposures assumed by an institution on the whole. In MERCOSUR, while there are limitations on credit exposure for financial institutions, no advancement has been made on convergence of credit limits set in each country.

D. INFORMATION AND TRANSPARENCY FLUIDITY.

In all cases, communication among regulators must be fluid. Fluidity permits coordinated and consistent action in the region with a view to the stability of its financial systems. Harmonization of the requirements for financial entities and coordination of the supervisory task, while important, are not enough in the context of integration. Those steps must necessarily be complemented by consistent policies geared to fluid, periodic, and systematic exchange of relevant information among the supervisors of countries involved in an integration agreement. This allows for maximizing the benefits of the new reality of global and interconnected financial markets without being clouded by the side effects they themselves can imply.

Fluid market information is also necessary for the general public. Increased information on banking systems and their institutions, reserve levels, operations and situation of central banks, levels of foreign debt and maturity profiles (especially short-term) have repercussions on investor confidence and capital movement efficiency.

E. SUPERVISORY COORDINATION.

The reality of financial institutions, with their internationalization and frequent conglomeration, implies coordinating the methodology and scope of the supervision performed by each country regarding the entities operating there. It is not enough for each supervisor to adequately fulfill its function regarding institutions operating locally. Supervisors in countries involved in integration agreements must coordinate supervisory responsibilities they assume over branches, subsidiaries and other forms in which regional, international or multinational institutions may set up business in each of those countries. Delimitation of the scope of functions and responsibilities assumed by each supervisor is fundamental to avoid loopholes or voids in the control of financial institutions.

To this end it is advisable for the supervisory methodology to be focused in line with the provisions established by the Basel Committee–particularly the guidelines concerning consolidated supervision. This is so not because those guidelines are unique or necessarily the best. It is simply because to date they seem to deal most consistently with the limitation of each supervisor's responsibilities and functions, including in regard to financial conglomerates, one of the basic aspects to be coordinated in situations of financial integration and free trade in financial services. Moreover, as indicated earlier, adoption of the Basel Committee guidelines enhances the reliability of the region's systems, given the broader familiarity with those guidelines among technical specialists, regulators and supervisors worldwide.